

CHAPTER 2

Regulatory Issues in Institutional Investment Management

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INTRODUCTION

This chapter examines legal and regulatory issues in institutional money management. Three important trends are central to the issues discussed here. First, institutions today account for the largest share of financial market activities and related regulatory issues. Households' share of direct ownership of corporate equities fell from about 95 percent in 1946 to just over 36 percent in 2010, as shown in Exhibit 2.1. Institutions also trade more actively than individuals do and so influence equity and bond markets disproportionately (Biais and Green 2007). Their activities' scale and scope transformed financial markets' technology, structure, and political and economic dynamics over the past 50 years (Davis and Steil 2004; Goldberg 2009).

The second major trend has three aspects: Despite the dominance of institutional investors, households remain an important source of capital and transactions, they continue to depend on well-functioning financial markets, and regulators emphasize protection of individual investors. In 2009, households (including small nonprofit organizations) held about 72 percent of their liquid financial assets in corporate equities, mutual funds, and various types of securities, with 28 percent in bank deposits or CDs. Households increasingly rely on mutual funds as an investment vehicle, as shown in Exhibit 2.2. Retirement assets presently are about 36 percent of household financial assets, and private pension funds and state and local retirement funds had about two-thirds of their assets in corporate equities or mutual funds as of 2010 (Investment Company Institute 2011, p. 8) (see Exhibits 2.3 and 2.4). Much of the greater institutional ownership of equities reflects institutions managing the money of individual savers and investors.

In the 1930s, the securities laws were written mainly to protect individual investors who, at the time, owned about 80 percent of outstanding corporate stock and about 50 percent of public debt securities (Auerbach and Hayes 1986, pp. 12–15). The Securities and Exchange Commission justifies most of its regulatory activities based on supporting individual investors' confidence in financial

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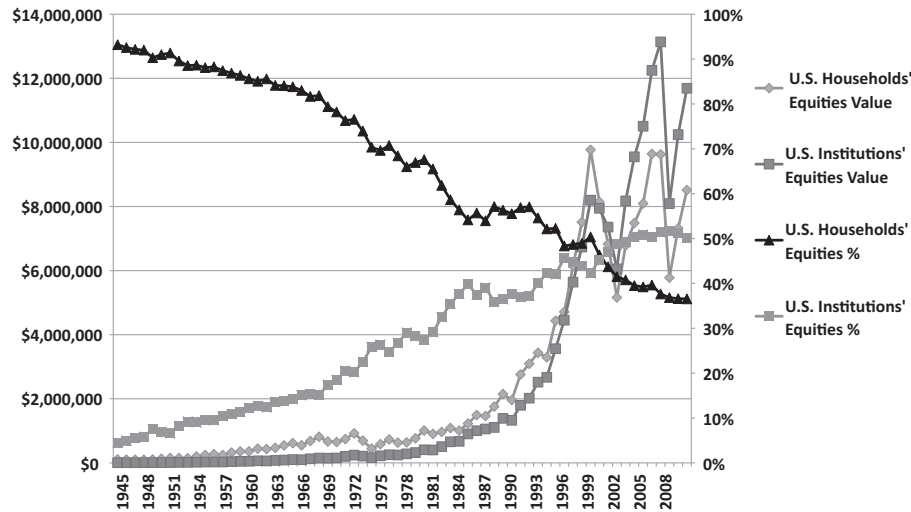


Exhibit 2.1 Value of U.S. Corporate Equities (Millions) and Percent Share Held by U.S. Households (including nonprofits) and U.S. Institutions, 1945–2010

Source: Compiled from Table L.213, March 10, 2011 Release. www.federalreserve.gov/datadownload/choose.aspx?rel=Z.1.

markets, deriving its political legitimacy primarily from its image as “the investor’s advocate” (Choi and Pritchard 2003; Langevoort 2006). Research in behavioral finance and surveys demonstrates that the majority of individual investors routinely misjudge the different roles and obligations of financial intermediaries, choose among individual providers based on personal ties rather than careful examination

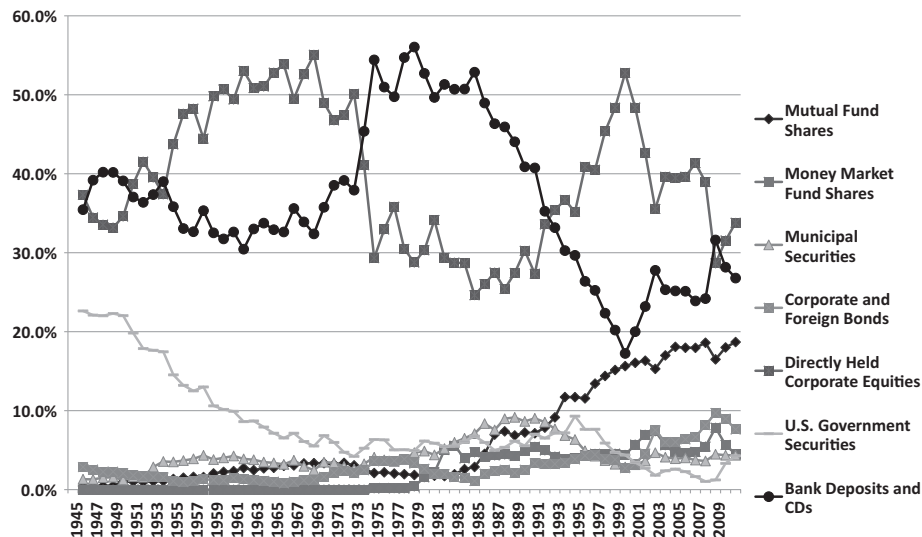


Exhibit 2.2 U.S. Household Liquid Financial Assets Percent 1945–2010

Source: Compiled from Table L.100, March 10, 2011 Release. www.federalreserve.gov/datadownload/choose.aspx?rel=Z.1.

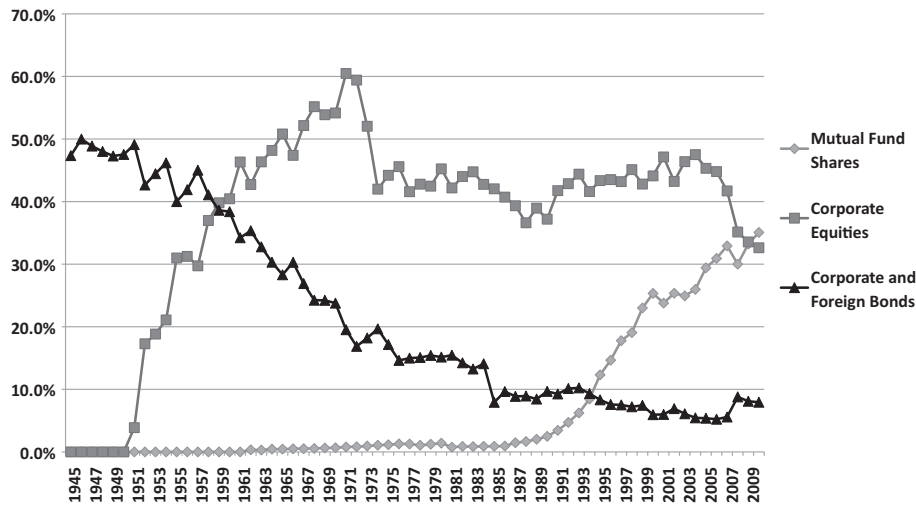


Exhibit 2.3 Corporate and Foreign Bonds, Corporate Equities, and Mutual Fund Shares as Percent of Total Assets for Private Pension Funds

Source: Compiled from Table L.118, March 10, 2011 Release. www.federalreserve.gov/datadownload/Choose.aspx?rel=Z.1.

of economic gain, and make nonrational investment decisions (Hung, Clancy, Dominitz, Talley, Berrebi, and Suvankulov 2008; infogroup/ORC 2010; United States Securities and Exchange Commission Staff 2011). Statutes, courts, and SEC exemptions have distinguished individual investors who need the full protection of the laws from institutional or otherwise sophisticated investors who do not need such protection. Institutional investors can effect transactions that are off-limits to

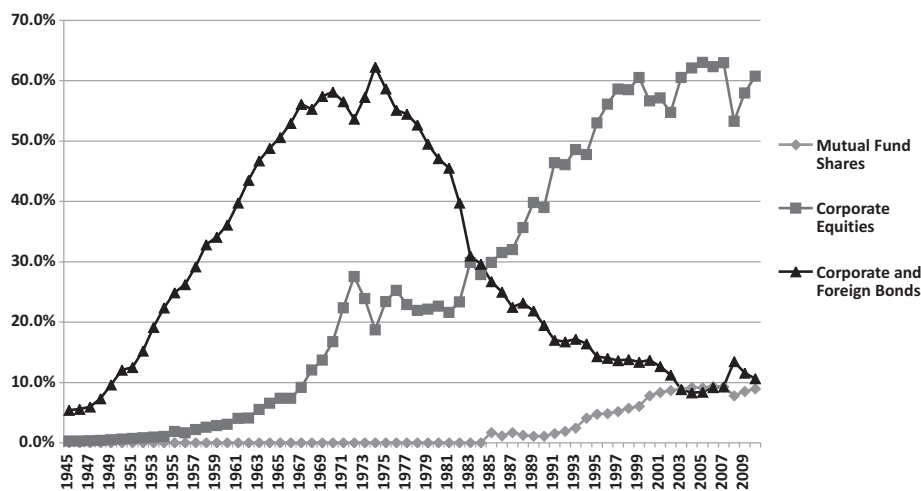


Exhibit 2.4 Corporate and Foreign Bonds, Corporate Equities, and Mutual Fund Shares as Percent of Total Assets for State and Local Retirement Funds 1945–2010

Source: Compiled from Table L.119, March 10, 2011 Release. www.federalreserve.gov/datadownload/choose.aspx?rel=Z.1.

individual investors on the grounds that they have abilities and resources to protect their own interests (*Securities and Exchange Commission v. Ralston Purina*, 346 U.S. 119 [1953]).

The third major trend is that these distinctions between individual investors who need regulatory protections and institutional and other sophisticated investors who do not need such protection have become less pronounced (Finger 2009). The increasingly complex structure and high rate of innovation in financial markets over the past 30 years eroded the image of institutions and sophisticated investors as consistently and capably fending for themselves. The same types of information asymmetry between individual investors and intermediaries operate between institutional investors and intermediaries to degrees varying by type of institution, management, transactions, and other factors (Poser 2001). Questions about whether regulation should be extended to previously unregulated institutions and transactions confronted policy makers well before the 2008 financial crisis. Sophisticated institutions arguably should bear the gains or losses from their own decisions in financial markets; however their losses ultimately fall on their individual investors or other stakeholders that regulators especially try to protect.

This chapter examines three regulatory issues flowing from these long-term developments. First, the chapter examines the debate over how effectively mutual fund regulation and governance benefits individual investors. Second, it discusses how complex financial markets challenge sponsors of pension plans and others with fiduciary obligations under the Employee Retirement Income Security Act (ERISA) when they hire service providers to help manage pension plans. A fiduciary is “a person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor,” including “one who must exercise a high standard of care in managing another’s money or property” (*Black’s Law Dictionary*, 9th ed., 2009). Ongoing business relationships among external service providers and the often opaque investments and services they create can generate conflicts of interest that, critics contend, harm pension plan beneficiaries. The chapter reviews this issue and the regulatory responses to them.

Third, the chapter describes how the Dodd-Frank Wall Street Reform and Investor Protection Act of 2010 handled the tension between the arguments for light regulation in institutional markets and the calls for greater regulation following the financial crisis. Institutional and sophisticated investors have been able to invest in lightly regulated hedge and private equity funds that are off-limits to individual investors requiring greater protection. The Dodd-Frank Act of 2010 extended greater regulation to such private pools of capital. To what extent does the law modify the approach to investor protection relating to such private funds?

INVESTOR PROTECTION AND THE REGULATION OF MUTUAL FUNDS

The Investment Company Act of 1940 and the Investment Advisers Act of 1940, along with other securities laws, regulate mutual funds. The statutes and related

regulations address conflicts of interest and relationships between the investment company and its advisers.

The Investment Company Act created a system in which a board of directors oversees the investment advisers who usually establish the fund and seek to manage it. The boards of directors are to act with shareholders' interests in mind before all else. "Interested persons" affiliated with fund management as defined by the statute and regulations may constitute no more than 60 percent of the board (Section 10). A majority of the voting securities of mutual fund shareholders must approve the contract between the fund and the adviser. Selection of another investment adviser or significant modification of the agreement terminates the contract, requiring shareholders' majority approval of a new contract. Private litigation by mutual fund shareholders complements the board's oversight of advisers. Shareholders can sue investment advisers for breaching their fiduciary duty to the investment company (Section 36[b]).

Growth in mutual fund activity in the 1960s prompted an SEC investigation and other reports describing excessively high fees and other types of regulatory problems. Congress amended the Investment Company Act in 1970. It tightened the standards for determining whether a board member was *disinterested*, or independent, of management; established a fiduciary duty of the board to shareholders in determining investment adviser compensation; and explicitly authorized mutual fund investors to sue investment advisers to recover excessive compensation.

The SEC regulates mutual fund advertising and requires extensive disclosures to current and prospective investors. The SEC also oversees mutual fund investment practices—for example, monitoring and regulating mutual funds' use of leverage and derivatives—to safeguard investors' interests (American Bar Association 2010; Donohue 2009). While SEC regulations clearly constrain mutual funds, the agency's enforcement program has focused on other areas that it considers to be at higher risk for securities law violations (United States Government Accountability Office 2005a, b). From Fiscal Year (FY) 1986 to 2010, cases classified mainly as involving investment companies constituted up to 4 percent of its caseload. Cases involving investment advisers accounted for 6 to 16 percent of the caseload over the period, and the Office of Compliance Inspections and Examinations (OCIE) currently focuses about half of its resources on examining investment advisers (see Exhibit 2.5) (United States Securities and Exchange Commission Staff 2011). The data reported by the SEC do not indicate the extent to which the investment adviser cases, or cases classified under other areas of enforcement, also involved mutual funds.

Many analysts maintain that investment companies disadvantage their investors despite such regulation. This argument includes the following points. The Investment Company Act and Investment Advisers Act eliminated obvious abuses of mutual funds that existed before 1940. However, the laws did not eliminate incentives of investment advisers to charge excessive fees, directly or indirectly, within broad legal constraints. Investment advisers usually established the mutual funds they advise, substantially determine the initial composition of the boards of directors, have superior and privileged access to information on their operations, and make almost all key decisions despite the veneer of board control. They extract high fees that would not be possible in a truly competitive market. When investment advisers must compete directly with other advisers to attract funds, they

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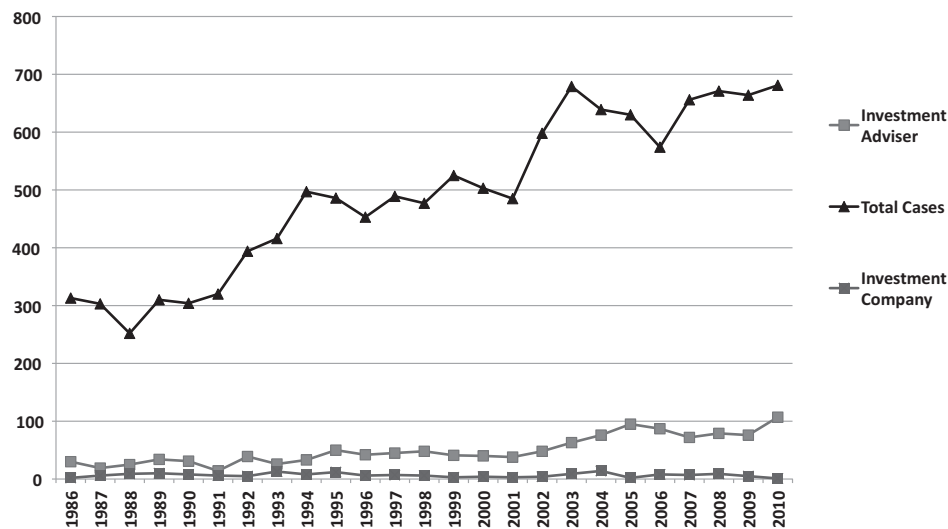


Exhibit 2.5 SEC Enforcement Cases Filed, Total Cases and for Investment Companies and Investment Advisers FY 1986–2010

Source: SEC Annual Reports and Select SEC and Market Data at www.sec.gov/about.shtml.

charge much lower fees than they charge to their captive mutual fund shareholders (Freeman and Brown 2001; Freeman, Brown, and Pomerantz 2008; Johnson 2009). Mutual fund investors commonly lack the financial skills to critically assess mutual fund disclosures and performance results and act nonrationally when investing. Mutual fund managers recognize these biases and target them opportunistically in advertising and other types of promotion (Birdthistle 2009; Cox and Payne 2005; Fisch 2010; Hu 2005; Langevoort 2009; Mercer, Palmiter, and Taha 2010). Mutual fund boards usually lack the will and the information to scrutinize advisers’ management of funds and oversee their decisions in ways that would keep mutual fund fees at appropriate levels; courts tend to defer to board decisions either because they want to or feel they must because of law or precedent (Langevoort 2005; Mahoney 2004). Regulators do not intervene effectively because excessive fees are subtle and ambiguous and so it would be hard to bring regulatory actions under the securities laws even if the regulators were willing to do so. Regulators, however, bring few such actions because of the political power of the investment management industry. Regulators did file enforcement actions against some mutual funds in the early 2000s because of their participation in or tolerance of illegal late trading and market timing by favored investors at the expense of other investors (Frankel and Cunningham 2006). However, absent such glaring, action-forcing violations, market failures allow the industry to consistently disadvantage individual investors. Proposed solutions include new regulations covering risk disclosures and marketing, encouragement of standard products with sellers having to explain deviations from standard products, and shifting of legal principles in favor of investors in mutual fund litigation (Fisch 2010; Hu 2005; Langevoort 2005; Mercer, Palmiter, and Taha 2010).

Critics of the argument that mutual funds exploit ill-informed investors point to the growth in mutual fund assets and the number of options available to investors as compelling evidence that mutual fund governance operates effectively. Hubbard et al. examined an extensive data set on mutual fund flows and returns. They maintained that criticisms of the mutual funds' competitiveness are based either on data acquired at a time when the industry was far less developed or often on no data at all, and that their own analysis of an extensive industry-provided data set covering mutual fund flows and returns refutes these criticisms. They report evidence that investors are sensitive to the fees they pay and shift investments accordingly and so market controls evidently operate effectively. The increase in the number and variety of mutual funds—most of which occurred after SEC investigations of market abuses in the 1960s—reflect and support the sector's highly competitive qualities (see Exhibit 2.6). Development of new types or products, like exchange-traded funds (ETFs), also put competitive pressure on the sector. While critics point to the lower asset management fees charged institutional investors or noncaptive customers as evidence that mutual fund investment advisers exploit ill-informed individual investors, Hubbard et al. and others argue that the differential fees reflect actual differences in costs of service. Furthermore, when mutual funds operate with the structures favored by industry critics, they do not produce superior returns; they make this argument after examining the returns of Vanguard Funds and TIAA-CREF (Coates and Hubbard 2007; Hubbard, Koehn, Ornstein, Van Audenrode, and Royer 2010).

A pivotal Supreme Court case in 2010, *Jones et al. v. Harris Associates L.P.* (United States Supreme Court, No. 08-586 [2010]), engaged the mutual fund fee issue and, more generally, set out principles for assessing the quality of private controls over

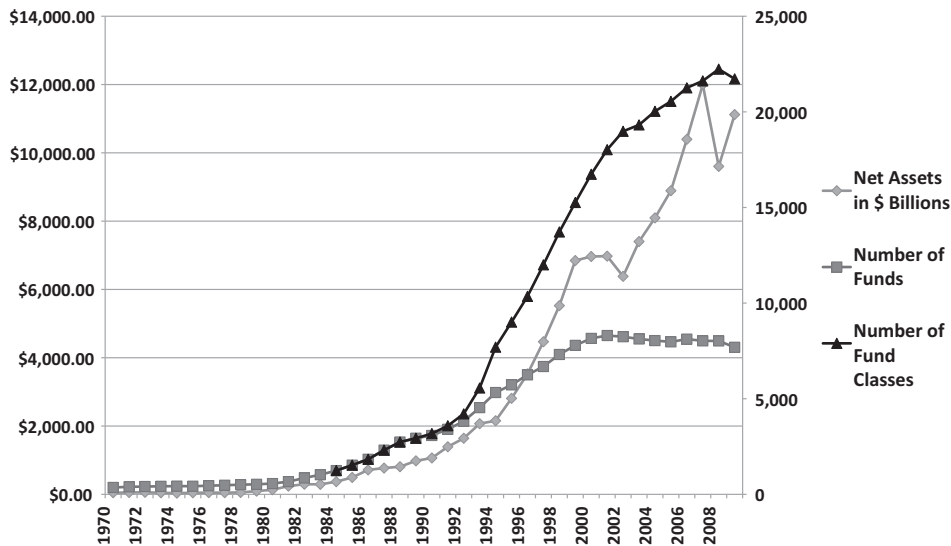


Exhibit 2.6 U.S. Mutual Fund Industry: Number of Funds, Share Classes, and Assets (\$ Billions, Left Axis) 1970–2009

Source: ICI 2010 Fact Book, Table 2, www.ici.org/pdf/2010_factbook.pdf Fact Book.

mutual funds. The Investment Company Act amendments in 1970 authorized investors to recover excessive compensation paid to investment advisers in violation of the adviser's fiduciary duties to mutual fund shareholders. In 1982, the United States Court of Appeals for the Second Circuit set out what became the accepted framework for judicial review of excessive fee claims in *Gartenberg v. Merrill Lynch Asset Management, Inc.* (694 F. 2d 923 [1982]). *Gartenberg* said that courts should decide if fees fell in the range that would have been negotiated in reasonable arm's-length bargaining as determined by several considerations such as fees paid in comparable situations. To be guilty of a violation of fiduciary duty "the adviser must charge a fee that is so disproportionately large it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining" (p. 928).

In *Jones et al. v. Harris Associates L.P.* in 2008, the Court of Appeals for the Seventh Circuit rejected the *Gartenberg* test (Seventh Circuit Court of Appeals, No. 07-1624 [2008]). Judge Frank Easterbrook, the decision's author, stated that the investment adviser as a fiduciary "must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge and jury, determine how much advisory services are worth" (p. 8). He wrote that the mutual fund industry was highly competitive and transparent, and there was no evidence in the immediate case, or generally, that adviser fees were set at levels violating reasonable principles of competitive bargaining. Judge Richard Posner called for a review of the decision by the full court of the Seventh circuit. He said that the decision exaggerated the effectiveness of market control on mutual fund fees given "the growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation" (*Jones et al. v. Harris Associates L.P., On Petition for Rehearing and Rehearing En Banc*, Seventh Circuit Court of Appeals, No. 07-1624, [2008]). When the Seventh Circuit denied the rehearing, the issue's importance and the prominence of the Easterbrook-Posner exchange invited Supreme Court review of the decision. While the Supreme Court's review was pending, the United States Court of Appeals for the Eighth Circuit handed down a decision siding with Posner's view that market forces failed to adequately constrain mutual fund fees. *Gallus et al. v. Ameriprise* (Eighth Circuit Court of Appeals, No. 07-2945 [2009]) said that boards of directors, and courts reviewing related cases, should critically examine the common defenses of fee levels cited by Judge Easterbrook.

The Supreme Court decided *Jones et al. v. Harris Associates L.P.* on appeal from the Seventh Circuit on March 30, 2010 (United States Supreme Court, No. 08-586 [2010]). Citing *Burks v. Lasker* (441 U.S. 471 [1979] at 482), the unanimous court noted that "scrutiny of investment adviser compensation by a fully informed mutual fund board is the 'cornerstone of the... efforts to control conflicts of interest within mutual funds'" (p. 11). The court affirmed the principle in the Investment Company Act that courts reviewing challenges to adviser fees must give board approval of the fees "consideration... as is deemed appropriate under all the circumstances" (Section 36[b][2]). It said that courts may consider fees charged to different types of investors in assessing reasonableness, but "courts must be wary of inapt comparisons... By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other

advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length" (pp. 13–14). The decision said that a reviewing court's "evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance. . . . Where a board's processes for negotiating and reviewing investment adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. . . . In contrast, where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. . . . It is also important to note that the standard for fiduciary breach under 36(b) does not call for judicial second-guessing of informed board decisions" (pp. 15–16). Overall, *Jones et al. v. Harris Associates L.P.* emphasized that courts should tend to defer to boards of directors' decisions when reviewing investment adviser compensation, but also that courts should be aware of circumstances in which boards' decisions would be sufficiently flawed to be overturned.

Statutes and the courts have thus made boards of directors' oversight a distinctively important part of mutual fund regulation. For better or worse, a board of directors' oversight, loosely overseen by shareholders and constrained by market dynamics, are the most routinely active and salient controls on the mutual funds. Analysts differ on how effectively boards of directors oversee mutual funds.

While the SEC's rules extensively shape mutual fund operations, it would be hard to credibly claim that the agency has regulated the industry intrusively. The SEC is a relatively small agency in all areas given the size of the financial markets, and it tends to react to regulatory issues identified by other sources. As indicated by Exhibit 2.5 earlier, it files few enforcement cases focusing mainly on investment company issues, although the data do not indicate the extent to which investment adviser cases occur in a mutual fund context. Other types of external controls—such as actions by states and media investigations—likely constrain mutual fund operations at least as much if not more (Dyck, Morse, and Zingales 2010; United States House of Representatives Committee on Financial Services 2003a, b).

FINANCIAL MARKET COMPLEXITIES AND PENSION FUND REGULATION UNDER ERISA

The 1974 Employee Retirement Income Security Act (ERISA) regulates private sector pension plans. ERISA, and related regulations and court decisions, specify when plan sponsors and those they hire to provide services for the plan are fiduciaries that must act primarily in the interest of plan beneficiaries. They also specify what *fiduciary obligations* actually mean under ERISA. ERISA generally prohibits the "furnishing of goods, services, or facilities between a plan and a party in interest to the plan generally," and so, absent an exemption, a relationship between a plan and a service provider would be prohibited. However, ERISA Section 408(b)(2) permits such transactions if the Department of Labor determines that the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services.

The Employee Benefits Security Administration (EBSA) in the Department of Labor regulates fiduciary, reporting, and disclosure requirements under ERISA. The Internal Revenue Service oversees ERISA's tax-related provisions, and the Pension Benefit Guarantee Corporation (PBGC) insures defined benefit pension plans when employers default on the plans. The SEC, while not drawing any authority from ERISA, regulates the investment advisers, investment companies, broker-dealers, and others hired to provide services to pension plans. EBSA and the SEC, among other regulators, ideally coordinate their activities.

EBSA recovers funds that private pension plans lose because of ERISA violations and can refer criminal charges to the Justice Department. It assesses penalties against fiduciaries and also against those nonfiduciaries who knowingly participate in a fiduciary violation. EBSA's penalties generally must be 20 percent of the applicable recovery amount as determined by settlement with the agency or as ordered by a court unless the secretary of labor determines that another amount would further ERISA's goals. EBSA reported that it recovered \$1.05 billion for private pension plans in federal fiscal year 2010, and closed 3,112 civil and 312 criminal investigations in FY 2010 (United States Employee Benefits Security Administration 2011).

Changes in the United States retirement market have shifted the relative risks of regulatory failures from employers to employees. Defined benefit pension plans pay fixed benefits to employees drawing primarily on employer contributions and investment returns over time. Defined contribution pension plans pay benefits based on employee contributions to a plan sponsored by the employer; the employer commonly matches employee contributions to some extent. The employee's eventual retirement income in a defined contribution plan thus depends mainly on the employee's contributions and investment returns; employees bear a much larger share of the risks of funding their retirements in such plans. Underfunding of defined benefit pension plans is a substantial and sometimes fatal liability for employers, and, of course, potentially harm employees and drain the PBGC insurance fund. However, failures and fund misallocations in defined contribution plans harm employees directly and immediately because the employer is not responsible for funding a defined level of benefits and defined contribution plans are not covered by PBGC insurance.

The United States retirement market has shifted to the defined contribution plans that expose employees to more risks. In 1985, private defined benefit plans held \$813 billion in assets and defined contribution plans held \$509 billion in assets. In the third quarter of 2010, the assets were \$2.18 trillion for private defined benefit plans and \$4.25 trillion for defined contribution plans (Investment Company Institute 2011, pp. 20–21).

The retirement market exemplifies the broader trend of increasing variety and complexity in financial markets' organizations and instruments. Firms market numerous investment options to pension plans, the organizations providing services to pension plans proliferated, and service providers regularly serve multiple functions or are linked through ongoing business relationships. These changes generate pervasive potential conflicts of interest in pension plans' operations. Employers have incentives to shift the costs of managing and funding plans, through higher fees, to employees; this is one reason why ERISA requires employers to act in the best interests of employees in the plan's investment management decisions. Also,

employers, who typically are not highly skilled in pension plan management, routinely hire service providers to advise them and manage key plan operations. Business relationships among service providers—often not revealed to employers sponsoring the plans—can create conflicts of interest. The United States Government Accountability Office (GAO) commented in a 2007 report that “the challenge to sound pension sponsorship posed by financial conflicts of interest is largely a consequence of the changes experienced by financial markets over the last 30 years. In fact, the pre-ERISA world of 1974 never anticipated the multiplicity and complexity of financial instruments that have expanded both investment opportunities and risks for plan fiduciaries. Index and hedge funds, the growth of complicated financial derivatives, and access to international financial markets represent only some of the extraordinary number of choices confronting today’s pension plan fiduciaries. . . . While conflicts of interest are not necessarily inherent in the provision of such financial services, the prevalence and the proliferation of consulting work and the complexity of business arrangements among investment advisors, plan consultants, and others have increased the likelihood. Our analysis of ongoing plans suggests that, in the aggregate, there may be some cause for concern” (United States Government Accountability Office 2007a, pp. 33–34).

For example, pension plan consultants may refer mutual funds or broker-dealers to pension plans because of the consultants’ existing business relationships with the funds or broker-dealers, raising the plans’ costs. The SEC staff, after examining 24 pension consultants working with defined benefit plans, reported in 2005 that the consultants’ ties with money managers, broker-dealers, and mutual funds frequently posed potential conflicts of interest in their dealing with pension fund clients, with limited or even no disclosure to clients. The report said that “many pension consultants believe they have taken appropriate actions to insulate themselves from being considered a ‘Fiduciary’ under ERISA. As a result, it appears that many consultants believe they do not have any fiduciary relationships with their advisory clients and ignore or are not aware of their fiduciary obligations under the Advisers Act” (United States Securities and Exchange Commission Staff 2005, p. 6). The GAO analyzed rates of return associated with the consultants examined by the SEC, finding that undisclosed conflicts of interest were associated “with lower [annual rates of return for clients] ranging from a statistically significant 1.2 to 1.3 percentage points over the 2000 to 2004 period, depending on the different model specifications tested” (United States Government Accountability Office 2007a, p. 15).

Analyses of pension fund operations over the past decade have emphasized that fees charged to pension plans, and passed on to plan beneficiaries through reduced returns, routinely were not transparent. The ERISA Advisory Council said in 2004 that the “emergence of defined contribution plans in the 1980s, in particular 401(k) and 403(b) plans, with the heavy reliance on pooled investment vehicles such as mutual fund investments, has caused a dramatic change in the way fees are charged. In particular, the pricing methodology has evolved from the explicit charges billed to and paid by the plan (or by the plan sponsor) into an asset-based fee model. Under such an arrangement, the investment management fees and expenses of the mutual fund are netted out of its performance on a daily basis in arriving at the mutual fund’s net asset value (NAV) and as such, those fees and expenses are intrinsic to the investment and not easily identifiable by the plan sponsor. . . . While some more sophisticated plan sponsors are cognizant

of the overall fees, both explicit and embedded, as well as the revenue sharing arrangements between various providers, many plan sponsors simply do not understand the total fees paid to service providers, nor the revenue streams between them" (ERISA Advisory Council 2004, p. 53). The Government Accountability Office reported in 2006 that plan participants usually did not understand, and did not receive the information required to understand, the fees charged 401(k) plan participants (United States Government Accountability Office 2006). Few plan sponsors or participants complain about excessive fees, and so EBSA files few fee-related enforcement actions, but the absence of complaints is likely a reflection of a lack of understanding of fees as much as it reflects the competitive reasonableness of the fees. When EBSA does examine fees, "according to agency officials, this effort does not find many fee violations because it is difficult to identify unreasonable fees" (pp. 21–22; see also United States Government Accountability Office 2008).

In 2010, the Employee Benefits Security Administration issued two significant rules and a proposal addressing these issues. It issued a final rule requiring more extensive disclosure of plan and investment-related information, including fee and expense information, to participants and beneficiaries in individual retirement account plans, among other matters. EBSA said that "this regulation is intended to ensure that all participants and beneficiaries in participant-directed individual account plans have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings" (United States Employee Benefits Security Administration 2010b, p. 64910). The agency also established an interim final regulation "requiring that certain service providers to employee pension benefit plans disclose information to assist plan fiduciaries in assessing the reasonableness of contracts or arrangements, including the reasonableness of the service providers' compensation and potential conflicts of interest that may affect the service providers' performance" (United States Employee Benefits Security Administration 2010c, p. 41600). EBSA justified the rule by saying that "in recent years, there have been a number of changes in the way services are provided to employee benefit plans and in the way service providers are compensated. Many of these changes may have improved efficiency and reduced the costs of administrative participants. However, the complexity resulting from these changes also has made it more difficult for plan sponsors and fiduciaries to understand what service providers actually are paid for the specific services rendered" (p. 41600). The rule mandated extensive disclosures from service providers to pension plan providers regarding their compensation, business relationships, and other matters that previously were made voluntarily, if at all.

Finally, EBSA proposed a broader definition of the term *fiduciary* under ERISA, "amend[ing] a thirty-five-year-old rule that may inappropriately limit the types of investment advice relationships that give rise to fiduciary duties on the part of the investment adviser. The proposed rule takes account of significant changes in both the financial industry and the expectations of plan officials and participants who receive investment advice; it is designed to protect participants from conflicts of interest and self-dealing by giving a broader and clearer understanding of when persons providing such advice are subject to ERISA's fiduciary standards" (United States Employee Benefits Security Administration 2010a, pp. 65263–65264). Still, concerns about conflicts of interest in pension plan services, and regulators' abilities

to deal with them, persist (United States Department of Labor Office of Inspector General 2010; United States Government Accountability Office 2011).

As discussed earlier, mutual fund regulation relies primarily on disclosure to investors and on boards of directors overseeing fund management, although SEC monitoring and enforcement clearly shapes the industry as well. Similarly, the Employee Benefits Security Administration relies primarily on disclosure to beneficiaries and plan sponsors and on overseers' fiduciary obligations under ERISA. Each of its regulatory actions in 2010 discussed earlier primarily strengthened the disclosure system or expanded fiduciary obligations. This is largely a matter of necessity, as EBSA is a strikingly small agency and its examination program generally does not detect violations in the absence of complaints or leads from other cases (United States Government Accountability Office 2007b). Private monitoring and enforcement through a system of disclosure to participants and fiduciary oversight is the more pervasive force in ERISA compliance.

REGULATION AND INVESTOR PROTECTION IN PRIVATE FUNDS AND THE IMPLICATIONS OF THE 2010 DODD-FRANK WALL STREET REFORM AND INVESTOR PROTECTION ACT

The securities laws require financial firms to disclose information to customers and comply with customer protection rules. SEC rules on mutual funds favor safety and stability given the extent to which individual investors rely on mutual funds. Such protection is not free. Collecting and distributing information is expensive, and restricting how financial firms can deal with investors restricts investors as well as the firms. For example, any mutual fund that solicits a public business must comply with regulations covering mutual fund operations, including use of leverage, compensation systems, and other practices. Prohibited practices increase the risks of the funds but also their potential profits that could be distributed to investors. Many protected investors might want to opt in to such a riskier structure but cannot do so under the Investment Company Act.

Since the 1930s, Federal securities laws have regulated much more lightly when investors do not need such protection. When funds are not marketed widely to the public, the laws prohibit fraud but do not impose the types of controls applying to regulated investment companies. Institutional and other sophisticated investors as a class are seen to be more knowledgeable than retail investors (Goldberg 2009; Ljungqvist, Marston, Starks, Wei, and Yan 2007; Malmendier and Shanthikumar 2007). Thus, investment funds and corporate issuers are frequently exempt from SEC regulations when they deal solely with investors who meet certain criteria indicating investment sophistication. Regulation D under the 1933 Securities Act identifies conditions under which investors may purchase unregistered securities, subject to restrictions on reselling the securities to the public. Rule 501 of Regulation D defines an *accredited investor* as someone able to make such purchases. The unifying theme among the categories is that they are organizations or individuals with sufficient investment experience or wealth that they do not need the full protection of the securities laws. They can enter into transactions that would be off-limits to nonaccredited investors.

Similarly, the Investment Company Act exempts from regulation as an investment company a private investment fund “whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities” (Section 3[c][1]). Under section 3(c)(7), an issuer is not an investment company when its “outstanding securities . . . are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” The Act’s Section 2(51) defines *qualified purchasers* as including individuals and institutions owning \$5 million or more in investments, or managing \$25 million or more in investments, both indicating investment sophistication (with other elements of the definition covered in the section). The Act also includes as qualified purchasers “qualified institutional buyers” as defined by their investments and other criteria. The reasoning is that such buyers are able to protect their interests without the help provided to individual investors (Sjostrom Jr. 2008). Section 3(c)(1) and Section 3(c)(7) allow the formation of hedge funds and private equity funds as investment pools that avoid most regulations applying to mutual funds because their clients are “shown to be able to fend for themselves” (*Securities and Exchange Commission v. Ralston Purina*, 346 U.S. 119 [1953]).

Until passage of the Dodd-Frank Wall Street Reform and Investor Protection Act in 2010, Section 203(b)(3) of the Investment Advisers Act of 1940 exempted from SEC registration an investment adviser “who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public nor acts as an investment adviser to any investment company registered under the Investment Company Act.” This exempted most managers of hedge funds from mandatory registration as investment advisers, given that the fund was defined as a single client, despite the SEC’s unsuccessful effort in the mid-2000s to require registration by redefining *client* to mean the investors in the fund (*Goldstein v. SEC*, 451 F.3d 873 [D.C. Cir. 2006]). The Dodd-Frank Act eliminated this exemption and thus extended regulation under the Investment Advisers Act to a large number of advisers to hedge funds.

Debates over regulatory exemptions for sophisticated institutional or individual investors are prominent today. On the one hand, when institutional or other accredited or qualified investors enter into transactions based on their legal status, the presumption arguably should be that they do so knowledgeably and responsibly. They accept the benefit of entering the transaction because of their legal status, and they ought to accept the good or bad results of nonfraudulent transactions. To allow sophisticated investors to challenge lightly regulated transactions after they have entered into them without the expected due diligence undermines the purpose of the regulatory exemptions. The history of aggressive litigation in the securities industry results partly from sophisticated investors trying to win back through court what they lost through bad judgments in transactions. As Stulz comments, “[i]nvestor protection should not motivate the SEC to regulate the hedge fund industry, because the small investors who are supposedly the focus of the SEC are already blocked from investing in hedge funds. There is no reason to believe that the occasional hedge fund losses of savvy and well-to-do investors, however painful they may be to those investors, have a social cost. These investors

can choose not to invest in a fund, and they also have legal recourse against acts of fraud" (Stulz 2007, p. 189).

Other analysts respond that this argument sanctions manipulative, damaging behavior by sales, advisory, and trading personnel in financial markets. Securities industry personnel are aware of investors' cognitive biases, including institutional investors, and targets them relentlessly (Langevoort 1996; Sklar 2009). Serious problems over the past 15 years in the derivatives and securitization markets demonstrate how market controls can lapse even in areas dominated by sophisticated investors (Das 2010; Frankel and Cunningham 2006; Partnoy 2001).

The Dodd-Frank Act of 2010 instituted many new controls on private investment funds. It repealed the exemption for registration of investment advisers with fewer than 15 clients, under which most hedge fund advisers were exempt, effective July 2011. It continued to exempt "any investment adviser of private funds, if each of such investment advisor acts solely as an advisor to private funds and has assets under management in the United States of less than \$150,000,000" (Section 403), and exempted certain other categories of advisers (Sections 403, 407–409). However, the Act required that many hedge fund advisers register as investment advisers to the extent that they had depended on the 15-client exemption, and even those who do not have to register will be required to submit to the SEC certain types of information at the agency's request. This means that they will need to disclose substantial additional information to investors, establish and review at least annually written compliance procedures, designate a chief compliance officer, and be subject to routine SEC examinations (see 17 C.F.R. 275.206(4)-4 through 7 [4-1-10 edition]). The Act also shifts regulation of many investment advisers to the states by raising the threshold for registration with the SEC, as opposed to the state in which it maintains its principal business, from \$25 million to \$100 million (Section 410) (United States Securities and Exchange Commission Staff 2011).

The Dodd-Frank Act authorizes the SEC to require previously unregulated hedge funds and private equity firms to register with the SEC. (Section 402[a] of the Act defines *private funds* as any issuer that would be considered an investment company under the 1940 Act but for Section 3[c][1] or 3[c][7].) The SEC can require such private funds to report to the SEC their assets, use of leverage, exposures to counterparties, policies for valuing assets, and trading practices (Section 404). Requiring hedge fund advisers to register with the SEC as investment advisers, as discussed earlier, means that they will need to disclose more information to investors and establish other types of internal controls. The new controls on private funds in the Dodd-Frank Act, however, do not impose the types of governance requirements that the Investment Company Act applies to investment companies soliciting public investments.

The Dodd-Frank Act intensifies regulation of customer relationships in institutional markets. In particular, Sections 731(h) and 764(h), applying to the Commodity Futures Trading Commission and SEC, respectively, establish business conduct standards for swap dealers (SDs) and major swap participants (MSPs). Sections 721 and 761 define a swap dealer as a dealer making markets in swaps or regularly entering into swaps for the dealer's own account. Major swap participants are those who are not swap dealers and who hold substantial positions in swaps, excluding positions for hedging or mitigating risk in commercial or ERISA benefit plan operations; or hold outstanding swaps that create substantial counterparty exposure

that could adversely affect U.S. financial stability; or who are highly leveraged financial entities with a substantial position in swaps whose capital is not otherwise regulated by a federal banking regulator. The law prohibits “fraud, manipulation, and other abusive practices” in the swaps market generally, and authorizes the SEC and CFTC to regulate such business practices “as the Commission determines to be appropriate.” The law especially elevates business standards when swap dealers and major swap participants are dealing with special entities, which include federal, state, and local agencies, private and governmental employee benefit plans as defined by ERISA, and endowments described in Section 501(c)(3) of the Internal Revenue Code of 1986. Sections 731(h)(3-6) and 764(h)(3-6) obligate swap dealers and major swap participants to provide substantial additional information to special entities and take other steps, depending on the circumstances, to confirm that the institution understands the transaction and is advised appropriately. These include acting in the special entity’s best interest when the dealer or major swap participant is advising the entity in a transaction.

The Commodity Futures Trading Commission proposed its business conduct standards for the swaps market in December 2010 (United States Commodity Futures Trading Commission 2010). Its proposal would require swap dealers and major swap participants to assess very carefully the ability of counterparties, and especially special entities, to enter into swap transactions and provide extensive information enabling them to understand the transactions’ terms and possible effects. Comments on the proposal vividly illustrated the debate over the appropriate responsibilities of institutional parties in complex financial transactions. For example, the Consumer Federation of America and Americans for Financial Reform said that the rule would improve the swaps market by preventing those who fully understood these complex transactions from exploiting those who did not (Consumer Federation of America and Americans for Financial Reform 2011). In contrast, the International Swaps and Derivatives Association (ISDA) and Securities Industry and Financial Markets Association (SIFMA) said that the proposed rule would require swap dealers and major swap participants to handle the due diligence and assessment that their counterparties to the transaction ought to complete. They argued that the rule would transform swap dealers and major swap participants into financial advisers with fiduciary obligations, going well beyond the mandate of the Dodd-Frank Act in applying investor protections found in retail markets to institutional markets (Securities Industry and Financial Markets Association and International Swaps and Derivatives Association 2011). The Consumer Federation of America responded that the Dodd-Frank Act in fact intended to remedy serious problems of information asymmetry in complex financial markets that had become clear even prior to the financial crisis (pp. 21–22).

The Dodd-Frank Act established new controls relating to investor and customer protection, and mandates related studies by the SEC and Government Accountability Office. It increased the protection of investors in private funds by broadening the range of mandatory investment adviser registration and establishing new business conduct standards in swaps markets. Still, the new registration and reporting requirements relating to private funds focused mainly on concerns about financial system stability rather than on investor protection in institutional markets. The investor protection regulations in retail markets (notably, mutual funds) and pension funds are still far tighter than those in the markets frequented

by accredited investors, qualified buyers, and qualified institutional buyers. However, the Dodd-Frank Act gives the SEC, CFTC, and banking agencies considerable discretion in writing the regulations implementing the law. Those regulations will determine the extent to which the law ultimately transforms relationships between buyers and sellers in institutional markets.

CONCLUSION

Changes in the financial services industry have generated a wide variety of investment options and new ways to allocate capital and manage risk. While analysts generally recognize both the benefits and risks of innovation, they tend to accent one or the other. Some analysts highlight how financial innovation has improved market efficiency through better capital allocation and risk management (Allen and Yago 2010; Merton and Bodie 1995; Shiller 2003). Others suggest that market participants increasingly do not sufficiently understand the transactions in which they engage. Financial crises and exploitation of investors, beneficiaries, and others—including in institutional markets—are much more likely (Bhidé 2010; Bookstaber 2007).

The Securities and Exchange Commission and the Employment Benefit Security Administration fundamentally shape institutional money management. But the SEC and EBSA have serious problems in coping with oversight and enforcement given that they are small agencies overseeing large areas of complex economic activity. Research suggests that most of the individuals and organizations uncovering corporate fraud are not regulatory organizations, even though regulators are involved in subsequent enforcement actions (Dyck, Morse, and Zingales 2010).

The regulatory developments reviewed here strengthen private controls over investment funds and pension plans. They rely on greater disclosure of information to private parties, even though the Dodd-Frank Act also expands the information that private funds must provide to regulators on request and alters buyer and seller relationships in the swaps markets. They broaden the range of those who are held accountable as fiduciaries to investors and pension beneficiaries, and emphasize the importance of existing fiduciary obligations. The quality of private monitoring seems to determine how well this regulatory system prevents problems. The SEC and EBSA obviously are critical in designing many of the rules and intervening after problems occur. But public regulation may be particularly useful in backing up private controls. Better understanding of how private and public controls interact formally and informally in this system would be valuable in understanding how it operates in practice.

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