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SHOULD INVESTMENT COMPANIES BE SUBJECT TO A NEW STATUTORY SELF-REGULATORY ORGANIZATION?

JOEL SELIGMAN*

I. BACKGROUND

Four developments have focused attention on whether investment companies registered with the Securities and Exchange Commission (“SEC” or “Commission”) under the Investment Company Act of 1940¹ (“The Investment Company Act”) should be subject to a new statutory self-regulatory organization (“SRO”).²

First, the SEC has periodically proven inadequate to inspect and discipline investment companies. This is both a matter of resources and priorities. In 2003, for example, there were 8126 mutual funds with total assets of \$7.414 trillion.³ SEC inspection of investment companies has long been astonishingly infrequent. According to the GAO, before 1998, each mutual fund was inspected an average of once every twelve to twenty-four years.⁴ The problem is not one merely of resources. Investment companies typically hold portfolios of securities that diversify firm-specific risk. In part because of this, investment companies have rarely been an enforcement priority for the SEC.

Second, the perennially inadequate SEC oversight was followed by a significant number of mutual fund trading or sales practice scandals, beginning in 2003.⁵ Much attention has focused on late trading⁶ and

* President, University of Rochester; Dean and Ethan A. H. Shepley Professor, Washington University in St. Louis (1999–2005); in January 2004 the author was elected to the NASD Board of Governors. Let me thank Robert Glauber, Chairman and CEO, NASD, and Mary Schapiro, Chairman and CEO-elect, NASD, for their thoughtful comments on an earlier draft.

1. 15 U.S.C. §§ 80a-1 to -52 (2000).

2. Elsewhere I have reviewed stock market self-regulation. See Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347 (2004).

3. Inv. Co. Inst., Mutual Fund Fact Book at 1, 13 (2003).

4. GEN. ACCOUNTING OFFICE, SEC OPERATIONS: OVERSIGHT OF MUTUAL FUND INDUSTRY PRESENTS MANAGEMENT CHALLENGES 4 (2004), <http://www.gao.gov/new.items/d04584t.pdf> (testimony before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives).

5. See generally LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 116–24 (3d ed. Supp. 2005).

6. In 2003, Eliot Spitzer, the New York Attorney General, settled *New York v. Canary Capital Partners, LLC*, in which a hedge fund agreed to pay \$40 million after civil allegations were filed

market timing,⁷ but the problems are broader, involving other areas such as variable products,⁸ the independence of mutual fund governance,⁹ soft dollars and directed brokerage,¹⁰ volume discount breakpoints,¹¹ portfolio

alleging an unlawful trading scheme involving several leading mutual funds. *N.Y. A.G. Launches Probe of Fund Industry; Hedge Fund Pays \$40M to Resolve Claims*, 35 Sec. Reg. & L. Rep. (BNA) 1505 (Sept. 15, 2003). See also Steven B. Markovitz, Securities Act Release No. 8298, Exchange Act Release No. 48,588, Investment Company Act Release No. 26,201, 81 SEC Docket 450 (Oct. 2, 2003) (SEC consent settlement with Millennium Partners, L.P. hedge fund trader who engaged in late trading); SEC v. PIMCO Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454 (S.D.N.Y. 2004) (pretrial motions to dismiss denied in part and granted in part in SEC cases under Investment Company Act against mutual fund executives for market timing).

7. Chairman Donaldson testified to a House hearing in late October 2003 that market timing and late trading abuses by mutual funds were “quite widespread . . . more widespread than we originally anticipated.” *Donaldson Says Improper Trading in Mutual Funds “Quite Widespread,”* 35 Sec. Reg. & L. Rep. (BNA) 1806 (Nov. 3, 2003).

In March 2004 the Commission settled the largest market timing and late trading case to that date with Bank of America and two FleetBoston Financial Corporation subsidiaries. The settlement aggregated \$675 million in a combination of disgorgement and civil penalties. *BOA, FleetBoston Agree on \$675 Million to Resolve SEC, N.Y. Charges over Abuses*, 36 Sec. Reg. & L. Rep. (BNA) 513 (Mar. 22, 2004). See also *Putnam to Pay \$110M to Resolve Charges Its Employees Engaged in Market Timing*, 36 Sec. Reg. & L. Rep. (BNA) 663 (Apr. 12, 2004).

8. See, e.g., OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC. & EXCH. COMM’N, JOINT SEC/NASD REPORT ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS (2004), <http://www.sec.gov/news/studies/secnasdrip.htm>; Cynthia Glassman, Comm’r, Sec. & Exch. Comm’n, Remarks Before the National Association for Variable Annuities (June 14, 2004), <http://www.sec.gov/news/speech/spch061404cag.htm>. In her remarks, Commissioner Glassman stated:

Among other things, the examinations revealed:

- lack of adequate suitability determinations;
- lack of adequate written policies and procedures;
- inadequate supervision and training;
- lack of adequate disclosure; and
- deficient books and records.

Lack of suitability determinations is particularly troublesome. In customer complaints received by the Commission and NASD, investors have indicated that they did not understand the variable product when it was sold to them, and have expressed concerns that the product was not appropriate, or suitable, for them, given their investment objectives.

Id.

9. See, e.g., *SEC Looking Closely at Role Played by Independent Directors in Fund Scandal*, 36 Sec. Reg. & L. Rep. (BNA) 49 (Jan. 12, 2004); *SEC Unanimously Proposes Requirements for Independent Fund Chair, Supermajority*, 36 Sec. Reg. & L. Rep. (BNA) 94 (Jan. 19, 2004).

10. See, e.g., Paul Royce, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm’n, Remarks Before the National Association for Variable Annuities (June 14, 2004), <http://www.sec.gov/news/speech/spch061404pfr.htm>.

11. See, e.g., NAT’L ASS’N OF SEC. DEALERS, REPORT OF THE JOINT NASD/INDUSTRY TASK FORCE ON BREAKPOINTS (2003). See also UBS Fin. Servs. Inc., Securities Act Release No. 8377, Exchange Act Release No. 49,236, 82 SEC Docket 414 (Feb. 12, 2004) (same); Raymond James Fin. Servs., Inc., Securities Act Release No. 8374, Exchange Act Release No. 49,234, 82 SEC Docket 409 (Feb. 12, 2004) (same); Legg Mason Wood Walker, Inc., Securities Act Release No. 8368, Exchange Act Release No. 49,230, 82 SEC Docket 399 (Feb. 12, 2004) (same); Am. Express Fin. Advisors Inc., Securities Act Release No. 8365, Exchange Act Release No. 49,227, 82 SEC Docket 394 (Feb. 12,

manager conflicts of interest and compensation arrangements,¹² and revenue sharing with broker-dealers.¹³

Third, in 2004, the SEC published a detailed rule proposal and a separate Concept Release,¹⁴ highlighting the need for more independent stock market governance given the systematic weaknesses in the effectiveness of stock market SRO regulatory programs, particularly in light of the inherent “conflict of interest that exists when an organization both serves the commercial interests of and regulates its members or users.”¹⁵

To ensure fair administration of stock market SRO governance, the Commission proposed a new Rule 6a-5, applicable to national securities exchanges, and an identical new Rule 15Aa-3, applicable to registered securities associations. The proposals noted: “Among other provisions, the proposed rules would require an exchange’s or association’s governing board to be composed of a majority of independent directors, with key board committees to be composed solely of independent directors.”¹⁶

2004) (cease and desist order and civil order regarding breakpoints); *15 Firms to Pay \$21.5M, Resolving SEC, NASD Charges over Breakpoints*, 36 Sec. Reg. & L. Rep. (BNA) 329 (Feb. 23, 2004).

12. In 2004, the Commission adopted amendments to Forms N-1A, N-2, N-3, and N-CSR to identify portfolio team managers, disclose potential conflicts of interest, and disclose the portfolio manager compensation structure and securities ownership. Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Securities Act Release No. 8458, Exchange Act Release No. 50,227, Investment Company Act Release No. 26, 533, 83 SEC Docket 1802 (Aug. 23, 2004) (adoption); Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Securities Act Release No. 8396, Exchange Act Release No. 49,398, Investment Company Act Release No. 26,383, 82 SEC Docket 1149 (Mar. 11, 2004) (proposal).

13. See, e.g., *Edward D. Jones & Co., L.P.*, Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1798 (Dec. 22, 2004) (cease and desist order and civil order regarding undisclosed revenue sharing arrangements with six mutual fund families and with investment representatives who promoted the “preferred families”); *Calif. AG Sues Edward D. Jones over “Shelf Space” Deals with Funds*, 37 Sec. Reg. & L. Rep. (BNA) 20 (Jan. 3, 2005); *Edward Jones to Pay \$75M to Avoid Charges in Deferred Compensation Deal*, 37 Sec. Reg. & L. Rep. (BNA) 7 (Jan. 3, 2005).

14. Exchange Act Release No. 50,699, 84 SEC Docket 444 (Nov. 18, 2004) (rule proposals); Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 84 SEC Docket 619 (Nov. 18, 2004).

15. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 84 SEC Docket 619, 620 (Nov. 18, 2004).

16. Exchange Act Release No. 50,699, 84 SEC Docket 444, 455 (Nov. 18, 2004).

Following the models of the new NYSE and Nasdaq listing requirements and the recent NYSE governance changes, the Commission proposed that each covered exchange and covered association, at a minimum, have five Standing Committees of independent directors: Nominating, Governance, Compensation, Audit, and Regulatory Oversight. *Id.* at 463.

Each Standing Committee was proposed to have the authority to direct and supervise any matter within the scope of its duties and to obtain advice and assistance from independent legal counsel and other advisors as it deems necessary. *Id.* at 464.

While the SEC did not propose to separate the SRO board chair and CEO, it did propose a more far-reaching separation of regulatory and market operations. Under proposed Rules 6a-5(n) and 15Aa-3(n), each covered securities exchange or covered association would be required to establish policies and procedures to assure the independence of its regulatory program from its market operations and other commercial interests.¹⁷ This could either be done by (1) structurally separating market operations from market regulation and other commercial interest by means of separate legal entities or (2) functional separation within the same legal entity.¹⁸ In either case, the proposed rules would require that the board appoint a Chief Regulatory Officer to administer the regulatory program and that the Chief Regulatory Officer report directly to the Regulatory Oversight Committee.¹⁹

Fourth, and considerably more far-reaching as a statutory self-regulatory model, was the enactment of the Sarbanes-Oxley Act of 2002, which addresses public accountant self-regulation.²⁰

The Public Company Accounting Oversight Board (“PCAOB”) was a response to a disciplinary breakdown in self-regulation in the auditing profession.²¹ Several features of the PCAOB are different from stock market self-regulation historically.

The PCAOB, unlike the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers (“NASD”), is more fully separate from the industry it regulates. Board members, for example, are selected by the SEC.²²

The PCAOB provides a single private regulator for the entire industry it regulates, not a stock-market-specific SRO like the NYSE.²³

The budget for the PCAOB is not directly susceptible to limitation by those the Board regulates, but instead is established by the Board subject to SEC approval.²⁴

The creation of the PCAOB occurred simultaneously with a restructuring of the standards applicable to auditors such as those that address conflicts of interest. Public accounting governance, in essence,

17. *Id.* at 468.

18. *Id.*

19. *Id.* at 469.

20. See generally Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

21. *Id.* at 477–82.

22. *Id.* at 483.

23. *Id.* at 482–84.

24. *Id.* at 489.

was adopted concomitant with the laws applicable to public accounting firms.²⁵

II. WHAT IS STATUTORY SELF-REGULATION?

One of the most significant concepts in federal securities regulation is statutory securities of industry self-regulation.²⁶ As articulated during the New Deal chairmanships of Landis, Douglas, and Frank, the necessity for self-regulation subject to SEC supervision stemmed primarily from two bases: first, the impracticality of direct SEC regulation of the several thousand broker-dealers and business corporations subject to its jurisdiction, and second, a preference for business, with its greater practical knowledge of its own affairs, to participate in the development and application of SEC rules and reduce the likelihood of unnecessary disruption or inefficiency.²⁷

Far from being a panacea, statutory self-regulation subject to SEC supervision generally has been effective in major applications only when the Commission has been willing to threaten or actually use its regulatory authority to create incentives for securities industry self-regulation.²⁸

As a 1973 report of the Senate Subcommittee on Securities aptly stated:

25. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 737–41 (Aspen Pub. 3d ed. 2003).

26. *Id.* at 439.

27. *Id.* at 439. *See also* Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 84 SEC Docket 619 (Nov. 18, 2004).

Self-regulation is a key component of U.S. securities industry regulation. All broker-dealers are required to be members of a self-regulatory organization (“SRO”), which sets standards, conducts examinations, and enforces rules regarding its members. Most, but not all, SROs also operate and regulate markets or clearing services. Inherent in self-regulation is the conflict of interest that exists when an organization both serves the commercial interests of and regulates its members or users.

The Securities Exchange Act of 1934 (“Exchange Act”), the Maloney Act of 1938 (“Maloney Act”), and the Exchange Act Amendments of 1975 (“1975 Amendments”), reflect Congress’ determination to rely on self-regulation as a fundamental component of U.S. market and broker-dealer regulation, despite this inherent conflict of interest. Congress favored self-regulation for a variety of reasons. A key reason was that the cost of effectively regulating the inner-workings of the securities industry at the federal level was viewed as cost prohibitive and inefficient. In addition, the complexity of securities trading practices made it desirable for SRO regulatory staff to be intimately involved with SRO rulemaking and enforcement. Moreover, the SROs could set standards that exceeded those imposed by the Commission, such as just and equitable principles of trade and detailed proscriptive business conduct standards. In short, Congress determined that the securities industry self-regulatory system would provide a workable balance between federal and industry regulation.

Id. at 620 (footnotes omitted). *But cf. id.* at 623–48 (discussing current challenges facing SROs).

28. SELIGMAN, *supra* note 25, at 439–40.

The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.²⁹

It is worth stressing that statutory self-regulation is a different concept than industry self-regulation. Under the federal securities laws, each self-regulatory organization is subject to SEC oversight and minimum statutory and regulatory requirements. This is strikingly different from an industry regulating itself.

The practical advantages of statutory self-regulation have long been viewed as outweighing the potential dysfunction caused by conflicts of interest. First implemented with stock markets in 1934,³⁰ statutory self-regulation has been extended to securities associations in 1938,³¹ securities account protection through the Securities Investor Protection Corporation in 1970,³² municipal securities in 1975,³³ public accountants (including both auditing-and accounting-standards-setting) in 2002,³⁴ and, more recently, the National Futures Association was created for the limited purpose of regulating futures products registered with the SEC.³⁵

III. WHAT FORM OF STATUTORY SELF-REGULATION SHOULD APPLY TO INVESTMENT COMPANIES?

There is no specialized SRO such as the PCAOB that currently applies to investment companies, although the NASD performs a limited role.³⁶ A

29. *Id.* at 440 (quoting Securities Industry Study, Report of the S. Subcomm. on Securities, S. Doc. No. 93-13, 93d Congress, 1st Session (1973), p.145).

30. Seligman, *supra* note 2, at 1349-52.

31. *Id.* at 1352-54, 1361-62.

32. See 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3288-310 (3d ed. rev'd 2003).

33. See 6 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3103.34-42 (3d ed. rev'd 2002).

34. See Seligman, *supra* note 20, at 482-99. Accounting-standard-setting had earlier been conducted by SROs such as the Financial Accounting Standards Board without detailed SEC statutory authority. See 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 733-51 (3d ed. rev'd 1999).

35. See National Futures Association, <http://www.nfa.futures.org/aboutnfa/indexAbout.asp>.

36. For example, the NASD requires its members to file investment company advertisements and

case can be made that the NASD's limited supervision combined with SEC oversight is sufficient. Notably, SEC oversight of investment companies has been enhanced. Since 2002 the Commission has dramatically increased the size of the Division of Investment Management, Division of Enforcement, and Office of Compliance, Inspections, and Examination (OCIE),³⁷ adopted or proposed several new Investment

sales literature within ten days of first use in publication, *see* NASD Rule 2210(c) (CCH Nov. 2003), and generally oversees member sales practice with respect to investment companies.

The Commission had previously considered creating an investment advisers SRO. Then SEC Chair Richard Breeden testified in 1992:

Another proposal that has been made in the past would be to create an SRO in this area. That's certainly a possibility. When the Commission proposed that a couple of years ago, there was a great deal of objection received from a number of groups in the public, and frankly, we believe it would be much more expensive than conducting examinations through the SEC.

SEC Oversight of Investment Advisers: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., and Urban Affairs, 102d Cong. 26 (1992) (statement of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission). An investment advisers SRO is different from the proposal in this article.

In 2003, Professor Mercer Bullard proposed a Mutual Fund Oversight Board in Congressional testimony. *Mutual Funds: Who's Looking out for Investors?: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 157-58 (2003) (statement of Mercer E. Bullard, Founder and President, Fund Democracy, Inc.).

37. *See* GEN. ACCOUNTING OFFICE, *supra* note 4, at 9, the GAO testified:

To address the mutual fund scandals, [the] SEC has plans to substantially increase the staffing in the units responsible for mutual fund oversight. As shown in table 1, between 2002 and 2005, [the] SEC plans to increase the staffing for OCIE and the Division of Enforcement by 46 and 30 percent, respectively. [The] SEC also plans to increase the staffing within the Division of Investment Management by 16 percent. [The] SEC staff told us that many of the new personnel will be working on mutual fund issues.

Table 1: Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, at Fiscal Year End

SEC Unit	Actual 2002	Actual 2003	Estimated 2004	Requested 2005	Percent change 2002- 2005
<i>Investment Management Division^a</i>	173	167	190	200	16%
<i>OCIE^b</i>	397	439	545	579	46
<i>Enforcement Division^c</i>	980	1,016	1,248	1,278	30

Source: GAO analysis of SEC data.

Notes:

^aIncludes staff in the office that administers the Public Utility Holding Company Act of 1935.

^bThe amounts for OCIE present only those staff in SEC's headquarters and regional offices who support or conduct examinations of mutual funds and investment advisers.

^cThe amounts for the Division of Enforcement include all staff in SEC's headquarters and regional that support or conduct enforcement activities over mutual funds, investment advisers, broker-dealers, and all other entities that SEC regulates.

Id.

Company Act rules in response to the scandals;³⁸ and brought a significant number of enforcement actions.³⁹

The question can fairly be put: Isn't this enough? However quiescent the SEC may have been, the Commission learned from experience and now should be more than equal to the task.

I am skeptical. The Commission's ability to devote sufficient resources to investment company inspection and discipline has been, at best, a sometime thing. It is now apparently facing a new period of budget stringency. For the 2006 fiscal year, the Bush Administration has proposed

38. Among other initiatives, in 2004, the Commission adopted amendments to Forms N-1A, N-3, N-4, and N-6 to require mutual funds to disclose their policies with respect to frequent purchases and redemptions of fund shares. The Commission also adopted amendments to Forms N-1A and N-3 to require specified variable annuities to explain the circumstances and effects of any use of fair value pricing. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 82 SEC Docket 2357 (Apr. 16, 2004); *See also* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8343, Investment Company Act Release No. 26,287, 81 SEC Docket 2425 (Dec. 10, 2003) (proposal).

The Commission has also proposed a time limit on the purchase of redeemable fund shares to prevent the receipt of an order after the time that the fund establishes for the calculation of its net asset value to prevent unlawful late trading in fund shares. Amendments to Rules Governing Prices of Mutual Fund Shares, Investment Company Act Release No. 26,288, 81 SEC Docket 2553 (Dec. 11, 2003).

In 2004 the Commission adopted several new Investment Company Act governance rules. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004). Collectively the rule amendments usually will require that covered funds have a board with at least seventy-five percent independent directors; an independent director be chair of the fund board; the board conduct an annual self-assessment; the independent directors meet at least once each quarter without any interested persons present; the independent directors be authorized to hire staff to help fulfill the board's fiduciary duties; and that the board retain copies of written materials that directors consider in approving advisory companies under § 15 of the Investment Company Act. *Id.*; *see also* Investment Company Governance, Investment Company Act Release No. 26,323, 81 SEC Docket 3414 (Jan. 15, 2004) (proposal). Commissioners Atkins and Glassman dissented from the requirements that seventy-five percent of the board and the chairman be independent. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384, 1402-07 (July 27, 2004).

Subsequently the Commission also adopted two new rules and other rule amendments to require broker-dealers to provide their customers with point-of-sale information regarding the costs and conflicts of interests that arise from the distribution of mutual fund shares, unit investment trust interests, and municipal fund securities. Disclosure of Breakpoint Discounts by Mutual Funds, Securities Act Release No. 8427, Exchange Act Release No. 49,817, Investment Company Act Release No. 26,464, 82 SEC Docket 3441 (June 7, 2004).

SEC oversight of mutual funds was harshly criticized. Stephen Labaton, *S.E.C.'s Oversight of Mutual Funds Is Said to Be Lax*, N.Y. TIMES, Nov. 16, 2003, at A1; Arthur Levitt, Jr. & Richard C. Breeden, Op-Ed, *Our Ethical Erosion*, WALL ST. J., Dec. 3, 2003, at A16.

In response, the Commission has expanded its investigation of mutual fund sales practices, *see* Stephen Labaton, *S.E.C. Has Found Payoffs in Sales of Mutual Funds*, N.Y. TIMES, Jan. 14, 2004, at A1, and brought the type of cases described above. *See supra* notes 6-7, 11, 13; Tom Lauricella & Christopher Oster, *Why Your Mutual Fund's Trading Matters*, WALL ST. J., Jan. 16, 2004, at C1.

39. *See* sources cited *supra* notes 6-7, 11, 13.

a “flat” budget,⁴⁰ which in real dollar terms, means a decline. There is little basis for optimism that the Commission’s budget will keep pace with its regulatory challenges if they increase or that Congress in the foreseeable future will approve self-funding for the Commission⁴¹ to avert the Commission’s periodic budget inadequacy. Under the circumstances, it is worth highlighting how reliant the SEC has been on SROs. Direct SEC regulation of stock markets, even during a period of dramatic budget expansion after Enron, was simply not feasible. In 2003, the NASD and the NYSE had a combined regulatory staff of 2650 and a regulatory budget of \$642 million.⁴² The NASD and NYSE staff is significantly larger than the staff of the SEC Division of Market Regulation and the Commission’s Office of Compliance, Inspections, and Examinations (OCIE). The Division of Market Regulation supervises all broker-dealers and registered representatives, all types of securities markets including stock, options and single stock futures, all clearing agencies, and the Municipal Securities Rulemaking Board.⁴³ Most of OCIE’s responsibilities are also unrelated to investment companies. Unless Congress is willing to make what appears to be a manifold increase in the number of Division of Market Regulation and OCIE staffers, direct SEC regulation of the stock market appears to be a nonstarter.

Compounding the inadequacy of the resources the Commission has long devoted to investment company oversight is the inevitability that investment company rulemaking will soon be far down the Commission’s priority list. Throughout much of the recent past, the Commission’s leadership in this area has been reactive, focusing particularly on the crisis of the day or ongoing enforcement actions. Investment company regulation is technical, not a field of expertise for the typical Commissioner, and, as a historical matter, rarely has seemed as urgent as

40. *Bush Seeks Flat Budget for SEC, Requesting Just Over \$888 Million*, 37 *Sec. Reg. & L. Rep.* (BNA) 261 (Feb. 14, 2005).

41. See Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 *NOVA L. REV.* 233 (2004).

42. Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, *WALL ST. J.*, Dec. 31, 2003, at A1. In 2003, the Wall Street Journal reported that the NASD had a regulatory staff of 2100 and a regulatory budget \$500 million; the NYSE a staff of 550 and a budget of \$142 million. *Id.*

43. SEC website, Division of Market Regulation, <http://www.sec.gov/divisions/marketreg/mrabout.shtml>. In 2002, the SEC staff allocation for the Division of Market Regulation and part of the OCIE was 465 positions; by 2004 it was anticipated to grow to 627. GEN. ACCOUNTING OFFICE, SECURITIES AND EXCHANGE COMMISSION: PRELIMINARY OBSERVATIONS ON SEC’S SPENDING AND STRATEGIC PLANNING 5 (2003), <http://www.gao.gov/new.items/d03969t.pdf> (testimony before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives). With respect to OCIE, see *supra* note 37.

activities the SEC has treated as its core functions, such as the mandatory disclosure system, stock market and broker-dealer oversight, and enforcement. This is not to suggest that investment companies have been ignored—quite clearly they have not—but instead to suggest a more nuanced point. Focusing SEC attention on investment companies is more difficult than focusing the Commission’s attention on stock markets, precisely because no investment company SRO originates rule proposals or enforcement actions.

To discuss seriously a new SRO for investment companies requires articulating a broad outline of how such an SRO would operate.

Scope: I would urge that a proposed Investment Company SRO solely address investment companies registered with the Commission and not address unregistered investment companies or investment advisers.⁴⁴ Among other exclusions, this would mean that the new SRO would not address hedge funds required by the Commission to register under the Investment Advisers Act.⁴⁵

Function: As with the PCAOB, securities exchanges, and securities associations,⁴⁶ the functions of an Investment Company SRO should include:

- registration of covered investment companies;
- the establishment of standards of practice;
- inspection;
- investigations and discipline; and
- establishment of a budget and management of the SRO’s operations.

The core SRO functions would be rulemaking, inspection, and discipline of investment companies.

SRO Board Selection and Budget: There are two models that could be employed. The older stock-market-SRO model allows industry selection of a board, subject, assuming some form of Regulation SRO is adopted, to

44. In 2004, there were “approximately 8000 investment advisers registered with [the SEC, who] manage[d] more than \$23 trillion in client assets.” Registration Under the Advisers Act of Certain Hedge Funds Advisers, Investment Advisers Act Release No. 2266, 83 SEC Docket 1124, 1125 (July 20, 2004).

45. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 84 SEC Docket 1032 (Dec. 2, 2004).

46. See Securities Exchange Act §§ 6(b), 15A(b), 15 U.S.C. §§ 78f(b), 78o-3(b) (2000); Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201–19 (Supp. II 2002) (especially § 7211(a)).

requirements that the governing board be composed of a majority of independent directors and specified committees will be composed solely of independent directors. Adoption of a Regulation SRO also will require that a nominating committee, comprised solely of independent directors, nominate new directors.⁴⁷ A stock-market-SRO budget is funded by its members. Historically, stock-market-SRO performance has been uneven,⁴⁸ principally because of the inherent conflict of interest implicit in an industry setting regulatory standards for itself. It is uncertain whether the SEC's Regulation SRO will overcome this conflict. I believe there is some chance that it might if the Regulation SRO is adopted as proposed, and I believe that the Regulation SRO itself deserves a fair chance to succeed.

The alternative is the PCAOB model, in which the SEC selects the Board's members subject to overarching requirements that the Chair and a majority of the five-person Board not be public accountants and a minority of the Board be accountants.⁴⁹ The SEC also approves the PCAOB's budget.⁵⁰

In my view, the decision on how a new SRO should be governed is of less consequence than the basic decision of whether there should be a new SRO at all. I think there is a substantial case that a focused SRO able regularly to inspect and discipline investment companies and develop the types of rules that currently govern the NYSE and the NASD would be wise. The NASD should retain its basic oversight of broker-dealers, so there will be delicate boundary issues to address.⁵¹ Thus, the focus of the new SRO should be the investment company itself as distinct from those that sell investment company products (when the sales effort is separate).

As painful as some of the recent scandals have been in the investment company world, they are of less moment than the breakdowns involving auditors that led to the PCAOB. I believe a case can be made for an SRO, like the NYSE or the NASD, with direct industry election of both independent and industry representatives. My enthusiasm for this approach is contingent upon Regulation SRO or similar standards being adopted and

47. See *supra* note 16.

48. See generally Seligman, *supra* note 2.

49. See *supra* text accompanying note 22.

50. See *supra* text accompanying note 24.

51. Alternatively, the NASD itself could be empowered to regulate investment companies. There are arguments that can be made in opposition to such an arrangement. A specialized SRO such as the PCAOB is better able to address issues particular to investment companies than an SRO with multiple missions. On the other hand, since many of the problems in the investment company industry have involved broker-dealer sales practices that the NASD already addresses, empowering the NASD to regulate investment companies might achieve economies of integration and scale and would avoid the time and expense of establishing a new SRO.

the investment company SRO not being subject to the threat of withdrawal of financial support that proved to be a key precipitant of the need for the PCAOB. As with the accounting industry, in which the trade association, the AICPA, has endured, I would assume that the investment company trade association, the Investment Company Institute, also would endure.

CONCLUSION

When one focuses on investment company accountability, one ultimately can pursue an internal or an external model or some combination of both. Professor Langevoort's symposium article well describes the more limited role that investment company boards play in contrast to corporate boards and how much more robust market forces such as a market for corporate control are with respect to corporate boards.⁵² Indeed, some like Richard Phillips have gone further and suggested that shareholder voting and independent directors on investment company boards should be scrapped altogether.⁵³ Each investment company could be viewed as a product, with only the mutual fund complex having a board.

These type of considerations militate in favor of relying on external accountability mechanisms. As a practical matter, SEC and State Attorney General enforcement actions should be viewed as a residual mechanism. The real issue is how to prevent dysfunction from occurring in the first place. From this perspective a new SRO makes particular sense. It could augment investment company boards, help investment companies themselves receive more rulemaking attention from the SEC, and, most significantly, help avoid the type of scandals that recently have besmirched the reputations of so many mutual fund families. Would it be worth the cost? I suggest now is the time to study seriously that type of empirical question.

52. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivatives Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005).

53. Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903 (1982).