

---

## DOWNSTREAM SECURITIES REGULATION

ANITA K. KRUG\*

INTRODUCTION .....	1590
I. SECURITIES REGULATION .....	1597
A. <i>Upstream Regulation</i> .....	1598
1. The Securities Act .....	1599
2. The Exchange Act .....	1601
B. <i>Downstream Regulation</i> .....	1603
1. Investment Advisers .....	1603
2. Mutual Funds .....	1606
3. Broker-Dealers .....	1609
II. REGULATORY FOUNDATIONS .....	1611
A. <i>Entity-Centrism; Doctrinal Dependence</i> .....	1612
B. <i>Structural Flexibility; Doctrinal Independence</i> .....	1617
C. <i>Disclosure</i> .....	1622
III. REGULATORY FAILURES .....	1626
A. <i>Downstream Rules</i> .....	1626
1. Mutual Fund Regulation .....	1626
2. Investment Adviser Regulation .....	1630
3. Broker-Dealer Regulation .....	1633
B. <i>The Downstream Subject and Upstream Rules</i> .....	1636
1. Antifraud in Securities Issuances .....	1636
2. Corporate Accountability .....	1639
IV. IMPLICATIONS .....	1643
A. <i>Upstream Reform</i> .....	1643
B. <i>Downstream Reform</i> .....	1646
CONCLUSION .....	1649

*Securities regulation wears two hats. Its “upstream” side governs firms in connection with their obtaining financing in the securities markets. That is, it*

---

\* Associate Dean for Research and Faculty Development and Associate Professor, University of Washington School of Law. The author thanks Mehrsa Baradaran, Brad Bernthal, Zachary Gubler, Matthew Jennejohn, Anna Laakmann, Elizabeth Porter, and Karen Sandrik for their comments on prior drafts of this Article. This Article also benefitted immensely from discussions at the 2013 Rocky Mountain Junior Scholars Forum and the 2014 Law & Society Association Annual Meeting.

*regulates firms' and issuers' offers and sales of securities, whether in public offerings to retail investors or in private offerings to institutional investors. Its "downstream" side, by contrast, governs financial services providers, who assist with investors' activities in those markets. Their services include providing advice regarding securities investments, as investment advisers do; aggregating investors' assets for purposes of enabling those investors to invest their assets collectively, as mutual funds do; and acting as "middlemen" between buyers and sellers of securities, as broker-dealers do. Yet neither scholars nor policymakers have adequately understood that the regulation of financial services providers under the securities laws is substantively different from the regulation of issuers. They have not, in other words, adequately understood downstream securities regulation.*

*The problems arising from this oversight are evident in laws and rules designed to protect investors from the excesses of brokerage firms, fraudulent conduct in the mutual fund industry, and hedge-fund managers' self-interested conduct, as well as in those enacted in the wake of Enron's bankruptcy and other corporate scandals. Moreover, the harm to investors is real: brokerage firm customers have struggled for the return of their deposited funds after the firm's bankruptcy; mutual fund shareholders have suffered from market timing scandals; shareholders of financial services firms have been harmed by fraud, notwithstanding antifraud statutes meant to protect them. This Article is the first scholarly work to articulate how securities regulation encompasses two distinct spheres of regulation, each of which is based on its own core principles – and, importantly, each of which necessitates its own regulatory approaches. The Article contends that policymakers' longstanding failure to recognize that securities regulation is bimodal has produced a securities regulatory regime scattershot with flaws and vulnerabilities. Securities regulation could become substantially better if those who make and influence it had a more complete understanding of how it works – how all parts of it work.*

#### INTRODUCTION

Federal regulation of securities has a long history in the United States. Dating back to the decade following the Great Depression, the U.S. securities statutes aim to ensure market integrity and thereby protect and instill confidence in investors – broadly defined as those whose capital is at stake in the securities markets.<sup>1</sup> Since their enactment, the securities statutes have not been substantially reformed. Moreover, although myriad amendments have addressed new or previously unforeseen problems,<sup>2</sup> those changes have not altered the core regulatory approach embodied in U.S. securities regulation.

---

<sup>1</sup> See *Investing*, INVESTOPEDIA, archived at <http://perma.cc/JA2R-MLN3> (last visited July, 13, 2014) (defining "investing" as "[t]he act of committing money or capital to an endeavor . . . with the expectation of obtaining an additional income or profit").

<sup>2</sup> See Thomas M. Selman, Exec. Vice President, Regulatory Policy, FINRA, Address at the Investment Program Association Fall Conference (Nov. 15, 2012), archived at

Which is what, exactly? Many policymakers and securities law scholars would say that securities regulation is based on disclosure: firms' disclosure, to those who might buy their securities, of material facts about themselves, their officers and directors, their performance, and their projects.<sup>3</sup> Put succinctly, under the dominant lore, securities regulation mandates that firms be open and truthful to shareholders and would-be shareholders.<sup>4</sup> However, setting aside for the moment that a regulatory approach based on disclosure is broadly perceived as the anointed one, the foregoing description betrays something telling: securities regulation is generally regarded as a single thing. In particular, it is understood to be the regulation of firms' – *public* firms'<sup>5</sup> – activity of raising capital by offering and selling securities,<sup>6</sup> thereby balancing the relationship between those who manage a firm and those who own it.<sup>7</sup>

Given this broad description, how might one explain the requirements – also falling under the heading of “securities regulation” – that a securities broker not charge its customers certain types of fees or that employees of a financial adviser not invest in certain types of securities? The answer is that there is another side to securities regulation, another domain beyond the regulation of securities offerings and sales, that the securities laws encompass. This second sphere is the regulation of those who *facilitate* transactions in the securities markets.

---

<http://perma.cc/EWU3-RZ4X>.

<sup>3</sup> See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953) (“The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”); 2 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 8.1[1][B] (5th ed. 2005) (referring to “federal securities law’s exclusive focus on full disclosure”).

<sup>4</sup> A component of the “truthfulness” requirement under the securities laws is a prohibition of “half-truths” – truthful statements that, without supplemental disclosure, are nonetheless materially misleading. See, e.g., 17 C.F.R. § 240.10b-5 (2013) (“It shall be unlawful for any person . . . to omit to state a material fact necessary in order to make the statements made . . . not misleading . . .”).

<sup>5</sup> See Sheila M. McDevitt, *The Legal Department’s Role in Managing Legislative and Regulatory Issues*, 12 FLA. ST. U. BUS. REV. 145, 150 (2013) (“The listing standards, the 1933 and 1934 Acts, Sarbanes-Oxley, and every other kind of regulation that applies to businesses are things that apply to public companies.”). Generally, companies are deemed “public” if their securities are listed on a national securities exchange, if they have issued securities in the public market, or if they have in excess of a certain number of shareholders. See *infra* notes 55-59 and accompanying text (describing public company status).

<sup>6</sup> See Michael Occhiolini, *Where to Draw the Line: Distinguishing Between Restricted and Publicly Registered Securities in an Era of Equity Swaps*, 1 STAN. J.L. BUS. & FIN. 209, 215 (1995) (“At the very foundation of securities regulation is Section 5 of the Securities Act, which provides that every offer and sale of a security must be registered under the Securities Act and preceded by the delivery of a prospectus . . .”).

<sup>7</sup> See ROBERT C. CLARK, *CORPORATE LAW* § 1.4, at 30 (1986) (observing that, traditionally, securities regulation has been defined as “deal[ing] only with relationships between shareholders and managers (directors and officers)”).

The roles of these “facilitators” are varied but also familiar. They are investment advisers who provide advice as to securities investments and manage investors’ assets, whether individually (through “separately managed” accounts), or collectively (through, for example, hedge funds and private equity funds). Blackstone, Paulson, and Bridgewater are oft-recited representatives of the latter headings – “pooled” investment entities that invest capital from scores of investors, on a collective basis, in the securities markets. These entities are mutual funds, a category in which Oppenheimer, Janus, and Vanguard are household names. They are also the broker-dealers<sup>8</sup> who act as agents, or “middlemen,” between buyers and sellers of securities – Goldman Sachs and Morgan Stanley being two of the more prominent examples.

Accordingly, securities regulation wears two hats. It governs firms, or issuers, in connection with their obtaining (and maintaining) financing in the securities markets, and it governs those who assist with investors’ activities in the securities markets. Put another way, we might say that securities regulation governs not only the producers of securities, but also the providers of financial services – securities-related financial services, that is.

Yet, in many respects, the financial services facet of securities regulation has been almost invisible. To be sure, although not deemed the nucleus of securities regulation, financial services regulation *has* always been a critical component of the securities markets. It has been especially prominent following the 2008 financial crisis, both as a perceived source of regulatory weakness and as a route through which to create a more robust and stable financial regulatory system.<sup>9</sup> Indeed, scholars have devoted ever more attention to securities “intermediaries” (the scholarly label for financial services providers) and the regulatory concerns that intermediaries are perceived to cause,<sup>10</sup> as have policymakers, whose debates and proposals about how best to regulate financial services firms were the grist of much of the policymaking that ultimately assumed the form of the Dodd-Frank Act of 2010 (“Dodd-Frank”).<sup>11</sup>

---

<sup>8</sup> A broker-dealer is a person (an individual or an entity) that is engaged in the business of buying and selling securities either on behalf of the person’s customers (a broker) or for the person’s own account (a dealer). See 15 U.S.C. § 78c(a)(4)(A) (2012) (defining “broker”); *id.* § 78c(a)(5)(A) (defining “dealer”); *id.* § 78i(j) (discussing requirements for those acting as “broker-dealers”).

<sup>9</sup> See Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are Too-Big-to-Fail?*, 62 HASTINGS L.J. 821, 822-28 (2011) (discussing post-financial crisis policy debates regarding financial regulatory reform).

<sup>10</sup> See generally Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 347-53 (2008) (explaining the role of intermediaries in the securities markets); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961 (2010) (proposing mutual fund regulatory reform).

<sup>11</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

Nevertheless, in various contexts, there has been no apparent recognition that the financial services component of securities regulation is a separate genre of securities regulation, different in important respects from its more renowned counterpart; that it does not revolve around securities issuers; and, critically, that it need not rely solely on disclosure and antifraud principles. For example, anyone who has taken a basic securities regulation course likely recalls that the course focused on the regulation of public securities offerings under the Securities Act of 1933 (the “Securities Act”).<sup>12</sup> It also surely delved into issuers’ “public reporting company” obligations under the Securities Exchange Act of 1934 (the “Exchange Act”).<sup>13</sup> However, the regulation to which broker-dealers are subject (also under the Exchange Act)<sup>14</sup> likely was not covered, at least not in any depth, let alone the regulation of investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act”)<sup>15</sup> or the regulation of mutual funds and other investment companies – that is, public funds, as opposed to hedge funds and other private funds – under the Investment Company Act of 1940 (the “Investment Company Act”).<sup>16</sup>

This myopia extends to the realms of policy and scholarship, notwithstanding policymakers’ and scholars’ sporadic and concerted focus on intermediaries noted above. Policymakers, failing to appreciate financial services regulation as a substantively different function of the securities laws, have seemingly misapprehended its nature and structure. Accordingly, they have produced structurally weak laws and rules that undermine the objectives of both financial services regulation and the regulation of issuers.<sup>17</sup> In the academy, both within and without the field of securities regulation, securities regulation is deemed one thing, and financial services regulation is deemed completely separate from it. Securities law scholars have tended to assume that securities regulation, in all its forms, is ultimately reducible to the regulation of securities issuers, particularly the public kind.<sup>18</sup> Meanwhile, scholars of banking and insurance law – subjects traditionally viewed as the bastions of financial services – have tended to disclaim the presence of financial services regulation in *non*-banking and *non*-insurance arenas, insurance and banking

---

<sup>12</sup> 15 U.S.C. §§ 77a-77aa (2012).

<sup>13</sup> *Id.* §§ 78a-78kk.

<sup>14</sup> *Id.* § 78o.

<sup>15</sup> *Id.* §§ 80b-1 to 80b-21.

<sup>16</sup> *Id.* §§ 80a-1 to 80a-64 (2012).

<sup>17</sup> See *infra* Part III (describing how policymakers’ failure to appreciate securities regulations’ dual function militates against regulatory efficacy in both realms).

<sup>18</sup> See McDevitt, *supra* note 5 and accompanying text (observing that U.S. securities regulation focuses on public companies).

being the traditional arenas of *consumer* financial services, rather than *securities investor* financial services.<sup>19</sup>

Securities regulation could become substantially better if those who make and influence it had a more complete understanding of how it works – how *all* parts of it work. Without such an understanding, it is impossible to determine whether there is an alternative way – a prescription for how it should work – or to identify the bases of regulatory failures. After all, the past eighty years have produced reasonably comprehensive understandings of the regulation of securities issuers. The same cannot be said for the regulation of financial services providers.

This Article shows how securities regulation encompasses two distinct spheres of regulation – spheres that are based on distinct foundational principles and that necessitate different regulatory approaches. It contends, moreover, that policymakers' longstanding failure to recognize that point has produced a securities regulatory regime scattershot with flaws and vulnerabilities. Although previous scholarship, focusing on discrete financial services regulatory issues, has made suggestions for improvement (mutual funds have been a particular interest<sup>20</sup>), none has suggested a connection among different types of regulatory failures or offered a comprehensive understanding of the ways in which financial services regulation is different from the general regulation of public issuers. This Article fills that void, the first to do so.

For ease of reference, this Article analogizes to terminology used in industrial production processes, referring to the regulation of issuers as “upstream regulation” and to the regulation of financial services providers as “downstream regulation.” Given what the different players in the securities markets do, those labels make intuitive sense. The upstream stage in production characteristically involves the supply of raw materials to downstream businesses, which refine or otherwise transform the materials for use by consumers or other customers.<sup>21</sup> The securities realm conforms to a similar framework. On the upstream side, issuers supply securities to the markets. On the downstream side, providers of securities-related financial

---

<sup>19</sup> See, e.g., John Flood, *Will There Be Fallout from Clementi? The Repercussions For the Legal Profession From the Legal Services Act 2007*, 2012 MICH. ST. L. REV. 537, 549 (listing “credit cards, insurance, banking” as encompassed by the term “financial services”).

<sup>20</sup> See, e.g., Fisch, *supra* note 10, at 2028 (“Mutual funds and comparable alternatives should be regulated as products, not investments.”); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 131–40 (2010) (arguing that corporate governance-style regulation should be replaced with product-style regulation).

<sup>21</sup> See Brian Bass, *The Definitions of “Upstream” and “Downstream” in the Production Process*, HOUS. CHRON. (last visited July, 13, 2014), archived at <http://perma.cc/XU4K-6G7L> (“The upstream stage in the production process may also manifest itself as a supplier providing raw materials to manufacturers or other businesses that ultimately process the materials.”).

services enable investors' activities in the securities markets by connecting (if only indirectly) those who have investment capital and, therefore, investment demand, with those who produce investment performance – namely, issuers.

Importantly, the difference between securities regulation's upstream component and its downstream component has critical implications for the nature of regulation and, beyond that, its content. Upstream, law's focus on securities issuers means that it is focused on entities.<sup>22</sup> Securities issuers may be large public companies, or they may be small start-up companies seeking their initial set of venture capital investors. They might be organized as corporations or, alternatively, they might be formed as LLCs or limited partnerships. Whatever might be the factors that distinguish them from one another, each of them is an entity. Upstream regulation, moreover, has the unusual distinction of being incomplete: it is supplemental in nature, specifying requirements that stand alongside requirements from another source, namely corporate law.<sup>23</sup> Like corporate law, after all, upstream regulation centers on the relationships among a firm's core constituencies: shareholders (as the firm's owners) and directors and officers (as its managers).

Upstream regulation, then, may be said to be both entity-centric and dependent on other laws and rules. It might also be said that downstream regulation is rather different, for it neither needs to be wary of entity boundaries nor does it serve a supportive function for other doctrine.<sup>24</sup> Rather, regulation downstream enjoys a certain degree of flexibility in its function and a wider scope in its application. These distinctions, moreover, have important consequences for the approaches that each mode uses to achieve its objectives. Most significantly, whereas rules requiring a firm to provide disclosure to its investors and prospective investors are arguably the most fitting tool for regulating issuers, downstream regulation has considerably more latitude.

There is more, however. These descriptive distinctions have not only been broadly ignored, but they have also been the launch pad for a saga of failed regulation. There are at least two ways in which this is so. First, there are many ways in which downstream laws and rules, rooted in the same fundamentals as their upstream counterparts, thwart downstream regulatory goals.<sup>25</sup> Most importantly, like upstream regulation, downstream regulation is often entity-centric in its formulation. That is, it is excessively deferential to the entity and associated norms governing the relationship between owners and managers at the expense of furthering its own objectives, which center on the protection of those who engage financial services providers to assist with their participation in the securities markets.

---

<sup>22</sup> See *infra* notes 149-155 and accompanying text.

<sup>23</sup> See *infra* notes 156-159 and accompanying text.

<sup>24</sup> See *infra* Part II.B.

<sup>25</sup> See *infra* Part III.A (discussing downstream regulatory failures caused by upstream principles).

That difficulty, which is apparent in numerous financial services regulatory contexts, is suggested by questions concerning existing regulatory doctrine: If the investment advisory firm that manages a mutual fund's securities portfolio is also the firm that selects the fund's independent directors, can it be said that the directors are truly independent of the advisory firm, certain to act in the fund's best interests even when doing so would be contrary to the advisory firm's wishes? If a broker-dealer is a multi-entity enterprise controlled by a single person, should the enterprise be able to escape critical regulatory obligations simply by placing offshore the entity that accepts and holds customer funds? If it seems that the appropriate answer to each of these questions is "no," then there is much work to be done.

Second, upstream principles counter not only downstream regulatory objectives but also *upstream* objectives. That is because a number of upstream laws and rules that apply to issuers – particularly public ones – apply also to financial services providers that happen also to be issuers. Because these upstream laws and rules do not expressly contemplate application to financial services subjects, they produce anomalies when that occurs.<sup>26</sup> Questions help elicit these concerns, as well: If the shareholders of an investment advisory firm are harmed (through a decline in stock price) by a revelation that the firm has engaged in fraud against investors whose assets it manages, should those shareholders have a remedy under the securities laws' antifraud provisions? If the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")<sup>27</sup> protects an employee of a public company from retaliation by the company when the employee "blows the whistle" on the company's fraud against its shareholders, should those protections dissipate if the whistleblower was instead employed by another (private) firm that controls the public company in virtually all respects? That the Supreme Court or other federal courts have replied "no" to both questions foretells additional challenges.

In the end, the failure of policymakers to understand the bimodal nature of securities regulation harms the cause of both downstream regulation and upstream regulation. The difference between these contexts turns on who bears the brunt of that harm: In the former context, in which downstream laws and rules reflect upstream principles, the injured parties are typically those who enlist the help of financial services firms – an investment adviser's clients, a mutual fund's shareholders, or a brokerage firm's customers, for example. In the latter context, in which upstream laws and rules are applied to downstream subjects, shareholders (and possibly employees) within financial services enterprises typically suffer the harm. Either way, however, it is glaringly

---

<sup>26</sup> See *infra* Part III.B (describing anomalies arising from the application of upstream principles in downstream contexts).

<sup>27</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, and 28 U.S.C.) (subjecting public companies to laws and rules aimed at fostering managerial accountability and deterring financial and accounting fraud) [hereinafter Sarbanes-Oxley].



evident that securities regulation, though perceived as monolithic, should not rely on the same principles and approaches for all of the subjects within its purview.

Part I provides a broad overview of both upstream regulation and downstream regulation, describing pertinent doctrine and policy objectives within the ambit of each. Moving to a higher level of abstraction, Part II discerns, for each mode of securities regulation, certain foundational principles on which it is based and which inform – or, at least, should inform – the regulatory approaches that it employs. This Part additionally deploys these principles to explain why disclosure neither is, in fact, the exclusive securities regulatory tool, nor should it be. Part III turns to the problems that widespread inattention to these insights has produced: recent securities regulatory failures have involved either downstream laws and rules that, despite their ostensible goals and orientation, nonetheless reflected upstream foundations or upstream laws and rules that, although nominally applicable to certain downstream contexts, were not equipped to function in those contexts. Turning to the implications of this analysis, Part IV offers proposals for formulating more coherent and workable law and policy, both upstream and downstream.

## I. SECURITIES REGULATION

U.S. securities regulation encompasses two distinct types of regulation, which we might think of as upstream regulation and downstream regulation. Upstream regulation is the regulation of issuers' offers and sales – that is, issuances – of units of ownership (and certain derivatives thereof<sup>28</sup>) otherwise known as securities. Issuers are entities that produce goods or provide services – so-called “operating” companies – such as Oracle or Nestlé. They are also entities that serve as instruments through which a group of investors pursue particular investment strategies, such as a First Eagle or Fidelity mutual fund, in that investors “invest” in a fund by buying its securities.<sup>29</sup> This regulation is aptly deemed “upstream” because the act of issuing securities is, in effect, the act of producing them and distributing them into the securities markets.<sup>30</sup>

---

<sup>28</sup> Derivatives of securities include instruments known as options and warrants. A buyer of an option contract has the right to either buy or sell a security at a specified price during a specified period of time. See *Option*, INVESTOPEDIA, archived at <http://perma.cc/JSPD-MRFR> (last visited July, 13, 2014). A warrant gives the holder the right to buy a security from the issuer at a specified price during a specified period of time. See *Warrant*, INVESTOPEDIA, archived at <http://perma.cc/PGS8-7PWF> (last visited July, 13, 2014).

<sup>29</sup> Put another way, the Securities Act, 15 U.S.C. §§ 77a-77aa (2012), does not distinguish among entities based on the types of activities they pursue.

<sup>30</sup> Secondly, upstream regulation also applies in connection with subsequent sales made by purchasers. However, because sales by issuers are subject to the most comprehensive regulation, while secondary market transactions largely fall within exemptions from that regulation, see *infra* notes 46-54 and accompanying text, upstream regulation may be viewed primarily as the regulation of issuers in their capacities as such.

With that understanding of upstream regulation, downstream regulation becomes almost self-evident. It is the regulation of those who provide securities-related financial services – who effect or otherwise facilitate securities purchases and sales on behalf of investors. The three signal varieties of downstream activity falling within the securities statutes’ perimeter are investment advisory services,<sup>31</sup> collective investment services, including those provided by mutual funds,<sup>32</sup> and broker-dealer services.<sup>33</sup> Notably, as this description reveals, a single legal person, such as a mutual fund, may be subject both to upstream regulation (in its capacity as an issuer) and to downstream regulation (in its capacity as a source of financial services).

This Part describes in greater detail each of the two strands of regulation contained in the U.S. securities laws. In particular, it describes the two groups of laws and rules that constitute, respectively, upstream regulation and downstream regulation. Focusing on the former, Part I.A provides a brief description of pertinent regulatory requirements under the Securities Act<sup>34</sup> and, secondarily, under the Exchange Act.<sup>35</sup> Part I.B turns to the downstream sphere, delving into the roles of investment advisers, mutual funds, and broker-dealers and describing, in general terms, the regulation governing each.

#### A. *Upstream Regulation*

The regulation of issuers under the securities laws occurs primarily through two statutes, which were Congress’s initial securities regulatory efforts in the Great Depression’s aftermath.<sup>36</sup> These statutes are the Securities Act and the Exchange Act.<sup>37</sup> The former regulates issuances – that is, the process that issuers follow in offering and selling securities in the relevant market, whether it be public or private in nature.<sup>38</sup> The latter, by contrast, primarily regulates transactions in the so-called secondary, or resale, markets – markets for

---

<sup>31</sup> Investment advisers are primarily regulated by the Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21, and the associated SEC rules, 17 C.F.R. §§ 275.0-2 to 275.222-2 (2013).

<sup>32</sup> Mutual funds are primarily regulated by the Investment Company Act, 15 U.S.C. §§ 80a-1 to 80a-64, and the associated SEC rules, 17 C.F.R. §§ 270.0-1 to 270.60a-1.

<sup>33</sup> Broker-dealers are primarily regulated by the Exchange Act, 15 U.S.C. §§ 78o-1 to 78o-3, and the rules adopted by the SEC under that statute, 17 C.F.R. pt. 240.

<sup>34</sup> 15 U.S.C. §§ 77a-77aa.

<sup>35</sup> *Id.* §§ 78a-78kk.

<sup>36</sup> See Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678, 719-20 (2013) (“The Great Depression gave birth to the [Securities Act], the [Exchange Act], and the formation of the SEC.”).

<sup>37</sup> *Id.*

<sup>38</sup> However, the brunt of the regulation under the Securities Act pertains to issuances in the public market. See Cory Alpert, *Financial Services in the United States and United Kingdom*, 5 B.Y.U. INT’L L. & MGMT. REV. 75, 76 (2008) (“The Securities Act regulates the primary market – direct sales from issuers – and requires issuers to register every offer or sale of a security . . . , except for certain exempted transactions.”).

securities that have already been placed in circulation, as it were. Among other things, the Exchange Act mandates that public issuers provide ongoing disclosures about their activities and regulates secondary market transactions effected by persons deemed to have control over public issuers.<sup>39</sup> Although the resale markets do not directly involve securities issuances, the regulation of them is part of upstream regulation because that regulation, like the regulation of issuers, pertains to the placement and circulation of securities in the markets – and, like the regulation of issuers, is generic, largely silent as to whether, which, or how financial services providers are involved in the activities it governs.

### 1. The Securities Act

If upstream regulation may be said to have an essential core, it is Section 5 of the Securities Act.<sup>40</sup> Under that section, it is unlawful for anyone to use any means of interstate commerce to sell a security “unless a registration statement is in effect” as to that security.<sup>41</sup> Though simple in its articulation, the provision is harshly encompassing. By its terms, it prohibits anyone from offering any security, whether as an issuer or in the secondary market, unless an extensive disclosure document – the registration statement – concerning all aspects of the security’s issuer has been prepared and filed with the Securities and Exchange Commission (“SEC”).<sup>42</sup> Before a *sale* can occur, moreover, the SEC must have approved the document.<sup>43</sup>

As this description implies, these strictures are transaction-based, rather than security-based. As a result, they apply to any resale of a previously issued security, even if a registration statement had been in effect as to that previous transaction.<sup>44</sup> Accordingly, by its terms, Section 5 prohibits one from reselling

---

<sup>39</sup> See Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation*, 10 U. PA. J. BUS. & EMP. L. 833, 845 (2008) (“While the Securities Act . . . primarily concerned initial public offerings, the Exchange Act . . . focused on the regulation of the secondary securities market.”); Anthony Ragozino, *Domesticating the United States’ Securities Laws: The Ninth Circuit Joins the Majority in Enforcing Forum Selection and Choice of Law Clauses Displacing U.S. Law in Richards v. Lloyds of London*, 10 PACE INT’L L. REV. 31, 32 n.4 (1998) (“The Securities Exchange Act regulates the secondary market, or the market after an issuer’s securities are first sold to the public.”).

<sup>40</sup> 15 U.S.C. § 77e.

<sup>41</sup> *Id.* In addition, under Section 5, it is also unlawful to use any means of interstate commerce to offer to sell a security unless a registration statement as to that security has been filed with the SEC. *Id.*

<sup>42</sup> See ABA Subcommittee on Annual Review, *Significant 1990 Legislative and Regulatory Developments*, 46 BUS. LAW. 973, 984 n.62 (1991) (“Section 5 by its terms applies to any offer or sale of a security involving interstate commerce or the use of the mails.”).

<sup>43</sup> *Id.*

<sup>44</sup> See Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 604 & n.121 (1997) (observing that “the Securities Act

a share of, say, Home Depot stock that the person bought last year in the open market unless the seller sees to the filing and SEC approval of a registration statement pertaining to the transaction.<sup>45</sup>

In practice, the possible onerous effects of Section 5 are substantially muted by a number of crucial exemptions. Among the most important are the exemptions for transactions “by any person other than an issuer, underwriter, or dealer”<sup>46</sup> and transactions effected by brokers in unsolicited transactions.<sup>47</sup> Those exemptions, taken together, permit the sale in the public securities markets of that share of Home Depot stock, protecting both the seller and the broker-dealer through which the sale is effected, at least insofar as the broker did not “solicit” the transaction – a condition that, in most circumstances, is readily met.<sup>48</sup>

Another exemption – one that is arguably the most important for issuers – is that pertaining to transactions “not involving any public offering.”<sup>49</sup> Pursuant to this exemption, as one might infer, if an issuer offers and sells its securities in a manner not constituting a public offering, then the issuer need not comply with Section 5’s requirements.<sup>50</sup> But what is a non-public offering? Congress did not provide much, if any, guidance on that point, leaving the task to the courts<sup>51</sup> and, ultimately, to the SEC, which adopted a “safe harbor”<sup>52</sup> that has become the mainstay of private securities issuances.<sup>53</sup> And a critical category

---

regulates individual securities market transactions” and that Section 5 is the “linchpin for this transaction-based focus”).

<sup>45</sup> See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 444 (3d ed. 2012) (“Because § 5 applies to ‘any person,’ even individual investors selling securities in the secondary market (and their brokers) would have an obligation to send a statutory prospectus to purchasing investors.”).

<sup>46</sup> 15 U.S.C. § 77d(a)(1).

<sup>47</sup> *Id.* § 77d(a)(4).

<sup>48</sup> Cf. HAZEN, *supra* note 3, at 209 (“One of the key provisions for dealing with many day-to-day securities transactions is found in section 4(4)’s exemption for unsolicited brokers’ transactions.”)

<sup>49</sup> 15 U.S.C. § 77d(a)(2).

<sup>50</sup> See Olufunmilayo B. Arewa, *Securities Regulation of Private Offerings in the Cyberspace Era: Legal Translation, Advertising and Business Context*, 37 U. TOL. L. REV. 331, 352 (2006) (“The statutory basis for the private placement exemption is found in Section 4(a)(2) of the Securities Act, which exempts transactions not involving a public offering from the requirements of Section 5.”).

<sup>51</sup> See, e.g., SEC v. Ralston Purina, 346 U.S. 119, 122-27 (1953) (interpreting what is now Section 4(a)(2) of the Securities Act); Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 902-04 (5th Cir. 1977) (emphasizing the importance of offerees’ access to information in determining whether an offering falls within Section 4’s private offering exemption).

<sup>52</sup> This safe harbor is Rule 506 of Regulation D under the Securities Act, 17 C.F.R. § 230.506 (2013).

<sup>53</sup> See Daniel H. Aronson, *SEC Lifts Ban on General Solicitation in Private Placements to Accredited Investors*, 2013-SEP BUS. L. TODAY 1, 1 (2013) (“The Rule 506 private

of issuances it is, as it encompasses hedge and private equity fund offerings of securities to their investors; small companies' offerings of sizable ownership stakes to venture capital firms; and public issuers' occasional small, private securities offerings, known as PIPEs.<sup>54</sup>

## 2. The Exchange Act

Beyond being subject to the registration requirements under Section 5 of the Securities Act, public issuers also have numerous obligations under the Exchange Act. Indeed, that statute specifies which entities – which issuers, that is – are deemed “public” under the securities laws.<sup>55</sup> An issuer is a public company if it is listed on a national securities exchange (the New York Stock Exchange, for example),<sup>56</sup> has at least \$10 million in assets and in excess of either 1,500 shareholders that are not accredited investors or 2,000 shareholders altogether,<sup>57</sup> or has publicly issued securities pursuant to Section 5 of the Securities Act.<sup>58</sup> An issuer that satisfies any of these tests must file with the SEC extensive quarterly and annual reports, as well as sporadic reports upon the occurrence of certain types of events, such as a termination of the issuer's auditor or the issuer's decision to merge with another firm.<sup>59</sup>

Whether an issuer is “public” also determines whether various other Exchange Act requirements apply. As an example, a firm or other person desiring to launch a so-called tender offer for the shares of a public issuer –

---

placement safe harbor is the most widely used exemption from Securities Act registration . . .”).

<sup>54</sup> See *id.* (observing that “companies that issue and sell their securities, including start-up and emerging companies, EB-5 programs, private equity funds, venture capital funds, and hedge funds” use the Rule 506 safe harbor “in connection with their capital raising activities”). “PIPE” is an acronym for “private investment in public equity.” See *Private Investment in Public Equity – PIPE*, INVESTOPEDIA, archived at <http://perma.cc/6KHF-27UT> (last visited July 13, 2014).

<sup>55</sup> See, e.g., SEC, *Public Companies*, archived at <http://perma.cc/3SKC-TRKW> (last visited July 13, 2014) (listing circumstances under which a private company must become a public reporting company).

<sup>56</sup> 15 U.S.C. § 78l(b) (2012).

<sup>57</sup> *Id.* § 78l(g).

<sup>58</sup> *Id.* § 78o(d).

<sup>59</sup> Exchange Act Sections 13(a) and 15(d) provide that issuers subject to these “public company” obligations file with the SEC such information as the SEC may require. See 15 U.S.C. §§ 78m(a), 78o(d). As others have noted, focusing on the SEC's rules implementing the Exchange Act's reporting requirements: “A public company has multiple disclosure obligations, including the filing of an annual report on Form 10-K . . . ; the filing of quarterly reports on Form 10-Q . . . ; the filing of ‘special’ reports on Form 8-K whenever one of the events enumerated in the Form occurs . . . ; and the filing of a proxy statement for the annual shareholders' meeting (as well as for special meetings) . . . .” James A. Fanto, Lawrence M. Solan & John M. Darley, *Justifying Board Diversity*, 89 N.C. L. REV. 901, 907 n.17 (2011).

desiring, in other words, to purchase the shares held by the issuer's shareholders – must, in effecting the tender offer, comply with relevant sections of the Williams Act,<sup>60</sup> a relatively recent addition to the Exchange Act.<sup>61</sup> Among other things, the offeror must hold the offer open for a certain period of time, pay the same price for all securities that it purchases, and, perhaps most importantly, disclose to offerees information sufficient for them to reasonably evaluate whether to accept the offer.<sup>62</sup>

A related provision<sup>63</sup> requires that any public issuer, in seeking the vote of its shareholders (such as to elect directors, approve a proposed merger (or not), or amend the issuer's articles of incorporation), comply with the SEC's proxy rules, which contain elaborate disclosure requirements pertaining to the purpose of the vote and relevant facts about the matters to be voted on.<sup>64</sup> Also notable is the Exchange Act's prohibition on "short swing" profits,<sup>65</sup> which targets insider trading.<sup>66</sup> Most significantly, that provision requires that a public issuer's insiders (defined as directors, officers, and shareholders owning more than ten percent of any class of the issuer's outstanding securities) disclose to the SEC each of their transactions in the issuer's securities, and it prohibits those persons from buying and then selling the stock, or selling and then buying it, within any six-month period.<sup>67</sup>

Alongside the Exchange Act's many "public"-centered mandates are Section 10(b)<sup>68</sup> and associated SEC Rule 10b-5,<sup>69</sup> which proscribe fraudulent

---

<sup>60</sup> The relevant Exchange Act provisions are Sections 14(d) and (e), 15 U.S.C. §§ 78n(d), (e).

<sup>61</sup> See Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 636 (2010) (stating that the Williams Act was enacted in 1968).

<sup>62</sup> See, e.g., 15 U.S.C. § 78n(d) (specifying the requirements that apply in connection with a tender offer by a shareholder that owns more than five percent of any class of securities of the company as to which the tender offer is made). Similar rules apply also in the case of a self-tender offer, in which an issuer commences a tender offer for its own securities. See 15 U.S.C. §§ 78m(e), 78n(e).

<sup>63</sup> 15 U.S.C. § 78n(a).

<sup>64</sup> 17 C.F.R. §§ 240.14a-1 to 14b-2 (2013).

<sup>65</sup> 15 U.S.C. § 78p.

<sup>66</sup> See Avi Strauss, Note, *Section 16(b) Existentialism: A Journey Towards the Fulfillment of 16(b)'s True Purpose*, 18 FORDHAM J. CORP. & FIN. L. 689, 690 (2013) (observing that Congress adopted Section 16 "as a restriction on insider trading").

<sup>67</sup> 15 U.S.C. § 78p(b). This provision constitutes, therefore, a prophylactic block on certain types of insider security trades, one that does not depend on an insider's intent or other state of mind. See, e.g., Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 888 n.38 (2010) ("Section 16 is a prophylactic remedy designed to prevent certain speculative transactions by designated statutory insiders . . .").

<sup>68</sup> 15 U.S.C. § 78j(b).

<sup>69</sup> 17 C.F.R. § 240.10b-5.

and misleading statements and omissions in connection with any securities transaction – and which have a much broader application: the provisions apply to *any* securities transaction, whether involving securities of a public issuer or of a private one.<sup>70</sup> In addition, Rule 10b-5 has been judicially interpreted over the years to prohibit securities transactions based on non-public material information in breach of a fiduciary duty the trader owes either to the issuer (the classical theory of insider trading)<sup>71</sup> or otherwise to the source of the information (the misappropriation theory of insider trading).<sup>72</sup> Accordingly, disclosure – *truthful* disclosure – is the key to avoiding liability under Section 10(b) and Rule 10b-5.<sup>73</sup> And, indeed, it should be apparent that informing the markets is the project animating upstream regulation more generally.

#### B. *Downstream Regulation*

Securities-related financial services are the services provided by investment advisers, who provide advice as to securities and securities-related investments. They are the services provided by mutual funds to their shareholders. They are also the services provided by broker-dealers, whose business is to effect securities transactions, whether in an agency capacity or in a principal capacity. The firms that provide any of these services are subject to corresponding regulation under the Advisers Act (for investment advisers), the Investment Company Act (for mutual funds), and components of the Exchange Act (for broker-dealers).

##### 1. Investment Advisers

Investment adviser regulation has as its aim the protection of those who are investment advisory clients – that is, those who engage an investment adviser to assist them in the investment of their assets in the securities markets.<sup>74</sup> The

---

<sup>70</sup> See *id.*

<sup>71</sup> See *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

<sup>72</sup> See *United States v. O'Hagan*, 521 U.S. 642, 652-66 (1997) (holding that a lawyer who traded in securities using his employer's confidential information was guilty of insider trading under Rule 10b-5 even though he owed no fiduciary duties to the company in whose securities he traded).

<sup>73</sup> For example, advance disclosure to those to whom a trader owes a fiduciary duty obviates Section 10(b) liability for transacting on non-public material information in breach of a fiduciary duty. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (“[A]nyone in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading in . . . the securities concerned . . .”). Disclosure, put another way, dissolves the “fraudulent” character of acts that otherwise would run afoul of Section 10(b).

<sup>74</sup> See James C. Sargent, Comm’r, SEC, Address Before the Investment Counsel Association of America, Inc.: The SEC and the Investment Counselor 2 (May 19, 1960), archived at <http://perma.cc/AQ9Z-RWTK> (observing that the Advisers Act’s “basic purpose” is the protection of investors “against malpractices on the part of” investment advisers).

origin of investment advisers – and, therefore, investment adviser regulation – is not difficult to discern: securities investing can be complicated, and doing it well requires some degree of expertise regarding the securities markets and, more granularly, individual firms (issuers) within the securities markets.<sup>75</sup> To be sure, any investor could, in principle, acquire this expertise by reading enough books or taking enough classes and seminars. However, most investors reasonably do not wish to expend that effort, if only because they have time-consuming jobs and other preoccupations.

Accordingly, investors often choose to rely on experts who, for a fee, provide the needed expertise. That expertise may take any of a number of forms. For example, an adviser's role for an investor might be simply to make periodic recommendations to the investor, such as by suggesting that the investor buy a certain security or sell a security already in the investor's portfolio, with the investor retaining the authority to decide whether to proceed with the transaction.<sup>76</sup> Alternatively, the arrangement might provide for such "non-discretionary" advice but, in addition, grant the adviser authority to execute its recommendations after it has obtained the investor's approval.<sup>77</sup> Yet another approach is a discretionary arrangement, in which an investor grants the adviser authority to make and act on investment decisions, meaning that the adviser buys and sells securities on the investor's behalf, based on its own judgment and in its own discretion.<sup>78</sup>

For its part, the advisory client – the "investor" – may also assume a number of forms. Clients may be "high net worth" individuals, who were the stereotypical clients of yore, or they may be entities – commonly referred to as institutional investors.<sup>79</sup> The latter group is sweeping, encompassing not only such entities as foundations, endowments, and charitable trusts but also so-called collective investment entities, both public (mutual funds or exchange-

---

<sup>75</sup> See Hans Wagner, *Removing the Barriers to Successful Investing*, INVESTOPEDIA (Jan. 6, 2013), archived at <http://perma.cc/4EZ5-FQT2> (emphasizing the importance of knowledge and education for successful securities investing).

<sup>76</sup> See Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265, 1309 (2011) ("[F]or the typical nondiscretionary account, the financial services provider lacks the authority to consummate the transaction without consent . . .").

<sup>77</sup> Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L.J. 125, 150 (2012) (describing arrangements in which the investment adviser does not have discretionary authority over the client's account but has responsibility to make recommendations and effect transactions following client approval).

<sup>78</sup> See *id.* at 150 n.121 (explaining that, pursuant to the form by which an investment adviser becomes registered as such with the SEC, discretionary authority is the "authority to decide which securities to purchase and sell for the client").

<sup>79</sup> See, e.g., Ryan Barnes, *What Is a Registered Investment Adviser?*, INVESTOPEDIA (Sept. 15, 2009), archived at <http://perma.cc/J35C-CKZV> ("A registered investment advis[e]r . . . manages the assets of high net-worth individuals and institutional investors . . .").



traded funds, for example) and private (hedge funds or private equity funds, for example).<sup>80</sup> When the client is a fund, the adviser almost always has discretionary authority over the fund's portfolio investments<sup>81</sup> because a fund is simply a mechanism to enable an adviser to manage numerous (would-be) clients' assets simultaneously.<sup>82</sup> In that structure, the adviser is typically the only party in a position to make investment decisions.<sup>83</sup>

Still, investment advisers' involvement in the securities investment activities of non-expert investors is not without its own risks, as the post-Depression Congress perceived.<sup>84</sup> In particular, investment advisers are subject to conflicts of interest in connection with managing client assets.<sup>85</sup> These conflicts may arise from an adviser's desire to invest in the same securities that it recommends to clients; dissimilar fee arrangements among the adviser's clients, with some paying more than others for the same services; or the adviser's having "custody" of substantial amounts of client assets – that is, access to, and complete authority over, those assets.<sup>86</sup> Similar types of risks are the bases of broker-dealer and mutual fund regulation, discussed below.

Investment adviser regulation, located in the Advisers Act and the associated SEC rules, is designed to reduce these risks.<sup>87</sup> The Advisers Act and its rules rely primarily on requirements that advisers disclose conflicts of

---

<sup>80</sup> See Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1162 (2011) ("Institutional investors include mutual funds, hedge funds, private pension funds, public pension funds, insurance companies, and state and local governments . . .").

<sup>81</sup> Cf. Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 164 (2010) ("[Venture capital fund] managers cite their total control of the pooled funds as a reason for why their activities are qualitatively different from those of a traditional investment adviser . . .").

<sup>82</sup> See Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 319 (2013) [hereinafter *Investment Company as Instrument*] ("[I]nvestment companies are an instrument that investment advisers use to provide investment advice to those who seek it.").

<sup>83</sup> See *id.* at 306-07 (discussing investment advisers' dominant role in mutual funds' existence and operations).

<sup>84</sup> See *Lowe v. SEC*, 472 U.S. 181, 193-94 n.35 (1985) (quoting H.R. REP. NO. 76-2639, at 28 (1940)) (observing that, in formulating and enacting the Advisers Act, Congress desired to eliminate conflicts of interests that impede investment advisers' ability to act in their clients' best interests).

<sup>85</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 183 (1963) (addressing conflicts of interest in the investment adviser context).

<sup>86</sup> See *infra* notes 164-168 and accompanying text (describing in greater detail conflicts of interest in financial services contexts).

<sup>87</sup> See *Lowe*, 472 U.S. at 190 (observing that the purpose of the Advisers Act was to eliminate "abuses in the securities industry" that had contributed to the 1920s stock market crash); 1 THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH, *REGULATION OF INVESTMENT COMPANIES* §§ 2.1-2.8 (2009) (observing that the Advisers Act was intended to provide protections to investors and promote the integrity of the securities markets).

interest and obtain client authorization to engage in certain types of transactions. For example, an investment adviser that may, for its own account, buy or sell securities of the same types that it recommends to its clients must disclose that fact to the clients,<sup>88</sup> and the adviser must seek client consent before causing client accounts to purchase securities from the adviser's account.<sup>89</sup> Those are not the exclusive tools, however. The statute and rules also require, for example, that investment advisers include certain provisions in their advisory agreements with clients<sup>90</sup> and follow detailed procedures in connection with engaging a third-party marketer<sup>91</sup> or having custody of client assets.<sup>92</sup>

## 2. Mutual Funds

Mutual funds – or, at least, predecessor forms of collective investment structures – date as far back as the early 17th century and are the product of the commonplace needs of the average investor.<sup>93</sup> Although many investors do not possess substantial investment assets, much like their wealthy counterparts, they desire to invest what assets they do have in the securities markets in order to achieve capital appreciation.<sup>94</sup> As with wealthy investors, if not more so, these smaller, retail investors are challenged by a lack of investing expertise.<sup>95</sup> Accordingly, they too may wish to engage an investment adviser to handle matters. The difficulty with that solution, however, is based on efficiency. It is often not profitable for advisers to take on small client accounts, given the

---

<sup>88</sup> See 17 C.F.R. § 275.204-3 (2013) (requiring investment advisers to deliver to their clients, at least annually, disclosure containing “all information required by Part 2 of Form ADV,” the disclosure component of the form by which investment advisers become registered as such with the SEC).

<sup>89</sup> See 15 U.S.C. § 80b-6 (2012) (prohibiting self-dealing transactions in the absence of client consent); 17 C.F.R. § 275.206(3) (requiring consent for agency cross-transactions).

<sup>90</sup> See 15 U.S.C. § 80b-5(a)(2) (requiring that certain consent provisions be included in advisory agreements).

<sup>91</sup> See 17 C.F.R. § 275.206(4)-3 (listing pre-conditions to advisers' use and payment of solicitors).

<sup>92</sup> See *id.* § 275.206(4)-2 (setting forth requirements for advisers having “custody”).

<sup>93</sup> See Jerry W. Markham, *Mutual Fund Scandals – A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 71 (2006).

<sup>94</sup> See Fisch, *supra* note 10, at 1963 (“[E]ven after much of the market collapse, equity mutual funds held over \$3.7 trillion in assets, ninety-two percent of which were contributed by the household sector.”); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 295 (2007) (“[M]any – perhaps even most – investors in mutual funds are retail investors with long-term goals.”).

<sup>95</sup> See Davidoff, *supra* note 10, at 351 (observing that retail investors “do not generally have . . . professional investment skill”).

fixed administrative costs of separate client arrangements.<sup>96</sup> Therein lies the basis of mutual funds and other collective investment entities: by pooling many investors' assets in an entity that invests those assets, as a unitary actor, in a diverse array of public companies' securities, an adviser can effectively serve retail investors in an efficient, albeit one-size-fits-all, manner.<sup>97</sup>

The regulation of mutual funds and other public "investment companies" (as public funds are formally labeled) occurs under the Investment Company Act and the SEC's rules under that statute. The Advisers Act and the Investment Company Act are related, in that Congress enacted them contemporaneously, as companion statutes covering two types of financial services that frequently function in tandem.<sup>98</sup> Whereas the Investment Company Act regulates public pools of capital that cater to retail investors, the Advisers Act regulates those firms (investment advisers) that manage mutual funds' assets – that, in other words, provide advisory services to mutual funds.<sup>99</sup> However, as noted above, the Advisers Act also regulates advisers who direct their services at other kinds of clients, including wealthy individuals, hedge funds, and foundations.<sup>100</sup> In other words, each mutual fund has an investment adviser that, in turn, is regulated under the Advisers Act. But not all investment advisers manage mutual funds.

All of this may prompt the question: If investment advisers provide advisory services to mutual funds, what financial services do mutual funds provide? It may seem that any such "services" must be unlike those one might readily consider to be financial services. That is, any given mutual fund does not itself provide investment advice or make investment decisions. Rather, its investment adviser does that.<sup>101</sup> Moreover, to become a mutual fund shareholder, an investor must buy securities – shares of equity ownership in the

---

<sup>96</sup> Cf. Peter R. Lando, *Business Method Patents: Update Post State Street*, 9 TEX. INTELL. PROP. L.J. 403, 405-06 (2001) (observing, in another context, that financial firms developed methodology involving "pooling assets . . . into a common portfolio" in order to achieve "lower administrative cost[s], and operating efficiency").

<sup>97</sup> See, e.g., *Investment Trusts and Investment Companies: Hearing on S. 3580 Before the Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 700 (1940) [hereinafter *Senate Hearings*] (statement of James N. White, Scudder, Stevens & Clark, Investment Counsel) (stating that the rationale behind pooling investors into a fund structure was "to make investment counsel available to the small investor").

<sup>98</sup> See Arthur B. Laby, SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940, 91 B.U. L. REV. 1051, 1082 (2011) (observing that the Investment Company Act is the "companion title" to the Advisers Act).

<sup>99</sup> See *supra* notes 76-92 and accompanying text (generally describing investment advisory services and investment adviser regulation).

<sup>100</sup> See *supra* notes 79-80 and accompanying text (describing investment adviser-client relationships).

<sup>101</sup> See Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 503 (2008) (observing that a mutual fund's assets are managed by "an external investment adviser").

fund<sup>102</sup> – an action that seems wholly unrelated to the procuring of financial services. When an investor buys 100 shares of Google stock, after all, she most likely does not consider herself to be buying services of any sort. She has made an investment in Google and holds shares as evidence of that fact.

The answer to the question is at once subtle and obvious. Mutual funds provide collective investment services, enabling multiple persons to invest on an aggregated basis.<sup>103</sup> Put another way, by virtue of their status as investment facilitators, mutual funds simply provide a particular format for investors' activities in the securities markets.<sup>104</sup> They do not – or, at least, need not – affect the substance of those activities. Accordingly, their role in the securities markets is far afield from Google's role or that of any other operating company. Investing in a mutual fund, through its provision of collective investment services, transforms the direct investment approach into one that is indirect and intermediated. If the investor who would buy Google stock instead buys shares of a mutual fund that buys Google stock, the mutual fund effectively stands between the investor and Google.<sup>105</sup> Either way, the investor still holds a beneficial ownership<sup>106</sup> interest in Google.

The role of the Investment Company Act, then, is to minimize the costs to investors of using a particular tool (collective investment) to deploy their investment capital.<sup>107</sup> It does so by subjecting mutual funds and their boards of directors to extensive requirements and procedures. Among them are rules governing transactions between a mutual fund and other clients managed by the fund's investment adviser,<sup>108</sup> portfolio valuation methods,<sup>109</sup> portfolio

---

<sup>102</sup> See Eric J. Gouvin, *Truth in Savings and the Failure of Legislative Methodology*, 62 U. CIN. L. REV. 1281, 1316 n.140 (1994) ("Mutual fund shares are securities and, as such, may only be purchased after the purchaser has obtained a prospectus from the fund.").

<sup>103</sup> See PETER J. WALLISON & ROBERT E. LITAN, *COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS* 8 (2007) (referring to "the collective investment services that mutual funds provide").

<sup>104</sup> See *Investment Company as Instrument*, *supra* note 82, at 307 (observing that the entity that is a mutual fund merely facilitates investment advisory services that could, instead, be provided directly); Robert H. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058, 1063 (1967) (observing that "[a] mutual fund is basically a vehicle through which numerous individuals can purchase diversification and investment advice" that is "intended to serve [the participants' shared] investment goals and needs").

<sup>105</sup> See Fisch, *supra* note 10, at 1963 (describing a mutual fund as a "form of intermediated investment").

<sup>106</sup> "Beneficial ownership" refers to a person's having the "benefits" of ownership of an asset (such as profits and losses from the asset), even though the person may not hold legal title to the asset. See BLACK'S LAW DICTIONARY 1214 (9th ed. 2009).

<sup>107</sup> See 15 U.S.C. § 80a-1(b) (2012) (describing the Investment Company Act's investor protection objectives).

<sup>108</sup> See 17 C.F.R. § 270.17a-7 (2013) (providing an exemption for so-called agency cross-transactions between a mutual fund and an affiliated person).

holdings and investment strategies,<sup>110</sup> the fund's use of leverage in its investment activities,<sup>111</sup> and its payment of marketing ("distribution") expenses.<sup>112</sup>

### 3. Broker-Dealers

Broker-dealer regulation aims to protect those who use broker-dealers – the salespersons of the securities markets – to carry out their securities-related transactions. In other words, it aims to protect almost everyone who participates in the securities markets, for broker-dealers play roles in virtually all aspects of those markets. A broker-dealer may effect transactions as an agent – that is, as a broker – facilitating securities purchases and sales,<sup>113</sup> or it may effect transactions as a principal – that is, as a dealer – standing at the ready to buy or sell particular issuers' securities and bearing the investment risk associated with those transactions.<sup>114</sup> While individual investors might use E-Trade, an online broker-dealer, or Charles Schwab, a retail broker-dealer, to carry out their trades,<sup>115</sup> the largest hedge funds might use Goldman Sachs or J.P. Morgan for the same purposes.<sup>116</sup>

In addition, broker-dealers may lend funds to their customers, thereby enhancing customers' investment activities, and may lend securities, thereby facilitating customers' short sales.<sup>117</sup> They may use the collateral they receive in connection with that lending (usually the assets in the borrower-customers' brokerage accounts) as collateral for their own borrowing, thereby enhancing their own, proprietary investment activities – a grand and notorious source of

---

<sup>109</sup> See, e.g., *id.* § 270.2a-1.

<sup>110</sup> See, e.g., *id.* § 270.2a-46.

<sup>111</sup> See 15 U.S.C. § 80a-12.

<sup>112</sup> See 17 C.F.R. § 270.12b-1.

<sup>113</sup> See Nan S. Ellis, Lisa M. Fairchild & Harold D. Fletcher, *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 111 n.47 (2010) ("When one acts as a broker, she is acting in an agency capacity.").

<sup>114</sup> See *id.* (noting that "[a] 'dealer' is one who buys [a security for] or sells a security from his own account" and that "[w]hen one acts as a dealer, he is acting in the capacity of a principal").

<sup>115</sup> See, e.g., Michael J. Borden, *PSLRA, SLUSA, and Variable Annuities, Overlooked Side Effects of a Potent Legislative Medicine*, 55 MERCER L. REV. 681, 723 (2004).

<sup>116</sup> Cf. Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 122 (2012).

<sup>117</sup> See Henry T. C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1688 (2012) (observing that a short seller will "borrow the security [to be sold short], typically from a broker-dealer or an institutional investor"); Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 709-10 (2012) ("A broker-dealer engages in numerous activities, such as . . . lending money to investors to invest on margin . . .").

brokerage firm profits.<sup>118</sup> Broker-dealers also serve as underwriters in initial public offerings.<sup>119</sup> In that role, they distribute newly issued securities to the public, usually buying them from the issuer at a discount and then selling them to investors, reaping as their profit the amount of the discount.<sup>120</sup> More broadly, broker-dealers are “marketers,” bringing together securities issuers – from large public firms, to private equity funds, to fledgling technology companies – and would-be securities buyers.<sup>121</sup>

It is not difficult to perceive the need for a strong broker-dealer industry.<sup>122</sup> As discussed above, investors have difficulty determining what securities to buy and sell because they lack sufficient time or expertise,<sup>123</sup> and they often do not have sufficient resources to procure individualized professional investment advice.<sup>124</sup> If that is the case, then the notion that investors might readily participate in initial public offerings (“IPOs”) by seeking out and negotiating with issuers, or that they might efficiently engage in secondary market transactions by locating their own counterparties, seems implausible. Broker-dealers have the knowledge of the securities markets that investors, whether large or small, sophisticated or not, do not have. They also have the connections, whether personal, institutional, or via electronic systems and databases, with securities markets participants – securities exchanges, institutional investors, wealthy individuals, and not-so-wealthy individuals – that are often prerequisites to successful securities issuances.<sup>125</sup>

---

<sup>118</sup> See Steven L. Schwarcz, *Distorting Legal Principles*, 35 J. CORP. L. 697, 703 n.30 (2010) (noting that a broker-dealer may “directly pledge[] the customers’ securities as collateral even though it . . . merely has a security interest in[] those securities”).

<sup>119</sup> See Lucas C. Townsend, Comment, *Can Wall Street’s “Global Resolution” Prevent Spinning? A Critical Evaluation of Current Alternatives*, 34 SETON HALL L. REV. 1121, 1125 (2004) (“In a typical IPO, the lead underwriter is a large broker-dealer . . . whose guiding function is to make an orderly and bona fide distribution of the issuer’s IPO shares to investors.”).

<sup>120</sup> See Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883, 885 (2000) (“A typical IPO is offered in a fixed price, firm commitment offering. In such an offering, a group of underwriters, called the underwriting syndicate, purchases the securities from the issuer . . . and resells them to the public.”).

<sup>121</sup> See John Polanin, Jr., *The “Finder’s” Exception From Federal Broker-Dealer Registration*, 40 CATH. U. L. REV. 787, 822 (1991) (observing that the activity of “arrang[ing] trades between buyers and sellers of securities” is “perhaps at the core of broker-dealer activity”).

<sup>122</sup> See, e.g., Paul D. Cohen, *Securities Trading Via the Internet*, 4 STAN. J.L. BUS. & FIN. 1, 14 (1998) (“Broker-dealers provide important services that permit securities markets to perform in an efficient and effective manner.”).

<sup>123</sup> See *supra* notes 75-78 and accompanying text (discussing the role of investment advisers).

<sup>124</sup> See *supra* notes 94-97 and accompanying text (explaining the basis of mutual funds).

<sup>125</sup> Cf. David A. Rines, *Identifying and Minimizing Risk for Private Equity Funds and Fund Managers*, in *INSIDE THE MINDS: PRIVATE EQUITY FUND EXPOSURE AND PROTECTION*

Yet, even putting aside lessons drawn from popular culture – movies such as *Wall Street* and books such as *Den of Thieves* – it is difficult to miss that the U.S. broker-dealer industry has been cast in a negative light. Analyses of the causes of many of the economy’s financial maladies, including the financial crisis, place considerable blame on the industry’s business practices.<sup>126</sup> Accordingly, it is also not difficult to perceive the need for regulation of broker-dealers. That regulation is another of the Exchange Act’s tasks – with the protection of brokerage customers being its primary objective.<sup>127</sup> Today, broker-dealer regulation involves oversight not only by the SEC but also by the Financial Industry Regulatory Authority (“FINRA”), the securities industry’s self-regulatory organization.<sup>128</sup> It also consists of extensive rules governing how broker-dealers conduct their businesses, including ones governing a firm’s net capital, the content of its advertisements, and the commissions it charges customers.<sup>129</sup>

## II. REGULATORY FOUNDATIONS

That there are two modes of securities regulation does not, without more, address the question of how regulation on one side of the line differs from that on the other. This Part takes on that task. Scrutinizing the functions of securities regulation, it identifies foundational principles for regulation both upstream and downstream. We might think of these principles as the bedrock that undergirds specific laws and rules. The discussion begins, in Part II.A, with upstream regulation, describing how it is based on entity-centrism and doctrinal dependence. Turning to downstream regulation, Part II.B suggests structural flexibility and doctrinal independence as defining concepts. Part II.C draws on these principles and the regulatory tool of disclosure to underscore that upstream regulation and downstream regulation are fundamentally different.

---

59 (Aspatore ed., 2009) (“Because the number of offerees known by issuers is often limited, issuers often need to retain third-party brokers . . . who have a much broader list of pre-existing substantive relationships, whom the broker may contact on the issuer’s behalf as potential investors in the fund.”).

<sup>126</sup> Cf. Laby, *supra* note 117, at 711 (observing that, after the financial crisis, “the Obama Administration embraced the regulation of broker-dealers” as part of its “financial regulatory reform agenda”).

<sup>127</sup> See *supra* note 33 (specifying the parts of the Exchange Act that constitute broker-dealer regulation).

<sup>128</sup> See Kristina A. Fausti, *A Fiduciary Duty for All?*, 12 DUQ. BUS. L.J. 183, 201 (2010) (“Broker-dealer regulation . . . is largely driven by FINRA and other SRO rules.”).

<sup>129</sup> See Eugene F. Maloney, *Banks and the SEC: A Regulatory Mismatch?*, 25 ANN. REV. BANKING & FIN. L. 443, 463-64 (2006) (quoting Cynthia A. Glassman, Comm’r, Sec. & Exch. Comm’n, The SEC’s Role as Functional Regulator of Bank Securities Activities, Remarks (June 18, 2004), *archived at* <http://perma.cc/HL9L-N67H>) (summarizing FINRA’s regulation of broker-dealers).

Importantly, the principles this Part sets forth are not only descriptive but also normative. That is, one might reasonably posit not only that, in the abstract, upstream regulation is based on upstream principles but also that, in the actual formulation, it *should* reflect upstream principles – and that the same holds for downstream regulation. This is not to suggest, however, that existing regulation dutifully conforms. To the contrary, as Part III demonstrates, many laws and rules are problematic: those downstream tend to be oriented around upstream principles, and those upstream may apply not only to upstream subjects (for example, issuers generally) but also to downstream subjects (for example, issuers that are financial services providers).

A. *Entity-Centrism; Doctrinal Dependence*

Gaining a deeper understanding of upstream regulation and of its foundational principles necessitates placing it and its objectives in context. To be sure, one might readily say that upstream regulation exists to protect securities investors. It should ensure that an investor participating in LinkedIn's IPO, for example, ends up holding a security with an intrinsic value of approximately the amount that the investor paid for it. But let us back up. What happens when someone "invests" in any particular firm? Most fundamentally, through that investment, the person assumes one of the original roles of the entrepreneur – namely, the role of providing financial resources to be deployed in furtherance of an entrepreneurial endeavor, whether that be producing furnaces or facilitating online social interaction.<sup>130</sup>

The investor, therefore, does not perform *all* of the entrepreneur's functions, which also include operating – otherwise called "controlling" or "managing" – the business.<sup>131</sup> This division of roles is simply a product of modern life. In the simplest economic structures of capitalist society, the person who conceives of, creates, and oversees the business – again, the entrepreneur – is also the person who funds its operations.<sup>132</sup> Thus emerges the sole proprietorship (in substance if not always in form).<sup>133</sup> Entrepreneurs, however, are often unable to continue

---

<sup>130</sup> See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-20 (1932) (explaining that the functions of ownership and control of a corporation once were united in the same group and the process by which those functions came to be separated into different groups).

<sup>131</sup> See *id.* at 119 (listing the "three functions" of an enterprise as "having interests in [the] enterprise, . . . having power over it, and . . . acting with respect to it").

<sup>132</sup> See *id.* ("Before the industrial revolution the owner-worker performed all three [functions] . . .").

<sup>133</sup> An entrepreneur might, for example, choose to organize her business as a corporation (in which the entrepreneur is both sole shareholder and sole director) or as a single-member LLC. See John O. Michaelson, *Limited Liability Companies and Check the Box – How They Affect State Tax Planning*, 5 ST. & LOC. TAX LAW. 43, 44 (2000) ("[T]he states have allowed the formation and operation of LLCs where there is only one owner."). The sole proprietorship, however, remains the most prevalent type of business entity. See Frederick V. Perry, *The Corporate Governance of Islamic Banks: A Better Way of Doing Business?*,



financing their businesses as the businesses grow and demand greater amounts of start-up resources, from employees, to capital equipment, to overhead, to supplies.<sup>134</sup> This creates the need for external sources of financing, whether those sources take the form of bank loans or the firm's issuance of debt securities (such as bonds) or equity securities.<sup>135</sup> To the extent an entrepreneur opts to issue units of equity, the result is that those who control the firm are no longer the same as those who own it.<sup>136</sup>

Phrased differently, ownership ultimately comes to be separated from control.<sup>137</sup> Managers no longer earn their keep by manipulating their own property but, rather, in Adolf Berle and Gardiner Means' famous formulation, by manipulating the property of others.<sup>138</sup> The adverse incentives that arise from that circumstance produced Berle's core concern, which was that modern business organizations, though nominally operating for the benefit of "owners" (shareholders), really benefitted managers – if, that is, they benefitted anyone at all.<sup>139</sup> Managerial incentives are also the core concern animating the study of corporate governance, which evaluates the ways that legal rules may reduce the costs to owners of managers' pursuit of their own objectives, rather than the firm's.<sup>140</sup> More generally, those incentives are the core concern of state corporate law and the fiduciary duties that it imposes, by default, on managers in carrying out their duties on the firm's behalf.<sup>141</sup> Lastly, and less obviously, they are the core concern of upstream regulation.

---

19 MICH. ST. J. INT'L L. 251, 255 (2011) (observing that a sole proprietorship is "the most prevalent type of business entity").

<sup>134</sup> See Heidi Brown, *How to Get Startup Capital for Your Business*, FORBES (May 19, 2010, 12:15 PM), archived at <http://perma.cc/G7S4-2477> (explaining the importance of start-up capital for new businesses).

<sup>135</sup> See Dileep Rao, *The 12 Best Sources of Business Financing*, FORBES (July 6, 2010, 4:30 PM), archived at <http://perma.cc/7MJY-YMB8> (describing various sources of financing for small businesses).

<sup>136</sup> See BERLE & MEANS, *supra* note 130, at 8 (describing "the dissolution of the old atom of ownership into its component parts, control and beneficial ownership" that occurs with a firm's public sale of securities).

<sup>137</sup> See *id.* at 5-9.

<sup>138</sup> See *id.* at 285 ("[A firm's] management is more or less permanent, directing the physical property which remains intact while the participation privileges of ownership are split into innumerable parts – 'shares of stock' – which glide from hand to hand, irresponsible and impersonal.").

<sup>139</sup> See, e.g., *id.* at 335 (observing that, in the modern corporation, the controlling group "may use its power for its individual advantage" and, therefore, to the disadvantage of shareholders).

<sup>140</sup> See Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1872 (2001) ("[T]he main focus of corporate governance is to establish an incentive structure bearing on corporate managers that assures that managers act in the interest of shareholders.").

<sup>141</sup> See Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face:*

As Part I explains, the upstream component of federal securities regulation centers on the relationships among a business organization's – an *entity's* – core constituencies: those who own it (shareholders, limited partners, LLC members) on the one hand, and those who manage it (officers and directors, general partners, LLC managers) on the other. So does corporate law. As suggested, corporate law, which is grounded in state corporate codes, pursues its goals largely through imposing fiduciary duties on officers and directors and, by and large, designating shareholders as the beneficiaries of those duties.<sup>142</sup> Accordingly, officers and directors must exercise due care in their decisionmaking, or else they risk incurring liability for breaching their duty of care.<sup>143</sup> They must also be loyal to the corporation and its shareholders, overseeing the corporation and acting on its behalf in good faith and in furtherance of the corporation's (and, indirectly, its shareholders') best interests.<sup>144</sup>

Despite upstream regulation's focus on the relationships between managers and owners, it has a different emphasis and uses different tools as compared with corporate law. In particular, it is based on the notion that fiduciary duties go only so far and that owners are not able to completely avoid the possibility of abuse by managers unless managers are forced to abide by specified protective measures.<sup>145</sup> Those measures primarily have fallen under the rubric of disclosure or "transparency,"<sup>146</sup> although recently enacted statutes such as Sarbanes-Oxley and Dodd-Frank have altered that to some degree.<sup>147</sup>

---

*Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Think and Act Long Term?*, 66 BUS. LAW. 1, 10 (2010) ("The existing model of corporate law focuses solely on the duties the managers owe to stockholders.").

<sup>142</sup> See Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773, 1789 (2013) (observing that a corporation's directors "owe fiduciary duties to the corporation and to shareholders").

<sup>143</sup> See John L. Reed, Bruce N. Telles & Matthew M. Rosini, *Directors' and Officers' Liability for Y2K: A Corporate Governance Litigation Bear and a Securities Litigation Bull?*, 24 DEL. J. CORP. L. 835, 841-42 (1999) ("The fiduciary duty of care requires that a board of directors . . . exercise due care in overseeing the actions of those to whom it does delegate duties.").

<sup>144</sup> See *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.").

<sup>145</sup> See Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 472 (2006) (observing that "[e]arlier in the twentieth century, common law fiduciary duties were seen as weak enough to demand new federal [securities] regulation" and that fiduciary duties are "not always as strong as they can be cracked up to be").

<sup>146</sup> See Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 317 (2007) ("The guiding purpose of the many and complex disclosure provisions of the federal securities laws is to promote 'transparency' in the financial markets.").

<sup>147</sup> Sarbanes-Oxley and, to a lesser extent, Dodd-Frank, present examples of the so-called

Moreover, not only does this brand of regulation further shareholder interests, but it also serves the (greater?) good of promoting market integrity.<sup>148</sup> By leveling the balance of power between ownership and control, upstream regulation is able to adjust power dynamics among everyone participating in the securities markets.

From these considerations, one can discern two hallmark principles that ground upstream regulation and, therefore, that help define and elucidate it: first, upstream regulation is based on the entity – the corporation, most significantly, but also the LLC, the partnership, the business trust, and other forms of business organization. One might say that it is entity-centric.<sup>149</sup> This can be seen from a couple of different perspectives, the first of which returns us to the discussion in Part I. Securities regulation on the upstream side is all about the issuance of securities and, in particular, disclosure by those who issue them to those to whom they are issued (and, secondarily, to those who buy or sell them in the secondary markets).<sup>150</sup> “Those who issue” securities are, of course, issuers. Whatever else an issuer might be or do, in the particular capitalist economy that has blossomed in the past 300 years, it is an entity.<sup>151</sup> After all, when an investor buys a share of stock, the investor owns a piece of only one particular entity.<sup>152</sup>

---

federalization of corporate law, in the sense that they further securities regulatory objectives by specifying how boards of directors and their audit committees should operate. *See, e.g.,* THERESE MAYNARD, *MERGERS AND ACQUISITIONS: CASES, MATERIALS, AND PROBLEMS* 39 (3d ed. 2013) (stating that Dodd-Frank contains independence requirements for boards’ compensation committees and mandates shareholder advisory votes on executive pay); Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1021-22 (2013) (explaining that Sarbanes-Oxley “explicitly regulates the responsibilities of corporate boards and officers” and thereby “removes the privilege of self-regulation from private actors”).

<sup>148</sup> *See supra* notes 1-4 and accompanying text (describing the purpose of securities regulation).

<sup>149</sup> For a comprehensive discussion of entity-centrism, see generally Anita K. Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039 (2013) (describing how entity-centrism counters the goals of financial services regulation, which includes certain aspects of securities regulation) [hereinafter *Escaping Entity-Centrism*].

<sup>150</sup> *See supra* Part I.A (generally describing upstream regulation).

<sup>151</sup> *See Issuer*, INVESTOPEDIA, archived at <http://perma.cc/9K6A-RWN8> (last visited July 13, 2014) (defining “issuer” as “[a] legal entity that develops, registers and sells securities for the purpose of financing its operations”).

<sup>152</sup> *See Share*, INVESTOPEDIA, archived at <http://perma.cc/4H7L-595S> (last visited July 13, 2014) (defining “share” as “[a] unit of ownership interest in a corporation”). Of course, many firms are actually enterprises that consist of many entities – or, at least, more than one. Many firms that operate internationally, for example, organize at least one entity in each relevant country. Even those firms that are based entirely in one country, however, may have ample reasons for divvying up their operations, assets, and liabilities into different organizational units.

A second perspective revealing the entity-centrism of upstream regulation stems from the role of upstream regulation in balancing the relative power between managers and owners, discussed above. Because of that role, upstream regulation, in addition to being centered on the issuing entity, is also centered on the relationships among the entity's core constituencies.<sup>153</sup> After all, the entity is the "thing" that is owned and managed. When we speak of a firm's owners, we are referring to those who hold shares of a specific entity, the management of which is placed with the entity's officers and directors.<sup>154</sup> To be sure, any particular owner may also happen to hold an ownership interest in other entities. But each of the entities is its own locus of accountability concerns, with its own board of directors or other governance mechanism, its own officers, and its own group of shareholders. That is, under corporate governance principles and, therefore, for upstream regulation as well, an owner's treatment at the hands of Entity A's managers is analytically separate from the owner's experience vis-à-vis Entity B's managers.<sup>155</sup>

The entity-centrism of upstream regulation highlights the second of the latter's foundational principles. Upstream regulation exists in order to add to or supplement other bodies of legal doctrine. The laws and rules that structure the relationships between owners and managers traditionally are the laws and rules of corporate law.<sup>156</sup> Upstream laws and rules buttress corporate law's structural role and further corporate law's objectives.<sup>157</sup> Zooming out from discrete entities, we might even say that securities regulation, by virtue of its role in relation to corporate law, helps structure the relationships within and among participants in the securities markets. Upstream regulation, therefore, is in some sense dependent on corporate law and the corporate governance norms that it spawns.

This doctrinal dependence is evidenced by considering the questions that, over the ages, have been fundamental in animating the evolution of corporate law and debates about it. These are the questions of managerial accountability

---

<sup>153</sup> See, e.g., CLARK, *supra* note 7, at 1 (observing that securities regulation has been viewed as governing the relationship between shareholders and managers).

<sup>154</sup> See Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1355 (2007) ("As a matter of law, shareholders are the owners of the corporation . . .").

<sup>155</sup> Cf. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987) (observing that "state regulation of corporate governance is regulation of entities").

<sup>156</sup> See Dave Ebersole, *Reforming Ohio Corporate Law and Securities Regulation to Facilitate Investment in Ohio*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 451, 524 (2012) ("A major purpose for corporate law is to strike a balance between management and shareholder power to decide corporate matters.").

<sup>157</sup> See CLARK, *supra* note 7, at 30 (explaining that securities regulation is aimed at the interaction between a corporation's management and its shareholders). On the other hand, as a result of the federalization of corporate law, federal law now also plays a role in structuring these relationships. See *supra* note 147 and accompanying text (describing the federalization phenomenon).

– to what extent should managers be accountable to shareholders (versus having decisionmaking discretion)? – and of the nature of corporate rules – to what extent should fiduciary duties and other rules governing managers’ relationships to shareholders be mandatory (versus negotiable)?<sup>158</sup> Although corporate law determines how, in any jurisdiction, those questions are answered, upstream regulation informs the answers, setting the floors and the ceilings within which corporate law has room to maneuver. Without corporate law, moreover, upstream regulation loses its purpose. Of course, because of its relationship to corporate law, upstream regulation’s purview is finite: its content ebbs and flows based on the extent to which the laws and rules that it supplements are effective in achieving their objectives.<sup>159</sup> Presumably, if fiduciary duties operated perfectly, there would be no need for upstream regulation.

B. *Structural Flexibility; Doctrinal Independence*

Downstream regulation is considerably different. It is, as noted in Part I, the regulation of certain “players” in the securities markets who, operating in various capacities, assist with investments and other transactions in securities.<sup>160</sup> They provide financial advice and recommend securities investments; aggregate disparate investors’ assets, investing them on a collective basis in (primarily) public companies; and act as agents for, or risk-bearing counterparties to, buyers and sellers of securities in both public and private markets. Taken together, they are, depending on the particular function and the preferred characterization, facilitators, mechanisms, instruments, and intermediaries. They are bridges between issuers and investors, supplying each with the capital or financial assets necessary for “issuer” and “investors” to have any meaning.

The function of downstream regulation is to place boundaries around and requirements on these players in carrying out their diverse “bridging” roles. As with upstream regulation, however, in evaluating the concepts animating downstream regulation, it is useful to place it and its evolution in context. One might imagine that, in the earliest days of securities investing, investors were, for the most part, entirely on their own, making their own securities investment decisions and effecting their own transactions without the assistance of others at any step in the process.<sup>161</sup> In a sense, the early investor was the downstream

---

<sup>158</sup> See Franklin A. Gevurtz, *The Globalization of Corporate Law: The End of History or a Never-Ending Story?*, 85 WASH. L. REV. 475, 511-20 (2011) (identifying these questions as the two “tough policy issues” of corporate law).

<sup>159</sup> Cf. Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451, 477 (2006) (“In corporate law, the unintended consequence of relaxing fiduciary duties has been to impose increasingly burdensome layers of mandatory regulation to stem malfeasance – notably securities regulation . . .”).

<sup>160</sup> See *supra* Part I.B (generally describing downstream regulation).

<sup>161</sup> This is suggested, for example, by the SEC’s statement in a 1939 report to Congress

equivalent of the early entrepreneur. Much as the entrepreneur embodied both “manager” and “owner” in a single person, in an investor’s securities transactions, the investor was not only the principal (the person whose assets were invested) but also the agent that facilitated the transactions.

The investor’s evolution from that point is reminiscent of the evolution of managers and owners in the upstream story. With the growth in the securities markets and corresponding increase in investor numbers, combined with the wealth accumulation that accompanies macroeconomic growth and the search for efficiency that accompanies an advancing society with ever less time available for investment activities, the emergence of financial services providers was inevitable.<sup>162</sup> The introduction of a third party to the issuer-investor relationship, however, brings with it problems similar to the accountability concerns that arise from the separation of ownership and control. How can it be ensured that those responsible for assisting with an investor’s investments will act in the investor’s best interests as opposed to their own?<sup>163</sup>

Indeed, the adverse incentives of financial services providers became apparent in the early years of securities investing. For example, an investment adviser with discretionary investment authority<sup>164</sup> could cause a client account to buy poorly performing securities from the adviser – from its personal holdings – at excessively high prices or to sell valuable securities to the adviser at bargain basement prices.<sup>165</sup> The adviser, having the expertise and control, was subject to few limitations and little oversight in carrying out its

---

that investment advisory services arose due to the “demands of the investing public, which required supervision of its security investments after its experience during the depression years.” SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 76-477, at 5 (2d Sess. 1939).

<sup>162</sup> See, e.g., *id.* at 3-4 (observing that investment counselors emerged as an “important independent occupation” after World War I as the public began to take a greater interest in investing in securities (quoting statement of James N. White, Scudder, Stevens & Clark, Investment Counsel)).

<sup>163</sup> See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189 (1963) (observing that regulation of investment advisers was a product of the SEC’s concern that “whenever advice to a client might result in financial benefit to the adviser – other than the fee for his advice – that advice . . . might in some way be tinged with that pecuniary interest”) (internal citation omitted).

<sup>164</sup> See *supra* notes 76-78 and accompanying text (describing discretionary authority versus non-discretionary authority).

<sup>165</sup> See *Galfand v. Chestnut Corp.*, 545 F.2d 807, 808 (2d Cir. 1976) (observing that “[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest”); John R. McConnell, Note, *Regulation of Investment Companies*, 88 U. PA. L. REV. 584, 588-89 (1940) (discussing “self-dealing” as an issue in the mutual fund industry).

responsibilities.<sup>166</sup> A broker-dealer faced few restraints when recommending securities transactions that did not necessarily benefit the customer but, rather, that benefited the broker because more transactions meant more commissions to the broker.<sup>167</sup> Downstream regulation aims to reduce these costs – losses to the principals (investors) that arise from agents’ (financial services providers) acting in their own interests – and increase agents’ accountability.<sup>168</sup>

As this discussion suggests, although downstream regulation *is* concerned with power imbalances, it is not concerned with the particular power imbalance that exists between an entity’s owners and its managers. As a result, downstream regulation, like regulation in other arenas, need not privilege the entity over other forms of business structures, such as those involving multiple entities, and need not otherwise be entity-centric. Its subject matter gives it scope to look beyond the entity and the concerns and principles that animate corporate governance norms. In other words, it can be structurally flexible.

Investment adviser regulation exemplifies this point. An investment adviser, as previously noted,<sup>169</sup> provides securities-related investment or financial advice to those who engage it – those who, in other words, enter into an advisory agreement with the adviser specifying the sorts of services the adviser is to provide and the remuneration the adviser is to receive in return.<sup>170</sup> In theory, an investment adviser could be an entity, an individual, or a group of entities or individuals, as could, for that matter, an advisory client.<sup>171</sup> Or – again, in theory – a single client relationship could involve a combination of any of these possibilities. Given what investment adviser regulation exists to

---

<sup>166</sup> See *Burks v. Lasker*, 441 U.S. 471, 480-82 (1979) (explaining that, in enacting the Investment Company Act, “Congress was concerned about the potential for abuse inherent in the structure of investment companies,” in which a fund’s investment adviser dominates the fund’s operations).

<sup>167</sup> This practice is known as “churning.” See *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820 (9th Cir. 1980).

<sup>168</sup> See Omarova, *supra* note 116, at 80 (“Before the latest crisis, financial services regulation was generally viewed as . . . economic regulation whose primary goal was to correct market inefficiencies (such as . . . agency problems) . . .”).

<sup>169</sup> See *supra* notes 74-83 and accompanying text (describing investment advisory services).

<sup>170</sup> See Anita K. Krug, *Moving Beyond the Clamor for “Hedge Fund Regulation”: A Reconsideration of “Client” Under the Investment Advisers Act of 1940*, 55 VILL. L. REV. 661, 664 (2010) [hereinafter *Moving Beyond the Clamor*] (“The terms and conditions of the advisory relationship are generally contained within an investment advisory agreement to which only the [advisory client] and the adviser are parties.”).

<sup>171</sup> See 15 U.S.C. § 80b-2 (2012) (defining “investment adviser” as “any person who, for compensation, engages in the business of advising others” and defining “person” as “a natural person or a company”); *Moving Beyond the Clamor*, *supra* note 170, at 663-64 (observing that investment advisers’ clients may be individuals or entities, including mutual funds and hedge funds).

do, there is no basis for it to privilege the entity over other relationship formats.

The same might be said of mutual fund regulation. To be sure, collective investment vehicles are entities and, arguably, appropriately so, in that the entity structure ensures that mutual fund shareholders have the benefit of limited liability.<sup>172</sup> Mutual funds, however, are unlike operating companies, such as Starbucks or Boeing, because a mutual fund has no officers or employees,<sup>173</sup> and effective control over it (including management of its assets) lies not in its board of directors but, rather, in a separate legal being, namely its investment adviser, who has no formal role *within* or ownership-based affiliation with the mutual fund.<sup>174</sup> Because the entity lacks the internal accountability dynamics between owners and managers that characterize operating companies, there is no reason for regulatory requirements to turn on the circumstance that a mutual fund is an entity.

That downstream regulation need not be entity-centric also eliminates the possibility that it plays a role in corporate governance functions. It does not exist to refine the relationships among a firm's constituencies or otherwise supplement corporate law. Nor, however, is downstream regulation bound to any other body of legal rules or doctrine: it neither fills a gap left by other laws or rules nor furthers other legal or regulatory objectives. It is, in other words, complete in and of itself. It is, therefore, also independent. Its content is determined by regulatory goals that, at least conceivably, came into form on a blank slate, based on objective considerations rather than, as is the case in the upstream context, the arguable subjectivity inherent in building upon something (such as corporate law) that already exists. Because downstream regulation has no alternative function or ulterior motive, it must be taken at face value: it is regulation for the sake of regulation.

The completeness of downstream regulation becomes evident by considering the ways in which financial or corporate crises trigger the creation of additional regulation. Upstream, the crises leading to new laws or rules are often corporate governance crises.<sup>175</sup> For example, as Part III elaborates,<sup>176</sup> Enron's massive bankruptcy, which was catastrophic to shareholders and

---

<sup>172</sup> See Mark E. Nance & Bernd Singhof, *Banking's Influence Over Non-Bank Companies After Glass-Steagall*, 14 EMORY INT'L L. REV. 1305, 1331 n.105 (2000) ("Investment companies are entities that exist to own stock in a company or companies."). Most mutual funds are organized as corporations or trusts. See Jonathan Macey, *Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally-Insured Bank Deposits*, 17 STAN. J.L. BUS. & FIN. 131, 133 (2011) (observing that mutual funds are "normally organized as corporations or business trusts").

<sup>173</sup> See *Jones v. Harris Assocs.*, 559 U.S. 335, 338 (2010).

<sup>174</sup> See *Burks v. Lasker*, 441 U.S. 471, 480-82 (1979) (internal citations omitted).

<sup>175</sup> See, e.g., Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 949 (2013).

<sup>176</sup> See *infra* notes 284-291 and accompanying text (generally describing Sarbanes-Oxley's genesis and content).



attributable to significant fiduciary failures on the part of Enron's directors and officers, was a corporate governance failure.<sup>177</sup> Lawmakers' and regulators' responses to that failure were Sarbanes-Oxley and the SEC's associated rules, which augment the requirements under the securities laws applicable to public firms.<sup>178</sup> Policymakers' response, in other words, was the adoption of additional upstream regulation.

Downstream, by contrast, the crises that produce new regulation are, somewhat circularly, financial services crises – failures of broker-dealers or investment advisers to act appropriately vis-à-vis their customers or clients. Consider the 2008 financial crisis. To the extent its regulatory offspring, Dodd-Frank, augments requirements applicable to broker-dealers and investment advisers, for example, it does so on the basis that then-existing regulation did not provide sufficient protections in various brokerage and advisory contexts.<sup>179</sup> Among other things, the crisis produced stories of broker-dealers' involving their clients in securities transactions in which the broker-dealers had conflicting interests, such as “long” investments in collateralized debt obligations as to which the broker-dealers had taken short positions.<sup>180</sup> The crisis also produced tales of investment advisers whose fixation with securitized instruments<sup>181</sup> led them to provide too-rosy reports to their clients, inducing the clients to buy more or, at the least, maintain their existing holdings.<sup>182</sup> Although those episodes, too, implicate (faulty) corporate

---

<sup>177</sup> See Gelter, *supra* note 175, at 949.

<sup>178</sup> See Gregory M. Gilchrist, *Condemnation Without Basis: An Expressive Failure of Corporate Prosecutions*, 64 HASTINGS L.J. 1121, 1123 (2013); Amy Deen Westbrook, *What's in Your Portfolio? U.S. Investors Are Unknowingly Financing State Sponsors of Terrorism*, 59 DEPAUL L. REV. 1151, 1181-82 (2010) (“[T]he Sarbanes-Oxley Act . . . dramatically heightened federal disclosure and compliance requirements for public companies.”).

<sup>179</sup> See *Regulatory Developments 2010*, 667 BUS. LAW. 665, 700-01 (2010) (observing that Dodd-Frank implements a number of investor protection provisions centering on the regulation of broker-dealers and investment advisers).

<sup>180</sup> See, e.g., Peter J. Henning, *The Litigation That Haunts Goldman Sachs*, N.Y. TIMES DEALBOOK (June 25, 2012, 12:57 PM), archived at <http://perma.cc/DAJ9-2SF5> (reporting that, leading up to the financial crisis, Goldman Sachs had “constructed [collateralized debt obligations tied to subprime mortgages] to be sold to its investors while failing to disclose that it was taking short positions against them”).

<sup>181</sup> Securitization is the process by which a sponsor (such as a broker-dealer) pools, into an entity or multiple entities, a number of units of a certain type of financial asset, such as mortgages or other debt obligations, and sells shares or other equity units of the entities to investors, often in “tiers” or “tranches” based on creditworthiness. See *Securitization*, INVESTOPEDIA, archived at <http://perma.cc/H664-KH4H> (last visited July 13, 2014).

<sup>182</sup> See, e.g., Thom Weidlich, *Ex-Bear Stearns Managers Cioffi, Tannin to Pay \$1.05 Million in SEC Suit*, BLOOMBERG (Feb. 13, 2012), archived at <http://perma.cc/V76F-66AJ> (reporting that two former Bear Stearns fund managers settled an SEC lawsuit alleging that the managers had misled the fund's investors about the value of the securities held by the fund, which consisted largely of subprime mortgage-backed securities).

governance, their effects are distinctly unrelated to the concerns at the core of corporate law, which, again, center on the manager-owner relationship. Indeed, their effects are unrelated to the concerns of any doctrinal realm other than financial services itself.

C. *Disclosure*

The contention that there are two different species of securities regulation both unsettles and necessitates further exploration of the maxim that disclosure is the primary securities regulatory tool. To begin, recall that upstream regulation, as the regulation of issuers and securities issuances, is entity-centric, measurable only by reference to its success or failure as to discrete entities.<sup>183</sup> After all, without the entity, the separation of ownership and control and managerial accountability are hollow concepts. The entity, moreover, necessarily is a composite. Not only is the entity itself a “person,” but the entity also relies for its operations, if not its existence, on officers and directors, in addition to owners,<sup>184</sup> each of whom plays a specific role and has obligations to the others.<sup>185</sup>

And, indeed, although the requirements of the Securities Act are directed at firms (at issuers, more precisely), the umbrella of “issuer” encompasses both the persons whom regulation exists to protect (owners) and the persons from whom they require protection (managers). These considerations entail that the subject of upstream regulation – the person that is obliged to comply with that regulation – is complex. Complexity in the upstream subject arises also from the fact that the particular entities being regulated have objectives distinct from the policy objectives that subject them to regulation. That is, the entity’s end is to produce and sell particular products or to supply particular services, usually for a profit;<sup>186</sup> its objective of raising financial capital in the securities markets is secondary, a means to achieving its more fundamental business objectives.<sup>187</sup> Accordingly, an entity’s activities as an issuer are but a

<sup>183</sup> See *supra* notes 149-155 and accompanying text (describing the nature of upstream regulation, as distinct from downstream regulation).

<sup>184</sup> See Charles R.T. O’Kelley, *Coase, Knight, and the Nexus-of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate*, 35 SEATTLE U. L. REV. 1247, 1265-66 (2012) (“[T]he corporation encompasses only the governance relationship between the shareholders, officers, and directors, who are, thus, the corporation’s only constituents.”).

<sup>185</sup> See Jens David Ohlin, *Nash Equilibrium and International Law*, 96 CORNELL L. REV. 869, 896 (2011) (observing that a corporation’s “constituent parts – officers, directors, employees, and shareholders – all benefit from, and consent to, corporate obligations”).

<sup>186</sup> See, e.g., Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation*, 73 TEX. L. REV. 477, 489 (1995) (observing that “each corporation does something different, with different commitments and different goals”).

<sup>187</sup> Cf. Janis Serra, *Rose Colored Glasses, Opaque Financial Reporting, and Investor Blues*, 76 ST. JOHN’S L. REV. 715, 757 (2002) (“Corporations are dependent on the availability of cost-effective capital; in North America much of that capital is derived from

secondary component – though perhaps a necessary one – of the business activities that constitute the entity’s *raison d’être*.

One might suppose that, when the regulatory subject is complex, regulation should be simple. After all, regulation is formulated *ex ante*. For it to be effective, policymakers need to understand the subject and how it operates.<sup>188</sup> That understanding is achievable if the subject is simple, as is the case when it is an individual. It is also achievable even when the regulatory subject comprises constituent components, but the relationships among those components are irrelevant for regulatory purposes, as is the case, for example, with employers – entities though they may be – in connection with their compliance with, say, worker safety laws or anti-discrimination statutes.<sup>189</sup> If, however, regulation is aimed at the relationships among the subject’s constituent components, which naturally operate pursuant to their own operational norms (based on chains of authority, delegation, and oversight) and legal norms (founded on the internal affairs doctrine of corporate law)<sup>190</sup>, then formulating complex regulatory strictures is difficult and perhaps futile.<sup>191</sup>

As suggested, upstream regulation is also dependent – namely, dependent on corporate governance norms and rules, largely the domain of state corporate law. Corporate law is on the front line, providing some measure of rights and protections to shareholders, primarily through fiduciary duties, and securities regulation plays a (supporting) role on behalf of shareholders in circumstances in which Congress determined that corporate law is not sufficiently effective.<sup>192</sup> Accordingly, upstream regulation’s specific objectives of protecting investors and promoting market integrity support the open-ended business objectives that corporate law enables.<sup>193</sup>

---

securities markets . . .”).

<sup>188</sup> See, e.g., Andrew J. Keller, *Robocops: Regulating High-Frequency Trading After the Flash Crash of 2010*, 73 OHIO ST. L.J. 1457, 1477 (2012) (“To institute an effective regulatory regime [governing high-frequency trading (“HFT”)], regulators must begin to understand HFT . . .”).

<sup>189</sup> In other words, regulation that does not pertain to the relationships among an entity’s (or other group’s) internal constituencies may simply regard the entity as a monolithic, cohesive “being,” similar to an individual.

<sup>190</sup> See *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982) (“The internal affairs doctrine is a conflict of laws principle [that] recognizes that only one State should have the authority to regulate a corporation’s internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders . . .”).

<sup>191</sup> Cf. Donald C. Langevoort, *The SEC and the Madoff Scandal*, 2009 MICH. ST. L. REV. 899, 903 (observing, in the context of discussing the regulatory challenges facing the SEC, that General Electric, a public company, “just by itself is of extraordinary complexity and opacity – a collective of thousands of officers, directors, employees, and affiliates”).

<sup>192</sup> See *supra* notes 156-159 and accompanying text (discussing how upstream regulation is dependent on corporate laws and norms).

<sup>193</sup> To be sure, corporate law is, in many respects, permissive, allowing managers and owners to opt out of rules that would otherwise apply. See Brett H. McDonnell, *Setting*

Upstream regulation's dependency on corporate law and its secondary status in relation to corporate law means that it must be harmonious with corporate law. Of course, federal law may conflict or otherwise be inconsistent with state law or, for other reasons, might preempt state law.<sup>194</sup> There is, in other words, no necessity for consistency between the two – a fundamental consequence of the principle of federalism and its division of sovereignty between central and local authorities.<sup>195</sup> However, although federalism suggests the prospect of inconsistency and preemption, it perhaps more strongly relies on the notion of cooperation among central and local authorities, to the extent their respective domains, though different, nonetheless are related to one another.<sup>196</sup> Therefore, securities regulation, cooperative and harmonious as it must be, cannot unduly interfere with corporate law's substance. It must be, in effect, "hands off" – not in the sense that its requirements are without burden but in the sense that they may seep into the fabric of corporate doctrine only where they find openings and crevices.

In short, the entity-centrism and doctrinal dependence of securities regulation's upstream side suggest that that regulation should be simple and noninterfering. And so it generally is. As suggested in Part I, upstream laws and rules preference disclosure over elaborately wrought operational restraints, thereby elevating procedural transparency over any notion of what firms should be.<sup>197</sup> Disclosure requirements, after all, are simple, at least in the

---

*Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. 67, 85 (2011) ("Most of state corporate law consists of default rules, which individual companies can alter to fit their own circumstances."). This includes, to some extent, directors' and officers' fiduciary obligations. For example, Delaware corporate law allows corporations to limit the scope of directors' and officers' fiduciary duties regarding "corporate opportunities." See DEL. CODE ANN. tit. 8, § 122(17) (2014) ("Every corporation . . . shall have power to . . . [r]enounce . . . any interest or expectancy of the corporation in . . . specified business opportunities . . ."). Meanwhile, securities regulation is generally mandatory: the rules that it comprises are neither waivable nor modifiable. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1975 (1996) (observing that, while "[c]orporate law required little financial disclosure by companies to shareholders," the securities laws "intervened to erect a system of mandatory disclosure"). That fact, however, does not alter upstream regulation's role as structural doctrine that, along with corporate law, supplies the legal framework for business organizations of all varieties.

<sup>194</sup> See *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230-31 (1947) (describing the general circumstances under which federal law is deemed to preempt state law).

<sup>195</sup> See Nicholas Aroney, *Formation, Representation and Amendment in Federal Constitutions*, 54 AM. J. COMP. L. 277, 293 (2006) ("[F]ederal legislative powers are mostly concurrent with the States, and inconsistency between State and federal laws is resolved in favor of the federal legislature.").

<sup>196</sup> See Jody Freeman & Daniel A. Farber, *Modular Environmental Regulation*, 54 DUKE L.J. 795, 812 (2005) ("[E]ven though federal agencies theoretically have paramount authority under the major federal regulatory schemes, practical imperatives lead them to negotiate for the cooperation not only of state but also local governments.").

<sup>197</sup> See *supra* notes 40-73 and accompanying text (describing generally upstream

articulation,<sup>198</sup> and, largely devoid of substantive “dos” and “don’ts,” avoid conflicting with a firm’s business objectives and internal relationships.

Downstream regulation, however, does not revolve around the entity or the corporate governance norms that govern the relationships among the entity’s constituencies.<sup>199</sup> As is the case upstream, the regulatory subject is typically an entity, to be sure.<sup>200</sup> Despite some variations, a broker-dealer or an investment adviser is generally a corporation, an LLC, or a limited partnership.<sup>201</sup> Yet, because downstream regulation exists to protect the customers and clients of financial services providers,<sup>202</sup> its role does not change based on whether the provider is an entity, an individual, or a Martian. Put another way, regulation is directed only at the subject, rather than also (indirectly) at certain parties within it (such as managers) for the sake of other parties within it (such as owners).

One might further suppose, therefore, that downstream regulation may be more complex than upstream regulation without similarly undermining its own efficacy. That supposition, moreover, is buttressed by the circumstance that the former is not dependent on any other body of law.<sup>203</sup> Its independence means that it need not be similarly deferential; it need not balance the competing interests of protecting investors and permitting another body of doctrine to play its own important role in protecting investors or promoting other aims.

Accordingly, downstream regulation can take whatever form it needs to take, and be however robust as it needs to be, in order to do its job effectively. More concretely, policymakers have the necessary latitude, and may deploy the necessary creativity, to formulate downstream regulation so as to best further regulatory goals. In addition, rather than revolve around disclosure-based approaches, downstream regulation may consist of an array of substantive rules dictating how financial services firms should conduct their

---

regulation and its reliance on disclosure).

<sup>198</sup> As the U.S. securities laws evidence, however, disclosure requirements can be exquisitely complicated in their formulation. *See, e.g.*, David Mashburn, Comment, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act’s Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 131 (2013) (“Congress drafted detailed, extensive, and complicated disclosure requirements for issuers using crowdfunding.”).

<sup>199</sup> *See supra* Part II.B (describing the nature of downstream regulation, as distinct from upstream regulation).

<sup>200</sup> *Escaping Entity-Centrism*, *supra* note 149, at 2051-53 (observing that discrete entities, rather than multi-entity groups, are the regulatory subjects of investment adviser and broker-dealer regulation).

<sup>201</sup> *Id.* at 2052 n.47 (citing the SEC’s application form for broker-dealer registration, which notes that a registrant may be a partnership, a corporation, a limited liability company, or other entity).

<sup>202</sup> *See supra* notes 25-26 and accompanying text (explaining the goals of downstream regulation).

<sup>203</sup> *See supra* notes 175-182 and accompanying text (contrasting the independence of downstream regulation with upstream regulation’s dependence on corporate law).

businesses and specifications governing their organizational and financial structures. And so it does. As Part I suggests, today's downstream regulation involves considerably more than disclosure requirements<sup>204</sup>, despite the prevalent lore and commentary to the contrary.<sup>205</sup>

### III. REGULATORY FAILURES

The previous Part's elucidation of securities regulation's two prongs provides a lens through which we may view and, more importantly, evaluate particular laws and rules. This Part shows how both upstream principles and upstream laws and rules effectively invade the downstream regulatory arena and hinder its operations. First, Part III.A discusses how particular downstream laws and rules are problematic – inefficient or ineffective, for example. This discussion also shows why that is the case: these laws and rules reflect the principles that ground upstream regulation rather than those grounding downstream regulation. Second, Part III.B shows how upstream laws and rules, when applied in downstream contexts, similarly counter downstream objectives. The deficiencies of these laws and rules arise from their failure to contemplate, let alone accommodate, the ways in which the subjects of downstream regulation differ from the issuers that are the core focus upstream.

#### A. *Downstream Rules*

This section delves into policymakers' proclivity to found downstream regulation on upstream principles, highlighting policy concerns – if not outright failures – in a range of contexts: mutual fund regulation, investment adviser regulation, and broker-dealer regulation. In different ways, upstream assumptions have informed discrete downstream laws and rules – or, in the case of mutual fund regulation, an entire body of regulation – and regulators' interpretation of them. These laws, rules, and interpretations reflect a pervasive regulatory failure to perceive the dual-purposed function and structure of U.S. securities regulation.

##### 1. Mutual Fund Regulation

The regulation of mutual funds under the Investment Company Act is an appropriate point at which to begin this discussion because it presents the most vivid example of downstream regulation that reflects upstream principles. A mutual fund is an entity – usually a corporation but often a trust.<sup>206</sup> Mutual

---

<sup>204</sup> See *supra* notes 87-92, 107-112, & 127-129 and accompanying text (describing some of the requirements that downstream regulation imposes on investment advisers, mutual funds, and broker-dealers).

<sup>205</sup> See *supra* note 3 (providing examples of the view that securities regulation revolves around disclosure).

<sup>206</sup> See *supra* note 172 (explaining how mutual funds are typically structured).

fund regulation revolves around this entity.<sup>207</sup> Most prominently, and reminiscent of upstream regulation, it directs obligations primarily at the entity's "managers" – its board of directors – specifying the investment activities in which the directors can and cannot allow the entity to engage and proscribing or mandating scores of other actions and decisions.<sup>208</sup> Moreover, like upstream regulation, mutual fund regulation is to some extent disclosure-oriented.<sup>209</sup> Among other things, the entity is obligated to provide quarterly and annual reports<sup>210</sup> to its shareholders regarding the entity's performance and ongoing activities.<sup>211</sup>

Yet, despite the fact that there are obvious structural similarities between mutual funds and operating companies – both are corporate entities – mutual funds are not operating companies. They do not produce widgets, supply cable services, or control fast-food franchises. That is, they do not pursue business objectives separately and apart from their activities under the securities laws.<sup>212</sup> They do provide services, of course, but those services consist of the very act of issuing securities.<sup>213</sup> Mutual funds, as noted, provide collective investment services.<sup>214</sup> The issuance of securities – that is, the procuring of investment capital from many dispersed investors – constitutes the "collective" part of those services.

This difference is important. The purpose of upstream regulation is to help balance the relationship between a firm's managers and its owners as the firm carries out its business activities.<sup>215</sup> For that reason, upstream regulation is necessarily entity-focused.<sup>216</sup> In the mutual fund context, the entity is simply

---

<sup>207</sup> See, e.g., Richard M. Spector, *Commodity Futures Law*, 66 FLA. B.J., Apr. 1992, at 54, 55 (observing that, under the mutual fund regulatory regime, "the investment company, i.e., the mutual fund, is itself registered under the Investment Company Act").

<sup>208</sup> See 15 U.S.C. § 80a *passim* (2012) (directing most mutual fund regulatory obligations to the companies' boards of directors).

<sup>209</sup> See Tamar Frankel, *The Failure of Investor Protection by Disclosure*, 81 U. CIN. L. REV. 421, 431 (2012) ("[I]nvestment company regulation is based on disclosure . . .").

<sup>210</sup> See 17 C.F.R. § 270.30e-1 (2013) (setting forth periodic reporting requirements).

<sup>211</sup> Furthermore, a mutual fund must prepare a registration statement containing lengthy and detailed disclosure about its activities and organization and provide that information to its prospective owners in connection with their buying the entity's securities. See 15 U.S.C. § 80a-8.

<sup>212</sup> See *Mutual Fund*, INVESTOPEDIA, archived at <http://perma.cc/A4GD-RJWL> (last visited July 13, 2014); *Investment Company*, INVESTOPEDIA, archived at <http://perma.cc/S3S2-JPG2> (last visited July 13, 2014) (defining "investment company" as "[a] corporation or trust engaged in the business of investing the pooled capital of investors in financial securities").

<sup>213</sup> See *supra* notes 103-106 and accompanying text (discussing the services that mutual funds provide).

<sup>214</sup> See *id.*

<sup>215</sup> See *supra* notes 156-159 and accompanying text.

<sup>216</sup> See *supra* notes 149-155 and accompanying text.

an instrument, used by its investment adviser – a separate entity – to bring together those to whom the adviser will provide investment services.<sup>217</sup> In this picture, the entity is not important. There is no reason for regulation to assume that it is.

Because of the difference between mutual funds and operating companies, mutual fund regulation's entity focus and reliance on corporate governance norms are problematic. Most fundamentally, they are inconsistent with the structure of mutual funds' operations. As noted in Part II, mutual funds are typically devoid of their own officers and employees.<sup>218</sup> Rather, a mutual fund's activities are carried out on the mutual fund's behalf by third party service providers such as the fund's administrator, its auditor, and, most importantly, its investment adviser.<sup>219</sup> All of these service providers are, as one might expect, businesses that operate separately from and independently of the mutual fund.<sup>220</sup>

In a sense, then, mutual funds contract out for the personnel that, in operating companies, would be based within the companies, as officers and employees.<sup>221</sup> That circumstance has significant implications for the role of a mutual fund's board of directors. In a typical corporation – one that pursues typical business activities – the board's role is not only to make decisions on the corporation's behalf but also to oversee the activities of the corporation's personnel, ensuring that information as to the corporation's and its employees' activities flows to the board.<sup>222</sup> The board is able to fulfill this obligation simply because of its control position within the firm: ultimately, the board not only is responsible for every officer's and employee's position in the corporation, but it also has the authority to procure any information it might desire regarding the happenings within the corporation and the corporation's actions.<sup>223</sup>

---

<sup>217</sup> See *supra* notes 95-97 and accompanying text (explaining that mutual funds facilitate an investment adviser's management of many investors' assets).

<sup>218</sup> See *supra* notes 172-174 and accompanying text (describing mutual funds' organizational structure).

<sup>219</sup> See *id.* (observing that mutual funds are generally controlled by their investment advisers).

<sup>220</sup> See Robert Eli Rosen, *Resistances to Reforming Corporate Governance*, 74 *FORDHAM L. REV.* 1251, 1265 (2005).

<sup>221</sup> See *Investment Company as Instrument*, *supra* note 82, at 273 (detailing how a mutual fund obtains from contractors services that, in operating companies, are typically provided by employees).

<sup>222</sup> See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (concluding that boards of directors must "assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to . . . the board . . . timely, accurate information sufficient to allow . . . the board . . . to reach informed judgments").

<sup>223</sup> See, e.g., DEL. CODE ANN. tit. 8, § 141 (2014) (providing that the power to manage the corporation rests with the board of directors).



The corporate governance basis of mutual fund regulation assumes that mutual fund boards likewise have decisionmaking and oversight functions.<sup>224</sup> Yet because a mutual fund has no employees, there is nothing for its board to oversee within the mutual fund. Instead, the personnel that carry out the mutual fund's activities are, by and large, located within the fund's investment adviser.<sup>225</sup> Accordingly, the board's oversight responsibility, for all practical purposes, is the responsibility to oversee the *investment adviser's* personnel.<sup>226</sup> Because the adviser is a separate entity, however, the board has no automatic or default entitlement to the necessary information about the activities of those personnel. As a result, the board's oversight obligation is effectively an obligation to oversee a black box.

That circumstance is problematic enough. It also means, however, that a mutual fund's directors, who usually are selected for that role by the investment adviser,<sup>227</sup> are to some extent beholden to and dependent on the adviser – and, therefore, perhaps too willing to accede to the adviser's wishes.<sup>228</sup> The market-timing and late-trading scandals of a decade ago<sup>229</sup> arguably are attributable to the special (too-close) nature of the adviser-board relationship, in that boards were too-readily amenable to market-timing arrangements proposed by advisers.<sup>230</sup>

---

<sup>224</sup> See A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 750 (2008) (observing that “the Investment Company Act requires that a board of directors oversee fund operations” and that “[t]he board . . . is intended to be a monitor, protecting the interests of mutual fund investors”).

<sup>225</sup> See Johnson, *supra* note 101, at 503 (stating that a mutual fund's adviser “establishes and ‘sponsors’ the [mutual fund] and provides all necessary personnel, facilities, and expertise”).

<sup>226</sup> See *id.* at 503-04 (describing the dominant role of the adviser in a mutual fund's operations).

<sup>227</sup> See *Conference on Mutual Funds: The Mutual Fund Management Fee*, 115 U. PA. L. REV. 726, 739 (1967) (comments of Abraham L. Pomerantz) [hereinafter Pomerantz Comments] (observing, with respect to investment advisers and independent directors, respectively, that “[t]he men who need to be watched pick the watchdogs to watch them”).

<sup>228</sup> See *Jones v. Harris Assocs.*, 559 U.S. 335, 338 (2010) (“Because of the relationship between a mutual fund and its investment adviser . . . ‘the forces of arm’s-length bargaining do not work in the mutual fund industry . . . .’” (quoting *Burks v. Lasker*, 441 U.S. 471, 481 (1979))); Pomerantz Comments, *supra* note 227, at 739 (“[Y]ou know and I know that if you are choosing . . . an independent director you are not going to choose anybody who is going to be too hard on you.”).

<sup>229</sup> For a comprehensive discussion of these scandals and the regulatory response, see Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 Hous. L. REV. 1271, 1272 (2006).

<sup>230</sup> See William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 76 (observing that market timing arrangements often benefited investment advisers because, in exchange for an adviser's agreeing to allow an investor to time the market through one mutual fund, the investor placed long-term capital in another fund the adviser managed, thereby ensuring additional

Mutual fund regulation's reliance on principles more at home in the world of upstream regulation defeats downstream objectives. Its reification of entity boundaries and reliance on corporate governance norms means that it is unable to acknowledge the foundational role of the investment adviser in a mutual fund's operations. It is also unable to acknowledge that investment advisers and mutual funds effectively are components of a single (multi-entity) enterprise and that they should be regulated as such. In other words, mutual fund regulation, as presently formulated, fails to reflect the structural flexibility and doctrinal independence that define downstream regulation.

## 2. Investment Adviser Regulation

Fundamentally, investment advisory services revolve around the relationship between an investment adviser and its client, the latter being the person who engages the adviser for purposes of obtaining the adviser's services and the person whom regulation seeks to protect. That is, the client is the beneficiary of the adviser's regulatory obligations.<sup>231</sup> That delineation seems simple and sensible. And, indeed, it reflects the understanding of advisory relationships that Congress appears to have embraced in formulating the Advisers Act almost 75 years ago.<sup>232</sup> The Advisers Act and the associated SEC rules center on advisers' obligations to their clients – clients who are contemplated to have the capacity to provide consent under specified circumstances<sup>233</sup> and to benefit from their advisers' obligatory disclosures regarding the advisers' business activities and services.<sup>234</sup>

Even in 1940, however, some adviser-client relationships were substantially more complex than the discussion above might suggest.<sup>235</sup> Moreover, even if that were not the case, a certain type of complex advisory relationship emerged in subsequent years, ultimately becoming a dominant structure for the provision of investment advisory services.<sup>236</sup> In this structure, an adviser

---

fee revenues to the adviser).

<sup>231</sup> That an adviser owes its regulatory obligations to its "clients" is evident from the text of both the Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21 (2012), and the rules adopted by the SEC under that statute, 17 C.F.R. §§ 275.0-2 to 275.222-2 (2013).

<sup>232</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 180 (1963) (observing that the Congress that enacted the Advisers Act regarded investment adviser-client relationships as "fiduciary . . . relationship[s]").

<sup>233</sup> See, e.g., 15 U.S.C. § 80b-6(3) (requiring advisers to obtain client consent for certain conflict-of-interest transactions).

<sup>234</sup> See, e.g., 17 C.F.R. § 275.206(4)-3 (prohibiting an investment adviser from paying for client solicitation services unless the adviser complies with certain requirements, including providing relevant disclosure to solicited clients).

<sup>235</sup> See *Senate Hearings, supra* note 97, at 700 (statement of James N. White, Scudder, Stevens & Clark, Investment Counsel) (describing the private funds that Scudder, Stevens & Clark had created "to make investment counsel available to the small investor").

<sup>236</sup> See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 45,172, at 45,173 (July 28, 2004) (observing that, "[i]nstead of managing client money

combines the assets it manages (or would otherwise manage) for multiple clients into a single “pot” and then effectively provides its services to the pot, allocating the profits and losses that accrue to the pot as a result of the adviser’s efforts to each contributor, proportionately, based on the amount of the contributors’ respective contributions.<sup>237</sup>

The rationale for this structure is obvious: if an adviser manages multiple persons’ assets pursuant to a single investment strategy, then pooling those assets and managing them on an aggregated basis is efficient, reducing both administrative and transaction costs, as compared with costs associated with multiple separately managed client accounts.<sup>238</sup> From the investor’s perspective, the structure is substantially the same as having a separately managed account. Either way, the investor receives the profits or losses arising from the investment of her assets in accordance with the adviser’s investment program.<sup>239</sup> The complexity of this arrangement – of using a “pot,” otherwise known as a hedge fund, private equity fund, or other investment fund – raises a critical question, however: Who is the advisory client? Put another way, to whom does the adviser owe its regulatory obligations?

Although the answer to the question was not always certain, policymakers ultimately provided an answer – one based on upstream considerations. In particular, the SEC came to embrace an entity-centric doctrine, pursuant to which the beneficiary of investment adviser regulation – the advisory client, in other words – was the fund, which was (and remains) an entity.<sup>240</sup> Accordingly, the entity is the legal person that is entitled to receive an

---

directly,” investment advisers increasingly “pool client assets by creating limited partnerships, business trusts or corporations in which clients invest”).

<sup>237</sup> See, e.g., AMARANTH ADVISORS L.L.C., CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM 35-38 (2006), archived at <http://perma.cc/F5R8-QL25> (describing the procedures that one Amaranth fund used in allocating profits and making distributions).

<sup>238</sup> See *Moving Beyond the Clamor*, *supra* note 170, at 690-91 (describing efficiency-based rationale for investment advisers’ creation of “pooled-asset structure[s]”).

<sup>239</sup> Cf. Ian Salisbury, *SMA’s Beat Funds in 2008*, WALL ST. J. (Mar. 12, 2009, 12:01 AM), archived at <http://perma.cc/ZCA3-ZMG5> (observing that, whereas separately managed account (“SMA”) clients “own their stocks directly,” mutual fund investors “own shares in a single pool of assets”).

<sup>240</sup> See 17 C.F.R. §§ 275.202(a)(30)-1(2)(i), 275.222-2 (2013) (providing that an investment adviser to a limited partnership may regard the partnership, rather than each of the partnership’s limited partners, as a client for purposes of certain Advisers Act provisions). Mutual funds and other investment companies are likewise deemed the clients of their advisers. They are not particularly relevant for this discussion, however, given that they are, in their own right, subject to comprehensive regulation. See *supra* notes 107-112 and accompanying text (discussing the regulation of mutual funds and other investment companies). That is not the case with hedge funds and other private funds, which, by definition, are exempt from that regulation under Section 3 of the Investment Company Act. See 15 U.S.C. §§ 80a-3(c)(1), (c)(7) (2012) (excluding certain hedge funds and other private funds from the definition of “investment company”).

adviser's disclosure regarding, for example, its conflicts of interest and personal securities trading practices and is the person from which the adviser must seek consent in connection with certain transactions as to which the adviser is conflicted.<sup>241</sup>

This policy determination is not entirely unreasonable. Although investment adviser regulation obligates the adviser to give things (disclosure) to and get things (consent) from its clients, regulation also requires that the adviser treat all of its clients fairly in connection with managing their assets.<sup>242</sup> When the adviser is charged with investing the assets that multiple investors have contributed to a fund, it is really charged with investing the fund's – the entity's – assets.<sup>243</sup> Accordingly, the entity, and not its contributing investors, is entitled to fair treatment and other regulatory protections relating to the investment process.<sup>244</sup>

Nonetheless, the upstream, entity-centric approach to designating the client is problematic. As an initial matter, both as conceived by the Advisers Act and as a matter of common sense, an advisory client has decisionmaking authority over the advisory relationship.<sup>245</sup> The client is the person who seeks out the adviser's services and determines to engage the adviser; the client is also, as one might expect, the person who, at some point, may decide to terminate the relationship and allocate her assets elsewhere.<sup>246</sup> Equally important, although the fund becomes the legal owner of the investment assets that the investor

---

<sup>241</sup> See *supra* note 89 and accompanying text (describing circumstances in which, under the Advisers Act, an adviser must seek client consent).

<sup>242</sup> See Pretzel & Stouffer Chartered, SEC No-Action Letter, 1995 WL 737153, at \*4 (Dec. 1, 1995) (“[A]n adviser has an obligation to treat all of its clients fairly and equitably.”). For example, to the extent investment opportunities are limited (but are appropriate for multiple clients, given their needs and preferences), the adviser must fairly allocate those opportunities among all relevant clients. See, e.g., Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, 65 Fed. Reg. 20,524, at 20,538 n.178 (proposed Apr. 17, 2000) (to be codified at 17 C.F.R. pts. 200, 275 & 279) (noting that an investment adviser must “allocate[] . . . trades in a way that treats all clients fairly”).

<sup>243</sup> See *supra* notes 80-83 and accompanying text (discussing the doctrine that a pooled investment structure is a single client of its adviser).

<sup>244</sup> This conclusion simply follows from the facts that, under the Advisers Act, investment advisers owe their obligations to their “clients,” see *supra* notes 231-234 and accompanying text (discussing the relationship between investment advisers and their clients), and that a fund, rather than its several investors, is deemed the client. See *supra* notes 240-241 and accompanying text.

<sup>245</sup> Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1, 4 (2011) (“Under the Advisers Act, ‘clients’ are deemed to have autonomy and an independent voice . . .”).

<sup>246</sup> Pursuant to the Advisers Act, an advisory client must have the right to terminate the advisory relationship. See Robert D. Brown Inv. Counsel, Inc., SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2661, at \*2, \*4 (July 19, 1984) (determining that “a contract for investment supervisory services purporting to bind a client for a period of one year without a right to terminate except annually would violate” the Advisers Act’s antifraud provisions).

contributes to it, the investor remains the beneficial owner of them – that is, the person (or one of the persons) for whose ultimate benefit the fund invests its assets.<sup>247</sup>

If, however, the investor does not have client status, it is not entitled to receive the disclosure that provides updates regarding the adviser's business practices.<sup>248</sup> And if, for example, the adviser desires to have the fund buy a security from a securities dealer that is an affiliate of the adviser – a classic conflict-of-interest transaction – the investor is not entitled to be informed of the transaction or to provide or withhold consent for the transaction.<sup>249</sup> Stated succinctly, by denying client status to those whose assets are pooled, investment adviser regulation, in its current form, denies regulatory protections to those who would be entitled to them had they structured their relationships with the adviser differently. This circumstance is all the more troubling because the fund lacks any independent decisionmaking authority: the adviser, recall, created the fund and, therefore, typically controls all aspects of its operations<sup>250</sup> – producing the untenable result that the adviser effectively owes many of its obligations to itself.

Like mutual fund regulation, then, investment adviser regulation is marred by an entity-centric, doctrinally dependent regulatory perspective. Regulation focuses formalistically on the thing whose assets are being invested, even when that thing is an entity that did not exercise discretion in selecting the adviser and that is not the ultimate owner of the assets being invested. This formalism fails to recognize that the entity in this context is simply a convenience mechanism and that entity boundaries have no relevance for the goals of investment adviser regulation.

### 3. Broker-Dealer Regulation

When a broker-dealer becomes insolvent, it may be the case that, at the time of insolvency, funds or securities are missing from the brokerage accounts of the firm's customers.<sup>251</sup> That might occur if, as broker-dealers often do, the broker-dealer used the customers' assets as collateral in connection with its

---

<sup>247</sup> For a definition of "beneficial owner," see *supra* note 106.

<sup>248</sup> See *supra* note 88 and accompanying text (describing certain regulatory disclosure requirements).

<sup>249</sup> See *supra* note 89 and accompanying text (discussing this consent requirement).

<sup>250</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 & 279) (describing the way in which investment advisers "organize" hedge funds); Johnson, *supra* note 101, at 503 (addressing the instrumental role of investment advisers in "establish[ing]" the mutual funds they manage).

<sup>251</sup> See Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1096 (1999) (explaining that, in broker-dealer liquidations, "the fund of customer property may be insufficient to satisfy all customer claims for net equity").

obtaining funding from its own lenders (so-called “repo” transactions) or loaned the assets to other brokerage customers in connection with those other customers’ securities transactions.<sup>252</sup> The regulation of broker-dealers permits a broker-dealer to use a customer’s assets in this manner, to the extent the customer has borrowed funds or securities from the firm in furtherance of the customer’s trading activities.<sup>253</sup> In those circumstances, the customer is usually obligated to pledge the assets in her account to the broker-dealer as collateral.<sup>254</sup>

A component of broker-dealer regulation, the Securities Investor Protection Act of 1970 (“SIPA”),<sup>255</sup> protects customers of an insolvent broker-dealer against any loss of funds and securities that customers had pledged to the firm and that the firm deployed in furtherance of its own borrowings.<sup>256</sup> SIPA required the establishment of a broker-funded insurance pool, as well as a non-profit firm, the Securities Investor Protection Corporation (“SIPC”), to administer it.<sup>257</sup> In the event of a broker-dealer’s insolvency, and provided that the broker-dealer is an SIPC member, SIPC administers the firm’s liquidation and compensates its customers for the amounts the firm owes them, less amounts they owe the firm.<sup>258</sup>

Brokerage firms’ downstream-specific organizational structures thwart these objectives, however. Specifically, financial services firms, particularly those carrying out broker-dealer functions, are often organized as multi-entity enterprises.<sup>259</sup> The largest broker-dealers comprise numerous entities, which

---

<sup>252</sup> See *Escaping Entity-Centrism*, *supra* note 149, at 2081 n.194 (noting that a broker-dealer may loan out securities in a customer’s account “for the purpose of allowing other brokerage customers to effect ‘short’ sales”).

<sup>253</sup> See Manmohan Singh & James Aitken, *The (Sizeable) Role of Rehypotheication in the Shadow Banking System* 3 (Int’l Monetary Fund, Working Paper No. 10/172, 2010), archived at <http://perma.cc/WY62-K3NY> (describing the process by which a broker-dealer may use “for its own purposes” collateral pledged by its brokerage clients).

<sup>254</sup> See *id.*

<sup>255</sup> 15 U.S.C. §§ 78aaa-78lll (2012).

<sup>256</sup> See Joo, *supra* note 251, at 1081 (observing that “SIPA is intended to protect customers from loss” in circumstances in which a broker-dealer insolvency produces a shortfall in property held on behalf of customers).

<sup>257</sup> See *id.* at 1096 (explaining that, when customer property held with a liquidating broker-dealer is insufficient to cover amounts owing to customers, “the SIPC fund will cover the shortfall”).

<sup>258</sup> See 15 U.S.C. § 78fff-3 (describing the method that SIPC must follow); Joo, *supra* note 251, at 1097 (“When necessary, SIPC will pay, out of the SIPC fund, up to \$500,000 to each holder of a valid customer claim for net equity.”).

<sup>259</sup> The largest U.S. securities brokerage firms, such as J.P. Morgan, Goldman Sachs, and Morgan Stanley, are apt examples of these multi-entity structures. Although, as the references in the preceding sentence suggest, each of these firms is often considered to be a single “thing,” each comprises numerous affiliated entities, each of which plays a distinct role in the firm’s overall business activities. See James A. Fanto, “*Breaking Up Is Hard to*

are typically scattered world-over.<sup>260</sup> Although only certain discrete entities within a brokerage enterprise are typically registered and regulated as broker-dealers, the entities generally work together as a cohesive unit, usually controlled, ultimately, by a parent company.<sup>261</sup> For example, entities within the enterprise may borrow funds from one another, or one entity may carry out its securities transactions through a “sister” entity, such as when the sister entity is based in a foreign jurisdiction in which the transaction primarily takes place.<sup>262</sup>

It may be that only some entities within such an enterprise hold customer assets. If those particular entities are not SIPC members and become insolvent, their customers are out of luck as far as SIPA is concerned, even though other entities within the enterprise might be SIPC members and even though the enterprise or the non-member entities may have marketed themselves using the SIPC label. SIPC’s denial of compensation to the defrauded customers of Allen Stanford’s Ponzi scheme was based on this state of affairs.<sup>263</sup> In particular, although the Stanford entity that conducted the firm’s marketing was a SIPC member (and advertised itself as such), the Stanford entity with which customers deposited their funds was based outside the United States (in Antigua) and therefore was not a SIPC member.<sup>264</sup> Similarly, in Lehman Brothers’ bankruptcy, many brokerage customers that had deposited funds with a U.S. Lehman Brothers entity covered by SIPC were not entitled to SIPC compensation because, prior to insolvency, the firm transferred those funds to a U.K. Lehman Brothers entity that, predictably, was not governed by SIPA.<sup>265</sup>

---

*Do’’: Should Financial Conglomerates Be Dismantled?*, 79 U. CIN. L. REV. 553, 553 (2010) (“Many securities firms, which are regulated as broker-dealers, operate within the conglomerate structure.”).

<sup>260</sup> See Martin J. Gruenberg, Acting Chairman, Fed. Deposit Ins. Corp., Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012), *archived at* <http://perma.cc/Q4RC-S43J> (observing that large financial services firms are “likely to . . . operate[] across national borders”).

<sup>261</sup> See *id.* (“Large financial companies conduct business through multiple subsidiary legal entities with many interconnections owned by a parent holding company.”).

<sup>262</sup> Cf. Elaine Knuth, *MF Global’s Original Sin*, FUTURES (Nov. 1, 2012), *archived at* <http://perma.cc/P9UJ-MZN4> (observing that the various entities MF Global, a sprawling financial services firm, comprised “operated as one entity”). So long as entity formalities are respected in the course of these activities, the activities are appropriate and, indeed, likely achieve substantial efficiencies for the group as a whole.

<sup>263</sup> See Securities Investor Protection Corporation’s Brief in Opposition to SEC’s Application for Order Under 15 U.S.C. § 78ggg(b) at 14-21, SEC v. Sec. Investor Prot. Corp., 872 F. Supp. 2d 1 (D.D.C. 2012) (No. 11-mc-678) (setting forth SIPC’s arguments as to why Stanford’s victims were not entitled to reimbursement from SIPC).

<sup>264</sup> See *id.* at 16-18 (explaining that Stanford’s customers deposited their funds with the Stanford entity that was not a SIPC member, rather than the entity that was a member).

<sup>265</sup> See Lukas Becker, *Protection Racket*, RISK, June 2012, at 62, 62 (observing that the deficiency in customer funds was the product of “an unexplained last-minute money transfer and a failure to correctly segregate” those assets); see also *Lehman Client Money Issue*

Broker-dealer regulation, then, has similarly created investor protection weaknesses, thanks to its upstream focus, manifested particularly in the ways in which regulation seeks to protect customers of insolvent broker-dealers. A single person (entity or individual) or group of persons may control multiple entities within a larger enterprise, and only some of those entities may be obligated to comply with customer protection requirements. In these (commonplace) circumstances, regulation neither contemplates nor remedies the ensuing customer vulnerabilities, to the detriment of both customers and regulatory objectives.

B. *The Downstream Subject and Upstream Rules*

As the previous section shows, downstream laws and rules that are based on upstream principles are less effective than they could be. This section describes a second way in which the entity-centrism and corporate governance orientation of upstream regulation affect the downstream regulatory realm – namely, through the application of primarily *upstream* laws and rules to financial services providers and their activities. These upstream regulatory requirements are varied in scope and purpose and may be found in both the Securities Act and the Exchange Act and in the associated SEC rules.

1. *Antifraud in Securities Issuances*

A core component of securities regulation is the prohibition against making materially fraudulent and misleading statements<sup>266</sup> or, in contexts in which the disclosing party owes fiduciary obligations to those to whom disclosure is made, failing to disclose material information.<sup>267</sup> Although the securities statutes contain many antifraud provisions, the most prominent is Section 10(b) under the Securities Act and the associated SEC rule, Rule 10b-5.<sup>268</sup> That prominence stems from the fact that Rule 10b-5 applies to all securities

---

*Resolved by UK Supreme Court*, PRACTICAL LAW CO. (Mar. 1, 2012), *archived at* <http://perma.cc/LK6W-VZD3> (“Many of the LBIE ‘clients’ were US prime brokerage customers, such as hedge funds, and swap counterparties that entered into transactions with Lehman’s US affiliates, but which had their posted collateral transferred to LBIE.”).

<sup>266</sup> See *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (explaining that, in enacting the Exchange Act, “Congress sought ‘to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*’” (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972))); *supra* notes 68-73 and accompanying text (describing the requirements of Section 10(b) of the Exchange Act).

<sup>267</sup> See 17 C.F.R. § 240.10b-5 (2013); *id.* § 230.408(a) (requiring issuers to disclose in their registration statements “such further material information, if any, as may be necessary to make the required statements . . . not misleading”); *Zandford*, 535 U.S. at 823 (“[A]ny distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients.”).

<sup>268</sup> See Gideon Mark, *RICO’s Extraterritoriality*, 50 AM. BUS. L.J. 543, 555-56 (2013) (“Section 10(b) is the most important antifraud provision of the Exchange Act . . .”).



offerings,<sup>269</sup> whether by private or public issuers, and that it contains an implied right of private enforcement.<sup>270</sup> In light of the rule's sweeping reach and availability to private litigants, a large portion of civil securities claims rely on it.<sup>271</sup> Accordingly, Rule 10b-5 has been the basis of a wide range of cases, from shareholder class actions against directors of public firms for issuing misleading financial statements, to a single shareholder's claim against an entrepreneur whose glowing (but false) forecasts induced the shareholder's investment.<sup>272</sup>

It may not be surprising, therefore, that Rule 10b-5 has also been the basis of shareholder claims against companies engaged in the financial services industry, including broker-dealers and investment advisers. In those downstream contexts, however, its potency is numbed, a product of the circumstance that it was conceived, and is largely interpreted, as a tool of upstream regulation. Put another way, the Rule 10b-5 doctrine that has developed over the years, largely through Supreme Court decisions, does not adequately account for the regulatory principles that are consonant with the downstream regulatory subject and downstream regulation.

Take, for example, an investment adviser that manages (provides investment advice to) a number of mutual funds. Mutual funds, just like other public companies, are required to comply with the Securities Act in connection with selling their securities to the public even though they are primarily regulated under the Investment Company Act.<sup>273</sup> Accordingly, a mutual fund is, like other public companies, required to file a registration statement and periodic reports with the SEC.<sup>274</sup> Yet, as noted above, a primary difference between operating companies and mutual funds is that the latter are formed and almost entirely controlled by their respective investment advisers.<sup>275</sup> It is a mutual fund's adviser, then, that ultimately has primary say in the content of the

---

<sup>269</sup> That is, by its terms, the rule does not distinguish between private offerings and public offerings or between privately held issuers and publicly held issuers.

<sup>270</sup> *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b).").

<sup>271</sup> See Mark, *supra* note 268, at 555-56 ("[I]n 2012, eighty-five percent of the securities class action complaints filed in federal court included allegations of section 10(b) and Rule 10b-5 violations.").

<sup>272</sup> See, e.g., *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 148 (2008) (involving a class action under Rule 10b-5 in which shareholders of Charter Communications, Inc. alleged that they had been defrauded by Charter's issuance of misleading financial statements).

<sup>273</sup> See *supra* notes 107-112 and accompanying text (summarizing the regulation that applies to mutual funds).

<sup>274</sup> See *supra* notes 40-42, 55-59 and accompanying text (discussing disclosure requirements applicable to public offerings and public companies).

<sup>275</sup> See *supra* notes 98-100 and accompanying text (describing the relationship between mutual funds and their investment advisers).

fund's disclosure documents and reports, notwithstanding that the fund, acting through its board of directors, is the nominal source of those documents.<sup>276</sup>

In the event that those documents are false or misleading, a predictable consequence is that, when the fraud is discovered, the fund's shareholders, perhaps having suffered losses, may redeem their shares – and prospective new shareholders will be scarce. Whatever the specific fallout might be, the mutual fund's assets are likely to shrink, as are the fees that the investment adviser receives from the fund, calculated as they are based on the fund's aggregate net assets.<sup>277</sup> That is not all, however. The loss of revenues to the investment adviser (as a result of the shrunken fees) will adversely affect the *adviser's* shareholders, raising the thorny question of what recourse those shareholders might have.<sup>278</sup>

One might think that both groups of shareholders – the fund's and the investment adviser's – could sue the investment adviser under Rule 10b-5, claiming that the adviser defrauded the fund's shareholders, which, in turn, also caused losses to the adviser's shareholders. A supporting contention would presumably be that neither group of shareholders would have bought their respective shares had they known that the relevant statements in the fund's documents were false. The claim would not succeed, however. According to the Supreme Court, because the fraudulent statements were produced by the fund, which is a separate entity from the adviser, there can be no claim that the adviser violated Rule 10b-5.<sup>279</sup> To be sure, the adviser may have assisted with the disclosure, just as a speech writer assists a speech giver, but the adviser did not itself *make* the statements.<sup>280</sup> Only the mutual fund, as the maker of the statements – analogous to the speech *giver* – can be held responsible for them.<sup>281</sup>

With this holding, upstream antifraud doctrine embraces the notion, based in corporate law, that each entity (adviser and mutual fund) is an independent, unattached legal being.<sup>282</sup> In other words, by ignoring the relationships among

---

<sup>276</sup> See *supra* notes 173-174 and accompanying text (detailing the control investment advisers have over the mutual funds they manage).

<sup>277</sup> See Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1023 (2007) ("Since fund management fees are a percentage of fund assets, any redemptions directly reduce the revenues of the fund[s] [investment adviser].").

<sup>278</sup> See, e.g., *Janus Capital Grp. v. First Derivative Traders*, 131 S. Ct. 2296, 2299 (2011) (evaluating whether certain mutual funds' publicly traded investment adviser could be liable to *its* shareholders for false disclosure contained in the mutual funds' prospectuses).

<sup>279</sup> See *id.* at 2304 ("[The adviser] did not 'make' any of the statements in the Janus Investment Fund prospectus; Janus Investment Fund did.").

<sup>280</sup> See *id.* at 2302 ("Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it.").

<sup>281</sup> See *id.* at 2305 (concluding that the mutual funds' investment adviser could not be responsible for the funds' statements).

<sup>282</sup> The reliance of mutual fund regulation on corporate governance principles is buttressed by judicial doctrine that supports and extends that reliance. For example, in

entities in a mutual fund enterprise, the doctrine endorses the upstream side's entity-centrism in a distinctly downstream context. In that context, however, upstream principles are wholly inappropriate, weakening the protections – for both investors and the securities markets more broadly – on which securities regulation is premised.

## 2. Corporate Accountability

While antifraud provisions weave through all of the securities statutes and are as old as the statutes themselves, certain newer provisions are considerably more targeted. These newer rules, though framed as securities regulation, are aimed at preventing the recurrence of particular types of corporate governance failures.<sup>283</sup> Sarbanes-Oxley, in particular, was Congress's response to the collapse of Enron, whose executives had manipulated the firm's financial statements to such an extent that the firm appeared healthy to the outside world until the time it declared bankruptcy.<sup>284</sup> Enron's employees and shareholders, not having been warned of the company's true condition and imminent implosion, suffered overwhelming losses.<sup>285</sup>

Sarbanes-Oxley is securities regulation in that it applies to certain entities by virtue of their status under the securities laws. In particular, it applies to public companies – that is, public reporting companies under Section 12 and Section 15 of the Exchange Act.<sup>286</sup> Among other things, the statute requires that public

---

adjudicating claims brought by a mutual fund's investors on the fund's behalf – so-called derivative claims – courts look to state corporate law to determine the applicable doctrine, such as whether shareholders must first make a “demand” on the board to bring the claim before proceeding themselves, even though demand doctrine under state corporate law typically works to defeat derivative claims, and even though the Supreme Court in *Burks v. Lasker*, 441 U.S. 471, 479 (1979), expressly held that, in deciding mutual fund-related claims, courts should not apply state corporate law if doing so would counter the Investment Company Act's investor protection objectives. *See Investment Company as Instrument*, *supra* note 82, at 296.

<sup>283</sup> *See, e.g.,* Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 949-50 (2013) (observing that Sarbanes-Oxley and Dodd-Frank “reacted to the corporate governance crises of Enron and the Great Recession respectively”).

<sup>284</sup> *See* Kurt Eichenwald & Diana B. Henriques, *Enron's Many Strands: The Company Unravels*, N.Y. TIMES, Feb. 10, 2002, *archived at* <http://perma.cc/R6LL-HYM6>.

<sup>285</sup> *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE SEN. COMM. OF GOVERNMENTAL AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (Comm. Print 2002), *archived at* <http://perma.cc/7VVQ-4DTF> (observing that “[t]housands of Enron employees lost not only their jobs but a significant part of their retirement savings” and that “Enron shareholders saw the value of their investments plummet”).

<sup>286</sup> *See* Gregory C. Keating, *Responding to and Preventing Whistleblower and Retaliation Claims* (ALI-ABA Continuing Legal Education, July 26-28, 2012), SU004 ALI-ABA 1191, 1273 (“[Sarbanes-Oxley]’s civil provisions apply to all companies with a class of securities registered under section 12 of the [Exchange Act] and any company required to file reports under section 15(d) of the [Exchange Act] (*i.e.*, public companies.)”); *supra*

companies' audit committees be comprised of independent directors<sup>287</sup> and that the companies' officers certify the companies' periodic financial statements<sup>288</sup> and prohibits certain kinds of conflict-of-interest transactions.<sup>289</sup> Put another way, Sarbanes-Oxley mandates that firms adhere to particular procedures in carrying out certain corporate governance functions that, prior to its enactment, were largely a matter of private ordering, default rules under state corporate codes, and, to some extent, "best practices."<sup>290</sup> However, Sarbanes-Oxley pursues its objectives less in the name of corporate governance than toward the end of promoting the integrity of the securities markets and protecting securities investors.<sup>291</sup> Moreover, by virtue of its centering on public issuers of all varieties, Sarbanes-Oxley may be thought to be within the stable of upstream laws and rules.

As previously noted, however, upstream laws and rules are relevant to issuers downstream, to the extent that those issuers are public companies.<sup>292</sup> In that regard, mutual funds most readily come to mind, given that, by definition, each mutual fund is publicly offered and held.<sup>293</sup> Accordingly, just as

---

notes 55-59 and accompanying text (summarizing public reporting status under the Exchange Act).

<sup>287</sup> 15 U.S.C. § 78j-1(m)(3) (2012).

<sup>288</sup> *Id.* § 7241; see Sale, *supra* note 147, at 1021 n.49 ("Sarbanes-Oxley requires that a public company's audit committee members are independent, and that CEOs and CFOs must certify that they have reviewed financial reports and the reports do not contain untrue material facts.").

<sup>289</sup> 15 U.S.C. § 78m.

<sup>290</sup> See Sale, *supra* note 147, at 1023 ("Sarbanes-Oxley replaces private ordering with legal rules.").

<sup>291</sup> See Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 103 (2009) (explaining that Sarbanes-Oxley reflects Congress's use of "federal securities regulation to enact laws that intrude into subjects traditionally seen to be within state corporation law").

<sup>292</sup> See *supra* notes 29-30, 273 and accompanying text (explaining that upstream regulation applies also to certain financial services providers).

<sup>293</sup> See Note, *Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control*, 83 YALE L.J. 1475, 1475 n.5 (1974) ("Mutual funds are publicly held corporations . . ."). To be sure, other downstream issuers may be public as well. The Blackstone Group and Fortress Investment Group are examples of public investment advisers. See Houtman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 276 (2008) ("Fortress Investment Group . . . was the first U.S.-listed alternative asset management company to go public . . ."); Marguerite Racher Snyder, *Recasting Carried Interest: An Examination of Recent Tax Reform Proposals*, 84 IND. L.J. 1449, 1469-72 (2009) (discussing how "alternative asset manager Blackstone" structured its IPO). Yet those other instances have tended to be exceptions. Consistent with the fact that most companies are privately owned, most broker-dealers and investment advisers are privately held – owned, either directly or through a parent company, by a relatively small group of founding entrepreneurs. See, e.g.,

Microsoft's directors must comply with Sarbanes-Oxley's requirements regarding terminating the firm's auditors, so must mutual funds' directors.<sup>294</sup> Whether that result is sensible and efficient given the context in which Sarbanes-Oxley was formulated and the goals it seeks to achieve and whether Congress intended for mutual funds to fall within the full range of Sarbanes-Oxley's provisions are obvious questions. Also worth questioning is whether Congress sufficiently considered the ways in which downstream public companies differ from those upstream – whether it understood the ways in which a financial services firm, which comprises multiple entities that, together, constitute a single enterprise, differ from operating companies.

A recent Supreme Court case is illustrative. The plaintiffs in *Lawson v. FMR LLC*<sup>295</sup> had challenged their respective terminations by their employers, FMR or certain of its affiliates, which operated numerous mutual funds.<sup>296</sup> Plaintiff Lawson complained that she was terminated in retaliation for her reporting to the SEC and other regulators FMR's allegedly fraudulent practices in calculating the operating expenses to be borne by the mutual funds. Because the fees that FMR charged the funds were for inflated amounts, the funds paid more than they actually owed, at the ultimate expense of the funds' shareholders.<sup>297</sup> In their claims, the plaintiffs relied on Section 1514A of Sarbanes-Oxley, which protects certain employees against discharge, suspension, harassment, or discrimination in the terms and conditions of employment by a public company or "any officer, employee, contractor, subcontractor, or agent of such company."<sup>298</sup>

The question to be answered by the Supreme Court: Whose employees does Section 1514A protect?<sup>299</sup> Certainly if a public company itself has retaliated

---

David W. Case, *Corporate Environmental Reporting as Informational Regulation*, 76 U. COLO. L. REV. 379, 412 & n.199 (2005) ("[P]ublic companies are an extremely small percentage of the vast number of companies in the United States." (citing 1 WARD'S BUSINESS DIRECTORY OF U.S. PRIVATE AND PUBLIC COMPANIES, at vii (46th ed. 2003))).

<sup>294</sup> See Philip H. Newman, *Boards of Directors of Registered Investment Companies* (ALI-ABA Continuing Legal Education, Oct. 28-29, 2013), SV009 ALI-ABA 259, 288-89 ("[M]any provisions of the Sarbanes-Oxley Act and related SEC rulemaking also apply to registered investment companies.").

<sup>295</sup> 134 S. Ct. 1158, 1161 (2014).

<sup>296</sup> See *Lawson v. FMR LLC*, 670 F.3d 61, 63 (1st Cir. 2012) ("[P]laintiffs are suing their former employers, which are private companies that provide advising or management services by contract to the Fidelity family of mutual funds.").

<sup>297</sup> See Petition for Writ of Certiorari 4, *Lawson*, 134 S. Ct. 1158 (No. 12-3) [hereinafter Certiorari Petition]. The other plaintiff, Jonathan Zang, alleged that he was terminated based on his objections to misleading statements contained in information that FMR had planned to file with the SEC concerning portfolio manager compensation. See *id.* at 5-6. Zang had also raised objections to FMR's collection of fees for managing certain Fidelity funds that, as "unmanaged index funds," did not require active portfolio management. See *id.* at 6.

<sup>298</sup> 18 U.S.C. § 1514A (2012).

<sup>299</sup> As stated in the plaintiffs' petition to the Supreme Court for certiorari: "The question

against one of its employees for whistleblowing activity, Section 1514A would protect that employee.<sup>300</sup> However, what if a (privately held) *contractor* of a public company discharged one of its own employees in response to the employee's acting as a whistleblower regarding harms to the public company's shareholders?<sup>301</sup> Although the statute is specific in articulating who may not retaliate, it does not answer the question of who is protected, instead referring to the beneficiaries of its protections – “employees” – without modifiers or further elaboration.<sup>302</sup>

The United States Court of Appeals for the First Circuit, focusing on the fact that Sarbanes-Oxley was enacted to address particular concerns associated with public companies, determined that the statute protects only public companies' employees, not employees of a public company's agents and contractors, such as the investment adviser of a mutual fund.<sup>303</sup> Focusing on context, however, produces just as compelling an argument on the other side: Enron's misdeeds were known (and obscured) not only by Enron's own employees but also by employees of Enron's contractors.<sup>304</sup> Arthur Andersen, Enron's auditor, readily comes to mind in that regard.<sup>305</sup> Moreover, discharge, threats, suspensions, and discrimination in the terms and conditions of employment – the things against which Section 1514A protects – are types of actions that a company characteristically may take against its own employees, not against the employees of a company for which it is a contractor.<sup>306</sup>

Although a divided Supreme Court sided with the plaintiffs,<sup>307</sup> it did so as much on the basis of public policy and fairness considerations as on the text of

---

presented is: Is an employee of a privately-held contractor or subcontractor of a public company protected from retaliation by section 1514A?” Certiorari Petition, *supra* note 297, at i.

<sup>300</sup> That conclusion is fairly evident from the language of Section 1514A, as well as the fact that Sarbanes-Oxley is primarily aimed at public companies. *See supra* note 178 and accompanying text (describing Sarbanes-Oxley's requirements and objectives).

<sup>301</sup> *See supra* note 299.

<sup>302</sup> *See* 18 U.S.C. § 1514A (prohibiting public companies, mutual funds, and “any contractor . . . [or] subcontractor . . . of such company [from] . . . discriminat[ing] against an employee in the terms and conditions of employment because of” the employee's engagement in certain specified activities).

<sup>303</sup> *See* Lawson v. FMR LLC, 670 F.3d 61, 61 (1st Cir. 2012) (“[T]he term ‘employee,’ within the meaning of [Sarbanes-Oxley]’s whistleblower protection provision, include[s] only employees of the defined public companies.”).

<sup>304</sup> *See* Certiorari Petition, *supra* note 297, at 8-13 (describing Congress's concern, in enacting Sarbanes-Oxley, with the ways in which auditors and other contractors knew about or assisted corporate misconduct).

<sup>305</sup> *See id.* at 8 (observing that Arthur Andersen had assisted with Enron's accounting “tricks”).

<sup>306</sup> *See id.* at 150a (“[R]arely would a contractor . . . be able to adversely affect the terms and conditions of an individual's employment with a publicly traded company . . .”).

<sup>307</sup> *See* Lawson v. FMR LLC, 134 S. Ct. 1158, 1176 (2014) (“[W]e hold that . . . § 1514A

the statute<sup>308</sup> – which, according to Justice Sotomayor writing for the dissent, just as easily permitted an interpretation favoring defendants.<sup>309</sup> Regardless of the ultimate holding, the fact that the interpretive question not only arose but also produced strongly contested answers suggests, at the very least, that Congress did not sufficiently consider the unique questions that might arise if the statute were ever called into action on the downstream side of the securities regulatory divide. In other words, they did not adequately consider that, because mutual funds act *only* through their contractors, this special breed of public company could never retaliate against its own employees, for it has none. Such are the anomalies that arise, however, when primarily upstream regulation is applied downstream.

#### IV. IMPLICATIONS

Not only is securities regulation charged with two different tasks, but also, as Part III shows, the differences between those tasks matter. The next step is to use this insight to formulate better regulation, both upstream and downstream. There is no one appropriate remedy, however, given that, as Part III also points out, two distinct types of problems hinder regulatory efficacy. One difficulty with downstream regulation is that at least some laws and rules rely on principles associated with the upstream side: they are entity-centric and are based on norms of corporate governance.<sup>310</sup> A second problem – one associated with upstream regulation – is that certain laws and rules that were formulated primarily to address upstream challenges “slosh” over, as it were, to downstream contexts, without adequate recognition of the differences between downstream and upstream subjects.<sup>311</sup> This Part focuses on moving forward on both fronts, with Part IV.A discussing upstream regulatory reform and Part IV.B turning to downstream regulatory reform.

##### A. *Upstream Reform*

Overcoming the limitations of upstream regulation may seem an impossible task. To begin with, upstream regulation is old – Section 10(b), for example, was part of the original Exchange Act – and seemingly set in its ways. In addition, in recent years, policymakers have firmly embraced regulatory

---

whistleblower protection extends to employees of contractors and subcontractors.”).

<sup>308</sup> See, e.g., *id.* at 1172 (“[A]ffording whistleblower protection to mutual fund investment advisers is crucial to Sarbanes-Oxley’s endeavor to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.” (internal citations omitted)).

<sup>309</sup> See *id.* at 1178 (Sotomayor, J., dissenting) (observing that “§ 1514A is deeply ambiguous” and arguing in favor of a narrow interpretation).

<sup>310</sup> See *supra* Part III.A (detailing the ways in which upstream principles have informed downstream regulation).

<sup>311</sup> See *supra* Part III.B (describing how certain upstream laws and rules apply also to downstream regulatory subjects).

approaches that seem inconsistent with the simplicity of disclosure requirements and that, therefore, complicate reform.<sup>312</sup> Finally, there is no discernible delineation of which upstream laws and rules may impact downstream activities and which likely will not. The project should begin, however, with two areas of focus.

First, policymakers should be especially concerned with laws and rules under which persons other than regulators may enforce proscriptions on fraudulent or similarly harmful conduct, for those laws and rules are the components of upstream regulation that have presented the greatest risks downstream. When enforcement responsibilities are placed with regulators, any non-compliant conduct is fair game, regardless of who might be responsible for it or where those persons may be situated. By contrast, when enforcement is placed in the hands of injured parties – shareholders, employees, or others – the narrow, corporate-law-centered approach of many laws and rules means that the “enforcers” may achieve redress only if they are located in exactly the right position in relation to the source or the occurrence of the injury.

The securities statutes’ myriad antifraud provisions, such as Rule 10b-5,<sup>313</sup> and provisions designed to expose (and, therefore, deter) harmful activity, such as Sarbanes-Oxley’s whistleblower protections,<sup>314</sup> exemplify this narrowness. Under many of these rules, recovery may be had only if the person harmed was a shareholder of the entity that formally made the disclosure or an employee of the entity that is a public company (or was otherwise properly situated in relation to a particular entity) – never mind that each such entity is but one component of a larger, multi-entity financial services enterprise.<sup>315</sup> Neither Rule 10b-5 nor Rule 1514A, for example, acknowledges that a fund and its investment adviser – separate entities – are of apiece, constituting a single firm in which the adviser fills the role of “management,”<sup>316</sup> or that harmed parties’ relationship to the harm may be more complex than what is the case in the generic upstream world of discrete entities with discrete shareholders.

Accordingly, in formulating any such law or rule, policymakers should consider whether the law or rule should be applied in downstream contexts. Should a rule pertaining to public companies apply also to mutual funds? Should a new law affecting the management of both private and public firms also capture hedge funds? If the answer is “yes,” then policymakers should not

---

<sup>312</sup> See *supra* note 147 and accompanying text (describing Sarbanes-Oxley and aspects of Dodd-Frank).

<sup>313</sup> 17 C.F.R. § 240.10b-5 (2013).

<sup>314</sup> 18 U.S.C. § 1514A (2012).

<sup>315</sup> As Part III.B explains, Rule 10b-5 applies to investment advisers and mutual funds, whether they be publicly held or not, and Sarbanes-Oxley’s anti-retaliation provision applies to mutual funds precisely because of their public status.

<sup>316</sup> See *supra* notes 172-174 and accompanying text (describing the relationship between mutual funds and their investment advisers).



only specify that conclusion but also consider the extent to which applying the law or rule in non-traditional circumstances might produce anomalous results. Taking this point to its conclusion, the law or rule could specify how it is to be read or interpreted when applied in downstream contexts or could include provisions specific to downstream subjects, such as ones detailing how the law or rule should be applied to the multi-entity firms that are characteristic of downstream activities. Or, it may be that a wholly separate rule should be formulated for application downstream. Perhaps, in other words, new upstream regulation, insofar as it applies also to downstream subjects, would benefit from additional *complexity*, to avoid being unduly confined to a single entity and the relationships between its owners and managers.<sup>317</sup>

A second, and subsidiary, focus of reform should be those laws and rules that have lost any connection to the regulatory simplicity that comports with upstream regulation. As discussed, statutes such as Sarbanes-Oxley – and, to the extent it seeks to foster corporate accountability, Dodd-Frank – have brought to upstream regulation obligations that may seem to fit more comfortably in state corporate codes.<sup>318</sup> In other words, these statutes seek to supplement state corporate law, thereby improving managerial accountability, not through disclosure requirements but through organizational specifications and other, more substantive obligations. In so doing, they also produce a situation in which complex regulation governs a complex regulatory subject – namely, the issuer. That is troublesome in light of the considerations that Part II.C presents<sup>319</sup> and regardless of whether the issuer is Twitter or the Putnam Capital Spectrum Fund.

Sarbanes-Oxley's whistleblower protection provision, discussed in Part III, is symptomatic of the confusion – confusion over who is protected, who is obligated, and what the statute's objectives are – and the regulatory inefficiency that is prone to arise from the “substantive” mode of regulation. This confusion, moreover, is unique to circumstances in which the regulatory subject is complex, encompassing both those charged with carrying out regulatory obligations (managers) and the beneficiaries of regulation (owners). Traditionally, upstream regulatory requirements did not venture beyond the four corners of that complex subject: managers were required to disclose material information for the benefit of owners. Full stop. The new approaches to regulation, by contrast, involve – obligate and provide protections for – others, including employees and auditors and other contractors and agents. But in what capacity? Which employees are protected? Against whom may contractors not retaliate?

---

<sup>317</sup> See *infra* Part IV.B (discussing downstream regulatory reform).

<sup>318</sup> See *supra* note 147 and accompanying text (explaining that Sarbanes-Oxley and Dodd-Frank use regulatory tools other than disclosure requirements).

<sup>319</sup> See *supra* notes 188-191 and accompanying text (proposing that simple regulation is most appropriate for upstream regulatory subjects).

For the sake of downstream activities and subjects (as well as their upstream counterparts), reform efforts should re-evaluate whether it is optimal to use tools beyond disclosure requirements to do the work of upstream regulation. They should consider whether it makes sense for securities regulation to prohibit relationships and transactions that managers may otherwise reasonably determine are in a mutual fund's (or an operating company's) best interests, however that might be defined. Conversely, they should evaluate whether securities regulation should mandate relationships, controls, or procedures that managers may otherwise reasonably determine do not serve those interests. Given that the new approaches have been a product of crisis policymaking,<sup>320</sup> there is ample reason to be skeptical.

This re-evaluation presumably should also involve examining how and whether fiduciary duties may be strengthened so as to alleviate the concerns that crisis policymaking has sought to address. It is within the purview of state legislatures, after all, to redefine the scope of fiduciary duties. One possible approach might be to require that managers owe fiduciary duties not only to shareholders but also to customers, clients, and consumers. That expansion of fiduciary duties might have prevented the collapse, and resulting harm to both shareholders and customers, of firms like MF Global, whose 2011 bankruptcy ranks among the largest in U.S. history<sup>321</sup> – and which met its fate in part because it had misused funds that its customers had entrusted to it. It might also have aided both shareholders and customers of firms like Lehman Brothers, which overextended itself financially in furtherance of its investment activities,<sup>322</sup> disregarding the ways in which doing so might place customer assets at risk – and shareholders along with them.

#### B. *Downstream Reform*

For its part, reform downstream is challenging because entity-centrism and associated corporate governance principles arise, to the detriment of effective regulation, in a number of ways. There is the circumstance that investment

---

<sup>320</sup> See *supra* notes 283-285 and accompanying text (observing that Sarbanes-Oxley was a policy response to corporate governance crises).

<sup>321</sup> Specifically, MF Global's bankruptcy is the eighth largest in U.S. history. See Alex Howe, *The 11 Largest Bankruptcies in American History*, BUSINESS INSIDER (Nov. 29, 2011, 12:33 PM), archived at <http://perma.cc/AL8P-CT65>. Lehman Brothers' is the largest. *Id.*

<sup>322</sup> See John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1073-74 (2012) (“[F]irms like Lehman failed because of their ill-advised principal investments.”). Indeed, this approach would be particularly useful in the broker-dealer context, as Congress has so far not heeded the call to amend broker-dealer regulation so as to impose client-directed fiduciary duties on broker-dealers. See Laby, *supra* note 117, at 735 (explaining that, in enacting Dodd-Frank, “Congress did not impose a fiduciary obligation” on broker-dealers). Although Congress directed the SEC to study the issue, see *id.* (explaining that Congress instead “handed the baton to the SEC”), as yet, the SEC has not adopted a rule on the issue.

advisers use entities as convenience mechanisms – tools to aggregate a number of investors seeking the advisers’ services. Such is a hedge fund or private equity fund. Then there are mutual funds – public companies that nonetheless are remarkably incomplete, their officer and employee functions carried out by separate entities. Finally, there are broker-dealer enterprises, which might comprise numerous entities, only some of which may be regulated as broker-dealers, or use multiple broker-dealer entities to provide distinct types of services, effectively divvying up among multiple entities services that could be performed by a single broker-dealer.

Because downstream regulation too often becomes fixated on the entity and associated corporate law concepts, it overlooks how the interests it exists to protect – those of investors, customers, clients – may be situated beyond regulation’s focus. Those are the lessons that Part III conveys. Yet because the myriad contexts and circumstances in which these problems arise are very different from one another, there seemingly is no unifying thread, no discrete problem for lawmakers and regulators to tackle and conquer.

Ultimately – and to use a perhaps unorthodox analogy – the best approach is arguably to view downstream policymaking much as one might view a child custody battle. Although all sides have conflicting (and often strong) interests, which differ from case to case, the court’s decision, ultimately, must be guided by the child’s best interests.<sup>323</sup> So should it be with downstream regulation – and, indeed, with forms of financial services regulation outside of the securities realm. Despite the multifaceted nature of financial services and the seemingly innumerable ways in which inapt upstream principles currently inform the regulation of those services, that regulation has one guiding objective: protection of those who use financial services, whether they be dubbed investors, customers, or clients. That objective must become the basis of all policymaking.

Accordingly, if policymakers would have the entity be the beneficiary of all regulatory protections (as is the case under the Advisers Act) rather than the entity’s disparate investors, there is room for improvement. If they would treat as a functioning business enterprise an entity that serves merely a facilitating purpose and that is under the control of a separate and unaffiliated entity (as does the Investment Company Act), they lack a complete understanding of securities regulation and, more precisely, that it need not be based on corporate governance norms. If they would base customer protections on entity formalisms and boundaries (as SIPA has done) rather than on a comprehensive view of a firm’s activities, they are placing customers at risk.

The translation of these considerations into policy could take a number of forms. Beginning with investment adviser regulation, one approach might be for the Advisers Act to specify that, in circumstances in which an adviser

---

<sup>323</sup> See Kerry Abrams, *Citizen Spouse*, 101 CAL. L. REV. 407, 437 n.168 (2013) (noting that most states “use[] a ‘best interest of the child’ standard in adjudicating child custody in child custody cases”).

manages a hedge fund or other private fund, the fund's investors are to be deemed the advisory client for at least some purposes.<sup>324</sup> As for mutual fund regulation, boards of directors' regulatory responsibilities – as well as their traditional oversight functions – could, instead, be placed primarily with mutual funds' investment advisers, based on the recognition that advisers are the control centers for funds' operations and activities. Accordingly, although boards would continue to exist for purposes of carrying out certain corporate governance functions – a fund is typically a corporation, after all – the funds' advisers would be the locus of most regulatory obligations.

Finally, on the broker-dealer front, regulation could more explicitly reflect the reality that the entities that are broker-dealers typically operate in conjunction with other, affiliated entities – and that customer assets may, for various reasons, be held by entities other than those that should hold them. It could, put another way, specify that customer protection obligations belong to the enterprise as a whole, not just to the entity that happens to be regulated as a broker-dealer. Because many broker-dealers or their parent companies are publicly held, such an approach might produce the added benefit of augmenting shareholder value.

At the end of the day, success with reform is a matter of being vigilant about the varied indicators of upstream principles that appear in disparate financial services contexts. It is also a matter of identifying the placement of those who need securities regulatory protections vis-à-vis the discrete entities that are but components of financial services firms. The challenge of formulating more effective regulation is formidable, to be sure, but it is dramatically aided by a heightened awareness of the vulnerabilities of downstream regulation, such as those described in Part III.

It is aided additionally by an awareness of the possibility of complexity in regulation, the prospect of drawing upon a range of regulatory approaches beyond disclosure requirements. Of course, downstream regulation presently uses both disclosure requirements and tools beyond them, such as consent requirements in the investment adviser context and operational rules in the broker-dealer context.<sup>325</sup> As we have seen, however, many existing rules fail to reflect a connection to downstream regulatory objectives and, in particular, the objective of preventing the harm that may arise from financial services providers' acting in their own interests rather than in their clients' interests. Reform should seek to establish that connection, using whatever tools and encompassing whatever obligations may be relevant, regardless how

---

<sup>324</sup> For example, the statute (or the SEC's rules) might require that, if the adviser desires to cause the fund to enter into a securities transaction as to which the adviser is conflicted, the adviser must first obtain the consent of the fund's investors, as opposed to the fund's consent. Investors that object to the transaction could have a specified remedy, such as a right to withdraw from the fund beforehand.

<sup>325</sup> See *supra* notes 88-92 and 127-129 and accompanying text (describing particular regulatory requirements in each of these contexts).

complicated (or not) the ultimate product may be. Clearly, considerable work awaits, both for policymakers and informed observers.

#### CONCLUSION

The past few years have shown that creating effective securities regulation is an ongoing challenge in the United States. The financial crisis produced stories of broker-dealers and investment advisers (not to mention banks, mortgage issuers, and credit rating agencies) acting in their own interests, to the detriment of their clients' and customers' interests, and stories of public companies, both of the investment and the operating varieties, providing misleading information to shareholders. Moreover, the regulatory "fixes" that emerged in the aftermath of the crisis to address regulatory weaknesses leave yawning gaps because policymakers have not, to date, fully grasped the complete nature of those weaknesses. That is, they have not understood this Article's contention that different components of the securities laws do different things and that the regulatory subjects that the securities laws cover need to be regulated in different ways, depending on whether they are situated upstream or downstream. They have not recognized that securities regulation should not be viewed exclusively as a body of disclosure requirements aimed at public issuers.

To be sure, public companies are critical to most everyone. One way or another, they make up a substantial portion of most investors' securities portfolios.<sup>326</sup> Less obviously, however, the modifier "one way or another" is also a critical aspect of today's investing. Instead of buying securities of particular companies that they have carefully researched or in which they otherwise have confidence, most investors instead buy shares of mutual funds that, in turn, invest in securities, based on the research and investment strategies of the funds' investment advisers.<sup>327</sup> Other, "accredited" investors pursue their investment activities also, or instead, through holding interests in hedge funds and private equity funds.<sup>328</sup> Still others place assets in separately

---

<sup>326</sup> To be sure, for retail investors at least, the relevant "public companies" are mutual funds, see Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 780 (2013) ("Retail investors today hold equity largely through intermediaries such as pension funds and mutual funds."), rather than operating companies, see Jennifer O'Hare, *Retail Investor Remedies Under Rule 10b-5*, 76 U. CIN. L. REV. 521, 525 (2008) ("[T]he portfolios of retail investors indicate that they own stock in only a small number of public [operating] companies.").

<sup>327</sup> See Fisch, *supra* note 326, at 780 (observing that retail investors "hold equity largely through intermediaries such as pension funds and mutual funds").

<sup>328</sup> See Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3399 (2013) ("Just as retail investors often join forces by investing in mutual funds, accredited investors can pool capital with their fellows in VC funds, private equity funds, and hedge funds.").

managed accounts, to be managed by investment advisers of their choosing.<sup>329</sup> If the demand for securities investing is robust, as it seems to be, then so is the demand for securities-related financial services.

Securities regulation should be viewed both as the regulation of (public) issuers and as the regulation of those who facilitate securities transactions. That dichotomy, moreover, is considerably more than a distinction of subject matter. It is also a distinction of function and of the foundational principles that underlie function. Regulation of issuers is fundamentally regulation of an entity and its constituent relationships – the relationships among its owners and managers, in other words. It is also supplemental to the rules and norms of corporate law, which likewise govern those relationships and, most importantly, provide for managers' fiduciary duties to owners. By contrast, regulation of facilitators – financial services providers – need not center on the entity nor must it play a supporting role to any other bodies of doctrine.

Those observations have meaningful regulatory implications, in that they inform what regulatory tools may be most appropriate for any given regulatory context. In addition, they allow us to discern instances in which regulation has gotten off track. It has gotten off track when policymakers have based downstream laws and rules on upstream principles and when they have insufficiently considered the consequences of applying upstream rules to downstream circumstances. This state of affairs is intensely problematic because laws and rules founded on principles incongruent to their function defeat their own objectives. Diverse examples show how this is so. To prevent future regulatory failings, whether of the corporate governance kind or of the financial services kind, and to effectively overcome regulatory failings that might come to fruition, we – policymakers, scholars, observers – must heed the lessons of those examples.

---

<sup>329</sup> See Salisbury, *supra* note 239 (describing separately managed account arrangements).