Volume 1 | Issue 1 Article 1

1999

Trends in the Regulation of Investment Companies and Investment Advisers

Tamar Frankel

Follow this and additional works at: https://digitalcommons.law.villanova.edu/vjlim

Part of the Banking and Finance Law Commons, and the Secured Transactions Commons

Recommended Citation

Tamar Frankel, *Trends in the Regulation of Investment Companies and Investment Advisers*, 1 Vill. J.L. & Investment. Mgmt. 3 (1999).
Available at: https://digitalcommons.law.villanova.edu/vjlim/vol1/iss1/1

This Article is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Journal of Law and Investment Management by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.

Trends in the Regulation of Investment Companies and Investment Advisers

Tamar Frankel*

Statutes, rules and enforcement actions are tea leaves we can read to predict future trends of mutual fund regulation. While statutes and rules are specific, the trends they signify are far more speculative. This Essay engages in such speculation to envision the long-term implications of the recent new N-1A disclosure form,[1] the plain English Rule,[2] and the profile.[3] More generally, the Essay speculates on future trends in Securities and Exchange Commission ("Commission") enforcement, and predicts a continued and stronger use of informal enforcement by the Commission.

I. THE LONG-TERM IMPLICATIONS OF THE NEW N-1A DISCLOSURE FORM, THE PLAIN ENGLISH RULE AND THE PROFILE

During the past decade, the Commission has made a fundamental change in its approach to determining mutual fund disclosure rules. Historically, the Commission relied on its own judgment and input from the industry to

---

* Professor of Law, Boston University School of Law. Professor Frankel is the author of, among other things, a four-volume treatise titled THE REGULATION OF MONEY MANAGERS (1978, 1980).

1 *See* Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7,512, 63 Fed. Reg. 13,916 (March 23, 1998) [hereinafter Registration Form Release] (adopting amendments to Form N-1A to "improve fund prospectus disclosure and to promote more effective communication of information about funds to investors").

2 *See* Plain English Disclosure, Securities Act Release No. 7,497, 63 Fed. Reg. 6,370 (Feb. 6, 1998) [hereinafter Plain English Release] (establishing plain English rules and principles for writing prospectus disclosure).

3 *See* New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 7,513, 63 Fed. Reg. 13,968 (March 23, 1998) [hereinafter Profile Release] (authorizing fund profile to provide summary of key information about fund).

Published by Villanova University Charles Widger School of Law Digital Repository, 1999

Villanova Journal of Law and Investment Management, Vol. 1, Iss. 1 [1999], Art. 1

determine the content and format of information that issuers should disclose to investors. More recently, however, the Commission has factored into its decision the wishes of investors, and has drawn disclosure contents and formats accordingly.

In order to ascertain investor preferences, the Commission has used focus groups and mass mailings that investors have answered on their own initiative or at the encouragement of others (for example, fund complex advisers). The Commission has also increased the use of the media, and polls and marketing methods designed to gauge public opinion. In sum, rather than relying only on its own judgment and industry suggestions on what investors need to know, the Commission sought investors' opinions about the substance, format and language of the information they want to receive, and those opinions have led to changes in disclosure requirements: modification of Form N-1A, emphasis on plain English, diverse forms of prospectuses, and permission to use profiles.

There are weighty arguments for paying attention to the desires of investors. Arguably, the securities acts covering securities transactions are designed to substitute for the rule of *caveat emptor* in contract law because investors cannot directly negotiate with issuers and ask them for information. Investors' questions are therefore determined by Congress and the Commission. To the extent that the Commission can determine (more or less) what information investors wish to receive, it should follow these wishes. One might argue, however, that the purpose of the securities acts is not merely to overcome the absence of direct negotiations but to entice investors to engage in securities transactions. These transactions are highly complex; investment decisions require a substantial amount of information, which may deter investors from engaging in securities transactions. Because securities markets are so important to our economy and political system, the government provides investors with support and incentives to engage in securities transactions. Government interference in this case is necessary as it is

in the case of the manufacture and distribution of drugs and poisons. Both can heal and kill. Because both arguments make sense, I suggest that the Commission's role is not fully abdicated to investors' desires (or the industry's desires), but that its decisions should present a mix of all three inputs: those of the investors, those of the industry, and those of the Commission as guardian of the public trust in the markets.

In addition to seeking investors' input on the substance and format of the information investors should receive from issuers, the Commission has initiated a movement to educate investors in investment decision-making. This new two-pronged approach can have serious implications for investors. The securities acts remove their protective mantle from investors that have relevant information about the issuers and the sophistication to evaluate this information. The movement to provide information that investors choose and to educate them may increase the number of investors who are not covered by the protection of the securities acts. This is designed to speculate about the implications of the Commission's new approach rather than to criticize it.

A. From Legal English to Plain English and Investor Education

Investors have long complained that prospectuses are not readable. The Commission has recently responded by a requirement to substitute plain, everyday English for the legal English used by lawyers and the courts.[4] The Commission has also taken the initiative to help investors understand the information on which they make their investment decisions by offering them educational materials and pressing issuers to educate investors by

[4] *See* Plain English Release, 63 Fed. Reg. at 6,370 (establishing plain English disclosure rules).

accessible plain English information about investment options.[5]

A requirement that fund disclosure be in plain English has its drawbacks. It introduces legal uncertainty because the plain English of new disclosure documents may be subject to different judicial interpretations than the legal English of the past. This uncertainty may be detrimental to both issuers and investors, depending on the extent to which it would lead to litigation and the outcome of litigation based on the new texts.

B. From a Uniform Format to a Diverse Disclosure Format; From a Single Document (Prospectus) to a Bifurcated Document (Prospectus and a Statement of Additional Information)

Heeding investor preferences, the Commission has allowed a diversity of disclosure documents, reflecting the diverse investor population and the varied information that different investors desire to receive before making their investment decisions. Some investors prefer detailed information while others seek simpler, more general information. Some investors buy or redeem shares after conducting their own research while others rely exclusively on the advice of investment advisers and brokers. Many investors fall within the two extremes. Consequently, the Commission allowed issuers to offer investors different types of disclosure documents in different sequences.[6] Issuers have adopted the variety of

[5] *See generally* James A. Fanto, *The Contribution of the Fund Profile to Investor Education*, 1 VILL. J. L. & INV. MANAG'T 59 (1999) (discussing benefits of investor education and plain English initiative).

[6] There are two times when a fund can provide an investor with disclosure documents, before an investment decision is made, and after the decision is made. A fund may provide an investor with any and all types of disclosure documents before an investment decision is made — advertising, a fund profile, a prospectus with or without a Statement of Additional Information (SAI). However, a fund may not accept money from an investor (permit an investment decision to be made) without first providing the investor with a profile or prospectus. If an investor makes an investment decision without having received a prospectus

disclosure formats permitted by the Commission. In part, the diverse format benefits issuers by reducing their costs and increasing their flexibility in designing more effective marketing materials.

These changes also affected the priorities and placement of information. One example relates to disclosure of conflicts of interest, including soft dollar arrangements.[7] Logically, disclosure of conflicts of interest helps investors

---

(but after receipt of a profile) the fund must provide the investor with a prospectus with confirmation of the purchase. *See* Profile Release, 63 Fed. Reg. at 13,969 ("An investor deciding to purchase fund shares based on the Proposed Profile would receive the fund's prospectus with the purchase confirmation."). A fund is not required to ever provide a potential investor with any document other than a prospectus. All other disclosure documents are optional. *See id.* at 13,971 (noting that profile is optional summary prospectus under section 10(b) of the Securities Act, but prospectus remains primary disclosure document). Section 10(b) of the Securities Act provides in part:

> In addition to the prospectus permitted or required in subsection (a) of this section, the Commission shall by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors permit the use of a prospectus . . . which omits in part or summarizes information in the prospectus specified in subsection (a) of this section.

15 U.S.C. § 77j(b) (1998).

[7] *See* Registration Form Release, 63 Fed. Reg. at 13,931 ("The Proposed Amendments also would no longer require a fund to state in its prospectus, if applicable, that the fund engages in brokerage transactions with affiliated persons and allocates brokerage transactions based on the sale of fund shares."). Disclosure of these soft dollar arrangements shifted to the SAI because "the Commission believes [they] are only of minimal importance to typical fund investors." *Id.*

The term "soft dollar arrangement" generally refers to a "triangular relationship between a money manager, his accounts and the broker." *See* Lee H. Pickard, *Institutional Portfolio Execution: Soft Dollar Arrangements,* 8 INSIGHTS 22 (Aug. 1990) (explaining that "money manager directs amount of portfolio commissions to broker . . . in return for execution services and research used by the money manager in making investment decisions on behalf of his client accounts."). These soft dollar arrangements are generally permitted under section 28(e) of the Securities Exchange Act. *See* 15 U.S.C. § 78bb(e) (1998) (providing that it is not unlawful to pay member of exchange, broker, or dealer a commission for "effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction").

In addition, the payment of commissions in these soft dollar arrangements is governed by section 17(e) of the Investment Company Act which provides:

choose their fiduciaries; investors may decide to avoid investing in funds whose advisers engage in conflicts of interest. In addition, such disclosure may preclude violations; if advisers must disclose their conflicts, they may avoid the conflicts altogether. Further, such disclosure facilitates legal enforcement actions; if advisers fail to disclose conflicts of interest, that failure *per se* constitutes a violation of the law.

However, many investors are not particularly interested in their fiduciaries' conflicts of interest. For the most part, in the United States investors trust the system, at least until they find that their trust in their fiduciaries was abused. Information about conflicts of interest is of interest after the fact, to the "private attorney generals" (the plaintiffs' bar), the enforcement arm of the Commission, and the courts.[8]

> It shall be unlawful for any affiliated person of a registered investment company or any affiliated person of such person . . .
>
> (2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

15 U.S.C. § 80a-17(e) (1998). Rule 17e-1 defines the "usual and customary broker's commission" as the term is used in section 17(e)(2)(A). *See* 17 C.F.R. § 270.17e-1 (1998) (providing in part that commission does not exceed usual and customary broker's commission, if it is "reasonable and fair" compared to commissions received by other brokers in comparable transactions).

[8] The Investment Company Act of 1940 vested the Commission with the duty to determine whether conflict of interest transactions would benefit investors. In the 1980s, approval of many transactions of this sort was transferred to funds' boards of directors and enforcement was relegated to the plaintiffs' bar. Disclosure was one of the mechanisms to reduce the plaintiffs' information costs and facilitate enforcement of fiduciary duties. This technique was one of the reasons prospectuses became longer and less readable.

In light of investors' priorities, the Commission has banished the conflict of interest disclosure to the Statement of Additional Information (SAI),[9] which reaches only a fraction of the investor population — those who ask for it. In the SAI, legal language is often still in bloom, for plaintiffs' lawyers to search for information on which to base claims, and the Commission's staff to look for evidence of wrongdoing. Thus, the SAI has retained to some extent the flavor of the prospectus of the past: the shield against, and basis for litigation.

C. From Traditional Textual Risk Disclosure to Graphic Presentations and More Specific Risk Description

Risk disclosure is not only affected by the plain English requirement, but also by the new item in Form N-1A, requiring graphic presentations of volatility of the portfolio, and to a lesser extent, risk. Arguably, requiring plain English and graphic description of risk raises the issuers' risk of liability. Hedging language that describes risks seems to have been an effective strategy to protect issuers against liability, at least in some courts.[10]

---

[9] *See* Registration Form Release, 63 Fed. Reg. at 13,929-931 (explaining that some disclosure of fund management and organization was moved to the SAI because it was "not necessary for a typical fund investor"). A mutual fund may, but is not required to, have an SAI as part of its registration statement. An SAI is not a prospectus, but if a fund includes information in the SAI that it would otherwise be required to include in its prospectus, the fund must offer to provide, and provide upon request, the SAI to investors. *See id.* at 13,917 (stating that goal of SAI was to provide investors "a prospectus that is substantially shorter and simpler, so that the prospectus clearly discloses the fundamental characteristics of the particular investment company").

[10] Under the "bespeaks caution" doctrine, "where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections and expectations with adequate cautionary language, these statements are not actionable as securities fraud." *In re* Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994). Almost all circuit courts have adopted the doctrine in some form. *See* Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just A State of Mind*, 58 U. PITT. L. REV. 619, 629 & n.51 (1997) (noting that all circuits except Fourth, Tenth and District of

However, the judicial trend in the courts may shift to require more specific explanations.[11] Specific explanations facilitate investors' investment decisions.

Perhaps we might witness more emphasis by issuers on risk, as they become convinced that promising less (not merely hedging after promising more) may be a better long-term strategy. Unlike the sales force that may focus on "spot sales," issuers seek to build their credibility with investing communities. Issuer credibility is crucial today because investors have a continuous relationship with mutual funds and their investment advisers, and investors continuously make substantial investments in the volatile equity markets. By promising less and shifting the decision on the level of risk to investors, issuers are less likely to be blamed for losses, and more likely to be trusted by investors.

Columbia Circuits have adopted doctrine; district courts in Tenth Circuit have adopted doctrine; Fourth Circuit has cited approvingly cases applying doctrine); *id.* at 628 & n.45 (citing cases); *see also* 15 U.S.C. §§ 77z-2 & 78u-5 (Supp. II 1996) (codifying safe harbor for forward-looking statements).

[11] *See In re Trump,* 793 F. Supp. at 554 (limiting application of doctrine to "precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus"). In affirming the district court's holding, the Court of Appeals for the Third Circuit stated that "a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation." 7 F.3d at 371-72 (adding that "[t]o suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge"); *see also* Rubinstein v. Collins, 20 F.3d 160, 167-68 (5th Cir. 1994) (applying doctrine following fact- and case-specific approach and stating, "cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law"); Furman v. Sherwood, 833 F. Supp. 408, 415 (S.D.N.Y. 1993) (requiring disclosure of assumptions on which predictions are based); Ballan v. Upjohn Co., 814 F. Supp. 1375, 1382 (W.D. Mich. 1992) (restricting application of doctrine to financial information; defendants allegedly concealed data concerning drug side effects); O'Hare, *supra* note 10, at 643 n.135 (noting disagreement over whether bespeaks caution doctrine "would protect an issuer if the issuer did not believe its forward-looking statement").

D. FROM COMMISSION AND INDUSTRY SUBJECT MATTER PREFERENCES TO EMPHASIS ON INVESTOR SUBJECT MATTER PREFERENCES

The substance of required information items has changed to accommodate investor preferences. For example, information about issuers' past performance, which the Commission has prohibited for decades, is now allowed, even though past performance is difficult to quantify and is not a predictor of future performance.[12] Yet, investors have consistently asked for this information. They may have done so perhaps because past performance may demonstrate the issuers' and advisers' ability to choose effective and creative portfolio managers. Past performance presented in a standard form may help investors compare the performance of funds long-term. The implication of this change is difficult to gauge. Whether this information is in fact misleading investors may never be known.

E. FROM THE PROSPECTUS AS AN INSTRUMENT FOR INVESTMENT PROFESSIONALS TO A TOOL FOR "DO IT YOURSELF" INVESTORS

The trend to provide investors' choice of information seems to imply that investors should make their own decisions as a matter of policy. The changes in the language, format and substance of the prospectuses and disclosure rules, and the emphasis on investor education seem to aim at encouraging investors to adopt a "do it yourself" mode. This new trend is likely to continue. Paternalistic designs, such as defined benefit plans, are replaced by 401(k) plans, which increase the involvement of savers-investors in investment decisions. The trend is also demonstrated by the proposed privatization of all or part of social security savings.

---

[12] *See* Registration Form Release, 63 Fed. Reg. at 13,951-952 (providing that management discussion of fund performance over the last ten years be included in Form N-1A).

There are two interesting related implications from this trend. One relates to the public policy concerning specialization and investors' reliance on the advisory and management industry and the importance of written information and advice to a large population of investors. The other implication relates to investors' protection.

The recent policy of encouraging "do it yourself" investors constitutes a fundamental shift from a strong public policy to promote specialization, supporting investors who rely on trained professionals. A large percentage of investors resort to broker-dealers and investment advisers to make investment decisions for them or with them. Such investors are either unsophisticated and hard to educate, or are not interested in devoting time and effort to self-education and self-investment management. These investors do not want a "do it yourself" package. They want reliable, trustworthy professional advice, oral or discretionary. For investors dependent upon such professionals, prospectuses are of little relevance, at least until investors decide to sue.

As to protection, these investors seek strict regulation of those who offer them advice. The new trend may help in this respect. Government cannot as strictly regulate oral disclosure by sales personnel and investment advisers as it can regulate disclosure. Educated investors with adequate information may help regulate the professionals. An alternative or at least supportive role can be played by the employers of the sales personnel. Thus, at the urging of the Commission, Congress authorized the Commission to sanction broker-dealers for failure to supervise their employees.[13] The Investment Advisers Act of 1940 places a similar duty on investment advisers.[14] To what extent

---

[13] *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 6(b), 78 Stat. 565, 571-72 (codified as amended at 15 U.S.C. § 78o(b)(4)(E) (1996)).

[14] *See* 15 U.S.C.A. § 80b-3(e)(5) (West Supp. 1998). For a discussion of supervision in the securities regulatory regime, *see* John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 171-206.

investor education will raise the level of protection remains to be seen.

At the same time, alternatives to disclosure as a means of enforcement seem to appear on the horizon. There is a growing focus on sales personnel, fund directors and investment advisers, by a possible increase of the strictness of their fiduciary duties, including a revision of their fees. Another trend that seems to point at strengthening the sales personnels' duties is already in sight involving the duties of employers to supervise their employees. These are not new areas of the law, but they seem to acquire attention, and that attention may continue.

A second implication of the trend to encourage investors to "do it themselves" relates to investor protection. A strong policy of encouraging investors to self-educate, self-inform, and self-regulate their advisers, and to make their own investment decisions, may reduce their protection, as the cost of protection shifts to investors. The fact that investors get the information they want in a readable form and obtain enhanced education implies a shift in responsibility to them. With this information and added sophistication, if they make the wrong decisions, they have only themselves to blame. Even with all its difficulties, the trend towards "do it yourself" investment decisions and responsibility is likely to continue in the foreseeable future.

II. TRENDS IN REGULATORY APPROACH

The Commission has increasingly refined and diversified its regulatory approach, and this trend is likely to continue. One can view the trend as a movement to reduce the Commission's direct regulation and use alternatives to achieve its regulatory goals.

The trend toward informal regulatory approaches by the Commission started long ago, perhaps from the day the Commission was established. For example, the drafters of

the Securities Act of 1933 envisioned a process in which issuers would file registration statements and the Commission would pass judgment on those registration statements. Soon thereafter, the Commission established a new process by which registrants had an opportunity to redraft the statements pursuant to staff comments.[15]

In the early 1970s, the Commission staff adopted a policy of publishing no-action letters which enabled it to obtain advance information about industry plans and prevent some violations of the law by providing industry with safe harbors before the fact and a source of law with a limited precedential value.[16] About the same time the staff and the industry through the American Bar Association started a dialogue that resulted in more constructive comments on the Commission's proposed rules by the bar. These comments were more useful and therefore more acceptable to the staff. This type of relationship has encouraged the Commission's development and use of informal enforcement mechanisms.

A. Informal Enforcement Mechanisms

The Commission has continued to develop different means for informal enforcement. It has increased the use of a public expression of concern over certain industry practices in the news media or by a "Dear Matt" letter: a letter to Matthew Fink, the president of the Investment Company Institute (ICI). Similarly, the Chairman and the

[15] Notwithstanding the different process, the Commission does not seem to have become a captive of the industry or the issuers. One explanation may be that issuers come and go and they have little opportunity to develop ongoing relationships with the Commission staff. However, the same may not be said with respect to the investment banking and investment management communities. Still, cooperation does not seem to result in capture perhaps because the industries as a whole are anxious to maintain the Commission's credibility as regulator and thereby the trust of investors in the industry communities.

[16] *See* Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 Bus. Law. 1019, 1021 (1987) (stating that importance of no-action process increased significantly in early 70s when the Commission determined that no-action letters should be public).

Commissioners accept speaking engagements. The Chairman holds "town meetings" to meet with investors. The staff appears at seminars, ALI-ABA courses, and ICI meetings, eagerly attended by industry, its lawyers and the media. In these communications the Commission and its staff state their positions, explain their decisions, and give fair warning about developing industry practices that are deemed violations. The Commission has also continued its monitoring of new problematic industry practices by noting industry's exemptions and no-action requests, and listening carefully to industry's presentations, and information from traditional sources.

Informal enforcement of this type has numerous advantages. First, it is effective in many cases. For example, after the Commission announced its decision to examine the soft dollar practices of the industry some lawyers experienced an avalanche of concerned clients' calls wondering how they could correct their practices, especially when they suspected that those practices were too lax. The mere announcement of the investigation produced substantial corrections.

To be sure, the announcement could have also produced more effective secret illegal practices. However, in an industry that is dependent on public confidence and recognizes the value of perceived tight regulation the chances of concealment on a large scale by successful fund advisers is unlikely. In addition, the industry recognizes that formal enforcement may lead to serious financial consequences; correcting lax practices is far more cost-effective and less risky.

Second, these communications are cost effective, relative to other enforcement mechanisms. They reduce enforcement costs for the Commission, industry and the courts. I believe, although I have no proof, that these announcements induce far more compliance and corrections than would after-the-fact, more formal proceedings.

Third, informal enforcement by way of public communications enhances the legitimacy of the Commission's formal enforcement actions. Such announcements meet many of the criteria for law: the announcements are usually clear and clarify the law, they are public, they are prospective, they put the industry and public on notice and they give fair warning about the Commission's future approaches with respect to perceived problems.

Fourth, informal enforcement of this sort sometimes helps the Commission sidestep serious mistakes highlighted by public reaction to informal communications.

Fifth, informal enforcement enables the Commission to design its enforcement and the law in a more flexible manner. This flexibility is crucial in light of the change in the Commission's regulatory focus dictated by Congress.[17] The Commission is becoming a mediator among the conflicting interests in the marketplace (investors, the industry, the issuers) rather than an advocate of one market segment (small investors). It is difficult to articulate the reasons for choosing a particular balance among these interests. It is easier and more effective to test the waters before, or perhaps in lieu of, a formal statement of the law.

Informal law-making may present problems especially if informality is coupled with lack of transparency. The law may become less clear; some parties may obtain preferential treatment; decisions may be postponed, allowing regulators to avoid responsibility. These dangers seem to be avoided for now. Informal enforcement is only public and addresses the industry or a segment of the industry rather than individual actors, and law proper is rarely announced informally. In addition, rules preclude lack of transparency. For example, the staff of the

[17] *See* H.R. REP. NO. 104-622, at 16 (1996) (stating that 1996 legislation "seeks to promote efficiency, competition, and capital formation in the capital markets without compromising investor protection" through a number of methods, including, "reducing regulatory burdens on the mutual fund industry"), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

Frankel: Trends in the Regulation of Investment Companies and Investment A

Commission may not speak at meetings that are not open to the public.[18]

B. USE OF PRIVATE SECTOR ENFORCERS

Private sector enforcers have played an increasingly important role in the securities areas. Accountants certify an issuer's financial statements and attorneys can sue the institutional agents of the issuer (the board of directors and officers) on behalf of a class and the issuer. In addition, the staff of the Commission has at times conditioned exemptions under the Investment Advisers Act of 1940 on a reputable accounting firm certification that the investment adviser has put in place the necessary control mechanisms.[19] A similar delegation of preventive enforcement power to rating agencies appears in rule 3a-7 under the Investment Company Act of 1940, exempting certain Special Purpose Vehicles used to securitize financial assets on condition that the securities of the exempt issuer are rated. Recently, the Commission proposed that accountants be required to certify as to the preparation of certain broker-dealers in solving the Year 2000 problem.[20] The Commission has also begun to emphasize the duties of investment bankers, investment advisers and other actors in the markets to supervise their

[18] For example, the staff may not participate in meetings organized by law firms for clients. *See* 15 U.S.C. § 552b(b) (1998) (providing that except in certain instances, "every portion of every meeting of an agency shall be open to public observation"). Public meetings, however, may involve entrance fees.

[19] *See* 15 U.S.C. § 80b-6a (1998) (stating that Commission may exempt persons or transactions from provisions of Investment Advisers Act if such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors").

[20] *See* Reports to be Made by Certain Brokers and Dealers, Exchange Act Release No. 39,724, 63 Fed. Reg. 12,056, 12,062 (Mar. 12, 1998) (proposing rule requiring accountant's opinion for broker-dealer's assertions regarding Year 2000 problem); *see also* Reports to be Made by Certain Brokers and Dealers, Exchange Act Release No. 40,164, 63 Fed. Reg. 37,709, 37,710 (July 13, 1998) (requesting additional comments).

Published by Villanova University Charles Widger School of Law Digital Repository, 1999

employees and prevent violations of the law.[21] This trend to delegation is likely to continue.

C. EXAMINATIONS

The Commission has also used a more formal enforcement tool through examinations of investment advisers and mutual funds. These examinations can be announced or unannounced. Examinations were less effective in the past because the Commission's resources could not match the need. In 1996 Congress reduced the Commission's burden by transferring the regulation of small investment advisers and investment companies to the states.[22] Thus, examinations have become far more effective. In addition, the staff has developed examinations targeted to a particular problem, which results in an effective way to address the problem.

The Commission has recently created an Office of Compliance, and moved all of its examiners to that Office. This move indicates the Commission's increased attention to examinations. Examiners perform an educational function as well as a preventive enforcement function. They take the position that a transgression that is disclosed and that has been corrected will be treated with far more leniency than a transgression that has not been disclosed and has not been corrected but rather has been concealed.

[21] *See* Walsh, *supra* note 14, at 171-206 (discussing supervision in securities regulatory regime, including Commission enforcement actions against broker-dealers and advisers).

[22] *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code). One of the amendments made by the 1996 Act was the Investment Advisers Supervision Coordination Act which transferred the regulation of small investment advisers and investment companies to the states. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1,633, 62 Fed. Reg. 28,112, 28,113 (May 22, 1997) (adopting new rules to implement provisions of Coordination Act that reallocate regulatory responsibilities for investment advisers between the Commission and the states).

Clearly, such concealment increases the Commission's enforcement costs and is discouraged. However, the disclosure and especially the correction sends a signal of approval and an incentive to industry to "self-correct." This signal is also strengthened by the Commission's incentives to the industry to "self-regulate." This means not only through a self-regulatory organization but mainly through encouraging compliance with the Commission's regulations by large fund complexes and other large industry actors. As these actors become larger, the cost to the Commission to monitor them far exceeds their internal costs for monitoring and prevention. Large industry actors also have at their disposal added sanctions for employees' violations; such as limitations on promotion and bonuses, and loss of employment.

D. TECHNOLOGY

Technology also affects both regulation and disclosure. While anti-fraud enforcement is more difficult on the Internet because the source of information can be anonymous, technology can be used to detect fraudulent statements and the Commission has enhanced its monitoring of the investment community through the use of new technologies, such as scanning the Internet.[23] The Commission has also provided investors with a Web site for information, answers to their inquiries and complaints.[24]

---

[23] *See* Will Morrow, *Is the Internet Participating in Securities Fraud?: Harsh Realities in the Public Domain*, 72 TUL. L. REV. 2203, 2210 (1998). In addition, there is a strong movement by international regulators to cooperate in cross-border frauds. *See* Tanya Epstein, et al., *Securities Fraud*, 35 AM. CRIM. L. REV. 1167, 1209 (1998) (noting that the Commision "currently has entered into 29 agreements with foreign counterparts for information sharing and cooperation").

[24] *See U.S. Securities and Exchange Commission* (visited Nov. 24, 1998) <http://www.sec.gov> (providing an extensive Web site for investors).

III. CONCLUSION

Informal enforcement mechanisms suggest a strong undercurrent that is likely to continue for some time, barring catastrophic market breakdown. The Commission's current approach tends to limit its formal regulatory actions, in perception and reality.

Informality tends to obscure the enforcement power behind advice, suggestions, and educational materials. Coaching investors into a "do it yourself" mode and developing the use of technology and automation for trading in securities point to limitations on formal regulatory actions. In sum, the Commission's recent actions signal a preference for a cooperative mode of regulation, and an informal exercise of government power, backed by possible exercise of ultimate direct power.

Straightening Out *Strougo:* The Maryland Legislative Response to *Strougo v. Scudder, Stevens & Clark, Inc.*

James J. Hanks, Jr.*

In May 1997, Senior United States District Judge Robert W. Sweet ignited a firestorm in the investment company world with his holding in *Strougo v. Scudder, Stevens & Clark, Inc.*[1] that, under Maryland law, receipt of "substantial compensation" in directors' fees for serving on the boards of several investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act" or the "Act")[2] with the same investment adviser "call[ed] into question the director's independence from the manager of that complex."[3] As a result, Judge Sweet excused the plaintiff-shareholder from making a demand on the Board of Directors of the Brazil Fund, Inc., (the "Brazil Fund" or the "Fund")[4] before filing a derivative action challenging an offering by the Fund to its shareholders of rights to buy more stock, which would have had the collateral result of increasing the investment adviser's asset-based fees because the sale of stock would have increased the Fund's assets.

The reasoning of the court's decision in *Strougo* implied that in any action affecting the investment adviser's interests, directors receiving substantial compensation (possibly as a result of serving on multiple

*James J. Hanks, Jr., is a partner in the Baltimore office of Ballard Spahr Andrews & Ingersoll, LLP, and an Adjunct Professor of Law at Cornell Law School. Mr. Hanks is the author of MARYLAND CORPORATION LAW (Supp. 1998).

[1] 964 F. Supp. 783 (S.D.N.Y. 1997), *reargument denied* (Aug. 18, 1997).

[2] 15 U.S.C. §§ 80a-1–80a-64 (1998).

[3] *Strougo*, 964 F. Supp. at 795.

[4] The Brazil Fund is a closed-end investment company advised by Scudder, Stevens & Clark, Inc. *See id.* at 787 (noting that shares of the Fund trade on the New York Stock Exchange).

Published by Villanova University Charles Widger School of Law Digital Repository, 1999

boards of commonly advised funds) would not be disinterested and, thus, their decisions would be open to attack under the standard of care for directors of Maryland corporations set forth in section 2-405.1 of the Maryland General Corporation Law (MGCL).[5] Section 2-405.1(a) of the MGCL requires that a director of a Maryland corporation perform his duties: "(1) [i]n good faith; (2) [i]n a manner he reasonably believes to be in the best interests of the corporation; and (3) [w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances."[6] Section 2-405.1(a) was adopted by the General Assembly of Maryland in 1976 and is derived, almost word for word, from former section 8.30(a) of the Model Business Corporation Act.[7]

The court also emphasized that because only one of the directors did not serve on multiple commonly advised boards, the Fund's board could not, under the MGCL, appoint a committee of disinterested directors to consider the plaintiff-shareholder's demand.[8] The MGCL, at the time of the relevant events, provided that the minimum number of directors to constitute a board committee was two.[9] Following Judge Sweet's decision, the same plaintiff filed a very similar complaint on behalf of a different closed-end fund, the Brazil Equity Fund, Inc., against its directors and the same investment adviser, seeking to

---

[5] MD. CODE ANN. CORPS. & ASS'NS § 2-405.1 (1998).

[6] *Id.*

[7] Section 8.30(a) of the Model Business Corporation Act was recently amended. *See* Committee on Corporate Laws, *Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct and Standards of Liability for Directors—Final Adoption*, 53 BUS. LAW. 813 (1998) (covering final adoption of certain amendments).

[8] *Strougo*, 964 F. Supp. at 795.

[9] *Id.* (stating that in Maryland, "two is the minimum number of directors necessary to form a committee to consider a demand"). In 1996, section 2-411(a)(1) was amended to decrease that number to one. *See* MD. CODE ANN. CORPS. & ASS'NS § 2-411(a)(1) (1998). Judge Sweet did not give any indication in his initial opinion or in his subsequent opinion denying reargument and certification that he was aware of this amendment to section 2-411(a)(1).

have demand excused in part due to the directors' service on the boards of other commonly advised funds.[10]

In August 1997, Judge Sweet denied reargument and further observed that his earlier order had "concluded that well-compensated service on multiple boards of funds managed by a single fund advisor can, in some circumstances, be indistinguishable in all relevant respects from employment by the fund manager, which admittedly renders a director interested."[11] The judge also denied certification of his interlocutory order to the Court of Appeals of Maryland (the state's highest court) for a definitive ruling on the issue that all the parties conceded was solely an issue of Maryland law.[12]

The Board of Directors of the Brazil Fund responded to Strougo's suit by electing an additional director, a visiting professor at the New York University business school with a Ph.D. in economics from Harvard and prior experience at Goldman Sachs, J.P. Morgan and the Federal Reserve Bank of San Francisco, who did not serve on any other boards of funds managed by the same investment adviser and thus was disinterested as a matter of Maryland law, even under Judge Sweet's ruling.[13] This new director, together with the one director whom Judge Sweet previously had identified as disinterested, was appointed to serve as a special litigation committee of the Fund's Board to review the allegations of the *Strougo* complaint.[14] The Fund sought and received a three-month stay of action in *Strougo* in order to permit the special litigation committee to complete its investigation.[15] However, the judge ordered that the stay should run from the date the motion for stay was filed, which meant that the stay

---

[10] Strougo v. Bassini, 1 F. Supp.2d 268 (S.D.N.Y. 1998).

[11] Strougo v. Scudder, Stevens & Clark, Inc., No. 96 Civ. 2136(RWS), 1997 WL 473566, *5 (S.D.N.Y. Aug. 18, 1997).

[12] *Id.* at *8.

[13] *See generally* Strougo v. Padegs, 986 F. Supp. 812, 814-15 (S.D.N.Y. 1997) (discussing appointment of new director).

[14] *See id.*

[15] *See id.* at 815-16 (stating that three-month stay was reasonable "[c]onsidering the complexity and seriousness of the allegations").

expired on December 15, 1997.[16] The special litigation committee retained the New York City firm of Simpson Thatcher & Bartlett as independent counsel to the committee.[17]

I. RATIONALE FOR CORRECTIVE LEGISLATION

Because Maryland has for many years been the favored jurisdiction for incorporation of mutual funds throughout the country, Judge Sweet's decisions in May and August 1997, roiled the investment company industry.[18] As a result, a drafting committee was formed under the auspices of the Committee on Corporate Laws (chaired by the author) of the Section of Business Law of the Maryland State Bar Association.[19] By December 1997, the drafting committee had concluded that corrective legislation was necessary for several reasons.

First, the court's holding, if not reversed, would have created tension between federal law and Maryland law. The investment company industry is predominantly organized in complexes — groups of funds offering different investment objectives but managed by the same investment adviser. Complexes generally employ a "pool" or "cluster" board structure in which the same independent directors serve on the boards of all or most of the funds in the complex. These structures permit

[16] *See id.* at 816.

[17] *Id.* at 814.

[18] Mutual funds are open-end investment companies. The Brazil Fund and the Brazil Equity Fund are closed-end funds. However, the logic, or lack thereof, of the court's decision applies equally to directors of open-end funds as to directors of closed-end funds. Thus, this article is written without regard for whether the situations described involve directors of open-end funds, closed-end funds or a combination thereof.

[19] Members of the drafting committee included: Larry Scriggins, Jay Smith and Henry Kahn of Piper & Marbury, LLP; Lee Miller of Venable, Baetjer and Howard; Dick Phillips and Jeff Maletta of Kirkpatrick & Lockhart LLP; Henry Hopkins of T. Rowe Price Associates, Inc.; Craig Tyle of the Investment Company Institute; Will Rheiner and John Ake of the Philadelphia office of Ballard Spahr Andrews & Ingersoll, LLP; and the author.

knowledgeable and efficient governance of the funds with the independent directors' oversight mandated by the rigorous requirements of the Investment Company Act. The Act sets forth specific criteria for determining when a director will be deemed an "interested person" of an investment company. Service on the boards of multiple funds with a common investment adviser and the receipt of "substantial" compensation for this service are not among these criteria. The Securities and Exchange Commission (SEC), which administers the Investment Company Act, has never determined that either service on multiple boards or the receipt of "substantial" compensation makes a director an interested person under the Act. Because approximately 1,600 investment companies registered under the Investment Company Act are incorporated in Maryland, it is important that Maryland law be consistent with federal law.

Second, there has never been any reason to believe that directors of an investment company or any other corporation are unable to act independently because they receive compensation — even "substantial" compensation — for their service on one or more boards. Directors are responsible to shareholders, not to the investment adviser of a fund complex or the management of an ordinary corporation, and receipt of directors' fees has not been held to taint the independence of directors of investment companies or of corporations generally. Indeed, in *Kamen v. Kemper Financial Services, Inc.*,[20] the United States Court of Appeals for the Seventh Circuit, applying Maryland law, held that receipt of directors' fees does not mean that directors are not independent.[21]

---

[20] 939 F.2d 458, 460 (7th Cir. 1991).

[21] *Id.* (rejecting plaintiff's argument that directors' fees meant directors were under fund's "thumb" because "[i]f allegations of this kind sufficed, the demand rule would be negated — for almost all directors receive fees"); *see also* Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) (directors' fees, "without more," do not affect directors' independence); Parnes v. Balley Entertainment Corp., Del. Ch. C.A. No. 15192, slip op. (May 12, 1997) (directors' fees and pensions, without more, do not imply that directors are not independent or disinterested).

Third, under Judge Sweet's holding, investment companies organized as Maryland corporations that share a common investment adviser could be precluded from having common independent directors. This would greatly increase the number of persons needed to serve on mutual fund boards, reducing the overall effectiveness and efficiency of these boards and unnecessarily increasing costs to shareholders with no resulting benefit.[22]

Fourth, many Maryland-incorporated investment companies operate multiple funds as separate series of shares of the same corporation, with one board of directors and one investment adviser, rather than as separate corporations, each with its own board. No one has ever objected to this structure as a matter of corporate governance. If the management of several series can be directed by one board of directors, there is no reason why several corporations cannot be capably governed by common boards.

Finally, under the judge's decision, boards composed of individuals who serve as directors of more than one mutual fund within the same complex would be disqualified from making many determinations affecting the investment adviser or other affiliates.[23] This, in turn, would subject a board's judgments on numerous issues to the threat of constant litigation and further undermine effective governance of these companies. Virtually any decision presented to the board of directors of an investment company may have the effect of increasing the

[22] Many issues addressed at a board of directors' meeting of one mutual fund in a complex must also be addressed at the meetings of other funds in the same complex. If each mutual fund in a complex must have a separate set of independent directors, the costs of educating each set of independent directors about the issues for which it is responsible could be significant and would be paid by shareholders.

[23] Disinterested directors of an investment company have responsibility for oversight of transactions between the investment company and its affiliates, including affiliates other than the investment adviser. *See, e.g.*, Investment Company Act Rule 17a-7, 17 C.F.R. § 270.17a-7 (1998). Transactions with these other affiliates could also be challenged under the reasoning in the court's decision.

company's assets and, therefore, the investment adviser's fees.

II. NEW LEGISLATION

Accordingly, the drafting committee developed a one-sentence bill, to add section 2-405.3 to the MGCL. The new bill provided:

> A director of a corporation that is an investment company, as defined in the Investment Company Act of 1940, who with respect to the investment company is not an interested person, as defined in that Act, shall be deemed to be independent and disinterested when making any determination or taking any action as a director.

Thus, the proposed new section 2-405.3 tied the independence and disinterestedness of a director of a Maryland-incorporated investment company to the definition of "interested person" in the Investment Company Act.[24] No implication was intended that failure to

[24] 15 U.S.C. § 80a-2(a)(19) (1998). The statute defines "interested person" as:

> (19) "Interested person" of another person means:
>
> (A) when used with respect to an investment company:
>
> (i) any affiliated person of such company,
>
> (ii) any member of the immediate family of any natural person who is an affiliated person of such company,
>
> (iii) any interested person of any investment adviser of or principal underwriter for such company,
>
> (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,
>
> (v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

meet the "interested person" standard of that Act would mean that a director of an investment company incorporated in Maryland could not be independent or disinterested.

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, that no person shall be deemed to be an interested person of an investment company solely by reason of: (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

In early January 1998, the draft bill[25] was submitted to the Maryland General Assembly's Legislative Reference Service, which re-organized the proposed section 2-405.3 into two subsections:

> (a) This section applies to a corporation that is an investment company as defined by the Investment Company Act of 1940.
>
> (b) A director of a corporation who with respect to the corporation is not an interested person, as defined by the Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a director.

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purpose of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

[25] The draft bill was sponsored by Delegate Robert L. Frank (Baltimore County), who had sponsored many corporate bills for the Maryland State Bar Association (MSBA) over the first three years of his service in the House of Delegates of the General Assembly, and Delegate Anne Marie Doory (Baltimore City). The Council of the Section of Business Law of the MSBA also approved the bill.

III. DEVELOPMENTS IN THE MARYLAND HOUSE OF DELEGATES

A. Introduction and Hearing

On January 30, 1998, this legislation was introduced in the House of Delegates as House Bill 356 ("H.B. 356" or the "Bill") and was assigned to the House Economic Matters Committee.[26] On February 19, 1998, the Committee held a hearing on the Bill.[27] Henry Hopkins of T. Rowe Price & Associates, Inc., Bryson Popham, representing the Maryland Securities Association, and the author, on behalf of the MSBA, testified at the hearing in support of the Bill. BT Alex. Brown, Inc. and Legg Mason, Inc. also sent letters in support. No one appeared in opposition to the Bill.

After the February 19 hearing, an amendment was proposed[28] providing that the Bill "shall be construed retroactively and shall be applied to and interpreted to affect only those cases filed on or after January 30, 1998."

---

[26] The House Economic Matters Committee was chaired by Delegate Michael E. Busch (Anne Arundel County).

[27] Shortly before the hearing, Dean Mark A. Sargent of Villanova University School of Law, formerly Chair of the MSBA Committee on Corporate Laws, sent a letter to the House Committee strongly criticizing Judge Sweet's decisions and supporting enactment of the Bill. In pertinent part the letter stated:

> Judge Sweet's holding that disinterested directors of commonly-advised investment companies may not be independent for purposes of considering an action that may increase the net assets and, therefore, the asset-based fees of the funds' advisers, is contrary to federal law on the subject and is unprecedented as a matter of state law....
>
> In my opinion, Judge Sweet's decision is wrong as a matter of Maryland law, as its extremely stringent conception of directors' independence is not based on any Maryland authority. It is also wrong as a matter of public policy. If not corrected promptly, it could be applied to an almost limitless number of board decisions, resulting in either sharply increased costs of administration or an industry-wide flight from Maryland.

Letter from Mark A. Sargent, Dean of the University of Villanova School of Law, to The Honorable Michael Busch, Chairman, House Economic Matters Committee (Feb. 16, 1998) (on file with the *Villanova Journal of Law and Investment Management*).

[28] Delegate Michael R. Gordon (Montgomery County), Vice-Chairman of the House Economic Matters Committee, proposed the amendment.

The proposed date (the date the Bill was introduced) was a compromise — it did not affect pending litigation, but it did close the potential window of opportunity for new suits to be filed before the customary effective date of October 1 for Maryland legislation. Proponents of the Bill acquiesced in the amendment.

B. Opposition

Shortly thereafter, the first opposition to the Bill emerged.[29] The first salvo was a one-page document,[30] which made several fallacious arguments that were often repeated.

One of the opposition arguments was that H.B. 356 would somehow limit the power of the shareholders of a Maryland corporation to bring a derivative suit. Nothing in

---

[29] The single opponent to the Bill was a plaintiffs' securities lawyer in Montgomery County.

[30] *See* Statement in Opposition to HB 356 (on file with the *Villanova Journal of Law and Investment Management*). The document contained the following points (as stated in the document — underlining replaced here with italics).

1. House Bill 356 seeks to create a special exception in Maryland law for investment companies ONLY — not available to any other Maryland Corporation.
2. The bill is the result of the finding in the *Strougo* case where Maryland law was applied and the Court found that there may not be two "disinterested Directors" (as required by Maryland law) and therefore did not dismiss the lawsuit brought by stockholders. The "disinterested" directors in the *Strougo* case were being paid **$81,000** and **$132,000** respectively for service on the Boards of 8 and 14 separate funds managed by Scudder, the investment company against which the action was brought. The mutual fund industry did not like the result of *Strougo* and therefore has introduced House Bill 356.

the Bill, of course, eliminated or diminished the right of shareholders to bring a derivative action. It simply adopted the standard of the Investment Company Act regarding who is an "interested person" in a decision by the board of directors of an investment company incorporated in Maryland. Shareholders of investment companies retain the full right to file suits on behalf of investment companies. Moreover, since 1881, the Court of Appeals of Maryland has required that a shareholder who brings a derivative action must first make demand upon the corporation to sue in its own name and the demand must be refused.[31] The reason for the demand requirement is because a derivative suit, in the words of the Court of Appeals, "is a matter for the corporate authorities themselves [that is, the board of directors], and not for the stockholders to determine. . . ."[32] In fact, Maryland shareholders have substantially greater rights to bring derivative suits than shareholders in many other states

3. Since 1881, the Court of Appeals of Maryland has permitted stockholders to bring a derivative action on behalf of the company if they believe that the Board of Directors has been engaged in self-dealing or breached its fiduciary duties to the corporation.
4. House Bill 356 seeks to prevent stockholders from bringing such an action directly before the Court if they believe that the Board of Directors is not "disinterested" and is engaging in self-dealing.
5. The last serious attempt to undermine these rules occurred in the mid-1960s. The Court of Appeals of Maryland soundly rejected the suggestion that the protections of Maryland law be weakened and stockholders be forbidden from asking a judge to look at their claims.
6. The Courts in Maryland have not had difficulty applying Maryland law to mutual funds and other companies. No segment of the legitimate business community has been hurt by a judge's ability to consider claims of fraud, waste or mismanagement. There is no reason to change Maryland law.
7. The Security *(sic)* and Exchange Commission (SEC) was asked by the Investment Company Institute to take industry's side in *Strougo* but the SEC refused to do so. Only the party that lost in the case thinks the judge was wrong.
8. HB 356 weakens the State's ability to protect investor's interests and does not better the mutual fund industry.

[31] Booth v. Robinson, 55 Md. 419, 439 (1881).

[32] Davis v. Gemmell, 70 Md. 356, 376 (1889).

because Maryland retains the futility exception to the demand requirement.[33]

Another opposition argument was that H.B. 356 would weaken the ability of the State of Maryland to protect the interests of fund shareholders. This argument overlooked the fact that protection of investors in funds has historically been primarily the responsibility of the SEC,[34] which has never adopted Judge Sweet's position. The MGCL, however, is the responsibility of the General Assembly of Maryland. For several decades the Maryland legislature has adopted reasonable and responsible legislation concerning the governance of investment companies formed in Maryland.[35]

[33] The futility exception excuses the requirement of demand on the board before a derivative action is brought. *See, e.g.*, ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (1994) (explaining that "[w]hat constitutes futility varies among jurisdictions"). In Maryland, however, the exception has been construed very narrowly. For example, in *Kamen*, the court held that under Maryland law, "a demand is 'futile' only if the directors' minds are closed to argument." *Kamen*, 939 F.2d at 462. Moreover, both The American Law Institute and the Model Business Corporation Act have eliminated the futility exception and have adopted a requirement of demand in all cases, subject only to a limited exception for irreparable harm to the corporation. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (1994); REVISED MODEL BUS. CORP. ACT § 7.42 (1998). The Supreme Court of Pennsylvania, in a recent landmark case, specifically adopted the universal demand rule of the ALI. *Cuker v. Mikalauskas*, 692 A.2d 1042, 1049 (Pa. 1997).

[34] As noted above, the SEC administers the Investment Company Act. The Act provides numerous protections for fund shareholders. *See, e.g.*, 15 U.S.C. §§ 80a-12 & 80a-17 (1998). The Act does not, however, preclude the application of state corporate law to funds incorporated in a particular state.

[35] One of the early reasons why many investment companies formed in Maryland was that Maryland law permitted redemption of shares of common stock. *See* MD. CODE ANN. CORPS. & ASS'NS § 2-105(a)(5) (1998). The Maryland legislature has also enacted many statutes specifically for investment companies, including unilateral redemption of small accounts, *see id.* at § 2-310.1, exemption from annual meetings, *see id.* at § 2-501(b), and power to make certain charter amendments without stockholder approval, *see id.* at § 2-605(a)(4). For further discussion, see Mark A. Sargent, *Maryland's Leadership in the Law of Business Organizations*, MD. B.J. (Jan./Feb. 1997), at 15, 17-18. In addition, there are many generally applicable features of the MGCL that are attractive to investment companies, including the absence of any franchise tax.

C. Passage by the House

After a favorable report from a specially constituted work group,[36] the House Economic Matters Committee voted on March 24, 1998, to give a favorable report to H.B. 356.[37] Three days later, H.B. 356 was passed by the House of Delegates by a vote of 83-36. The three dozen votes against the Bill in the House indicated that there could be serious opposition to the Bill in the Senate of Maryland.

IV. DEVELOPMENTS IN THE MARYLAND SENATE

A. Opposition Arguments

In the Senate, the Bill was referred to the Committee on Judicial Proceedings.[38] On April 3, 1998, the opponent sent a letter to the chairman of that committee that was filled with various incorrect and irrelevant statements. For example, the letter asserted that the proponents of the Bill were wrong when they claimed that Judge Sweet's decision "misstates Maryland law."[39] To support its assertion ,the letter then cited several cases establishing the demand requirement and the futility exception in derivative proceedings — issues that were totally beside the point of Judge Sweet's decision.

The letter also challenged the claim that compensation for service as a director does not taint a director's independence by citing several cases involving some form of compensation or some relationship other than directors' fees. In addition, the letter miscited an article in The New

[36] Chairman Busch appointed a "work group," chaired by Delegate Michael A. Crumlin (Prince George's County), to review H.B. 356 and all other pending legislation relating to corporations and other forms of business entities.

[37] The vote was 16 in favor, three opposed, with one abstention and one absent.

[38] The Senate Committee on Judicial Proceedings was chaired by Senator Walter M. Baker (Cecil County), one of the most senior and respected members of the Senate.

[39] Letter from Ronald B. Rubin to The Honorable Walter M. Baker, Chairman, Senate Judicial Proceedings Committee (April 3, 1998) (on file with the *Villanova Journal of Law and Investment Management*).

York Law Journal, co-authored by Dennis J. Block,[40] for the proposition, as stated in the letter, that directors "who receive substantial payments for these services" are not "independent."[41] In fact, Mr. Block in the then-current edition of his celebrated treatise, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, specifically states that demand is not excused merely because directors "[r]eceive compensation for service as directors . . . ."[42]

Most egregiously, however, the letter claimed that H.B. 356 would "insulate the actions of a mutual fund's Board of Directors from any judicial scrutiny."[43] There was no acknowledgment of the fundamental distinction that the Bill was not aimed at derivative suits but only at the narrow issue addressed by Judge Sweet — the disinterestedness of investment company directors who receive "substantial compensation" for serving on multiple boards of commonly advised investment companies.

B. HEARING

On April 6, 1998, a hearing regarding H.B. 356 was held before the Senate Judicial Proceedings Committee.[44] Testimony offered in opposition to the Bill included several inflammatory and irrelevant comments.[45] It referred to the "futility demand" cases in Maryland, apparently meaning

[40] D.J. Block & J.M. Hoff, *Corporate Governance and Independent Directors*, NEW YORK LAW JOURNAL, July 21, 1994, at 5.

[41] Letter from Ronald B. Rubin to The Honorable Walter M. Baker, *supra* note 39.

[42] DENNIS J. BLOCK, ET AL., THE BUSINESS JUDGEMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 756, 759 (Supp. 1995).

[43] Letter from Ronald B. Rubin to The Honorable Walter M. Baker, *supra* note 39.

[44] Although it is the tradition of the Committee not to invite witnesses other than the sponsor to testify on bills already passed by the House of Delegates, Senator Baker asked the author of this article and the opponent's representative to testify before his Committee on H.B. 356.

[45] The author testified first, so he did not have an opportunity at the time to rebut the inaccurate statements made in opposition to the Bill. The author did submit a letter after the hearing responding to the erroneous points in that testimony. Letter from James J. Hanks to The Honorable Walter M. Baker, Chairman, Committee on Judicial Proceedings (April 8, 1998) (on file with the *Villanova Journal of Law and Investment Manqgement)*. The discussion of the testimony in

cases establishing the futility exception to the demand requirement in derivative suits, none of which were affected by H.B. 356. It also repeatedly referred to "stacking of fees" and "stacking of directorships," despite the fact that Judge Sweet's point in the *Strougo* case was not the number of directorships but the amount of compensation involved. More to the point, the testimony in opposition not only ignored cases holding that the compensation paid to directors does not affect their independence but also noticeably failed to cite a single case holding that the amount of compensation paid to directors does taint their independence.[46]

The testimony also stated that "Maryland law requires two disinterested directors" to approve dismissal of a derivative suit. There is no such law. Perhaps the testimony was referring to Judge Sweet's reference to the two-director requirement for members of committees of the board of directors of Maryland corporations. As noted above, after the events giving rise to the *Strougo* case, the General Assembly, following Delaware and many other states, amended the MGCL to decrease the minimum number of directors for board committees from two to one.[47]

C. Unfavorable Report, Amendment, Enactment

The Judicial Proceedings Committee on April 9, 1998, gave an unfavorable report to H.B. 356 by a vote of eight to three. The fact that two other corporate law bills heard the same day were also given unfavorable reports suggests that the unfavorable report of H.B. 356 was based on the end-of-the-session crush of bills or other considerations not relating to the merits of the bills.

The proponents of H.B. 356 were discouraged but not deterred by the unfavorable report in the Senate Judicial

---

opposition to the Bill is based on the letter from the author to Chairman Baker, rather than a copy of the testimony.

[46] For a discussion of cases holding that the compensation paid to directors does not affect their independence, see *supra* note 21.

[47] *See supra* note 9.

Proceedings Committee.[48] During the last few days of the 1998 session, the substance of H.B. 356 was amended onto another bill, S.B. 468 (which had already passed the Senate), on the floor of the House of Delegates with the help of members of the House Economic Matters Committee.[49] Debate on the House floor was particularly lively but after a delegate[50] stood up and announced that Maryland investment companies would consider reincorporating in other states if S.B. 468 failed, S.B. 468 passed the House by a vote of 113 to 10, giving the amended S.B. 468 thirty more favorable votes than H.B. 356 on final passage in the House. After passing the House, the bill was sent back to the Senate, which concurred with the House amendment to the bill by a vote of 27 to 19 on April 12, the final day of the 1998 legislative session.[51]

Senate Bill 468 was signed by Governor Parris N. Glendening on May 12, 1998, as Chapter 397 of the Laws of Maryland (1998), and became effective on October 1, 1998. On November 3, 1998 most of the Maryland State Senators and Delegates responsible for straightening out *Strougo* were reelected. The sponsor of H.B. 356 was not, however, on the ballot. He had lost in the Democratic primary election in September.[52]

---

48 Strong support for the Bill was provided by George Roche and Henry Hopkins of T. Rowe Price and Associates, Inc.; Bryson Popham and John Stierhoff, representing the Maryland Securities Association; and Paul Tiburzi of Piper & Marbury, aiding the author's efforts in representing the MSBA.

49 Chairman Busch and Delegate Crumlin were particularly helpful.

50 Delegate Crumlin.

51 Senator Thomas V. Mike Miller, Jr. (Prince George's County), President of the Senate, and Chairman Baker aided in passage of the amended Senate bill.

52 In the quadrennial elections for the General Assembly in November, 1998, Senate President Miller, Senator Baker, Delegate Busch and Delegate Gordon were easily re-elected. Delegate Crumlin did not run for re-election. Delegate Frank, the sponsor and tireless worker for H.B. 356, was defeated in the Democratic primary election in September, 1998, by 96 votes.

V. MEANWHILE, BACK AT THE COURTHOUSE

While the legislative wheels were beginning to turn in Maryland, on January 7, 1998, defendants in the original *Strougo* suit filed a motion to dismiss based on the recommendation of the two-director special litigation committee.

On May 27, 1998, the same day that the House of Delegates gave final approval to H.B. 356, the Court of Special Appeals of Maryland decided *Wittman v. Crooke*.[53] The court held that the possibility of serving on the board of directors of an acquiring corporation does not violate the duties of the directors of the target corporation in approving a merger with the acquiring corporation.[54] *Wittman* arose out of the proposed merger between Baltimore Gas & Electric Company (BG&E) and Potomac Electric Power Company.[55] The plaintiff, a shareholder in BG&E, alleged that the BG&E directors were prohibited from recommending the merger because each director might be elected to the board of the successor.[56] The court held that the possibility that one or more members of the board of directors of an acquired corporation might be elected as directors of the acquiring corporation is not "sufficient to cause the kind of conflict of interest that cannot be ratified by the shareholders."[57] Likewise, the adoption of employment contracts for the directors and the CEO did not create a non-ratifiable conflict.[58] This ruling of the Court of Special Appeals strongly reinforced the position taken by the proponents of H.B. 356.

---

[53] 707 A.2d 422 (1998).

[54] *See id.* at 425 ("We reject appellant's argument that the opportunity for a position on the board of directors of the new corporation is sufficient to cause the kind of conflict of interest that cannot be ratified by the shareholders.").

[55] *Id.* at 423.

[56] *Id.* at 425.

[57] *Id.*

[58] *See id.* Unfortunately, the court repeated the mistake of earlier decisions in holding that section 2-419, the interested director statute of the MGCL, could be "violated." The court also erroneously analyzed the BG&E directors' duties under the business judgment rule, which has largely been superseded by section 2-405.1 of the MGCL. *See* James J. Hanks, Jr., Maryland Corporation Law § 6.8 (Aspen Law and Business Supp. 1998).

On April 6, 1998, the same day as the hearing before the Senate Committee, Judge Sweet denied the defendants' motion to dismiss the original Strougo complaint against the Brazil Fund.[59] The judge ruled that, although the issue had not been decided by a Maryland court, Maryland would apply the standard established by the Supreme Court of Delaware in *Zapata v. Maldonado*[60] and (a) impose on the corporation the burden of proving that the board committee recommending dismissal of a derivative action was independent, acted in good faith and had a reasonable basis for its recommendation and (b) permit the court to apply its own business judgment to the committee's recommendation.[61] Although Judge Sweet noted that the Brazil Fund "has met its *prima facie* burden of proof with respect to the *Zapata* standard,"[62] he permitted further discovery by the plaintiff, including inspection of the 30 boxes of documents made available to the special litigation committee, inspection of the notes of interviews by the committee and drafts of the committee's report and deposition of the members of the committee — just the sort of fishing expedition that the universal demand rule is designed to avoid.

On that same day, Judge Sweet also denied a motion to dismiss the derivative action claims in the suit against the Brazil Equity Fund on the ground that Strougo had established futility of demand because of the receipt of fees (less in aggregate amount than in Strougo's first action) by directors from multiple commonly advised funds.[63]

In late November, 1998, Judge Sweet dismissed the remaining claims brought by Strougo and his suit against the Brazil Fund.[64] The dismissal was based on the determination by the special litigation committee that continuation of the action was not in the best interests of

---

[59] Strougo v. Padegs, 1 F. Supp.2d 276, 282 (S.D. N.Y. 1998) (stating that motion to dismiss is denied and additional discovery is permitted).

[60] 430 A.2d 779 (Del. 1981).

[61] Strougo v. Padegs, 1 F. Supp.2d 276, 280-281 (S.D.N.Y. 1998).

[62] *Id.* at 282.

[63] Strougo v. Bassini, 1 F. Supp.2d 268, 273-74 (S.D.N.Y. 1998).

[64] Strougo v. Padegs, No. 96 Civ.2136(RWS), 1998 WL 805038, *16 (S.D.N.Y. Nov. 18, 1998).

the Fund or its shareholders. Judge Sweet determined that both members of the committee were independent and rejected the argument that bias due to the independent directors' relationship to the other directors tainted the committee's independence. The court then found that the committee had reached its conclusions in good faith, independently and with a reasonable basis, thus satisfying the first requirement of the *Zapata* standard of review. Applying the second requirement of the *Zapata* standard — application by the court of its own business judgment — the court found that Strougo's claim that the directors and the Fund's investment manager had breached their duties was unlikely to succeed, that there was no proof of damages to the Fund from the rights offering and that Strougo's claims did not merit further consideration.

VI. EPILOGUE

On December 4, 1998, Massachusetts Governor Paul Celluci signed Senate Bill 2079, the Massachusetts Prudent Investor Act, providing, among other things, that a trustee of a trust registered under the Investment Company Act as an investment company with the SEC who "is not an interested person, as defined in said Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a trustee."[65] The Massachusetts legislation adopted almost the exact words of H.B. 356.

Finally, by the Fall of 1998, at least five suits had been brought against various funds and advisers challenging the independence of directors serving on multiple boards of commonly advised mutual funds under the Investment Company Act itself, rather than under state law.[66]

---

[65] 1998 Mass. Laws ch. 398, § 2A.

[66] Carol Carangelo, *Common Boards Targeted at Prudential and Fidelity*, FUND DIRECTIONS (Oct. 1998). One of the two co-counsel in all five suits was the sole opponent to H.B. 356.

Commentary on a Rare Luddite Victory — The *Templeton Dragon Fund* Shareholder Proposal No-Action Letter

Howard M. Friedman*

Securities and Exchange Commission (SEC) no-action letters have been described by the United States Court of Appeals for the Second Circuit as "non-binding statements of the SEC's intent not to prosecute a potential rule violation."[1] Formally they have no binding effect even on the parties to whom the letter is issued.[2] Nevertheless, lawyers have come to rely on SEC no-action letters for guidance in interpreting federal securities laws.[3] Several developments explain the increasing importance of no-action letters. First, on-line services such as LEXIS and Westlaw have made no-action letters more accessible. Second, the body of securities case law that is available for guidance is diminishing as the courts and Congress narrow private rights of action. Third, more disputes are resolved through arbitration, resulting in unwritten opinions. Therefore, the rare no-action letter that appears to depart radically from more formal SEC pronouncements deserves attention.[4]

* Professor of Law, University of Toledo College of Law. Professor Friedman is author of SECURITIES REGULATION IN CYBERSPACE (2d ed., 1998).

[1] New York City Employees' Retirement Sys. v. SEC, 45 F.3d 7, 13 (2d Cir. 1995) (citing Amalgamated Clothing & Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994)).

[2] *See Amalgamated Clothing*, 15 F.3d at 257 (noting that SEC no-action letter does not fix any legal relationship between parties).

[3] *See* Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019 (1987) (noting that no-action process is chief mechanism "permitting the public and practitioners to obtain the informal views of the SEC staff on proposed transactions that appear to raise compliance issues under applicable federal securities laws and the rules thereunder"); Richard H. Rowe, *A SEC Staff "No-Action" Position: An Impervious Shield Against Liability or a Paper Tiger?*, 6 INSIGHTS 21 (July 1992).

[4] For judicial discussion of another example of a no-action letter that departed from a formal SEC pronouncement, *see* New York City

The June 1998 *Templeton Dragon Fund* no-action letter[5] may be unique in departing radically from two separate lines of formal Commission interpretations without acknowledging either departure. Particularly since 1995, the SEC has been in the forefront of those encouraging innovative uses of Internet technology to disseminate information to investors.[6] In both letter and spirit, *Templeton Dragon Fund* reverses course. Moreover, in 1992, the SEC adopted extensive amendments to its proxy rules to encourage more communication among shareholders who were not actually seeking authority to vote the shares of others. It did this by deregulating a good deal of speech among investors who were not themselves seeking proxy authority. No longer was every communication that related to matters on an upcoming meeting agenda to be screened in advance by the SEC. The requirement to speak only through a formal proxy statement was to be applied more selectively.[7] *Templeton Dragon Fund* also repudiates an important application of these 1992 liberalizations.

Employees' Retirement Sys. v. SEC, 45 F.3d 7 (2d Cir. 1995) (holding that no-action letter was interpretive, not legislative, and thus not subject to notice and comment procedures, and was reviewable as arbitrary or capricious agency action only through a suit against the issuer).

[5] Templeton Dragon Fund, Inc., SEC No-Action Letter, 1998 WL 337469 (June 15, 1998) [hereinafter *Templeton Dragon Fund*].

[6] The two major SEC releases that initiated the SEC's pro-technology stance were Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7,233, 1 Fed. Sec. L. Rep. (CCH) ¶ 3,200 (Oct. 6, 1995) and Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Information, Securities Act Release No. 7,288, 1 Fed. Sec. L. Rep. (CCH) ¶ 3,201 (May 9, 1996). *See generally* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE (2d ed., 1998).

[7] *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (noting that new rules remove "unnecessary government interference in discussions among shareholders of corporate performance").

I. BACKGROUND OF *TEMPLETON DRAGON FUND*

The SEC's shareholder proposal rule, Rule 14a-8, embodies finely tuned compromises between the interests of management and those of shareholders.[8] If a shareholder who has not solicited its own proxies must first introduce a proposal that management opposes from the floor of the shareholders' meeting, the proposal will surely be defeated. Management will hold sufficient proxies, with discretionary authority to vote on proposals raised for the first time at the meeting, to defeat any such proposal.[9] Even so, it is typically cost-prohibitive for a small shareholder to solicit its own proxies in order to obtain passage of a resolution at the shareholders' meeting of a publicly-held company. Therefore, for many years, Rule 14a-8 has permitted a shareholder to submit a proposal to management that the shareholder wishes to place before fellow investors at the company's annual meeting, along with a statement in support of the proposal.[10] The shareholder proposal and supporting

[8] *See* Securities Exchange Act of 1934 Rule 14a-8, 63 Fed. Reg. 29,118, 29,119 (1998) (to be codified at 17 C.F.R. § 240.14a-8) (providing new rule for shareholder proposals). For a discussion of the many factors that are involved, *see* Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 19,135, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,262 (Oct. 14, 1982).

[9] Securities Exchange Act of 1934 Rule 14a-4(c), 63 Fed. Reg. 29,118, 29,118 (1998) (to be codified at 17 C.F.R. § 240.14a-4(c)) (permitting management to obtain in its proxy discretionary authority to vote on matters that are raised at meeting without advance notice to management). Even where management has been notified in advance, if the proponent is not soliciting its own proxies and is not making use of Rule 14a-8, management may seek discretionary authority so long as it discloses how it intends to exercise its discretion.

[10] The first shareholder proposal rule was adopted in 1942. *See Part 240 — General Rules and Regulations, Securities Exchange Act of 1934*, 7 Fed. Reg. 10,655, 10,656 (Dec. 21, 1942) (formalizing earlier interpretations of Commission). *See* Arthur H. Dean, *Non-Compliance With Proxy Regulations: Effect On Ability of Corporation To Hold Valid Meeting*, 24 CORNELL L.Q. 483, 497-506 (1939) (discussing proxy regulations relating to shareholder proposals and problems confronting management). For a history of the rule's development, see IV SECURITIES REGULATION 1998-2052 (Louis Loss & Joel Seligman, 3d ed. 1990); Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635, 654-57 (1977) (providing history of Rule 14a-8).

statement together may not exceed 500 words. Management may object to inclusion of the shareholder proposal and supporting statement in its proxy materials on several grounds set forth in Rule 14a-8(i).[11] In such a case the SEC staff issues a letter in which the staff either agrees or disagrees with management's contention that the shareholder proposal may be excluded.[12]

The *Templeton Dragon Fund* letter involved an attempt by Newgate LLP, a shareholder in the Fund, to place its shareholder resolution in Templeton Dragon Fund's proxy statement. Underlying the letter is a broader movement by shareholders of closed-end mutual funds to force management to convert their funds to open-end investment companies.[13] Closed-end funds often sell at a discount from their net asset value while the price of open-

[11] Securities Exchange Act of 1934 Rule 14a-8(i), 63 Fed. Reg. 29,118, 29,120 (1998) (to be codified at 17 C.F.R. § 240.14a-8(i)). According to the rule, there are 13 grounds for omitting a shareholder proposal and supporting statement from the proxy. *See id.*

[12] Under Rule 14a-8, if a shareholder submits a proposal that the company proposes to exclude, the company must submit its reasons and a supporting opinion of counsel to the SEC no later than 80 calendar days before it files its definitive proxy statement. *See* Securities Exchange Act of 1934 Rule 14a-8(j), 63 Fed. Reg. 29,118, 29,120 (1998) (to be codified at 17 C.F.R. § 240.14a-8(j)). It must at the same time furnish the shareholder with a copy of its submission. *See id.* The shareholder is permitted, but not required, to file a response. Securities Exchange Act of 1934 Rule 14a-8(k), 63 Fed. Reg. 29,118, 29,120 (1998) (to be codified at 17 C.F.R. § 240.14a-8(k)). After considering this material, the staff of the SEC will write to the company either agreeing or disagreeing with its assertion that the proposal may be excluded. Sometimes the staff takes the position that the proposal must be included only if the shareholder proponent makes specified revisions to it. Securities Exchange Act of 1934 Rule 14a-8(m)(3)(i), 63 Fed. Reg. 29,118, 29,121 (1998) (to be codified at 17 C.F.R. § 240.14a-8(m)(3)(i)). At the time of the *Templeton Dragon Fund* no-action letter, similar provisions appeared in Securities Exchange Act of 1934 Rules 14a-8(d)-(e), 17 C.F.R. § 240.14a-8(d)-(e) (1998).

[13] *See* Carol Carangelo, *SEC Clears Hurdle for Closed-End Fund Shareholders*, FUND DIRECTIONS, June 1998, at 2; Carole Gould, *How a Closed-End Fund Aims to Tame Its Discount*, N.Y. TIMES, June 28, 1998, § 3, at 8; Eric Rosenbaum, *Mercury Closed-End Fund Lowers Open-Ending Hurdle*, FUND ACTION, Aug. 10, 1998, at 1, 12.

end funds reflects no similar discount.[14] Therefore, opening a closed-end fund results in an instant increase in value for existing shareholders. Despite this, managers of closed-end funds have resisted change, often arguing that opening the fund would have other negative impacts.

In March 1998, Newgate, which owned over 1.8 million shares of Templeton Dragon Fund, notified Fund management that it planned to introduce a resolution at the 1998 annual meeting recommending that the Fund's directors take all necessary action to convert from closed-end to open-end status. Invoking Rule 14a-8, Newgate requested that its resolution, along with a supporting statement, be included in the Fund's proxy statement that would be sent to shareholders. Newgate attempted to alleviate the problem posed by the 500 word limitation through the use of new technology. The supporting statement began as follows:

> We are limited by Federal law to a 500 word statement. Accordingly, we hope that shareholders will carefully review the 4 points set forth below. Additional historical performance data on this Fund can be accessed on Newgate's Internet site at newgateglobal.com.[15]

Fund management objected to including the proposal in the Fund's proxy statement. In particular, it objected to the reference to Newgate's Internet Web site. Three separate objections were made. The most straight forward was that reference to the Web site would subvert "the intent of the 500 word limit of paragraph (b)(1)." According to management, making additional information available in this way would circumvent "the spirit, if not the letter" of Rule 14a-8's limitation on the length of shareholder proposals and accompanying supporting statements.

A second objection focused on the impermanent nature of information on a Web site. Because Newgate might

[14] For discussion of discounts in closed-end funds, *see* The Internet Closed-End Fund Investor, *A Deeper Look at Discount/Premium* (visited Oct. 22, 1998) <http://www.icefi.com/icefi/tutorial/anal_dis.htm>.

[15] *Templeton Dragon Fund, supra* note 5, at *1.

continually change the content of its Web site, it would not be able to furnish the SEC with a copy of the information that would be on the site in the future. This meant that potentially false and misleading information on the site would not be subject to SEC staff review. In addition, management asserted, that it would not be able to readily respond to changing information on Newgate's Web site without the considerable cost of preparing, filing and mailing supplemental proxy materials to its shareholders. This, management argued, "subverts the proxy process."[16]

A third objection was that the historical performance data that Newgate claimed was on its Web site in fact was not available there and had not been otherwise furnished to the Fund. This, it was argued, made the reference to Newgate's Web site misleading.

In a typically cryptic no-action letter, the SEC's Division of Corporation Finance agreed with the Fund that "[t]here is support for your view that the reference to Proponent's internet site in the supporting statement potentially may violate the proxy process requirements of paragraph (b)(1) of the Rule" and therefore the reference could be omitted from the Fund's proxy statement.[17] This language in the no-action letter left unclear whether the staff agreed with all, or only some, of the arguments made by the Fund, since paragraph (b)(1) of Rule 14a-8 was the provision in the Rule that both limited the length of the shareholder proposal and supporting statement to 500 words and required the supporting statement to be furnished to the issuer at the same time as the shareholder proposal itself was furnished.[18]

---

[16] *Templeton Dragon Fund, supra* note 5, at *2.

[17] *Templeton Dragon Fund, supra* note 5, at *7.

[18] *See* Securities Exchange Act of 1934 Rule 14a-8(b)(1), 17 C.F.R. § 240.14a-8(b)(1) (1998). On May 28, 1998, Rule 14a-8 was amended. The 500 word limitation of paragraph (b)(1) now appears in paragraph (d). *See* Securities Exchange Act of 1934 Rule 14a-8(d), 63 Fed. Reg. 29,118, 29,119 (1998) (to be codified at 17 C.F.R. § 240.14a-8(d)).

II. THE USE OF THE INTERNET IN PROXY SOLICITATIONS

Since 1995, the Internet has become an increasingly important tool in proxy solicitations. For uncontested meetings, companies increasingly post their proxy statements and annual reports to shareholders on their Web sites, delivering these documents electronically and permitting proxies to be returned via the Internet.[19] In proxy contests, the Internet is beginning to be used as a supplement to the proxy statement to furnish more information to interested shareholders.[20] For example, in their 1996 challenge to the management of RJR Nabisco, Carl Icahn and Bennett Lebow posted follow-up information on the Web site of Georgeson & Co., their professional proxy soliciting firm.[21] Where dissidents have already sent out a proxy statement, this kind of additional soliciting material does not need to be pre-cleared by the SEC. It must merely be filed with the SEC and the relevant stock exchanges on the date that it is first made available to shareholders.[22]

Just as a Web site seems an appropriate vehicle for supplementing dissidents' arguments in a proxy fight, it seems similarly well suited for supplementing the bare-bones 500 word (or less) statement in support of a shareholder's proposal under Rule 14a-8. Indeed, nothing in the SEC's *Templeton Dragon Fund* no-action letter precludes shareholder proponents from placing additional information on a Web site. The no-action letter merely prevents the shareholder from calling the Web site to fellow-shareholders' attention through management's proxy statement. In reaching that result, the arguments accepted by the SEC seem surprisingly unpersuasive.

---

[19] *See* FRIEDMAN, *supra* note 6, at ch. 11.

[20] *See* FRIEDMAN, *supra* note 6, at ch. 12.

[21] *See* Hal Lux, *Internet Becomes Tool In Nabisco Proxy Fight*, INV. DEALERS' DIGEST, Jan. 29, 1996, at 8 (discussing experiment with Internet in proxy fight and noting that while "the Web is not likely to be the deciding factor in [proxy] fight . . . proxy experts say it is a medium worth the experiment").

[22] Securities Exchange Act of 1934 Rule 14a-6(b), 17 C.F.R. § 240.14a-6(b) (1998); *see* FRIEDMAN, *supra* note 6, § 12.01[b].

III. WHY THE SEC WAS WRONG
A. 500 Word Limitation

The simplest argument put forward by management was that the shareholder's Web site violated the 500 word limitation for shareholder proposals in Rule 14a-8. This deceptively literal conclusion fails to address the policies behind Rule 14a-8's 500 word limitation. While the SEC has not always spelled out the rationale for its long-standing limitation on the length of shareholder proposals and/or supporting statements,[23] the least persuasive explanation is that the government has determined that shareholder proponents should not speak at length. In the past, when government has attempted — usually unsuccessfully — to restrict the quantity of speech, its goal has been to equalize the relative ability of competing sides to reach an audience.[24] That cannot be the SEC's

[23] The exact limitation has varied over time. Early versions of Rule 14a-8 contained only a limitation on the length of the supporting statement. The earliest version (then numbered Rule 14a-7) merely limited supporting statements to 100 words. *See Part 240 — General Rules and Regulations, Securities Exchange Act of 1934*, 7 Fed. Reg. 10,655, 10,656 (Dec. 21, 1942). When that limitation began to be abused through the use of lengthy "Whereas clauses" in the proposal which were in fact arguments for adoption of the proposal, the Commission amended Rule 14a-8 to provide that these clauses would be counted as part of the supporting statement, but raised the word limit for the supporting statement to 200 words. *See* Adoption of Amendments to Rules 14a-5 and 14a-8 under the Exchange Act, Exchange Act Release No. 9,784, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,997 (Sept. 22, 1972). In 1976, the Commission added a separate 300 word limitation for the shareholder proposal itself. *See* Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,812 (Nov. 22, 1976) (noting that 300 word limitation was due in part to several proposals that "exceeded the bounds of reasonableness"). In 1983, these were combined into a 500 word limit for the proposal and supporting statement together. *See* Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 20,091, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,417 (Aug. 16, 1983).

[24] *See* Buckley v. Valeo, 424 U.S. 1, 48-49 (1976) (holding that "the concept that government may restrict the speech of some elements of

goal here since management has no limits imposed on the length of the counter-arguments that it places in its proxy statement. Indeed, the SEC's entire attempt to restore shareholder democracy has been a battle *against* the voicelessness of the small shareholder. Rule 14a-8 was an attempt to give the small shareholder some power, not to limit his or her voice.[25]

A different rationale is suggested by the administrative history of Rule 14a-8 and seems more persuasive. In its 1976 amendments to Rule 14a-8 that, for the first time, imposed length restrictions on the shareholder's resolution itself, as well as on the supporting statement, the SEC noted:

> [I]n recent years several proponents have exceeded the bounds of reasonableness . . . by submitting proposals that are extreme in their length. Such practices are inappropriate under Rule 14a-8 not only because they constitute an unreasonable exercise of the right to submit proposals at the expense of other shareholders but also because they tend to obscure other material matters in the proxy statements of issuers, thereby reducing the effectiveness of such documents.[26]

Stated more fully, since Rule 14a-8 forces management to include unwanted material in its proxy statement, Rule 14a-8 is designed to limit the burden and costs imposed on management and other shareholders. A 500 word

---

our society in order to enhance the relative voice of others is wholly foreign to the First Amendment . . ."); *see also* First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 789-92 (1978) (same). *Cf.* Austin v. Michigan Chamber of Commerce, 494 U.S. 652, 658-60 (1990) (upholding prohibition on corporate expenditures to support or oppose candidate on ground that restriction "ensures that expenditures reflect actual public support for the political ideas espoused by corporations").

[25] *See* Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635, 638-48 (1977) (discussing costs and benefits of Rule 14a-8).

[26] *See* Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,812, at 87,127 (Nov. 22, 1976).

statement adds little in printing or postage costs to the corporation's mailing. On the other hand, permitting an unlimited amount of material to be included at corporate expense could create a substantial burden. The length limitation also avoids deflecting attention from management's basic message. A very lengthy discussion of a shareholder proposal might overwhelm other — and to management, more important — issues discussed in the proxy statement. By limiting the length of shareholder proposals, Rule 14a-8 still permits management to focus the attention of shareholders on the other issues it wishes to bring to a vote. Neither the goal of avoiding new costs nor of assuring appropriate focus on other items is undercut by permitting the shareholder proponent to include in his or her 500 word statement a reference to a Web site.[27]

B. Prior Review

Fund management also argued that the impermanent nature of information of a Web site would preclude prior review by the SEC staff of potentially false and misleading information. The SEC, however, has disclaimed any interest in being able to review such communications in advance. In fact, the SEC has put forward a wide range of initiatives in recent years to lessen its role as censor of materials sent out to shareholders in connection with shareholder meetings. In 1992, the SEC adopted major amendments to its proxy rules that were designed to eliminate much of the SEC's previous role as censor of speech relating to upcoming meetings.[28] Proxy statements

[27] It might be thought that while the goal of Rule 14a-8 is not to place an absolute limit on shareholder argumentation, perhaps its goal is to limit speech unless a shareholder proponent first files a full proxy statement with the SEC. In that way, the SEC would have the opportunity to review the accuracy of long arguments. This argument for prior review is no more persuasive than the argument for prior review made by Fund management, which is discussed below.

[28] *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (noting that amendments to rules "eliminate

for routine meetings no longer have to be filed in advance for SEC review.[29] Management merely needs to file a definitive copy of the proxy statement when it sends the proxy statement to shareholders. Even in mergers and contested elections where proxy statements do need to be filed in advance, additional soliciting material only needs to be filed at the same time that it is sent to shareholders.[30] Thus no advance review is mandated for material placed on a Web site after a proxy statement is mailed, even in proxy contests. In adopting amendments eliminating the advance filing of most proxy material, the SEC observed:

> The Commission believes that the most cost-effective means to address hyperbole and other claims and opinions viewed as objectionable is not government screening of the contentions or resort to the courts. Rather, the parties should be free to reply to the statements in a timely and cost-effective manner, challenging the basis for the claims and countering with their own views on the subject matter through the dissemination of additional soliciting material.[31]

More importantly, the 1992 amendments deregulated much speech relating to upcoming shareholder meetings where the speaker is not actually soliciting proxy authority and does not otherwise, because of a substantial interest in the matter being voted upon, stand to receive a benefit that will not be shared pro rata by all other holders of the

---

unnecessary regulatory obstacles"). In explaining the new rules, the SEC stated, "The amendments adopted today reflect a Commission determination that the federal proxy rules have created unnecessary regulatory impediments to communication among shareholders and others and to the effective use of shareholder voting rights." *Id.* at 83,355.

[29] Securities Exchange Act of 1934 Rule 14a-6(a), 17 C.F.R. § 240.14a-6(a) (1998) (providing filing requirements of preliminary proxy statements).

[30] Securities Exchange Act of 1934 Rule 14a-6(b), 17 C.F.R. § 240.14a-6(b) (1998).

[31] Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051, at 83,365 (Oct. 16, 1992).

same class of securities.[32] In such cases, no proxy statement needs to be filed or distributed. In its Release adopting these rules, the SEC stated explicitly that sponsorship of a Rule 14a-8 shareholder proposal does not create a substantial interest that would preclude the proponent from freely communicating with other shareholders, unless there is something special about the content of the proposal that creates a substantial interest. The mere fact of inclusion of the proposal does not create such an interest.[33]

C. Burden of Response

A subsidiary part of Templeton management's argument was that it would not be able to readily respond to changed information on the shareholder's Web site without costly preparation, filing and mailing of supplemental proxy materials to its shareholders. This ignores the fact that Templeton need not use "snail mail" to respond to proponent's cyberspace message. A response through Templeton's own Web site would be speedier, less costly and probably more effective when management is countering other Internet-based speech. Anyone with sufficient computer knowledge to access Newgate's Web site could in turn easily access Templeton's.

---

[32] Securities Exchange Act of 1934 Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1998). The one exception is institutional investors which are required to file a Notice of Exempt Solicitation pursuant to Rule 14a-6(g) within three days of sending out material, to guard against secret solicitation campaigns by large shareholders. *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051, at 83,359 (Oct. 16, 1992).

[33] *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051, at 83,361 (Oct. 16, 1992).

IV. A NARROW BASIS FOR THE SEC'S DETERMINATION

While the major arguments put forward by Templeton Dragon Fund management and accepted by the SEC staff seem unpersuasive, the facts do give the staff an acceptable narrow ground for its conclusion. Interpreting the no-action letter in this way may save it from threatening future innovative approaches to promoting shareholder democracy. Newgate's supporting statement submitted for inclusion in the Fund's proxy statement specifically said that additional historical performance data on Templeton Dragon Fund was available at Newgate's Web site. In fact no such information had been placed on the Web site.

Rule 14a-8 permits management to exclude a shareholder proposal or supporting statement if its language is materially false or misleading.[34] This might well be an acceptable basis for permitting management to exclude Newgate's supporting statement, or at least for requiring Newgate to modify its statement to indicate merely that Newgate planned in the future to post additional material relating to the shareholder proposal on its Web page.

V. PROPOSED RULE CHANGES TO FACILITATE USE OF WEB SITES TO SUPPLEMENT SHAREHOLDER PROPOSALS

Despite my criticism of the SEC's willingness to permit the exclusion of Newgate's supporting statement, management of Templeton Dragon Fund did raise two objections that call for further examination and that suggest the need for new rule making.

[34] Securities Exchange Act of 1934 Rule 14a-8(i)(3), 63 Fed. Reg. 29,118, 29,120 (1998) (to be codified at 17 C.F.R. § 240.14a-8(i)(3)). At the time of the *Templeton Dragon Fund* no-action letter, these provisions appeared in Rule 14a-8(c)(3), 17 C.F.R. § 240.14a-8(c)(3) (1998).

A. Requiring Mutual Hyperlinks

Templeton Dragon Fund's management was concerned about its ability to respond to ever-changing content on the proponent's Web site. As suggested above, a like-kind response, that is, one through management's own Web site, is an inexpensive and effective way to participate in an ongoing exchange of ideas with a shareholder proponent. A rule change would facilitate this kind of on-line interchange.

The SEC has a legitimate interest in making certain that shareholders have convenient opportunities to consider arguments on both sides of an issue. Therefore, it should consider mandating through Rule 14a-8 mutual hyperlinks between Web pages arguing both sides of an issue. If proponents set up a Web page to furnish additional information, they should be required to include on the page a prominent hyperlink to any management Web page that has been created to discuss management's side of the issue. Similarly, any management page discussing the issue should contain a hyperlink to the relevant page on the proponent's Web site.[35] Moreover, if management posts its proxy statement on the World Wide Web, proponent's textual reference to its Web site should also be a hypertext link to the site.

Mutual hyperlinks will not only assure that shareholders have ready access to both sides' arguments, they will also provide an easy method for each side to check on whether the other has recently changed the material on its Web site. Any new rule might go further and require each side to notify the other by e-mail when it makes a change to its Web site relating to the shareholder proposal. This addition, however, is probably unnecessary since it requires little effort to check the linked Web site regularly during the period between the mailing of the proxy statement and the convening of the annual meeting.

[35] The SEC should probably consider imposing a similar requirement when Web sites are used by opposing interests in any type of proxy solicitation.

A notification provision *would* call attention to minor changes that might go unnoticed through a routine check of the Web site. However, such a provision might also invite unnecessary disputes about whether timely notice was given. The rule mandating mutual hyperlinks needs to be limited to situations in which one side has notified the other of the existence of its Web site, and the SEC will need to stand ready to adjudicate disputes about inclusion of hyperlinks in the same way that it passes on other disputes under Rule 14a-8.

One other technical concern arises in implementing competing Web-based discussions. Under present Rule 14a-6(b), management (but not the Rule 14a-8 shareholder proponent) is required to file all of its additional soliciting material with the SEC.[36] This means that the material on management's Web site, and each changed version of the material, must be filed at the time it is first posted on management's server. As EDGAR is transformed to an Internet based system,[37] this will become a simple task. With little effort, management can save its Web page to a file and transmit that to the SEC electronically just as any other EDGAR document would be transmitted.

B. Prior On-Line Misstatements As a Basis for Exclusion

A second legitimate concern raised by Templeton Dragon Fund management is the added danger of false and misleading statements being disseminated when a proponent can constantly change the content of its Web

[36] The 1992 amendments eliminated the reciprocal obligation of non-management shareholders who were not actually seeking proxy authority to file soliciting material with the SEC in order to encourage free discussion among shareholders of matters on an upcoming shareholder meeting agenda. *See supra* notes 24-29 and accompanying text.

[37] For discussion of the conversion of the SEC's Electronic Data Gathering, Analysis and Retrieval system (EDGAR) to an Internet-based system, *see SEC Awards EDGAR Modernization Contract*, 30 SEC. REG. & L. REP. (BNA) 1016 (July 3, 1998); FRIEDMAN, *supra* note 6, § 15.04.

Villanova Journal of Law and Investment Management, Vol. 1, Iss. 1 [1999], Art. 1

site. The danger of misleading argumentation through constantly changing content is not unique to Web sites. Telephone calls and individual e-mail communications during the proxy process pose similar issues. However, the broader reach of statements on a Web site, and other widely disseminated on-line messages, creates special risks of influencing votes through false or exaggerated claims. Particularly when new content is disseminated shortly before a shareholders' meeting, there may not be an effective opportunity for rebuttal. Relegating management to seeking remedial relief through litigation under Rule 14a-9 may be an inadequate alternative. Therefore, I suggest an additional rule change to deal with the heightened threat of false and misleading information that is introduced late in the proxy process.

Few shareholder proposals in fact succeed.[38] Often the goal of proponents is merely to obtain sufficient votes in favor of their proposal so that it can be resubmitted the following year. The strong message of such a vote may lead to successful negotiations or voluntary action by management on the subject matter of the proposal.[39] Under Rule 14a-8(i)(12), depending on how often the proposal has been included during the last five years, the proponent must obtain from 3% to 10% of the votes cast to include it the following year. An amendment to Rule 14a-8 should provide that an additional basis for excluding a shareholder proposal is that the proponent, during the past five years, included materially false or misleading information relating to a prior shareholder proposal on a Web site or in other broadly disseminated Internet communications. In addition to information on the proponent's Web site, the exclusion would apply to

[38] *See* Robert Todd Lang et al., *Shareholder Initiatives: Proposals and Solicitations*, 4 SECURITIES LAW TECHNIQUES § 53.06[1][a] (A.A. Sommer, Jr., ed., 1998) (noting that in 1993, only nine shareholder proposals passed).

[39] *See id.* § 53.02[1][b], at 36-37; § 53.06[1][a], at 31-32 (noting that willingness of management to address shareholder concerns depends on extent to which management believes shareholder can mobilize larger number of shareholders for future action).

materially false or misleading information that the proponent disseminated through such means as group e-mail messages, Internet bulletin boards or on-line chat rooms.

Such an additional basis for exclusion will not cast the SEC in any dramatically different role than it now assumes in passing on whether management may exclude a shareholder proposal. Currently one basis for management's exclusion of a proposal is that the proposal or supporting statement is materially false or misleading in violation of Rule 14a-9.[40] Also if the shareholder proponent believes that management's statements in opposition to the proposal violate rule 14a-9, the SEC's rule encourages the shareholder to promptly notify the Commission staff.[41]

VI. CONCLUSION

New technology creates possibilities for improving disclosure, increasing shareholder protection, promoting capital formation and furthering shareholder democracy. Innovative uses of technology require nurturing. Nipping them in the bud through reflexive literalism or in response to pleas of corporate management that are not justified in terms of broader regulatory policy discourages the experimentation which the SEC has so carefully nourished since 1995. Hopefully, the *Templeton Dragon Fund* no-action letter will come to be seen as a too-hasty response and will in fact lack precedential authority as no-action letters are supposed to do. Better yet, the Commission should formally repudiate the narrow and stilted interpretation of Rule 14a-8 reflected in *Templeton Dragon Fund*.

[40] Securities Exchange Act of 1934 Rule 14a-8(i)(3), 63 Fed. Reg. 29,118, 29,120 (1998) (to be codified at 17 C.F.R. § 240.14a-8(i)(3)).
[41] Securities Exchange Act of 1934 Rule 14a-8(m)(2), 63 Fed. Reg. 29,118, 29,121 (1998) (to be codified at 17 C.F.R. § 240.14a-8(m)(2)).

The Contribution of the Fund Profile to Investor Education

James A. Fanto*

I. INTRODUCTION

More so than at any time in this nation's past, ordinary people are investing, directly or indirectly, in the capital markets.[1] Saving and investing are now important, everyday tasks for which they are responsible, but for which they may not be adequately educated. Therefore, the educational implications of any securities regulation affecting the ordinary investor must be carefully considered.

If investor education becomes an important area for securities regulators generally, it must naturally receive even more attention from mutual fund[2] regulators. In the recent past, investments by Americans in mutual funds have grown exponentially as mutual funds have become the investment of choice both in retirement and non-

* Associate Professor of Law and Associate Director, Center for the Study of International Business Law, Brooklyn Law School. I thank Dean Joan Wexler and Brooklyn Law School for a summer stipend that supported my writing of this Article. I would also like to thank Professor Donald Langevoort and Craig S. Tyle for their review of an earlier draft of this article.

[1] *See* NEW YORK STOCK EXCHANGE, FACT BOOK FOR THE YEAR 1997 57 (1998) (discussing growth of individual stock ownership in America and noting that "one adult in every three owns corporate stock directly, indirectly through a stock mutual fund, or through shares that are held in a corporate thrift plan or defined contribution pension plan"); Edward Wyatt, *Share of Wealth in Stock Holdings Hits 50-Year High*, N.Y. TIMES, Feb. 11, 1998, at A1 (citing data of Federal Reserve indicating that Americans have more assets invested in stock market, as compared to other assets considered part of household wealth, than at any time in last 50 years).

[2] For simplicity's sake, my reference to mutual funds in this Article is to what are termed "open-end" management companies that sell redeemable fund shares. *See* 15 U.S.C. § 80a-5(a)(1) (1996). As a result of the Securities and Exchange Commission (SEC or the "Commission") regulatory initiative discussed below, mutual fund shares may now be offered in a new document.

retirement accounts (employer-sponsored or IRAs).[3] This growth is not surprising, because mutual funds provide consumers with investment options and access to professional money managers that would otherwise be available only to the wealthy. Astute mutual fund investing can enable an ordinary investor to build the kind of optimal portfolio that basic finance suggests is critical to wealth enhancement (that is, a diversified portfolio with an asset allocation among investments with different risks that changes over the life cycle).[4] Because of the popularity of mutual funds for consumer investing, securities regulators need to consider how mutual fund companies should educate investors to understand the advantages of mutual fund investing and the benefits of particular kinds of funds and fund investment strategies, and to comprehend fund disclosure.[5]

---

[3] *See* INVESTMENT COMPANY INSTITUTE, 1998 MUTUAL FUND FACT BOOK 1 (1998) (describing growth in total assets in mutual funds from $1.07 trillion in 1990 to $4.5 trillion in 1997). Moreover, the number of mutual funds has more than doubled since 1990, *see id.* at 16, and approximately 16% of the $6.6 trillion of total retirement assets at year-end 1996 was invested in mutual funds. *Id.* at 44.

[4] *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 400-21 (6th ed. 1996) (providing basic explanation of life-cycle investing with differing asset allocations depending upon life stage).

[5] This emphasis on investor education should be no surprise to the mutual fund industry and its regulators. Designed to serve the small investor who may invest on his or her own, the industry has always realized that investors need understandable descriptions of funds and the benefits of fund investing in order to encourage them to invest initially in mutual funds and to remain invested in them. Fund companies have thus experimented with ways of communicating to investors about issues that could be characterized as educational, such as the basics of saving and investing. *See infra* note 25. Similarly, because its regulated industry markets a product to ordinary investors, the Division of Investment Management of the SEC has likely been more sensitive than other divisions to issues of effective communication to investors and their ability to understand securities disclosure.

The SEC has standardized and simplified mutual fund disclosure because it recognized that fund investments were mainly designed for ordinary investors. *See, e.g.*, Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Act Release No. 13,436, 48 Fed. Reg. 37,928 (1983) (adopting two-tier disclosure format for mutual fund registration with prospectus and Statement of Additional Information); Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16,244,

This Article examines the educational implications of a new mutual fund disclosure format recently approved by the SEC[6] that allows fund companies to market their funds by a summary document known as a "profile."[7] Both the profile and significantly revised prospectus disclosure were part of a larger SEC project to improve overall fund disclosure and promote "effective communication" to fund

---

53 Fed. Reg. 3,192 (1988) (adopting uniform fee table in funds); Advertising by Investment Companies, Investment Company Act Release No. 16,245, 53 Fed. Reg. 3,868 (1988) (adopting uniform formula for calculating fund performance); Disclosure of Mutual Fund Performance and Portfolio Managers, Investment Company Act Release No. 19,382, 58 Fed. Reg. 19,050 (1993) (adopting uniform presentation of management's discussion of fund performance); Money Market Fund Prospectuses, Investment Company Act Release No. 21,216, 60 Fed. Reg. 38,454 (proposed July 26, 1995) (proposing amendments to simplify money market fund disclosure).

[6] The following discussion admittedly highlights only one aspect of the educational issue regarding securities regulation, and only this regulation's effect on education regarding mutual funds, because it concentrates on education that mutual fund companies provide directly to investors. Yet many ordinary investors, including investors in mutual funds, invest through or with the guidance of brokers and/or financial planners. There may well be a need to place educational responsibilities on such professionals to reach those investors who have no direct contact with the fund companies. *See, e.g.*, SECURITIES INDUSTRY ASSOCIATION, INVESTOR EDUCATION HANDBOOK 6 (Nov. 1996) (encouraging financial firms to have their employees conduct more education of investors to respond to such investors' need and desire for education). Moreover, a more troubling issue is the adequacy (or even accuracy) of education conducted by "interested" parties, whether fund companies or brokers, and the possible need for "neutral" (or at least non-financial industry) education providers. *See generally* James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE WES. RES. L. REV. (forthcoming 1999) (discussing how competition in education services, both by for-profit and nonprofit firms, has produced a standardized educational product and how financial market regulators generally provide some basic investor education and oversee market efforts).

[7] *See* New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 7,513, 63 Fed. Reg. 13,968 (1998) [hereinafter, Final Profile Release] (authorizing fund profile that presents summary of key information about fund); Proposed New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 7,399, 62 Fed. Reg. 10,943 (proposed Mar. 10, 1997) [hereinafter, Profile Proposal](proposing fund profile).

investors.[8] The Article argues that the profile initiative, as part of the larger regulatory undertaking, is educational in nature primarily because, by focusing investors' attention on certain basic fund features and their comparability with those of other funds,[9] the new format in effect invites them to think about the kind of issues that investor education identifies as central to optimal investing. That is, requiring fund companies to put information into a format to which investors can easily apply saving and investing education encourages investors to recognize their need for this education.

This Article initially summarizes briefly the reasons for the importance of investor education in the United States and the need for U.S. securities regulators to examine their consumer-oriented regulations, particularly affecting mutual funds, from an educational perspective. In this connection, it refers to the large number of investor educational products and services developed and provided by fund companies, nonprofit organizations and even government regulators. It next identifies the educational importance of the profile within the overall educational orientation of the revised fund disclosure initiative. Finally, it argues that the SEC should now take a further regulatory step to make explicit the educational

[8] In effect, the revisions went to the entire fund registration statement, the Form N-1A, although key amendments altered the prospectus part of this statement. *See* Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7,512, 63 Fed. Reg. 13,916 (1998) [hereinafter, Final Registration Release] (stating that amendments are intended to improve fund prospectus disclosure); Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7,398, 62 Fed. Reg. 10,898 (proposed Mar. 10, 1997) [hereinafter, Registration Proposal] (same). This disclosure initiative also included a proposal regulating investment company names. *See* Investment Company Names, Investment Company Release No. 22,530, 62 Fed. Reg. 10,955 (proposed Mar. 10, 1997) [hereinafter, Names Proposal]. The SEC has not yet taken final action on this proposal.

[9] *See* Final Registration Release, *supra* note 8, at 13,917 (observing that the two major disclosure initiatives are "intended to: improve fund disclosure by requiring prospectuses to focus on information central to investment decisions; provide new disclosure options for investors; and enhance the comparability of information about funds").

implications of the profile by allowing, even requiring, fund companies explicitly to link the profile to their's and others' educational materials—thus alerting ordinary investors to the existence and importance of these materials.

II. THE NEED FOR INVESTOR EDUCATION

The importance of and need for investor education basically arises because saving and investing have increasingly become ordinary activities in the United States (and much of the developed world)[10] that are as essential for survival in society as finding lodging and a job. This situation has emerged in the last two decades and owes much to the increased use by employers of defined contribution plans[11] that place upon the individual

[10] In another paper, I examine how investor education is becoming important in other countries for reasons similar to those explaining its growing significance in the United States, as outlined below. *See* James A. Fanto, *Comparative Investor Education*, BROOK. L. REV. (forthcoming 1999). *See also* GROUP OF TEN, THE MACROECONOMIC AND FINANCIAL IMPLICATIONS OF AGEING POPULATIONS (Apr. 1998) (discussing effects of increased longevity and declining fertility on pension systems in developed countries and possible need for funded, including individually funded, pensions). One example of the international significance of this subject is a recent SEC investor education campaign coordinated with countries in the Western Hemisphere. *See Overview: Get the facts. It's your money. It's your future.*, (visited Oct. 6, 1998) <http://www. sec. gov/consumer/cosra/about/facts.htm> (describing campaign and participation by securities regulators in twenty-one countries in Western Hemisphere).

[11] *See* U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: MOST EMPLOYERS THAT OFFER PENSIONS USE DEFINED CONTRIBUTION PLANS 4-9 (GAO/GGD-97-1, Oct. 3, 1996) (presenting growth statistics for defined contribution plans); Olivia S. Mitchell, et al., *Introduction: Assessing the Challenges to the Pension System, in* POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY 1, 2-6 (Michael S. Gordon, et al., eds., 1997) (explaining shift to defined contribution plans). In the defined contribution plan, an individual sets aside a portion of his or her earnings in an account and may receive an additional contribution to it from the employer, and he or she must decide how to invest the funds within a limited number of options provided by the plan. *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 57-59, 70-72 (5th ed. 1997) (describing different types of defined contribution plans, including savings or thrift plans, profit-sharing plans, money purchase pension plans, employee stock

employee most of the responsibility for saving and investing for his or her retirement, at the expense of the defined benefit retirement programs[12] where an employer basically assumes this responsibility. Different explanations, ranging from the cost of defined benefit programs to the compatibility of defined contribution plans with the needs of an increasingly transient workforce, account for this shift.[13] Whatever one's view of

---

ownership plans and 401(k) arrangements); *see also* U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: PLAN FEATURES PROVIDED BY EMPLOYERS THAT SPONSOR ONLY DEFINED CONTRIBUTION PLANS 11-18 (GAO/GCD-98-23, Dec. 1, 1997) (describing contribution features of subset of defined contribution plans). In one well-known type of defined contribution plan pursuant to Section 401(k) of the Internal Revenue Code, an employee can defer, on a pre-tax basis, a portion of his or her compensation as a contribution to an individual retirement account and receive a matching contribution from an employer (generally, a percentage of an employee's earnings), at the employer's option. For an employer to receive certain benefits of such plans (chiefly, a limitation on its fiduciary liability with respect to the plan), applicable regulations stipulate that it must offer plan participants at least three investment alternatives that are each diversified and with different risk/return features. *See generally* Gordon P. Goodfellow & Sylvester J. Schieber, *Investment of Assets in Self-Directed Retirement Plans, in* POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY 67, 70-71 (Michael S. Gordon, et al., eds., 1997).

[12] *See generally* EMPLOYEE BENEFIT RESEARCH INSTITUTE, *supra* note 11, at 69-70 (explaining that in "defined benefit" plans, employer provides employee with pension calculated in accordance with set formula, usually based upon years of service and percentage of pay). Defined benefit plans use different formulae: some pay a flat-dollar amount for each eligible year of service; others use a percentage of pay for each eligible year or a percentage of career-average pay; still others calculate benefits as a percentage of average pay in the final employment years. *See* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 44 (2d ed. 1995). They are all designed to ensure that an employee works a set number of years before becoming eligible for (or "vesting" in) the plan. Although complicated, the vesting rules generally require a plan to vest an employee fully after either five or seven years of employment. *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, *supra* note 11, at 42-43 (noting that once vested, employee's rights generally cannot be revoked).

[13] *See* Kelly Olsen & Jack VanDerhei, *Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going,* EMPLOYEE BENEFIT RESEARCH INSTITUTE SPECIAL REPORT SR-33/ISSUE BRIEF NO. 190, Oct. 1997, at 13-14 (discussing costs of defined benefit plans, which include not only the actuarial help to

this transformation, it has clearly begun to focus the attention of ordinary individuals on saving and investing (particularly capital market investing) because individual investors are beginning to realize that their well-being in retirement will depend upon how much they save *now* and how well they invest their retirement funds.

Several other factors make individual saving and investing an urgent matter. First, for many people retirement may no longer be a brief period at the end of a working life, but a time that can extend for years because of decreases in mortality and that could thus demand

---

calculate the employer contributions needed to provide the agreed-upon benefits for retirees, but also the premium paid to a government retirement insurance fund (the Pension Benefit Guaranty Corporation) to protect employees of companies that fail to fund their pension liabilities). *See also* RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE: EVIDENCE, ANALYSIS, AND POLICY 85-89 (1997) (arguing that the decline of defined benefit plans owes much to the popularity of Section 401(k) plans, which are not so much cheaper for companies to administer as they enable companies to key retirement benefits to worker productivity); STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS 238-46 (1997) (discussing reorganization of big business and arguing that defined contribution plans are more suitable in labor environment where highly-educated employees "rent" their services to many different companies over their working lives, which means that they could not take full advantage of defined benefit plans because of vesting requirements). The negative aspect of this shift is that the defined benefit plans better protect an individual against the risk that he or she will outlive his or her retirement resources in the actual retirement and that he or she will not have the competence to save adequately in retirement or have the market power to make the best investments. *See, e.g.*, E. PHILIP DAVIS, PENSION FUNDS: RETIREMENT-INCOME SECURITY, AND CAPITAL MARKETS: AN INTERNATIONAL PERSPECTIVE 23 (1995). Yet defined contribution plans avoid any unfairness of the defined benefit plans due to the latter's redistributive nature and enable an investor to capture the upside of investment growth and avoid cumbersome eligibility requirements. *See* RICHARD DISNEY, CAN WE AFFORD TO GROW OLDER? A PERSPECTIVE ON THE ECONOMICS OF AGING 111-21 (1996) (explaining that, in defined benefit plans, older workers benefit at expense of others because they are given early retirement, which typically requires more contributions from younger workers); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1539-40 (1997) (observing that employers providing defined benefit plans captured most of the 350% gain in pension fund assets from 1980 to 1995 because their pension obligations to employees were fixed).

considerable resources.[14] Second, the main federal retirement program, Social Security, which is really a "pay-as-you-go system" where present workers pay benefits for current retirees, has potential funding difficulties and, in any event, cannot support an adequate retirement for most people.[15] Indeed, many policy discussions and legislative proposals regarding Social Security suggest replacing, partly or entirely, its current defined benefit with a defined contribution approach, that is, allowing at least some of an individual's contributions to be placed in an individualized account subject to his or her own limited investment decision-making, rather than to be used to pay the Social Security benefits of current retirees.[16]

---

[14] *See* U.S. GENERAL ACCOUNTING OFFICE, RETIREMENT INCOME: IMPLICATIONS OF DEMOGRAPHIC TRENDS FOR SOCIAL SECURITY AND PENSION REFORM 17 (GAO/HEHS-97-81, July 11, 1997) [hereinafter, GAO RETIREMENT INCOME] (providing chart showing steady longevity increase since 1940 and projected increase in future).

[15] *See generally* U.S. GENERAL ACCOUNTING OFFICE, SOCIAL SECURITY: DIFFERENT APPROACHES FOR ADDRESSING PROGRAM SOLVENCY 12-20 (GAO/HEHS-98-33, July 22, 1998) (describing basic structure of program and funding difficulties caused by lower fertility and increased longevity of "Baby Boom" generation); GAO RETIREMENT INCOME, *supra* note 14, at 40-41; Robert J. Myers, *Will Social Security be There for Me?*, *in* SOCIAL SECURITY IN THE 21ST CENTURY 208, 209-11 (Eric R. Kingson & James H. Schulz eds., 1997) (summarizing various actuarial reports on date of future deficit in Social Security funds). In the Social Security program (officially, the Old-Age, Survivors, and Disability Insurance (OASDI) program), present workers are taxed to pay for the benefits of current retirees. *See* Myers *supra*, at 208. Social Security now collects more than it pays out and has generated a surplus that is invested in, and receives interest payments as, U.S. Treasury securities. *Id.* at 209. Under current estimates, Social Security's surplus will rapidly fall in 2009 and disappear in 2012. *Id.* The federal government will then have to begin repaying Social Security's loan to it to make up the shortfall. Proceeds from this loan (also known as the Social Security trust funds) will be used up in 2029. *Id.*

[16] *See, e.g.*, GAO RETIREMENT INCOME, *supra* note 14, at 29-41 (listing possible solutions, such as reducing initial benefits, raising retirement age, reducing cost-of-living adjustments, means-testing benefits, increasing income taxes on Social Security benefits, increasing payroll taxes, etc.); U.S. GENERAL ACCOUNTING OFFICE, SOCIAL SECURITY FINANCING: IMPLICATIONS OF GOVERNMENT STOCK INVESTING FOR THE TRUST FUND, THE FEDERAL BUDGET, AND THE ECONOMY 4-6 (GAO/AIMD/HEHS-98-74, Apr. 22, 1998) (discussing implications of shifting Social Security trust funds from investing in government securities to stocks); NATIONAL COMM'N ON

This development may, or may not be, for the best. Many individuals may not be competent to plan adequately about an issue that they experience once in their lives.[17] And the literature on individual saving and investing behavior (and on rationality in general) suggests that there are many reasons, including psychological factors, why individuals do not save and invest optimally.[18] Placing such an important issue as retirement planning on individuals' shoulders could lead to significant disparities in retirement income beyond those that naturally flow from differences in pre-retirement income, kinds of jobs and the generosity of an employer's pension plans.[19] Yet, as I argue elsewhere,[20] individual saving and investing responsibility will exist in the United States primarily for cultural reasons. The situation is not bleak, because, more so than ever in the past, individuals have a wealth of investment opportunities, primarily because of the

RETIREMENT POLICY, "THE 21ST CENTURY RETIREMENT SECURITY PLAN" 2 (May 19, 1998) (summarizing its reform recommendations on Social Security, which include having individual Social Security accounts with individually-directed investments).

[17] *See* Richard H. Thaler, *Psychology and Savings Policies*, 84 AM. ECON. ASSN. PAPERS & PROC. 186, 187 (May 1994); *see also* U.S. GENERAL ACCOUNTING OFFICE, SOCIAL SECURITY: DIFFERENT APPROACHES FOR ADDRESSING PROGRAM SOLVENCY 69 (GAO/HEHS-98-33, July 22, 1998) ("Under a privately managed system of individual accounts, individuals or employers might contract directly with financial institutions. This could mean a wide array of investment choices for individuals and, at the same time, a wide variation in potential financial outcomes.").

[18] *See, e.g.*, Christine Jolls, et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477-78 (1998) (discussing data calling into question rationality of economic actors); Cass R. Sunstein, *The Future of Law and Economics: Looking Forward: Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1179-92 (1997) (outlining psychological factors that can affect rationality); Thaler, *supra* note 17, at 186-91 (arguing that psychological factors affect investors so that they do not perform optimal life-cycle investing). *See generally* Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 24-31 (Mar. 1998) (discussing evidence of biases in decision-making).

[19] That is, giving individuals saving and investing responsibility cannot affect such issues as the enormous disparities in income arising from kinds of employment. Other things being equal, however, it could lead to differences in retirement income that depend upon the amount saved and one's investment strategy.

[20] *See* Fanto, *supra* note 6.

Villanova Journal of Law and Investment Management, Vol. 1, Iss. 1 [1999], Art. 1

development of mutual funds. The major policy question, therefore, is how to help ordinary people perform optimally their saving and investing responsibilities.[21]

Investor education, one of the central ways of so helping ordinary investors, raises many issues, such as the identity of its provider and the nature of its content. Because this is not the place to explore these theoretical questions,[22] it is enough to observe that policy-makers in financial services[23] are clearly focusing on investor

---

[21] One problem with a narrow definition of investor education is that it encourages investors to concentrate only on their portfolio and to ignore "larger" social issues relating to company activity. Yet they must acquire this basic financial education, which is critical to their social survival, before progressing to education about "larger" corporate and financial issues. *See* James A. Fanto, *Investor Education, Securities Disclosure and the Creation and Enforcement of Corporate Governance and Firm Norms*, 48 CATH. U. L. REV. (1998).

[22] I have outlined a theoretical model for the kinds and appropriate providers of investor education. *See* Fanto, *supra* note 6. Economists, most notably Douglas Bernheim, have investigated the efficacy of investor education in different contexts. *See, e.g.*, PATRICK J. BAYER, ET AL., THE EFFECTS OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF EMPLOYERS (National Bureau of Econ. Research Working Paper No. 5655, 1996) (discussing evidence from workplace financial education); B. DOUGLAS BERNHEIM, ET AL., EDUCATION AND SAVING: THE LONG-TERM EFFECTS OF HIGH SCHOOL FINANCIAL CURRICULUM MANDATES (National Bureau of Econ. Research Working Paper No. 6085, 1997) (presenting empirical research on results of high school financial education); B. DOUGLAS BERNHEIM & DANIEL M. GARRETT, THE DETERMINANTS AND CONSEQUESCES OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF HOUSEHOLDS (National Bureau of Econ. Research Working Paper No. 5667, 1996) (presenting empirical research on effects of workplace financial education).

[23] Securities regulators cannot accomplish this task alone. For one reason, they have no jurisdiction over the individual investing that occurs through employer-sponsored defined contribution plans, which the Pension and Welfare Benefits Administration in the Department of Labor oversees under the statutory structure of the Employee Retirement Income Security Act of 1974 (ERISA). *See* 29 U.S.C. §1104(c) (West Supp. 1998) (authorizing employer to provide defined contribution individual account plan); 29 C.F.R. § 2550.404c-1(b)(3) (1998) (Department of Labor's regulations providing that employer must offer employee minimum of three diversified investment alternatives with different risk and return characteristics). The applicable regulations for such plans require that an employer supply information about the investment alternatives so that employees can make an informed decision, *see* 29 C.F.R. § 2550.404c-l(c) (1998), and this

education. A recent amendment to the Employee Retirement Income Security Act of 1974 (ERISA), for example, requires pension regulators and associated financial market regulators to develop saving and investing education,[24] and the SEC has promoted investor education through the activities of its Office of Investor Education and Assistance, such as the recent "Facts on Saving and Investing Campaign."[25] Those in the financial services industry, and their friends, have not waited for policy guidance to engage in investor education, but have created numerous educational products and services in

---

information can come in the form of disclosure concerning a given investment prepared in accordance with securities regulations. The aid given to individual investors must come, therefore, from many sources, including the government regulator having jurisdiction over the particular kind of investing in question. *See, e.g.*, Participant Investment Education, Interpretive Bulletin 96-1, 29 C.F.R. § 2509.96-1(d) (1996) (establishing a "safe harbor" for four kinds of information and education that employers, and particularly financial firms operating the plans for them, can supply to employees without triggering a fiduciary obligation to them (i.e., without being deemed to be giving investment advice)).

[24] *See, e.g.*, Savings Are Vital to Everyone's Retirement Act of 1997 or SAVER Act, which amended ERISA to provide outreach to promote retirement income savings and a national summit on retirement savings. *See* 29 U.S.C. §§ 1146-47 (West Supp. 1998). The SAVER Act states that its purpose is:

> (1) to advance the public's knowledge and understanding of retirement savings and its critical importance to the future well-being of American workers and their families; (2) to provide for a periodic, bipartisan national retirement savings summit in conjunction with the White House to elevate the issue of savings to national prominence; and (3) to initiate the development of a broad-based, public education program to encourage and enhance individual commitment to a personal retirement savings strategy.

Savings Are Vital to Everyone's Retirement Act of 1997, Pub. L. No. 105-92, § 2, 111 Stat. 2139, 2139 (1997).

[25] *See Overview: Get the facts. It's your money. It's your future.*, (visited Oct. 6, 1998) <http://www.sec.gov/consumer/cosra/about/facts.htm> (describing week-long, SEC-sponsored "Facts on Saving and Investing Campaign" from March 29 to April 4, 1998 with participation of other government agencies, state securities regulators, consumer organizations and financial industry trade groups). Most recently, the SEC has placed a "Financial Facts Toolkit" on its web site. *See Get the facts. It's your money. It's your future. Financial Facts Tool Kit*, (visited Oct. 6, 1998) <http://www.sec.gov/consumer/toolkit.htm>.

response to investor demand and, as is most likely, as a way to stimulate this demand.[26]

Federal financial regulators clearly have a role in investor education. This role involves participating in a national campaign to help change the norms and behavior of individuals regarding saving and investing[27] and to

---

[26] Sources of investor educational materials and services are simply too numerous to list. Fund companies, brokers, trade organizations and nonprofit organizations, among others, provide educational materials and services through various media, including the World Wide Web. *See, e.g., Fidelity Investments: Know what you own and know why you own it,* (visited Oct. 6, 1998) <http://www.fidelity.com/planning/investment> (providing investment educational materials about importance of saving, particularly for retirement needs, elementary finance, investments, tax-reducing retirement options, mutual funds, investment basics and asset-allocation strategies); *Mutual Fund Connection,* (visited Oct. 6, 1998) <http://www.ici.org> (providing general educational materials explaining nature of mutual fund, its risks and benefits (chiefly diversification), kinds of mutual funds, typical fees, expenses and services of funds and pricing and redemption of mutual fund shares); *AARP Webplace,* (visited Oct. 6, 1998) <http://www.aarp.org> (web site of American Association of Retired Persons with extensive educational materials); *National Institute for Consumer Education,* (visited Oct. 6, 1998) <http://www.emich.edu/public/coe/nice/nice.html> (including educational materials developed with assistance of National Association of Securities Dealers, and hypertext link to free or inexpensive sources of investor education). *See generally,* Fanto, *supra* note 6 (discussing these private educational materials and services).

[27] *See* Fanto, *supra* note 6. Federal and state government officials need to encourage improved saving and investing by ordinary Americans, so that investing and saving become both optimal and almost habitual. *See* Hersh M. Shefrin & Richard H. Thaler, *The Behavioral Life-Cycle Hypothesis, in* RICHARD H. THALER, QUASI-RATIONAL ECONOMICS 91, 92-101 (1991) (describing usefulness of "habitual rules" in enabling individuals to resist impulses, and explaining prominence of "mental accounts," whereby individuals divide their income and assets into various accounts, some of which are unavailable for current consumption). *See generally* Assar Lindbeck, *Incentives and Social Norms in Household Behavior,* 87 AMER. ECON. REV. 370, 375-76 (1997) (discussing saving and consumption norms that "provide a third important illustration of relations between economic incentives and social norms in the context of household behavior"); Richard H. McAdams, *The Origin, Development, and Regulation of Norms,* 96 MICH. L. REV. 338, 351 (1997) (defining "norms" as nonlegal obligations arising within decentralized groups or at societal level); Richard A. Posner, *Social Norms and the Law: An Economic Approach,* 87 AMER. ECON. REV. 365, 365 (1997) ("By 'social norm' ('norm' for short) I shall

educate them on protecting themselves against financial fraud. As part of this activity, they should also consider how they could best work with private parties to develop and deliver investor education.

III. THE EDUCATIONAL IMPORTANCE OF THE PROFILE

The profile initiative, which essentially involves allowing mutual fund companies to sell mutual funds by means of an abbreviated prospectus or profile, raises significant issues for fund companies and legal practitioners in investment management. A central one involves the liability implications of permitting a company to use an abbreviated document, as opposed to the full prospectus, to solicit interest in the fund.[28] This Article's analysis of the profile, however, focuses only on its implications for investor education. From this perspective, the profile initiative first exemplifies how investor education should involve a partnership between private firms providing, and experimenting with the design of, educational products and services and government regulators who oversee and promote this activity. Second,

---

mean a rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with (otherwise it wouldn't be a rule).") (footnote omitted).

[28] The central concern is that a fund company would incur liability by using a profile, which omits material information about the fund that the full prospectus otherwise includes. The company could not rely on the full prospectus in using the profile, because the profile does not incorporate by reference the longer document. Although the profile is a summary or "omitting" prospectus under Section 10(b) of the Securities Act of 1933 that is exempt from the strict liability of Section 11 of the Act, *see* 15 U.S.C. § 77j(b) (1996), a company could incur liability for the profile under Section 12(a)(2) of that Act or generally under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. *See generally* Final Profile Release, *supra* note 7, at 13,970-13,972 (discussing liability issues concerning profile); Profile Proposal, *supra* note 7, at 10,950 (same). The SEC believes that fund companies should not incur increased liability for using a profile so long as a profile provides material information (or does not omit such information) required by the line items of the profile format. *See* Final Profile Release, *supra* note 7, at 13,971-13,972.

the initiative shows, as a general matter, the increasing link between securities disclosure and education because of the renewed focus in securities regulation on effective communication to the ordinary investor. Third and more specifically, by raising key topics that should be on every investor's mind, a profile presupposes on an investor's part some investor training and invites the investor to apply an educational framework to it.

The development of the profile exemplifies how the private sector (a term used broadly to include both "for profit" and nonprofit companies) has often taken the lead in providing investor educational products and services to the ordinary investor. Closer to the consumer than government regulators and responding to the needs of their customers, private firms pay attention to the increased saving and investing responsibilities of ordinary people and their confusion in the face of numerous investment products and services. In particular, mutual fund companies are well situated to observe that the typical investor, whether inside or outside retirement plans, "face[s] an increasingly difficult task in choosing among different fund investments" [29] and has limited financial sophistication or "literacy."[30] They also realize that, because many of these investors cannot understand, and/or do not have the time to read, the lengthy, financially and legally complex fund prospectuses,[31] they increasingly look to simple comparisons, evaluations and

[29] *See* Final Profile Release, *supra* note 7, at 13,968 (noting that "[t]he Commission, fund investors, and others have recognized the need to improve fund disclosure documents to help investors evaluate and compare funds.") (footnote omitted).

[30] *See id.* (discussing different types of investors). *See generally*, Henry T. C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2358-79 (1996) (observing that mutual fund disclosure laws increasingly require discussion of attributes of *class* of investments to which fund belongs (or in which it invests) and thus leads to issues of investor "literacy").

[31] *See* Final Profile Release, *supra* note 7, at 13,970 ("The Commission and others, in seeking to identify ways to improve the disclosure of information about mutual funds to investors, have collected data about investors. This data demonstrates that different investors desire and

ratings of funds offered by market services[32] or to the more accessible materials supplementary to a prospectus, such as sales literature and advertisements, supplied by fund companies, to make an investment decision.[33] Accordingly, in consultation with the SEC and the Investment Companies Committee of the North American Securities Administrators Association, the Investment Company Institute (ICI) and eight fund companies developed prototype shorter prospectuses or profiles and tested consumer reaction to them. The tests showed that the shorter documents were popular with consumers and that led to the profile initiative.[34]

The initiative also demonstrates that a primary focus of securities regulation pertaining to consumer issues is increasingly educational in nature because of an enhanced concern for disclosure's "effective communication" to ordinary investors.[35] If the inquiry is whether disclosure is in fact reaching the ordinary

---

use different types and amounts of materials in determining whether to invest in funds.") (footnote omitted).

[32] *See, e.g., The Kaufmann Fund: Morningstar.net,* (visited Oct. 6, 1998) <http://www.morningstar.net> (web site of one well-known mutual fund rating service).

[33] *See, e.g.,* Clifford E. Kirsch, et al., *Mutual Fund and Variable Insurance Products Performance Advertising,* 50 BUS. LAW. 925, 933-35, 952-59 (1995) (summarizing advertising laws and regulations and discussing problems with simplified fund prospectuses and fund advertising); Paul S. Stevens & Craig S. Tyle, *Mutual Funds, Investment Advisers, and the National Securities Markets Improvement Act,* 52 BUS. LAW. 419, 425-27, 459-68 (1997) (discussing development of simplified fund disclosure and advertising).

[34] *See* Profile Proposal, *supra* note 7, at 10,944 (describing history of experimentation with profiles by large fund companies); Final Registration Release, *supra* note 8, at 13,918 (same). *See generally* INVESTMENT COMPANY INSTITUTE, THE PROFILE PROSPECTUS: AN ASSESSMENT BY MUTUAL FUND SHAREHOLDERS (1996) (presenting research into consumer attitudes regarding fund profiles to the SEC).

[35] *See, e.g.,* Final Registration Release, *supra* note 8, at 13,917 ("Taken together, these initiatives [new fund prospectus format, profile, etc.] are designed to promote more effective communication of information about funds to investors without reducing the amount of information provided to investors. The Proposed Amendments reflected the Commission's strong belief that the primary purpose of the disclosure in a fund's prospectus is to help an investor make a decision about investing in the fund.") (footnote omitted).

investor, one must improve both ends of the communication process, the disclosure itself *and* the comprehension abilities of the investor. The recent focus on the ordinary investor has been a priority of the current SEC Chairman, Arthur Levitt, who has championed such investors in many initiatives, most notably in the "plain English" regulation.[36] This emphasis (for it is only that) in securities regulation is necessary as so many new investors enter the securities markets and as the possibilities for their individual investing, through the World Wide Web or otherwise, multiply.[37] Even if their expertise traditionally has lain with regulating company disclosure, securities regulators cannot ignore the comprehension of individual investors, for, if it proves to be inadequate, there could be adverse consequences in the securities markets.[38]

---

[36] Chairman Levitt has clearly been the catalyst for the SEC's educational initiatives: in 1993 he established an Office of Investor Education and Assistance and has conducted town meetings with ordinary investors. *See Permanent Subcomm. On Investigations of the Senate Comm. On Government Affairs,* 105th Cong., 1st Sess. 18 (1997) (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Comm'n) (describing town meetings as "typically well-attended (often over 1,000 investors attended each meeting) and featur[ing] a series of seminars for investors on a wide variety of topics"). On the SEC "plain English" initiative, see Plain English Disclosure, Securities Act Release No. 7,497, 63 Fed. Reg. 6370 (1998) (establishing "plain English" rules and principles for writing prospectus disclosure); Plain English Disclosure, Securities Act Release No. 7,380, 62 Fed. Reg. 3152, 3155-59 (proposed Jan. 21, 1997) (discussing elements of plain English in proposed rule). *See generally* Fanto, *supra* note 6.

[37] *See, e.g.,* Peter Galuszka, *Guess Who's Courting the Beardstown Ladies?,* BUS. WK., Sept. 22, 1997, at 90 (discussing direct investment movement and National Association of Investors Corporation which encourages this movement and educates investors): Barbara Hetzer, *Direct Stock Buying: A Load of New No-Loads,* BUS. WK., June 16, 1997, at 152 (explaining that individual investors have increasing opportunities to buy stock directly from public companies and thus bypass brokers).

[38] *Cf.,* FRANKLIN R. EDWARDS, THE NEW FINANCE: REGULATION AND FINANCIAL STABILITY 123-24 (1996) (describing concern that investors could panic in market downturns and upset market structure). Of course, during the high market volatility of recent months, all eyes have rested on ordinary investors to see whether, in fact, they will panic and bring about a market crash as some commentators have speculated.

In its profile releases, the SEC affirms that the central purpose of the profile is to ensure that funds are communicating effectively to ordinary investors.[39] The profile initiative compels companies to present essential information about themselves in a simple way so that an investor who has little time and, even more importantly, little investment sophistication can understand it.[40] The profile does this in an obvious way by encouraging fund companies to use attractive graphic presentations and charts, to avoid dense textual descriptions and thus to make the profile an inviting document to read.[41] A fund can provide in the profile only nine items of information in a set order (and several of these involve a chart or table presentation)[42] so that an ordinary investor receives only limited, key information about a fund in a simplified format. The final release invites fund companies to experiment with presentation devices (such as, question-and-answer format) that will further enhance the comprehensibility of these items.[43] Part of effective communication involves access to profiles, and a fund company can distribute them to consumers widely

[39] *See* Final Profile Release, *supra* note 7, at 13,970 ("the Commission encourages all funds that decide to use profiles to take the steps necessary to ensure that their prospectuses effectively communicate information to investors").

[40] *See id.* ("The Commission's strongly held belief is that the principal goal of fund disclosure, whether it takes the form of a long or short document, should be to provide investors with useful and relevant information.").

[41] *See id.* at 13,985. A fund company must prepare a profile using the "plain English" writing principles, as now incorporated at 17 C.F.R. § 421(d) (1998). *See* Final Profile Release, *supra* note 7, at 13,969-13,970, 13,972.

[42] *See* Final Profile Release, *supra* note 7, at 13,972.

[43] In the rule proposal, the SEC would have required that a fund present the items in a question-and-answer format that was popular with consumers in focus groups who were the subjects of experimentation with the profile. *See* Profile Proposal, *supra* note 7, at 10,945 ("The proposed question-and-answer format, frequently used by many funds, is intended to help communicate the required information effectively."). To allow for continued industry developments with profile presentation, the SEC omitted this requirement from the final release, but kept the requirement that the nine items be presented in a set order. *See* Final Profile Release, *supra* note 7, at 13,972.

through various media, including through mass mailing, newspapers and electronic delivery.[44] In fact, the SEC recognizes the suitability of the profile to the growing Internet use by fund companies and fund customers because a company can electronically provide a profile and then "hypertext link" it to the full prospectus and other information about the fund.[45]

The most important aspect of the profile initiative is the way it encourages an investor to use whatever investor education he or she has received. The central purpose of investor education is to teach an investor the basics of finance and investing so that he or she becomes part of the investment "culture."[46] This means that an investor must learn about the basic kinds of investments (including about the securities markets in which they trade and the regulation of those markets) and investment professionals. An investor must also learn to locate information about investment performance (and acquire the ability to understand the conventions of presentation of this information).[47] Even more importantly, he or she must learn the relation of risk to return, the means of minimizing or eliminating certain risks (such as, through diversification) and some fundamentals about investing

---

[44] *See id.* at 13,981.

[45] *See* Profile Proposal, *supra* note 7, at 10,951 n.94 (noting that profile is especially effective in Internet dissemination because of ability to hyperlink to prospectus from profile). *See also* Final Profile Release, *supra* note 7, at 13,980-13,981. On electronic delivery of disclosure documents, *see generally* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 2-1 to 3-42 (2nd ed., 1998). The profile initiative also permits fund companies to tailor profiles used in employer-sponsored retirement plans (such as those under Section 401(k)) to the plan's needs and participant investment limitations. *See* Final Profile Proposal, *supra* note 7, at 13,981-13,982 (permitting omission of information relating to purchases and sales of fund shares, fund distributions and tax consequences).

[46] *See* Fanto, *supra* note 6.

[47] An example of this "standardized" investing education is in NATIONAL INSTITUTE FOR CONSUMER EDUCATION, THE BASICS OF INVESTING: A GUIDE FOR EDUCATORS, at Unit 2 ("How Financial Markets Work: Lesson 1–Types of Financial Markets"), Unit 3 ("Investment Choices: Lesson 2–Types of Savings and Investments") (1997) (also available at <http://www.emich.edu>).

strategy. In order to create an optimal portfolio, an investor needs to know how to make a correct asset allocation in line with his or her life stage and investment goals (that is, life-cycle investing) and the way to choose among comparable investments, taking into account such factors as expenses and tax consequences.[48]

The profile's content, which uses disclosure items from the revised fund prospectus,[49] gives investors the above kinds of information. A fund profile must summarize the fund's basic investment objectives and the general strategies of its advisor for achieving them, such as, that an equity fund adopts a "growth" approach and that it attains this objective through purchases of securities of companies with specific characteristics.[50] With such an identification, an investor can consider whether an investment in a fund is appropriate in light of his or her portfolio objectives. A profile's risk disclosure requires a fund to identify in general terms the specific risks to which it is subject because of its portfolio, objectives and strategies, as well as to provide a bar chart of annual total returns over a ten-year period and a table indicating the fund's average annual returns for one-, five- and ten-year intervals.[51] Such disclosure encourages an ordinary

---

[48] *See* Fanto, *supra* note 6.

[49] The profile would alert investors that they could obtain from the company a full prospectus (which, in any event, would be sent to them upon confirmation of purchase). *See* Final Profile Release, *supra* note 7, at 13,969. *See also* Profile Proposal, *supra* note 7, at 10,944 ("The profile would allow investors to choose the amount and format of information they want before making an investment decision.").

[50] *See* Registration Proposal, *supra* note 8, at 10,910 ("The information might describe, for example, whether an equity fund emphasizes value or growth, or blends the two approaches, or whether the fund invests in stocks based on a 'top-down' analysis of economic trends or a 'bottom-up' analysis that focuses on the financial condition and competitiveness of individual companies."); at 10,902 (requiring fund to disclose whether it intends to concentrate on particular kinds of securities and/or on industry or group of industries). *See also* Final Registration Release *supra* note 8, at 13,920.

[51] *See* Final Registration Release, *supra* note 8, at 13,919, 13,948-13,949; Registration Proposal, *supra* note 8, at 10,903. A fund must also present the best and worst returns for a quarter during this ten-year period so as to indicate the extreme range of volatility in a

investor to think about the relationship between risk and return in a fund (that is, that a greater return comes with greater volatility) and the appropriateness of such an investment given his or her risk profile. A fund must also provide disclosure relating to the kinds and amounts of mutual fund fees (a subject attracting increasing regulatory attention[52]), which includes a standardized example showing the accumulated costs of a fund for one-, three-, five- and ten-year intervals.[53] This presentation allows investors to compare funds on the important issue of their costs, as well as their performance.[54]

Indeed, the prominence that educationally important information receives in a profile can almost cause a fund to conduct some investor education itself. In discussing a fund's risks, a fund may, but is not required to, identify the kind of investor for which it is suitable, depending upon the investor's risk tolerance and preferences.[55] A

fund. *See* Final Profile Release, *supra* note 7, at 13,977; *see also* Registration Proposal, *supra* note 8, at 10,911 & n.136 (explaining that fund companies disagreed about appropriate quantitative risk measurement standards and about the ability of consumers to understand and to use effectively quantitative risk measurement, which led the SEC not to impose any such risk disclosure requirements). This Article does not discuss the technicalities of return/risk presentation (*e.g.*, for funds with a shorter than ten-year life).

[52] *See, e.g.*, Arthur Levitt, *Remarks at the Investment Company Institute* 3-4 (May 15, 1998), *available at* <http://www.sec.gov/news/speeches/spch212.txt>; Pension and Welfare Benefit Administration, *Study of 401(k) Plan Fees and Expenses (Apr. 13, 1998).*

[53] *See* Final Registration Release, *supra* note 8, at 13,949-13,951.

[54] The other profile items involve disclosure relating to (i) a fund's investment adviser, (ii) the purchase of fund shares, (iii) the sale of fund shares, (iv) fund distributions and their taxation and (v) other fund services. *See* Final Profile Release, *supra* note 7, at 13,986.

[55] *See* Final Profile Release, *supra* note 7, at 13,975-13,976; Final Registration Release, *supra* note 8, at 13,921. The original proposal required that funds identify appropriate investors. *See* Registration Proposal, *supra* note 8, at 10,903 (providing that risk section would include disclosure of types of investors for whom the fund may be appropriate). In response to opposition by commenters who thought that the requirement would conflict with suitability rules imposed on brokers and investment professionals (*i.e.*, that brokers must determine whether an investment is suitable for a client), the SEC made identification optional in the new registration form and profile (although it encouraged funds to make the identification).

fund company cannot do this disclosure properly without educating an investor about asset-allocation and life-cycle decision-making. A growth fund may explain that its "ideal" investor has a long-term investment horizon and no immediate need for funds and may additionally point out that this investor is typically a younger person with years of future earning potential who has no near-term need of funds from investment return (echoing life-cycle asset allocation that would tell such a person to weight his or her portfolio heavily toward growth stocks). A risk disclosure requirement that a fund's bar chart of risk/return information compare the fund's annual returns for one-, five- and ten-year intervals to those of an appropriate market index encourages[56] investors to compare a fund's performance to that of other funds and particularly to a market index. If a particular fund is actively managed, this comparison, together with the cumulative cost disclosure, invites an investor to consider whether investing in the fund would be better or worse than following a passive indexing investing strategy.[57]

[56] *See* Final Registration Release, *supra* note 8, at 13,922-13,924.

[57] *See, e.g.*, MALKIEL, *supra* note 4, at 422-32 (describing benefits of index strategy); at 441-46 (addressing why some money managers consistently outperform market indices). The SEC proposal regarding investment company names may have even a more basic educational effect when used in conjunction with the profile because it will protect an investor's application of educational principles to fund investing. This proposal, promulgated pursuant to the National Securities Markets Improvement Act of 1996, which amended Section 35(d) of the Investment Company Act of 1940 to empower the SEC to address deceptive or misleading company names by its rule-making authority, *see* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 208, 110 Stat. 3416, 3432 (1996), would require that a fund invest at least 80% of its assets in a specific kind or kinds of securities if its name suggests a fund focus on them (the SEC currently takes the position that a fund invest 65% of its assets in securities of the kind indicated by the fund's name). *See* Names Proposal, *supra* note 8, at 10,956. In the proposal, the SEC explains that consumers increasingly use investment companies to meet their retirement and other investment needs and base their fund investments on asset-allocation theory—a primary component of investor education. *See id.* at 10,956-10,957. In allocating their money, they use well-defined kinds of funds, such as stock, bond and money market funds, to meet their target portfolio composition. Yet, in the SEC's view, investors rely too much on fund names. *See id.* at 10,956. Therefore, if a mutual fund

IV. FURTHER EDUCATIONAL POSSIBILITIES FOR THE PROFILE

The investor education features of the profile initiative help ordinary investors, particularly regarding mutual fund investing. Yet the SEC should expand this initiative, partly by having funds encourage investors, by means of profile items, to pay more attention to the basics of investing. More importantly, the SEC should allow, and even consider requiring, fund companies expressly to link profiles to educational materials developed by them, or by industry or nonprofit organizations. This link will further stimulate an investor to consider, and to integrate into his or her decision-making, the important educational issues so essential to optimal investing. To do this, the SEC must explicitly recognize (as it is starting to do) the importance and value of educational products and services of private organizations.

With an appropriate change to the rule governing the profile, a mutual fund company could conduct more education in the profile itself (or in the fund prospectus). For example, a fund company could explain how a particular fund would fit into an asset-allocation strategy and what, in fact, this strategy means. Although a possible problem with this approach is that it forces a company to spend too much time hypothesizing about the identity of the typical investor and his or her need for information and education, the current regulatory solution in fund disclosure, which is sensible, is to design disclosure for an investor who has little training or sophistication in investing.[58] The main difficulty with putting education in the profile is that it would threaten to expand the profile, and even a full prospectus, beyond its intended scope. The profile is designed to be a short document (or "virtual"

---

implies through its name that it specializes in particular investments, but does not in fact do so, it undermines the beneficial effects of investor education.

[58] *See* Final Registration Release, *supra* note 8, at 13,919 ("Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision.").

document) that provides only the *basic* information (that is, the nine items stipulated by the profile rule) that an investor needs to make an investment decision, which involves comparing funds on performance and costs. The profile must, therefore, be kept short because investors are reluctant to read a lengthy document (as the Names Proposal implies, they often read only the name of a fund!).[59]

The SEC could, however, enhance the educational focus or compatibility with investor education of some profile disclosure items. A good example, as discussed above, is that a fund indicate the kind of investor for which it is appropriate. This reference, which need not be long, can convey the information to which an investor could apply the basic asset-allocation, life-cycle strategy that he or she should have learned in an investor education program, or at least alert an investor to find out about this strategy. Indeed, profiles presenting a family of funds for different stages in a life cycle would be particularly useful places to include this discussion because they could key funds to different kinds of investors.[60] In allowing fund companies to present multiple funds in a profile, the SEC thus enables the presentation of information that truly invites the investor to apply the life-cycle perspective.[61] Even without an explicit SEC requirement (and without

[59] *See* Names Proposal, *supra* note 8, at 10,956 ("Congress reaffirmed its concern that investors may focus on an investment company's name to determine the company's investments and risks ...").

[60] There is, for example, Vanguard's LifeStrategy Portfolios, designed for different life-cycle stages. *See* THE VANGUARD GROUP, VANGUARD LIFESTRATEGY PORTFOLIOS: ANNUAL REPORT (Dec. 31, 1997). Such educational aid might not be of use to everybody and would hardly substitute for a broker or financial planner who could assess an individual's total financial position and recommend appropriate investments to create an optimal portfolio. If, however, an investor is following a simple life-cycle asset-allocation model and has few investment assets other than his or her portfolio, it would be of use to him or her to know where a fund would fit into a typical portfolio.

[61] *See* Final Profile Release, *supra* note 7, at 13,973 ("The Commission believes that the ability to describe different investment options in one summary document will enable funds to develop profiles that help investors compare investment alternatives offered by a fund group.").

undermining broker suitability requirements),[62] it makes sense for fund companies to give some indication to prospective buyers about who is a suitable investor for a particular fund.

A fund company should not have to do more investor education in the profile itself, other than what is suggested above, because the company is likely already providing such education, directly or indirectly through an organization like the ICI, outside the profile. It would thus be unnecessary to require a fund company to repeat its educational product in each of its profiles. Yet this coexistence of educational services with the profile (and, in the case of products available on a fund's web site, the "virtual" proximity of these services to the profile)[63] points to the most significant improvement to the profile initiative that the SEC could make by further amendment to its new profile rule. The profile format invites an ordinary investor to apply a basic investing education to the standardized fund information; the fund company has extensive materials and services providing this education. The obvious need is to link the two together.

The SEC should thus take the additional regulatory step of allowing—perhaps even requiring—a mutual fund to link the profile to investor education materials supplied by the fund or by some other financial intermediary or organization. By connecting a profile to educational materials, a fund company would drive home to an ordinary investor that he or she needs the education to make more sense of the simplified fund information and to invest optimally. In fact, linkage between the information and education would work particularly well electronically, which is how many ordinary individuals are increasingly

[62] *See generally* NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION 2-1 to 2-110 (2d ed. 1997) (discussing fiduciary obligations of brokers).

[63] *See, e.g., Fidelity Investments: Know what you own and know why you own it,* (visited Oct. 6, 1998) <http://www.fidelity.com/planning/investment> (providing online service where individual account information co-exists with educational information and access is a mouse-click away).

investing.[64] In such cases, the linkage would occur throughout a profile: when, for example, a fund discusses its risks and identifies the appropriate kind of investor for the fund, it could point the investor by a hypertext link specifically to educational materials on risk, asset allocation and life-cycle investing.[65] Even if an investor relies on a written profile, a fund could accompany it with a basic investor education booklet to which the profile could be cross-referenced, just as funds now send an investor a handbook on fund services to accompany a profile or a prospectus.[66]

With industry consultation, the SEC must work out the details of the linkage, which means that it would need to submit an amending rule proposal regarding the profile and the new prospectus format.[67] An obvious concern would be how to introduce an investor to the need for education and to provide cross-references without adding to the size or complexity of the profile. The SEC would have

---

[64] *See* YANKELOVICH PARTNERS INC., 1997 ANNUAL SIA INVESTOR SURVEY: INVESTORS' ATTITUDES TOWARDS THE SECURITIES INDUSTRY 12 (Nov. 1997) (referring to growing numbers of investors who use personal computers to obtain investment information and to trade).

[65] In all its disclosure simplification initiatives, the SEC worries about confusing a consumer by providing cross-references. Yet the electronic delivery of disclosure documents and educational materials, with their hypertext links, ensures that the use of cross-references does not impede reading and comprehension, because a reader can access them so easily and then return without difficulty to the main document.

[66] Funds now send investors such educational booklets. *See, e.g.*, CHARLES SCHWAB, THE ESSENTIAL INVESTOR (1997); FIDELITY INVESTMENTS, MANAGING RISK IN YOUR PORTFOLIO: A FIDELITY GUIDE FOR EXPERIENCED INVESTORS (1995) (describing risk, risk management and asset allocation); MERRILL LYNCH, YOU AND YOUR MONEY: A FINANCIAL HANDBOOK FOR WOMEN INVESTORS (1997); THE VANGUARD GROUP, THE VANGUARD INVESTMENT PLANNER: A GUIDE TO ASSET ALLOCATION (1996). The SEC understands and accepts that a fund might send a handbook that supplies information about multiple funds together with a profile or prospectus. *See* Final Registration Release, *supra* note 8, at 13,954 (explaining how fund can separate out fund purchase and redemption information in separate document, incorporate it by reference in prospectus and distribute it to investors).

[67] The SEC might also issue a concept release on investor education. *See* Fanto, *supra* note 6. The SEC could make this proposal regarding the linkage in its concept release.

to draft a simple legend, in "plain English," to be placed at the beginning of the profile, that encouraged investors to use a company's educational materials and services, and it would also have to identify the key items, and appropriate language, for educational cross-references. The logical items for such cross-reference are those involving a fund's objectives, strategies, risks and returns, and fees (the first four profile items). In addition, the SEC will want a fund to make some reference to the SEC's own anti-fraud education materials and to the availability of education providers unaffiliated with the fund. One possible legend incorporating all such educational references would be the following:

> You should decide whether an investment in the [fund] is suitable to your personal circumstances and fits with your other investments. For help in making this decision, you should consult your broker or financial advisor, if you have one, and the investor education materials of [fund company], which are available at [provide reference/web site link] and to which this profile will occasionally refer. The Securities and Exchange Commission will also direct you to other education providers, as well as help you protect yourself against investment fraud and abuse (please call [telephone number] or go to the Commission's Internet site, www.sec.gov).[68]

And the SEC would have to consider providing companies with a "safe harbor" from any liability for the educational

[68] The new disclosure format has reduced the "clutter" of legends and cross-references in the fund prospectus, but still provides for some general ones pointing investors to other documents. *See, e.g.*, Final Registration Release, *supra* note 8, at 13,948 (providing legends that refer investors outside prospectus to fund's annual and semi-annual reports, Statements of Additional Information and even to SEC web site). If a fund company does not provide educational services, it could link its disclosure documents to the services of the ICI or of the brokerage firms through which the fund is sold. *Cf.*, *id.* (allowing a fund sold through a broker to indicate that further information about the fund is available with the broker or another financial intermediary).

materials, for fund companies would be reluctant to make educational references if it enhanced their liability risks.[69]

The SEC has begun to recognize the value of private educational services provided by fund companies.[70] Additional profile reform in line with the above suggestion could be a significant opportunity for the SEC publicly to acknowledge the developments in investor education by financial firms and nonprofit organizations and to encourage consumers to use these educational services. As such, the reform would fit well in the national campaign relating to investor education on pension investing and the SEC's own recent efforts to improve the position of ordinary investors in the securities markets.

V. CONCLUSION

The current focus on investor education is necessary in this country as individuals bear the responsibility for their retirement future through their own saving and investing. It is not known how much education will improve the investing performance of ordinary investors, and educational efforts should not foreclose other ways of helping Americans (particularly those with lower incomes) prepare for retirement. If, however, education is not effective, the consequences may indeed be grim, as wealth disparities increase through generations and as other, more politically charged solutions might be needed to address the plight of the elderly in retirement. Moreover,

---

[69] *Cf.*, 15 U.S.C. § 77b(a)(10)(a) (1997) (exempting supplementary sales literature from the prospectus definition); 17 C.F.R. § 230.135a (1998) (providing that generic advertising for mutual funds will not be deemed to offer security for sale when certain conditions are met). The most sensible approach might well be to exempt educational materials from the definition of a prospectus.

[70] *See* Levitt, *supra* note 36, at 2 (praising publicly the educational activities of private firms); Rachel Witmar, *SEC Wants Mutual Funds Voluntarily To Disclose Risk, Fee Data, Barbash Confirms*, 30 SEC. REG. & L. REP. 1006, 1007 (No. 27, July 3, 1998) (reporting that then SEC Director of Investment Management Barry Barbash (as well as Mike Miller of Vanguard) "focused on the need to educate investors beyond the prospectus and other official fund documents, through brochures, the Internet, and the media").

the need for investor education for the ordinary investor is a salutary reminder to those who focus exclusively on institutions in the securities markets and on pension fund capitalism.[71] Behind those institutions stand ordinary investors who place money in a 401(k) plan, an individual retirement account or a brokerage account and must decide how to invest it. If such investors lose confidence in the markets, the impact could be tremendous.

Financial regulators like the SEC have, therefore, no choice but to consider investor education in all of their regulations affecting ordinary investors, even if it presents new challenges to them. This Article argues that, in its profile initiative, the SEC exhibits the appropriate educational focus by adopting a simplified format, the profile, for presenting fund information, by encouraging fund companies to conduct some education in their profile disclosure, and, most importantly, by having them present information that invites the investor to apply to it investor education principles. Because so many fund companies, fund organizations, nonprofit groups and even the SEC itself now provide educational materials and services, the SEC should simply take the next step and facilitate the connection between the profile and these educational materials. To do so would promote the education that ordinary investors so desperately need.

---

[71] *See, e.g.*, MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA (1996) (in a discussion of the relations between public corporations and their shareholders he all but dismisses the ordinary investor).

Participant Self-Direction of Account Balances: Investment Advice or Investment Education?

Marcia S. Wagner and Robert N. Eccles *

With the exponential growth of pension plans established pursuant to section 401(k) of the Internal Revenue Code (the "Code")[1] more and more employees[2] are responsible for making the investment decisions on which the comfort and security of their retirement years will depend. In other words, where professional trustees and investment managers once, practically exclusively, invested pension plan assets, more and more plans are providing that participants themselves invest their pension plan assets.

Freed of the responsibility for investing pension plan assets or hiring professionals to do so, employers have nonetheless been concerned about the competence of their employees to direct the investment of those assets. To assist their employees in directing the investment of their pension plan assets, some employers have hired others to provide employees with either investment education or investment advice. Providing investment education means providing investment information to employees to assist them in making informed investment decisions — without

* Marcia S. Wagner has her own law firm, Marcia S. Wagner, Esq. & Associates, P.C., Boston, Massachusetts. Robert N. Eccles, is a partner at O'Melveny & Myers, Washington, D.C. The authors were counsel to Trust Company of the West in receiving *Prohibited Transaction Exemption 97-60*. Marcia S. Wagner has also written on the issues discussed in this Article in *The Provision of Investment Advice Under Prohibited Transaction Exemption 97-60*, TAX MANAGEMENT COMPENSATION PLANNING JOURNAL 3-10 (Jan. 2, 1998).

[1] I.R.C. § 401(k) (1998) (providing for cash or deferred arrangements).

[2] Although this Article refers to persons with pension plan assets for which they direct the investment as employees or participants, the same principles apply to beneficiaries of pension plan assets who direct the investment of those assets. Thus, the word participant in this Article should be read to include both employees and beneficiaries where appropriate.

providing employees with the kind of individualized investment information that constitutes investment advice. In this context, for investment information to be considered investment advice, the information must be understood to be "a primary basis for investment decisions with respect to plan assets" and must be individualized and based on the particular needs of the participant "regarding such matters as, among other things, investment policies or strategy, overall portfolio composition or diversification of plan investments."[3]

The first section of this Article summarizes Department of Labor (DOL) Interpretive Bulletin 96-1,[4] concerning investment education. The second section describes a prohibited transaction exemption received by Trust Company of the West (TCW) to permit it to offer investment advice to certain pension plan participants.[5] The third section explains the advantages of the investment advisory approach.

I. DOL INTERPRETIVE BULLETIN 96-1

A. BACKGROUND

A person who is otherwise a fiduciary with regard to pension plan assets over which a participant has investment control is not responsible for any losses that result from the participant's exercise of such control.[6] Thus, a plan sponsor, subject to regulations adopted by DOL,[7] can set up an employee pension plan that has individual accounts for each employee and for which each participant, not the plan sponsor, is responsible for managing the investments ("individually directed pension plan").

[3] 29 C.F.R. § 2510.3-21(c) (1998).

[4] Interpretive Bulletin Relating to Participant Investment Education [hereinafter Interpretive Bulletin], 29 C.F.R. § 2509.96-1 (1998).

[5] Prohibited Transaction Exemption 97-60 [hereinafter PTE], 62 Fed. Reg. 59,744 (1997).

[6] Employee Retirement Income Security Act of 1974, as amended (ERISA) § 404(c)(1)(B), 29 U.S.C. § 1104(c)(1)(B) (1998).

[7] 29 C.F.R. § 2550.404c-1 (1998).

A plan sponsor may still have fiduciary responsibility for investment advice provided to a participant who directs the investment of his or her individual account assets if the sponsor provides the participant with investment advice for compensation.[8] A service provider hired by a plan sponsor to advise participants would also be a fiduciary with respect to the individually directed pension plan. Moreover, a sponsor who hired a service provider to provide participants with investment advice would be required by the Employee Retirement Income Security Act of 1974 (ERISA) to be prudent in the choice of a fiduciary to provide investment advice[9] and could even be subject to co-fiduciary liability with the investment adviser if the plan sponsor chose imprudently.[10]

B. DOL Clarifies When Participant Investment Education is not Investment Advice

Because DOL shared the concern of many employers that employees might not be competent to direct the investment of their individually directed pension plan assets,[11] the Department issued Interpretive Bulletin 96-1 on June 11, 1996. The purpose of the Interpretive Bulletin is to encourage plan sponsors to provide participants with investment information without concern on the part of the sponsor about the fiduciary duties the sponsor might assume if the investment information provided were considered to be investment advice. The Interpretive Bulletin accomplishes this by clarifying when investment

[8] ERISA § 3(21)(A)(ii), 29 U.S.C. §1002(21)(A)(ii) (1998).

[9] Specifically, a plan sponsor must act "prudently and in the sole interest of plan participants and beneficiaries...." Interpretive Bulletin, 29 C.F.R. § 2509.96-1(e) (1998).

[10] *See id.* Specifically, the Interpretive Bulletin provides:

> [t]he designation of an investment advisor to serve as a fiduciary may give rise to co-fiduciary liability if the person making and continuing such designation in doing so fails to act prudently and solely in the interest of plan participants and beneficiaries; or knowingly participates in, conceals or fails to make reasonable efforts to correct a known breach by the investment advisor. *Id.*

[11] *See* Interpretive Bulletin, 29 C.F.R. § 2509.96-1(b) (1998).

education is not "investment advice" for purposes of the definition of "fiduciary" in section 3(21)(A)(ii) of ERISA.[12] Specifically, the Interpretive Bulletin describes "a series of graduated safe harbors under ERISA for plan sponsors and service providers who provide participants and beneficiaries with four increasingly specific categories of investment information and materials — plan information, general financial and investment information, asset allocation models and interactive investment materials."[13]

Neither of the first two safe harbors — for plan information and general financial and investment information — applies to information about specific investment alternatives available to participants under a plan. In contrast, the third and the fourth safe harbors permit the use in investment education materials of specific investment models incorporating actual investment alternatives available under the plans offered to participants. The use of the models in participant investment education materials is subject to the following restrictions.

The third safe harbor — for asset allocation models — permits a plan sponsor or service provider to make available to employees models "of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles, where:

> (i) Such models are based on generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time;
>
> (ii) all material facts and assumptions on which such models are based (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and rates of return) accompany the models;

[12] The Interpretive Bulletin does not address the question of when advice is provided for compensation. Interpretive Bulletin, 29 C.F.R. § 2509.96-1(b) (1998).

[13] Interpretive Bulletin, 61 Fed. Reg. 29,586, 29,586 (1996).

(iii) to the extent that an asset allocation model identifies any specific investment alternative available under the plan, the model is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained; and

(iv) the asset allocation models are accompanied by a statement indicating that . . . participants or beneficiaries should consider their other assets, income, and investments . . . in addition to their interests in the plan."[14]

The fourth safe harbor — for interactive investment materials — permits a plan sponsor or service provider to make available to participants materials, including worksheets, questionnaires and software, that enable the participant to estimate his or her own future retirement income needs and to "assess the impact of different asset allocations on retirement income" as long as there is "an objective correlation between the asset allocations generated by the materials and the information and data" provided by the plan sponsor or service provider and as long as restrictions similar to the ones applied to asset allocation models are met.[15]

C. Assumption of Responsibility Under Interpretive Bulletin 96-1

The Interpretive Bulletin also makes clear that hiring a person to provide investment educational services to participants in individually directed pension plans is "an exercise of discretionary authority or control with respect to management of the plan"[16] just as is the hiring of a person to provide investment advisory services.[17] Thus, the

[14] Interpretive Bulletin, 29 C.F.R. § 2509.96-1(d)(3) (1998).
[15] *Id.* § 2509.96-1(d)(4).
[16] *Id.* § 2509.96-1(e).
[17] *See supra* notes 9-10 and accompanying text.

act of employing a service provider to provide investment educational services is subject to the prudent man standard of care in section 404(a) of ERISA.[18] A plan sponsor must be prudent in selecting (and continuing to retain) a service provider, even though the sponsor neither has liability for the education provided nor for the consequences of investment decisions made by participants who have received the education.

II. PROHIBITED TRANSACTION EXEMPTION 97-60

A. BACKGROUND

Although the Interpretive Bulletin provided guidance for plan sponsors who wish to offer investment education to participants, it did not offer comparable guidance for sponsors who wish to offer participants more significant assistance in the form of investment advice. As noted above, the act of hiring someone to provide investment advice to an individually directed pension plan is a fiduciary act. In addition, a service provider hired to provide plan participants with investment advice is a fiduciary.[19] Moreover, if the service provider also offers the investment alternatives about which participants are receiving investment advice, then the service provider may have committed a transaction prohibited by ERISA unless the service provider has received an exemption from the application of provisions of that Act.

The following is a description of one program under which investment advice may be offered to certain pension plan participants and the prohibited transaction exemption that permits the offer of the program under specified conditions. For reasons set forth in a later section of this Article,[20] the authors believe that the conditions for receipt of the prohibited transaction exemption would also protect participants from breaches of fiduciary responsibility by the sponsor and the service provider and, thus, lessen the

[18] 29 U.S.C. § 1104(a) (1998).
[19] *See supra* notes 8-10 and accompanying text.
[20] *See infra* note 46 and accompanying text.

liability for any sponsor who hired a service provider with a similar prohibited transaction exemption to provide investment advice to participants.

B. DESCRIPTION OF THE TCW PORTFOLIO SOLUTIONS PROGRAM

In Prohibited Transaction Exemption 97-60 (PTE),[21] DOL granted exemptive relief[22] under section 408(a) of ERISA[23] and section 4975(c)(2) of the Code[24] on behalf of The TCW Group, Inc., and its wholly owned subsidiaries TCW and TCW Funds Management, Inc., the investment adviser to the TCW Galileo Funds, Inc. ("Galileo Funds").[25] In the PTE, DOL considered "TCW Portfolio Solutions," a program under which TCW could render investment advice to participants in individually directed pension plans. The program would provide an individual plan participant responsible for the investment of his or her account balance with a convenient way to benefit from the knowledge and experience of professional investment advisers and thereby receive advice concerning which of the investment vehicles offered under the program would represent an appropriate allocation of the assets in that individual's account.

---

[21] PTE, 62 Fed. Reg. 59,744 (1997).

[22] The relief granted was from the application of section 406(b) of ERISA to certain proposed transactions involving TCW and fiduciaries of individually directed pension plans whose participants receive investment advice from TCW.

TCW also received relief for the proposed purchase and sale by individually directed pension plans of units in commingled trusts described below and of shares of the Galileo Funds. The grant of relief for the purchase and sale transactions is not discussed further in this Article.

[23] 29 U.S.C. § 1108(a) (1998).

[24] I.R.C. § 4975(c)(2) (1998).

[25] The Galileo Funds is a series mutual fund, an open-end investment company, that has separate series that operate as individual mutual funds. *See generally* PTE, 62 Fed. Reg. 59,744, 59,746 (1997).

The program could be offered to independent fiduciaries[26] of individually directed pension plans.[27] In accordance with its responsibilities under Title I of ERISA,[28] an independent fiduciary would have to review the program before offering it under the pension plan.

1. *TCW Portfolio Solutions Trusts*

Under TCW's proposed program, TCW would recommend to participants one of a number of trusts maintained under the program or a money market fund or similar vehicle[29] as an investment vehicle for the participant's account balance. Multiple trusts would be established, structured as separate commingled trusts.[30] Each trust would hold, in varying proportions, shares of some or all of the mutual funds offered by the Galileo Funds.

The mix of mutual funds in each commingled trust would be designed to accommodate the investment needs and risk tolerances of a different profile of a participant with the salient factors being the participant's financial objectives, time horizon, other savings and risk tolerance. The trusts could range from aggressively structured (generally comprised of mutual funds invested primarily in equities), to conservatively structured (generally comprised

[26] An independent fiduciary would be a fiduciary who has discretionary authority with regard to an individually directed pension plan and who is not affiliated with TCW. The term could include named fiduciaries of the plan such as the plan sponsor or plan administrator or any fiduciary responsible for selecting investment vehicles for the pension plan.

[27] TCW's program would only be offered to sophisticated plans, that is those with a minimum of $5 million in plan assets.

[28] *See* ERISA, Pub. L. No. 93-406, Title 1, 88 Stat. 832 (1974) (codified as amended in 29 U.S.C.).

[29] The money market fund or similar option would be provided so that TCW's program could comply with the requirements of 29 C.F.R. § 2550.404c-1 (1998).

[30] Each commingled trust would be a group trust, satisfying all requirements of Revenue Ruling 81-100, 1981-1 C.B. 326, and thus, qualifying for tax exemption under section 501(a) of the Code. I.R.C. § 501(a) (1998).

of mutual funds invested primarily in fixed income instruments).

TCW would employ a financial expert to construct appropriate asset allocation models for the commingled trusts, using generally accepted principles of modern portfolio theory. The financial expert would be independent from and have no previous pre-existing relationship with TCW or its affiliates.[31] The asset allocation models would not be static, but rather the financial expert, in its sole professional discretion, would adjust them, taking into consideration the investment goals and risk tolerances that the models represent and changes in the economy and market conditions. The financial expert would be solely responsible for deciding how the models might best be implemented by selecting the mutual funds each commingled trust held and the weightings thereof.

The commingled trusts might comprise all or part of the investment alternatives available to a participant in an individually directed pension plan.

2. *Investment Advice Offered to Participants Under the Program*

An integral part of the program would be the investment advice offered to participants. TCW would provide each plan participant with worksheets[32] that would elicit from the participant his or her retirement funding needs, risk tolerance and life cycle stage. Upon completion of the worksheets, the participant's responses would be analyzed and the participant would receive a written recommendation from TCW of an appropriate commingled trust.[33] There would be no separate fee at the

[31] In addition, no more than five percent of the financial expert's gross income in any taxable year could be derived from TCW or its affiliates.

[32] The worksheets would be formulated by an independent expert.

[33] Because the worksheets would take into account risk tolerances, TCW might find itself in the position of recommending a more conservative commingled trust than would be the case if the worksheets had only a mathematical basis with no behavioral or psychological

trust level for the provision of this investment advice; however, the costs of the program (for example, the costs of developing and implementing the asset allocation models and the worksheets)[34] would be paid by TCW and TCW would be reimbursed for such expenses by the trusts.[35]

Whether a participant elected to invest in the recommended commingled trust would be entirely within the participant's discretion. A participant might disregard the recommended trust and invest in another trust. Moreover, some participants might not elect to participate in the asset allocation program at all, in such cases a person independent of TCW, generally the participant, would elect in which trust to invest the pension plan assets.

3. *Disclosure Under the Program*

TCW would provide plan sponsors with full disclosure concerning the composition of the commingled trusts and concerning fees and expenses charged at the mutual fund and the trust level. TCW also would provide sponsors with a quantitative annual report by which each sponsor could determine if the program had attained its objectives.

---

component. Since equity-based mutual funds provide TCW with higher fees (and generally higher profits) than fixed-income mutual funds, TCW would not necessarily maximize its short-term return by incorporating the behavioral or psychological component into the worksheets.

[34] Other trust level expenses would include expenses payable to regulatory authorities, accounting, auditing and legal expenses, clerical and administrative expenses, expenses of printing and mailing reports, expenses for computer programmers, certain insurance and fidelity bond premiums and other expenses incurred by each commingled trust in the ordinary course of its business.

[35] Because TCW generally would pay for direct expenses and then seek reimbursement from the commingled trusts, the payment of expenses could be viewed as an extension of credit between a plan and a party-in-interest prohibited under sections 406(a)(1)(B), 406(a)(1)(D) and 406(b)(2) of ERISA. 29 U.S.C. §§ 1106(a)(1)(B), 1106(a)(1)(D) and 1106(b)(2) (1998). However, relief likely would be available under Prohibited Transaction Class Exemption 80-26, 45 Fed. Reg. 28,545 (1980) concerning interest free loans between a plan and a party-in-interest.

Finally, participants also would receive full disclosure concerning the composition, operating costs, and historical performance of the commingled trusts and a description of the Galileo Funds before directing their account balances.

C. EXEMPTIVE RELIEF GRANTED BY PTE 97-60

Section 406(b) of ERISA[36] prohibits a fiduciary from dealing with a pension plan in the fiduciary's own interest or for the fiduciary's own account; from acting on behalf of a party whose interests are adverse to a plan in any transaction involving the plan; or from receiving consideration for the fiduciary's own account from a party dealing with the plan in connection with a transaction involving plan assets.[37]

DOL gives several examples of transactions prohibited by section 406(b) in a rule adopted under section 408(b)(2)

---

[36] 29 U.S.C. §1106(b) (1998).

[37] Section 406(a) of ERISA prohibits a fiduciary with respect to an employee benefit plan from causing the plan to engage in certain prohibited transactions, including the sale or exchange of property between a plan and a party-in-interest, the furnishing of services between the plan and a party-in-interest and the transfer to, or use by or for the benefit of, a party-in-interest of any assets of the plan. ERISA §§ 406(a)(1)(A), 406(a)(1)(C) and 406(a)(1)(D), 29 U.S.C. §§ 1106(a)(1)(A), 1106(a)(1)(C) and 1106(a)(1)(D) (1998).
Section 408(b)(2) of ERISA provides that the prohibitions provided in section 406 shall not apply to the provision of services "necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor." 29 U.S.C. § 1108(b)(2) (1998). DOL regulations state that section 408(b)(2) of ERISA "does not contain an exemption from acts described in section 406(b). . . ." 29 C.F.R. § 2550.408b-2(a)(3) (1998). Although section 408(b)(2), thus, does not resolve the question of whether TCW's program would involve transactions prohibited under section 406(b), section 408(b)(2) would apply to transactions that would otherwise be prohibited under section 406(a) of ERISA. Since an independent fiduciary of a sophisticated benefit plan would have to decide to enroll in the program and TCW would have every incentive to ensure that services were provided at the Trust level in a cost effective manner because it would not profit from providing such services, the authors believe that the provision of services under the program should not be a violation of section 406(a) of ERISA, because such transactions would likely be exempt under section 408(b)(2) of ERISA.

of ERISA. [38] Under DOL's second example, an investment adviser ("C") by recommending the purchase of an insurance contract on which C would receive a commission from the insurance company, engages in an act prohibited by section 406(b), even if C fully discloses the reasons for the recommendation and the fact that it will receive a commission, and even though an independent fiduciary (a fiduciary of the plan independent of C) considers the recommendation and approves the transaction. Similarly, because TCW could be deemed to be a fiduciary of individually directed pension plans enrolled in its program by virtue of the investment advice it would provide to participants in such plans, [39] TCW could be deemed to engage in a prohibited transaction if it advised a participant to invest in one of the more aggressive equity-based commingled trusts because TCW generally would receive higher net fees (and, thus could receive higher net profits) from such trusts.

Because of the risk that an offer of investment advice to participants in its program might be viewed as involving an act of prohibited self-dealing, TCW sought and received an exemption from the provisions of section 406(b) with respect to the proffer of investment advice. In support of its request, TCW noted that its proposed exemption was similar to Prohibited Transaction Exemption 93-59 received by Prudential Mutual Fund Management, Inc.,[40] in which DOL permitted an investment adviser affiliated with the applicant to evaluate and recommend a mutual fund investment mix comprising mutual funds that were advised by the applicant. TCW also cited the similar exemption received by Shearson Lehman Brothers, Inc.[41]

---

[38] 29 C.F.R. § 2550.408b-2(f) (1998).

[39] Because the participants under the individually directed pension plans often would be financially unsophisticated, it is anticipated that any advice rendered by TCW would be relied upon by participants. Therefore, provision of the advice could render TCW a fiduciary of the plans according to the definition of fiduciary in section 3(21)(A) of ERISA. *See supra* note 5 and accompanying text.

[40] 58 Fed. Reg. 47,290 (1993).

[41] Prohibited Transaction Exemption 92-77, 57 Fed. Reg. 45,833 (1992).

Frankel: Trends in the Regulation of Investment Companies and Investment A

III. THE ADVANTAGES OF INVESTMENT ADVICE OVER INVESTMENT EDUCATION

There are several advantages to a plan sponsor in hiring a service provider who provides investment advice rather than investment education.

First, the provider can give participants the investment advice they desire and need. Consequently, plan participation and retention rates should increase.

Second, any prohibited transaction exemption received by a service provider offering investment advice would contain protective conditions that could protect the plan sponsor as well as participants.

As noted above, a plan sponsor is responsible for the selection and oversight of the service provider whether the service provider is an educator or an adviser.[42] Because a prohibited transaction exemption relieves liability from the prohibitions of the self-dealing provisions of section 406 of ERISA but does not provide relief from the responsibility of prudence and care under section 404,[43] DOL must, in order to grant a prohibited transaction exemption, find that the transaction is in the interests of plan participants.[44] Therefore, DOL only grants exemptions that incorporate conditions and procedures that the Department believes will ensure, to the greatest extent possible, that the transactions it exempts are prudent.

---

[42] *See supra* notes 9 and 16-18 and accompanying text. Also, as noted above hiring by a plan sponsor of a person as an investment adviser may result in co-fiduciary liability under section 405 of ERISA (29 U.S.C. § 1105) if the fiduciary hiring the adviser fails to carry out the designation in a manner consistent with the general fiduciary responsibility provisions of ERISA. *See supra* note 10 and accompanying text. As a practical matter, the liability of a plan sponsor in selecting TCW or any other fiduciary where conduct is circumscribed by an exemption is no greater than the liability a plan sponsor would incur in selecting an educator.

[43] ERISA § 408(a), 29 U.S.C. § 1108(a) (1998).

[44] *Id.* § 1108(a)(2).

Published by Villanova University Charles Widger School of Law Digital Repository, 1999

Villanova Journal of Law and Investment Management, Vol. 1, Iss. 1 [1999], Art. 1

Similarly, DOL must also find that the terms of a transaction are protective of the rights of participants.[45] Accordingly, unless the Department is comfortable that the terms of a transaction are favorable to participants, it will not issue an exemption. It is not unusual for the Department to insist that the terms of a transaction be made more favorable to participants than the requester of the exemption had initially proposed.

The caution of DOL has had a predictable result. Exhaustive computer searches have failed to uncover any case in which a party complying with the conditions of an individual prohibited transaction exemption was held liable for a breach of its fiduciary responsibilities. Further, the authors have been unable to locate a single reported case in which a fiduciary breach was even alleged against such a person. Thus, as long as a service provider has a prohibited transaction exemption, complies with the conditions of that exemption, and fulfills its responsibilities to the individually directed pension plans, a plan sponsor could take comfort in the likelihood that its duties of prudence and care in hiring the service provider have been met.[46]

Third, if a plan sponsor hired a service provider offering investment advice, the sponsor would not have to monitor whether the provider actually provided investment education or investment advice. In contrast, if a plan sponsor hired a service provider who claimed only to offer investment education, the sponsor would have to monitor

[45] *Id.* §1108(a)(3).

[46] A plan sponsor would have had to have made an initial determination that the investment advice furnished by the service provider would be likely to be helpful to its employees. Moreover, a fiduciary who hires a service provider that performs well could still be subject to equitable relief, such as removal, for not following proper procedures in hiring the provider. *See* Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987). However, the disclosures that a service provider would be required to make to receive a prohibited transaction exemption are intended to ensure that proper procedures are used in the selection process. For the information provided by TCW under its program, see section II.B.3 of this Article (Disclosure Under the Program), *supra*.

whether the investment education provided slipped over the line into investment advice. If the investment education were actually investment advice, then the plan sponsor might be found to have hired a fiduciary on behalf of the plan, which fiduciary would not have received a prohibited transaction exemption addressing any possible self-dealing issues involved in the arrangement.

Fourth, hiring a service provider who offers investment advice rather than investment education protects a plan sponsor from certain ambiguities in the interplay of state and federal law.

A service provider offering investment education may be subject to state law,[47] rather than to ERISA. This may permit an educator with a financial interest in which investment vehicle a participant selects to skew the investment education to lead to the selection of vehicles that result in higher fees and profits for the educator without liability for the educator under ERISA. Such a scenario would enhance the possibility of liability under ERISA for the plan sponsor for either improper selection or inadequate monitoring of the educator.

Finally, many of the different state laws to which a service provider offering investment education might be subject may well have different standards than ERISA. If an educator were held liable for a violation of state law, the holding might be evidence in a federal court that a plan sponsor had not satisfied ERISA's prudence requirement in selecting and monitoring the educator. On the other hand, if the educator were not held liable under state law for something that would be a violation of ERISA because

[47] *See* Coyne v. Selman, 98 F.3d 1457 (4th Cir. 1996); Curtis v. Nevada Bonding, 53 F.3d 1023, 1027 (9th Cir. 1995); Dukes v. U.S. Healthcare, Inc., 57 F.3d 350, 355 (3d Cir. 1995), *cert. denied*, 116 S. Ct. 564 (1995). In contrast, most state laws do not apply to a service provider acting as a fiduciary to a pension plan subject to ERISA. *See* ERISA § 514(a), 29 U.S.C. §1144(a) (1998), which generally preempts the application of all state laws to fiduciaries except for those laws that relate to banking, insurance, securities, and generally applicable criminal law.

of less restrictive standards in the state law, the plan sponsor might still be liable for the imprudent selection or monitoring of the service provider since the less restrictive state laws might have deprived the plan of a cause of action against the educator.