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Are Retail Investors Better off Today?

Barbara Black

ARTICLES

ARE RETAIL INVESTORS BETTER OFF TODAY?

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In recent years retail investors—individual investors who, compared to institutional investors or wealthy individual investors, have modest portfolios, a lesser degree of investment acumen and less individualized attention from professional advisors[1]—have had reason to doubt the honesty and fairness of the securities markets and securities professionals. By spring 2002, the collapse of corporate giants like Enron and Worldcom and the bursting of the dotcom bubble revealed to these investors what more knowledgeable investors had long known: stock recommendations by sell-side analysts[2] were frequently not the unbiased product of careful research, but instead were written to promote securities firms' investment banking activities. In fall 2003, investors in mutual funds, the egalitarian investment product that was supposed to provide retail investors with the opportunity to achieve a diversified portfolio and professional management at low cost, were shaken by revelations of market timing[3] and late trading[4] abuses. To their dismay, investors learned that certain preferred investors received special trading privileges to the detriment of other fund investors.[5]

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1. As used in this paper, "retail investor" means any natural person who owns stock by any means, direct or indirect, and does not qualify as an "accredited investor" under Rule 501(a) of Regulation D. 17 C.F.R. § 230.501(a) (2007).

2. Sell-side analysts work for large securities firms that typically have both brokerage customers and underwriting departments. *See* SEC, Investor Alert: Analyzing Analyst Recommendations, http://www.sec.gov/investor/pubs/analysts.htm (last visited Feb. 5, 2008).

3. Market timing is described as "mutual fund insiders' subtle use of the inherent structures of mutual funds and inside information to selectively provide benefits to favored participants at the expense of less-favored participants." Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235, 236 (2006).

4. Late trading "involves purchasing mutual fund shares at the 4:00 p.m. price after the market closes." *E.g.*, Press Release, Office of the N.Y. State Attorney Gen., State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

5. *Id.*; *see also* In re Theodore Charles Sihpol, III, 81 SEC Docket 177 (Sept. 16, 2003) (order instituting proceedings) [hereinafter In re Sihpol]. The proceeding was settled two years later. In re Theodore Charles Sihpol, III, Order Making Findings and Imposing Remedial Sanctions and a

Not surprisingly, investors' confidence in the securities industry plummeted along with the value of their portfolios. Investors identified "dishonesty" as the industry's main problem.[6]

Congress and regulators responded to these scandals by asserting the need for reforms to restore the confidence of the retail investor.[7] In the wake of both the market timing and late trading scandals, Congress held hearings and proposed legislation, and regulators brought numerous enforcement actions, adopted new regulations, and committed to renewed vigilance over the industry, all in the name of restoring investor confidence. This paper examines these reform efforts and assesses whether they have improved the environment for retail investors.

We begin by revisiting a basic question: why is investor confidence an important policy? The traditional answer is that strong capital markets require investor confidence, because otherwise investors will flee the market.[8] Indeed, the Securities and Exchange Commission (SEC) uses

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Cease-and-Desist Order, Securities Act Release No. 8624 (Oct. 12, 2005), *available at* http://www.sec.gov/litigation/admin/33-8624.pdf.

6. HARRIS INTERACTIVE, SEC. INDUS. ASS'N, ANNUAL SIA INVESTOR SURVEY: INVESTORS' ATTITUDES TOWARD THE SECURITIES INDUSTRY 2002, at 7–8 (2002) (on file with author); HARRIS INTERACTIVE, SEC. INDUS. ASS'N, ANNUAL SIA INVESTOR SURVEY: INVESTORS' ATTITUDES TOWARD THE SECURITIES INDUSTRY 2003, at 6, 14 (2003) (on file with author). In 2004, investors expressed mixed feelings; although six out of ten investors stated they were "confident" in the reforms, a majority of investors continued to believe that greed was a "big problem." WIRTHLIN WORLDWIDE, SEC. INDUS. ASS'N, ANNUAL SIA INVESTOR SURVEY: ATTITUDES TOWARD THE SECURITIES INDUSTRY 6–7 (2004), *available at* http://www.sifma.org/research/surveys/pdf/2004investorsurvey.pdf. The Securities Industry and Financial Markets Association (SIFMA), the successor to the industry trade association, Securities Industry Association (SIA), has not conducted an annual survey since 2004. The Investment Company Institute (ICI) conducts an annual tracking survey on mutual fund ownership and reports that the mutual fund favorability rating declined to a low of 71% in 2003 but has steadily risen since then, to 77% in 2006. *Shareholder Sentiment About the Mutual Fund Industry, 2006*, ICI RES. FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Dec. 2006, at 1, *available at* http://www.ici.org/shareholders/us/fm-v15n8.pdf [hereinafter *ICI Survey*].

7. *See infra* notes 39–42 and accompanying text; *Mutual Fund Industry Practices and Their Effects on Individual Investors: Hearing before the Subcomm. on Capital Markets, Insurance and Gov't Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 1 (2003) (statement of Rep. Richard Baker, Chairman, Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.) (stating that the hearing was "a next step in the committee's continuing efforts to protect America's investors and help in the restoration of public confidence in the capital markets"). In late 2003, SEC Commissioner Harvey Goldschmid stated:

> [T]he mutual fund industry cannot continue to function as it has in the past. Trust, honesty and fair dealing must be restored. Before average investors grow more disillusioned, and before we as a nation pay a heavy long-term price, we must act now to bring about a time of healing and reform.

Harvey J. Goldschmid, Comm'r, SEC, Speech at the ICI 2003 Securities Law Developments Conference: Mutual Fund Regulation: A Time for Healing and Reform (Dec. 4, 2003), *available at* http://www.sec.gov/news/speech/spch120403hjg.htm.

8. *See, e.g.*, H.R. REP. NO. 97-626, at 3 (1982) (stating that a purpose of securities law amendments was to restore investor confidence "in order to attract needed funds back into the U.S. capital markets"); SEC v. Zandford, 535 U.S. 813, 819 (2002) (stating that among the

investors' investment in mutual funds as a measure of investor confidence.[9] Since the scandals, investors have returned to the markets,[10] so we might view their return as a sign of regained trust. However, this traditional explanation for the importance of investor confidence has now lost much of its force. Today's reality is that investing is no more an optional activity for most American adults than is working. American workers are increasingly expected to assume responsibility for their financial security in retirement, and thus have no choice but to invest in the markets.[11]

With the diminished economic justification for investor confidence, it is important to consider other explanations for its importance. One reason is political. If investors are required to participate in markets that they perceive treat them unfairly, they might direct their resulting resentment and frustration at individual politicians or the political system as a whole. This explains why major securities reform generally follows market crashes.[12] An equally compelling justification for investor confidence is morality. Since the present-day reality is that investors must invest in the markets, the government has a moral obligation to assure that investor confidence is warranted and that investors are treated fairly and honestly. It would be immoral to make investors participate in a system that they may rationally perceive is stacked against them.

Moreover, while investors may have no choice about *whether* to invest, they do have many investment choices, and the choices they make will have a significant effect on their financial security. Their specific choices include, for example, whether to buy individual stocks or mutual funds, and, if the latter, which of the wide varieties of mutual funds should they choose. They must also decide whether to use the services of a financial services provider or make their own choices, and, if the former, what type

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objectives in passing the Securities Exchange Act was to insure honest markets and thereby promote investor confidence after the 1929 crash); *see also* Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 408 (2000) ("Without investor trust, our market would be a thin shadow of its present self.").

9. The SEC uses the percentage of U.S. households owning mutual funds as an indicator of investor confidence in assessing the Agency's performance in promoting healthy capital markets. *See* SEC, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 32 (Nov. 2007) [hereinafter 2007 PAR]. All of the SEC's Performance and Accountability Reports referred to in this article are available at http://www.sec.gov/about.shtml.

10. *See, e.g.*, INV. CO. INST., 2007 INVESTMENT COMPANY FACT BOOK 3 (47th ed.), *available at* http://www.icifactbook.org/pdf/2007_factbook.pdf.

11. Forty-four percent of all American households owned mutual funds in 2007 (51 million households in total), and 65% of those households held funds in some form of employer-sponsored retirement account. *Trends in Ownership of Mutual Funds in the United States*, *2007*, ICI RES. FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Nov. 2007, at 1, *available at* http://www.ici.org/home/fm-v16n5.pdf; *see also* Jennifer O'Hare, *Retail Investor Remedies under Rule 10b-5*, 75 U. CIN. L. REV. (forthcoming 2008) (citing statistics showing that a substantial number of individual U.S. investors invest directly in the markets).

12. *See* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997).

of financial services provider should they select.[13] These are important investment decisions that investors will be forced to make, whether or not they feel equipped to make them.

Law and economics scholars will protest that an explanation based on morality is paternalistic and that the market provides adequate protections.[14] Their argument, however, is refuted by recent history. Retail investors were the victims of the conflicted research scandal,[15] because the "smart money" (institutional and other sophisticated investors) discounted the sell-side analysts' optimistic recommendations. Retail investors similarly were victimized by mutual fund managers and broker-dealers who gave preferential treatment to wealthy investors. In addition, efficient trading markets do not necessarily mean that retail investors will get the best advice on what investments to make, particularly when broker-dealers have conflicts of interest that may result in putting their own financial incentives ahead of the customers' interests.

In order to view investor confidence through the lens of morality, we must identify certain prerequisites for investor confidence. First and foremost, it requires a belief in honest and fair treatment. The SEC's enforcement actions against insider trading are based on this belief's importance to investor confidence.[16] This does not mean, as the brokerage firms' advertisements pitched it in the dotcom era,[17] that retail investors can compete with professional and sophisticated investors. It is unrealistic to think that someone with a modest portfolio will have the same opportunities as someone with a multi-million dollar portfolio. Investors, however, should be able to have confidence that the actions of sophisticated and wealthy participants do not unfairly harm them. The loss of investor confidence resulting from both the conflicted research and mutual fund scandals stemmed from exactly this kind of harm.[18]

Second, investor confidence requires that investors believe that they have the requisite tools to make sound investment choices, including the availability of accurate, useful information presented in clear fashion. Whether one subscribes to an economic or paternalistic philosophy of securities regulation, there is consensus that fair and full disclosure is the

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13. A study commissioned by the SEC reports investor confusion about the differences in the types of services offered by broker-dealers and investment advisers, as well as their legal obligations. LRN-RAND CTR. FOR CORPORATE ETHICS, LAW & GOVERNANCE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, at xxiii–xxxiv (pre-publication copy, Dec. 2007), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

14. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 694 (1984).

15. *See* discussion *infra* Part I.A.

16. U.S. v. O'Hagan, 521 U.S. 642, 657–59 (1997).

17. *See* Barbara Black, *Securities Regulation in the Electronic Age: Online Trading, Discount Broker's Responsibilities and Old Wine in New Bottles*, 28 SEC. REG. L.J. 15, 18–19 (2000).

18. *See* sources cited *supra* note 6.

bedrock principle of federal securities law.[19] This includes both information contained in third-party research as well as disclosures from the mutual fund and the brokers that sell the funds to their customers.

Third, policy makers increasingly view investor education as an important aspect of fairness; the SEC identifies "encourage and promote informed investment decision-making" as one of the Agency's goals.[20] It is unfair treatment if investors must participate in markets about which they lack the necessary education. Investor education becomes particularly important with the increasing variety of investment products of greater complexity. In addition, many retail investors make their investment decisions based on recommendations from brokers. In both the conflicted research and mutual fund scandals, broker-dealers frequently recommended investment choices that proved harmful to retail investors.[21] Thus, investors need education about basic investment theory so that they can understand and assess their advisors' recommendations.[22]

Finally, investor confidence requires a belief that the regulatory agency charged with looking out for investors is performing this task competently and consistently. Retail investors need to believe that the SEC is the "Investor's Advocate," as it proclaims.[23] If the recent egregious instances of unfair treatment have not resulted in meaningful reforms that benefit retail investors, then they have reason to feel betrayed.

Part I of this article summarizes the conflicted research and mutual fund scandals and identifies common contributing factors. Part II reviews the reforms enacted in response to the conflicted research scandal and offers an assessment on whether these reforms have resulted in an improved environment for retail investors. Part III provides a similar review and assessment with respect to the mutual funds scandal. Part IV offers a comparative assessment of the SEC, with particular emphasis on its efforts in the area of investor education. The article concludes that in these areas of vital interest to retail investors, the SEC's reform efforts have, to date,

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19. Even those who believe that market forces should determine the optimal amount of disclosure do not question its importance. *See, e.g.*, Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 928 (1994).

20. SEC, 2004-2009 STRATEGIC PLAN 3 (2004), *available at* http://sec.gov/about/secstratplan0409.pdf [hereinafter 2004-2009 STRATEGIC PLAN]; *see also* 2007 PAR, *supra* note 9, at 6 (identifying one of its goals as "foster[ing] informed investment decision making").

21. *See* Gus De Franco, Haui Lu & Florin Vascari, *Wealth Transfer Effects of Analysts' Misleading Behavior*, 45 J. ACCT. RES. 71, 72 (2007).

22. *See* James Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 130–35 (1998). Lack of financial sophistication is particularly acute in employer-sponsored defined contribution plans, where the participants may not perceive themselves as investors. *See generally* Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMP. RTS. & EMP. POL'Y J. 491 (2001).

23. SEC, How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 5, 2008).

fallen short of the four previously identified prerequisites for investor confidence.[24] In short, the SEC has not yet earned the accolade of the "Investor's Advocate."

I. THE SCANDALS

Both the conflicted research and mutual fund scandals involved prevalent industry practices that, as a result of dishonesty and conflicts of interest, gave unfair advantages to sophisticated investors and other market participants. The practices also harmed retail investors who did not understand the degree to which more knowledgeable participants could take unfair advantage of the system.

A. CONFLICTED RESEARCH

The financial press reported suspicions about the objectivity of research recommendations at least by summer 2001,[25] when a House of Representatives subcommittee held hearings on the subject. Witnesses described common practices that included research departments' participation in investment banking activities, investment banking departments' influence over research analysts' compensation, and analysts' personal trading in stocks contrary to their professional or public recommendations.[26] The conflicted research scandal thus exposed the subservient role of research departments within the major securities firms. In order to promote their firms' investment banking businesses, analysts frequently issued overly optimistic research reports that they did not themselves believe[27] and rarely issued "sell" recommendations for fear of issuer retaliation.[28]

While sophisticated investors understood analysts' promotional roles and discounted their recommendations accordingly, retail investors made

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24. *See supra* pp. 4–5.

25. *See* Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud*, 2002 COLUM. BUS. L. REV. 631, 632–35 (2002) (providing a fuller description).

26. *Analyzing the Analysts: Hearings Before the Subcomm. on Capital Markets, Insurance and Gov't Sponsored Enterprises of the H. Comm. on Financial Services*, 107th Cong. 227 (prepared statement of Laura S. Unger, Acting Chair, SEC) [hereinafter *Unger Testimony*].

27. *See, e.g.*, Complaint, SEC v. Johnson, No. 03 Civ. 177 (S.D.N.Y. 2003), *available at* http://www.sec.gov/litigation/complaints/comp17922.htm (alleging analyst's private conversations with senior executives at the investment firm regarding a particular company were contradictory to his existing "buy" recommendation for that same company); *see also* Affidavit of Eric Dinallo in Support of Application for an Order Pursuant to General Business Law Section 354, at 10–11 (Apr. 8, 2002), *available at* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf [hereinafter Affidavit of Eric Dinallo] (alleging that analysts' public "accumulate" recommendations for a variety of stocks were inconsistent with internal discussions among the analysts).

28. *See* Deborah Solomon & Robert Frank, *"You Don't Like Our Stock? You Are Off the List"—SEC Sets New Front on Conflicts by Taking Aim at Companies that Retaliate Against Analysts*, WALL ST. J., June 19, 2003, at C1. *See generally* Gross, *supra* note 25.

the mistake of believing them, particularly when their brokers recommended the securities on the strength of the research reports.[29] Although conflicted research was not a new phenomenon,[30] the problems it created were intensified in the final years of the twentieth century because of the hyperbolic nature of the stock market and the presence of so many unsophisticated investors. As a result, allegations that the analysts' private email messages disparaged the very stocks they were publicly promoting generated widespread indignation.[31]

B. MUTUAL FUND SCANDALS

In fall 2003, shortly after the conflicted research scandal receded from national attention, the mutual fund scandal grabbed headlines. These market timing and late trading abuses similarly demonstrated unfair treatment of retail investors.

1. Late Trading

Because mutual funds sell and redeem their shares at their net asset value (NAV) and because they generally determine the NAV only on a daily basis, market conditions can result in stale pricing. This in turn presents opportunities for exploiting differences between the current and future NAVs. Some mutual funds allowed favored investors to arbitrage differences in the fund portfolio's NAV by engaging in purchases or redemptions that violated the fund's stated policies, in exchange for benefits to the fund managers.[32] In other cases, brokers assisted their favored customers' arbitrage activities by deceiving mutual funds so the customers could circumvent the fund's policies.[33] In both instances, long-term

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29. Individual investors lost about 2.5 times the amount lost by institutions. *See* De Franco et al., *supra* note 21, at 72. "The real effect of the overly positive research reports . . . may have been to cause naïve investors to hold more shares of risky securities than they would have otherwise held." Erik Sirri, *Investment Banks, Scope and Unavoidable Conflicts of Interest*, ECON. REV. (Fed. Res. Bank of Atlanta, Atlanta, Ga.), Fourth Quarter 2004, at 34.

30. *See* Securities Act of 1933 § 17(b), 15 U.S.C.A. § 77q(b) (2006) (prohibiting stock touting); *see also Unger Testimony*, *supra* note 26, at 72 (noting that "some conflicts will always exist").

31. *See* Affidavit of Eric Dinallo, *supra* note 27, at 10–11.

32. *See, e.g.*, Press Release, SEC, Banc of America Capital Management, BACAP Distributors and Banc of America Securities to Pay $375 Million, Exit Mutual Fund Clearing Business, and Make Other Remedial Reforms to Settle SEC Market Timing and Late Trading Charges (Feb. 9, 2005), *available at* http://www.sec.gov/news/press/2005-16.htm (finding that Banc of America Capital Management had allowed favored investors to engage in market timing in exchange for long-term investments); Press Release, SEC, Alliance Capital Management Will Pay Record $250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges (Dec. 18, 2003), *available at* http://www.sec.gov/news/press/2003-176.htm (finding that Alliance Capital Management had "allow[ed] market timing in certain of its mutual funds in exchange for fee-generating investments in other Alliance Capital investment vehicles").

33. *See, e.g.*, Press Release, SEC, Settled Administrative Proceeding Against Canadian Imperial Bank of Commerce Subsidiaries (July 20, 2005), *available at*

investors in the fund were harmed by the dilutive impact and cost to the fund of these arbitrage activities.

2. Market Timing

The office of the New York State Attorney General (NYSAG) first exposed market timing as a serious problem when it settled a case in which a hedge fund allegedly obtained special trading arrangements with several major mutual fund complexes.[34] Shortly thereafter, the SEC instituted its first proceeding against a registered representative who assisted a favored customer's market timing by deceiving the mutual funds.[35] These practices illuminated the serious conflicts of interest that can exist among the mutual fund, its affiliated investment adviser, favored customers and broker-dealers. Like conflicted research, market timing was not an unknown problem, but the SEC apparently believed that the funds would guard against attempts to market time because of their interest in preventing dilution.[36] Thus, both the conflicted research and the mutual fund abuses represent situations where the "smart" money knew the rules of the game and could take advantage of them, while the less savvy retail customers had no such advantage.

II. CONFLICTED RESEARCH

A. REFORMS

Although the securities industry adopted some initial reforms beginning in 2001,[37] these voluntary housecleaning efforts proved insufficient to ward

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http://www.sec.gov/news/press/2005-103.htm; Joint Press Release, SEC & NYSE, Southwest Securities to Pay $10 Million to Settle SEC and NYSE Supervision Charges, Relating to Fraudulent Market Timing and Late Trading by Southwest Registered Representatives (Jan. 10, 2005), *available at* http://www.sec.gov/news/press/2005-2.htm; Press Release, SEC, SEC Charges Dallas Investment Complex and Three of Its Officers with Defrauding Hundreds of Mutual Funds in Market Timing and Late Trading Scheme (Dec. 4, 2003), *available at* http://www.sec.gov/news/press/2003-169.htm.

34. Press Release, Office of the N.Y. State Attorney Gen., *supra* note 4.

35. *See* In re Sihpol, *supra* note 5.

36. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-313, MUTUAL FUND TRADING ABUSES: LESSONS CAN BE LEARNED FROM SEC NOT HAVING DETECTED VIOLATIONS AT AN EARLIER STAGE 10–12 (2005); *see also* RICHARD J. HILLMAN, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-692T, SEC MUTUAL FUND OVERSIGHT: POSITIVE ACTIONS ARE BEING TAKEN, BUT REGULATORY CHALLENGES REMAIN 5 (2005) [hereinafter GAO-05-692T] (reporting that because of limited resources, SEC examinations were limited in scope and focused on areas that presented what were perceived as the highest risks).

37. Several major securities firms adopted policies that prohibited or restricted analysts' ownership of shares they covered. SIA endorsed "best practices" that addressed the conflicted relationship between investment banking and research, and the Association for Investment Management and Research (AIMR) issued recommendations to promote more objective research. *See* NAT'L ASS'N SEC. DEALERS & NYSE, JOINT REPORT BY NASD AND THE NYSE ON THE OPERATION AND EFFECTIVENESS OF THE RESEARCH ANALYST CONFLICT OF INTEREST RULES 3–

off regulation, as the enforcement efforts of the NYSAG and the SEC intensified. In 2002 and 2003, Congress, the SEC, the Self-Regulatory Organizations (SROs)[38] and state regulators responded to the conflicted research scandal by instituting reforms for the express purpose of restoring investor confidence. Congress addressed research analysts' conflicts of interest in the Sarbanes-Oxley Act of 2002 (SOX)[39] because of concern that investors' knowledge of analysts' conflicts of interest harmed "the integrity and credibility to the public of stock analyst recommendations."[40] Believing it was "critical to restore investor confidence,"[41] Congress mandated regulation "in order to improve the objectivity of research and provide investors with more useful and reliable information."[42] The SROs, the SEC and state regulators also made attempts, both individually and as a group, to address analysts' conflicts of interest.

1. The SROs

Even prior to SOX's enactment, the SROs had proposed changes to their rules to address analysts' conflicts of interest[43] and obtained SEC approval of these changes within three months[44]—a swift process by SEC standards. According to the SEC, these rules "represent[ed] an important step towards helping to rebuild investors' confidence in the integrity of research and in the equities markets as a whole."[45] These rule changes implemented structural reforms designed to achieve two purposes: increasing analysts' independence and requiring increased disclosure of conflicts.[46] Later in 2002, the SROs filed a second round of proposed rules, including specific rules required by SOX that further addressed conflicts of interest.[47] In addition, this second round of rule changes introduced a third purpose: improving the quality of the research. In approving the second set

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4 (2005), *available at* http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p015803.pdf [hereinafter JOINT NASD/NYSE REPORT].

38. The Self-Regulatory Organizations (SROs) refer to National Association of Securities Dealers (NASD) and the regulatory arm of the New York Stock Exchange (NYSE), which in July 2007 were combined as the Financial Industry Regulatory Authority (FINRA). *See* FINRA, About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (last visited Feb. 5, 2008).

39. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

40. S. REP. NO. 107-205, at 32 (2002).

41. *Id.* at 33.

42. 15 U.S.C.A. § 78*o*-6 (2006).

43. Self-Regulatory Organizations, Exchange Act Release No. 45,526, 67 Fed. Reg. 11,526 (proposed Mar. 14, 2002).

44. Self-Regulatory Organizations, Exchange Act Release No. 45,908, 67 Fed. Reg. 34,968–69 (May 16, 2002).

45. *Id.* at 34,970.

46. *Id.* at 34,969.

47. Self-Regulatory Organizations, Exchange Act Release No. 48,252, 68 Fed. Reg. 45,875 (Aug. 4, 2003).

of rules in July 2003,[48] the SEC noted that "the rules should provide investors with more useful and reliable information and promote greater public confidence in securities research."[49]

Accordingly, the final SRO rules[50] are intended to (1) reduce the influence over the research department by both the investment banking department[51] and the companies that are the subjects of the research reports[52] and also restrict the analysts' personal trading in covered securities;[53] (2) require disclosure of stock ownership in covered securities (both the firm's and the research analyst's) and any compensation based on investment banking activities or from any subject company, as well as other possible conflicts of interest;[54] and (3) seek to assure that research analysts possess a certain minimum level of competence through registration and qualification requirements.[55] The rules also require a clearer rating system[56] and information to assist the investor in assessing the recommendation.[57]

2. The SEC

The SEC independently adopted Regulation AC[58] to "promote the integrity of research reports and investor confidence in those reports."[59]

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48. *Id.*

49. *Id.* at 45,878.

50. Nat'l Ass'n Sec. Dealers, NASD Conduct Rules, Rule 2711: Research Analysts and Research Reports (2006), *available at* http://finra.complinet.com/finra/display/display.html?rbid=1189&recordid=1159006971&element_id=1159000532&highlight=2711#r1159006971 [hereinafter NASD Rule 2711]. NYSE, Inc., Rule 472: Communications with the Public (2006), *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_6&manual=/nyse/nyse_rules/nyse-rules/ [hereinafter NYSE Rule 472]. The SROs have also issued two joint memoranda setting forth interpretive guidance. *See* JOINT NASD/NYSE REPORT, *supra* note 37, at exhs. B & C. The rules were further amended in April 2005 to prohibit analysts' participation in road shows. Self Regulatory Organizations, Exchange Act Release No. 51,593, 70 Fed. Reg. 22,168 (Apr. 28, 2005).

51. The investment banking department cannot review or approve the reports prior to publication, NASD Rule 2711(b)(2), *supra* note 50; NYSE Rule 472(b)(2), *supra* note 50. The investment banking department cannot supervise or control the research department in any way, including any involvement in compensation decisions. NASD Rule 2711(b)(1), *supra* note 50; NYSE Rule 472(b)(1), *supra* note 50. Research analysts cannot be involved in the solicitation of investment banking business, NASD Rule 2711(c)(5)–(6), *supra* note 50; NYSE Rule 472(b)(5)–(6), *supra* note 50, and their compensation cannot be affected by investment banking services transactions, NASD Rule 2711(d), *supra* note 50; NYSE Rule 472(h), *supra* note 50.

52. NASD Rule 2711(c), *supra* note 50; NYSE Rule 472(b)(4), *supra* note 50.

53. NASD Rule 2711(g), *supra* note 50; NYSE Rule 472(e), *supra* note 50.

54. NASD Rule 2711(h), *supra* note 50; NYSE Rule 472(k), *supra* note 50.

55. Research analysts must pass the Research Analyst Qualification Examination (Series 86/87). JOINT NASD/NYSE REPORT, *supra* note 37, at 12. Between April 1, 2004 and November 30, 2005, 5599 research analysts and 418 research principals had satisfied the applicable registration and qualification requirements. *Id.*

56. Ratings must be consistent with their plain meaning. NASD Rule 2711(h)(4)–(5), *supra* note 50; NYSE Rule 472(f)–(g), *supra* note 50.

57. NASD Rule 2711(h)(6)–(7), *supra* note 50; NYSE Rule 472(e), (h), (j), *supra* note 50.

58. Regulation AC – Regulation Analyst Certification, 17 C.F.R. §§ 242.500–505 (2007) [hereinafter Regulation AC].

This Regulation requires that research reports contain a "clear and prominent" certification by each research analyst that the views expressed in the report accurately reflect the analyst's personal views.[60] In addition, the analyst must certify whether or not he received any compensation for his specific recommendations. If he did, he must disclose the source, amount and purpose of the compensation and state that it may influence the recommendation.[61] The SEC patterned this regulation after the SOX requirement of CEO and CFO certification of financial statements,[62] but otherwise added little to the regulation adopted by the SRO rules.

3. Joint Effort: The Global Settlement

The most widely publicized reform was the Research Analysts' Global Settlement (the Global Settlement), which was agreed to in principle in December 2002 and finalized in April 2003.[63] The signatories included the SEC, the NYSAG, the North American Securities Administrators Association (NASAA), the SROs, and ten major securities firms. [64] Besides including regulatory provisions similar to the SRO rules,[65] the Global Settlement identified a fourth objective: fostering the development of independent research "[t]o ensure that individual investors get access to objective investment advice."[66] Accordingly, the Global Settlement requires the firms to fund independent research, for a period of five years, at a total cost of $460 million. According to Eliot Spitzer, the industry subsidy was to provide "an alternative way to ensure that the marketplace gets the research it needs."[67]

The Global Settlement requires each signatory firm to contract with three unaffiliated research firms to provide research to the firm's customers, with an outside consultant having the final authority to procure the

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59. Regulation Analyst Certification, Securities Act Release No. 8193, 68 Fed. Reg. 9482, at 9482 (Feb. 27, 2003).

60. 17 C.F.R. § 242.501(a)(1).

61. 17 C.F.R. § 242.501(a)(2).

62. 15 U.S.C.A. § 7241 (2006).

63. Joint Press Release, SEC, N.Y. State Attorney Gen., N. Am. Sec. Adm'rs Ass'n, N.Y. Stock Exch., Nat'l Ass'n Sec. Dealers, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm.

64. Federal Court Approves Global Research Analyst Settlement, SEC Litigation Release No. 18,438, 81 SEC Docket 1699 (Oct. 31, 2003) [hereinafter Global Settlement Release]. Two other firms later agreed to substantially the same terms. *See* SEC Sues Deutsche Bank Securities Inc. for Research Analyst Conflicts of Interest and Failure to Timely Produce All E-mail, SEC Litigation Release No. 18,854, 83 SEC Docket 1990 (Aug. 26, 2004); SEC Sues Thomas Weisel Partners LLC for Research Analyst Conflicts of Interest, SEC Litigation Release No. 18,855, SEC Docket 1992 (Aug. 26, 2004).

65. *See* JOINT NASD/NYSE REPORT, *supra* note 37, at exh.D (provides a comparison).

66. Global Settlement Release, *supra* note 64.

67. *See* Juliet Schlosser & Elliot Spitzer, *Spitzer Speaks*, FORTUNE, June 9, 2003, at 168.

independent research.[68] Specifically, the Global Settlement requires that for the common stock of "covered companies,"[69] each firm must use reasonable efforts to procure independent research.[70] If the independent research providers drop coverage or do not timely pick up coverage of the covered company's stock, the firm may continue to disseminate its own research reports if it takes reasonable steps to request that the independent consultant procure coverage promptly.[71] The firm must adopt policies and procedures reasonably designed to ensure that its registered representatives, when soliciting orders in the United States for the common stock of a covered company for which independent research is available, inform retail customers that they can receive independent research at no cost.[72] If the solicitation results in a buy order, the trade confirmation must set forth the stock's ratings contained in the firm's own research reports and in the independent research.[73] There are also two additional notice requirements that are not limited to solicited orders. Every account statement sent to a U.S. customer that reflects a position in a covered company's stock must set forth the ratings contained in the firm's own research reports and in the independent research.[74] Notice of the availability of independent research must also be included "prominently" on all U.S. customers' account statements, in the firm's research reports, and on the firm's website.[75]

B. ASSESSMENT

To some extent, the purposes of the congressional, SRO and Global Settlement reforms were contradictory. Congressional and SEC statements emphasized improving the objectivity and quality of research prepared by securities firms so that investors could have confidence in the firms' research. The reforms, however, also mandate additional disclosure of conflicts, suggesting that informed investors should view the research *more* skeptically.[76] Finally, the purpose behind the Global Settlement's industry

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68. The terms are set forth in Global Research Analyst Settlement, Final Judgment Addendum A (Sept. 24, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18438.htm (setting forth the terms under III.1).

69. Common stock of "covered companies" is generally defined as common stock listed on a U.S. national securities exchange or quoted on NASDAQ and covered in the firm's research reports. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at III.1(c).

73. *Id.* at III.1(h).

74. Global Research Analyst Settlement, Final Judgment Addendum A, at III.1(i) (Sept. 24, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18438.htm. The independent consultant will select the independent research ratings. *Id.* at III.1(j).

75. *Id.* at III.1(k).

76. Professor Jill Fisch advocates greater emphasis on disclosure to manage the conflicts of interests to replace the current model of forced separation of research and investment banking. *See* Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 83–90 (2007).

subsidy of third-party research is uncertain. It may reflect regulatory doubt that the other measures[77] will be sufficient to improve sell-side analysts' research. Alternatively, it may anticipate that these measures will have an adverse impact on production of research by securities firms, since it seeks to assure the availability of research from other sources by requiring firms to supply the seed money for the development of independent research. Not surprisingly, considering the conflicting purposes of the reforms, the results have been mixed.

1. Improving Securities Firms' Research

Since adoption of the SRO rules, SRO staffs have made their enforcement a priority.[78] In December 2005, at the request of the SEC, the staffs of NASD and NYSE issued a joint report assessing the operation and effectiveness of the rules.[79] While both SROs reported a large number of violations, it is not possible to determine whether the violations resulted from intentional disregard of the new rules or more benign difficulties of applying them.[80] The report did give some notable examples of non-compliance[81] that continue to date.[82] Notably, the report did not provide an assessment of the rules' effectiveness from the regulators' perspective. Instead, it provided summaries of academic studies and media reports and noted that "most have concluded that the rules have helped to address the

77. *See supra* notes 70–72 and accompanying text.

78. *See* JOINT NASD/NYSE REPORT, *supra* note 37, at 12.

79. *Id.*

80. NASD reported that between July 2002 and November 30, 2005 it initiated 467 examinations reviewing firms for compliance with NASD Rule 2711 and Regulation AC; it found 110 violations of NASD Rule 2711 and twenty-five violations of Regulation AC. The greatest number of violations was for failure to have adequate procedures in place to supervise the activities of research analysts with respect to conflicts of interest. As of November 30, 2005 NASD Enforcement settled twenty-nine cases involving NASD Rule 2711 violations and two cases involving violations of Rule 1050 (the analyst registration rule). The vast majority of settled NASD Enforcement actions involved violations of the disclosure requirements of NASD Rule 2711(h) relating to over 265 research reports. NASD's Advertising Regulation Department also conducted sweeps of firms (including ten Global Settlement firms) to determine whether there was good-faith compliance with NASD Rule 2711 and found continued deficiencies in several areas. The NYSE reports 296 examinations between August 2002 and October 2005 that resulted in seventy-five firms with a total of 271 findings for partial or non-compliance with the SRO Rules and Regulation AC. During that same period, thirteen examination findings were referred to NASD Enforcement, many of which were ongoing. *See id.* at 13–14.

81. For example, one firm was fined $1.5 million for violations that included having a research analyst participate in a road show and a research analyst giving statements that were not fair and balanced. *Id.* at 16.

82. In November 2007 FINRA censured and fined Wachovia Capital Markets LLC $300,000 for violations of the research analyst conflict of interest disclosures rules over a two-year time period. News Release, Fin. Indus. Regulatory Auth., FINRA Fines Wachovia Capital Markets $300,000 for Deficient Disclosures in Research Reports (Nov. 28, 2007), *available at* http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P037532.

conflict-of-interest issues that have previously compromised the objectivity and reliability of research."[83]

Finance scholars have, indeed, conducted a number of studies on the success of the reforms aimed at improving research analysts' practices. The research has produced mixed results.[84] Some studies appear to show that the recommendations have become more balanced[85] and less conflicted,[86] although there is skepticism about whether the conflicts of interest have been eliminated.[87] Others have found that the reforms have had little effect on recommendations or their long-term investment value for investors.[88] Moreover, some conclude that analysts at investment banks already provided reliable research and therefore dispute that the research is now of better quality.[89]

2. Fostering Independent Research

Whatever the benefits of less biased research, its price is clear: a decline in the availability of sell-side securities analysis. According to one study, half of the analysts at six major firms who published research in 2003 stopped by 2006.[90] If the drafters of the Global Settlement expected that independent research providers would compensate for the decline in sell-side analysis, it has not happened. Initiatives to promote issuer-sponsored research and to broker relationships between companies and independent

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83. JOINT NASD/NYSE REPORT, *supra* note 37, at 16.

84. *See* Fisch, *supra* note 76, at 72 (concluding that the early reports on the effect of the new regulations are mixed).

85. *See* Brad M. Barber et al., Buys, Holds, and Sells: The Distribution of Investment Banks' Stock Ratings and the Implications for the Profitability of Analysts' Recommendations (Sept. 2005) (unpublished manuscript, *available at* http://ssrn.com/abstract=495882).

86. *See* Ohad Kadan et al., Conflicts of Interest and Stock Recommendations—The Effects of the Global Settlement and Related Regulations (May 2007) (unpublished manuscript, *available at* http://ssrn.com/abstract=5688840).

87. *See Fixing Wall Street Research Years After Global Settlement, Critics Say Conflicts Remain*, WALL ST. J. ONLINE, Nov. 10, 2006, http://online.wsj.com/public/article/SB116311187931119039-OscKt8q7_5_frb0hKpQqKocn9bM_20061117.html [hereinafter *Fixing Wall Street Research*] (noting that the ratio of buys to sells is now higher than before the settlement).

88. *See generally* Leslie Boni, Analyzing the Analysts after the Global Settlement (Sept. 28, 2005) (unpublished manuscript, *available at* http://www.tcf.or.jp/data/20050928_Leslie_Boni.pdf).

89. *See* James C. Spindler, *Conflict or Credibility: Analyst Conflicts of Interest and the Market for Underwriting Business* (Am. Law & Econ. Ass'n Annual Meetings, Working Paper No. 55, 2006), *available at* http://law.bepress.com/alea/16th/art55; Jonathan Clarke et al., The Good, the Bad and the Ugly? Differences in Analyst Behavior at Investment Banks, Brokerages and Independent Research Firms (Sept. 2004) (unpublished manuscript, *available at* http://papers.ssrn.com/so13/papers.cfm?abstract_id=562181); John Jacob, Steve Rock & David P. Weber, Do Analysts at Independent Research Firms Make Better Earnings Forecasts? (July 2007) (unpublished manuscript, *available at* http://ssrn.com/abstract=434702).

90. Study: 50% of Analysts Dropped Out Since '03, WALL ST. LETTER, May 14, 2007, *available at* http://www.researchexchange.com/WSL%20-%20NRE%20-%20051407.pdf (reporting on a National Research Exchange study).

analysts have not, to date, filled the gap. While new firms entered the field to provide the independent research mandated by the Global Settlement, a number of them have already shut down due to insufficient market demand.[91] Moreover, there is skepticism that issuer-financed research provides a good solution, as it presents an equally dangerous conflict[92] and, in particular, raises concerns about issuer retaliation.[93]

The result of less sell-side research is less transparency in the markets.[94] Approximately 50% of all publicly held companies have three or fewer analysts[95] and approximately 35% of all public companies have no analyst coverage.[96] Since January 2002, almost seven hundred companies have reduced analyst coverage.[97] This represents over 17% of all companies with analyst coverage.[98] Moreover, when the Global Settlement's subsidy of independent research ends in July 2009,[99] the funding for independent research may dry up.[100] The perennial problem—who will pay for research?—remains unsolved.

B. DOES THE SEC CARE ABOUT RESEARCH?

If the SEC believes that providing retail investors with useful and reliable research is important for investor confidence, then the Agency should be concerned that the effects of the reforms have proven detrimental to this goal and that, when the Global Settlement's subsidy is gone, the

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91. Caren Chesler, *Back to the Drawing Board*, INVESTMENT DEALERS' DIG., Mar. 27, 2006, at 26 (reporting that many of the independent research firms that opened after the Global Settlement have shut down because investors do not want to pay for research). This includes a joint venture between Reuters and NASDAQ, which was formed to provide research coverage for small and mid-cap companies. *See* Joseph A. Giannone & Anupreeta Das, *Nasdaq, Reuters Pull Plug on Research Venture*, REUTERS, Sept. 11, 2007, http://www.reuters.com/article/ousiv/idUSN1144247920070912.

92. Rating agencies have been criticized because they are paid by the issuer of the bonds they rate. *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999).

93. To address these issues, the CFA Centre for Financial Market Integrity developed Best Practices Guidelines. CFA CTR. FOR FIN. MKT. INTEGRITY, BEST PRACTICE GUIDELINES GOVERNING ANALYST/CORPORATE ISSUER RELATIONS (2005), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n7.4004.

94. Dana Cimilluca, *Another Analyst Jumps the Wall*, WALL ST. J., Mar. 24, 2007, at B4; *see Fixing Wall Street Research*, *supra* note 87; Karen Richardson, Peter A. McKay & Serena Ng, *Desperately Seeking Research*, WALL ST. J., Sept. 19, 2005, at C1; Justin Schack, *Settling for Nothing*, INSTITUTIONAL INVESTOR, Oct. 2005, at 26; Fisch, *supra* note 76, at 76–80.

95. Press Release, NASDAQ, The Independent Research Network Announces Seven Members to Join its Research Independence Council (Nov. 16, 2005), *available at* http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_111.stm.

96. SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, FINAL REPORT 72 n.144 (2006), *available at* http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

97. Press Release, NASDAQ, *supra* note 95.

98. *Id.*

99. *See supra* notes 66–67 and accompanying text.

100. *See* Chesler, *supra* note 91 (reporting that observers expect a shakeout in the industry when the settlement period ends).

availability of research coverage will, in all likelihood, further diminish. Since the Global Settlement, however, the SEC has not identified the availability of better research as an Agency priority.[101] Indeed, the SEC's recent extension of Form S-3 availability to smaller public companies[102] suggests that it does not consider research coverage as important a component of market efficiency as it once did. While the efficient capital markets hypothesis and the role of securities analysts in enhancing market efficiency were the guiding principles behind integrated disclosure, with the creation of Form S-3 and shelf registration,[103] the SEC now emphasizes the ready availability, at low cost, of corporate disclosure documents to investors.[104]

The SEC's emphasis on "Plain English" disclosure[105] and Chairman Cox's deep interest in interactive data[106] also suggest a significant, though

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101. Neither its 2004-2009 Strategic Plan nor any of its PARs subsequent to the Global Settlement address the issue. *See* 2004-2009 STRATEGIC PLAN, *supra* note 20; 2007 PAR, *supra* note 9; SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 9 (Nov. 2006) [hereinafter 2006 PAR]; SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 7 (Nov. 2005) [hereinafter 2005 PAR]; SEC, 2004 PERFORMANCE AND ACCOUNTABILITY REPORT 23 (May 2005) [hereinafter 2004 PAR].

102. In December 2007, the SEC extended Form S-3 eligibility to most corporations with exchange-traded securities so long as they did not offer securities worth more than one-third of their public float within a twelve-month period. Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 8878, 72 Fed. Reg. 73,534 (Dec. 27, 2007). In 1992, when the SEC established the requirement of a $75 million public float (which was a reduction from the original $150 million), the staff based it on an analysis of trading markets and market following of registrants in various capitalization ranges and noted that approximately two-thirds of the companies that would become eligible were followed by at least three analysts. Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6943, Exchange Act Release No. 30,930, 57 Fed. Reg. 32,461, at 32,464 (July 22, 1992).

103. Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18,524, 47 Fed. Reg. 11,380, at 11,382 n.9 (Mar. 16, 1982) (stating that Form S-3 relies on the efficient market theory).

104. *See* Revisions to the Eligibility Requirements for Primary Securities Offerings, 72 Fed. Reg. at 73,535 (stating that in contrast to 1992, all filings on Form S-3 are now filed on EDGAR and are available at little or no cost).

105. Chairman Arthur Levitt made Plain English disclosure a priority so that "investors might better understand their investments." *See* SEC OFFICE OF INVESTOR EDUC. & ASSISTANCE, A PLAIN ENGLISH HANDBOOK 1 (1998), *available at* http://www.sec.gov/pdf/plaine.pdf. Christopher Cox, SEC Chairman, has continued the campaign with enthusiasm. *See, e.g.*, Christopher Cox, Chairman, SEC, Keynote Address to the Center for Plain Language Symposium: Plain Language and Good Business (Oct. 12, 2007), *available at* http://www.sec.gov/news/speech/2007/spch101207cc.htm (stating that "disclosures intended for retail investors should be concise and clearly written"). Chairman Cox has also announced that the SEC will conduct a survey of investors to see if they find SEC filings useful. *Id.*

106. The SEC launched its interactive data filing initiative in April 2005 "to make filings more accessible and understandable to the common investor" and recently created an Office of Interactive Disclosure to lead the transformation to interactive financial reporting by public companies. Press Release, SEC, SEC's Office of Interactive Disclosure Urges Public Comment as Interactive Data Moves Closer to Reality for Investors (Dec. 5, 2007), *available at* http://www.sec.gov/news/press/2007/2007-253.htm. It recently released for public comment a

not expressly stated, shift in the SEC's attitude toward disclosure. For many years, regulatory policy focused on the role of the intermediaries, particularly brokers, to act as filters and interpreters of complex financial information.[107] In contrast, Chairman Cox appears to think that retail investors have the time to study, and the ability to comprehend, information in SEC filings. This shift could be justified because of the dominant presence in the market of institutional investors,[108] except that both Chairman Levitt (the architect of Plain English) and Chairman Cox have emphasized the importance of these developments for retail investors.[109] If the SEC expects that retail investors will review SEC filings, that expectation does not appear well-founded, as indicated by polls and surveys demonstrating the general "financial illiteracy" of retail investors.[110]

Perhaps, however, from the viewpoint of retail investors, the lack of independent research is not critical because, for many of them, mutual funds are the better investment choice. This article turns now to an examination and assessment of the SEC's reforms to improve the fair treatment of retail investors in mutual funds.

III. MUTUAL FUNDS

A. REFORMS

From fall 2003, when the NYSAG brought the first enforcement action involving market timing,[111] through 2005, Congress held numerous hearings on mutual funds,[112] proposed new legislation,[113] and considered

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taxonomy for GAAP accounting standards and instructions for creating financial statements in XBRL. *Id.*

107. *See, e.g.*, Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 632 (1973) (stating that "the theory that the prospectus can be used by the lay investor is a myth"); SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS – THE WHEAT REPORT 52–54 (CCH 1969) (discussing the value of the filtration process in communicating complicated business facts to average investors).

108. JOHN C. COFFEE, JR., JOEL SELIGMAN & HILLARY A. SALE, SECURITIES REGULATION: CASES AND MATERIALS 37 (10th ed. 2007).

109. *See supra* note 105 and accompanying text.

110. A 2003 survey of individual investors conducted for NASD found that 97% of investors believed it was important to increase their investment knowledge. More alarmingly, only 35% of investors answered at least seven of ten Basic Market Knowledge questions correctly. APPLIED RESEARCH & CONSULTING LLC, NASD INVESTOR LITERACY RESEARCH (2003), *available at* http://www.finra.org/web/groups/inv_info/documents/investor_information/p011459.pdf.

111. *See* Press Release, Office of the N.Y. State Attorney Gen., *supra* note 4.

112. *Mutual Funds: A Review of the Regulatory Landscape: Hearing Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises of the H. Comm. on Financial Services*,109th Cong. (2005); *Mutual Fund Trading Abuses: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 109th Cong. (2005); *Oversight Hearings on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Subcomm. on Federal Financial Management, Gov't Information, Federal Services, and International Security of the S. Comm. Homeland Security and Governmental Affairs*, 108th Cong. (2004); *Review of Current Investigations and Regulatory*

new models for regulating the industry.[114] In contrast to its response to the conflicted research scandal, Congress ultimately decided not to enact legislation dealing with mutual fund reform. Instead, because the SEC was actively engaged in reform efforts, Congress decided to await the results of these efforts before assessing the need for additional legislation.[115] The SEC, in turn, brought a number of enforcement actions involving trading abuses against both mutual fund complexes and brokers[116] and began an extended process of rulemaking to consider cures not only for the trading abuses, but also for other pervasive problems relating to mutual funds. We discuss first the reform efforts related to the trading abuses and provide an assessment of those efforts. We then examine the SEC's broader reform efforts.

1. Trading Abuses

The SEC has consistently used two approaches to reform mutual fund trading practices: increasing the independence and the responsibilities of the mutual fund board to deter abuses (in lieu of mandating direct measures to deter abuses) and requiring additional disclosures about abusive practices and the board's actions to deter them.

Actions Regarding the Mutual Fund Industry: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs, 108th Cong. (2003-2004); *Mutual Funds: Who's Looking Out for Investors?: Hearing Before the Subcomm. on Capital Markets, Insurance, and Gov't of the H. Comm. on Financial Services*, 108th Cong. (2003); *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. (2003); *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003); *The Mutual Funds Integrity and Fee Transparency Act of 2003: Hearing on H.R. 2420 Before the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003).

113. The most-publicized proposal was for the establishment of a Mutual Fund Oversight Board. Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201(a) (2003).

114. *Compare* Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115 (2005) (arguing that there should be a mutual fund SRO) *with* Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11 (2006) (arguing that SEC should continue to regulate mutual funds).

115. Many members of Congress made statements to this effect. *See, e.g.*, *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 1057 (2004) (statement of Sen. Richard C. Shelby, Chairman, S. Comm. on Banking, Housing, and Urban Affairs) (stating that "If necessary, . . . Congress stands ready to enhance the SEC's authority through the grant of new authority. Hopefully, . . . [this] hearing will shed more light on what Congress should do to complement SEC's efforts.).

116. *See* 2004 PAR, *supra* note 101 (noting that enforcement actions are pending "against ten mutual fund complexes to date, and others are still under investigation"); 2005 PAR, *supra* note 101 (identifying several significant market timing cases); 2006 PAR, *supra* note 101 (noting that in 2006 the "SEC continued to address abuses relating to the market timing of mutual funds" and identifying several cases against traders and brokers who market timed); 2007 PAR, *supra* note 9, at 92 (containing language similar to 2006 PAR).

The centerpiece of the SEC's reform efforts, and the most controversial of its rulemaking initiatives, is its rule mandating independence for 75% of fund directors and an independent board chair.[117] According to a majority of the SEC Commissioners at the time the rule was adopted, a more independent mutual fund board was central to mutual fund reform because a more independent culture would deter market timing and other abuses.[118] Because mutual funds are already required to have a majority of independent directors,[119] many commentators, including two Commissioners, doubted whether increasing the percentage of independent directors and mandating an independent chair would provide any real benefit to investors.[120] The rule has not become effective, as the Court of Appeals for the D.C. Circuit has twice remanded it to the SEC for further fact-finding.[121] In December 2006 the SEC solicited additional comments on the rule,[122] but since then has taken no further action.

The SEC also adopted several modest measures designed to strengthen oversight in an effort to deter trading abuses. Both mutual funds and registered investment advisers are required to adopt, implement and annually review policies and procedures reasonably designed to prevent violations of the federal securities laws.[123] They must also appoint a chief compliance officer, who, in the case of mutual funds, must report directly to the fund's board.[124] In addition, investment advisers must adopt codes of ethics that address, among other things, conflicts that arise from personal trading by advisory personnel.[125]

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117. 17 C.F.R. § 270.0-1(a)(7)(i), (iv) (2007); *see* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004).

118. Investment Company Governance, 69 Fed. Reg. at 46,378.

119. The SEC conditions ten of its exemptive rules on the fund board's consisting of a majority of independent directors. Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 2, 2001).

120. *See* Dissent of Commissioners Cynthia A. Glassman & Paul S. Atkins, Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,390 (July 27, 2004).

121. U.S. Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006) (requiring SEC to afford the public an opportunity to comment on publicly available materials that were not made part of the record); U.S. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) (remanding to SEC for further findings on costs and alternatives).

122. *See* Investment Company Governance, Investment Company Act Release No. 27,600, 71 Fed. Reg. 76,618 (Dec. 21, 2006).

123. 17 C.F.R. § 270.38a-1(a)(1), (3) (2007).

124. 17 C.F.R. § 270.38a-1(a)(4). Compliance officers had previously expressed concerns about market timing but lacked sufficient independence to curb the practices. GAO-05-692T, *supra* note 36, at 3.

125. 17 C.F.R. § 275.204A-1. In its discussion of the code of ethics rule, the SEC strongly urged that the code should be more than a compliance manual, as the rule was adopted in response to enforcement actions involving breach of fiduciary duties by investment advisers to their clients, including mutual funds. Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, Investment Company Act Release No. 26,942, 69 Fed. Reg. 41,696, at 41,696–97 (July 9, 2004).

Another rule requires mutual fund boards to consider imposing redemption fees to discourage market timing and recoup some of the costs incurred as a result of short-term trading strategies.[126] The rule as initially proposed would have required funds to impose 2% redemption fees if shares were held less than five days.[127] Ultimately, the SEC was persuaded that it was the responsibility of mutual fund boards to determine whether redemption fees were appropriate.[128] In addition, the rule requires mutual funds to enter into information-sharing agreements with financial intermediaries so that the funds can monitor the frequency of short-term trading in omnibus accounts and, if necessary, instruct the intermediary to restrict or prohibit short-term trading by fund holders who violate the fund's market timing policies. [129]

The SEC frequently requires disclosure in order to encourage certain conduct, and it has employed this strategy to require extensive disclosures in the fund prospectus about funds' policies and procedures to deter market timing.[130] Accordingly, the prospectus must disclose the risks that short-term trading presents for other fund holders. It must then disclose whether or not the fund's board has adopted market timing policies and procedures, and, if it has not, it must explain the specific basis for the board's view that it is appropriate for the fund not to have such policies.[131] Similarly, the prospectus must describe any policies and procedures for deterring frequent purchases and redemptions.[132] The prospectus must also explain both the circumstances under which the fund will use fair value pricing and the effects of fair value pricing.[133] Finally, funds are required to state their policies with respect to disclosing information about the fund's portfolio holdings.[134]

Another rule requires disclosures about portfolio managers, particularly concerning their identities, conflicts, compensation and holdings in the

126. 17 C.F.R. § 270.22c-2 (2007); *see* Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328 (Mar. 18, 2005); Mutual Fund Redemption Fees, Investment Company Act Release No. 27,504, 71 Fed. Reg. 58,157 (Oct. 3, 2006).

127. Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A, 69 Fed. Reg. 11,762 (proposed Mar. 11, 2004).

128. 17 C.F.R. § 270.22c-2(a)(1); *see* Mutual Fund Redemption Fees, 70 Fed. Reg. at 13,330.

129. 17 C.F.R. § 270.22c-2(a)(2). The term "financial intermediary" is defined in the rule. § 270.22c-2(c)(1).

130. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 23, 2004) (to be codified at 17 C.F.R. pts. 239, 274).

131. *Id.* at 22,302.

132. *Id.* at 22,302–03. If the fund has adopted arrangements to permit frequent purchases and redemptions, however, those disclosures do not have to be in the prospectus, but in the Statement of Additional Information (SAI), which it not required to be given to the investor. *Id.* at 22,303.

133. *Id.* at 22,304–05. Fair valuation, which is required under certain circumstances, can serve to foreclose certain arbitrage opportunities. *See id.*

134. *Id.* at 22,305–06.

funds they manage.[135] The SEC stated that increasing transparency of information about fund managers may assist investors in evaluating fund management and making investment decisions.[136]

2. Assessment of Trading Abuse Reforms

Market timing and late trading are serious problems that directly impact the value of investors' holdings. The preceding recital demonstrates that the SEC's reform efforts of mutual fund practices, unlike the SRO rulemaking dealing with conflicted research, have been neither smooth nor swift. Unfortunately, it remains doubtful that the SEC's regulatory efforts will provide sufficient deterrence against further instances of unfair treatment of retail investors.

First, increasing the independence and responsibilities of the mutual fund board has consistently been the SEC's principal approach to reforming the mutual fund industry.[137] The SEC staff's own studies, however, cast doubt on whether increasing independence will have any meaningful impact on improving board performance.[138] Moreover, the past behavior of mutual fund boards makes questionable whether it is a realistic solution.[139] While the SEC has emphasized that it adopted the independent chair requirement to enhance independent oversight of conflict of interest transactions, not to enhance fund financial performance or lower fees,[140] neither the studies nor past board performance provide solid empirical support for the proposition

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135. Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Securities Act Release No. 8458, Exchange Act Release No. 50,227, Investment Company Act Release No. 26,533, 69 Fed. Reg. 52,787 (Aug. 27, 2004).

136. *Id.* at 52,789.

137. *See supra* Part III.A.

138. *See* Memorandum from Chester S. Spatt, Chief Economist, SEC Office of Economic Analysis, re: Power Study as Related to Independent Mutual Fund Chairs 1 (Dec. 29, 2006), *available at* http://www.sec.gov/rules/proposed/s70304/oeamemo122906-powerstudy.pdf (concluding that "existing empirical studies of the effects of mutual fund governance have failed to consistently document a statistically significant relation between fund governance and fund performance, particularly with respect to board chair independence"); Memorandum from Chester S. Spatt, Chief Economist, SEC Office of Economic Analysis, re: Literature Review on Independent Mutual Fund Chairs and Directors 1 (Dec. 29, 2006), *available at* http://www.sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf (drawing two main inferences from the literature: (1) "boards with greater proportion of independent directors are more likely to negotiate and approve lower fees, merge poorly performing funds more quickly or provide greater investor protection from late-trading and market-timing" and (2) "broad cross-sectional analysis reveals little consistent evidence that board composition *is related* to lower fees and higher returns for fund shareholders"); SEC, EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION 64 (2005), *available at* http://www.sec.gov/news/studies/indchair.pdf (concluding that empirical data regarding the relationship between an independent chair and fund performance and fees are inconclusive). *But see* Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 275–77 (2003) (finding that funds have less market timing where boards have fewer insiders).

139. *See infra* note 172 and accompanying text.

140. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, at 46,384 (July 24, 2004).

that independent boards will provide more effective oversight over abusive trading practices than they have over fund performance or costs.

Second, the SEC's failure to adopt a "hard close" rule[141] or to require more current NAV determinations means that opportunities for sophisticated investors to engage in arbitrage activities remain.[142]

Third, the increased disclosure requirements seem pro forma, and it is doubtful that these disclosures provide meaningful information to a mutual fund investor. Given the complexity of the choices investors encounter in selecting mutual fund investments, it seems unrealistic to expect that they will take into account a fund's policies to deter trading abuses. Rather, these disclosures contribute to the serious problem of "information overload" for which mutual fund prospectuses have long been criticized.[143]

Finally, whatever the merits of the SEC's approach, increased and constant SEC vigilance is essential because of the intractable nature of the conflicts of interest involving mutual funds. Since at least part of the failure to detect the trading abuses was lack of sufficient resources,[144] Congress increased the SEC's funding so that it could hire additional examiners in 2003.[145] However, whenever there are budgetary constraints, funding for non-glamorous, low-profile positions like examiners is the first to go.

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141. The SEC proposed a rule to require that an order to purchase or redeem shares would receive the current day's price only if the fund, its designated transfer agent, or a registered securities clearing agency received the order by the time that the fund established for calculating its NAV, typically 4:00 p.m. Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388, at 70,389–90 (Dec. 17, 2003). At the 2005 State of the Securities Industry Congressional hearing, SEC Chairman Donaldson stated the Agency had postponed finalizing the rule to explore technological solutions to deal with administrative difficulties in submitting order information by the 4:00 p.m. deadline. *The State of the Securities Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 10–11 (2005) (statement of William H. Donaldson, Chairman, SEC). To date the SEC has not adopted the rule.

142. Professor Mercer Bullard argues that the SEC has erred in its regulatory approach by not focusing more on stale pricing:

> Stale pricing principally, and late trading secondarily, . . . should be the focus of the SEC's enforcement actions and regulatory reforms. Instead, the Commission has concentrated its efforts on frequent trading, a practice that raises fundamentally different and less vital concerns from those raised by fund arbitrage, and in the arbitrage arena it has focused principally on late trading while taking virtually no new steps to address stale pricing.

Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1295 (2006).

143. *See infra* note 149 and accompanying text.

144. SEC staff stated that given the number of mutual fund companies, the breadth of their operations, and the SEC's limited examination resources, the SEC's examinations were limited in scope and focused on discrete area that presented what the staff perceived to be the highest risks. GAO-05-692T, *supra* note 36, at 5.

145. *Mutual Fund Trading Abuses: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 109th Cong. 33 (2005) (testimony of Lori Richards, SEC, Div. of Compliance Inspections & Examinations). The number of examiners increased from 360 to 500. *Id.*

Indeed this appears already to have happened: In fiscal year 2006, examinations of both investment advisers and investment companies fell,[146] which is at least partially attributable to a decrease in resources.[147]

B. COSTS AND FAIR TREATMENT

Apart from the trading abuses that were at the heart of the mutual fund scandals, meaningful mutual fund reform needs to provide better solutions for persistent problems affecting the costs of mutual fund investments. Reforms need to address both costs paid directly by investors and costs borne by the fund that diminish the investors' investments. The conflicts of interest among the investment adviser, the investment fund, and the broker-dealers that market the funds, and the complexity of the structure that make mutual funds difficult for investors to understand, create additional dangers for investors. Fees vary widely among funds, and investors do not sufficiently understand their importance in selecting investments. In addition, funds have incentives to reward brokers for good salesmanship at the expense of the mutual fund investors.[148] Thus, the issue of costs raises the fundamental issue about the fair treatment of retail investors, particularly the many, frequently less-sophisticated, retail investors who purchase mutual funds through broker-dealers. The general issue of costs presents three interrelated problems: (1) disclosure; (2) board oversight; and (3) broker-dealer practices. While the SEC has engaged in extended rule-making processes on these questions, to date it has adopted only limited reforms to deal with these problems.

1. Disclosure

Mutual fund disclosure is dismal. As the SEC recently acknowledged, fund prospectuses have been universally criticized because they are "long and complicated" and "often prove difficult for investors to use efficiently in comparing their many choices."[149] The current disclosure regime for mutual funds does a poor job of providing investors with the necessary

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146. 2006 PAR, *supra* note 101, at 12 exh.1.3. For example, examinations of investment companies fell from 783 in fiscal year 2004, to 344 in 2006. *Id.*

147. *Id.* at 12. The statistics for fiscal year 2007 are roughly comparable. *See* 2007 PAR, *supra* note 9, at 28 tbl.2.5 (noting that staff resources have been dedicated to new proactive compliance initiatives designed to improve compliance); *see also* SEC, FY 2008 PERFORMANCE BUDGET 137 (2007), *available at* http://www.sec.gov/about/2008budgetperform.pdf (identifying decrease of resources as a factor in fewer examinations of investment advisers and investment companies).

148. *See* John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685, 714 (2007) (concluding that "it is obvious that something needs to be done to eliminate, or at least reduce, the conflicts of interest that have been created by revenue sharing, directed brokerage, differential compensation, and soft dollar commissions").

149. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861, Investment Company Act Release No. 28,064, 72 Fed. Reg. 67,790 (proposed Nov. 30, 2007).

information to evaluate the overall costs of their investments, despite the importance of costs in the selection of mutual fund investments. In addition, many mutual funds and the broker-dealers that sell them do an equally poor job of educating investors about the importance of costs in selecting mutual funds.[150] As a result, many mutual funds are sold on the basis of the fund's past performance,[151] and many retail investors do not pay sufficient attention to costs in selecting mutual fund investments. The SEC acknowledged that "the degree to which investors understand mutual fund fees and expenses remains a concern,"[152] and in December 2003 published a concept release on improving disclosure of mutual fund transaction costs.[153] While the SEC adopted a rule requiring funds to provide periodic disclosure of fund expenses borne by the investors,[154] more meaningful reform is long overdue.

More recently, the SEC has undertaken two more ambitious rulemaking initiatives to improve disclosure of information to retail investors. One rule concerns disclosures in the prospectus provided by the fund;[155] the other deals with disclosures made by brokers when they sell mutual fund shares to their customers.[156]

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150. "Virtually all financial experts . . . consider a fund's risks, including the volatility of its past returns, and its expenses to be among the most important factors for investors to consider when selecting a fund." BARBARA ROPER & STEPHEN BROBECK, CONSUMER FED'N OF AM., MUTUAL FUND PURCHASE PRACTICES: AN ANALYSIS OF SURVEY RESULTS 1 (2006), *available at* http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf.

151. *Id.* at 1–2. This survey, conducted on behalf of the Consumer Federation of America as part of a research project funded by the NASD Investor Education Foundation, found that only a third of current fund owners considered either costs or volatility to be very important in selecting funds. Most investors, instead, gave more weight to fund company reputation and the fund's past performance. Significantly, those who purchased most of their funds directly were far more likely than either workplace purchasers or those who purchased most of their funds through a professional to consider costs important. *But see* INV. CO. INST., 2007 INVESTMENT COMPANY FACTBOOK 65 (2007), *available at* http://www.ici.org/pdf/2007_factbook.pdf (more than two-thirds of recent fund investors considered fees and expenses as well as historical performance in selecting funds).

152. Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8393, Exchange Act Release No. 49,333, Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,243 (Mar. 9, 2004).

153. Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Securities Act Release No. 8349, Exchange Act Release No. 48,952, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,819 (Dec. 24, 2003).

154. Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. at 11,244. The rule also requires periodic disclosure of portfolio investments and past performance. *Id.*

155. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861, Investment Company Act Release No. 28,064, 72 Fed. Reg. 67,790, at 67,798 (proposed Nov. 30, 2007).

156. Confirmation Requirements and Point of Sale Disclosure Requirements, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438 (proposed Feb. 10, 2004); Point of Sale Disclosure Requirements and Confirmation Requirements, Securities Act Release No. 8544, Exchange Act Release No. 51,274,

In November 2007 the SEC proposed significant changes in the content and delivery of mutual fund prospectuses—what the Agency describes as the "potential to revolutionize the provision of information to the millions of mutual fund investors who rely on mutual funds for their most basic financial needs."[157] To deal with the "long and complicated" prospectus,[158] the SEC proposes a "layered approach to disclosure."[159] Funds would be required to include a summary section (three to four pages) at the front of the prospectus consisting of seven categories of "key information,"[160] presented in plain English in a standardized order, to enable investors to evaluate and compare funds. If the prospectus applies to multiple funds, the summary information must be presented separately for each fund.[161]

In addition, the proposal would permit funds to meet the prospectus delivery requirements by giving a summary prospectus, consisting of the summary section containing the key information, and by providing the statutory prospectus online, with the investor having the option of requesting a paper copy of the statutory prospectus.[162] In this way, the SEC expects "to create a disclosure regime that is tailored to the unique needs of mutual fund investors in a manner that provides ready access to information that investors need, want and choose to review in connection with a mutual fund purchase decision."[163]

The SEC's proposal is premised on policy choices that require careful consideration. For example, despite Chairman Cox's great enthusiasm for the Internet, the emphasis on online delivery of the statutory prospectus does not meet the needs of investors who do not use computers and who will be required to take the initiative to ask for a hard copy. Nevertheless, it is a long-overdue first step toward improving prospectus disclosures. The Agency, however, does not have an encouraging track record of moving forward quickly on proposals with the potential to "revolutionize" current practice. The SEC's extended rule-making process on point of sale

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Investment Company Act Release No. 26,778, 70 Fed. Reg. 10,521 (reopening comment period Mar. 4, 2005).

157. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. at 67,792.

158. *Id.* at 67,790.

159. *Id.* at 67,798.

160. *Id.* at 67,812. Key information includes investment objectives; fees and expenses; principal investment strategies, risks and performance; top-ten portfolio holdings, investment advisers and portfolio managers; purchase and sale of fund shares; tax information; and financial intermediary compensation. *Id.* at 67,819–21. An illustrative hypothetical summary prospectus is found in an appendix to the Release. *Id.* at 67,822–24.

161. *Id.* at 67,793.

162. *Id.* at 67,798.

163. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. at 67,799. In addition, the SEC asks if it should require funds to tag any of the information using XBRL taxonomy to facilitate comparison of fund data. *Id.* at 67,804.

disclosure provides a telling example of the Agency's inability to adopt rules that generate substantial controversy from securities professionals.

First proposed in January 2004, the point of sale rule would require broker dealers to provide their customers, at the time of the sale, with information "regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares."[164] Over one-third of mutual fund sales are done through intermediaries, principally broker-dealers, [165] and broker-dealers typically market load funds to their less sophisticated customers.[166] Since many investors who purchase mutual funds on the advice of their broker frequently do not receive the prospectus from the fund until after they have consummated the purchase, the more meaningful opportunity for disclosure is from the broker at the time of sale. Investor groups have advocated for disclosure of targeted information and exclusion of irrelevant information to avoid "information overload."[167] Brokers have argued, however, that tailored disclosure would be too expensive and time-consuming.[168] The SEC has met with investor groups, conducted focus groups and engaged a consultant to assist in investor testing of possible forms for confirmation and point of sale disclosures. The proposal has generated tremendous controversy[169] and, after four years, has not yet resulted in a final rule. Some have accused the SEC of "dragging its feet."[170]

2. Board Oversight

As with trading abuses, quality of board oversight has direct bearing on costs. A principal function of the mutual fund board is to negotiate the advisory agreement.[171] Evidence that mutual fund advisers frequently charge lower fees to other institutional clients suggests that boards do not

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164. Confirmation Requirements and Point of Sale Disclosure Requirements, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438, at 6438 (proposed Feb. 10, 2004).

165. Disclosure of Breakpoint Discounts by Mutual Funds, Securities Act Release No. 8347, Exchange Act Release No. 48,939, Investment Company Act Release No. 26,928, 68 Fed. Reg. 74,732 (proposed Dec. 24, 2003).

166. *See* John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739, 745 (2007).

167. *See* Comments on Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, http://www.sec.gov/rules/proposed/s70604.shtml (last visited Apr. 1, 2008).

168. *See id.*

169. The SEC received over 1000 separate letters and another 4000 standard form letters. Point of Sale Disclosure Requirements and Confirmation Requirements, Securities Act Release No. 8544, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 70 Fed. Reg. 10,521, at 10,522 (reopening comment period Mar. 4, 2005).

170. Editorial, *SEC Dragging Its Heels on Point-of-Sale Rule*, INVESTMENT NEWS, Feb. 26, 2007, at 8.

171. *See* Investment Company Act, 15 U.S.C.A. § 80a-15(c) (2006).

perform this responsibility well.[172] The SEC's solution for this is disclosure: a new rule requires additional disclosure about how mutual fund boards evaluate, approve and recommend shareholder approval of investment advisory contracts.[173]

Directed brokerage arrangements[174] also call into question the adequacy of mutual fund boards' control of funds' costs. Since 1981, the SEC has permitted fund advisers to take into account brokers' sales of mutual fund shares in selecting a broker-dealer to execute the funds' transactions.[175] As a result, directed brokerage arrangements became commonplace among funds that used broker-dealers to sell their shares, even though the practice of trading brokerage for sales was likely to harm mutual fund investors for a number of reasons. Specifically, directed brokerage could adversely impact best execution of fund transactions, circumvent limits on distribution expenses, reduce the transparency of distribution expenses and give rise to broker conflicts of interest.[176] In 2004, the SEC acknowledged the conflict when fund advisers are permitted to use brokerage commissions to pay for the distribution of mutual fund shares.[177] The SEC's solution requires a fund or its adviser to implement policies and procedures designed to ensure

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172. *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798, at 39,799 (June 30, 2004); *see also* Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165 (asserting that the mutual fund board has not lived up to the expectations of the 1940 Act).

173. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. at 39,799.

174. *See generally* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,356, 69 Fed. Reg. 9726, at 9726–27 (proposed Mar. 1, 2004) (providing examples of such arrangements).

175. Order Approving Proposed Rule Change and Related Interpretation Under Section 36 of the Investment Company Act, 46 Fed. Reg. 16,012 (Mar. 10, 1981).

176. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 69 Fed. Reg. 54,728, at 54,729–30 (Sept. 9, 2004).

177. *See, e.g.*, Press Release, SEC, Franklin Advisers and Franklin Templeton Distributors to Pay $20 Million to Settle Charges Related to use of Brokerage Commissions to Pay for Shelf Space (Dec. 13, 2004), *available at* http://www.sec.gov/news/press/2004-168.htm; Press Release, SEC, SEC Charges Pimco Entities with Failing to Disclose Their Use of Directed Brokerage to Pay for Shelf Space at Brokerage Firms (Sept. 15, 2004), *available at* http://www.sec.gov/news/press/2004-130.htm. Similar conflicts are present when an adviser or money manager uses client commissions to buy research from a broker dealer, a practice known as "soft dollars." Moreover, the use of soft dollars further increases the difficulties for mutual fund investors in knowing the actual brokerage and other management costs of funds. *See* Christopher Cox, Chairman, SEC, Address at the Commission Open Meeting Regarding the Proposed Soft Dollar Interpretive Release (Sept. 21, 2005), *available at* http://www.sec.gov/news/speech/spch092105cc2.htm. Section 28(e) of the Securities Exchange Act, 15 U.S.C. § 78bb, provides a safe harbor for soft dollars, and the SEC's Interpretive Guidance places the responsibility on the money manager for determining whether the products or services provided by the broker falls within the safe harbor. Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978, at 41,980 (July 24, 2006).

that the fund's selection of selling brokers is not influenced by considerations about the sale of fund shares.[178] Approval of these procedures by the fund's board, including a majority of the independent directors, is also required.[179]

The SEC has also turned its attention recently to the issue of Rule 12b-1 fees.[180] Rule 12b-1 permits the use of fund assets to pay for distribution costs.[181] In 1980, when the SEC adopted Rule 12b-1 as a temporary measure, mutual funds were experiencing net redemptions and the SEC wished to nurture mutual fund growth.[182] At that time Rule 12b-1 fees were relatively small amounts used to offset distribution costs like printing and advertising.[183] Today, however, Rule 12b-1 fees have increased and are primarily used as a substitute for sales loads.[184] Thus, Rule 12b-1 allows funds to transfer selling costs that otherwise the fund managers or new investors would bear to the existing investors in the fund.[185] In addition, Rule 12b-1 fees contribute to investors' confusion about the costs of mutual fund investments,[186] particularly the less sophisticated investors who are the typical purchasers of load funds.[187]

Rule 12b-1 places specific responsibilities on the fund's board of directors and its independent directors to ensure that the fees benefit the fund and the fund investors. Fundamentally, the directors must conclude, "in the exercise of reasonable business judgment and in light of their fiduciary duties . . . that there is a reasonable likelihood that the plan will

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178. Prohibition on the Use of Brokerage Commissions to Finance Distribution, 68 Fed. Reg. at 54,730.

179. *Id.*

180. For criticism of the SEC's efforts to date, see Freeman, *supra* note 166, at 743 ("The [A]gency's efforts to provide quality disclosure to investors has been desultory, unfocused, often ineffectual, and sometimes counter-productive.").

181. *See* 17 C.F.R. § 270.12b-1(d) (2007).

182. Press Release, SEC, SEC Announces Roundtable Discussion Regarding Rule 12b-1 (May 29, 2007), *available at* http://www.sec.gov/news/press/2007/2007-106.htm; Christopher Cox, Chairman, SEC, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *available at* http://www.sec.gov/news/speech/2007/spch041207cc.htm.

183. Cox, *supra* note 182.

184. *Id.* Funds that use brokers to sell their shares typically compensate the brokers by imposing a fee on investors, known as a "sales load." SEC, Mutual Fund Fees and Expenses, http://www.sec.gov/answers/mffees.htm#salesloads (last visited Mar. 25, 2008).

185. Freeman, *supra* note 166, at 744.

186. Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Remarks Before the ICI 2007 Securities Law Developments Conference (Dec. 6, 2007), *available at* http://www.sec.gov/news/speech/2007/spch120607ajd.htm (opining that the rule in its current form is not functioning as it should).

187. Freeman, *supra* note 166, at 745. The complexity of the different share classes makes effective disclosure difficult. The hypothetical summary prospectus proposed by the SEC attempts to deal with this, but the explanations are not self-evident. *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861, Investment Company Act Release No. 28,064, 72 Fed. Reg. 67,790, at 67,822–24 (Nov. 30, 2007).

benefit the company and its shareholders."[188] Accordingly, both a majority of the fund's directors and a majority of the independent directors must approve the written Rule 12b-1 plan under which the fees are paid.[189] In addition, directors must review, at least quarterly, the amounts paid and their purposes and must also annually approve the continuation of the plan.[190] The benefit of Rule 12b-1 fees to the fund and its shareholders is typically stated to be economies of scale.[191] Academic studies, however, do not provide much support for a showing that fund investors benefit in any way from Rule 12b-1 fees.[192]

In 2007 the SEC held a roundtable on Rule 12b-1 fees and solicited comments on the rule.[193] As of November 2007, it had received more than 1,450 comment letters. Approximately 1,000 were form letters from financial planners and registered representatives who oppose reform.[194] An additional 400 letters were individualized letters from financial planners, the majority of whom opposed substantive reform.[195] Another twenty-five letters were from mutual funds, large broker-dealers, insurance companies, industry associations and counsel, the majority of whom also oppose substantive reform.[196] Only about ten letters submitted by investors support reform or repeal of the rule.[197] To date the SEC has not released any proposal for change, and signals from individual Commissioners indicate that significant change is unlikely. Chairman Cox has suggested that Rule 12b-1 fees could be justified to pay for administrative services provided to current investors,[198] and Commissioner Atkins recently expressed the view that the rule "had been a great success overall for investors" and requires only minor revisions.[199]

3. Brokerage Practices

As noted, some brokerage practices in selling mutual funds are harmful to mutual fund customers because of conflicts of interest that may cause

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188. 17 C.F.R. § 270.12b-1(e) (2007). To reinforce this, the rule requires that minutes describing the factors the directors considered and the basis for the decision to use company assets must be made and preserved. *Id.* at § 270.12b-1(d).

189. *Id.* at § 270.12b-1(b).

190. *Id.* at § 270.12b-1(b)(3).

191. *See* Cox, *supra* note 182; *cf.* Freeman, *supra* note 166, at 768–71.

192. *See* Freeman, *supra* note 166, at 770.

193. Transcript of SEC Division of Investment Management Rule 12b-1 Roundtable (June 19, 2007), *available at* http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf

194. Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Keynote Address at the Investment Company Directors' Conference (Nov. 28, 2007), *available at* http://www.sec.gov/news/speech/2007/spch112807ajd.htm.

195. *Id.*

196. *Id.*

197. *Id.*

198. Cox, *supra* note 182.

199. Paul S. Atkins, Comm'r, SEC, Remarks before the Independent Directors Council (Nov. 28, 2007), *available at* http://www.sec.gov/news/speech/2007/spch112807psa-2.htm.

selling brokers to select funds for their customers for reasons other than their suitability for their customers' investment goals.[200] In addition, many brokers have overcharged customers because they did not offer them discounts on fees to which they were entitled by reason of the size of their purchases (known as "breakpoints").[201] The SEC's response to this broker-dealer malpractice[202] was to require additional disclosure about breakpoints in the mutual fund's prospectus.[203]

4. Assessment

In the past few years the SEC has proposed numerous rules in an effort to provide fairer treatment to retail investors in mutual funds. Unfortunately, while the SEC regulatory approach has been consistent, it has not been effective in solving these problems. The SEC rulemaking approach principally consists of: (1) requiring or encouraging more responsibilities on the mutual funds' boards of directors, even though their past performance may not give cause for much confidence;[204] and (2) requiring more information in the prospectus, even if the relevance of the information may not be readily apparent to the retail investor and raises the danger of "information overload" that investor advocates have warned against.[205]

The poor track record of mutual fund boards is illustrated by their failure to negotiate lower advisory fees[206] and by their approval of ever-increasing Rule 12b-1 fees. In many ways, the history of Rule 12b-1 provides an excellent example of what is wrong with SEC regulation of mutual funds. The Agency adopted a temporary solution to address a specific issue, what were modest fees became big fees, and the fees became "ingrained" in the funds and the intermediaries who sell the funds.[207] The result is a "fund distribution system and the sometimes complicated share

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200. *See* discussion *supra* Part III.B.2.

201. NAT'L ASS'N SEC. DEALERS, REPORT OF THE JOINT NASD/INDUSTRY TASK FORCE ON BREAKPOINTS 4 (2003), *available at* http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p006434.pdf. These discounts are known as "breakpoints." *Id.* at 3.

202. The most frequent cause for not providing the discounts involved failures to recognize the customer's right to accumulate purchase amounts among related funds or related family members. Disclosure of Breakpoint Discounts by Mutual Funds, Securities Act Release No. 8347, Exchange Act Release No. 48,939, Investment Company Act Release No. 26,298, 68 Fed. Reg. 74,732, at 74,733 (proposed Dec. 24, 2003).

203. Disclosure of Breakpoint Discounts by Mutual Funds, Securities Act Release No. 8427, Exchange Act Release No. 49,817, Investment Company Act Release No. 26,464, 69 Fed. Reg. 33,262 (June 14, 2004).

204. *See supra* note 172; *see also* Jerry W. Markham, *Mutual Fund Scandals: A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 68–69 (2006) (concluding that the corporate governance model for mutual funds failed and is "overly costly, complex, and ineffective").

205. *See supra* note 149 and accompanying text.

206. *See supra* note 172 and accompanying text.

207. Donohue, *supra* note 186.

class structures" that, according to the current Director of Investment Management, no one would construct if "starting from scratch."[208] Moreover, all this occurred despite the fact that mutual fund boards must approve and annually review Rule 12b-1 plans.[209] Nevertheless, industry pressure makes meaningful reforms difficult.[210]

To state the obvious, the purpose of disclosure should be to provide *useful* information to investors. The SEC has a poor track record in assuring that mutual fund disclosures are meaningful to investors, particularly on the question of costs, as the point of sale disclosure process illustrates.[211] Using disclosure to encourage more responsible fund policies and practices has not proven to be an effective method of improving fund governance and is detrimental to the principal goal of disclosure, as it contributes to the length and complexity of the mutual fund prospectus.

The SEC's poor performance in assuring fair treatment for retail investors in mutual funds is especially disappointing, since, unlike the brokerage industry, the SEC is the regulator that is responsible for the mutual fund "brand." Congress floated the concept of a mutual fund SRO or a mutual fund-oversight board after the market timing scandals,[212] and there were strong arguments in support of a new regulatory model.[213] The industry, however, has consistently opposed the creation of an SRO for mutual funds, and Congress ultimately concluded that it would be counter-productive to derail the SEC's extensive rule-making efforts.[214]

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208. Donohue, *supra* note 186.

209. *See supra* note 189 and accompanying text.

210. *See, e.g.*, SEC. INDUS. & FIN. MKTS. ASS'N, RESPONDING TO MUTUAL FUND INVESTORS' CHANGING NEEDS: MUTUAL FUND DISTRIBUTION AND SHAREHOLDER SERVICING PRACTICES 3 (2007), *available at* http://www.sifma.org/regulatory/pdf/12b-1MFWhitePaper6-13-07.pdf ("Rule 12b-1 has been a success. . . . [I]t would be a major mistake for the SEC to withdraw or substantially curtail Rule 12b-1.").

211. *See* discussion *supra* Part III.B.1.

212. The concept of a mutual fund regulator, modeled after the broker-dealer SROs, is not new. Indeed, the SEC itself again raised the idea of a mutual fund SRO just a few months before the mutual fund scandal broke. Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25,925, Investment Advisers Act Release No. 2107, 68 Fed. Reg. 7038 (Feb. 5, 2003).

213. *See* the competing arguments of Professors Seligman and Nagy *supra* note 114; *see also* Zitzewitz, *supra* note 138, at 275 (discussing the SEC's slow response in dealing with market timing). In fairness to the SEC, it should be noted that the NASD, as SRO for broker-dealers, has responsibility for assuring that broker-dealers comply with mutual fund sales practices, and it also did not discover the market timing agreements.

214. *See supra* note 115 and accompanying text.

IV. COMPARISON: CONFLICTED RESEARCH AND MUTUAL FUND REFORM

A. THE SEC'S EFFECTIVENESS AS REGULATOR

A comparative assessment of the conflicted research and mutual fund reform efforts suggests that the SEC is most effective when it oversees the relevant SROs, rather than when it provides direct regulation over an industry. In the case of conflicted research, once it became clear that voluntary industry efforts would not be sufficient, the SROs quickly shepherded through the SEC approval process rules that addressed both the conflicts of interest and the quality of research, which were in place before Congress adopted SOX. Perhaps including conflicted research in SOX served a valuable purpose because it kept the issue alive and provided incentive for the regulators to continue their efforts. The SEC's own involvement was minimal. It participated in the Global Settlement, but the NYSAG was perceived as the dominant party. It adopted Regulation AC, requiring certification by analysts that the views expressed are their personal views and disclosure of any compensation received for specific recommendations. Both requirements were already encompassed under antifraud principles.[215] In short, the SEC's involvement may have been just enough to evidence a commitment to solving these problems.

In contrast, there is no SRO to take the lead in adopting regulations to deal with the trading abuses or any of the other complicated, technical issues involving mutual fund regulation. The SEC quickly responded in the market timing scandal by proposing a series of rules. This was sufficient to persuade Congress, after holding many hearings on mutual funds, to back away from the creation of another regulatory body or mutual fund SRO. This left the SEC to address the problems on its own, and it has turned out to be a prolonged approach that has not significantly improved the mutual fund as an investment for retail investors. Because of the importance of mutual funds to retail investors, it is disappointing that Congress did not pursue better solutions to regulating the industry. If Congress is serious about assessing the situation after SEC reforms are in place, now would be a good time for that reassessment.

B. THE SEC'S EDUCATION MISSION

Both the conflicted research and mutual fund reforms are premised on the importance of providing investors with good information to make informed investment choices, which presupposes investors who are capable of understanding the information. Indeed, the SEC identifies "encourage[ment] and promot[ion of] informed investment decision-

215. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

making" as a primary Agency goal,[216] so that investors will have "access to disclosure materials that are useful" and a "better understanding of the operations of the nation's securities markets."[217] The SEC's Office of Investor Education and Advocacy assists the SEC "in ensuring that in all of the Agency's activities, the SEC is truly 'the Investor's Advocate,'"[218] and according to the SEC, it has recently "reinvigorated its focus on retail investors"[219] with two objectives. First, it focuses on assessing the views and needs of retail investors and ensuring that their views inform the SEC's regulatory polices and disclosure programs.[220] Second, it seeks to improve financial literacy and help investors make informed investment decisions.[221]

The SEC performs this latter function principally by producing and distributing educational materials both in hard copy[222] and on its website.[223] The Investor Education page on the SEC website confidently asserts, "[while] we cannot tell you what investments to make, . . . we can tell you how to invest wisely and avoid fraud."[224] The information available includes basics on budgeting and saving,[225] a primer on fundamental investment principles,[226] a calculator for mutual fund costs,[227] and a variety of brochures on avoiding investment scams.[228] While the advice is sound, the presentation is not of the quality found in comparable publications prepared by securities firms.[229] However, the fact that the SEC, and not the

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216. 2004-2009 STRATEGIC PLAN, *supra* note 20, at 3; *see also* 2007 PAR, *supra* note 9, at 6 (identifying one of its goals as "foster[ing] informed investment decision making").

217. 2004-2009 STRATEGIC PLAN, *supra* note 20, at 44, 45. The SEC focuses on issuer (including mutual fund) disclosure and, to a lesser extent, disclosure of information about broker-dealers and investment advisers. It does not address the issue of research.

218. SEC, *supra* note 23.

219. 2007 PAR, *supra* note 9, at 37; *see also The State of the Securities Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (testimony of Christopher Cox, Chairman, SEC) (stating that "[e]xpanding the responsibilities of the Office of Investor Education and Advocacy will help the Commission stay firmly focused on its work to put individual investors first").

220. 2007 PAR, *supra* note 9, at 37.

221. *Id.*

222. *Id.* at 38.

223. The SEC estimates that its investor education web pages will receive about 15 million hits in fiscal year 2008. SEC, IN BRIEF: FY 2008 CONGRESSIONAL JUSTIFICATION 11 (Feb. 2007), *available at* http://www.sec.gov/about/secfy08congbudgjust.pdf.

224. SEC, Investor Education and Advocacy, http://www.sec.gov/investor.shtml (last visited Feb. 23, 2008).

225. SEC, Get the Facts: The SEC's Roadmap to Saving and Investing, http://www.sec.gov/investor/pubs/roadmap.htm (last visited Jan. 8, 2008).

226. SEC, Beginners' Guide to Asset Allocation, Diversification and Rebalancing, http://www.sec.gov/investor/pubs/assetallocation.htm (last visited Jan. 8, 2008).

227. SEC, The SEC Mutual Fund Cost Calculator, http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm (last visited Jan. 8, 2008).

228. *E.g.*, SEC, Oil and Gas Scams, http://www.sec.gov/investor/pubs/oilgasscams.htm (last visited Jan. 8, 2008).

229. *See, e.g.*, Merrill Lynch—Products & Planning, http://askmerrill.ml.com/publish/marketing_centers/adviceplanmain/ (last visited Jan. 8, 2008).

securities industry, provides this information may give it greater credibility with a retail customer, although it is difficult to assess this.

Perhaps Professor James Fanto was right when he suggested, in an earlier examination of the SEC's investor-education efforts, that the SEC is not in the best position to educate consumers, because, "the SEC staff simply lacks the continuous contact with consumers, the strong profit motive and/or *the need to justify its existence* that would enable it to design and tailor general education efforts to consumers' needs."[230] Nevertheless, one of the principal purposes of the federal securities laws, to provide better information to investors, necessarily depends on an investing public capable of understanding the information, either by themselves or with a financial services provider. At a time when the government expects citizens to provide for their financial security through their own investments, the government cannot leave investor education solely in the hands of the marketplace.

Considering the importance of investor education, it is disappointing that the SEC has not taken a prominent role in exploring better ways to educate investors. As part of the Global Settlement, the securities firms paid $55 million for investor education, and the SEC, with great fanfare, announced the creation of an investment education entity that would examine more creative ways of educating investors and would become "a national treasure that will benefit investors for years to come."[231] About eighteen months later, however, this entity was disbanded and the funds folded into the NASD Investor Education Foundation (now the FINRA Investor Education Foundation).[232] Today the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education.[233] Its mission is to "provide investors with high-quality, easily accessible information and tools to better understand the markets and the basic principles of saving and investing,"[234] and it has an active grant program to fund educational or research projects to accomplish this.[235] To date it has awarded thirty-nine grants totaling $10.4 million.[236]

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230. *See* Fanto, *supra* note 22, at 161–62 (emphasis added).

231. Press Release, SEC, Commission Investor Education Plan Approved; Investor Education Organization Leaders Named (Mar. 25, 2004), *available at* http://www.sec.gov/news/press/2004-40.htm.

232. Press Release, SEC, Revised Investor Education Funding Plan Approved (Sept. 2, 2005), *available at* http://www.sec.gov/news/press/2005-124.htm. For a fuller account of the missteps in the creation of the investor education entity, see Schack, *supra* note 94.

233. FINRA Investor Education Foundation—About Us, http://www.finrafoundation.org/about_us.asp (last visited Jan. 8, 2008).

234. *Id.*

235. FINRA Investor Education Foundation—Grants, http://www.finrafoundation.org/grants.asp (last visited Jan. 8, 2008).

236. Descriptions of awards are available at its website, as well as links to the results of completed projects. *See* FINRA FAQ, http://answers.atgnow.com/finra (follow "FINRA Foundation" hyperlink) (last visited Feb. 23, 2008); FINRA Investor Education Foundation—

V. CONCLUSION

The conflicted research and mutual fund reforms were undertaken for the express purpose of restoring the confidence of retail investors. Investor confidence takes on a different meaning today, as, increasingly, retail investors have no choice but to invest and take charge of their own investments for their financial security. The issue that should concern policy makers and regulators is not the specter of retail investors fleeing from the market, the traditional explanation for the importance of investor confidence. Rather, the likelihood that investors will be forced to participate in markets that they do not understand and that they do not perceive as fair should drive current reform efforts. Effective reform requires finding workable solutions to provide better protection for retail investors. To date the SEC has failed to enact reforms to accomplish this, even in response to two highly publicized examples of regulatory failure to address recognized industry practices that inflicted harm on retail investors. This article began by identifying four prerequisites for investor confidence. It concludes by repeating those prerequisites and summarizing the SEC's progress to date.

Reasonable belief in honest and fair treatment. While the SROs' rules have reduced the conflicts in sell-side research, the result is less research available to retail investors, and the SEC does not appear to consider the lack of research important. The SEC's mutual fund efforts do not inspire confidence in its ability or commitment to craft regulatory policies to deter industry practices that unfairly harm investors. In both instances, regulatory vigilance to enforce these policies is essential, yet the SEC has reduced its examinations of mutual funds.

Availability of accurate, useful information presented in a clear fashion. In the aftermath of the conflicted research and mutual fund scandals, regulators have done a poor job of determining what information is meaningful to retail investors. The SEC does not appear to have considered whether retail investors can be expected to read issuer disclosures or whether they need reliable third-party research. Mutual fund disclosures have long been acknowledged as confusing to investors, yet the SEC has been slow to take on this issue. Instead, its reforms mandating additional disclosure of questionable value to the retail investor have contributed to "information overload."

Investor education is an important aspect of fairness. The SEC's efforts on behalf of investor education have been more of a slogan than regulatory action. It is disappointing that the Agency has not taken a leadership role in exploring more effective methods to educate investors.

A regulatory agency that is performing its responsibilities competently and consistently, not just in response to scandals. Perhaps the most

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Grants Approved, http://www.finrafoundation.org/grants_approved.asp (last visited Jan. 23, 2008).

optimistic assessment at this point is that the SEC has plenty of unfinished business to attend to.

A real danger of the SEC efforts is that retail investors may perceive that the reforms justify a renewed confidence in the markets and therefore investors may develop an unwarranted sense of investor confidence. If the reforms did not result in meaningful change, then America's investors are doomed to repeat the boom and bust cycle that will eventually lead to another wave of scandals that will, in turn, once again shake investors' confidence in the fairness of the securities markets. Investors may reasonably ask what are they supposed to do to provide for their financial security and who will help them?