BENEFICIAL CONFLICTS OF INTEREST

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Conflicts of interest exist in both professional and private settings, and everyone experiences them from time to time. If a person harboring a conflict acts on it—meaning the person acts against interests she ought to uphold—innocent parties may be harmed. Accordingly, the key to addressing a conflict in most settings is to eliminate it, such as by prohibiting conflicted behavior or recusing oneself from a deliberative process. However, conflicts of interest have a special character in the securities realm, both because they are ubiquitous given financial firms' myriad competing interests and because the goal of the agency charged with addressing conflicts in the securities context, the U.S. Securities and Exchange Commission (SEC), is not to eliminate them but, rather, merely to mitigate them, tempering them for the benefit of securities regulation's dual objectives: investor protection and capital formation. This approach reflects the recognition that, while eliminating conflicts of interests helps protect investors, it can impede the cause of capital investment and growth. Accordingly, the SEC's challenge in regulating financial firms is to strike a balance between these two objectives, allowing firms to act on conflicts of interest in the name of capital formation but simultaneously restricting those conflicted actions in the name of protecting investors. Yet, as this Article argues, the agency has not always gotten the balance correct, at times erring on the side of permitting too much conflicted activity and at times erring on the side of permitting too little. Providing examples in each category, the Article suggests that the SEC could consistently produce better rulemaking outcomes by heeding prior episodes of failed rulemaking, drawing more from its own experience, and training its regulatory focus at the appropriate level of analysis.

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INTRODUCTION

Conflicts of interest cause concern in virtually every corner of economic and private life and in every sector, industry, business, and relationship. This is a broad statement, to be sure, but when one considers what a conflict of interest is, most reasonable people will conclude that the assertion is surely correct. The Cambridge Dictionary provides as apt a description as any of what a conflict of interest is, defining it as "a situation in which someone's private interests are opposed to that person's responsibilities to other people."[1]

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[1] *Conflict of Interest*, CAMBRIDGE DICTIONARY, https://dictionary.cambridge.org/us/dictionary/english/conflict-of-interest [https://perma.cc/VR7Z-W6BH].

Those in the legal profession know that one of the most insidious types of conflicts of interest arises when a lawyer begins representing someone whose matter is directly averse to the interests of an existing client.[2] In the day-to-day activities of the business world, an archetypal conflict exists when an employee desires to use company resources or opportunities for personal purposes.[3] Outside of the economic realm, a friend who does nice things for me solely to "butter me up" before she asks to borrow my car likewise harbors a conflict of interest.

In economic life, a person's acting on a conflict of interest—that is, furthering a personal interest at the expense of the interests of the person to whom loyalty is owed—typically involves that person's breaching a fiduciary duty that she owes to an employer, a client, a patient, or some other person or entity.[4] In personal life, one's acting on a conflict typically is an act of betrayal. Either way, however, it is a breach of trust, even if the infraction is on the minor side of the spectrum and even if the person harmed can readily repair the damage.

Yet stopping there is stopping too soon. Although perhaps not intuitive, in one important area of economic life, conflicts of interest are ameliorative—and, indeed, critical. This area is the securities realm, which encompasses buying securities from, or selling them to, a securities dealer at a brokerage firm; transacting in securities through one's online brokerage account; buying or selling shares of a mutual fund or exchange-traded fund; directing an investment adviser or broker-dealer to buy or sell securities on one's behalf; liquidating one's interest in a venture capital fund by privately selling it; and much more.[5]

Taken together, the myriad securities transactions that occur every day constitute the world of investment activity, and this activity, in turn, builds productive capital across the economy and drives economic growth. Yet, counterintuitively, the presence of conflicts of interest in this world makes it more efficient than it would otherwise be. This is because

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2 *See Developments in the Law: Conflicts of Interest in the Legal Profession*, 94 HARV. L. REV. 1244, 1295–96 (1981) ("If a fiduciary attempts to serve two beneficiaries in a matter in which their interests are adverse . . . , the fiduciary will almost certainly be unable to avoid a breach of his duty to promote the interests of each with loyal vigor.").

3 *See* Michael McDonald, *Ethics and Conflict of Interest*, U.B.C. SCH. OF POP. & PUB. HEALTH, https://ethics.ubc.ca/peoplemcdonaldconflict-htm [https://perma.cc/C2U5-5P9Z] (listing "[u]sing your employer's property for private advantage" as an example of a conflict of interest).

4 *See Conflicts of Interest: When Employees Aren't on Your Side*, WEAVER (Oct. 31, 2019), https://weaver.com/blog/conflicts-interest-when-employees-arent-your-side [https://perma.cc/4ULR-6X4S] (describing how an employee's acting on a conflict of interest constitutes a breach of the employee's fiduciary duty to the employer) [hereinafter *Employee Conflicts of Interest*].

5 *See* Will Kenton, *What Are Financial Securities? Examples, Types, Regulation, and Importance*, INVESTOPEDIA, https://www.investopedia.com/terms/s/security.asp# [https://perma.cc/SCX4-8ULW] (Apr. 24, 2023) (describing types of securities and securities transactions).

some conflicts of interest to which investment advisers, broker-dealers, and other facilitators of securities transactions are subject actually help incentivize these firms to *better* advance the interests of the parties they serve and to further the process of making the economy more productive.[6]

Take, for example, an investment advisory firm—dubbed simply an "investment adviser" for regulatory purposes—that manages a privately offered fund (private fund), such as a hedge fund. As is often the case, the investment adviser's principals, including its portfolio managers (those who directly make investment decisions on behalf of the fund), may be some of the first investors in the fund. If all goes well, over time—and often because of the firm's marketing skill—other individuals and entities will invest in the fund, and the fund's net asset value will increase, possibly reaching one billion dollars or more.

Meanwhile, the principals, who remain investors, benefit personally from the fund's greater asset size. First, because every fund must bear operating expenses, which reduce the profit (or increase the loss) allocated to investors' interests, the economies of scale that accrue from a larger asset size redound to the benefit of the early investors, who bear fewer costs, proportionately, as assets increase. Second, when capital is added to a fund's portfolio as a result of investments by new investors, the fund must often buy additional shares of the securities it already holds in order to put the additional cash to work and maintain the weighting of each security in the fund's portfolio. These additional purchases may increase the market price of the relevant securities already in the fund's portfolio, thereby increasing the fund's net asset value and, with it, the value of the principals' interests in the fund.[7]

Principals of an investment adviser often profit substantially from interests they hold in investment funds under their employer's management. One might say, therefore, that they have a conflict of interest in that they benefit personally from the work they do, as fiduciaries, for both their employer and their fellow investors. It is not difficult to imagine that these conflicting interests could potentially harm both constituencies. Continuing with the example above, the principals may cause the fund to invest outside of its investment policy, such as in

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6 *See infra* Part II (describing various conflicts of interest that can serve investors' interests and promote the securities regulatory goal of capital formation).

7 Whether the prices of the securities increase depends on a number of factors, including the capitalization of the companies issuing them (the smaller the capitalization, the more volatile the price) and the demand for them. *See What Causes Stock Prices to Change?*, DESJARDINS ONLINE BROKERAGE, https://www.disnat.com/en/learning/trading-basics/stock-basics/what-causes-stock-prices-to-change [https://perma.cc/4KT4-B2ZZ] ("If more people want to buy a stock (demand) than sell it (supply), then the price moves up.").

high-risk securities that have the potential of not only outsized returns but also outsized losses, because they believe those securities will in fact be profitable, thereby producing substantial personal benefit through their fund holdings. By pursuing such a transaction, however, the principals would be subjecting other fund investors to more risk than they bargained for—that is, risk beyond what the fund disclosed to them at the time they invested—and, as a result, a potentially significant depreciation of their investments.

On the other hand, a large investment by the principals could be beneficial to other investors. If the individuals that decide how to invest the fund's capital also have a stake in the outcome of those decisions, the argument goes, they are more likely than they would be otherwise to make decisions that will be profitable—not only to them, of course, but also to the other investors, since fund investors share all profits and losses equally, based on their proportionate interests in the fund.[8] This is the "skin in the game" argument supporting principals' investments in the products their employer (the investment adviser) manages,[9] and arguably most investors prefer putting their money into funds and investment strategies in which the firm or its personnel themselves have substantial interests.[10] What is good for the goose, after all, must also be good for the gander.

Given this and many other circumstances in which conflicts of interest may serve the interests of those who are the beneficiaries of the work of financial firms—advisory clients, fund investors, and customers of broker-dealers—the U.S. Securities and Exchange Commission (SEC) has often sought merely to control conflicts of interest, rather than to eliminate them altogether. Take, for example, a cross transaction, a term referring to a securities transaction between two mutual funds, exchange-traded funds (ETFs), or other publicly offered funds (public funds) managed by the same fund manager that could produce better prices for each side of the transaction but that also could inappropriately advance the personal interests of the manager or its personnel.[11] Rather than prohibit the manager—which, as in the private fund context, is an investment adviser and regulated as such—from causing the transaction

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8 *See* Will Kenton, *Skin in the Game: Meaning, Examples, and SEC Rules*, INVESTOPEDIA, https://www.investopedia.com/terms/s/skininthegame.asp [https://perma.cc/N8CQ-CRKT] (Dec. 26, 2022) (describing incentives for executives and portfolio managers to invest in companies they operate and promote to others).

9 *See id.* (explaining the meaning of the phrase).

10 *See id.* ("If principals or owners have also invested their own money in the investment vehicle, then prospective and existing investors will translate this move as a vote of confidence.").

11 *See* James Chen, *Cross Trade*, INVESTOPEDIA, https://www.investopedia.com/terms/c/crosstrade.asp [https://perma.cc/ED6X-4K3S] (Jan. 23, 2021) ("A portfolio manager can effectively move one client's asset to another client that wants it and eliminate the spread on the trade.").

to occur, the SEC instead requires that the manager follow certain procedures intended to ensure the transaction is fair to both funds participating in it.[12] More specifically, the requirements ensure that the investors in both funds are protected while enabling the funds (and, indirectly, their investors) to realize the lower transaction costs generally associated with cross transactions.

Another example pertains to performance fee arrangements, pursuant to which an investment adviser is entitled to a periodic fee equal to a percentage of profit the adviser generates for a client. Such a fee arrangement gives the adviser a stake in the results it achieves on behalf of the client—which is generally desirable—but could also encourage the adviser to pursue too-risky investments in hopes of earning larger profits and, therefore, larger performance fees.[13] Rather than disallow performance fees altogether, the SEC requires advisers, when charging them, to adhere to certain protocols designed to protect clients.[14] Here, again, the agency has sought to shield clients from harm while also potentially benefiting them, through permitting a compensation structure that might be fairer to them than other compensation methods.

The SEC's approach to addressing conflicts of interest is about more than merely allowing activities that may benefit investors while ensuring that investors are not harmed by those activities. Rather, it is about balancing the two defining goals of the securities regulatory regime in the United States: investor protection and capital formation.[15] The first of these goals is self-explanatory, in that the regulation of the securities markets and financial firms helps protect investors from being taken advantage of by those who have superior knowledge of, and control over, investment products and services.[16] The second of these goals, while

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12 *See* 17 C.F.R. § 270.17a-7 (2023) (setting forth the requirements for cross transactions between two public funds).

13 *See* James Chen, *Performance Fee: Definition and Example for Hedge Funds*, INVESTOPEDIA, https://www.investopedia.com/terms/p/performance-fee.asp [https://perma.cc/6UW9-AA32] (Sept. 29, 2022) (describing performance fees and noting that the "basic rationale for performance fees is that they align the interests of fund managers and their investors, and are an incentive for fund managers to generate positive returns").

14 *See* 17 C.F.R. § 275.205-3 (2023) (setting forth the procedures that an investment adviser must follow in connection with charging a performance fee).

15 *See* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 43 (2011) ("Congress' principal intent in enacting the securities laws was investor protection . . . ."); *What We Do*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml [https://perma.cc/VY72-3APE] (Apr. 6, 2023) (noting that the SEC's mission is to "protect[] investors, maintain[] fair, orderly, and efficient markets, and facilitat[e] capital formation").

16 *See* Kelli Alces Williams, *Market-Based Innovation in Consumer Protection*, 51 CONN. L. REV. 155, 173 (2019) ("The securities law has focused on creating conditions that protect

perhaps less understood, is equally important. In addition to protecting investors, the laws and rules governing the securities realm are intended to encourage investment in the economy—into firms and their capital assets—to further increase its capacity for growth and production.[17] To be sure, investor protection and capital formation are related, in that protecting investors creates investor confidence in the markets and encourages additional investment, which contributes to capital growth.[18] In some sense, however, the two objectives are also at odds, in that activities that may place investors unduly at risk may also be significant contributors to capital expansion.[19] This is the balance that the SEC strives to achieve in its regulation of conflicts of interest—namely, the balance between ensuring that investors are protected, on the one hand, and permitting certain activities deemed to spur capital formation, on the other.

This approach appears throughout the SEC's rules governing investment advisers and public funds, such as mutual funds and ETFs. The agency adopted these rules pursuant to its authority under the Investment Company Act of 1940 (Investment Company Act),[20] the statute that governs publicly offered funds, and the Investment Advisers Act of 1940 (Advisers Act),[21] the statute that governs investment advisers.[22] Moreover, and not surprisingly given the balancing act they perform, these rules are complex—indeed, arguably more complex than the laws and rules that are often thought to be the mainstays of U.S. securities regulation—the Securities Act of 1933 (Securities Act)[23] and the

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unsophisticated investors from being taken advantage of at the hands of more sophisticated 'sellers.'").

17 *See* Alicia Tuovila, *Capital Formation: Definition, Example, and Why It's Important*, INVESTOPEDIA, http://www.investopedia.com/terms/c/capital-formation.asp [https://perma.cc/D6SP-UZTW] (July 27, 2022) (observing that "[c]apital formation is the net capital accumulation during an accounting period for a particular country" and noting that the term "refers to additions of capital goods, such as equipment, tools, transportation assets, and electricity").

18 *See* Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2268 (2014) ("Capital formation and investor-choice protection are two sides of the same coin—reducing barriers to matching investor preferences with available investment opportunities.").

19 *See, e.g.*, Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS U. L. REV. 1013, 1027 (2016) ("[E]xempting companies from making disclosures for the sake of capital formation is clearly at odds with the 'sunlight' policies and their goal of protecting investors by making information available to them.").

20 15 U.S.C. §§ 80a-1 to -64.

21 *Id.* §§ 80b-1 to -21.

22 The SEC's rules under the Investment Company Act are set forth at 17 C.F.R. §§ 270.0-1–.60a-1 (2023), while its rules under the Advisers Act are set forth at 17 C.F.R. §§ 275.0-2–.222-2.

23 15 U.S.C. §§ 77a–77aa.

associated SEC rules,[24] which govern securities offerings, and the Securities Exchange Act of 1934 (Exchange Act)[25] and associated SEC rules,[26] which govern securities transactions and broker-dealers, the firms that act as intermediaries in those transactions.

Nevertheless, despite the careful balancing of interests that the SEC tries to achieve in its rulemaking—namely, permitting conflicts in the name of efficiency and capital growth, while, at the same time, mitigating them in the name of protecting investors—it sometimes gets the balance wrong.[27] In the recent past, this has occurred in two types of contexts. First, in certain situations, the SEC's rules have not been sufficiently stringent to prevent financial firms from engaging in conflicted activities that have harmed clients and investors.[28] In these situations, the agency did not go far enough in restricting potentially harmful activities, perhaps because it did not fully appreciate the severity of the potential harm or perhaps because it was itself influenced by conflicts of interest. One notorious and devastating example of this type of miscalculation was the 2007–09 financial crisis—or, more accurately, the rampant risk-taking that created the crisis, which was fueled by conflicts of interest that led traders and financial firms to (lawfully) benefit themselves by taking advantage of unknowing clients, customers, and investors.[29]

Second, in other situations, the SEC's rules have been too stringent, limiting conduct that was sufficiently beneficial (or, at least, benign) vis-à-vis clients and investors, where a more measured regulatory approach would have been appropriate.[30] An example similarly presents itself here, relating to a rule the SEC adopted as a measure to protect investors but that served to hinder investment advisers in carrying out responsibilities for the benefit of the same constituents. Under this rule, which the D.C. Circuit Court of Appeals ultimately invalidated, the SEC required that investment advisers that manage hedge funds regard the investors in those funds, rather than the funds themselves, as the advisers' "clients" for regulatory purposes.[31] Regardless of whether the rule would have, in some way, served the interests of fund investors, it promised to adversely

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[24] 17 C.F.R. §§ 230.100–.1001.

[25] 15 U.S.C. §§ 78a–78kk.

[26] 17 C.F.R. §§ 240.0-1–.36a1-2.

[27] *See infra* Part III (describing situations in which the SEC's rulemaking has erred either on the side of capital growth or on the side of investor protection).

[28] *See id.*

[29] *See infra* Section III.A (describing ways that the SEC's rulemaking erred on the side of permissiveness that exacerbated the financial crisis).

[30] *See infra* Part III (describing situations in which the SEC's rulemaking has erred either on the side of capital growth or on the side of investor protection).

[31] *See infra* Section III.B (describing ways that the SEC's rulemaking has erred on the side of restrictiveness).

affect fund managers' ability to provide services to the funds they managed, thereby also adversely affecting fund investors.[32]

To an extent, it is difficult to be too critical of the SEC for this Goldilocks situation, in which regulation—and regulatory action—betrays either too much or too little tolerance for conflicts of interest. After all, achieving the right balance between furthering regulation's efficiency and growth goals while still protecting investors is necessarily an imperfect science. This Article contends, however, that there are ways to perform more thoughtful rulemaking that would better serve investors' interests *and* further the goal of capital formation. In other words, it is possible for regulation to consistently embody the right tolerance of conflicts of interest and, therefore, to consistently get the balance right.

More specifically, the suggestion this Article puts forth is that finding the "sweet spot" between allowing conflicts of interest, on the one hand, and maintaining good investor protection protocols, on the other, requires that the SEC use more nuance in the rulemaking project. In particular, the SEC needs to be better at appreciating the likely effects of pulling the conflicts versus investor-protection lever one way or the other. The agency's development of this capacity for understanding in any rulemaking endeavor will be aided by its ensuring that the information forming the basis of the new rule is complete and its exercising better vigilance to prevent past mistakes from recurring. Yet perhaps the most important aspect of the SEC's achieving improved success rates will be its developing a deeper appreciation of the role of conflicts of interests in its regulatory charge. By articulating that role, this Article aims to help foster this appreciation among both regulators and observers alike.

The Article has four Parts. Part I starts with a primer on conflicts of interest, discussing how conflicts are present in both professional and personal settings. It provides examples of conflicts in both settings, showing how they can be minor in nature, producing relatively inconsequential harm if acted upon, but can also have significant, harmful consequences for those whose interests are inappropriately subordinated. The second half of this Part discusses the securities regulatory context, where, perhaps counterintuitively, conflicts of interest may be made to serve the interests of the capital markets and, indirectly, investors.

Part II provides examples of rules that the SEC has adopted that demonstrate the agency's approach to rulemaking, in which it mitigates, without eliminating, conflicts of interest in furtherance of securities

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32 *See infra* notes 192–210 and accompanying text (describing the rule that required investment advisers managing hedge funds to become registered with the SEC and the later invalidation of that rule).

regulatory goals. This Part focuses, in particular, on rules the SEC adopted under the Advisers Act governing investment adviser advertising and compensation and transactions between an investment adviser and an advisory client—so-called principal transactions—as well as rules adopted under the Investment Company Act governing portfolio valuation procedures, distribution of public fund shares, and cross transactions. It describes how, in each case, the SEC chose to allow conflicted behavior while simultaneously limiting it in the name of protecting investors.

Part III discusses situations in which the SEC's rulemaking has been either too permissive, insufficiently tempering conflicts to the detriment of investors, or too restrictive, serving to constrain productive activity that would promote capital formation. As examples in the former category, it presents episodes in which the SEC too readily permitted an accounting rule change applicable to money market funds and in which it failed to adequately regulate sponsors of entities offering asset-backed securities. As examples in the latter category, it discusses the rule the SEC adopted that would have required most hedge fund managers to register with the SEC as investment advisers and rules that regulate the content of agreements between private fund investors and the funds in which they invest.

Finally, Part IV ties the strands together, discussing approaches the SEC ought to have used in the circumstances set forth in Part III. This Part makes the case that, in the context of too-permissive rules, the agency should have, before adopting the problematic rules, sought to collect and evaluate more information than it apparently did and heeded lessons arising from previous episodes of rulemaking involving similar issues. It also proposes that, in the context of too-restrictive rules, the agency should have relied more heavily on its own extensive regulatory experience. This Part further suggests that the SEC's focus in the problematic examples was either too broad (in the case of excessive permissiveness) or too narrow (in the case of excessive restrictiveness) and contends that one key to successful rulemaking is for the agency to train its focus at the correct level of analysis. The Article then concludes.

I. CONFLICTS OF INTEREST

Almost universally, conflicts of interests are considered undesirable and harmful. They are things to be eliminated, and, where appropriate, operational policies and other conventions, as well as legal rules, seek to do that. Moreover, they are everywhere, in the sense that they can arise in any social interaction, be it personal or professional. However, conflicts of interest in a professional setting present particular concerns for law

and regulation because they directly counteract the duties and responsibilities that define the particular profession.[33] Still, as this Part discusses, there are circumstances in which conflicts are not necessarily all bad, all the time. Section I.A highlights common contexts that give rise to conflicts of interest, providing ample reminder of why policing conflicts is critical, while Section I.B introduces certain types of conflicts of interest found in the securities realm and the regulatory position that, to better serve both investors and the capital markets, many conflicts should be mitigated, rather than eliminated.

A. *Ubiquitous Conflicts*

Avoiding conflicts of interest is challenging. A child who promises her friend she will attend the friend's birthday party has a conflict of interest if her grandfather offers to take her to a movie starring her favorite animated characters the same afternoon as the birthday party. The child desires to go the movie and is tempted to do so, despite her previous commitment to her friend to attend the party. Does she break her promise to her friend in order to see the movie? Or does she decline her grandfather's invitation in order to keep her promise to her friend? Of course, this conflict is easily resolved if the child explains the circumstances to her grandfather, and her grandfather offers to take her to the movie another day. It is a conflict nevertheless, but of the personal variety.

Although individuals frequently experience personal conflicts of interest, we tend to regard conflicts as something that largely afflict workplace and professional settings. In those settings, moreover, more is often at stake when a conflict arises than breaking a promise to attend a birthday party—although that, too, is a serious matter, as anyone who has felt personally betrayed, or has dealt with the fallout after betraying someone else, will attest. In professional settings, conflicts similarly give rise to the possibility of promise breaking and betrayal, to be sure. However, they also create the possibility of legal liability and punishment,[34] and, because of that, acting on a conflict of interest is imbued with a weightiness, a severity, not present in many of our personal interactions.

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33 *See Employee Conflicts of Interest*, *supra* note 4 (describing how employee conflicts of interest may lead employees to breach their fiduciary duties to their employers).

34 *See* Roy Kreitner, *Frameworks of Cooperation: Competing, Conflicting, and Joined Interests in Contract and Its Surroundings*, 6 THEORETICAL INQUIRIES L. 59, 67 (2005) (discussing different types of legal penalties for behavior arising from conflicts of interest and observing that "[t]he most extreme remedial response to a conflict of interest is the criminal sanction").

The severity of professional conflicts of interest is the product of a countervailing and powerful legal rule that exists precisely to deter actors from being too tempted by whatever conflicting interests may arise. This legal rule is the duty that all employees owe, as fiduciaries, to their employers to serve their employers' best interests at all times while they remain employed and, in certain circumstances, even after they cease to be so employed.[35] In other words, employees have a duty to be loyal to their employers and to disregard any conflicting interests.[36]

As a result, if an employee removes a stapler from her workplace (without the intention of returning it) because she needs a new stapler for personal use, the employee, in acting on a conflict of interest—namely the interest in upholding her duty of loyalty to her employer, on the one hand, and the interest in acquiring a new stapler, on the other—the employee has breached the fiduciary duty she owes to her employer.[37] Of course, she has also committed a theft, but that would be the case even if she were not an employee. Only her employee status creates the possibility of a professional conflict of interest and an associated violation of the fiduciary duty she owes to her employer.[38] It may be that the cost of the stapler is sufficiently small that the employer may not take severe action even if it learns of the theft, but the employee has committed a wrongful act against the employer nevertheless.

All of us have likely heard about much more consequential fiduciary duty violations in the workplace, however. In this regard, situations in which employees have embezzled millions of dollars from employer coffers,[39] or have taken for themselves business opportunities that would be advantageous for their employers,[40] come to mind. There are also

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35 *See* Matthew T. Bodie, *Employment as Fiduciary Relationship*, 105 GEO. L.J. 819, 819 (2017) ("Under traditional agency law doctrine, employees are agents of their employers and owe an agent's concomitant fiduciary duties.").

36 *See id.* at 820 (noting that employees have a duty to be loyal to their employers).

37 *See Breach of Fiduciary Duty*, KENNY LAW FIRM, https://www.kennylawfirm.com/employment-litigation/breach-of-fiduciary-duty [https://perma.cc/Q7KG-5VFQ] (listing different ways that employees might breach their fiduciary duties to their employers, including by stealing property).

38 *See id.*

39 *See, e.g.*, *A Wolf in Employee's Clothing*, HAMILTON DUNCAN, https://www.hamiltonduncan.com/a-wolf-in-employees-clothing [https://perma.cc/72G8-MAQ7] (describing a case in which an employee's embezzlement of funds from her employer constituted a breach of her fiduciary duty to the employer).

40 *See, e.g.*, Michael Weissman, *Employee Owes Fiduciary Duty to Employer and Cannot Misappropriate a Corporate Opportunity*, LEVIN GINSBURG (June 5, 2019), https://levinginsburg.com/employee-owes-fiduciary-duty-to-employer-and-cannot-misappropriate-a-corporate-opportunity [https://perma.cc/7F8J-8NTU] (describing a case in which a company founder's theft of a business opportunity from the company constituted a breach of the founder's fiduciary duty to the company).

stories involving employee failures to uphold their fiduciary duties that harm not only the relevant employers but also their customers or clients.[41] This might occur, for example, when an employee who is responsible for choosing wholesale suppliers selects one that sells inferior or defective products, which the employer will ultimately sell to retail customers, over other supplier candidates because of financial "kickbacks" that the selected supplier pays to the employee. In each of these situations, the employee has failed to uphold the standard of conduct that she agreed to uphold when she accepted the job.

As suggested above, an employee in a generic employee-employer relationship, in which the employee owes no duties to the employer's clients or customers, may nevertheless harm those clients or customers (in addition to her employer) by breaching the fiduciary duty she owes to the employer. But the potential impact of conflicts of interest is especially palpable in situations in which the actor owes a fiduciary duty not only to her employer but also to the "end users," be they customers, clients, or patients or bear some other label. For example, a lawyer owes a fiduciary duty not only to the law firm that employs her—with the result that the lawyer breaches that duty when she simultaneously provides legal services through a competing firm—but also to the clients that retain the firm.[42] By accepting as a client (on behalf of the firm) someone whose interests in the matter at hand are adverse to those of another client that the lawyer serves, the lawyer has created a conflict of interest in that she has situated herself on both sides of a transaction or dispute—a move that would almost inevitably lead the lawyer to further one client's interests at the expense of the other's, substantially harming the disfavored client.[43]

The conflicts of interest in the examples above serve no useful purposes. In each context, the conflict leads to a breach of one or more fiduciary duties that the actor owes to others and, simultaneously, produces potential harm to one or more parties. In each case, everyone

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41 *See, e.g.*, Catherine Hermsen, *Drug Tampering and Product Substitution in Healthcare Facilities*, 38 J. HEALTHCARE PROT. MGMT. 51, 52–54 (2022) (describing episodes of drug tampering by employees of health care facilities).

42 *See* Benjamin P. Cooper, *When Clients Sue Their Lawyers for Failing to Report Their Own Malpractice*, 44 HOFSTRA L. REV. 441, 441–44 (2015) (describing certain types of breaches of lawyers' fiduciary duties to their clients).

43 *See Developments in the Law: Conflicts of Interest in the Legal Profession*, *supra* note 2, at 1296–1301 (describing how such a direct conflict of interest would inevitably require the lawyer to place one client's interests over those of the other client). Thankfully, legal rules generally prohibit such conflicts of interest, and sanctions from the relevant credentialing authority and malpractice suits are often effective enforcement and deterrence mechanisms. *See* John S. Dzienkowski, *Positional Conflicts of Interest*, 71 TEX. L. REV. 457, 459 (1993) ("In the case of a conflict of interest between two clients of one law firm, [codes of professional responsibility] have focused on whether the firm's representation of one client is 'directly adverse' to another client or may be 'materially limited' by the firm's responsibilities to another client or party.").

would be better off had there been no conflict or if acting on it had been precluded, such as when a judge recuses herself from a case in which she has a personal relationship with one of the parties—or, in situations where the conflict was bound to exist, if the actor had not been inappropriately influenced by it. Indeed, the actor also would have fared better had no conflict arisen, given the likely consequences of her actions, which might include termination or legal charges, whether of the administrative, civil, or criminal varieties.[44] As the next Section explains, however, in the realm of securities regulation, sometimes conflicts do, in fact, serve useful purposes, including the founding objectives of U.S. securities regulation.

B. *The Exception to the Rule*

Securities regulation—which encompasses the regulation of both securities transactions and the securities markets—is critical for a thriving capitalist economy. Without it, potential investors would have little confidence in the securities markets because they could not be sure that their counterparties were truthful or that the repositories of their would-be investments were financially viable or, indeed, actually existed.[45] And without confidence in the markets, investors would avoid investing, lest they lose all of their invested capital.[46] Such were the conditions in the years leading up to the 1929 stock market crash and the ensuing Great Depression, and, by enacting the securities laws, Congress sought to ensure that investors would never again be as vulnerable[47]—and never again suffer the financial pain and personal despair that accompanied the Depression years.

Congress had two objectives for securities regulation. The first was to grow the economy—a process called "capital formation"—by encouraging investment into companies that would allow them to provide more goods and services and employ more people.[48] The second objective was to protect those who place their capital at stake in the

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44 *See* Kreitner, *supra* note 34, at 67–70 (describing possible sanctions associated with an employee's breach of her fiduciary duty to her employer).

45 *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 999 ("The logic of federal securities regulation . . . is that the mandatory disclosure regime of the federal securities laws shores up investor confidence and the integrity of securities markets . . . .").

46 *See id.* ("Mandatory disclosure and federal antifraud provisions . . . encourage investors to invest, leading to more efficient and more highly valued securities markets.").

47 *See* 26 MICHAEL J. KAUFMAN, SEC. LIT.: DAMAGES § 9:13 (2022) ("In enacting the securities laws, Congress intended to prevent the circumstances leading to the market crash of 1929.").

48 *See* Tuovila, *supra* note 17 (explaining capital formation as a goal of securities regulation).

securities markets, including clients of investment advisers, shareholders of mutual funds and other public funds, and customers of brokerage firms.[49] In other words, the second objective was to protect investors, broadly defined.[50]

It is the first objective—capital formation—that has greatest relevance for any discussion of conflicts of interest in the securities arena because conflicts of interest may further the cause of capital formation. This assertion is based on the two things on which successful capital formation depends. First, it depends on efficiency and minimal transaction costs. That is, for capital formation to happen, securities transactions need to happen—and for securities transactions to happen, the components of any given transaction (buyer, seller, and agreement between them on key terms) need to readily come together. Conflicts of interest can aid efficiency by helping to bring together the components of a securities transaction.[51] Second, capital formation depends on incentives—that is, a compelling reason for any investor to engage in a particular securities transaction and for any securities broker, investment adviser, or fund manager to assist the investor in doing so.[52]

A classic example of a conflict of interest that can further the cause of capital formation is that arising from a portfolio manager's having "skin in the game," meaning, for example, that the portfolio manager has invested her own personal assets in the fund or funds that she manages.[53] As discussed in the Introduction, a portfolio manager's personal investment in her firm's own products creates a conflict of interest because of the risk that the portfolio manager will make investment decisions based on her own investment preferences rather than in accordance with the products' disclosed investment policies.[54] For example, the portfolio manager may cause a mutual fund that she manages and in which she has personally invested to invest in too-risky

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49 *See* Williams, *supra* note 16, at 173 (describing investor protection as a goal of securities regulation).

50 "Investors" is an all-encompassing term, in that it describes clients of an investment advisory firm, customers of a broker-dealer, shareholders of a public fund, and limited partners of a private fund. Unlike public fund shareholders and private fund limited partners vis-à-vis the funds in which they have invested, however, advisory clients and brokerage customers are investors not by virtue of their relationships with the investment advisers and broker-dealers from which they obtain services but, rather, by virtue of the fact that their purpose in engaging an adviser or broker-dealer is to invest in relevant companies by buying those companies' securities.

51 *See infra* text accompanying notes 53–59 (generally describing the beneficial function of conflicts of interests in the securities markets).

52 *See id.*

53 *See* Kenton, *supra* note 8 (explaining the concept of a director or manager having her own capital at risk in the company or fund she manages).

54 *See id.*

securities that produce substantial losses for the fund's portfolio. On the other hand, the inappropriate securities could instead turn out to be very profitable as compared with more conservative but policy-compliant choices for which the possible upside is not as great.[55] However, the outcome of the portfolio manager's acting on the conflict of interest by causing the fund to invest in risky securities is a secondary matter. The critical point is that the fact that someone has a conflict does not mean that she will act on it.[56] This circumstance, combined with the fact that the existence of the conflict may further efficiency in securities transactions, counsels in favor of permitting the conflict while implementing precautions to discourage the affected person from acting on it.

Yet how might the portfolio manager's personal investment in a fund she manages be helpful to the cause of capital formation? The answer is that, because the portfolio manager is the beneficial owner of some of the fund's assets, she will be more likely than she might otherwise be to focus on the fund and its profitability.[57] Among other things, she may be more likely than she might otherwise be to do the research or engage in the analysis necessary to cause the fund to invest in companies with the best prospects (relative to other companies within the parameters of the fund's investment policy) of using invested capital productively and profitably.[58] By doing this, moreover, the portfolio manager will do more to further the interests of the fund's investors—and to create a compelling track record for possible new investors—than might be the case if she had no personal stake in the fund's performance. Beyond that, she will do more to fuel the economy than would otherwise be the case.[59]

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55 *What Does "Skin in the Game" Mean in Finance?*, FINECO BANK (May 18, 2022) [hereinafter *Skin in the Game in Finance*], https://uk.finecobank.com/newsroom/having-sking/#main-content [https://perma.cc/FY6G-Y3VH] (cautioning that managers' holding shares in the companies they run "may also create skewed incentives," such as "to pump up the share price at the expense of long-term returns" or "to take too much short-term risk").

56 *See, e.g.*, Hamid Mehran & René M. Stulz, *The Economics of Conflicts of Interest in Financial Institutions*, 85 J. FIN. ECON. 267, 269 (2007) ("The existence of a conflict of interest within a financial institution does not mean that, in equilibrium, the customers of that institution will be harmed.").

57 *See Skin in the Game in Finance*, *supra* note 55 ("Fund managers having a significant holding in the trust can help to keep them on their toes and ensure they don't take careless risks, while invested board directors may be more inclined to hold the fund management team to account.").

58 *See id.*

59 *See* Luis Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Capital Formation from the Investor's Perspective (Dec. 3, 2012), https://www.sec.gov/news/speech/2012-spch120312laahtm [https://perma.cc/W9WL-965U] ("The more productive [investment] assets are, the greater the capital formation from the investment . . . .").

The example above highlights how, although actions taken based on the incentives created by a conflict of interest are undesirable, the mere existence of the conflict may, in fact, be desirable because it could boost capital formation and, in the process, further investors' profit-making objectives. It is only one example of many, moreover. The existence of conflicts of interest in the securities realm can work in favor of regulatory objectives in a range of different contexts.

Fortunately, this has not been lost on the SEC, the agency to which Congress delegated the power to implement and enforce the securities laws.[60] Although the regulatory scheme that Congress enacted[61] speaks in terms of prohibitions, in some cases those prohibitions are accompanied by provisos or exceptions. For example, section 5 of the Securities Act provides that it is unlawful for anyone to offer or sell securities unless a registration statement is in effect for those securities,[62] while section 4 of the statute sets forth exceptions to section 5's registration requirement, including for transactions by an issuer that do not involve a public offering.[63] In many cases, however, rather than articulate exceptions, Congress left that work to the SEC to the extent that, as to any given statutory prohibition, the SEC found it appropriate to articulate exceptions. As the next Part describes, the SEC has historically exercised its authority to roll back blanket prohibitions in the statutes in a manner designed to permit certain conflicts of interest—and their potential benefits for capital formation—while seeking to prevent any harm to investors that those conflicts might otherwise cause.

II. THE SEC'S BALANCING ACT

As the previous Part suggests, conflicts of interest are part of human life, particularly workplace life, and they can be immensely problematic, causing substantial harm to employers, customers, clients, and investors. In most contexts, there is no regulator to oversee specific employee activities and monitor whether conflicts exist and, if they do exist,

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60 *See* Matt Levine, *Is the SEC Unconstitutional?*, BLOOMBERG (May 19, 2022), https://www.bloomberg.com/opinion/articles/2022-05-19/is-the-sec-unconstitutional?leadSource=uverify%20wall#xj4y7vzkg [https://perma.cc/TN9P-9BZ2] ("Congress largely set up the SEC and its underlying system of securities laws in the 1930s, and the SEC took it from there.").

61 This scheme consists of four major statutes: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, *see supra* notes 20–26 and accompanying text (referencing the statutes).

62 *See* 15 U.S.C. § 77e(a) ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security . . . .").

63 *See id.* § 77d(a)(2).

whether an employee is prone to act on them. Still, even in those circumstances, the fiduciary duty that an employee owes to her employer and, in some cases, to the clients or customers she serves, fills the gap, providing a standard of behavior that, ideally, deters the employee from acting on conflicts that arise.[64] Other contexts are, however, subject to extensive regulation, the securities realm being one of them.[65] This regulation is the product of Congress's recognition of the importance of protecting the economy that fuels productive activity and the investors that place their capital at risk in the securities markets, often with the goal of building a secure future for themselves and their families.[66] To be sure, fiduciary duties (where they exist) are also a part of this regulation, but it is the laws and rules themselves that are charged in the first instance with governing conflicts of interest, with fiduciary duties potentially serving as a failsafe mechanism in the event that regulation is insufficient in advancing regulatory objectives.[67]

As to many conflicts of interest, however, securities regulation aims not to eliminate but rather to mitigate, allowing the conflicts to exist while tempering the possible negative effects that may arise from them. This is particularly so with regard to the laws and rules governing SEC-registered investment advisers, a category that includes firms that serve as hedge fund and private equity fund managers; investment managers of accounts held by a single investor, outside of a fund structure;[68] and managers of SEC-registered investment companies (referred to in this Article as "public funds"), a category that encompasses mutual funds, ETFs, and other publicly offered investment products. This Part provides examples of the SEC's regulatory approach vis-à-vis conflicts of interest, focusing in Section II.A on registered investment advisers and, in Section II.B, on registered investment companies.

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64 *See supra* notes 35–44 and accompanying text (describing the fiduciary duty that employees owe their employers).

65 *See* U.S. Sec. & Exch. Comm'n, *The Laws That Govern the Securities Industry*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry [https://perma.cc/H4T7-2QLX] (describing the various statutes that govern the securities markets).

66 *See supra* notes 48–50 and accompanying text (discussing the reason Congress enacted the securities laws and the goals of securities regulation).

67 *Cf.* Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 472 (2006) ("Earlier in the twentieth century, common law fiduciary duties were seen as weak enough to demand new federal regulation.").

68 *See* Ian Salisbury, *SMAs Beat Funds in 2008*, WALL ST. J. (Mar. 12, 2009, 12:01 AM), https://www.wsj.com/articles/SB123679669243098151 [https://perma.cc/9PDU-DHXF] (describing such "separately managed account" arrangements).

A. *The Investment Advisers Act of 1940*

The Advisers Act, in a nutshell, governs firms that manage others' assets for compensation. "Manage" in this context is defined broadly to include both nondiscretionary management, where an investment adviser merely executes securities transactions on behalf of a client but where the client retains authority to make all investment decisions,[69] and discretionary management, where the adviser both makes the investment decisions on behalf of the client and executes the associated transactions,[70] as is the case where the "client" is a fund, whether of the public or the private variety. But regardless of what specific investment management service a firm provides, the firm must become registered with the SEC and comply with the requirements of the Advisers Act and the rules the SEC adopted pursuant to the authority the statute gives it. In addition, the firm will be subject to numerous conflicts of interest.[71] This Section discusses three of the more salient ones and regulation's approach to addressing them.

1. Advertising

As for-profit businesses, investment advisers seek to market themselves for the same reason that any business engages in marketing activities—namely, to generate interest from individuals or institutions that may be in need of investment management services. Moreover, like many businesses that market themselves, investment advisers often want their marketing activities to highlight their achievements—that is, the

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69 *See* Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L.J. 125, 150 (2012) (describing arrangements in which an investment adviser effects transactions following client approval of the adviser's recommendations). A variation of this approach is for the client to retain authority to execute the transaction, in addition to approving it. *See* Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265, 1309 (2011) ("[F]or the typical nondiscretionary account, the financial services provider lacks the authority to consummate the transaction without consent . . . .").

70 *See* Chertok, *supra* note 69, at 150 n.121 (observing that, as stated on the application by which an investment adviser becomes registered as such with the SEC, discretionary authority is the "authority to decide which securities to purchase and sell for the client").

71 *See* Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act After Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 435 (2016) ("Conflicts of interest are common in every fiduciary relationship in the financial services industry."); *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest [https://perma.cc/DMR8-DFS6] (Aug. 3, 2022) ("All broker-dealers, investment advisers, and financial professionals have at least some conflicts of interest with their retail investors.").

ways in which they have been able to generate profits for those they serve. Yet in pursuing such a marketing strategy, investment advisers have a conflict of interest. On the one hand, in presenting their investment results to prospective clients and fund investors, their fiduciary duty mandates that they present their past performance fairly and accurately, while, on the other hand, they have an incentive to ignore the investment decisions that produced losses and the periods in which their investment strategies underperformed.[72]

At first glance, there is nothing different about marketing in the investment management context, as compared with marketing in other business contexts. All businesses presumably wish to highlight their successes and the customers who were pleased with the goods or services provided and downplay instances of mediocre or poor performance and the customers who were unimpressed. Nevertheless, there is an important difference that sets the investment management context apart—and this difference is not the mere fact of regulation, since many industries are regulated. Rather, it is the content of the regulation to which investment advisers are subject. This content is heavily shaped by what is at stake in the investment world—namely, individuals' money and the savings individuals count on to eventually retire. The importance of investing to individuals' livelihoods requires substantial regulatory vigilance, lest investment advisers mislead their would-be clients and investors into believing that they are better? than they really are.[73]

Accordingly, the SEC allows advisers to disseminate advertisements but only if those advertisements comply with a number of fairly stringent requirements. Under rule 206(4) of the Advisers Act, an advertisement cannot discuss possible ways an adviser's services may benefit clients and investors unless it also discusses, in a fair and balanced manner, risks or limitations that may be associated with those services.[74] In addition, an advertisement may not contain a testimonial unless it is accompanied by full disclosure about who is giving the testimonial; whether that person was compensated for doing so and, if so, the material terms of the compensation arrangement; and the existence of any conflicts of interest that the person may have as a result of her relationship with the investment adviser.[75] Furthermore, the SEC prohibits an investment

[72] *See* Investment Adviser Marketing, 86 Fed. Reg. 13024, 13025 (Mar. 5, 2021) (to be codified at 17 C.F.R. pts. 275, 279) (observing that, although "[a]dvertisements can provide existing and prospective investors with useful information as they contemplate whether to utilize and pay for investment advisory services," they nevertheless "present risks of misleading investors because an investment adviser's interest in attracting investors may conflict with the investors' interests").

[73] *See id.*

[74] *See* 17 C.F.R. § 275.206(4)-1(a)(4) (2023).

[75] *See id.* § 275.206(4)-1(b).

adviser from presenting gross performance results in an advertisement unless it calculates net performance for the same period and using the same methodology as it calculated gross performance and simultaneously presents net performance "[w]ith at least equal prominence to" the gross performance numbers.[76]

The SEC's approach to regulating advertisements reflects the principle that advertising may promote regulatory goals because it can bring additional clients and investors into the securities markets, thereby furthering both their financial goals and the goal of capital formation. As a result, rather than flatly prohibit all advertisements, worrisome though they may be, the SEC carves out a space for ones that present information fairly and truthfully. In other words, it permits the conflicts of interests that investment advisers harbor in advertising their services but strives to remove any prospect that advisers might act on those conflicts to clients' and investors' detriment.

2. Compensation

The classic mode of compensation for an investment adviser, whether paid by a pool of investors—that is, a fund—or by a single advisory client, is a fee calculated as a percentage of the net assets being managed by the adviser.[77] Such asset-based fees—also called "management fees"—are simple. There is never a question about how much is owed to an adviser who is entitled to such a fee, so long as there is no question about the net asset value of the relevant client's account. Asset-based fees may also seem intuitively fair to both parties, increasing or decreasing based on the adviser's performance: profits increase the amount of assets on which the fee is calculated (assuming the profits are reinvested), thereby proportionately increasing the dollar amount of the fee, while losses reduce the amount of assets on which the fee is calculated, thereby proportionately decreasing the dollar amount of the fee.

Nevertheless, there are other compensation models that many clients and advisers embrace, particularly when an adviser's strategy centers not on the traditional buying and selling of publicly traded equity securities but instead revolves around more risky or speculative activities,

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76 *See id.* § 275.206(4)-1(d).

77 *See* Daisy Maxey, *How to Pay Your Financial Adviser*, WALL ST. J., http://www.wsj.com/articles/how-to-pay-your-financial-adviser-1378302678 (Dec. 11, 2011) (describing asset-based fees). For example, as to a client in a separately managed account arrangement, periodically the client will pay the investment adviser an amount equal to a certain percentage of the value of the assets in the account, whether through allowing the adviser to withdraw the fee from the account or by paying the fee out of funds held outside of the account.

such as selling securities short or investing in assets that cannot be readily liquidated. In those circumstances, the uncertainty of the success of the investment program may counsel in favor of ensuring that clients pay a fee only if the program is, in fact, successful. The adviser is typically willing to agree to this arrangement—and, indeed, may be the party proposing it—not only because of its confidence in its investment strategies but, in some cases, also because it believes that charging a fee only when its strategy has been successful is the fairest approach.[78]

Under this alternative fee model—which is sometimes deployed alongside a management fee—the adviser is entitled to a percentage (often twenty percent) of the net revenues that the adviser realizes on a client's assets over a specified period, usually a year.[79] The problem with such "performance fee" arrangements is that the securities laws prohibit them. In particular, under the Advisers Act, a contract for advisory services is illegal if it "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds . . . of the client."[80] The basis of this prohibition is policymakers' concerns regarding the conflicts of interest such compensation could create for advisers. Among other things, the argument goes, knowing that the profit they achieve is the basis for their compensation, advisers may be inclined to engage in riskier investment and trading activities than would otherwise be the case, including by employing excessive leverage or investing in securities with volatile prices.[81]

Pursuant to the authority Congress gave the SEC under the Advisers Act, however, the agency has created an exemption to the performance fee prohibition that permits investment advisers to enter into

78 *See* Ben Geier, *How Financial Advisor Performance Fees Work*, SMARTASSET (Aug. 19, 2022), https://smartasset.com/financial-advisor/performance-based-fee [https://perma.cc/Y39Y-696J] (noting that a performance fee may "incentivize your investment manager to earn you the most money possible, because it will in turn earn them money" and that "[t]his incentive could make advisors who are more inclined to be conservative and simply collect a management fee think harder about investments and go for a big increase in value for their clients").

79 For example, if an investor contributes $100,000 to a private fund on January 1, and the investment grows to $120,000 by December 31, then as of that date the manager will be entitled to a performance fee of 20% (or such other applicable percentage) of that appreciation, or $4,000. *See* James Chen, *Performance Fee: Definition and Example for Hedge Funds*, INVESTOPEDIA, https://www.investopedia.com/terms/p/performance-fee.asp [https://perma.cc/6FD8-SLT3] (Sept. 29, 2022) (explaining performance fees and how they are calculated).

80 15 U.S.C. § 80b-5.

81 *See* Amerivest Inv. Mgmt., LLC, SEC Staff No-Action Letter (Aug. 19, 2014), http://www.sec.gov/divisions/investment/noaction/2014/amerivest-081914-205a1.htm [https://perma.cc/2X5A-FATR] (noting that performance fees may "'encourage advisers to take undue risks with the funds of clients,' to speculate, or to overtrade").

performance fee arrangements.[82] At the same time, the exemption aims to mitigate the potentially adverse incentives associated with performance fees. Accordingly, under the exemption, set forth in rule 205-3, performance fee arrangements are permissible notwithstanding the statutory prohibition, provided that each relevant client and each investor in a private fund subject to a performance fee either has placed at least a threshold amount of capital with the adviser or has at least a threshold net worth, in each case, as set by the SEC from time to time.[83]

In allowing this exemption from the performance fee prohibition, the SEC recognizes that, in some circumstances, performance fees may further investors' interests. After all, some investors, in placing capital under the management of an investment adviser, want to ensure that the adviser is incentivized to earn returns for them, and many prefer to compensate their advisers only when their accounts are profitable. Performance fees further both goals, thereby encouraging investment and, therefore, capital formation. Moreover, by implementing measures to ensure that clients and investors subject to performance fees have sufficient wealth to endure possible losses,[84] the SEC has addressed what presumably was Congress's primary concern in prohibiting this mode of compensation.

3. Principal Transactions

From time to time, investment advisers desire to enter into so-called principal transactions with advisory clients, in which the adviser or an affiliate sells a security it owns to a client or buys a security from a client for its own account.[85] Principal transactions may be desirable from a client's perspective, to the extent the adviser is able to provide a better price than what would be available to the client if she transacted in the open market—meaning a higher selling price (if the client is the seller) or

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[82] *See* 17 C.F.R. § 275.205-3 (2023).

[83] *See id.* § 275.205-3(a).

[84] One might reasonably question, however, whether the "qualified client" definition actually does provide this assurance. The SEC most recently updated the definition in 2021, providing that a qualified client is someone who has at least $1.1 million under the management of the investment adviser she has engaged or who the adviser reasonably believes has a net worth of at least $2.2 million. *See* Performance-Based Investment Advisory Fees, 86 Fed. Reg. 62473, 62474 (Nov. 10, 2021) (to be codified at 14 C.F.R. pt. 107).

[85] *See* Carl Ayers, *Sorting Out Principal Trades from Cross Trades*, REG. COMPLIANCE WATCH (May 15, 2023), https://www.regcompliancewatch.com/stay-compliant-by-sorting-out-principal-trades-from-cross-trades (last visited July 2, 2023) (noting that principal transactions "involve an adviser acting as a 'principal for its own account' by selling a security it owns to a client or buying one from a client").

a lower purchase price (if the client is the buyer).[86] However, these transactions also create the risk of self-dealing, a classic conflict of interest. For example, when an adviser sells a security it owns to a client, it has an incentive to cause the client account to pay more for the security than what the client would pay if transacting in the open market.[87] Conversely, when the adviser buys a security from a client for its own account, it has an incentive to pay the client a lower price than what the client would receive if transacting in the open market.[88]

Given the self-dealing risks associated with principal transactions, the Advisers Act prohibits them[89]—but, based on the possible benefit of these transactions to advisory clients, the statute also provides a limited exception to the prohibition. Pursuant to this exception, an investment adviser may engage in a principal transaction with a client, provided that, "before the completion of such transaction," the adviser discloses to the client the capacity in which it is acting—that is, as principal—and obtains the client's consent.[90] The animating principle behind this exception is to allow a proposed principal transaction to proceed only if the client understands it and has approved it.

The example of principal transactions presents an instance of Congress itself recognizing that it is not desirable to completely eliminate at least some conflicts of interest. Moreover, this recognition was perhaps a product of the further recognition that these transactions can both be good for investors and create transaction efficiencies in the capital markets. Nevertheless, the SEC's guidance has been critical to ensuring that that the allowance Congress provided for principal transactions is meaningful.

In particular, early on, uncertainty regarding the meaning of "before the completion of such transaction" as used in the statutory provision caused advisers to avoid principal transactions that could be beneficial to their clients.[91] Under one interpretation of the statute, "before such

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86 *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, 63 Fed. Reg. 39505, 39505 (July 23, 1998) (to be codified at 15 C.F.R. pt. 746) (observing that advisory clients "can benefit from" principal transactions).

87 *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Adv. Act Rel. No. IA-2653 (Sept. 24, 2007) at 13, www.sec.gov/rules/final/2007/ia-2653.pdf [https://perma.cc/DR6E-N7HB] ("Congress intended section 206(3) of the Advisers Act to address concerns that an adviser might engage in principal transactions to benefit itself or its affiliates, rather than the client.").

88 *See id.*

89 15 U.S.C. § 80b-6(3).

90 *Id.*

91 *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, 63 Fed. Reg. at 39506 (noting that "[c]ertain of our settled enforcement actions have raised questions regarding our interpretation of specific aspects of Section 206(3)" and that "[w]e are concerned

completion" means before the transaction is executed—that is, before the first stage of a transaction, when the parties have agreed to the terms of a transaction, but the exchange of securities for payment has not yet occurred.[92] Using this interpretation, because advisers often wish to proceed with principal transactions relatively quickly given possible developments in the market, they could confront the difficulty of contacting clients to provide disclosure and obtain consent prior to execution.[93] Under an alternative interpretation of the statute, "before the completion" means after execution but prior to settlement—that is, before the point at which the exchange of the security for payment occurs—a reading that would allow advisers additional time to provide disclosure to the relevant client and procure consent.[94]

To address the uncertainty regarding the appropriate meaning of the statute, the SEC issued an interpretation to govern principal transactions. Recognizing the difficulty associated with effecting principal transactions when disclosure and consent must be addressed prior to execution, the SEC opined that "before the completion" should be interpreted to mean prior to settlement.[95] It reasoned that the marker for transaction completion should be when all stages of a transaction have been concluded—namely at the time the securities and payment have been exchanged.[96]

In issuing this interpretation, the SEC not only concurred with Congress's view that principal transactions should be permitted under some circumstances because of the benefits associated with them. It also took the steps necessary to ensure that advisers could actually take advantage of that exception, engaging in theoretical self-dealing in a manner—and with the restraints—that serves investors' interests. The next Section sets forth similar examples in the context of mutual funds and other public funds.

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that . . . advisers will unnecessarily avoid engaging in principal . . . transactions that may serve their clients' best interests").

92 *See id.* at 39506–07 (describing the interpretation that "completion" means before executing a transaction and the problems associated with that interpretation).

93 *See id.* ("It is our understanding that advisers find it difficult to satisfy their disclosure obligations under Section 206(3) prior to the execution of a transaction because of the practical difficulties of contacting some clients within a relatively short time . . . .").

94 *See id.* at 39507 ("Interpreting the phrase 'completion of such transaction' to mean at the time of settlement of the transaction is consistent with Congress' intent in enacting Section 206(3) . . . .").

95 *See id.* at 39506 ("[A]n adviser may obtain client consent for purposes of Section 206(3) to a principal or agency transaction after execution, but prior to settlement, of the transaction . . . .").

96 *See id.* at 39507 (observing that the "ending point of a transaction is when the actual exchange of securities and payment occurs, which is known as 'settlement'").

B. *The Investment Company Act of 1940*

Whereas the Advisers Act governs the firms that manage separate client accounts and pooled investment entities—whether in the form of private funds or public ones—the Investment Company Act focuses solely on funds. Specifically, it regulates the public variety, with the goal of ensuring the protection of retail investors, who rely on mutual funds, ETFs, and the like, to grow their retirement assets.[97] The requirements set forth in the statute and the associated SEC rules are extensive and prohibit large swaths of conduct deemed to create undue risk for investors.[98] Moreover, the basis of a significant component of the prohibitions is the goal of eliminating the conflicts of interest to which funds (meaning their managers) are subject.[99] Yet, in many contexts, regulation's approach to addressing conflicts parallels that of the Advisers Act, in the sense that it seeks not to eliminate conflicts entirely but instead to prevent them from harming investors.[100] This Section presents three examples of this phenomenon.

1. Valuation Procedures

Among the requirements applicable to most public funds is the mandate that their portfolios be relatively liquid—meaning that the securities constituting their portfolios can be readily sold for cash.[101] This requirement allows funds to manage investor redemptions, which is

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97 *See* Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 780 (2013) ("Retail investors today hold equity largely through intermediaries such as pension funds and mutual funds."); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 295 (2007) ("[M]any—perhaps even most—investors in mutual funds are retail investors with long-term goals.").

98 *See* Cary Martin Shelby, *Profiting from Our Pain: Privileged Access to Social Impact Investing*, 109 CAL. L. REV. 1261, 1282 (2021) (observing, with regard to the Investment Company Act, that "[t]his complex piece of legislation provides additional layers of protection that extend well beyond the 'truth in securities' framework of the inaugural Securities Act of 1933 . . . and the Securities Exchange Act of 1934").

99 *See Laws and Rules*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/investment/laws-and-rules [https://perma.cc/F77J-4TS4] (May 13, 2020) (observing that Congress designed the Investment Company Act "to minimize conflicts of interest that arise" in the operation of mutual funds and other public funds).

100 *See supra* notes 69–96 and accompanying text (describing how the Advisers Act and the SEC's rules under that statute seek to mitigate conflicts of interest).

101 *See* James Chen, *What Is a Liquid Asset, and What Are Some Examples?*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liquidasset.asp [https://perma.cc/QS3W-WMBR] (Aug. 4, 2022) (defining "liquid asset" as "an asset that can easily be converted into cash in a short amount of time").

critical because, pursuant to another requirement, most funds must permit investors to redeem shares on a daily basis.[102] Despite the liquidity obligation, however, a fund may still invest in illiquid or other hard-to-value securities—that is, securities that cannot be readily sold, typically because they were issued by a private company—provided that the value of those securities does not exceed fifteen percent of the value of the fund's entire portfolio.[103]

The problem with illiquid securities, apart from the fact that they are challenging to sell (and, in many cases, cannot be sold until the company that issued them becomes public),[104] is that they are difficult to value.[105] Nonetheless, the process of attaching a price to each asset in a fund's portfolio is critical for the reason noted above—namely, that investors have daily redemption rights.[106] If part of a fund's portfolio cannot be valued, then it is impossible to determine the amount of redemption proceeds the fund should pay to a redeeming investor.[107] To be sure, there are pricing services that can be helpful to a fund manager in determining the value of an illiquid security,[108] but in many cases the manager is a natural candidate for performing valuation because, as to any security, the manager presumably has the necessary knowledge and expertise to do

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102 *See* D. Bruce Johnsen, *Myths About Mutual Fund Fees: Economic Insights on* Jones v. Harris, 35 J. CORP. L. 561, 583 (2010) ("Mutual funds must be prepared to process redemptions and sales daily, which requires them to hold substantial liquid assets . . . .").

103 *See Revisions of Guidelines to Form N-1A*, 57 Fed. Reg. 9828 (Mar. 20, 1992) (to be codified at 17 C.F.R. pts. 239, 274) (adopting a rule limiting a mutual fund's illiquid positions to fifteen percent of the fund's total assets); Henry Bregstein et al., *Katten Discusses SEC's Focus on Liquid Alternative Funds Market*, CLS BLUE SKY BLOG (Aug. 4, 2014), http://clsbluesky.law.columbia.edu/2014/08/04/katten-discusses-secs-focus-on-liquid-alternative-funds-market [https://perma.cc/LZ85-RYWZ] (noting that the Investment Company Act requires that public funds limit investments in illiquid securities to fifteen percent of their assets).

104 *See* Azam Ahmed, *For Sale: Illiquid Assets, Hard to Value*, N.Y. TIMES DEALBOOK (Mar. 28, 2011, 3:09 PM), http://dealbook.nytimes.com/2011/03/28/for-sale-illiquid-assets-hard-to-value [https://perma.cc/U33H-R6FS] (observing that illiquid assets are difficult to sell because of the difficulty matching buyers' and sellers' respective expectations).

105 *See* OFF. OF INV. EDUC. & ADVOCACY, SEC. EXCH. COMM'N, INVESTOR BULLETIN: HEDGE FUNDS 2 (2013), http://www.sec.gov/investor/alerts/ib_hedgefunds.pdf [https://perma.cc/6DWM-YPVN] ("Hedge funds may invest in highly illiquid securities that may be difficult to value.").

106 *See infra* notes 113–14 and accompanying text (noting the Investment Company Act's valuation requirements).

107 *See* Anita K. Krug, *Investors' Paradox*, 43 J. CORP. L. 245, 255 (2018) ("To the extent that inaccurate prices are used to calculate a fund's net asset value, an investor that redeems her shares at that time may receive an amount of redemption proceeds that is greater or less than the amount she should have received.").

108 *See* INV. CO. INST., FUND VALUATION UNDER THE SEC'S FAIR VALUE RULE 13 (2021), https://www.ici.org/system/files/2021-12/21-ppr-fund-valuation-primer.pdf [https://perma.cc/2S6K-6LQU] ("The use of third-party pricing services mitigates the potential conflicts of interest that investment advisers face in valuing funds' portfolio investments . . . .").

so.[109] After all, the manager would likely not have bought the security for the fund's portfolio without sufficient research into its prospects.[110] Recognizing this, as described below, the SEC allows the manager to be the designated valuation agent for illiquid securities in the portfolios of the funds that it manages.[111]

A fund manager charged with valuing difficult-to-value securities in a fund's portfolio has an obvious conflict of interest, however, in that it has an incentive to artificially inflate the value of those securities above what the selling price would be in a hypothetical arm's-length transaction.[112] This is because the higher the value of the assets in the fund's portfolio, the higher the management fee paid to the manager, given that the fee is calculated as a percentage of the fund's net asset value. A manager that acts on this conflict harms investors by causing the fund to pay inflated redemption proceeds to redeeming investors and causing new investors to pay too high a price for their fund shares.

Recognizing this conflict, pursuant to rule 2a-5 of the Investment Company Act, the SEC gives valuation authority to the fund's board of directors in the first instance but allows the directors to delegate that authority to the manager, provided the board reviews and ratifies, on a regular basis, any valuations the manager performs.[113] In addition, the SEC requires all funds, through their boards, to adopt policies governing the valuation of any illiquid securities in their portfolios and requires

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[109] *See* Jennifer Banzaca, *Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees*, HEDGE FUND L. REP. (Aug. 16, 2012), https://www.hflawreport.com/2544256/key-considerations-for-hedge-fund-managers-in-organizing-and-operating-valuation-committees.thtml [https://perma.cc/GZ95-XQ7G] (observing that managers "often play a fundamental role in the valuation of portfolio assets" and that, "in general, the more difficult to value the asset, the more important the role of portfolio management staff in the valuation process").

[110] *See id.* ("As a practical matter, if a smart portfolio manager has spent six months or a year analyzing a complex asset, it is unlikely that a valuation firm or administrator will have greater insight into the value of that asset.").

[111] In particular, the SEC's rule governing public fund valuation allows a fund's board of directors to appoint a "valuation designee," which the rule defines as "the investment adviser . . . of a fund or, if the fund does not have an investment adviser, an officer or officers of the fund." *See* 17 C.F.R. § 270.2a-5(e)(4) (2023).

[112] *See* Banzaca, *supra* note 109 (noting that, because managers' compensation is often tied directly to the valuation of portfolio assets, managers "often have an incentive to assign greater values to portfolio assets"); HOULIHAN LOKEY, INDEPENDENT THIRD-PARTY VALUATION INSIGHTS: PORTFOLIO VALUATION BEST PRACTICES 5 (2016), https://www.hl.com/uploadedFiles/50_Newsroom/43_Insights_and_Ideas/Valuation%20Best%20Practices_Houilhan%20Lokey.pdf [https://perma.cc/7Q5K-B4H7] ("Fund managers' compensation is normally tied to total assets under management and portfolio performance; a fund manager's influence over the valuation of illiquid assets may create a conflict of interest.").

[113] *See* 17 C.F.R. § 270.2a-5(b) ("The board may choose to designate the valuation designee to perform the fair value determination relating to any or all fund investments . . . .").

managers, in valuing illiquid securities, to perform the valuation in accordance with the policy.[114] By allowing fund managers to set prices for certain securities in "their" funds' portfolios but also requiring close oversight by the funds' boards of directors, the SEC has both acknowledged the conflict of interest associated with manager valuation and sought to mitigate it. This approach serves investors' interests by protecting them from the conflict of interest arising from manager valuation, while ensuring that valuations are as accurate as possible. In turn, it promotes investor confidence, thereby encouraging investment and, with it, capital growth.

2. Fund Distribution

Like any business, the business of operating publicly offered investment products, to be successful, requires that potential customers—investors, more accurately—know about the services offered and how those services can help them grow their capital. Like any business, therefore, public fund businesses have to market themselves—and, historically, "marketing" in the public fund context has referred to registered broker-dealers' promotion and sale of public funds' securities.[115] After all, broker-dealers exist to perform marketing services and effect securities transactions, whether as brokers in open market securities transactions, as underwriters in IPOs, or as market makers that transact in securities for their own accounts.[116] In selling public fund securities, moreover, broker-dealers act in their capacities as brokers (rather than as dealers) and are typically paid commissions, which is the classic compensation for selling agents.[117]

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114 *See id.* § 270.2a-5(a) (requiring a consistent selection and application of "an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments").

115 *See* 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS THE SECURITIES AND COMMODITIES LAWS § 10:24.55 (2022) ("Mutual funds are often sponsored or distributed by broker-dealers.").

116 *See* Michael Koffler, *The Brave New World of Fiduciary Duty for Broker-Dealers and Investment Advisers*, ENVESTNET 3 (2010), https://www.fiduciaryregulatory.com/portalresource/TheBraveNewWorldofFiduciaryDutyforBrokerDealersandInvestmentAdvisers [https://perma.cc/X7VL-MCCZ] ("Broker-dealers often are involved in underwriting securities offerings, serving as syndicate members or wholesalers, matching buyers and sellers of securities, acting as market makers, selling securities to the public from inventory, and clearing and settling trades.").

117 *See* Daisy Maxey, *Ruling Near on Fiduciary Duty for Brokers*, WALL ST. J.: WEALTH MGMT., http://www.wsj.com/articles/ruling-near-on-fiduciary-duty-for-brokers-1396894687 (Apr. 13, 2014, 4:51 PM) (last visited Aug. 10, 2023) ("Lower- and middle-income investors often turn to brokers who are compensated through product commissions . . . .").

The sale of public funds' securities through broker-dealers frequently takes the form of arrangements whereby a fund is placed among those that a broker-dealer offers and sells to its customers on an online "platform."[118] As compensation for selling shares of the fund to an investor, the firm might receive a commission at the time the investor buys her shares (known as a "front-end load") that is equal to a percentage of the value of the shares purchased.[119] Alternatively, the firm might receive a commission at the time the investor redeems her shares (known as a "back-end load") that is equal to a percentage of the value of the redeemed shares.[120] In either case, the investor bears the cost of the commission, which is subtracted from her capital contribution in the case of a front-end load and subtracted from her redemption proceeds in the case of a back-end load.[121]

There is yet another way that funds might compensate their selling agents, which has the dual advantages to investors—perceived, if not in fact—of gradual payment, over a period of time, and payment by the funds themselves, rather than by their investors.[122] Indeed, in this third approach, the payment of marketing expenses out of a fund's assets is not even tied to share purchases or redemptions.[123] Rather, if a fund has established such an arrangement with a broker-dealer, it is obligated to pay the firm a certain percentage of the value of each share that it has issued, with the result that the firm receives a steady payment stream that is not contingent on its sale of shares to any particular investor.[124] Under

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118 *See* Michael Sacchitello, *Best Online Brokers and Trading Platforms*, INVESTOPEDIA, https://www.investopedia.com/best-online-brokers-4587872 [https://perma.cc/26WE-2KAE] (Nov. 9, 2022) (describing various types of online brokerage platforms for mutual funds).

119 *See* Troy Segal, *Front-End Loads: Definition, Types, Average Percentage, and Example*, INVESTOPEDIA, https://www.investopedia.com/terms/f/front-endload.asp [https://perma.cc/39P5-F2KJ] (Mar. 26, 2020) ("A front-end load is a commission or sales charge applied at the time of the initial purchase of an investment.").

120 *See* James Chen, *Back-End Load: Benefits, Criticisms, Example*, INVESTOPEDIA, https://www.investopedia.com/terms/b/back-end-load.asp [https://perma.cc/X8KL-EPCL] (Mar. 31, 2022) ("A back-end load is a fee paid by investors when selling mutual fund shares, and it is expressed as a percentage of the value of the fund's shares.").

121 *See* Mark P. Cussen, *Introduction to Load Funds*, MUTUALFUNDS.COM (Nov. 20, 2014), https://mutualfunds.com/load-funds/introduction-load-mutual-funds [https://perma.cc/YWU8-9SEH] ("The load, or sales charge[,] that is assessed is paid by the investor at the time of either purchase or redemption.").

122 *See* ICI INV. CO. INST., FREQUENTLY ASKED QUESTIONS ABOUT MUTUAL FUND FEES 4 (2004), https://www.ici.org/doc-server/pdf%3Abro_mf_fees_faq_p.pdf [https://perma.cc/6Q34-8NNS] ("Many investors prefer this [third] option, as it allows their entire investment to be put to work for them immediately instead of having it reduced initially by a sales commission.").

123 *See id.*

124 *See id.* ("This fee can be thought of as an alternate way of paying sales-related expenses because it allows shareholders to pay for the service they receive from sales professionals through installment payments rather than in a single upfront payment.").

this type of marketing arrangement, everyone wins: first, the investor, who avoids paying a sales load; second, the broker-dealer, which receives a steady payment stream; and third, the fund manager, which is able to market its products without itself bearing the associated marketing and promotional expenses.

Perhaps for these reasons—particularly the third one—the Investment Company Act prohibits this alternative approach to compensating mutual fund marketers.[125] In other words, in adopting the statute, Congress perceived that fund managers may have a conflict of interest in causing the payment of marketing expenses from fund assets because, relieved of the burden of paying those costs itself, a manager might not exercise sufficient care and diligence in pursuing marketing activities.[126] Excessive fund-paid marketing, though possibly beneficial to fund managers, may be harmful to investors, as the ultimate owners of the assets from which fund expenses are paid.[127]

Forty years after Congress enacted the statute, the SEC acknowledged that the use of fund assets to pay a fund's marketing costs not only presented conflicts of interest but also might benefit investors,[128] presumably because it could potentially increase the rate at which a fund increases its assets, thereby creating economies of scale, and could potentially decrease portfolio volatility caused by redemptions.[129] Accordingly, the agency adopted rule 12b-1 under the Investment

125 *See* 15 U.S.C. § 80a-12(b) ("It shall be unlawful for any registered open-end company . . . to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe . . . .").

126 *Cf.* Lori Walsh, *The Cost and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns*, U.S. SEC. & EXCH. COMM'N 2 (2004), https://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf [https://perma.cc/8ECR-GZSL] (observing that opponents of rule 12b-1 "argue that there is a conflict of interest from allowing fund advisers to use fund assets to pay for attracting new investors, since fund advisers earn fees based on assets under management").

127 *See* Bearing of Distribution Expenses by Mutual Funds, 42 Fed. Reg. 44810, 44810 (Sept. 7, 1977) (to be codified at 17 C.F.R. pt. 271) (noting the concern that "any increased sales of shares resulting from the use of mutual fund assets to finance distribution activities would benefit mainly the management of a mutual fund rather than its shareholders").

128 *See* Bearing of Distribution Expenses by Mutual Funds, 45 Fed. Reg. 73898, 73901 (Nov. 4, 1980) (to be codified at 17 C.F.R. pts. 239, 270, 274) (noting that "there may be circumstances under which it would be appropriate for a fund to bear its distribution expenses").

129 Although the SEC did not itself articulate specific potential benefits to funds and investors of permitting funds to bear distribution expenses, in the release in which it proposed the rule it discussed comments it had received regarding potential benefits, including that "the use of fund assets to finance distribution activities could lead to increased sales of shares, thereby alleviating the difficulties perceived to result from net redemptions or small asset size." Bearing of Distribution Expenses by Mutual Funds, 45 Fed. Reg. 23589, 23590, (May 31, 1978) (to be codified at 17 C.F.R. pt. 270).

Company Act,[130] pursuant to which fund assets may be used to pay marketing expenses if the payment occurs according to the terms of a so-called "12b-1 plan" that details the material aspects of the fund's distribution of shares.[131] The rule further requires that the fund's board of directors and, if the fund has already sold shares, the fund's investors approve the plan based on their respective conclusions that the plan will benefit the fund and its investors.[132]

The SEC's purpose in adopting rule 12b-1 was to strike a balance between completely eliminating the conflict that arises from a fund's bearing its own marketing expenses and the benefit that might accrue to investors as a result of its doing so.[133] Like many of the SEC's rules, it is controversial in that it remains uncertain whether the benefits outweigh the costs.[134] Regardless, the rule amply demonstrates the SEC's approach to regulating an industry uniquely characterized by significant conflicts of interest.

3. Cross Transactions

Recall that Section II.A described how an investment advisory client may benefit from buying securities from, or selling them to, the investment adviser managing her account in a principal transaction.[135] In particular, the terms of such a transaction may be more beneficial to the client than would be the case if the transaction were carried out in the open market.[136] A similar rationale applies also in the context of public funds, in circumstances in which a fund manager wants two funds that it manages to transact with one another. In these situations, it may be that one fund needs to liquidate securities to pay redemption proceeds to a

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130 *See* 17 C.F.R. § 270.12b-1 (2023).

131 *See id.* § 270.12b-1(b) ("A registered, open-end management investment company . . . may act as a distributor of securities of which it is the issuer: *Provided*, That any payments made by such company in connection with such distribution are made pursuant to a written plan describing all material aspects of the proposed financing of distribution . . . .").

132 *See id.*

133 *Cf. supra* note 129 (describing certain potential benefits of the rule that the SEC recited in its adopting release).

134 At least one experienced observer has contended that the benefits of rule 12b-1 do not outweigh the costs. *See* Walsh, *supra* note 126, at 2 (finding in her study of 12b-1 plans that "while funds with 12b-1 plans do . . . grow faster than funds without them, shareholders are not obtaining benefits in the form of lower average expenses" and that "[f]und shareholders are paying the costs to grow the fund, while the fund adviser is the primary beneficiary").

135 *See supra* notes 85–96 and accompanying text (describing principal transactions between investment advisers and funds they manage and associated conflicts of interest).

136 *See supra* notes 85–86 and accompanying text (setting forth the rationale for principal transactions).

redeeming investor, while another fund needs to invest the cash contributed by a new investor.[137] To the extent the two funds' investment strategies overlap, with the result that they hold many of the same securities, then effecting a cross transaction is often appropriate because such a transaction typically involves fewer transaction costs than a transaction effected in the open market.[138] Much like effecting a principal transaction, executing a cross transaction can be a win-win situation.

Cross transactions present conflicts of interest, however. For example, in carrying out a transaction, a manager might implicitly favor one fund over the other, such as when the compensation the manager receives from one fund is higher than the compensation it receives from the other fund or when an affiliate of the manager holds a large interest in the favored fund.[139] Whatever the specific circumstances, they could lead the manager to effect cross transactions between the two funds on terms that benefit the favored fund and its investors at the expense of the nonfavored fund and its investors.[140]

Congress recognized the risk that cross transactions may create for investors as a result of potential conflicts of interest, and, as a result, the Investment Company Act prohibits them, leaving it to the SEC to determine whether any exceptions to the prohibition might be appropriate.[141] The SEC's rules under the Investment Company Act—specifically, rule 17a-7—reflect the agency's recognition that cross transactions can be efficiency-enhancing, reducing the trading costs that both funds would otherwise need to bear.[142] Specifically, to achieve a balance between mitigating risks to investors while nevertheless permitting cross transactions, the rules require that these transactions be carried out pursuant to prescribed procedures, including that each cross

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137 *See* INV. CO. INST., RULE 17A-7 AT THE CROSSROADS: SUPPLEMENTAL INFORMATION ON EQUITY CROSS TRADING 1 (2021), https://www.ici.org/system/files/2021-10/21_ppr_rule17a7_supplement.pdf [https://perma.cc/B5ZJ-67EX] (listing among the benefits of cross transactions "reduced transaction costs and settlement risk and more efficient portfolio management and compliance with investment policies").

138 *See* Alexander Eisele, Tamara Nefedova, Gianpaolo Parise & Kim Peijnenburg, *Trading Out of Sight: An Analysis of Cross-Trading in Mutual Fund Families*, 135 J. FIN. ECON. 359, 359 (2020) (observing that "cross-trades should reduce transaction costs for both trading parties").

139 *See* Chen, *supra* note 11 ("When the trade doesn't get recorded through the exchange one or both clients may not get the current market price that is available to other (non-cross trade) market participants.").

140 A factor that contributes to a manager's ability to benefit one fund at the expense of another is that the investors in both funds "may not be made aware as to whether a better price may have been available" because the orders "are never listed publicly." *Id.*

141 *See* 15 U.S.C. § 80a-17(a)(1)–(2) (prohibiting cross transactions between a public fund and an affiliate).

142 *See* 17 C.F.R. § 270.17a-7 (2023) (setting forth the requirements for effecting a cross transaction).

transaction is consistent with both funds' investment policies and conducted at market price; the transaction does not involve a brokerage fee; and the board of directors of each fund determines that the cross transaction complied with the fund's policies governing cross transactions.[143]

Like many of the SEC's rules designed to mitigate the risks of conflicts of interest while still permitting productive activity, the cross-transaction rules are relatively complicated. Indeed, the SEC's project of conflict mitigation arguably helps explain the detail and complexity of the Investment Company Act, as compared with its better-known counterparts—the Securities Act and the Exchange Act—which govern securities-market actors and transactions outside of the investment realm. This complexity, in turn, arguably reflects the SEC's efforts to strike the right balance between, on the one hand, permitting conflicts in furtherance of capital formation goals and, on the other, protecting investors. As the next Part demonstrates, however, the SEC has not always gotten the balance right.

III. Regulatory Imbalance

The examples in Part II demonstrate how securities regulation recognizes that conflicts of interest on the part of financial firms may be tempered so as to serve investors' interests. By merely limiting conflicts without eliminating them, this approach to regulation also furthers the regulatory goal of capital formation.[144] In other words, both investors and the capital markets are better off with a regulatory structure that recognizes that eliminating conflicts entirely by prohibiting the conduct that creates them is often not the best policy.[145] This principle of mitigation in lieu of elimination depends on the SEC's striking the right balance between, on the one hand, permitting conflicted conduct for the sake of promoting capital investment and, on the other, protecting against its potentially harmful effects on investors.[146] Arguably, the agency has struck the correct balance in most cases.

In some cases, however, its rules have placed too much weight either on the side of mitigation or on the side of permissiveness. These

143 *See id.* § 270.17a-7(a)–(e).

144 *See supra* notes 48–59 and accompanying text (describing how conflicts of interest can aid the process of capital formation).

145 *See supra* notes 57–60 and accompanying text (explaining why merely mitigating conflicts of interest, as opposed to eliminating them, is the preferred policy approach).

146 *See supra* notes 144–46 and accompanying text (discussing the importance of achieving a balance between capital formation goals and investor protection goals).

regulatory mistakes have both caused harm to investors and impeded capital formation and, more broadly, raised the question of how they might have been avoided. This Part presents situations in which the SEC has failed to achieve an appropriate balance in its effort to mitigate conflicts in a way that furthers regulatory objectives. Section III.A discusses two episodes in which the SEC was too permissive of conflicted activity, both of which involved conduct that harmed investors during the 2007–09 financial crisis. Section III.B focuses on the other side of the scale, describing rulemaking episodes in the private fund context in which the SEC's approach to mitigating conflicts has gone too far.

A. *Overweighted Permissiveness*

In the situations in which the SEC has gotten it wrong, in terms of finding the proper balance between permitting and prohibiting conflicted behavior by financial firms, the reason for the mistake has generally been the agency's excessive deference to those firms. Another reason might be its assumption that the fiduciary duty that investment advisers owe their clients would guide them to act appropriately, even in the absence of a regulatory mandate. Typically, the SEC's excessively deferential stance toward financial firms has taken the form of too-lenient rules that permit investment advisers and fund managers to act on conflicts in contexts that place investors at risk. This Section describes two examples of foot faults in the SEC's balancing act that became apparent during the 2007–09 financial crisis. Despite differences in the factors giving rise to each example, both examples demonstrate the imprecision characterizing the task of weighing conflict mitigation against capital formation objectives.

1. Money Market Funds

The financial crisis had many causes.[147] In its aftermath, it became apparent that the regulatory failures that fueled it extended far beyond the regulation of securities and the securities markets proper and involved failures in the regulation of derivative instruments—credit default swaps, in particular—and banks.[148] But securities regulation, or

[147] *See* Anne Field, *What Caused the Great Recession? Understanding the Key Factors That Led to One of the Worst Economic Downturns in US History*, INSIDER, https://www.businessinsider.com/personal-finance/what-caused-the-great-recession [https://perma.cc/N6VM-36C8] (Aug. 8, 2022, 3:56 PM) (describing myriad factors that contributed to the global financial crisis).

[148] *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE

the lack thereof, also contributed to the losses that so many individuals and businesses suffered.[149] The money market fund episode of 2008 presents perhaps the starkest example of how crisis circumstances impacted even investments deemed among the safest of all.

For all practical purposes, money market funds are mutual funds, in that they are largely subject to the same regulation and oversight as mutual funds.[150] The primary difference between the two fund types is that money market funds are often deemed substitutes for bank accounts,[151] with the added advantage that the return they typically produce is higher than the interest that banks pay depositors.[152] As a result of this deemed interchangeability, those who invest in money market funds generally regard their investments as safe and protected from losses, similar to how they view their bank deposits.[153]

Nevertheless, money market funds are *funds* and, like any fund, can lose money.[154] Whereas a bank customer's agreement with her bank specifies that she will receive a certain amount of interest on her account deposit and that her deposit is insured by the U.S. government up to a maximum amount, there is no insurance or guarantee that will make investors whole if their fund investments experience losses.[155] In addition, like any public fund, money market funds invest their portfolio capital in

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UNITED STATES xviii (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/9E6R-2W9U] (concluding, among other things, that "widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets").

149 *See, e.g.*, Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. TIMES (Jan. 25, 2011), https://www.nytimes.com/2011/01/26/business/economy/26inquiry.html [https://perma.cc/85BM-LP8N] (noting the Financial Inquiry Commission's finding that the SEC "failed to require big banks to hold more capital to cushion potential losses and halt risky practices").

150 *See* U.S. Sec. & Exch. Comm'n, *Money Market Fund*, INVESTOR.GOV [hereinafter *Money Market Fund*], https://www.investor.gov/introduction-investing/investing-basics/glossary/money-market-fund# [https://perma.cc/PER3-7CGA] ("A money market fund is a type of mutual fund . . . .").

151 *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 192 (2016) ("Many ordinary investors believe that their savings in money market accounts are just like deposits in bank accounts.").

152 *See id.* at 193 (noting that "[b]ecause mutual funds are governed by the federal securities laws, but not the federal banking laws, Regulation Q and its limit on interest rates" does not apply to money market funds and that the interest rates paid by money market funds are generally "more attractive than those of bank accounts").

153 *See id.* at 196 (noting how the features of money market funds are "extremely redolent of bank accounts").

154 *See id.* (observing that money market funds are investment funds and, as such, carry "the real potential for loss").

155 *See Money Market Fund*, *supra* note 150 ("Unlike a 'money market deposit account' at a bank, money market funds are not federally insured.").

securities instruments that may increase in value or may decline in value.[156] Accordingly, like any public fund, they cannot promise that investors will receive a particular return on their capital.[157]

Again, however, the risks associated with money market funds and the ways in which these funds differ from bank accounts have traditionally escaped many retail investors.[158] A primary reason for this is that money market funds invest in low-risk debt instruments—namely, high-quality, short-term corporate bonds.[159] Although regulation requires these funds to pursue low-risk investments,[160] there are two additional compelling reasons for them to do so. First, as noted above, they (or, more accurately, their managers) aim to provide an attractive alternative to bank accounts, with the result that they cannot risk losing their investors' capital by investing in speculative instruments.[161] Second, thanks to an accounting rule that money market fund managers convinced the SEC to adopt,[162] provided a money market fund's portfolio contains only conservative, low-risk instruments, it may forego mark-to-market accounting, which requires a daily valuation of its portfolio and produces daily share-price fluctuations, in favor of a stable daily net asset value, which is typically one dollar per share.[163] Under the original iteration of the rule, although the actual price per share of any fund would continue to fluctuate, so long as that value did not slip by more than half of a percent, the fund was not required to take any particular action, such

156 *See id.* (noting that money market funds "must allow their NAV to float based on the current market value of the securities in their portfolios").

157 *See* Fid. Learning Ctr., *What Are Money Market Funds?*, FIDELITY, https://www.fidelity.com/learning-center/investment-products/mutual-funds/what-are-money-market-funds [https://perma.cc/ACN3-YD58] ("[T]here is no guarantee that you will receive $1 per share when you redeem your shares.").

158 *See* Rachel Murphy, *Can You Lose Your Money in a Money Market Account?*, FORBES ADVISOR (Dec. 20, 2022, 7:33 AM), https://www.forbes.com/advisor/banking/can-you-lose-money-in-mma [https://perma.cc/FX5H-TAVA] ("People often confuse money market [bank] accounts and money market funds.").

159 *See Money Market Fund*, *supra* note 150 ("Money market funds invest in high quality, short-term debt securities and pay dividends that generally reflect short-term interest rates.").

160 *See* 17 C.F.R. § 270.2a-7(d)(2) (2023) (setting out the requirements for the quality of a money market fund's portfolio).

161 *See* BIRDTHISTLE, *supra* note 151, at 196 (noting that "there was no escaping the sense that money market funds were not as safe as bank accounts" but that "that impression was precisely what fund advisers wanted investors to confuse").

162 *See id.* at 196 (stating that money market fund managers "petitioned the SEC for a special dispensation from ordinary fund accounting rules").

163 *See* 17 C.F.R. § 270.2a-7(c)(1)(i) (permitting the "amortized cost method" of valuation, whereby, effectively, a money market fund can assign a consistent value to its shares).

as disclosing the drop to investors.[164] Money market fund managers sought the adoption of this rule presumably to give investors further comfort that, yes, these funds can provide all of the benefits of a bank account, including protection against losses.[165]

Despite the similarities between money market funds and bank accounts, the fact that money market funds are not bank accounts became evident during the financial crisis when the per-share price of one of the country's largest money market funds, the Reserve Primary Fund, slipped below one dollar.[166] In money-market-fund terminology, the Fund had "broken the buck" as a result of its price per share dipping three percent, to ninety-seven cents.[167] The reason for the drop was not difficult to discern: as it turned out, some of the corporate bonds in which the Fund had invested on the basis that they were high quality—namely those issued by Lehman Brothers—were, in fact, low quality.[168] The day before the Fund broke the buck, Lehman Brothers' corporate bonds were AAA rated.[169] The next day, the investment bank declared bankruptcy, producing, among its consequences, a run not just on the Reserve Primary Fund but also on money market funds throughout the country when investors realized that money market funds actually differed from bank accounts in an important way.[170]

The SEC's missteps in this example are also not difficult to discern. The conflict of interest harbored by money market fund managers in seeking to shed adherence to mark-to-market accounting rules—namely, their desire that money market funds look as much like bank deposit accounts as possible in order to attract more investor capital—had been

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164 *See id.* § 270.2a-7(g)(1)(i)(B) ("In the event [a] deviation from the money market fund's amortized cost price per share exceeds 1/2 of 1 percent, the board of directors shall promptly consider what action, if any, should be initiated . . . .").

165 *See* BIRDTHISTLE, *supra* note 151, at 191 (observing that "[t]he SEC granted permission to investment advisers to use special accounting rules to disguise the volatility of money market funds," which, in turn, "helped to suggest that these funds may be sleepy and harmless").

166 *See Money-Market Fund 'Breaks the Buck,'* N.Y. TIMES: DEALBOOK (Sept. 17, 2008, 8:09 AM) [hereinafter *Breaks the Buck*], https://archive.nytimes.com/dealbook.nytimes.com/2008/09/17/money-market-fund-says-customers-could-lose-money [https://perma.cc/H8LP-UFUX] (reporting the Reserve Primary Fund's announcement that "because the value of some investments had fallen, customers now have only 97 cents for each dollar they had invested").

167 *See* James Chen, *Breaking the Buck*, INVESTOPEDIA (Sept. 27, 2022), https://www.investopedia.com/terms/b/breaking-the-buck.asp [https://perma.cc/RE7A-44XP] ("Breaking the buck occurs when the net asset value (NAV) of a money market fund falls below $1.").

168 *See Breaks the Buck*, *supra* note 166 (noting that the Reserve Primary Fund's investment in Lehman Brothers' debt securities had become "essentially worthless").

169 *See* BIRDTHISTLE, *supra* note 151, at 198 ("Lehman's paper held a AAA rating all the way to September 14, 2008.").

170 *See id.* ("The following day, Lehman filed for bankruptcy.").

obvious. In adopting the rule that permitted the requested accounting treatment, the SEC erred by failing to take steps to help ensure that money market funds' investments would, in fact, be safe. Among other things, the agency might have prevented some of the losses that investors experienced by tightening the threshold of disclosure to, say, a downward fluctuation of a quarter of a percent, which might have further chastened managers to select only the most conservative corporate bonds. Alternatively, it might have declined to accede to the managers' wishes altogether (although, to be sure, doing so may have unduly tipped the scale the other way). Either way, having pursued neither of these alternatives, the SEC placed excessive weight on the capital formation side of the scale and too little on the side of protecting investors.[171]

2. Asset-Backed Securities

Although money market funds—and inadequate regulation of them—caused harm during the financial crisis, that harm can also be viewed as a symptom of the crisis. At its foundation, the crisis arose from the actions of more significant players.[172] Among them were financial firms that sponsored entities that issued asset-backed securities to investors, which promoted these securities and their performance prospects while at the same time betting that the securities would experience negative returns.[173] Such were the conflicts of interest that fueled the crisis.

Asset-backed securities have a different flavor than "normal" equity or debt securities. In the context of equity securities issued by

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171 Subsequent to the financial crisis, the SEC amended its rules to divide money market funds into two categories—retail funds, in which retail investors place their money, and institutional funds, which are repositories of large investors' savings—and to require funds in the latter category to use mark-to-market accounting. *See* Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736, 47736 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274, 279) (adopting the final rule to eliminate the valuation-related exemption that had allowed institutional money market funds to maintain a stable daily net asset value per share and to require those funds "to sell and redeem shares based on the current market-based value of the securities in their underlying portfolios").

172 *See* Miranda Marquit, *Too Big to Fail Banks: Where Are They Now?*, INVESTOPEDIA, https://www.investopedia.com/insights/too-big-fail-banks-where-are-they-now [https://perma.cc/4RZU-H4G3] (Sept. 13, 2022) (listing Goldman Sachs, Morgan Stanley, Bank of America, and other large banks as major actors during the financial crisis).

173 *See What Role Did Securitization Play in the Global Financial Crisis?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/041515/what-role-did-securitization-play-us-subprime-mortgage-crisis.asp [https://perma.cc/WG6J-VJG4] (Aug. 27, 2021) ("Securitization, specifically the packaging of mortgage debt into bond-like financial instruments, was a key driver of the 2007–08 global financial crisis.").

corporations, the issuer is a going concern, managed (presumably) by responsible executives, with oversight by a board of directors.[174] The issuer, in other words, has a stake in the market performance of its securities. Likewise, in the context of debt securities issued by governments, elected officials are responsible for making good on that debt and ensuring that interest payments are made on time.[175] In other words, the "buck stops" with the issuer, and, as one observer has put it, "the value of the transaction is measured in the context of an ongoing enterprise, introducing a longer-term perspective on the transaction."[176]

Asset-backed securities are a different beast because the "issuer" is really nothing other than an entity created solely for the purpose of issuing its securities.[177] The incentive of the issuer's sponsor, which is typically a financial intermediary such as a broker-dealer, to orchestrate a deal to sell asset-backed securities has nothing to do with the long-term performance of the newly-formed issuer's assets.[178] Rather, financial firms sponsor these transactions because of the benefit to them of the transaction itself—specifically, the compensation attached to putting the pieces together.[179] The issuer's assets are debt obligations, which, during the financial crisis, often took the form of poor-quality (subprime) mortgages, and the sponsors' compensation, ultimately, was paid by mortgage originators who did not wish to continue bearing the risk of holding the mortgages.[180] To receive its compensation, a sponsor had only to create the entity and cause it to buy the debt obligations from the originators and issue its securities to investors, who then assumed the risk

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174 *See, e.g.*, Letter from Americans for Financial Reform, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Feb. 13, 2012), https://www.sec.gov/comments/s7-38-11/s73811-37.pdf [https://perma.cc/2FAW-4MPE] [hereinafter Americans for Financial Reform] ("When corporations issue shares, there is a company with (hopefully) responsible managers to make final judgments regarding the underpinnings of an offering.").

175 *See id.* (observing that "when governments offer their debt to the public, elected officials are ultimately responsible for the offering").

176 *Id.*

177 *See* Tarun Sabarwal, *Common Structures of Asset-Backed Securities and Their Risks*, 4 CORP. OWNERSHIP & CONTROL 258, 259 (2006) (observing that, in an asset-backed securities deal "[a] lender (or originator) pools together and sells loans (or other receivables) to a special-purpose entity . . . , which in turn issues several securities backed by a beneficial interest in the receivables on these loans").

178 *See* Americans for Financial Reform, *supra* note 174 (noting that financial institutions that structure asset-backed securities deals "benefit from the transaction, not the long term performance of the assets").

179 *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 148, at 117 ("The business of structuring, selling, and distributing [an asset-backed securities] deal . . . was lucrative for the banks.").

180 *See What Role Did Securitization Play in the Global Financial Crisis?*, *supra* note 173 (observing that mortgage-backed securities fueled the "excessive risk-taking" that led to the financial crisis).

of default (but also the promise of interest payments) on the unwanted debt.[181]

Tomes have been written about the damage caused by the subprime mortgage market, but for present purposes the important aspect is, as noted above, that issuers of asset-backed securities were detached from any functioning, productive enterprise.[182] As a result, no one felt compelled, by either ethics or by fiduciary duties, to look after investors' interests[183]—and, importantly, regulation at the time failed to fill the gap.[184] In 2005, the SEC had adopted Regulation AB to address investor risks associated with asset-backed securities,[185] but the regulation largely required disclosure and did not do much to regulate sponsors' conduct.[186] That the SEC did not go far enough to curb sponsors' abuses became evident three years later when sponsoring firms, having no obligation to investors, took short positions (bets that the debt obligations would default) against the asset-backed securities they had been responsible for creating and promoting.[187] It was a classic conflict of interest akin to a lawyer representing both the plaintiff and the defendant in a dispute.

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181 *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 148, at 125 ("The originate-to-distribute model undermined responsibility and accountability for the long-term viability of mortgages and mortgage-related securities and contributed to the poor quality of mortgage loans.").

182 *See supra* notes 177–81 and accompanying text (noting that the issuers of asset-backed securities are created for that purpose).

183 *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 148, at xxii (observing that financial institutions, in structuring asset-backed securities deals, "knew a significant percentage of the sampled loans did not meet their own underwriting standards or those of the originators" but sold the securities to investors nevertheless).

184 *See* John Carney, *Here's Another SEC Regulation that Helped Cause the Financial Crisis*, CNBC (Apr. 5, 2012, 7:09 PM), https://www.cnbc.com/id/46971868 [https://perma.cc/BZ7Z-YBYH].

185 *See* 17 C.F.R. § 229.1100 (2023); Asset-Backed Securities, 70 Fed. Reg. 1506, 1506 (Jan. 7, 2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 230, 232, 239, 240, 242 245, 249) (adopting rules "to address comprehensively the registration, disclosure and reporting requirements for asset-backed securities").

186 *See* William W. Bratton & Adam J. Levitin, *A Tale of Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets*, 2020 U. ILL L. REV. 47, 69 (2020) (observing that Regulation AB "had required disclosure of only the 'material terms' of the assets, as well as disclosure of the underwriting criteria, the identity of any originator of more than 10% of assets, the selection criteria for the asset pool, and the cut-off date for establishing the asset pool"); FIN. CRISIS INQUIRY COMM'N, *supra* note 148, at 44–45 ("Yet as [asset-backed securities] became increasingly complex, regulators increasingly relied on the banks to police their own risks.").

187 *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, *supra* note 148, at 237 (noting, with reference to Goldman Sachs, that "[i]n addition to selling its subprime securities to customers, the firm took short positions using credit default swaps").

In the aftermath of the financial crisis, Congress closed this gap by enacting section 621 of the Dodd-Frank Act,[188] which prohibits a sponsor of an issuer of asset-backed securities from betting against the performance of the securities for one year.[189] Section 621 was codified at section 27B of the Securities Act, the statute that governs securities issuances by mutual funds, ETFs, and all other public investment entities.[190] The new law, which the SEC has proposed implementing through new rule 127B under the Securities Act, would flatly prohibit conflicts of interest in the issuance of asset-backed securities to prevent sponsors of entities that issue these securities from profiting when the securities lose value—which is the inevitable result of defaults on mortgages in issuers' portfolios.[191]

In this stark example, in the post-crisis era, both Congress and the SEC went considerably beyond the SEC's signature practice of mitigating, without completely eliminating, conflicts of interest. Nevertheless, arguably such a response was necessary, given the severity of the conflict. The broader point is that, although the SEC recognized in adopting Regulation AB that the issuance of asset-backed securities created conflicts for sponsors and, therefore, risks for investors, it failed to recognize that the distinctly passive nature of special purpose issuers created the prospect of particularly harmful conflicts of interests that could not be mitigated sufficiently. Accordingly, in this episode, too, the agency got the balance wrong by overweighting the permissiveness side of the scale, with the result that it placed investors at risk and ultimately also did little, if anything, to promote capital growth.

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188 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1631–32 (2010).

189 *See* Joshua R. Rosenthal, *Burning Down the House or Simply Rolling the Dice: A Comment on Section 621 of the Dodd-Frank Act and Recommendation for Its Implementation*, 17 FORDHAM J. CORP. & FIN. L. 1263, 1263 (2012) (observing that section 621 of the Dodd-Frank Act "modifies the Securities Act . . . to prohibit the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an asset-backed financial product from betting against that very product for one year after the product's initial sale").

190 *See* 15 U.S.C. § 77z-2a.

191 *See* Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60320, 60320 (proposed Sept. 28, 2011) (to be codified at 17 C.F.R. pt. 230) ("Proposed Rule 127B . . . would prohibit certain persons who create and distribute an asset-backed security, including a synthetic asset-backed security, from engaging in transactions, within one year after the date of the first closing of the sale of the asset-backed security, that would involve or result in a material conflict of interest with respect to any investor in the asset-backed security."). It appears that the SEC has not finalized the rule, despite the passage of more than twelve years since it issued the proposed rule.

B. *Overweighted Restrictiveness*

Although securities regulation has gotten the balance between permissiveness and restrictiveness wrong by being too permissive, it has also on occasion erred by being too restrictive. In those cases, its conflict mitigation efforts have gone too far, with the effect of prohibiting conduct that otherwise would be beneficial for the capital markets and for investors. This circumstance has sometimes become completely apparent only when market actors challenge a problematic law or rule, leaving it to the courts determine whether, in fact, regulation has overstepped its boundaries, however those boundaries might be defined. This Section delves into two examples of this phenomenon, both of which are drawn from the private fund context, and both of which involve rules that were, or that will likely prove to be, too restrictive to fully serve securities regulatory objectives. Similar to the examples set forth in Section III.A, these examples relate to different aspects of the subject under discussion, but each shows that managing conflicts of interest is an imprecise science.

1. The Definition of Advisory "Client"

In the late 1990s and early 2000s, privately offered funds, particularly hedge funds, became popular among investors.[192] As their popularity grew, so did the SEC's concerns about them, which stemmed from then-recent hedge fund failures,[193] growing numbers of fraud actions against them, and their so-called "retailization," meaning ordinary investors' increasing exposure to these funds due to funds' relaxation of their investment requirements and the increasing investment in them by pension funds, endowments, and charitable organizations, among other entities.[194] In other words, the SEC identified that hedge fund managers were putting investors at risk by engaging in improper conduct in an effort to spur the success of the funds they managed—a classic conflict of interest.

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192 *See Hedge Funds Are Raising Fees as Investor Interest Increases*, WALL ST. J. (Apr. 30, 2002, 12:01 AM), https://www.wsj.com/articles/SB1020112201466347080 [https://perma.cc/8F5E-FLLX] (noting that, since the late 1990s, "the $500 billion hedge-fund industry has been pulling in more cash than at any time in its history" and that it "attracted $31 billion of new money in 2001, more than three times the 2000 level").

193 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45172, 45174 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (referencing the collapse of the large hedge fund firm, Long Term Capital Management, Inc.).

194 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, 72055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (summarizing some of the SEC's concerns associated with hedge funds).

Based on its concerns, in 2004 the SEC adopted a rule that eliminated an exemption to the requirement that hedge fund managers be registered with and regulated by the SEC as investment advisers under the Advisers Act.[195] Under the registration exemption, an investment adviser could avoid registering with the SEC if, during the previous year, it had fewer than fifteen clients, with each private fund that the adviser managed (rather than its investors) being considered a single client.[196] Under the SEC's new rule, for purposes of the statute's registration exemption, advisers had to count each investor in the private funds they managed as a single client.[197] The effect of this rule was to require most hedge fund managers to register with the SEC.[198]

The SEC's decision to adopt the rule was consistent with its efforts to temper conflicts of interest that could harm investors. In this case, those conflicts stemmed from fund managers' obvious desire to increase fund assets—hence, the loosening of admission requirements, which possibly allowed investments by people who could not tolerate the risk[199]—and to attract investments from entities such as pension funds that similarly provided hedge fund exposure to investors who would not have been permitted to invest in the funds directly.[200] Yet those who challenged the rule countered, among other things, that the rule would place fund managers in the position of serving two principals whose interests may not always be aligned—namely, the fund, on the one hand, and its investors, on the other—hindering their ability to efficiently

195 *See id.* at 72058 (adopting the new rule 203(b)(3)-2 under the Advisers Act, pursuant to which "most hedge fund advisers would have to register with the Commission and would be subject to SEC oversight").

196 *See id.* at 72054 ("The [Advisers] Act exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company.").

197 *See Client Alert: SEC Approves New Rule Requiring the Registration of Investment Advisers to Hedge Funds*, ROPES & GRAY 1 (2004), https://www.ropesgray.com/-/media/files/alerts/2004/12/sec-approves-new-rule-requiring-the-registration-of-investment-advisers-to-hedge-funds.pdf [https://perma.cc/T9VE-7D68] ("The new rule requires that an adviser look through each 'private fund' it advises to the fund's investors for purposes of counting clients.").

198 *See supra* note 32 and accompanying text (noting the effect of the new rule).

199 *See* Jane Bryant Quinn, *The Street's Latest Lure*, NEWSWEEK (May 25, 2003, 8:00 PM), https://www.newsweek.com/streets-latest-lure-137503 [https://perma.cc/H7PJ-DQHC] (noting that "[t]he new breed of [hedge] funds . . . go for smaller fry"—a reference to retail investors); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45172, 45176 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) ("Our staff observed . . . that many hedge funds' minimum investment requirements have decreased over time.").

200 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45176 ("[I]n the last few years, a growing number of public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds.").

pursue their operations.[201] Not surprisingly, opponents sued to have the rule invalidated.[202]

Siding with the plaintiffs, the U.S. Court of Appeals for the D.C. Circuit invalidated the rule on the basis that it went too far.[203] The court's primary contention in reaching its conclusion was that the agency's new definition of "client" was unreasonable.[204] The SEC had maintained that, because the Advisers Act had not defined the term, it was ambiguous,[205] but the court disagreed, noting that Congress's failure to define a word does not mean the word is ambiguous.[206] To the contrary, according to the court, other components of the statute imply that "client" refers to a private fund, rather than its investors[207]—an interpretation the SEC had itself affirmed in its previous rules and releases.[208] To the SEC's point that its definition applied only to the Advisers Act's registration exemption but not elsewhere in the statute, the court responded that a single word cannot mean different things within the same statute.[209]

Although the court's opinion sounds in principles of statutory interpretation, its subtext is that the SEC overstepped its bounds, erring too far on the side of investor protection goals at the expense of capital formation objectives. The opinion is also a concurrence with Congress's and even the SEC's own apparent positions on that score, which are

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201 *Cf.* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72060 (noting arguments by some commenters who opposed the new rule that "registration would somehow inhibit hedge fund advisers' willingness to engage in complex or innovative strategies because they would be second-guessed").

202 *See* Siobhan Hughes, *Hedge Fund Sues to Block Registry of Advisers by SEC*, WALL. ST. J. (Dec. 23, 2004, 12:01 AM), https://www.wsj.com/articles/SB110375524285007637 [https://perma.cc/UKH7-2AYT] (reporting that "[a] New York hedge-fund manager sued federal securities regulators in an effort to block a rule that will force hedge-fund advisers to register with the government for the first time").

203 *See* Goldstein v. SEC, 451 F.3d 873, 883–84 (D.C. Cir. 2006) (holding that the SEC's rule requiring that a hedge fund's investors be counted as clients of the fund's manager for purposes of the Advisers Act's fewer-than-fifteen-clients registration exemption was "arbitrary" and bore "no rational relationship" to the goal it was intended to further).

204 *See id.* at 881, 884 (noting that the SEC's interpretation of "client" as used in the new rule "falls outside the bounds of reasonableness").

205 *See id.* at 878 (noting the SEC's contention that, because the Advisers Act does not define "client," the term is "ambiguous as to a method for counting clients").

206 *See id.* ("If Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose any one of those meanings.").

207 *See id.* at 879–80 (noting other Advisers Act provisions suggesting that Congress intended that a fund, rather than the fund's investors, was the "client" of the fund's manager).

208 *See id.* at 880 (observing that, until the SEC adopted the new rule, its view on the meaning of "client" was that "[i]f the person or entity controlling [a] fund is not an 'investment adviser' to each individual investor, then *a fortiori* each investor cannot be a 'client' of that person or entity").

209 *See id.* at 882 ("We ordinarily presume that the same words used in different parts of a statute have the same meaning.").

evident from both bodies' articulated understandings of what the word "client" means.[210] This is not to discount the concern that private fund investments placed ordinary investors at risk, but it is a reflection of the circumstance, throughout the securities markets, that achieving regulatory goals in those markets involves a careful balance between mitigating conflicts and protecting investors, on the one hand, and promoting investment and capital growth, on the other.

2. Contractual Arrangements with Investors

The SEC's concerns regarding risks posed by hedge funds, as well as private equity funds, has persisted in the years following the D.C. Circuit Court's decision.[211] One might have expected these concerns to abate to some extent after the Dodd-Frank Act imposed further regulation on private funds, in the form of new annual reporting requirements, among other things.[212] Yet Dodd-Frank's requirements (as implemented by the SEC in rules adopted under the statute) did not affect a particular point of ire for the SEC, namely contractual provisions giving favored investors special investment terms, such as preferential information or withdrawal rights.

The SEC's worry regarding preferential investment terms—documented in agreements called side letters[213]—was that those terms might harm a fund's non-preferred investors.[214] Side letters granting preferential information rights or preferential redemption rights have

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210 *See id.* at 878–80 (discussing how courts, Congress, and the SEC historically have understood the term "client" as used in the Advisers Act).

211 *See Securities Litigation Alert: Private Funds Remain a Top Priority for the SEC in 2022: A Review of Recent Cases and Their Implications for Private Fund Managers*, AKIN GUMP 1 (Oct. 26, 2022), https://www.akingump.com/a/web/h1Ri1dfbZ59LEwJy92AT7k/4uv3nF/securities-litigation-alert.pdf [https://perma.cc/G46N-MHEK] ("Late last year, [SEC] Chair Gary Gensler warned private fund managers that they should be prepared for increased regulatory scrutiny.").

212 *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act, (June 22, 2011), https://www.sec.gov/news/press/2011/2011-133.htm [https://perma.cc/4ZXH-N2Y5] (detailing reporting and other requirements imposed on private funds by the rules the SEC adopted pursuant to the Dodd-Frank Act's mandates).

213 *See* Glenn Kennedy, *The Use of Side Letters in Hedge Funds*, HEDGE FUND J., Apr. 2005, https://thehedgefundjournal.com/the-use-of-side-letters-in-hedge-funds [https://perma.cc/L8Q5-BDA5] (defining "side letter" as an agreement between a private fund or its manager and an investor that grants the investor special rights and entitlements).

214 *See Private Fund Side Letters: Common Terms, Themes and Practical Considerations*, DECHERT LLP (Oct. 28, 2018) [hereinafter *Private Fund Side Letters*], https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html [https://perma.cc/33VN-ATYM] (observing that, in the SEC's view, "there is concern about an investor being given preferential treatment in a side letter that may have a negative impact on other investors, such as preferred liquidity and information rights").

historically been the SEC's primary focus, although these agreements might also contain a variety of other, less worrisome terms.[215] Importantly, the agency's concerns relating to information and redemption rights are closely related, as both serve to permit preferred investors to redeem their interests in a fund upon learning of negative developments in the fund's portfolio, while other investors are deprived of that opportunity, potentially to their detriment.[216] For example, an investor in a fund with quarterly redemption rights, but who has negotiated for monthly redemption rights, may "exit" the fund relatively quickly in the event of problematic news about the fund's outlook, a right that is supported by the investor's right to receive information from the manager more frequently, or in a more detailed format, than what other investors are entitled to receive.

To address this ongoing concern, in 2023 the SEC adopted rules that would sharply curtail managers' ability to grant certain investors preferential information and redemption rights.[217] More specifically, the rules prohibit a manager from providing special information and redemption rights to an investor to the extent the manager reasonably

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215 *See id.* Examples of some other common side letter terms include ones granting preferential fee terms, transfer rights, or the right to in-kind redemptions.

216 *See* Susan Ferris Wyderko, Dir., Off. of Investor Educ. & Assistance U.S. Sec. & Exch. Comm'n, Testimony Concerning Hedge Funds (May 16, 2006) https://www.sec.gov/news/testimony/ts051606sfw.htm [https://perma.cc/57UV-7LVJ] (listing side letters "that give certain investors liquidity preferences or provide them with more access to portfolio information" as "chief among" types of side letters that "are more troubling because they may involve material conflicts of interest that can harm the interests of other investors").

217 *See* Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews, Adv. Act Rel. No. IA-6383 at 261–286 (Aug. 23, 2023) [hereinafter Final Rule Release]. At the same time that the SEC proposed the new rules, it also proposed a rule that would curtail provisions often contained in funds' governing documents giving managers and their affiliates rights to be indemnified out of fund assets, except under circumstances evidencing particularly egregious conduct. *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (Mar. 24, 2022) (to be codified at 17 C.F.R. pt. 275). Such provisions are concerning to the agency because they permit managers to be indemnified out of a fund's assets for losses they incur in connection with legal proceedings brought against them involving their management of the fund, even if the conduct at issue in the proceedings was wrongful in some way. *See Legal Update: SEC Publishes Final Interpretation of Investment Adviser Standard of Conduct*, MAYER BROWN 4–5 (June 14, 2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/06/sec-publishes-final-interpretation-of-investment-adviser-standard-of-conduct_v2.pdf [https://perma.cc/H4K4-QTLZ] (describing the SEC's concerns relating to limitations of liability contained in hedge fund documents). Because fund investors beneficially own fund assets, indemnification provisions effectively require investors to make managers whole even though the managers' conduct arguably harmed them in some way. *See id.* The SEC did not adopt this rule, however, on the basis that "much of the activity that it would have prohibited is already prohibited by the Federal fiduciary duty and antifraud provisions." Final Rule Release at 26.

expects those rights to have a material adverse effect on other investors.[218] They also require that the manager disclose the specifics of any other side letter terms to all non-preferred investors,[219] a requirement that supplants the historical practice of managers' giving investors only a general description of the preferential terms they have granted.[220]

These rules once again embody the agency's attempt to balance capital growth with investor protection. Managers have a conflict in acceding to special terms proposed by large investors because of their interest in securing those investors' capital.[221] Yet recognizing that these terms can harm investors, the SEC historically has limited them informally, through its periodic regulatory examinations of managers under its oversight and though the regulatory guidance that it has issued from time to time.[222]

The SEC's new rules, however, upend the agency's previous approaches and, indeed, also upend its traditional respect for private contracts between managers and investors. Given that the rules are so new, it remains a question as to whether courts will regard such an abrogation of private contracting rights as overreaching, a misstep that places too much weight on the investor-protection side of the scale and too little on the capital-growth side. Because the rules are poised both to deter at least some managers from continuing operations—or, at least, continuing operations in the same way as they had prior to the rules' adoption—and to deter some investors from allocating assets to private funds, including ones that might be the most beneficial for them, judicial intervention may be in order.

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218 *See* Final Rule Release, *supra* note 217, at 26 (adopting a rule "that prohibits advisers from providing preferential treatment with respect to redemption rights and portfolio holdings or exposure information, in each instance, that the adviser reasonably expects would have a material, negative effect on other investors, and requires disclosure of all other types of preferential treatment").

219 *See id.* at 290 (adopting a rule prohibiting other preferential terms unless the adviser provided certain written disclosures to prospective and current investors).

220 *See id.* at 31 (expressing concern "that an adviser's current sales practices do not provide all investors with sufficient detail regarding preferential terms granted to other investors").

221 *See Understanding "Side Letters" When Raising Capital*, TREMBLY LAW FIRM, https://tremblylaw.com/understanding-side-letters-raising-money-capital [https://perma.cc/AG4E-BBTA] ("[Side letters] create a conflict of interest for the fund manager because they will be responsible for stewarding the entire fund for all investors, but also have to honor their obligations with respect to the various side letters with individual investors.").

222 *See, e.g.*, *Private Fund Side Letters*, *supra* note 214 ("The SEC staff on examination has been known to review side letters to test whether they are being adhered to and whether proper disclosure was made.").

IV. ENSURING THE RIGHT BALANCE

This Article seeks to show that the securities realm is characterized by conflicts of interest that, when mitigated, can further the interests of both investors and the capital markets. This circumstance creates special challenges for regulators—the SEC, in particular—because the project of mitigating, but not completely eliminating, conflicts of interest requires that the agency carefully balance the securities laws' goal of protecting investors with their goal of promoting capital formation.[223] Specifically, as the previous Part discusses, the regulatory project may counter its own purpose when it gets the balance wrong with regard to a particular rule, whether because the rule provides too wide a berth for financial firms to act on conflicts of interest—that is, the rule is too permissive[224]—or because it is too constraining, unduly limiting conflicts that could be harnessed in furtherance of regulatory goals.[225] In these cases, when the balance is skewed in one direction or the other, either investors are inappropriately placed in harm's way, or capital formation objectives are unreasonably hindered.

Thus, the question arises as to why these regulatory imbalances have occurred. Although one cannot speculate on the SEC's motivations for taking any particular regulatory approach, one theory, in particular, bears mentioning: its focus is not at the correct analytical level to be able to achieve the needed balance between investor protection and capital growth. This deficiency appears in different ways, depending on whether the concern is that the particular rule at issue is too permissive or whether the concern is that the rule is too restrictive. A component of this theory is that, in relevant instances, the agency fails to conduct sufficient due diligence or to pay sufficient attention to what has come before, whether in terms of previous episodes of rulemaking or in terms of its extensive experience working with financial firms.

To unpack these notions, it is important to appreciate that effective, well-balanced rulemaking—by any regulatory body—begins with the regulator's identification of a problem and, more critically, its collecting all relevant facts and information about the subject matter at issue.[226] That

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223 *See supra* notes 61–68 and accompanying text (describing the balancing act that the SEC must perform when it formulates new rules).

224 *See supra* Section III.A (providing examples of the SEC's rulemaking where the rules were too permissive of conflicts of interest).

225 *See supra* Section III.B (providing examples of the SEC's rulemaking where the rules were (or promise to be) too constraining of financial firms' activities).

226 *See* OFF. OF THE FED. REG., A GUIDE TO THE RULEMAKING PROCESS 3 (2011), https://www.federalregister.gov/uploads/2011/01/the_rulemaking_process.pdf [https://perma.cc/8THH-2XAG] (noting that, "before issuing a proposed rule," regulatory agencies "gather

means that the regulator must have a deep and comprehensive understanding of the context in which it proposes to position a new rule, as well as the impact that the rule may have on those who are subject to it and those who, like investors in the securities realm, will feel the effects of it.[227] It is this deep appreciation and understanding of the subject matter at hand that will enable the regulator to place its focus at the "correct level"—that is, to situate its drafting in the space between too permissive and too restrictive.

These ideas play out particularly starkly in the context of rulemaking in which the SEC erred on the side of permissiveness, to the detriment of investors.[228] In the case of the accounting rule the agency adopted that permitted money market funds to market themselves to investors as bank account equivalents,[229] the facts themselves suggest a situation in which the SEC proceeded to acquiesce to these funds' requests for the rule without having adequately considered the risks associated with doing so.[230] Yet the risk that a fund's valuation might at some point dip below the set threshold for having to report the actual value of its securities—as opposed to reporting the standard one dollar per share—should have been part of its analysis. And, indeed, that factor arguably would have been part of the analysis had the agency considered previous episodes in which it seemed to consider as "safe" certain securities that ultimately revealed themselves to be quite risky. A particularly prominent example in this regard is the SEC's granting Enron permission to rely on mark-to-market accounting to value its energy contracts, notwithstanding that there was no public market for the securities on which such valuations could be based.[231]

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information through unstructured processes and informal conversations with people and organizations interested in the issues").

227 This process is aided by the fact that agencies first issue rules in proposal form and solicit comments from the public. *See id.* at 4 (noting that "proposed rules must be published in the *Federal Register* to notify the public and to give them an opportunity to submit comments" and that the comments received, along with the proposed rule itself, serve as the "basis of the final rule").

228 *See supra* Section III.A (providing examples of the SEC's rulemaking where the rules were too permissive of conflicts of interest).

229 *See supra* notes 158–65 and accompanying text (describing the accounting rule and its purpose).

230 *See supra* notes 166–70 and accompanying text (explaining that a large money market fund "broke the buck" during the 2007–09 financial crisis).

231 *See* Jonathan Weil & John Wilke, *Systemic Failure by SEC Is Seen in Enron Debacle*, WALL ST. J. (Oct. 7, 2002, 3:22 PM), https://www.wsj.com/articles/SB1033944629262271233 [https://perma.cc/QG4H-Y76V] (reporting that, the SEC "as far back as 1992 granted Enron permission to use easily manipulated 'mark-to-market' accounting to record the values of its energy contracts, even in instances where no public markets existed from which to obtain data about such contracts' fair market values" but "never followed up to ensure that Enron was applying the method appropriately").

In the case of the SEC's rulemaking to regulate asset-backed securities, which created an ideal stage for sponsors of issuing entities to act on the conflicts of interests associated with these securities to investors' detriment,[232] the deficiency in the rulemaking process was somewhat different. In particular, the circumstances indicate that the SEC did not sufficiently take into account the nature of asset-backed securities, as compared with securities issued by companies that sell goods or services.[233] As noted in Part III, the entities that issue asset-backed securities are really nothing more than convenience mechanisms that allow the lenders and other intermediaries that create them to efficiently sell the debt obligations they hold to third parties.[234] One might at first think this business model is similar to that of a mutual fund or hedge fund—or really most public and private funds that sell equity (as opposed to debt) securities—except that, in the case of public and private funds, fund managers are responsible for ensuring that investors are not harmed by conflicts of interest.[235] After all, these firms are fiduciaries to the funds they manage, with duties to further the funds' best interests and, indirectly, the best interests of the funds' investors.[236] In the case of the entity that a sponsor creates to issue asset-backed securities, once the sponsor causes the entity to issue its securities, the sponsor has no further role in what happens to the entity or its investors.[237]

It may be that the SEC did not completely take account of the nature of asset-backed securities because it did not adequately understand important aspects of them. Although that suggestion may seem surprising, it might be explained by the simple fact that regulators are not omniscient and that, like any government agency—or, indeed, any employer—some employees are newer than others, and some have more knowledge and experience than others.[238] So-called regulatory capture

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232 *See supra* notes 172–91 and accompanying text (describing asset-backed securities and the conflicted actions of sponsors of those securities during the 2007–09 financial crisis).

233 *See supra* notes 182–84 and accompanying text (detailing how offerings of asset-backed securities are different from offerings of securities issued by, for example, companies that sell products or services).

234 *See supra* notes 174–81 and accompanying text (describing the nature of asset-backed securities).

235 *See* Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1356 (2017) ("Because of the trust investors bestow in them, mutual fund managers are fiduciaries of the funds they manage and, by extension, their shareholders.").

236 *See id.*

237 *See supra* notes 177–81 and accompanying text (describing sponsors' roles in asset-backed securities deals).

238 *See* Stefanie Haeffele, Jordan K. Lofthouse & Agustin Forzani, *The Perils of Regulating COVID-19: Insights from Kirznerian Entrepreneurship and Ostromian Polycentricity*, ECON. GOVERNANCE, Nov. 1, 2022, at 15, https://link.springer.com/content/pdf/10.1007/s10101-022-

may be another possible explanation.[239] Whatever was the basis of the SEC's failure, a more troublesome aspect is the process flaw whereby the SEC did not fully appreciate the risks that investors were undertaking, nor did it collect additional information to fill that gap.[240] In other words, like anyone tasked with making a decision, it is important to know what one does not (or might not) know.

These instances of excessive rulemaking permissiveness are tied to the notion presented above regarding focusing on the correct analytical level. Both in the SEC's rulemaking on accounting rules for money market funds and in its laudable, but ultimately inadequate, rulemaking to require issuers of asset-backed securities to provide disclosure to investors, the SEC seems to have relied on an unduly bird's-eye view of the issue at hand and what it needed to do in terms of its rulemaking. If it had instead honed in on the concerns that have arisen in the past regarding accounting rule changes,[241] it might have hesitated before permitting money market funds to use a constant valuation that might have readily led investors to believe that a money market fund investment was as safe and secure as a bank account. Meanwhile, if it had acted on the principle that it may need more information in adopting regulation covering asset-backed securities,[242] it would likely have developed additional concerns in an extended due diligence process.

As for rules that have reflected undue rulemaking restrictiveness, including the ill-fated hedge fund registration rule and the controversial impending regulation of provisions in contracts between privately-offered funds and their investors,[243] a different factor seems to be at play.

00284-z.pdf?pdf=button [https://perma.cc/YRE2-9AVZ] ("Experimentation and mutual learning are important for creating regulations because policymakers are not omniscient."); Letter from Paul N. Roth, Schulte Roth & Zabel, LLP, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 9 (Sept. 15, 2004), https://www.sec.gov/rules/proposed/s73004/schulte091504.pdf [https://perma.cc/R8F6-PFEA] ("[T]he average tenure of the [SEC] inspection staff currently is approximately 1.9 years.").

239 *See* Will Kenton, *Regulatory Capture Definition with Examples*, INVESTOPEDIA, https://www.investopedia.com/terms/r/regulatory-capture.asp [https://perma.cc/5WFG-24KA] (Mar. 1, 2021) ("Regulatory capture is an economic theory that says regulatory agencies may come to be dominated by the industries or interests they are charged with regulating.").

240 That this failure may occur is suggested by the fact that regulatory agencies seek public comment on proposed rules. *See* Reporting Threshold for Institutional Investment Managers, 85 Fed. Reg. 46016, 46024–30 (July 31, 2020) (to be codified at 17 C.F.R. pts. 240, 249). If, as to any proposed rule, some relevant constituencies do not provide comments, then the agency proposing the rule will lack relevant information when drafting the final version.

241 *See supra* note 231 and accompanying text (describing the concerns that arose in the aftermath of Enron's bankruptcy regarding the SEC's leniency in allowing Enron to use mark-to-market accounting).

242 *See supra* notes 232–37 and accompanying text (explaining why the SEC needed additional information in formulating pre–financial crisis rules governing asset-backed securities).

243 *See supra* section III.B (providing examples of the SEC's rulemaking where the rules were (or promise to be) too constraining of financial firms' activities).

Recall that these rules are part of the SEC's efforts over the past two decades to further regulate hedge funds and, in some cases, also private equity funds.[244] This rulemaking endeavor has been the product of the agency's perception of risks to investors and, to some extent, its concerns relating to episodes of financial firm misconduct.[245] And it may be that greater regulation of private funds, which, by definition, are exempt from the regulation to which public funds are subject, has been warranted, and, if so, the agency is merely carrying out its role of protecting investors.[246] But the particular measures the SEC has pursued in multiple cases seem woefully off the mark, in terms of hitting the correct balance between the goals of protecting investors, on the one hand, and promoting capital formation, on the other.[247]

As is the case with rules that have been too permissive, the problem with too-restrictive rules—that is, rules that excessively tip the scale toward investor protection to the detriment of capital growth—lies with the SEC's level of focus. However, instead of evaluating its concerns from too high a level and limiting its analysis to the broad strokes of financial firms' demands, in the case of too-restrictive rules, the agency's focus is too granular, centering in on familiar regulatory tools to the exclusion of a broader view of what tools might be more effective in addressing the problems identified. In addition, whereas additional information gathering and diligence might help avoid too-permissive rulemaking, the SEC's greater reliance on its own extensive experience regulating financial firms might help preclude too-restrictive rulemaking.

To begin with the SEC rule that required most hedge fund managers to become registered as investment advisers,[248] the primary concerns that led the agency to adopt the rule related to its perception of increasing fraud in the hedge fund sphere; a trend toward retailization, whereby even non-sophisticated investors were gaining financial exposure to hedge

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244 *See supra* notes 192–94, 213 and accompanying text (describing the SEC's longstanding concerns about private funds).

245 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (describing the concerns that led the SEC to adopt the rule requiring most hedge fund managers to become registered with the SEC); MAYER BROWN, *supra* note 217 (describing the concerns that led the SEC to propose the rule that would limit the indemnification terms in private fund contracts).

246 *See What We Do*, *supra* note 15 ("We protect investors by vigorously enforcing the federal securities laws to hold wrongdoers accountable and deter future misconduct.").

247 *See, e.g.*, *supra* notes 204–10, 222–23 and accompanying text (describing problems the D.C. Circuit identified with regard to the SEC's rule requiring hedge fund managers to become registered with the SEC).

248 *See supra* notes 192–98 and accompanying text (describing the rule and the SEC's reasoning behind it).

funds; and the dearth of census data about hedge fund managers.[249] To address these concerns, the SEC seemingly rushed to require registration,[250] even though alternatives might have achieved similar results with less burden on fund managers,[251] there was scant evidence of the problems that led the agency to propose the rule,[252] and it was questionable whether the agency's chosen alternative would actually achieve the results it desired.[253] These factors, of course, are unrelated to the D.C. Circuit's reasoning in invalidating the rule, which largely relied on statutory interpretation,[254] but because that invalidation was founded on Congress's intent regarding the regulation of investment advisers, including private fund managers, it supports the conclusion that the SEC chose the wrong tool to correct the problems it had identified.

As an initial matter, to the extent there has been rampant fraud in the hedge fund industry, the SEC's requiring widespread registration of fund managers—even if the rule the agency adopted to do that were permissible under the Advisers Act—would not have addressed the problem.[255] Registration is essentially an information-gathering tool, but it does very little to increase the SEC's vigilance over the activities of the firms that are registered, be they fraudulent or not.[256] Although the SEC acknowledged this point,[257] it emphasized that the deterrence function of registration would be helpful in reducing instances of fraud by fund

249 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054 (summarizing some of the SEC's concerns associated with hedge funds).

250 *See supra* notes 192–94 and accompanying text (describing the basis of the rule).

251 *See* Letter from Managed Funds Ass'n, to the U.S. Sec. & Exch. Comm'n 3–4 (Oct. 18, 2004), https://www.sec.gov/rules/proposed/s73004/mfa101804.pdf [https://perma.cc/L4N3-PG4J] [hereinafter M.F.A. Letter to SEC] (listing possible alternative approaches the SEC could have pursued to achieve its objectives).

252 *See id.* at 2 ("The SEC found no evidence of the 'retailization' of the industry.").

253 *See id.* (observing that "[a]ll investment advisers are already subject to the anti-fraud and anti-manipulation provisions of the Advisers Act" and that "[t]here is [already] a comprehensive body of Federal regulations and required filings applicable to hedge funds and hedge fund managers"); Roth, *supra* note 238, at 8 ("We are concerned that the Commission overstates the likelihood that examinations deter fraud.").

254 *See supra* notes 203–09 (describing the basis of the D.C. Circuit's invalidation of the rule).

255 *See, e.g.*, Letter from Rebecca McEnally, Vice Pres., CFA Inst., to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. 2 (Sept. 30, 2004) ("We are not convinced that registration alone will prevent the possible ethical violations and potential meltdowns that many fear in this sector.").

256 *See* Roth, *supra* note 238, at 9 ("Commission officials have stated that even with additional staffing for hedge fund adviser examinations, inspections of most advisers will occur only once every four years.").

257 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, 72061 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) ("We are not suggesting that registration under the Advisers Act will result in our eliminating, or even identifying, every fraud.").

managers.[258] That suggestion, however, is belied by the circumstance that the agency consistently has not had sufficient resources to conduct regular compliance examinations of all registrants.[259] Beyond that, regarding the agency's concern about the increasing numbers of retail investors gaining exposure to hedge funds—assuming that was actually occurring—there were alternative, more effective tools the SEC could have deployed.[260] Among other things, given its embrace of registration requirements as a regulatory measure, it might have required only managers of private funds—hedge fund or otherwise—that accept retail investor capital to become registered (again, assuming it did so in a statutorily permissible way).[261] On this score, there would presumably be a deterrent effect, given the costs associated with registration and the ease with which a fund manager could avoid it.[262]

The point is that, in the case of the registration rule, the SEC's analytical vision was too tunneled, too low to the ground. This problem might also be identified in the rules the agency recently adopted that would prohibit certain provisions in contracts between private fund managers and their investors—namely, preferred fee and information rights in a manager's side agreement with an investor.[263] In each case, the SEC relied on a tried-and-true regulatory tool—manager registration, in the first case, versus complete prohibition, in the second—without expanding its scope to consider what other options might be available.

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258 *See id.* ("The prospect of a Commission examination . . . increases the risk of getting caught, and thus will deter wrongdoers.").

259 *See* M.F.A. Letter to SEC, *supra* note 251, at 2 ("Currently, the SEC has only 495 employees responsible for examining 8,000 mutual funds with about 91 million investors, managing $7 trillion.").

260 *See* Roth, *supra* note 238, at 7 ("We do not support the conclusion that registration of hedge fund advisers is an optimal means of addressing the fact that greater numbers of people today are qualified to invest in hedge funds.").

261 *See* Letter from Richard H. Rowe, Proskauer Rose LLP, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 3 (Aug. 31, 2004), https://www.sec.gov/rules/proposed/s73004/s73004-38.pdf [https://perma.cc/G9TR-Q6B2] ("Most of the SEC's goals could be met if it exempted from registration investment advisers that accept capital only from truly wealthy and sophisticated investors."); Letter from Richard G. Whiting, Exec. Dir., Fin. Servs. Roundtable, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 3 (Sept. 15, 2004), https://www.sec.gov/rules/proposed/s73004/rmwhiting091504.pdf [https://perma.cc/VW5G-WKDQ] ("The Roundtable also suggests that the Commission draw a distinction for advisers to funds whose investors consist only of qualified purchasers.").

262 *See* Letter from Managed Funds Ass'n, to the U.S. Sec. & Exch. Comm'n (Oct. 22, 2004), https://www.sec.gov/rules/proposed/s73004/mfa102204.pdf [https://perma.cc/RT4Z-2E4B] (expressing the view that the costs of registering as an investment adviser and ongoing compliance with regulatory requirements "are substantial and increasing and will in some form be passed on to, and affect returns realized by, hedge fund investors").

263 *See supra* notes 217–26 and accompanying text (discussing the proposed rules).

This approach is particularly problematic with regard to the rules governing contractual provisions because it sidesteps the characteristic securities regulatory method that is the subject of this Article: the balancing act that permits conflicts of interest while mitigating their adverse effects on investors. Indeed, that the SEC departed from its usual modus operandi with regard to its subject matter in this case presents greater concern than if it had done so in other contexts. In particular, agreements between private parties are typically just that—private and, as many believe, necessarily beyond the reach of the state.[264]

To be sure, the SEC's new rulemaking does not represent the first time that the SEC has dictated the content of contractual provisions,[265] but it is arguably the first time that, rather than take an intermediate approach that might mitigate its concerns, it jumped immediately to outright prohibition. The tool of prohibition is simple, and it is easy; it always exists as a regulatory option. But had the SEC focused its analysis at a higher level to allow itself to view the other available regulatory options, it might have settled on something that tempered one-sided indemnification clauses without eliminating them or that set forth standards for side letters, without requiring regulated parties to second-guess whether a provision rises (or sinks) to the point of being impermissible.

CONCLUSION

In the securities realm, conflicts of interest not only are everywhere, they also create substantial risks for investors. The source of the risks associated with these conflicts is not difficult to identify because, in the securities markets, perhaps more than in any other context, money—significant amounts of it—are at stake. In the securities markets, therefore, livelihoods are at stake. To be sure, there is often much at stake in any other business context in which conflicts of interest may arise. But, in the securities realm, the line between acting on conflicts of interest and achieving financial gain is arguably straighter and shorter than it is in other realms. As a result, the line between acting on conflicts of interest

264 *See Contract*, CORNELL L. SCH.: LEGAL INFO. INST., https://www.law.cornell.edu/wex/contract# [https://perma.cc/49EY-ZNXH] (observing that contracts are private law and that "[t]his private law may override many of the rules otherwise established by state law").

265 *See, e.g.*, 17 C.F.R. § 275.206(4)-2(a)(4) (2023) (specifying that an investment adviser deemed to have "custody" of client assets must engage an independent public accountant to examine those assets annually, pursuant to an agreement requiring the first examination to occur within no later than six months after the adviser first assumed custody of the assets).

and causing harm to advisory clients, fund investors, and brokerage customers is arguably also straighter and shorter.

Perhaps because of this, when it comes to regulating investment advisers and public and private funds, fiduciary duties have never been deemed sufficient. The laws and rules governing financial firms are numerous and complicated and aim to temper the effects of conflicts of interest—that is, to reduce, and hopefully eliminate, the damage that conflicts of interest might cause. However, the goal of these laws and rules, which fall under the umbrella of securities regulation, has never been to eliminate conflicts of interest altogether. Although that approach may not at first be intuitive, its logic becomes apparent when one considers that some of the activities of financial firms that might be regarded as conflicted may further the interests of the capital markets and, ultimately, investors transacting in those markets.

And that is the challenge of regulation—or, more specifically, the challenge of the SEC in its ongoing project of adopting and amending rules to implement, in particular, the Investment Company Act and the Advisers Act. More specifically, the SEC's regulatory task is, for each rule, to find a balance between permitting potentially harmful conflicts, on the one hand, and limiting them so as not to allow them to harm investors, on the other. As this Article has shown, in many cases the SEC has gotten the balance right. Yet in some cases, it has erred by embracing rules that allow too much permissiveness for regulated entities, while, in other cases, it has erred by unduly restricting productive (but conflicted) activities that would otherwise further capital growth objectives while leaving investors unharmed. Overweighting permissiveness is arguably the worse of the two regulatory failings because, in those situations, investors directly bear the consequences.[266]

Nevertheless, bringing a critical focus to this aspect of securities regulation is yet another way that the rulemaking process may, over time, come to have fewer foot faults. Of course, neither financial firms nor investors nor commentators are the ones who will make the changes to the regulatory process that may be in order. That job falls to the SEC. But to the extent that the insights in this Article and in follow-on

266 The examples presented in Section III.A largely bear this out, whereas, in the examples discussed in Section III.B, in which the SEC's rules or proposed rules promised to unduly restrain fund managers, the risk of investor harm was only indirect. That is, in circumstances in which the SEC's rules are unduly constraining, the direct risks concern possible losses of efficiency and increased barriers to innovation and capital growth. *See* M.F.A. Letter to SEC, *supra* note 251, at 2 (noting that the rule requiring hedge fund managers to become SEC-registered would harm capital markets "by impeding entrepreneurial efforts that characterize the industry's diversity and innovation").

commentaries influence that process for the better, then so too will investors and the capital markets be better off.