INTRODUCTION

STANDING ON THE SHOULDERS OF A GIANT

Linda Chatman Thomsen*

Thank you and congratulations to everyone here at Brooklyn Law School and at the Securities and Exchange Commission Historical Society responsible for putting together this very important and timely program, especially Dean Wexler, Professors Janger, Karmel and Poser of Brooklyn Law School and Carla Rosatti of the Historical Society. Congratulations are definitely in order for the students responsible for launching the Brooklyn Journal of Corporate, Financial & Commercial Law, which promises to be a terrific journal. Before I forget, let me remind everyone that my views are my own and do not necessarily reflect the views of the Commission or any other member of the staff.

It is a special treat for me to be here in Brooklyn, which I associate with the beginnings of my professional life. The summer I was a summer associate I lived with my aunt and uncle in their wonderful apartment over the even more wonderful restaurant they owned and operated, Gage and Tollner’s. When I started practicing full time, a year or so later, my first apartment was a few blocks from here in Brooklyn Heights, on Montague Street, over a Haagen Dazs ice cream store. No wonder my memories of Brooklyn are so favorable—they include great food.

But the best treat today is to be able to join everyone here in honoring Irving Pollack; a 1938 graduate of Brooklyn College, a 1942 graduate of Brooklyn Law School, and a living legend in the legal and securities world. Much has been said about Irv at this conference, but I thought it was worth noting a few things. In 1967, after spending over two decades on the staff of the Securities and Exchange Commission, Irv received the SEC’s Distinguished Service Award. It is the Commission’s highest honorary award, designed to recognize those who have made major contributions to the work of the Commission and the administration of the federal securities laws. It was richly deserved for all of Irv’s wonderful work. But as it turns out, it was premature. After receiving that award, Irv remained at the agency for thirteen more years during which time he became the agency’s

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first Director of Enforcement and thereafter one of its Commissioners. His career has been and continues to be an example to us all.

Late in the 17th century, Isaac Newton wrote in a letter to fellow scientist Robert Hooke, “If I have seen further, it is by standing on the shoulders of giants.” It is a quote you often hear about the debts people owe their predecessors. If you Google the phrase, as I did, you learn that at time the letter was written, Newton and Hooke were actually in the midst of some long-simmering feud, replete with accusations of plagiarism and theft of research and ideas. You also learn that Hooke himself was reported to be quite short—not, in any event, a giant. So, Newton’s words to Hooke, while on the surface polite, may have been intended as an insult. All of this I found a bit discouraging until I learned that the sentiment expressed by Newton was a relatively common and formulaic notion among scholars and scientists dating back to at least the 12th century.

I think of this phrase often when I think about my predecessors in my job as Director of the SEC’s Enforcement Division and the staffs they led. Our work today is based on a rich and proud foundation laid by those predecessors—and the basis for that foundation—the first bricks, if you will—were laid out by Irv Pollack. Among other things, it was our former Enforcement Division Directors who established: our independent litigating authority, our ability to seek disgorgement as a matter of equity (which was later codified), our penalty remedies, and the development of insider trading principles now recognized in the federal securities laws. They were also among the first to breathe life into our investor protection mission.

Further proof of their work in setting the foundations of the Enforcement Division can be seen in today’s topic: “New Models for Securities Law Enforcement: Outsourcing, Compelled Cooperation and Gatekeepers.” I wish I could have seen Irv’s face when he first saw this topic, because I think he must have found these novel ideas to be quite


familiar. While it is certainly true we are using these models—and I may quibble with the adjective “compelled”—there is nothing new about them. Irv and his colleagues used them all. When we use them today, we are indeed standing on the shoulders of our predecessors and building on the foundations they laid.

As the program materials note, SROs have been around as long as there have been federal securities laws, cooperation has been the name of the game since the beginning of enforcement (notably in the foreign payments arena), and the notion of gatekeepers—I think Irv and his colleague Stanley Sporkin called it “access theory”—has also been around for as long as we’ve been in this business. These ideas have been around from the beginning for very good reasons. First, industry numbers: there are far more people in the business than the number of people watching it. A recent conference sponsored by the Securities Industry Association was attended by 2000 legal and compliance people—twice as many as we have in SEC Enforcement Division—but they comprise only a tiny fraction of the vast number of people who make their livelihoods in the securities industry. Second, the securities industry is a legitimate business based on investor trust and confidence, and people in the business have every incentive to keep it that way. Even if we in law enforcement were sitting around eating bonbons—and we aren’t—the securities industry would want to make sure illegal behavior was rooted out and stopped. Third, and related to the first two points, the use of gatekeepers may have exponential deterrent effects throughout the industry. Gatekeepers—accountants, lawyers and other professionals—are generally motivated to be law abiding and the possibility that they themselves may face liability for their clients’ securities law violations only increases that motivation. Moreover, a single gatekeeper may guard the entry ways to the securities industry for scores of existing and potential clients. A law-abiding gatekeeper may be able to stop multiple bad actors and prevent violations in multiple transactions before they ever make it into the securities industry—which maximizes our law enforcement effectiveness.

The good news—the white collar crowd is deterrable. The bad news—scandals keep happening. Which causes one to wonder; when it comes to fraud, why do the white collar types do what they do? Now, just to ask the question makes me a little nervous. As a recovering litigator, I know to avoid the “why” questions. As a law enforcer, I know I am not required to prove the “whys”, as opposed to the related issue of intent. And as a person with a few decades of life behind me, I know that when we do figure out the “whys” they often look nutty—especially after the fact.

But let’s think about the “why” question for a few minutes. If our only choice were to starve or steal, most of us would steal. However, for the people I’m talking about, starving is generally not a problem, and stealing not their only option. They are, by and large, exceptionally smart. Some of
them have been called “the smartest guys in the room”—and that may well have been true. They have been very well educated. They have been raised in relative economic comfort and in relatively functional families. Certainly, by the time of the fraudulent conduct, they are more often than not enjoying a level of economic comfort or wealth that many of us can barely imagine. They are often pillars of their communities and professionally well-regarded. And, while it isn’t always easy to know the details of someone’s private life, it appears that even on the non-monetary front, these individuals have lives with many pluses. They have, in short, an abundance of riches. And they put them all at risk. Why?

To draw on a real example from a few years back: why does the wealthy head of a major investment bank give confidential stock tips to his exotic dancer friend? With everything else wrong with his conduct, did he have to add insider trading to the mix? The “whys” from the current scandals are perhaps less dramatic but equally puzzling. Why, when you have everything, do you risk everything by tinkering with the company books? Why, when your company will pay you anything, do you pretend personal expenses are business expenses and run them through the company? Why, when everyone knows there are ups and downs in the life of a company, and in the life of an economy, do you do everything in your power to lie your way into an illusion that the only direction is up?

To be sure, there are some immediate and obvious answers to the why question; to meet the numbers. To beat the street. It’s a one time problem, with this one time fix. It will save the company. It’s a close question. I won’t get caught.

Let us look behind the obvious for a moment to explore the possibility of some other, additional reasons. I urge caution. I learned a long time ago that sometimes the obvious answer is the answer. As Sigmund Freud once said, “Sometimes a cigar is just a cigar.” With that caveat, let’s think again about the question.

I submit that among some of the deeper, underlying reasons are ones of culture. In our culture, we value talent—especially what I think of as practical smarts. We especially value it in combination with money or power or both. And that is neither surprising nor bad. Indeed, the success of a capitalist democracy depends on it. In his State of the Union address this year, President Bush said he wanted a population that was educated,
hardworking and ambitious. Where would we be if we didn’t? This country’s proud history and hundreds and hundreds and hundreds of family success stories—poor immigrant in one generation and well into the mainstream a generation later—depends on it. Many of those success stories find their roots here in Brooklyn. Our record of innovation and expansion—the car, the assembly line, the light bulb, the railroad—depends on it. We need smart people working hard to make the country a success. To do that, we need to value and reward them.

To my mind, Benjamin Franklin is the quintessential American success story. Indeed, he was such a huge success and was so influential in the success of this nation that America celebrated his 300th birthday in January 2006. Franklin was born in Massachusetts, the 15th child of a Boston candle maker. Not only was he a writer, scientist, inventor and statesman, he was a great entrepreneur. Over the course of his life he amassed a fortune. He had brains, ambition, a limitless capacity for work—he had, in short, everything a new country needed and everything we still value.

At some point during his life, this Founding Father articulated a list of thirteen virtues to which his descendants should aspire. They are: Temperance, Silence, Order, Resolution, Frugality, Industry, Sincerity, Justice, Moderation, Cleanliness, Tranquility, Chastity and Humility. You may find the fact that the list includes thirteen items a bit peculiar; I know I did. But Franklin explains that: “My list of virtues contained at first but twelve; but a Quaker friend having kindly informed me that I was generally thought proud; that my pride showed itself frequently in conversation; that I was not content with being in the right when discussing any point, but was overbearing, and rather insolent, of which he convinced me by mentioning several instances; I determined endeavoring to cure myself, if I could, of this vice or folly among the rest, and I added Humility . . . . In reality, there is, perhaps, no one of our natural passions so hard to subdue as pride. Disguise it, struggle with it, beat it down, stifle it, mortify it as much as one pleases, it is still alive, and will every now and then peep out and show itself; . . . for, even if I could conceive that I have completely overcome it, I should probably be proud of my humility.”

Now another thing about Franklin’s list—intelligence, wealth, success, and power nowhere appear. What is my point?—simply this, that intelligence, wealth, success and power are attributes and accomplishments. And for those of us possessed of these attributes or accomplishments—and I include everyone in this room in that number—the fact that we have those things doesn’t mean we’re virtuous, it means we’re lucky. And when compared to the conditions of life for most of the people on this planet,

these attributes and accomplishments are gifts, not something we necessarily earned or deserve. Don’t get me wrong, having these great gifts doesn’t mean we’re not virtuous either. To be sure we can use our talents or gifts virtuously; and we love to see the gift of brains in combination with the virtues of, as the President would say, hard work and ambition, or as Franklin might say Resolution and Industry. Indeed, some would argue that having these gifts makes being virtuous easier. Franklin certainly thought so when he said, “[I]t is] hard for an empty sack to stand upright.”

So what can we do? Maybe we can think about a few things to check some of the less attractive aspects of some of these attributes. We can think about, for example, competition. Competition is often a good thing. It builds friendships and character and, not to beat a dead horse, railroads. But it can run amok. The need to compete is one thing; the need to always be first is quite another. With Opening Day just around the corner, think for a moment about all those baseball players who are alleged to have used performance enhancing drugs. Now think of the names of those players. They are not the guys wavering on the cusp between the minor leagues and the majors. It’s the stars, the guys whose places in the Hall of Fame are, or were, secure. You see the same kind of phenomenon played out over salaries in a venue closer to home—in law firms. In many firms you see people who are making more money than they ever dreamed of. And when they find out what they are making, they are usually delighted—until they learn that one of their colleagues is making a little bit more.

Second, perhaps by rewarding talent, we have managed to convey to the talented that they are deserving, rather than lucky, and that anything they want is their due. Put another way, while it is certainly good to be talented, being talented doesn’t make you good. Someone once told me the only two groups of people who could consistently pass a polygraph while lying are psychotics and white collar defendants. Now that may be entirely false. But I think the fact that we even entertain the idea that it may be true is based on the fact that it sounds true. Psychotics live in a world where they are incapable of distinguishing truth from lies. White collar defendants seem to me to be in a continuous process of self-justification and spin. Indeed, it is not unusual to confront someone who has done something totally and profoundly illegal and have that person react with surprise, indignation or outrage. “Me—you think I violated the law, did something wrong!?!” It’s as if a constant refrain runs through their brain—I, one of the rich and smart, want this. Ergo, it must be good and right.

So what do we do about all this? First, and foremost, we confront the conduct. We enforce the law. We investigate the misconduct and impose meaningful sanctions. We fine. We use all our tools with a keen eye toward deterrence, as all of the sanctions and tools discussed today are designed

9. Id. at 212.
with deterrence in mind. We exploit the fact that this is a deterrable population and that the businesses we deal with are, by and large, legitimate, and their long term success depends on that legitimacy. Similarly, the people in these businesses are, by and large, law abiding, talented people whose personal success also depends on being law abiding.

But, at the risk of sounding like the secular equivalent of a sanctimonious twit, maybe we can do more. We can all try to do a better job of valuing virtue for its own sake—which is a whole lot harder to do than to say. I need only think about the grading system at my son’s school. For some years now the school has labored to recognize effort in addition to achievement. All courses have grades for achievement, A, B, C, D, F; and all courses have grades for effort, 5, 4, 3, 2, 1. There is an honor roll for achievement grades and an equally prominent, featured honor roll for effort grades. And yet ask any kid which is better—an A with an effort grade of 1 or a B with an effort grade of 5 and they will go for the A. All of them, without hesitation.

Perhaps more success can be achieved if we focus on recognizing that we are human and we are capable, no matter how talented, of screwing up. Remember Franklin’s remarks about his capacity for pride—and his recognition that he could probably find a way to be proud about his humility. Because so many things come easily for the smart and talented, it is probably worth finding ways to remind ourselves what Franklin knew—it’s hard work to be virtuous and ethical and it’s not going to happen by accident.

We can teach ethics in professional schools and we can train ourselves to ask, in a business setting, is this right? Who are we helping? Who are we hurting? Just as we are now asking, I hope, what are the compliance challenges with rolling out this new product, we can ask what are the ethical and fairness issues?

Above all, we can try to be better at whatever it is we do—and I came across a remarkable example of how well this can work. Last June I happened to read a front page article in the Wall Street Journal about medical malpractice insurance premiums. The article reported that premiums are going up except for one group of doctors—anesthesiologists. The bulk of the article explored why anesthesiologists’ premiums were not only not going up, but were going down. Turns out their premiums are going down not because of especially effective lobbying efforts for tort reform or very clever negotiation with hospitals and others to share costs and liability. Instead, some number of years ago anesthesiologists decided to be better anesthesiologists. They spent time, money and attention at figuring out what was going wrong and how to catch, prevent, avoid, and

mitigate problems. They invested in research. They invested in education. And in that process they became better anesthesiologists. And their premiums went down. For the doctors, I know they’re happy to have lower premiums but I hope they are even more thrilled, as I know their patients are, to have fewer problems.

Not to put too fine a point on it, but that last story reflects my very sincere hope that not only do those in the securities industry seek to avoid enforcement issues, but that they do so for the right reasons—that is, because it is the right way to treat investors and the right way to sustain the industry that provides their livelihoods. And I think I’ll end with the explicit recognition that to achieve that goal, we in law enforcement have a big responsibility too. We too must aspire to doing the right thing.

For most of my professional career I have carted around with me a copy of an old speech. It’s reasonably short and I read it often. It looks like it was typed on a manual typewriter, courier typeface (probably pica), and it may even be a copy of carbon copy on onion skin (does anyone here who is a current law student have any idea what I’m talking about?). The contents reflect a variety of biases common to its time, including, about the role of women. But despite all of this, I think it has quite a bit to say to many of us.

The speech was delivered sixty-six years ago, on April 1, 1940, by then-Attorney General of the United States, and later Supreme Court Justice, Robert H. Jackson, to the Second Annual Conference of United States Attorneys. There was a heck of a lot going on then at the federal law enforcement level and plenty of things to talk about. We were, for example, in the midst of a World War that our nation would soon be joining. But what Jackson chose to talk about was fairness and character. He said, “It would probably be within the range of that exaggeration permitted in Washington to say that assembled in this room is one of the most powerful peace-time forces known to our country. The prosecutor has more control over life, liberty and reputation than any other person in America . . . .

Nothing better can come out of this meeting of law enforcement officers than a rededication to the spirit of fair play and decency that should animate the federal prosecutor. Your positions are of such independence and importance that while you are being diligent, strict, and vigorous in law enforcement you can also afford to be just . . . . The qualities of a good prosecutor are as elusive and as impossible to define as those which mark a gentleman. And those who need to be told would not understand it anyway. A sensitivity to fair play and sportsmanship is perhaps the best protection against the abuse of power, and the citizen’s safety lies in the prosecutor who tempers zeal with human kindness, who seeks truth and not victims,
who serves the law and not factional purposes, and who approaches his task
with humility."11

What Justice Jackson describes is a model to which I think all of us in
law enforcement should aspire and, if we ever need to see that model in
practice, we need look no further than Irving Milton Pollack, Brooklyn Law
School, Class of 1942.

Thank you very much.

(1940), available at http://www.roberthjackson.org/Man/theman2-7-6-1/.
Brooklyn Law School has long had an outstanding business law faculty. Many of our graduates have gone on to work in the field of securities regulation, as attorneys at the Securities and Exchange Commission and self-regulatory organizations, as practitioners prosecuting and defending securities litigation and working on securities transactions, and as in-house legal and compliance officers at securities firms. Others have engaged in corporate practice in law firms and corporations across the country. In recognition of the contributions and interests of our faculty and alumni, our students urged us to consider adding a specialized business law journal to our family of publications. After serious consideration, the faculty determined that one should be established. The result was the *Brooklyn Journal of Corporate, Financial & Commercial Law*, which was organized in the fall of 2005.

Organizing any new venture is, of course, difficult. But we have been very fortunate to have had from the start an energetic and committed group of students working on this project. They were given tremendous support by Professors Roberta Karmel and Ted Janger, who volunteered to serve as faculty advisors.

This first issue of this new *Journal* includes articles that were the result of the Securities and Law Enforcement Symposium that was held at the Law School on March 31, 2006. After the bursting of the stock market bubble in 2000–2001, prosecutors and the Congress developed new models of securities law enforcement to bring bad actors to task. The Public Company Accounting Oversight Board was established as a novel form of self-regulatory organization, corporate monitors were selected to oversee the settlement of securities fraud cases, and deferred prosecution agreements were utilized a remedial tool. There was a re-focus by regulators and judges on gatekeepers, and how they should be held responsible for the abuses of the 1990s. These topics were the focus of the Symposium’s discussants. The program was a stimulating one by outstanding presenters and commentators, who were a representative mix of regulators, academics, and practitioners. I am delighted that it resulted in the publication of the fine articles in this issue of the *Journal*. I hope you enjoy reading them.

*Dean Joan G. Wexler*

*Joseph Crea Dean*

*Brooklyn Law School*
REGULATING THE MUTUAL FUND INDUSTRY

Donna M. Nagy*

Today in the United States, nearly ninety-five million people, comprising more than half of all U.S. households, invest in mutual funds either directly or through retirement plans. In April 2006, the total net assets of U.S. mutual funds hit a record high of nearly $9.5 trillion, held in 8,008 separate funds. By way of comparison, in 1980, there were combined assets of approximately $135 billion in 564 funds. As these numbers reflect, the growth in the mutual fund industry over the last twenty-five years has been explosive.

The Securities and Exchange Commission (SEC), however, has not seen the budgetary increases that would have enabled it to stay in pace with the mutual fund industry. In the 1980s, the SEC sounded what became a perennial alarm as to its inability to keep up with industry growth and the consequent compromise to the effectiveness of its investment company inspection program. Self-regulation was proposed as a possible solution,

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and from time to time throughout the next two decades, the SEC, Congress, and industry participants considered various proposals. Yet, for a variety of reasons—including the mutual fund industry’s relatively unblemished regulatory record and its claim to an extraordinarily high level of public confidence—none of these proposals resulted in the creation of a mutual fund self-regulatory organization (SRO).

Concerns about the adequacy of mutual fund oversight reached new heights in the wake of the market timing and late trading scandals first brought to public attention by New York State Attorney General Eliot Spitzer in 2003. Following closely on the heels of the Enron and WorldCom accounting scandals that gave rise to the creation of the Public Company Accounting Oversight Board (PCAOB), these mutual fund trading abuse scandals prompted renewed calls for restructured mutual fund regulation. And while proposals for statutory self-regulation modeled on the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) continue to be advanced for the mutual fund industry, even more attention is now being focused on the PCAOB’s model of “private” independent regulation.

5. See infra Part I.B.


7. While the importance of the mutual fund trading abuse scandals, as well as the extent and effects of the wrongdoing, is certainly open to debate, see, e.g., Larry E. Ribstein, Do the Mutuals Need More Law?, 27 REG. 14 (2004); Henry G. Manne, What Mutual Fund Scandal?, WALL ST. J., Jan. 8, 2004, at A22; see also Mercer Bullard, The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC’s Response to the Mutual Fund Scandal, 42 HOU S. L. REV 1271, 1274 (2006) (arguing that the SEC has “misunderstood the true nature of the scandal” and over-reacted to occurrences of frequent trading while under-reacting to the problem of fund arbitrage), few would dispute that the scandals provided advocates for change with a powerful rhetorical vehicle. Indeed, as Professor Jonathan Macey has observed, “public policy crises, whether real or imagined, provide an opportunity for entrepreneurial politicians and regulators to break the typical log-jams that make it more difficult to pass new rules during times of ordinary politics.” Jonathan R. Macey, Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer, 70 BROOK. L. REV. 117, 118 (2005). Some of the calls for restructured mutual fund regulation were likely directed to this “policy window.” See id. at 137–38 (emphasizing “the need for federal officials to appear to be ‘doing something’ . . . in the wake of the scandals . . .” uncovered by Eliot Spitzer).

8. See Joel Seligman, Should Investment Companies be Subject to a New Statutory Self-Regulatory Organization?, 83 WASH. U. L.Q. 1115, 1126 (2005) (“[A new SRO] 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.”). See also American Enterprise Institute, Former SEC Division Directors Give Their Views on Regulatory Reform (Feb. 28, 2006), http://www.aei.org/events/filter.all,eventID.1264/transcript.asp (moderated roundtable
This article contends that while the regulatory regime for mutual funds could certainly be improved, the substitution of a private entity for the SEC as the industry’s primary overseer is not the answer. Indeed, private regulation does not hold the solution for strengthening the oversight of mutual funds, whether along the lines of the PCAOB’s model of independent regulation or the self-regulatory models of the NASD and NYSE. Rather, assuming that further study demonstrates the desirability of more frequent and/or more comprehensive inspections of mutual funds and their advisers, Congress should infuse the SEC with the resources necessary to accomplish that end. This undertaking could be funded through any number of avenues.

This article proceeds in three parts. Part I provides a brief overview of the mutual fund industry and its regulatory landscape. Part II focuses on private regulation and concludes that neither the PCAOB’s model of independent regulation nor the NASD and NYSE’s model of self-regulation is appropriate for the mutual fund industry. Part III explores how to improve the regulatory regime for the mutual fund industry and advances a number of suggestions.

I. THE MUTUAL FUND INDUSTRY AND ITS REGULATORY LANDSCAPE

A. THE CURRENT REGIME

The mutual fund industry continues to thrive despite the bevy of scandals revealed to the investing public in 2003 and 2004, at least by the measures of total assets under management ($9.485 trillion as of April 2006) and new dollars invested (more than $500 billion in the first four...
months of 2006). Although late trading and market timing scandals captured the lion’s share of publicity, many other illegal practices were unearthed during this time period including those involving unpaid breakpoint discounts, mispriced assets, and undisclosed revenue-sharing with broker-dealers.

The response to the mutual fund scandals at the federal level was swift. Although political pundits predicted the passage of mutual fund legislation in the wake of the scandals, Congress opted instead for a “wait and see” approach to evaluate the results of the SEC’s unprecedented efforts toward industry reform. Accordingly, proposals for private sector regulation of the mutual fund industry must be assessed in light of the regulatory regime described below.

1. The Statutory Framework

of 1940 (the Advisers Act), and the Investment Company Act of 1940 (the ‘40 Act). Often described as the most complex of these laws, the ‘40 Act was enacted specifically to regulate mutual funds and other types of investment companies as well as the investment advisers who manage them.

The statutory scheme in the ‘40 Act requires mutual funds to register with the SEC, mandates extensive disclosure, and, because disclosure alone was viewed as insufficiently protective of shareholder interests, imposes a vast array of highly specific substantive requirements and prohibitions. These requirements and prohibitions include those that relate to mutual funds and their capital structure, the composition and structure of their boards of directors, the types of transactions in which they can engage (including a near outright ban on transactions with affiliates), and the diversification of their investments among different industries. However, to mitigate some of the harshness of these provisions, the ‘40 Act gave the SEC broad authority to exempt investment companies and advisers—conditionally or unconditionally—from virtually any statutory requirement or prohibition. The ‘40 Act also gave the SEC broad authority to issue rules imposing additional regulatory requirements.
As Congress envisioned, the SEC’s role in regulating mutual funds is substantial. In addition to its broad exemptive and rulemaking authority, the SEC has the responsibility of ensuring compliance with the ’40 Act’s provisions and the rules and regulations promulgated thereunder. In furtherance of this end, the SEC’s Office of Compliance Inspections and Examinations (OCIE) conducts periodic inspections of mutual funds and their investment advisers. When these inspections reveal serious regulatory violations, or when regulatory violations are otherwise suspected, the Division of Enforcement can initiate investigations. If warranted, the Division may seek Commission authorization for the initiation of enforcement actions which may be brought in federal court or in administrative proceedings.

As the principal regulator for broker-dealers, the NASD also plays a limited role in mutual fund regulation. Specifically, broker-dealers who sell mutual funds must comply with NASD rules pertaining to sales practices and advertising, and are subject to periodic examinations and inspections by the NASD staff. Broker-dealers who violate these rules or the federal securities laws are subject to discipline by the NASD.

The statutory framework further places considerable supervisory responsibilities on a mutual fund’s board of directors, particularly independent (or disinterested) directors. Among other responsibilities, directors are charged with initial approval and periodic review of the mutual fund’s investment advisory and distribution contracts (including the fees charged for these services). These contacts must be reviewed annually and must be approved by a majority of the fund’s independent directors.

Federal courts are, of course, the ultimate arbiter of whether mutual funds, and those who direct and advise them, have complied with their statutory obligations. In addition to statutory provisions that authorize both

without resort to legislation.” FRANKEL & SCHWING, supra note 24, § 1.02[B][2]. However, it goes on to note that approximately every ten years, Congress reviews the Act and “in most cases, codifies[es] the SEC’s exemptive rules, sometimes with changes.” Id.


31. Investment companies and investment advisers are required to maintain records for examination by the SEC. See id. § 80a-30 (2000).

32. The Enforcement Division may initiate informal investigations on its own accord. But formal investigations, pursuant to which enforcement staff may subpoena documents and testimony, may only be initiated with approval by the Commission. 17 C.F.R. § 202.5(a) (2006).


34. See Roberta S. Karmel, Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility: What Regulation By the Securities and Exchange Commission is Appropriate?, 80 NOTRE DAME L. REV. 909, 915 (2005) (noting that Congress structured the Investment Company Act in a way that positioned “the disinterested directors in the role of watchdogs to act as an independent check on the management of the investment company”).

and civil monetary penalties, the ‘40 Act provides an express private right of action for breaches of fiduciary duty involving compensation and fees paid by mutual funds to their advisers or affiliated persons. Although courts traditionally recognized implied rights of action under various statutory provisions, a number of recent decisions have held that the ‘40 Act does not give rise to causes of action that are merely implied from the statutory text.

2. Recent Regulatory Reforms

That the mutual fund scandals were first unearthed by the New York State Attorney General’s Office and not the SEC, the agency principally charged with enforcing the federal securities laws, gave the SEC much to answer for.

Based on a survey sent to mutual fund complexes shortly after Spitzer’s revelations, the SEC estimated that approximately half of the eighty-eight largest mutual funds had undisclosed arrangements with favored clients that allowed these shareholders to engage in market timing that contravened publicly stated policies regarding short term trading. See Looking Out for Investors Hearing, supra note 9, at 11–12 (testimony of Stephen Cutler, Director, SEC Division of Enforcement). Surveys to the 34 largest broker-dealers revealed that more than 25% permitted certain customers to place or confirm orders after 4:00 p.m. and receive the 4:00 p.m. net asset value (NAV) price.

Where is the [SEC] in this reform effort? Why did it leave it to a state AG to oversee the mutual-fund industry, just as it did with Wall Street research? It has been left to New York Attorney General Eliot Spitzer to uncover one problem after another in the securities business and to show the SEC and its boss, William Donaldson, what regulation is all about.

Where is the [SEC] in this reform effort? Why did it leave it to a state AG to oversee the mutual-fund industry, just as it did with Wall Street research? If Washington doesn’t want 50 Eliot Spitzers making policy, it had better make sure the SEC and Justice do their jobs.
The question was also the principal focus of a report to Congress prepared by the Government Accountability Office (GAO). Not surprisingly, the SEC’s failure to detect the mutual fund trading abuses has been attributed to a variety of factors, including inadequate resources and inaccurate risk assessment by SEC staff, the latter due in part to the staff’s mistaken belief that mutual fund complexes were being vigilant in self-policing frequent trading. Others have argued that the SEC, and more particularly its Division of Investment Management, fell prey to the problem of agency capture.

Yet even the SEC’s critics would likely acknowledge that the SEC placed a high priority on reform once it was alerted to the extent of the trading abuses in the mutual fund industry. Specifically, the SEC responded to the scandals with aggressive rulemaking, stepped-up enforcement actions, and a revamped mutual fund inspection program that revised examination techniques and significantly expanded the number of examiners. The following sub-sections briefly explore each of these regulatory reforms.

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45. See id. at 11–12. (recognizing that the SEC faced “competing examination priorities and had limited examination resources prior to September 2003” and noting that the SEC staff viewed fund complexes as having “financial incentives to control frequent trading”).

46. See Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Financial Management, the Budget, and Int’l Security Subcomm. of the Comm. on Gov. Affairs, 108th Cong. 268 (2004) (statement of Professor John P. Freeman) (arguing that the SEC’s Division of Investment Management “has become far too deferential to the industry” and thus “presents a classic case of ‘regulatory capture’”). See also Coffee, supra note 43, at 46 (“[A]dopting a profile of being tougher than the SEC may further Spitzer’s political ambitions, but this does not mean that he is wrong to suggest that the SEC has been too soft—that it has, to a degree, been ‘captured’ by the politically powerful mutual fund industry.”); Macey, supra note 7, at 117–18 (“The SEC’s passivity” in areas including mutual fund regulation “was likely caused by the agency’s capture by the same special interests it was ostensibly regulating.”).

47. Some might contend that the principal impetus for reform was a need on the part of SEC officials to restore the agency’s reputation as an effective regulator. See Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L REV. 951, 967 (2005) (“It is hardly likely that the SEC’s neglect of the problems in the mutual fund industry would have ended so suddenly without the pressure exerted by the New York Attorney General’s interest in the issue.”).
Mutual fund initiatives were much on the minds of SEC officials after the burst of the so-called high-tech bubble and the collapses of Enron and WorldCom. But the pace of the SEC’s rulemaking agenda quickened substantially in the months following the public revelation of the late trading and market timing scandals.

A principal component of the SEC’s rulemaking agenda involved the tightening of internal controls and operations of mutual funds. Pursuant to these new rules, investment companies and investment advisers registered with the SEC are required to implement, review, and maintain “written compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations.” Mutual funds and their advisers must also designate a chief compliance officer (CCO) who is responsible for monitoring both the entity’s compliance with laws and regulations and the entity’s own written policies and procedures. In addition, registered investment advisers must adopt written codes of ethics, a mandate previously applicable only to investment companies.

Other new rules were designed to enhance the governance structure of mutual funds. The most important (and most controversial) of these governance rules required that in order for a mutual fund to avail itself of certain SEC exemptions, the chairman of its board of directors and at least seventy-five percent of the board itself must be independent from the fund’s investment adviser. The new governance rules also condition exemptions on the
requirements that independent directors hold quarterly “executive sessions” separate from the board and that they have the authority to hire staff (including independent counsel) to support their oversight responsibilities.53

The SEC also proposed rules to address the specific problems of market timing and late trading. One proposed rule would have imposed a mandatory two percent redemption fee on fund shares sales made within five days of a purchase.54 However, in response to comments from the industry, the SEC ultimately adopted a modified rule that allows—but does not require—funds to impose such fees.55 To thwart the illegal practice of late trading, the SEC proposed a rule that would require all orders for purchases or sales of fund shares to be received at the fund by a 4 p.m. EST “hard close.”56 Opposition to this proposed rule has been intense, however, and the SEC appears to be considering alternatives.57

A final set of rules are aimed at enhancing the disclosures made by mutual funds to the investing public. Pursuant to these requirements, mutual funds must disclose their policies and procedures with respect to (1) market timing, (2) “fair valuation” of their portfolio holdings, and (3) disclosure of their portfolio holdings.58 The new rules also significantly expanded the information required to be disclosed periodically to mutual fund

In addition, mutual funds are now required to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads.\(^{59}\)

\(b\). Enforcement Actions Against Mutual Funds

The SEC wasted no time stepping up its own enforcement efforts in response to Eliot Spitzer’s widely publicized charges of fraud in the mutual fund industry.\(^{61}\) As the Director of the SEC’s Enforcement Division reported to Congress, “immediately following [Spitzer’s] announcement, relying on the Commission’s examination powers, the Commission’s staff sent detailed information requests to 88 of the largest mutual fund complexes in the country and 34 broker dealers . . . [seeking] information on each entity’s policies and practices relating to market timing and late trading.”\(^{62}\) Many of the responses “warranted aggressive follow-up” inspections by SEC examiners and others “led to referrals to the enforcement staff for further investigation.”\(^{63}\) Additional investigations were launched based on evidence uncovered through the efforts of both the SEC’s enforcement staff and state attorneys general, particularly Spitzer.\(^{64}\)

As of May 2005, the SEC had initiated 29 enforcement actions involving fund complexes and their employees (including many of the nation’s largest complexes) and 12 enforcement actions involving broker-dealers and their employees.\(^{65}\) Through settlements with these firms and actions filed subsequently, the SEC has collected more than $3.3 billion dollars in penalties and disgorgement.\(^{66}\) The SEC intends to distribute this

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62. Looking Out for Investors Hearing, supra note 9, at 184–85 (statement of Stephen Cutler, Director, SEC Division of Enforcement).

63. Id. at 185.

64. Id. at 180 (describing SEC enforcement efforts relating to mutual fund trading and stating that “we are working aggressively . . . in close connection with State regulators, including Mr. Spitzer and Mr. Galvin in Massachusetts”).

65. See Trading Abuses Hearings, supra note 1, at 38 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations).

settlement money to mutual fund shareholders who had been harmed by the trading abuses. In addition to substantial monetary payments and prophylactic relief in the form of cease-and-desist orders or injunctions, the SEC settlements contained undertakings that required the firms to improve their compliance practices and corporate governance structure.

c. Mutual Fund Inspections and Examinations

Approximately 500 examiners are currently assigned by the OCIE to inspect investment companies and investment advisers. Prior to the mutual fund scandals, the SEC had fewer than 360 examiners. Even before the scandals broke, a significant number of new hires had been planned from the substantial appropriation increases to the SEC’s budget as part of the Sarbanes-Oxley Act of 2002. But the scandals reemphasized the priority of enhancing the oversight of mutual funds.

The addition of these new examiners enabled the OCIE to increase the frequency of its examinations: the nation’s largest funds are now scheduled for examination at least once every two to three years. From 1998–2003, the OCIE examined these firms once every five years, and prior to 1998 the cycles for examination had been the remarkably long length of once every 12 to 24 years.
The OCIE has also substantially revised its examination techniques to improve the staff’s ability to more promptly identify emerging compliance problems. Specifically, the OCIE has shifted to a “risk-based” methodology for examining mutual funds and investment advisers which “allows the staff to move more quickly, to be more nimble, and to be more responsive to the rapidly changing risk environment in the fund community.” This new risk-based approach focuses routine examinations on the nation’s largest funds and other firms posing the greatest compliance risks (approximately 200 fund groups and 600 advisers). The remaining firms are examined “for cause” in sweeps directed at specific risks or possible violations across numerous firms, or at random.

The OCIE’s new methodology is also credited with making greater use of technology and data and increasing the number of interviews during examinations in order to better assess a firm’s control or risk environment. Other enhancements include the establishment of “monitoring teams” for the largest fund complexes, which allow examiners to become better acquainted with the business and operations of a specific complex. In addition, OCIE staff examiners work closely with the SEC’s new Office of Risk Assessment “to help identify and coordinate areas of risk across the agency.”

B. PERIODIC CALLS FOR PRIVATE SECTOR REGULATION

From time to time over many decades, the SEC, Congress, and the industry itself has considered the possibility of utilizing private sector regulation for mutual funds and/or investment advisers. This section briefly

\[\text{GAO Lessons Learned Report, supra note 44, at 24.}\]
examines several proposals relating specifically to the mutual fund industry and explores some of the reasons why these proposals have not resulted in private regulation.

1. Proposals from the SEC

While informal discussions between SEC officials and industry participants about private regulation for mutual funds are legion, only twice—in 1983 and 2003—has the SEC sought public comment on a specific proposal for a mutual fund SRO. On both occasions the industry

80. As far back as the early 1960s, the SEC had begun urging the Investment Company Institute to establish itself a self-regulatory organization for mutual funds. See William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 247 (1963) (“The SEC and the ICI both agreed on the principle that more inspection of investment companies is called for,” but the “industry believed [that the SEC] should perform the inspection,” whereas the SEC “suggested that the Institute take the initiative.”). These informal discussions between the SEC and the ICI intensified again in the early 1980s. See *Will ICI Lend SEC a Hand in Watching Over Industry*, FUND ACTION, Feb. 7, 2005, at 1 (“When David Ruder was SEC Chairman . . . we came very close to making ICI the SRO for funds.” (quoting former ICI President David Silver)). According to Silver, it floundered on only one point: the “ICI wanted an assurance the SEC would not give that if the Institute took an enforcement action against a fund company the SEC, NASD or the states would not jump in with actions of their own.” *Id.*


83. On several occasions during the 20 year period between these proposals, SEC officials raised in congressional testimony the possibility of an SRO for funds and/or advisers. See *Hearings on the Unfair Practice that Exists with Some Financial Planners and the Need for Congress to Support the SEC Through Additional Funding and Staffing for Regulation of the Financial Planning Industry: Hearing Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 26 (1992) (testimony of Richard C. Breeden, SEC Chairman).

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.

*Id.* Proposed Amendments to the Investment Advisers Act of 1940: *Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce*, 102d Cong. 127 (1992) (testimony of Richard C. Breeden, SEC Chairman) (“I would agree that, in concept, [an SRO] is something worth looking at . . . . In fact it might be considerably more costly than an SEC examination. . . . We would be happy to work with the SRO’s in areas where it made sense, and from an overall point of view of economy.”). See also *Oversight Hearing on the Mutual Fund Industry: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong. 12 (1993) (hereinafter *Oversight Hearing on the Mutual Fund Industry*) (testimony of Arthur J. Levitt, SEC Chairman):

I think, in general, an SRO has proven to be one of the most effective ways of monitoring a growing complex of financial services in our society, and it’s a way that I am seriously considering with respect to investment companies and even considering more seriously with respect to investment advisers.
reaction was exceedingly negative.\textsuperscript{84} Indeed, unlike the broker-dealer industry which historically has embraced self-regulation, the mutual fund industry has been quite content with direct regulation and examination by the SEC.\textsuperscript{85}

The SEC’s 2003 proposal was significantly broader than the “inspection-only” proposal floated twenty years earlier. Couched in the Release as one of four potential approaches to increasing private sector involvement in the SEC’s regulatory program, the 2003 proposal noted that an SRO for mutual funds:

would function in a manner analogous to the national securities exchanges and registered securities associations under the Securities Exchange Act of 1934 by (i) establishing business practice rules and ethical standards, (ii) conducting routine examinations, (iii) requiring minimum education or experience standards, and (iv) bringing its own actions to discipline members for violating its rules and the federal securities laws.\textsuperscript{86}

As with the NASD and the NYSE, any SRO for mutual funds “would be subject to the pervasive oversight of the Commission” and the SEC “would examine its activities, require it to keep records, and approve its rules. . . .”\textsuperscript{87} But the Release further stated that the “staff would continue to examine the activities of funds and advisers, both to ensure adequate examination coverage and to provide oversight of the SRO examination program.”\textsuperscript{88}

\textit{Id.}

84. \textit{See infra} notes 91–95 and accompanying text.
85. The same is true for the investment adviser and financial planning industries. Despite several SEC and congressional proposals to establish one or more SROs for investment advisers, none have been adopted. \textit{See, e.g., Investment Adviser Self-Regulation Act of 1989, 135 CONG. REC. E. 2736 (1989); see also Investment Adviser Reform: Hearing on H.R. 578 Before the Subcomm. On Telecomms. And Fin. Of the H. Comm. On Energy and Commerce, 103d Cong. 8 (1993).} The possibility of creating one or more SROs for investment advisers also was raised as a recommendation in the SEC’s 1963 study of the securities markets. \textit{See REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 88-95, pt. 1, at 158–59 (1963).}

As others have noted, the problem of effectively regulating investment advisers was resolved, at least in part, when Congress enacted the National Securities Markets Improvement Act of 1996. \textit{See FRANKEL \& SCHWING, supra note 24, § 1.02[A][8] (citing National Securities Markets Improvement Act, Pub. L. No. 104-290, 104th Cong., 2d Sess., 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code)).} Among other reforms, the Act divided jurisdiction over the regulation of investment advisers between the federal government and the states: advisers with more than $25 million of assets under management must register with the SEC and adhere to federal law whereas advisers managing assets beneath this threshold are regulated by the states pursuant to state law. \textit{See Paul S. Stevens \& Craig S. Tyle, Mutual Funds, Investment Advisers, and the National Securities Markets Improvement Act, 52 BUS. LAW. 419, 443 (1997).}

87. \textit{Id.} at 87,184.
88. \textit{Id.}
The impetus for the 2003 proposal was the SEC’s lack of adequate resources, notwithstanding the anticipated substantial increase to the SEC’s budget.\footnote{See id. at 87,182.} In fact, the Release went so far as to predict that “even if we are able to substantially expand our examination staff, it is unlikely that future growth in our resources will ever keep pace with future growth of investment advisers and investment companies.”\footnote{Id.} It bears noting that the 2003 proposal was released for comment in February 2003, more than six months before the revelation of the market timing and late trading scandals that prompted congressional hearings and demands for change.

Industry participants and representatives of the investing public, with very few exceptions, were vehemently opposed to the 2003 proposal. Most commentators questioned the need for change, highlighting the SEC’s success with direct regulation and examination of funds\footnote{See Letter from Craig S. Tyle, Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec’y, SEC (Apr. 17, 2003), available at http://www.sec.gov/rules/proposed/s70303/s70303-15.pdf (“It bears emphasizing that the current system of Commission oversight of mutual funds has worked exceptionally well for more than sixty years.”).} and pointing to the mutual fund industry’s proud “record of compliance with both the letter and the spirit of the securities laws.”\footnote{Id.} Commentators were also concerned that the establishment of an SRO for mutual funds would create “inconsistent and fragmented layers of regulation”\footnote{Letter from David Riggs, Vice President & Assoc. Gen. Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Sec’y, SEC, Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers 5 (Apr. 23, 2003), available at http://www.sec.gov/rules/proposed/s70303/charlesschwab042303.htm.} and that “forming and operating an SRO would be extremely costly” with such costs ultimately to be borne by investors.\footnote{Hester Peirce, Div. Inv. Mgmt., Compliance Programs of Investment Companies and Investment Advisors: Summary of Contents on Proposed New Rules 38a-1 Under the Investment Company Act and 206(4)-7 Under the Investment Advisors Act, and Proposed Amendments to Rule 204-2 Under the Investment Advisers Act (Nov. 20, 2003), available at http://www.sec.gov/rules/extra/s70303summary.pdf.} Others bemoaned that self-regulation “would require funds to pay twice, once to the Commission and once to an SRO, for essentially the same amount of oversight they receive today.”\footnote{Letter from Heidi Stam, Principal, Sec. Regulation, Vanguard Group, to Jonathan G. Katz, Sec’y, SEC 6 (Apr. 16, 2003), available at http://www.sec.gov/rules/proposed/s70303/vanguard041603.htm (“Requiring Commission staff to continue to examine funds and advisers, with the additional burden of overseeing an SRO, ultimately would weaken rather than strengthen the Commission’s ability to effectively oversee funds and advisers.”).}

The 1983 proposal was developed in a manner similar to the 2003 proposal and met with a similar fate. After more than twenty years of back and forth discussions between SEC officials and industry participants,\footnote{See supra note 80 and accompanying text.} in February 1983 the SEC issued a release seeking public comment on the concept of utilizing the private sector to perform routine inspections of...
mutual funds and other investment companies. After highlighting the industry’s “dramatic growth” and lamenting the “budgetary constraints that prevent the allocation of greater staff resources to the investment company examination program,” the release sought guidance on a number of alternatives, including the possibility of creating one or more SROs to conduct routine periodic inspections of investment companies. Under this alternative, the SRO would have the “limited function of conducting examinations of investment companies which elect to participate in such an examination program, and making the results of those examinations available to the Commission.” But even with this limited function, an SRO for the purpose of inspecting mutual funds lacked the necessary support from the industry.

The comments from the mutual fund industry in response to the SEC’s proposals, particularly the 2003 proposal, reflect the industry’s concerns with the costs of private regulation and the fragmentation that could result from concurrent private and public regulation. Some observers might argue that the industry is well aware that the SEC’s budget has not kept pace with the explosive growth of mutual funds and that the industry prefers to be regulated by an entity that is strapped for resources. But cutting against this explanation for its reticence to private regulation is the industry’s traditional support in Congress for increased SEC appropriations for mutual fund oversight.

Another explanation for the reticence may be that the mutual fund industry places a high value on its ability to advertise itself as “regulated by the SEC.” As Professor Tamar Frankel has observed:

> Regulation offers issuers and institutions government support in their efforts to gain investors’ trust in the financial markets. Just as it is difficult to validate the trustworthiness of these institutions, it is also very costly for the institutions to convince investors of their trustworthiness. Regulation reduces the institutions’ costs. Regulation also helps to restrain the “bad apples” that may ruin confidence in the industry; a few

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98. Id. at 8486.
99. Id. at 8486–87.
100. Id. at 8487.
101. See, e.g., Oversight Hearing on the Mutual Fund Industry, supra note 83, at 95 (statement of Matthew P. Fink, President, Investment Company Institute) (“[The ICI] has for years supported increased funding for the SEC (and for the Division of Investment Management in particular), so that the highly effective regulation that the mutual fund industry has experienced to date will be assured in the future.”).
102. Cf. Tamar Frankel, Regulation and Investors Trust in the Securities Markets, 68 BROOK. L. REV. 439, 442 (2002). Small investment advisers “vehemently opposed” legislation curtailing federal regulation because “[t]hey wanted to continue to advertise themselves as ‘Regulated by the SEC,’ which they valued more than the advertising of ‘Regulated by State X.’” Id.
untrustworthy members may spoil the reputation for trustworthiness for all industry members. Regulation provides the industry with the stamp of “good housekeeping.” It implies that the government guards investors’ interests, and reduces the very high costs that investors would otherwise bear in monitoring the issuers and the institutions.\(^{103}\)

Earning a “good housekeeping” stamp from the SEC may well be significantly more valuable to the mutual fund industry than a “good housekeeping stamp” from an SRO.

2. Congressional Proposals

After decades of listening to the SEC’s repeated warnings of inadequate resources in the area of mutual fund regulation,\(^ {104}\) in the wake of the market timing and late trading mutual fund scandals, Congress was jolted into action. The result was a series of oversight hearings and a flurry of bills, with some bills proposing new regulations as well as the creation of a “Mutual Fund Oversight Board” modeled on the recently created PCAOB.

Due in part to the upcoming 2004 presidential election, a bill jointly sponsored by Senators John Kerry, Edward Kennedy, and Thomas Daschle—The Mutual Fund Protection Act of 2003—drew substantial attention from the media and financial press. The bill called for the congressional creation of a not-for-profit corporation—the Mutual Fund Oversight Board—which “shall not be an agency or establishment of the United States Government.”\(^ {105}\) As envisioned, it would have possessed registration, investigation, disciplinary, and rulemaking authority over mutual fund directors.\(^ {106}\) The Board’s members would have been selected by the SEC,\(^ {107}\) and it would have been funded by assessments against mutual fund assets or management fees.\(^ {108}\) Providing the rationale for its creation, Senator Kerry maintained:

> The actions by the SEC show that it is incapable of protecting investors from securities fraud by mutual fund companies and will not prosecute this type of fraud to the full extent of the law. Therefore, we must take the day-to-day oversight of mutual funds away from the SEC and develop a new Mutual Fund Oversight Board to provide oversight, examination and enforcement of mutual funds. This new board will be similar to the Public

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103. Id.
105. Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201(b), 149 CONG. REC. 15,977, 15,984 (2003). Much of the text of the provisions creating the Board was drawn verbatim from Title I of the Sarbanes-Oxley Act, which created the PCAOB. See infra notes 113–121 and accompanying text.
107. Id. § 201(e)(3).
108. Id. § 207(d)(1)–(2).
Company Accounting Oversight Board developed in the Sarbanes-Oxley Act.\footnote{109}

The Kerry-Kennedy-Daschle bill, along with a number of other bills on the subject of mutual fund reform, failed to proceed very far in Congress.\footnote{110} To be sure, the demand for reform was high.\footnote{111} But as recounted above, the SEC managed to put forth a convincing case that it was focused on the problems in the mutual fund industry and was proceeding down a path of substantial change.

**II. AN ANALYSIS OF PRIVATE SECTOR REGULATION FOR THE MUTUAL FUND INDUSTRY**

Private regulation for the securities industry pre-dates the creation of the SEC by almost 150 years.\footnote{112} Until very recently, this private regulation took the form of self-regulation under SEC oversight, whereby broker-dealers trading on exchanges, and later in the over-the-counter market, agreed to comply with detailed rules and principles of fair dealing promulgated by the industry. With the creation of the PCAOB, however, another type of private regulation was born: so-called “independent” private regulation. This part explores both types of regulation and concludes that neither constitutes an appropriate model for the mutual fund industry.

**A. INDEPENDENT PRIVATE REGULATION: THE PCAOB MODEL**

1. The Structure and Responsibilities of the PCAOB

Congress created the PCAOB in July 2002 as the centerpiece of the Sarbanes-Oxley Act.\footnote{113} The PCAOB’s principal mission was to restore investor confidence by preventing the types of accounting scandals that resulted in the collapses of Enron, WorldCom, and numerous other companies in 2001 and 2002.\footnote{114}
As part of this congressionally-designed crackdown, Title I of the Sarbanes-Oxley Act\(^\text{115}\) charged the ostensibly private PCAOB\(^\text{116}\) with the broad responsibility of overseeing the audits of public companies (rendering the PCAOB as the auditor’s auditor). Specifically, the legislation provided that the PCAOB shall: register accounting firms that audit public companies;\(^\text{117}\) enact rules setting standards for auditing, quality control, ethics, and independence;\(^\text{118}\) inspect on a yearly basis the nation’s largest accounting firms and inspect other firms at least once every three years;\(^\text{119}\) investigate possible violations of PCAOB rules or the federal securities laws by accounting firms and their associated persons;\(^\text{120}\) and impose discipline for established violations through a range of sanctions including censures, temporary suspensions, permanent bars, and substantial monetary fines.\(^\text{121}\)

Congress also charged the SEC with ultimate oversight of the PCAOB (rendering the SEC, in a manner of speaking, the auditor of the auditor’s auditor). Specifically, the SEC appoints the PCAOB’s Chairperson and its four other members (who can only be removed for cause);\(^\text{122}\) approves the PCAOB’s budget;\(^\text{123}\) approves any rules adopted by the PCAOB;\(^\text{124}\) and retains review power over any disciplinary actions taken by the PCAOB.\(^\text{125}\)

The PCAOB was deemed fully operational by the SEC on April 25, 2003.\(^\text{126}\) Since that time, the PCAOB has grown into an organization with approximately 450 employees in Washington, D.C. and seven regional offices, and an operating budget of $130.5 million for fiscal year 2006.\(^\text{127}\) Congress provided that its primary source of funding—often referred to as “private sector funding”—was to come from the “accounting support fees” that the PCAOB was authorized to levy on public companies in accordance with a formula based on market capitalization.\(^\text{128}\)


\(^{116}\) Title I provides that “[t]he Board shall not be an agency or establishment of the United States Government,” and that “[n]o member or person employed by, or agent for, the Board shall be deemed to be an officer or employee of or agent for the Federal Government by reason of such service.” Id. § 7211(b).

\(^{117}\) Id. § 7211(a).

\(^{118}\) Id. § 7211(c)(2).

\(^{119}\) Id. § 7214(b)(1)(A)–(B).

\(^{120}\) Id. § 7211(c)(4).

\(^{121}\) Id. § 7215(c)(4)(A)–(D).

\(^{122}\) Id. § 7211(e)(4), (6).

\(^{123}\) Id. § 7219(b).

\(^{124}\) Id. § 7217(b)(2).

\(^{125}\) Id. § 7217(c)(2).

\(^{126}\) PCAOB, 2003 Annual Report, supra note 114, at 5.


\(^{128}\) 15 U.S.C. § 7219(c)(1), (g).
2. Should an Independent Oversight Board be Established for Mutual Funds?

I have argued previously that the decision to create the PCAOB as a private entity was profoundly unwise, both for doctrinal reasons as well as normative ones.\(^{129}\) To be sure, the accounting profession was sorely in need of restructured regulation and Congress was right to take up that task. But Congress’s resort to the legal fiction that the PCAOB is a private corporation jeopardizes the PCAOB’s ability to fulfill its role as the accounting industry’s principal regulator.

Prior Supreme Court precedent makes very clear that, for purposes of the U.S. Constitution, the PCAOB is part of the federal government notwithstanding its congressional designation as a private corporation. The decision most directly on point is \textit{Lebron v. National Railroad Passenger Corp.},\(^{130}\) where the Court set forth a three prong test for determining whether an ostensibly private entity is actually part of the “Government itself.”\(^{131}\) Under \textit{Lebron}, when (1) “the Government creates a corporation by special law,” (2) “for the furtherance of governmental objectives,” and (3) “retains for itself permanent authority to appoint a majority of the directors of that corporation,” that “corporation is part of the Government,” at least for purposes of constitutional law.\(^{132}\) Thus, federal courts—including one at this very moment in the U.S. District Court for the District of Columbia\(^{133}\)—must now grapple with whether the PCAOB’s structure comports with the Appointments Clause and the doctrine of separation of powers. And even if these threshold issues are resolved in the PCAOB’s favor, other challenges against the constitutionality of the PCAOB’s actions will invariably follow.\(^{134}\)

Congress’s decision to create the PCAOB as a private corporation is also troubling from a policy perspective. As a private entity, even one that is subject to SEC oversight, the PCAOB is less publicly accountable, its operations are less transparent, and its policymaking is less legitimate than its federal regulatory counterparts.\(^{135}\) Moreover, the PCAOB’s status as a private corporation raises, rather than lowers, the overall costs of its regulatory program. Had the PCAOB been established as a federal entity, it

\(^{129}\) See Nagy, \textit{supra} note 9, at 1048–57, 1061–69.

\(^{130}\) 513 U.S. 374 (1995). In \textit{Lebron}, an 8–1 majority of the Supreme Court held that Amtrak was part of the federal government, notwithstanding Congress’s statutory declaration that it is a private corporation and “not . . . an agency or establishment of the United States Government.” \textit{Id.} at 391.

\(^{131}\) \textit{Id.} at 397.

\(^{132}\) \textit{Id.} at 400.


\(^{134}\) See Nagy, \textit{supra} note 9, at 1044.

\(^{135}\) See \textit{id.} at 1062–66.
could be operating more cost effectively, in part because the compensation to its members and staff likely would have been less.\footnote{136}

My opinion about the appropriateness of the PCAOB model for the mutual fund industry should therefore come as no surprise: Congress should not compound its mistake in creating the PCAOB as a private corporation by establishing a new centaur-like entity for the mutual fund industry. Such an entity would surely fall prey to the same constitutional challenges and policy indictments currently being launched at the PCAOB.

3. The Road Not Taken—Independent Government Regulation

At the congressional hearings that preceded the enactment of the Sarbanes-Oxley Act, U.S. Comptroller General David Walker testified that while there were “several alternative structures” from which Congress could choose in establishing a new regulator for the accounting industry, the one that he favored would have created “an independent government entity within the SEC.”\footnote{137} His second favored alternative, possibly modeled on the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, would have created “an independent government agency outside the SEC.”\footnote{138} He did not favor the creation of “a non-governmental private-sector entity overseen by the SEC” because such a “body would have less direct accountability to the Congress and the public than a body with board members who are PASs [president appointed confirmed by the Senate].”\footnote{139}

\footnote{136. Of course, some would argue that the regulator for the accounting industry “needed” to be private because the regulator “needed” to pay private-sector salaries to attract highly qualified board members and staff. See, e.g., The Fourth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law, 9 FORDHAM J. CORP. & FIN. L. 583 (2004).


\footnote{138. Id.

\footnote{139. Id.}}
He also expressed concern that a private sector entity “would increase the SEC’s responsibility as well as its workload.”

Short of a Supreme Court decision invalidating the PCAOB’s current structure as unconstitutional, however, there is little reason to expect Congress to revisit this issue and recreate the PCAOB as an independent government regulator. That reality is unfortunate because the road not taken would have led to a stronger PCAOB that was more aligned with democratic values.

The possibility of independent government regulation remains open for the mutual fund industry. Yet a path down that road would make little sense. In the case of accounting, the creation of an entirely new entity was warranted because the SEC did not have a long and established tradition of inspecting and regulating the practice of auditing, and the need to replace the prior system of self-regulation was clear. Mutual funds, in contrast, have been inspected and regulated by the SEC for the last 65 years, with notable success and only infrequent criticism. In light of that experience, it is difficult to see how a new federal regulator could oversee the mutual fund industry any more efficiently or effectively with the same expenditure of resources.

Moreover, to the extent that the SEC’s shortcomings in regulating mutual funds can be attributed to agency capture, the potential for capture would only be increased in a newly created federal agency designed to focus exclusively on the regulation of the mutual fund industry. Indeed, as others have noted, “a well-known empirical regularity is that single industry regulators are typically more prone to capture than [multi]–industry regulators.”

**B. SELF-REGULATION: THE NASD AND NYSE MODEL**

1. **Self-Regulation as Distinguished from the PCAOB**

The recent litigation challenging the constitutionality of the PCAOB has focused renewed attention on the structural similarities between the PCAOB and the NASD and NYSE, and has prompted some to question whether a determination that the PCAOB is part of the federal government would jeopardize the legal status of these SROs. To be sure, as the SEC

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140. *Id.*
141. See Nagy, *supra* note 9, at 984.
142. See Birdthistle, *supra* note 6, at 1408.
tacitly acknowledged in *The Matter of Frank Quattrone*,145 the NASD and the NYSE’s close entwinement with the SEC raises legitimate questions as to whether some SRO actions should be deemed “state action” for purposes of the Constitution.146 But under the Supreme Court’s decision in *Lebron*, neither the NASD nor the NYSE should be deemed the “government itself.” Taking the three prongs of the test in *Lebron*,147 we can see why this is so.

Focusing on the first prong, neither the NASD nor the NYSE were “created” by Congress. Although Congress created a scheme of statutory self-regulation pursuant to which both entities are afforded certain quasi-government powers, both the NASD and the NYSE were formed by members of the industry they regulate—the “self” in self-regulation. The NYSE was established in 1792 when a group of securities brokers signed the “Buttonwood Agreement.”148 The NASD can trace its roots back to 1912 when a group of investment bankers formed the Investment Bankers Association of America (IBA).149 In contrast, the PCAOB owes its entire

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146. See infra notes 157–158 and accompanying text.

147. See supra notes 132 and accompanying text.


149. See PROCEEDINGS OF THE ORGANIZATIONAL MEETING AND OF THE FIRST ANNUAL CONVENTION OF THE INVESTMENT BANKERS’ ASSOCIATION OF AMERICA 12 (August 8, 1912) (Address of Chairman George Caldwell). See also Paul G. Mahoney, The Political Economy of the Securities Act of 1933, 30 J. LEGAL ST.UD. 1, 23–24 (Jan. 2001) (discussing the predecessor organizations to the NASD); VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 165 (Ralph W. Hidy ed., 1970) (“The IBA was the industry’s united response to mounting public criticism and increasing demands for regulatory legislation.”). In 1933, the IBA availed itself of the self-regulatory framework provided in the National Industrial Recovery Act (NIRA), ch. 90, 48 Stat. 195 (1933), and formed the Investment Bankers Code Committee (IBCC), charging it with the establishment of a code of fair competition. President Roosevelt approved that code in November 1933, but it fell victim to the Supreme Court’s decision in *Schechter Poultry Corp. v. United States*, 295 U.S. 495, 551 (1935), which declared the NIRA unconstitutional. Most investment bankers “continued to adhere to the code voluntarily,” and in 1936, the IBCC (which reorganized itself informally as the Investment Bankers Conference Committee (the “Conference Committee”)) began working with the SEC “to establish a new, permanent nationwide organization under the SEC.” CAROSSO, supra, at 389. According to Carosso, the Conference Committee’s “most important contribution was to draft the legislation subsequently passed as the Maloney Act.” Id. at 390. The Maloney Act added Section 15A to the Exchange Act, specifying the criteria pursuant to which the SEC may register “national securities associations” with rulemaking, investigative, and enforcement authority over their members. After the Maloney Act’s passage in 1938, the Conference Committee again reorganized to form the NASD, and in August 1939, the SEC formally registered the NASD as the nation’s first, and until the recent registration of the National Futures Association, only national securities association. See, e.g., Robert Glauber, Chairman and CEO, NASD, Testimony Before the Subcomm. on Capital Mkts., Ins. and Gov’t Sponsored Enters. of the Comm. on Fin. Servs., U.S. H.R. Hearing on Self-Regulatory Organizations: Exploring the Need for Reform 1 (Nov. 17, 2005), available at
existence and structure to Congress. That is, as previously noted, Congress designed the PCAOB and specified that it was to have five members; Congress imposed for PCAOB members a limit of two terms; Congress protected PCAOB members from removal except by the SEC (and then only for good cause); and Congress assigned the PCAOB its very specific oversight responsibilities. Moreover, to separate the PCAOB further from its self-regulatory cousins, Congress specifically provided that no more than two CPAs can serve as members at any one time.

Skipping to the third prong of the Lebron test, it is also clear that neither the NASD nor the NYSE are controlled by a board that is appointed by the government. Both entities select their own boards and the government plays no role in the appointment of NASD or NYSE directors. In stark contrast, the SEC appoints the PCAOB’s board (after consultation with the Chairman of the Federal Reserve and the Secretary of the Treasury) and only the SEC can remove PCAOB members—and then only for cause.

Some courts applying the Lebron test also look to government funding of an ostensibly private entity as an additional indicia of governmental
control. But here again we see a significant difference between the NASD/NYSE and the PCAOB: both the NASD and the NYSE receive their funding from the members they regulate, whereas the PCAOB’s funding stems from a congressional mandate effectively requiring public companies to pay “accounting support fees.”

Thus, even if the “government control” prong of the Lebron test is viewed more flexibly, it is highly unlikely that a court would deem either the NYSE or the NASD as an entity “controlled” by the government.

Returning to the second prong under Lebron, there is certainly no denying that Congress vested the NASD and the NYSE with government-like rulemaking, investigative and disciplinary powers and that these SROs, in the words of Lebron, further important “governmental objectives.” But while a necessary condition, that is hardly sufficient to deem an entity the government itself. Indeed, if furthering important “governmental objectives” were the sine qua non of a public entity, than a host of services frequently “contracted out” by the government—including education, medical care, transportation, and insurance—would be forever removed from the private sector.

The government-like rulemaking, investigative and disciplinary powers of the NASD and NYSE do, however, make these entities susceptible to constitutional challenges on the ground that their actions constitute “state action” under Supreme Court precedents. Such challenges have in the past been met with mixed success.

153. See, e.g., Gorman-Bakos v. Cornell Cooperative Extension of Schenectady County, 252 F.3d 545, 552–53 (2d Cir. 2001) (concluding in dicta that the state-created and state funded agricultural cooperative was a state actor even though only two of its ten board members were appointed by the government).


155. See, e.g., Sotack v. Pa. Prop. & Cas. Ins. Guar. Ass’n, 104 F. Supp. 2d 471, 478 (E.D. Pa. 2000) (finding that because the Commissioner of Pennsylvania’s Department of Insurance “has virtually limitless authority to supervise and regulate [the] PPCIGA at all times,” the PPCIGA satisfies the “control” prong in Lebron, even though “the members of the Board are typically not appointed by the government”).


157. Traditional state action analysis requires a court to determine whether “there is a sufficiently close nexus between the State and the challenged action.” Am. Mfrs. Mut. Ins. Co. v. Sullivan, 526 U.S. 40, 52 (1999) (holding that private insurer who withheld payment was not a state actor despite being subject to extensive government regulations). More recently, the Court has focused on the private entity’s overall “entwinement” with the government. See Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n, 531 U.S. 288, 302 (2001) (“Entwinement to the degree shown here” supports the conclusion that the TSSAA “ought to be charged with a public character and judged by constitutional standards.”). The scholarly literature on the so-called state action doctrine is voluminous. For insightful overviews, see Erwin Chemerinsky, Rethinking State Action, 80 NW. U. L. REV. 503 (1985); Ronald J. Krotoszynski, Back to the Briarpatch: An Argument in Favor of Constitutional Meta-Analysis in State Action Determinations, 94 MICH. L. REV. 302 (1995); Gillian E. Metzger, Privatization as Delegation, 103 COLUM. L. REV. 1367 (2003).

158. Compare Villani v. N.Y. Stock Exch., Inc., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (“It is now beyond dispute that the Fifth Amendment due process requirements as to federal action
2. Should an SRO be Established for Mutual Funds?

Having drawn the distinction between the PCAOB (an ostensibly private independent regulatory body) and the NASD and NYSE (private self-regulatory bodies), we can now explore the question of whether an SRO modeled on the NASD or NYSE should be established for the mutual fund industry. Although self-regulation under SEC oversight has worked reasonably well for the broker-dealer industry,159 such a self-regulatory system should not be established for mutual funds.160

Many of the arguments against the creation of an SRO for mutual funds relate to the well-recognized weaknesses inherent to any system of self-regulation. As a congressional committee observed more than 30 years ago:

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.161

With respect to broker-dealers, both Congress and the SEC have determined that these disadvantages are outweighed by the benefits of self-regulation. Among other benefits:

apply to the disciplinary hearings conducted by the Exchange.") aff’d sub nom Sloan v. N.Y. Stock Exch., Inc., 489 F.2d 1 (2d Cir. 1973), and Intercontinental Indus., Inc. v. Am. Stock Exch., 452 F.2d 935, 941 (5th Cir. 1971) (“The intimate involvement of the Exchange with the [Commission] brings it within the purview of the Fifth Amendment controls over governmental due process”), with United States v. Solomon, 509 F.2d 863, 867–68 (2d Cir. 1975) (finding that NYSE’s status as a private institution insulates it from defendant’s claim that he was denied the Fifth Amendment’s privilege against self-incrimination), and Jones v. Sec. Exch. Comm’n, 115 F.3d 1173, 1183 (4th Cir. 1997) (rejecting defendant’s constitutional challenge under the Double Jeopardy Clause in part because “[w]hile the NASD is a closely regulated corporation, it is not a governmental agency, but rather a private corporation organized under the laws of Delaware”). For articles analyzing whether constitutional protections should apply to SRO disciplinary actions, see William I. Friedman, The Fourteenth Amendment’s Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited, 23 ANN. REV. BANKING & FIN. L. 727 (2004); Richard L. Stone & Michael Perino, Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law, 1995 COLUM. BUS. L. REV. 453 (1995).


160. For additional scholarly commentary on this question, see Seligman, supra note 8, at 1120–26 and Frankel, supra note 8, at 448–50.

The expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals of regulation and their own stake in it. In some areas the self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law.162

But for a variety of reasons, the calculus performed for the broker-dealer industry would not yield the same result for the mutual fund industry. Indeed, for mutual funds, the benefits of self-regulation would be far less meaningful and the disadvantages would be substantially greater.

As Part I of this article has demonstrated, mutual funds already operate under a highly specific and demanding system of statutory regulation that has been in existence for more than 65 years. That was not the case for broker-dealers when Congress opted to delegate substantial rulemaking, investigative, and disciplinary authority to the stock exchanges in 1934 and to the NASD in 1939.163 Thus, SROs operating under SEC oversight spared the SEC and Congress much heavy lifting in the area of broker-dealer regulation. In the case of mutual funds, however, the heavy lifting has already been done by the government. It is impossible to turn back the clock to recapture that significant self-regulatory advantage.

An SRO for mutual funds also cannot be justified as a cost-savings measure. As the mutual fund industry has been quick to point out, the creation of an SRO would be tremendously expensive and the SRO’s funding would in all likelihood have to come—directly or indirectly—from mutual fund shareholders.164 Such membership fees to the SRO would be on top of the substantial registration and filing fees already paid to the SEC by funds and advisers.165 The SEC, in turn, would face the added cost of overseeing this new SRO. And given the SEC’s statement in its 2003 proposal that its “staff would continue to examine the activities of funds and advisers,”166 there would be little reason to expect a significant offsetting reduction in the SEC’s present costs of mutual fund regulation.

Moreover, the self-regulatory promise of higher standards of ethical behavior holds less value in the mutual fund industry, where the securities law itself demands a very high standard of conduct. Unlike broker-dealers who generally deal in arms-length transactions with their customers and

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163. See supra notes 148–49 and accompanying text.
164. See supra notes 93–95 and accompanying text.
165. But cf. Seligman, supra note 8, at 1126 (expounding the benefits of an SRO for mutual funds, but acknowledging that whether they are worth the costs is an empirical question meriting serious study).
other broker-dealers, investment companies and their investment advisers owe fiduciary duties to the shareholders who entrust their money to mutual funds. The critical question then is who is better positioned to ensure that the mutual fund industry adheres to those very high standards—the SEC or the industry itself?

There should be little doubt that, as the federal agency charged with the responsibility of protecting investors, the SEC would be far more effective than the industry in ensuring that mutual funds and their advisers adhere to the very high standards of conduct proscribed by the law. A mutual fund SRO would suffer from the same inherent conflicts of interest that occur whenever an industry has principal responsibility for overseeing the policies and practices of its members. But the creation of a mutual fund SRO laden with these conflicts is particularly troubling because mutual funds already operate under a built-in conflict resulting from their management by affiliated investment advisers. Although SEC officials (not to mention members of Congress) may be susceptible to pressure from the mutual fund industry to lessen the burdens of regulation and enforcement, that pressure does not even come close to the daily conflicts that would be faced by regulators selected by and responsible to the firms that are members of the SRO.

The SEC would also be less likely to promulgate rules aimed specifically to discourage competition. In contrast, a mutual fund SRO may frequently be tempted to use its control over membership to thwart competition. Although the tendency toward anti-competitive behavior is a general weakness of self-regulation, that concern is exacerbated in the context of mutual fund regulation because of the industry’s relatively low start-up costs and barriers to entry.

A final reason for opposing the creation of an SRO for mutual funds is the very practical issue of timing. The mutual fund reforms undertaken by

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167. See Barbara Black, *Brokers and Advisors—What's in a Name?,* 11 FORD. J. CORP. & FIN. L. 31, 36 (2005) (“A broker-dealer’s relationship with his customers is not, however, generally considered a fiduciary one, unless the broker exercises investment discretion over the customer’s account.”).

168. See *FRANKEL & SCHWING, supra* note 24, § 1.02[A][3] (“[B]oth the Advisers Act and the 1940 Act are based on the central premise that investment advisers are fiduciaries of their clients.”).


171. See *The Mutual Fund Summit Transcript,* 73 MISS. L.J. 1153, 1157 (2004) (emphasizing that the investment company industry is one “that has very low barriers to entry, many new entrants and a great deal of competition” (quoting Paul Haggi, former Chairman of the Investment Company Institute)).
the SEC in the wake of the trading abuse scandals have not been in place for long and their effectiveness is still being evaluated. A drastic change in the course of mutual fund regulation might undermine the investor confidence that both the SEC and the industry itself has been working diligently to restore.  

III. TOWARD MORE EFFECTIVE REGULATION OF MUTUAL FUNDS

What then, if anything, can be done to improve the way in which mutual funds are regulated? This final Part offers several suggestions. The first constitutes a somewhat ambitious undertaking that would require congressional action. But three more modest recommendations are also advanced.

A. AN EXPANDED AND ENHANCED SEC

Assuming that further study demonstrates the desirability of more frequent and/or more comprehensive inspections for mutual funds and their advisers, one possibility would be for Congress to infuse the SEC with additional resources to accomplish that end. Such additional funding could bring the SEC more in line with the substantially lower examiner-to-assets ratios, and the examiner-to-entity ratios, that exist for federal bank regulators such as the Federal Reserve and FDIC. This observation should not be viewed as an argument for complete parity with federal bank regulator ratios. To be sure, many experts contend that the U.S. banking industry is substantially over-regulated. But in light of the sheer volume of money currently invested in mutual funds, a forceful argument can be

172. See Frankel, supra note 8, at 455 (“[D]ifferent, untested scheme of regulation” for mutual funds may be perceived by the public as a sign of “reduced regulatory supervision.”).

173. See U.S. GOV’T ACCOUNTABILITY OFFICE, MUTUAL FUND INDUSTRY: SEC’S REVISED EXAMINATION APPROACH OFFERS POTENTIAL BENEFITS, BUT SIGNIFICANT OVERSIGHT CHALLENGES REMAIN, REP. NO. GAO-05-415 (Aug. 2005). The GAO reported that the then $8 trillion in assets held by mutual funds and other investment companies at the start of fiscal year 2005 was “nearly double the $4.5 trillion in insured deposits at commercial banks and about equal to the $8 trillion of financial assets at commercial banks.” Id. at 15. The GAO further reported that in 2004, the SEC had 495 examiners managing 9,517 entities (including investment advisors (8,535) and fund complexes (982)); the Federal Reserve had 1,223 examiners managing 6,970 entities (bank holding companies (5,863), state member banks (919), and foreign banking organizations (188)); and the FDIC had 1,824 examiners managing 5,272 entities (FDIC-insured, state-chartered institutions not members of the Federal Reserve System). Id. at 16.


175. See supra note 2 and accompanying text.
made that the current system of inspection should be expanded and enhanced.

Assuming an expanded and enhanced SEC mutual fund inspection program is warranted, the additional monies to the SEC need not come from general federal appropriations. Rather, following the “full cost recovery” model of the Federal Reserve and the FDIC, Congress could authorize the SEC to retain the registration and filing fees that currently are paid by mutual funds and their advisers and, if necessary to fund the enhanced program, could authorize higher fees.176 Although Congress has rejected self-funding proposals for the SEC in the past,177 this proposal would be on a more limited scale and would preserve for Congress much of its coveted control over the SEC’s budget.

Alternatively, Congress could authorize the SEC to charge mutual funds or their advisers for the cost (or partial costs) of enhanced inspections and examinations. Although these charges may be passed along to fund shareholders in the form of reduced profits, the cost of an enhanced SEC inspection program would be substantially lower than the creation of an entirely new federal regulatory entity or a new self-regulator along the lines of the NASD and NYSE.

B. OTHER REFORMS

1. Heightened Enforcement of Duties for Mutual Fund Directors

Many scholars have emphasized that the trading abuse scandals reflected a systemic failure of oversight by mutual fund boards.178 Although the SEC has enacted a number of new rules to strengthen the oversight role of mutual fund boards,179 the SEC can and should do a better job of holding mutual fund directors to their statutory responsibilities.

In particular, the SEC should set forth clearer standards regarding the minimal level of diligence that independent directors must demonstrate to

176. In May 2006, the SEC announced that the registration and transaction fees charged to securities issues and other parties will be reduced by $1 billion in the fiscal year that begins October 1. See SEC Press Release 2006-64, SEC Announces Billion Dollar Fee Cut to Benefit Investors, May 3, 2006, available at http://www.sec.gov/news/press/2006/2006-64.htm. For securities issuers, including mutual funds, this change amounts to a fee reduction of 71%. Id. But if necessary to fully fund an enhanced mutual fund inspection program, this fee reduction could be readjusted.


178. See, e.g., Looking Out for Investors Hearing, supra note 9, at 152 (prepared statement of Professor Mercer Bullard) (“[A]ll of the frauds share a common element: the failure of mutual fund boards to satisfy fundamental standards of compliance oversight.”).

179. See supra notes 52–53 and accompanying text.
fulfill their role as “watchdogs” of the management of mutual funds. As Professor Alan Palmiter points out in his article for this Symposium, a comprehensive specification of board duties is noticeably absent from the ’40 Act, and thus it is generally state, rather than federal, law that determines whether mutual fund directors are fulfilling their duties to shareholders. But certain oversight and monitoring responsibilities—such as those involving fund fees and performance as well as the pricing of portfolio securities—are duties which are specifically set out in the ’40 Act and its rules and regulations. If SEC officials articulated their expectations for independent directors more clearly and more directly, independent directors may well increase their vigilance in response.

The SEC must also be more willing to initiate enforcement actions and seek sanctions, including monetary penalties and officer and director bars, against independent directors who flagrantly disregard their duties. As Commissioner Roel C. Campos emphasized in a written dissent to a settled proceeding against the four independent directors of Heartland Group Funds, the failure to impose severe sanctions against outside directors in the face of egregious misconduct undercuts the SEC’s recent initiatives to strengthen the responsibilities of independent directors and “diminishes the solemn obligation and duty of directors being vigilant in protecting the interests of shareholders.” Independent directors who recklessly fail to fulfill their oversight responsibilities may be liable under the broad fiduciary provision in Section 36(a) of the ’40 Act, and depending on the particular facts and circumstances, may be liable for aiding and abetting fraud under Section 10(b) and Rule 10b-5 of the Exchange Act and Section 17(a)(1) of the Securities Act. Independent directors who act negligently but not recklessly may be liable for violating Sections 17(a)(2) and (3) of

180. See Thomas R. Hurst, The Unfinished Business of Mutual Fund Reform, 26 PACE L. REV. 133, 152 (2005) (“Currently, fiduciary duties are so broadly defined as to be almost meaningless . . . . Strengthening fiduciary duties is one of the key elements remaining for effective mutual fund reform.”) (internal quotation marks omitted). See also Mercer Bullard, Rouge on a Corpse Won’t Bring Mutual Fund Directors Back to Life, JURIST ONLINE (Mar. 15, 2004), http://jurist.law.pitt.edu/forum/bullard1.php (“Neither the SEC nor the fund industry has set forth standards regarding the minimum steps that fund directors must take to fulfill their fiduciary duties to shareholders.”).
183. See Bullard, supra note 180 (criticizing the SEC’s enforcement program for failing to demonstrate “that directors will be held accountable for the gross disregard of their duties”).
185. Id. See also Hillary A. Sale, Independent Directors as Securities Monitors, 62 BUS. LAW. (forthcoming Nov. 2006) (“[T]argeted SEC enforcement actions against independent directors could be a powerful incentive to animate the securities monitoring role.”).
186. See id.
the Securities Act, provisions which do not require the SEC to make a showing of scienter.

2. Returning OCIE Staff to the Policymaking Divisions

Another possible reform for the SEC to consider would involve dismantling the OCIE and returning staff examiners to their respective operating divisions. As others have noted, increased interaction among the OCIE’s approximately 500 examiners for investment companies/advisers and the 200 or so members of the staff of the Division of Investment Management may allow problems and abuses to be identified more quickly, which may result in more effective and efficient mutual fund rulemaking.

Although the views of the current SEC staff, in particular directors and associate directors, should be sought and carefully considered, it is instructive to note that several former Directors of the Division of Investment Management have argued forcefully for a change. Specifically, these directors emphasize that frequent contacts and exchanges between examiners and division staff provides “interactive benefits” that result in higher quality rules and policies.

3. Continued Cooperation with the ICI

As noted above, often-cited advantages of self-regulation include industry expertise and the greater sense of stake in the process that comes when industry members participate in the development of rules. To these ends, the SEC should heighten its interactions with the Investment

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187. The OCIE was established in 1995 during the Chairmanship of Arthur Levitt. It was formed by consolidating the inspection and examination programs authorized by the Exchange Act, the Investment Company Act, and the Investment Advisers Act, responsibility for which had previously been divided between the Division of Market Regulation and the Division of Investment Management. See Lori A. Richards and John H. Walsh, Compliance Inspections and Examinations by the Securities and Exchange Commission, 52 BUS. LAW. 119 (1996).


189. See American Enterprise Institute, supra note 8. Marianne Smythe, who directed the Division of Investment Management from 1990–93, agreed with one audience participant who characterized inspectors and examiners as the “eyes and ears” of division directors. And Kathryn McGrath, who directed the Division from 1983–90, called attention to the disconnect that occurs when examiners and policymakers interact infrequently. Id.

190. See supra note 162 and accompanying text.
Company Institute (ICI), the principal trade association for mutual funds and their investment advisers. In particular, the SEC should encourage the ICI to take a more active role in proposing rules to the SEC for possible adoption. The ICI should also be encouraged to increase the number and frequency of the “best practice guidelines” it has developed for members.\(^{191}\)

Indeed, whenever new policies and procedures would benefit funds by boosting or restoring public confidence in the industry, the ICI should have very strong incentives to work with the SEC in the development of rules and guidelines for funds and their advisers.\(^{192}\) Thus, at least in the area of rulemaking and guidance for investment companies and advisers, systematic restructuring of mutual fund regulation is not at all necessary in order to capture several historical advantages of self-regulation.

### IV. CONCLUSION

With virtually every other household in the United States invested in mutual funds, effective and efficient regulation of the mutual fund industry must be a top national priority. But the creation of a new private regulator—whether along the lines of SROs such as the NASD and NYSE or the recently created PCAOB—would be a step in the wrong direction. For the reasons set forth in this article, much more can be gained by strengthening the SEC’s longstanding role as the principal overseer of mutual funds and improving other aspects of the existing regulatory regime.

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\(^{192}\) See Frankel, supra note 8, at 465 n.51 (“The SEC would greatly benefit from the ICI comments on various regulatory issues and from surveys of its members. It is in the interests of the ICI membership to supply such information and have an impact on its regulation.”).
THE TRANSFORMATION OF CORPORATE CRIMINAL LAW

Leonard Orland*  

The formal and quite harsh federal rules of vicarious corporate criminal liability remain relatively unchanged since their elaboration by the Supreme Court in 1909.1 However, in the past decade, the operative rules of corporate criminal liability have undergone profound change. This change derives not from new congressional or Supreme Court command, but from the United States Department of Justice’s (Justice Department) new and different attitudes toward the prosecution of corporate crime.2

The first Justice Department development occurred in 2003, with the promulgation of revised criteria for prosecution of corporations—the Thompson Memorandum (Thompson).3 A second less visible, yet potentially more important, Justice Department development occurred in the years following Thompson. Since 2003 (the year of the conviction and disintegration of Arthur Andersen), every major federal case of corporate misconduct has been resolved without filing an indictment against the corporation.4 The Justice Department now routinely disposes of charges of corporate misconduct by entering into deferred prosecution or non-prosecution agreements with putative corporate defendants. Between 1992 and 2006, the Justice Department resolved forty-four criminal cases by either a deferred prosecution or non-prosecution agreement.5 These agreements are often complex and not always readily available to the

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1 See New York Central & Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909). See also 10 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 4942 (“It is held today, almost universally, that a corporation may be liable criminally for crimes which its agents are capable of committing on its behalf.”).


4 The indictment of Milberg Weiss is a conspicuous exception to this trend. See Julia Cresswell, U.S. Indictment for Big Law Firm in Class Actions, N.Y. TIMES, May 19, 2006, at A1. See also infra text accompanying note 193.

5 See infra Part VI, summarized in Tables I & II (all agreements in Tables I & II are on file with author).
They constitute a sea change in the way the federal government responds to perceived serious corporate misconduct. This essay explores the contours and implications of these profound changes in the administration of corporate criminal law.

I. TRADITIONAL AMERICAN CORPORATE CRIMINAL LAW

The idea of applying criminal law to corporate entities derives from *New York Central v. United States*, a 1909 Supreme Court opinion. The Supreme Court explicitly based its ruling on the perceived relationship between corporate criminal responsibility and corporate control of the nation’s economy. The Court recognized that “the great majority of business transactions in modern times are conducted through” corporations, and that to “give them immunity from all punishment because of the old and exploded doctrine that a corporation cannot commit a crime would virtually take away the only means of effectually . . . correcting the abuses aimed at.” The Supreme Court perceived “no valid objection in law, and every reason in public policy, why the corporation, which profits by the transaction . . . shall be held punishable.”

In 1958, the Supreme Court extended the *New York Central* vicarious liability rule to partnerships:

[I]t certainly makes no difference whether the carrier which commits the infraction is organized as a corporation, a joint stock company, a partnership or an individual proprietorship. The mischief is the same, and we think Congress intended to make the consequences of infraction the same. . . . The power of Congress hardly is denied. The constitutionality of the statute against corporations is established, and no reason is suggested why Congress has not equal power to charge the partnership assets with a liability and to personify the company so far as to collect a fine by a proceeding against it by the company name. . . . The policy to be served in this case is the same. The business entity cannot be left free to break the law merely because . . . partners in the present [case] . . . do not personally participate in the infraction.

In practice, the responsibility for the vicarious criminal liability thrust upon corporations by the *New York Central* rule has been quite harsh. Rarely has a corporation successfully defended itself against a criminal charge if the underlying criminal responsibility of the executive has been
established. The collective mens rea of multiple executives has been typically combined and attributed to the corporate entity. American courts have rejected defense claims that the corporation is not responsible because the executive conduct was not authorized or was undertaken in violation of corporate policy.

Prior to 1960, prison sentences were rarely imposed on convicted corporate executives. Traditionally the corporate punishment imposed on a corporation was a fine. Probation was rarely imposed on corporations. The traditional strategy of corporate criminal defense lawyers was to persuade the government to indict the corporation, not culpable executives. The proliferation of deferred prosecution and non-prosecution agreements changed the default position of corporate defense lawyers who now appear all too ready to sacrifice senior executives in order to save the corporate entity from indictment.

II. TRANSFORMATIVE CHANGE: CONGRESSIONAL RESPONSE TO CORPORATE CRIME

Congress has not altered the substantive law of corporate criminal liability. However, Congress enacted two major statutory schemes affecting a corporation facing criminal prosecution: the Sentencing Reform Act of 1984 and, in 2003, the Sarbanes-Oxley Act.

13. See infra text accompanying notes 14, 15.
15. See United States v. Twentieth Century Fox Film Corp., 882 F.2d 656, 660 (2d Cir. 1989); United States v. Hilton Hotels Corp., 467 F.2d 1000, 1006–07 (9th Cir. 1972). See also generally James V. Dolan & Richard S. Rebeck, Corporate Criminal Liability for Acts in Violation of Company Policy, 50 GEO. L.J. 547 (1962) (arguing that there are doubts as to whether public policy requires across-the-board imposition of vicarious liability on the corporation for criminal acts of all agents); Kevin B. Huff, The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach, 96 COLUM. L. REV. 1252, 1253 (1996) (“Traditionally, the federal courts have applied the doctrine of respondeat superior, holding corporations vicariously liable for the criminal actions of their employees. Corporations are held liable even where lower-level employees commit crimes without the knowledge of upper management and contrary to express corporate policy or instructions.”).
A. THE RISE AND FALL OF THE SENTENCING GUIDELINES


The Organizational Guidelines utilize the individual guidelines offense levels in calculating the initial fine and provide detailed guidelines for imposition of fines (the primary sanction), as well as for the secondary sanctions of restitution, remedial orders, and probation. The basic scheme of the Organizational Guidelines is that the defendant can avoid the imposition of a significant fine by qualifying for mitigation credits that reward self-policing programs and cooperation with authorities. Additionally, the Organizational Guidelines contain rules for ancillary sanctions such as restitution, compliance programs, and monitors, all of which have become important features of the deferred prosecution and non-prosecution agreements considered below.

21. U.S. SENTENCING GUIDELINES § 8 (1991). There is a marked contrast between the individual and the organizational guidelines in terms of underlying purpose. As Federal Judge Jed Rakoff has explained, in the late 1980s, when the Commission turned to devising the organizational guidelines, it found that:

Because there had been relatively few federal sentences for organizations...the historical data was sparse and ambiguous. For similar reasons, it was unclear what inadequacies, if any, had characterized prior organizational sentencing. As for the Congressional mandate, it was debatable whether Congress had required the Commission to promulgate organizational sentencing guidelines at all. Finally, the Commission, perhaps reflecting the more general absence of consensus regarding the goals of corporate criminal liability, was frank to admit that among its members "there was no consensus as to a single theory of organizational sentencing."

22. See RAKOFF, supra note 21, § 2.04.
23. Id. § 1.05.
24. The rules for "organizations" specified in the Organizational Guidelines, as well as in Thompson, apply to partnerships as well as corporations. See U.S. SENTENCING GUIDELINES § 8B; see also Thompson Memo, supra note 3.
Between 1989 and 2002, the Supreme Court, in a series of five cases, rejected multiple constitutional attacks on the guidelines. But on January 12, 2005, in United States v. Booker, a divided Court ruled that the Federal Sentencing Guidelines for individuals were unconstitutional. Booker contained two separate majority opinions, one authored by Justice Stevens and a second authored by Justice Breyer. The mandatory nature of the guidelines, the Stevens majority concluded, deprived individual defendants of their Sixth Amendment right to a jury trial. The Supreme Court, however, has never clearly addressed the question of whether a corporation has a Sixth Amendment right to a jury trial. It is possible that the Supreme Court, when faced with the issue of a corporation’s right to a jury trial, might well conclude that corporations are not protected by the Sixth Amendment. In that event, the Booker infirmity would not extend to the Organizational Guidelines.

However, under the Breyer majority, if Booker is applied to corporations, the Organizational Guidelines would simply become advisory rather than mandatory. In any event, the Organizational Guidelines will remain of continuing importance. The guidelines have been a major factor in the development of the law and practice of corporate compliance and it is


27. The opinion on the question of the constitutionality of the guidelines was written by Justice Stevens and joined by Justices Scalia, Souter, Thomas and Ginsburg. The Stevens majority concluded that the Sixth Amendment prohibits a judge from increasing a sentence beyond the sentence that could have been imposed solely based upon facts found by the jury or admitted by the defendant. The Federal Sentencing Guidelines require judges to sentence criminal defendants based on numerous factors, many of which may not be considered by a jury. The Stevens majority thus held that the Sentencing Guidelines violate the Sixth Amendment’s guarantee of a jury trial in criminal cases. See id. The second opinion, regarding the appropriate remedy, was delivered by Justice Breyer and joined by Justices O’Connor, Kennedy and Ginsburg and Chief Justice Rehnquist. Justice Ginsburg thus provided the fifth vote on both issues. The Breyer majority concluded that the two provisions of the Sentencing Reform Act must be excised to make the guidelines constitutional—(i) the statutory requirement that sentencing courts must impose a sentence within the applicable guidelines range, absent circumstances justifying a departure; and (ii) the statutory provision which establishes standards of review on appeal, including de novo review of departures from the applicable guidelines range. The Breyer majority held that, despite the unconstitutionality of the mandatory nature of the guidelines, the guidelines should nonetheless remain in place as advisory. With respect to appeals, the Court held that the appropriate standard of review for appeals from sentences rendered under the new system articulated by the Court in Booker is review for “unreasonableness.” Id. at 259–61.

28. See id. at 235–36.


30. See Booker, 543 U.S. at 220.
likely that they will continue to have an impact on corporate governance. Moreover, the alternative corporate sanctions embodied in the guidelines appear not as conditions of a criminal sentence imposed by a judge, but as agreed upon provisions of corporate deferred prosecution and non-prosecution agreements negotiated between putative corporate defendants and the Justice Department.

B. SARBANES-OXLEY

Extraordinary and unprecedented episodes of corporate wrongdoing burst upon the national scene in 2002. Senior executives of Enron, Arthur Andersen, Tyco, Global Crossing, ImClone, Adelphia, and MCI-WorldCom were charged with serious misconduct. In response, Federal Reserve Chairman, Alan Greenspan condemned a “corporate culture” of “infectious greed.”

The Sarbanes-Oxley Act (Sarbanes-Oxley), Congress’s response to these corporate scandals, was swift and shows the haste of its drafters. The vast bulk of the provisions outlined in Sarbanes-Oxley address SEC enforcement, accounting, and corporate governance, not criminal law.
However, Sarbanes-Oxley also contains a number of important criminal provisions which create new criminal offenses and increase the penalties for preexisting and newly created crimes. These new Sarbanes-Oxley criminal prohibitions and penalties appear to apply only to individuals, not corporate entities. Sarbanes-Oxley fails to address rules for determining entity liability and does not establish new or increased entity criminal sanctions.

Since the enactment of Sarbanes-Oxley, corporate criminal prosecutions and convictions continue to be a major focus of the Justice Department, spearheaded by the Justice Department’s Corporate Fraud Task Force. The Task Force’s efforts have resulted in a large number of indictments and convictions of corporate executives including executives of Enron, MCI-WorldCom, Adelphia, Rite-Aid, and HealthSouth, all of which were the focus of sustained public attention.

the statute of limitations for securities fraud cases and establishing broad new protection for whistle-blowers. The Act also creates new criminal offenses with substantial penalties, increases maximum penalties for preexisting crimes, broadens the offense of document destruction and doubles the maximum penalties for that offense. The Act requires chief executive and financial officers to certify financial results and imposes substantial penalties for misleading certifications.

37. See id. § 4.06[C].
38. See id. § 4.06[B].
40. The Justice Department Corporate Fraud Task Force, created by executive order in 2002, has as its mandate to “investigate and prosecute significant financial crimes, recover the proceeds of such crimes, and ensure just and effective punishment of those who perpetrate financial crimes.” Exec. Order No. 13271, 67 Fed. Reg. 46,091 (2002) (Establishment of the Corporate Fraud Task Force); see also SECOND YEAR REPORT TO THE PRESIDENT: CORPORATE FRAUD TASK FORCE (July 20, 2004), reprinted in CORPORATE COUNSEL FORUM 2005: WHAT YOU NEED TO KNOW ABOUT CORPORATE LIABILITY & GOVERNMENT ENFORCEMENT 545 (Michael E. Horowitz & Leonard Orland eds., 2005) [hereinafter SECOND YEAR REPORT].
41. Between March 2003 and July 2004, federal prosecutors filed criminal charges relating to nineteen major corporate fraud scandals. . . . The charges were filed in sixty-nine separate but often related prosecutions naming more than a hundred twenty-five defendants . . . . During the same time frame, prosecutors successfully concluded cases against two-thirds of the defendants. With the exception of four acquittals and two dismissals, all of the dispositions . . . are either guilty pleas or jury convictions.

Kathleen F. Brickey, Enron’s Legacy, 8 BUFF. CRIM. L. REV. 221, 246 (2004–2005) (citations omitted). The Chairman of the Corporate Fraud Task Force summarized the results in these terms:

[S]ince the inception of the Task Force through May 31st of this year [2004], Justice Department prosecutors, working hand-in-hand with regulatory Task Force members, and investigators from the Federal Bureau of Investigation, the Internal Revenue Service’s Criminal Investigation division, and the U.S. Postal Inspection service have: (1) Obtained over 500 corporate fraud convictions or guilty pleas. (2) Charged over 900 defendants and over 60 corporate CEOs and presidents with some type of corporate fraud crime in connection with over 400 charged cases. . . .

SECOND YEAR REPORT, supra note 40, at 549. Many of the prosecutions in the 2004 period arise from major corporate scandals. For example, Adelphi generated several prosecutions, Enron thirty-one prosecutions, HealthSouth nearly twenty prosecutions and WorldCom six prosecutions. Substantively, the major statutes most frequently invoked were conspiracy, securities fraud, wire
The most important post-Sarbanes-Oxley development has been the proliferation of corporate deferred prosecution and non-prosecution agreements, coupled with indictments of senior management, including Chief Executive Officers, Chief Financial Officers, and General Counsels, of the corporations that were the beneficiaries of the corporate agreements. Consequently, the focus of corporate criminal prosecution shifted from the corporate entity to the corporate executive.

III. TRANSFORMATIVE CHANGE: THE JUSTICE DEPARTMENT AND THE THOMPSON MEMO

A. PROSECUTORIAL DISCRETION

Discretionary decision-making permeates the American system of criminal justice. The discretionary power to prosecute or to decline prosecution “has traditionally been exercised sub rosa and on an ad hoc basis, and has thus remained largely unstructured.” Prosecutors are not held to anything remotely like what due process would require if they were engaged in an acknowledged rather than a hidden system of adjudication. Prosecutors enjoy a unique position in the American criminal justice system since their decisions to prosecute, or not to prosecute, are not subject to judicial review. As Judge Richard Posner explains:

A judge in our system does not have the authority to tell prosecutors which crimes to prosecute or when to prosecute them. Prosecutorial discretion resides in the executive, not the judicial branch, and that discretion, though subject of course to judicial review to protect constitutional rights, is not reviewable for a simple abuse of discretion.

Repeatedly, the Supreme Court has reinforced this immunity from judicial review:

[T]he decision to prosecute is particularly ill-suited to judicial review. Such factors as the strength of the [government’s] case, the prosecution’s general deterrence value, the Government’s enforcement priorities, and the case’s relationship to the Government’s overall enforcement plan are not

fraud, false books and records, false statements, mail fraud, obstruction of justice, insider trading, money laundering and tax fraud. See id. at 558–59.

42. See infra Tables I & II.


45. United States v. Giannattasio, 979 F.2d 98, 100 (7th Cir. 1992).
readily susceptible to the kind of analysis the courts are competent to undertake.\textsuperscript{46}

All prosecutors, state and federal, exercise considerable discretion; however, federal prosecutors exercise a much broader discretion than their state counterparts.\textsuperscript{47} Under the theory of respondeat superior, the very nature of corporate crime further enhances federal prosecutorial discretion. That is, if a corporate executive or employee violates the criminal law to benefit the corporation, the vicarious liability of the corporate entity for that conduct is virtually automatic. Moreover, most corporate criminal conduct, in addition to violating the criminal law, also violates administrative and civil regulatory processes. This confluence of criminal and civil regulatory systems thrusts upon the federal prosecutors unusual discretionary powers regarding whether the corporation, as well as corporate individuals, should be prosecuted.\textsuperscript{48} This factor imposes onto the federal prosecutors the special responsibility of carefully weighing the adequacy of available non-penal remedies before deciding whether or not to indict the corporation.\textsuperscript{49}

The very threat of corporate indictment enables federal prosecutors to achieve far-reaching and otherwise unattainable comprehensive settlements not only by deciding to prosecute but also by deciding \textit{not} to prosecute, either by declining or deferring prosecution.

\textbf{B. STRUCTURING PROSECUTORIAL DISCRETION IN CORPORATE CRIME CASES}

For some time, the Justice Department has articulated general principles to guide United States Attorneys in the exercise of their discretion.\textsuperscript{50} In 2000, the Justice Department refined its prosecutorial priorities in corporate crime cases with the Holder Memorandum, \textit{Federal Prosecution of Corporations}, designed to “provide[] guidance as to what factors should generally inform a prosecutor in making the decision whether to charge a corporation.”\textsuperscript{51} Holder was revised in 2003; its successor was Thompson.\textsuperscript{52} A former United States Attorney explained the crux of the 2003 revision:

Mr. Thompson’s revision of the Holder Memorandum makes clear that a number of changes have been made in direct response to the recent spate of corporate fraud cases. . . . [T]he recent modifications to these guidelines

\begin{footnotes}
\footnote{48. \textit{See} ORLAND, \textit{supra} note 33, § 6.02.}
\footnote{49. \textit{See} id.}
\footnote{51. Holder Memo, \textit{supra} note 2.}
\footnote{52. \textit{See} Thompson Memo, \textit{supra} note 3.}
\end{footnotes}
make clear that a corporation seeking to avoid federal prosecution through cooperation may have a tougher row to hoe.\textsuperscript{53}

Under Thompson, the Justice Department’s central focus when deciding whether or not to prosecute a corporation is an appraisal of the extent of the corporation’s cooperation with the government.\textsuperscript{54} “Cooperation” is frequently interpreted by the Justice Department to involve waiver of privilege and assistance in prosecuting corporate executives.\textsuperscript{55}

Thompson enumerates nine specific factors which “prosecutors should consider . . . in reaching a decision as to the proper treatment of a corporate target.”\textsuperscript{56} The factors are:

1. the nature and seriousness of the offense . . .
2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management . . .
3. the corporation’s history of similar conduct, including prior criminal, civil, and regulatory enforcement actions taken against it . . .
4. the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection . . .
5. the existence and adequacy of the corporation’s compliance program . . .
6. the corporation’s remedial actions, including any efforts to implement an effective compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies . . .
7. collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven personally culpable and impact on the public arising from the prosecution . . .
8. the adequacy of the prosecution of individuals responsible for the corporation’s malfeasance . . .
9. the adequacy of remedies such as civil or regulatory enforcement actions.\textsuperscript{57}

\textsuperscript{53} Vinegrad, \textit{supra} note 3.
\textsuperscript{54} See Thompson Memo, \textit{supra} note 3. The Thompson Memo states:

The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of the corporation’s cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation.

\textit{Id.}

\textsuperscript{55} See, e.g., \textit{id.}
\textsuperscript{56} \textit{Id.}
\textsuperscript{57} \textit{Id.}
Thompson also declares that: “In gauging the extent of the corporation’s cooperation, the prosecutor may consider the corporation’s willingness . . . to waive attorney-client and work product protection.”

Beyond its initial purpose of guiding the decision whether or not to indict the corporation, Thompson, combined with the Organizational Guidelines, has become a blueprint for the restrictions embodied in deferred and non-prosecution agreements.

**IV. TRANSFORMATIVE CHANGE: THE JUSTICE DEPARTMENT, DEFERRED PROSECUTION AND NON-PROSECUTION AGREEMENTS**

**A. VARIETIES OF ALTERNATIVES TO PROSECUTION**

The Justice Department has a “wide-array of options available” once it concludes that there is sufficient evidence to bring a case against a corporate entity. Christopher J. Christie, the United States Attorney for the District of New Jersey explains the options available to the government in these terms: “Corporate fraud cases present prosecutors with a particularly complex mix of considerations to analyze and ultimately balance in order to appropriately resolve allegations of corporate wrongdoing. The range of options available to prosecutors in the corporate context is broad.”

The charging options available to the Department are:

1. “Proceed with the prosecution by seeking an indictment or entering into a plea agreement with the company;”
2. “Decline to prosecute the company on public-policy grounds (‘declination of prosecution’);”
3. “Enter into a deferred prosecution agreement with the company; or”
4. “Enter into a non-prosecution agreement with the company.”

For the corporation under criminal investigation by the Justice Department, the choice of options is potentially “the difference between life and death for a corporation.” A corporate indictment is a highly publicized event and a corporate plea agreement is subject to public judicial control. In contrast, a declination of prosecution is rarely accompanied by a public announcement from the Justice Department. When the Justice Department

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58. *Id.*


goes beyond simple declination and enters into a formal non-prosecution agreement, that agreement is frequently, but not universally, made public. The most formal of federal alternatives to corporate indictment is the deferred prosecution agreement. The indictment or information remains open during the deferral period.

The basic difference between a deferred prosecution agreement and a non-prosecution agreement centers on the contingent threat to the corporation in the event of a perceived violation of the agreement:

In a [non-prosecution agreement], no charge is filed in court, but the government can still file and prosecute a charge later if the company violates the terms of the deal. In a [deferred prosecution agreement], the government files the criminal charge in court but doesn’t prosecute the claim. If the company abides by the terms of the DPA, the government dismisses the charge when the agreement expires. If not, the government can prosecute the already-filed charge.62

“In contrast to the far more rigid sentencing process,” United States Attorney Christie explains:

[D]eferred prosecution agreements allow prosecutors and companies to work together in creative and flexible ways to remedy past problems and set the corporation on the road of good corporate citizenship. They also permit us[, the government,] to achieve more than we could through court-imposed fines or restitution alone. These agreements, with their broad range of reform tools permit remedies beyond the scope of what a court could achieve after a criminal conviction.63

**B. THE RISE OF DEFERRED PROSECUTION AND NON-PROSECUTION AGREEMENTS**

Since 1993, the Justice Department has resolved corporate criminal investigations not by issuance of an indictment, but by entry into corporate deferred prosecution and non-prosecution agreements.

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62. Sue Reisinger, By Any Other Name . . ., CORP. COUNS., Sept. 19, 2006. On occasion, it is difficult to determine if an “agreement” is a deferred prosecution or non-prosecution agreement. For example, Prudential Financial, Inc. signed “what it thought was a non-prosecution agreement” ending a three year probe into illegal mutual fund activity committed by its Prudential Equity Group. Id. However, Deputy Attorney General Paul McNulty describes the agreement as a deferred prosecution agreement. See id.; Deputy Attorney Gen. Paul J. McNulty, Remarks at Press Conference Regarding Prudential Equity Group Securities Fraud Allegations, Washington, D.C. (Aug. 28, 2006), available at http://www.usdoj/dag/speech/2006/dag_speech_060828.htm. In fact, the language of the agreement reflects the harsher penalties typically seen in deferred prosecution agreements, yet, like non-prosecution agreements, no charges were filed or pending against Prudential.

63. Christie & Hanna, supra note 59, at 1043.
TABLE A. NUMBER OF FEDERAL NON-PROSECUTION AND DEFERRED PROSECUTION AGREEMENTS FILED

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NON-PROSECUTIONS</th>
<th>DEFERRED PROSECUTIONS</th>
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<tr>
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<td>1</td>
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<tr>
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<td>3</td>
<td>6</td>
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<tr>
<td>TOTALS</td>
<td>20</td>
<td>24</td>
</tr>
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</table>

These non-prosecution and deferred prosecution agreements are complex and constitute a sea change in the way the federal government responds to perceived serious corporate misconduct. An understanding of this development requires examination not of statutes, cases, or regulations, but of the negotiated agreements themselves.

Deferred prosecutions, by utilizing statutory or judicially crafted pretrial diversion programs, are commonplace in state judicial decisions.\(^64\) Deferred prosecution is also explicitly authorized by both a federal statute\(^65\) and the United States Attorneys’ Manual.\(^66\) Pretrial diversion and deferred prosecution, under these programs, are typically crafted for first offender street criminals, and, historically, have rarely been used for white collar offenders. Indeed, prior to 1993, deferred prosecution had not been used to resolve federal criminal charges against corporations. The genesis of the current proliferation of deferred and non-prosecution agreements in corporate criminal law may be traced to two important settlements in the Southern District of New York in the 1990s involving Salomon Brothers and Prudential Securities.

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C. PROGENITORS: SALOMON BROTHERS AND PRUDENTIAL SECURITIES

1. Salomon Brothers

The government charged Salomon Brothers, a primary dealer in Treasury Notes, with engaging in a conspiracy to coordinate trading activity in Treasury notes in order to affect prices in the secondary and financing markets. The company submitted false bids and subverted notes to circumvent the Treasury Department’s 35% cap for single buyer purchases of notes. The misconduct resulted in the criminal prosecution of one senior executive, the resignation of another senior executive, and civil actions against the entity, which were then settled by the SEC and Antitrust Division consent decrees.

No criminal charges were brought against Salomon Brothers. Despite the absence of a formal agreement by the government not to prosecute, the disposition of the charges against Salomon contained the basic components of future formal agreements, including:

1. The indictment and conviction of a senior manager;
2. The resignation, under pressure, of senior management, including Salomon’s President and Chief Executive Officer;
3. Civil settlements with the SEC and the Antitrust Division, which imposed a total of $290 million in sanctions, forfeitures and restitution, (which include $122 million in civil penalties, $50 million in forfeitures, $18 million in restitution, and $100 million to fund claims and costs);
4. An appointment of an administrator to direct the restitution compensation fund;
5. Cooperation with the government investigation, including disclosure of the corporation’s internal investigation;
6. An obligation to continue cooperation with the government investigations;
7. And the institution of corporate reforms to prevent recurrence of the violation.


In a press release, United States Attorney Otto Obermaier stressed Salomon Brothers’ undertakings for reform and the sanctions imposed. He explained that:

Salomon had cooperated extensively in the investigation and had taken decisive and extraordinary actions to restructure its management to avoid future misconduct. The cooperation included providing detailed information concerning the firm’s own internal investigation, turning over documents and making employees available for interviews and testimony. ... “Such actions are virtually unprecedented in my experience.”

2. Prudential Securities

The 1994 deferred prosecution agreement entered into by Mary Jo White, United States Attorney for the Southern District of New York, and Prudential Securities is the nation’s first comprehensive formal federal corporate deferred prosecution agreement. The Prudential agreement, in many respects, has become the blueprint for subsequent deferred prosecution and non-prosecution agreements. The agreement arose from a criminal complaint charging Prudential Securities with a violation of § 10(b) of the 1934 Securities Exchange Act by fraudulently selling $1.4 billion worth of limited partnerships in oil and gas.

Notwithstanding the seriousness of the charges, the United States Attorney announced an agreement to defer prosecution for a period of three years. In that agreement, Prudential undertook important corporate restructuring and established extraordinary internal monitoring mechanisms, including the appointment of an experienced former Federal Judge as an outside director and ombudsman with reporting responsibilities not only to the Prudential Board, but also to the United States Attorney. Specifically, under the Deferred Prosecution Agreement, Prudential had the following obligations:

1. Payment of $330 million into a special fund established by the SEC for investors who purchased the Prudential oil and gas limited partnerships with any fund in excess of investor claims to be paid to the United States and an additional sum of $330 million to compensate innocent investors.

2. The installation of an independent “ombudsman” to receive allegations of misconduct by any Prudential employee and to file

70. Id.
71. Press Release, Dep’t of Justice, supra note 67 (quoting Otto Obermaier, United States Attorney for the Southern District of New York).
72. See Letter from Mary Jo White, U.S. Attorney for the Southern District of New York, to Scott W. Muller & Carey R. Dunne, Counsel for Prudential Sec. Inc. (Oct. 27, 1994). See also ORLAND supra note 34, § 6.06[A], [B].
73. See ORLAND, supra note 33, § 6.06[B].
quarterly reports with the United States Attorney of any such allegations. (Former Federal Judge Kenneth Conboy was appointed ombudsman).

3. The retention of an independent law firm acceptable to the government to review Prudential’s policies and procedures to determine the adequacy of its regulatory and compliance controls. (Allen Levensen, a senior partner in Fulbright and Jaworski was selected).

4. Full and truthful cooperation in any criminal investigation, including voluntarily providing any requested records and unlimited access to Prudential’s facilities, documents, and employees.

5. Undertakings by Prudential’s parent groups to take appropriate steps to further Prudential’s compliance.

6. Public acknowledgment by Prudential of its wrongdoing.\(^{74}\)

In announcing the Deferred Prosecution Agreement, Ms. White spoke in terms generally applicable to the scores of deferred prosecution and non-prosecution agreements formed after Prudential:

The public interest is well served by this agreement. Upon conviction, a corporation cannot be sentenced to jail, but only to pay restitution, fines and adopt measures aimed at enhancing internal controls to prevent and detect wrongdoing. This agreement imposes such sanctions. It will insure restitution of over $660 million to defrauded investors and cause Prudential, through the appointment of an ombudsman and other measures to adhere to the highest ethical and legal standards in its dealings with customers and regulatory authorities. If Prudential fulfills all of its obligations under the agreement, further prosecution will be unnecessary.\(^{75}\)

**D. THE PROLIFERATION OF DEFERRED PROSECUTION AND NON-PROSECUTION AGREEMENTS**

In the past five years, an increasing number of corporations have entered into deferred prosecution and non-prosecution agreements.\(^{76}\) These

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74. *Id.; see also Letter from Mary Jo White, supra note 72.*
75. *ORLAND, supra note 33, § 6.06[B] (citing Mary Jo White).*
76. At the same time, a substantial number of corporate executives have been indicted and convicted of serious corporate crimes and have received lengthy prison sentences. Although there were several acquittals—notably Mark Belnick, former General Counsel of Tyco and Richard Scrushy, former CEO of HealthSouth Senior—executives in the major corporate fraud cases received were convicted and received substantial prison sentences. Bernard Ebbers, former CEO of WorldCom was sentenced to 25 years imprisonment; John Rigas, founder of Adelphia was sentenced to fifteen years incarceration—Judge Leonard Sand said the sentence would have been longer but for the defendant’s health and age; Judge Sand sentenced Rigas’s son, Timothy Rigas, to twenty years incarceration; Tyco’s former CEO, L. Dennis Kozlowski, and CFO Mark Swartz were convicted of state criminal charges; Andrew Fastow, former CFO of Enron, pled guilty to
agreements are modeled, in many respects, after the Prudential Agreement—the entity accepts responsibility for its misconduct, agrees to cooperate with the government, undertakes corporate reforms and agrees to pay substantial fines and restitution.

There is a “growing recognition by corporate management of the risk and the need to settle with the government and the increased perception on the part of the government that corporate indictments and convictions can be overkill.”77 From the government’s point of view, deferred prosecutions facilitate corporate cooperation while reducing the uncertainty for employees and investors of a continuing unresolved criminal investigation.78 Deferred prosecution allows prosecutors to “send a message that certain corporate conduct won’t be tolerated without risking the viability of the company or the business.”79

The message of the increasing use of deferred corporate prosecution agreements, coupled with the disintegration and corporate death of Arthur Andersen is clear: corporations faced with serious wrongdoing by corporate executives must promptly accept full responsibility, discipline wrongdoers, institute serious institutional reform and fully cooperate with the government. Increasingly, corporations must also waive the attorney-client privilege and agree not to contradict a detailed factual statement documenting the entity’s culpability.80 If an organization complies, it may escape organizational indictment. If it does not, it faces the risk of indictment, conviction and corporate death.81

multiple charges and received a ten year sentence (later reduced); Martin Grass, former CEO of Rite-Aid Corp., received an eight year sentence; James Olis, former Vice President and Counsel of Dynegy, received a twenty-four year sentence, which was reduced on appeal; Kirk Shelton, former Vice-Chair of Cendant Corp., received a ten year sentence; Sam Waksal, former CEO of ImClone, received a seven year sentence. See Guilty, Not-Guilty, Mistrial, WALL ST. J. ONLINE, July 13, 2005; Erin McClam, ImClone Founder Wants Sentence Shortened, LATIMES.COM, Mar. 31, 2005; Former Executive of Cendant Receives 10-year Sentence, WALL ST. J., Aug. 4, 2005, at B2. Jeff Skilling, Enron’s former CEO received one of the longest sentences of any corporate executive—24 years. John R. Emshwiller, Skilling Gets 24 Years in Prison, WALL ST. J., Oct. 24, 2006, at C1.


81. See Indictment, United States v. Milberg Weiss Bershad & Schulman LLP, David Bershad, Steven Schulman, Seymour Lazar, and Paul T. Selzer, CR 05-587 (A) - DDP (C.D.C.A. 2006) (indicting defendants for racketeering conspiracy, mail fraud, money laundering, subscribing to false tax return, obstruction of justice, aiding and abetting and causing an act to be done, and criminal forfeiture). See also infra text accompanying note 193.
Arthur Andersen’s initial refusal to accept responsibility for its misconduct is a primary reason for its indictment and conviction. Andersen, with a loosely structured leadership and no one clearly in charge, was simply not prepared to promptly accept responsibility and fully cooperate with the government by agreeing to major institutional reform. A corporation, or partnership, cannot obtain the benefit of deferred prosecution without prompt acceptance of responsibility and complete cooperation. As Philip Urofsky, the former Assistant Chief of the fraud section of the Justice Department put it, “The bar has been pressing for more clarity on when prosecution will be deferred.” Urofsky noted that the Justice Department “would consider a deferred prosecution agreement when the company had voluntarily disclosed the conduct, and where it cooperated and undertook to continue cooperating in our investigation.”

That “cooperation” could include making witnesses available, providing documents voluntarily, disclosing the results and conclusions of their internal investigation and, if necessary, waiving the privilege with respect to contemporaneous legal advice, where advice of counsel is a potential defense. In addition, the company would have to turn over interview and witness statements from its internal investigation, and show that it had already taken remedial steps to put new compliance and financial controls in place. The company would also have to discipline the wrongdoers. “The decision to go the deferred prosecution route . . . may also turn on factors such as the extent in dollars and duration of the misconduct, and the involvement of senior management.”

The Justice Department continues to see benefits from the deferred prosecution agreements. “By and large, [deferred prosecution agreements have] worked well. . . . We’ve been able to recover a lot of money for victims without going through the delay and expense of a trial, and we’ve seen some positive . . . internal reforms.”

E. TWO MAJOR AGREEMENTS: COMPUTER ASSOCIATES AND KPMG

While the Salomon Brothers and Prudential Securities dispositions formed the model for scores of subsequent agreements, two recent settlements—Computer Associates and KPMG—illustrate an increasingly common structure of deferred prosecution agreements. These two

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82. See ORLAND, supra note 33, § 6.06(C).
83. See id.
84. Post, supra note 80 (quoting Philip Urofsky).
85. Id. (quoting Philip Urofsky).
86. Id. (quoting Philip Urofsky).
87. Greg Burns, Corporations Avoid Criminal Cases: Individuals prosecuted instead, avoiding Andersen effect: policy too easy, critics Say, CHI. TRIB., Mar. 20, 2005, Business Section, at 1 (citing Timothy Coleman, senior counsel at the Justice Department).
agreements are the clearest examples of the Justice Department’s ability to achieve sweeping corporate concessions: in both cases, the entity entered into a deferred prosecution agreement that includes cooperating in the prosecution of the entity’s culpable corporate executives.

For a corporate executive facing potential criminal indictment, the results of a deferred prosecution agreement can be ominous. Multiple indictments of former senior managers accompanied both the Computer Associates and KPMG deferred prosecution agreements. Both corporations agreed to cooperate in those prosecutions. Under the terms of the deferred prosecution agreement, Computer Associates discharged its CEO and General Counsel and cooperated with the government in the indictment of those key executives. KPMG currently is cooperating in the criminal trials of its former senior executives.

1. Computer Associates

In September of 2004, Computer Associates, faced with the stark prospect of a corporate indictment for securities fraud and obstruction of justice, entered into a deferred prosecution agreement. There were parallels between the Computer Associates agreement and its predecessor, the Prudential Securities agreement. Both agreements required the acceptance of responsibility, restitution, internal reform, and substantial compliance undertakings. Furthermore, both agreements included, as an element of cooperation, the discharge of senior management combined with extensive cooperation in the prosecution of those managers. However, the Computer Associates agreement added a new element to the Prudential form—an agreement to a lengthy statement of facts combined with a covenant not to contradict that factual statement. This provision is an increasingly common element of deferred prosecution agreements and is also an important feature of the KPMG agreement considered below. Specifically, the Computer Associates deferred prosecution agreement enumerated the following undertakings:

88. See Mark Hamblett, Deferred Prosecution, N.Y.L.J., Apr. 25, 2006 (discussing the defense motions filed by indicted KPMG partners).
91. See Id. Computer Associate’s CEO, Sanjay Kumar, Head of Worldwide Sales, Stephen Richards, General Counsel, Steven Woghin, and Senior Vice President were indicted. Woghin promptly pled guilty. Alex Berenson, Former Executives of Software Maker Indicted in Fraud, N.Y. TIMES, Sept. 23, 2004, at A1. On November 2, 2006, Kumar was sentenced to twelve years in prison and fined $8 million. William M. Bulkeley, Former CA Chief Is Sentenced to 12-Year Term, Fined, WALL ST. J., Nov. 3, 2006, at A1.
1. Acknowledgment of Wrongdoing: In a comprehensive acknowledgment of wrongdoing, a detailed information and an extensive Stipulation of Facts, Computer Associates acknowledged that it and certain executives and officers filed false and misleading financial reports with the SEC and obstructed investigations by a federal grand jury and the SEC.93

2. Payments: The company agreed to substantial payments consisting of $225 million in restitution, issuance of stock, and cash payments of $163 million to compensate shareholders in four shareholder class actions.94

3. Remedial Actions: Computer Associates agreed to the termination of executives, including terminating culpable officers and employees, officers and employees who refused to cooperate in the internal investigation “or otherwise took steps to obstruct or impede that investigation.” The firm also agreed to appoint new management, including a new Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Head of Worldwide Sales and a new General Counsel.95

4. Continuing Cooperation: The agreement contained provisions for ongoing disclosure to investigators, providing documents and records, and making best efforts to make present and former employees available to investigators. Additionally, the agreement stipulated that Computer Associates would be “providing active assistance” in any “investigation, criminal prosecution, civil trial or other legal proceeding” including proceedings to “obtain disgorgement” of compensation to any current or former employee. Computer Associates also undertook to continue cooperation after the expiration of the agreement.96

5. Waiver of Privilege: The entity agreed not to assert, in any government investigation “any claims of attorney-client or attorney work product” privileges.97

6. Appointment of an Independent Examiner: The Examiner has broad specified responsibilities for corporate reform. Computer Associates also agreed to the addition of new independent directors;98 the establishment of a compliance committee and a new disclosure committee; establishment of “enhanced corporate governance procedures” to improve communications; and the establishment of a comprehensive compliance and ethics program, including the appointment of a “senior-level Chief Compliance Officer”; reorganization of the firms Finance Department, and Internal Audit Department.99

93. See id. at 2.

94. See id. at 2–3. The restitution fund administrator’s cost will be born by the entity, not the restitution fund. Id.

95. Id. at 4.

96. Id. at 6.


98. See id. at 9. Laura Unger, a former SEC commissioner is a designated outside director; at least two-thirds of the board must be outside directors. See id. at 10.

99. Id. at 10–11.
2. KPMG

In August 2005, KPMG faced potential criminal charges that it had “participated in a scheme to defraud the IRS by devising, marketing, and implementing fraudulent tax shelters . . . .”100 Moreover, the government charged that a number of KPMG tax partners engaged in conduct that was unlawful and fraudulent, including preparing fraudulent tax returns, drafting fraudulent factual tax recitations, issuing false and fraudulent opinions, actively taking steps to conceal true facts from the IRS, and impeding the IRS by failing to produce relevant documents.101 The Justice Department did not proceed with an indictment against KPMG. Instead, the Department and KPMG entered into a comprehensive deferred prosecution agreement102 that paralleled, in many respects, the Computer Associates agreement.103 Specific provisions of the KPMG agreement include:

1. Payments of $456 million: The KPMG agreement called for a fine consisting of disgorgement of $128 million in fees, restitution to the IRS of $228 million, and an IRS penalty of $100 million.104

2. Cooperation and Waiver of Privilege: The agreement required that “cooperation with the criminal investigation” was “an important and material factor” as was “not asserting . . . any claim of privilege (including but not limited to the attorney-client and the work product protection).”105

3. Permanent Restrictions of and Elevated Standards for KPMG’s Tax Practice Cooperation.

4. Establishment of a New Compliance Program: KPMG must institute a compliance and ethics program “that fully comports with the criteria set forth in Section 8B2.1 of the United States Sentencing Guidelines.”106 The “maint[enance of] a permanent compliance office and a permanent educational and training program” were also essential to the agreement.107

101. Id. at ¶ 8–10.
103. For a discussion of the Computer Associates agreement, see Computer Associates Agreement, supra note 90.
104. See KPMG DPA, supra note 102, at 2–3. KPMG agrees that no portion of this amount is deductible on any tax return and that the government will receive 50% of any reimbursement under any insurance policy. Id. at 3–4
105. Id. at 9–11. KPMG secured an exception to the privilege waiver issue to allow protection of some advice given by its counsel as well as in private civil litigation. Id.
106. Id. at 17.
107. Id.
5. Independent Monitor: “KPMG agrees to oversight and monitoring by a government appointed monitor.”

6. Agreement not to contradict the Statement of Facts: KPMG agrees that “it shall not, through its attorneys, agents, partners, or employees, make any statement, in litigation or otherwise, contradicting the Statement of Facts or the representations in this agreement.” The agreement also stated that “[a]ny such contradictory statement . . . shall constitute a breach of this Agreement.”

More than a dozen former KPMG partners have been indicted. Several filed motions to dismiss the indictments against them, or, alternatively, to void portions of the KPMG Deferred Prosecution Agreement. One brief argued that KMPG’s Agreement with the government was for the purpose of intimidating and influencing the firm and those working for it. A brief by another defendant asserts that “by obligating KPMG and its agents to testify favorably, and only favorably, for the Government, the

108. KPMG DPA, supra note 102, at 18. The agreement spells out, in detail, the jurisdiction, powers and oversight authority of the monitor. Compensation for the monitor is the responsibility of KPMG. See id. at 19–25.

109. Id. at 16. KPMG may “avoid a finding of breach . . . by repudiating such statement” within 48 hours of notice of breach by the government. Id. at 17.

110. See Unsealed Indictment, United States v. Stein, 05 Crim. 0888 (S.D.N.Y. Aug. 29, 2005), available at http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgindividualsin.pdf (indicting eight former KPMG partners); see also Stephen Taub, Ex-CFO of KPMG among 10 Newly Indicted, CFO.COM, Oct. 18, 2005, available at http://www.cfo.com/article.cfm/5051982?related (noting that, at that time, the total number of people “facing counts that include conspiracy to defraud the government, tax evasion, and obstruction of internal revenue laws” was nineteen).

111. Defendant David Rivkin’s Memorandum of Points and Authorities in Support of Motion to Dismiss Indictment or Alternatively Void Portions of the KPMG Deferred Prosecution Agreement, to Disclose Grand Jury Transcripts and Instructions to Grand Jury Regarding Venue, and to Join Motions of Codefendants at 4, United States v. Stein, 05 Crim. 0888 (Jan. 12, 2006). The brief argues:

The appropriate sanction for this violation [of due process] is dismissal of the indictment. At a minimum, this court should void the deferred prosecution agreement and compel KPMG to advise all of its employees in writing of this fact. Further, KPMG should be ordered to admonish all of its employees to be completely truthful in any statements they make, without regard to the Statement of Facts attached to the deferred prosecution agreement.

Id. at 5. Judge Kaplan denied the motions to dismiss the indictment or to invalidate the KPMG deferred prosecution agreement but expressed concern about KPMG’s refusal to pay legal costs of former partners. See Lynnley Browning, A Single Trial For 18 Named in Tax Shelters, N.Y. TIMES, Mar. 31, 2006, at C3; see also Lynnley Browning, Judge Questions Clarity of Prosecution’s Tax-Shelter Case, N.Y. TIMES, Mar. 31, 2006, at C4. Judge Kaplan concluded that “the government has a legitimate interest in seeing to it that KPMG not gain the benefit of deferred prosecution, only to undermine its formal acceptance of guilt by making statements inconsistent with it.” Hamblett, supra note 88.
Department of Justice has irreparably distorted the fact-finding process and ensured that the prosecution of this matter will result in a mock trial."\footnote{112 Memorandum of Law in Support of Defendant Jeffrey Eischeid’s Motion to Dismiss the Indictment at 2, United States v. Stein, 05 Crim. 0888 (Jan. 12, 2005). The brief also asserts that the government’s “oppressive tactics violate long-established notions of ethical prosecutorial conduct, and constitute plain violations of Eischeid’s rights under the Fifth and Sixth Amendments.” \textit{Id.} See also infra text accompanying note 189 (discussing Judge Kaplan’s response to defense claims that KPMG, in cooperation with the government, had unconstitutionally violated defendants’ Sixth Amendment right to counsel by refusing to advance legal fees).}

V. RECENT DEVELOPMENTS: STOLT-NIELSEN AND BOEING

Two recent developments in the Justice Department’s handling of corporate misconduct reflect a somewhat inconsistent approach to the most basic elements of deferred and non-prosecution agreements—cooperation and compliance.

A. STOLT-NIELSEN


The Justice Department’s quite formal amnesty program shares common attributes with deferred and non-prosecution agreements. In both, the entity avoids prosecution in exchange for cooperation and compliance with the terms of the agreement.\footnote{115 Id. \textit{Id.}} Indeed, the Justice Department characterizes its agreement with Stolt as a “conditional leniency or non-prosecution agreement.”\footnote{116 Answer of the U.S. to Petitions for Reh’g en Banc at 1, Stolt-Nielsen, S.A. v. United States, No. 05-1480 (3d Cir. June 9, 2006) [hereinafter U.S. Response to Stolt].}

The Stolt Amnesty Agreement, which granted amnesty for criminal customer and territorial allocations in violation of the Sherman Act, had two core requirements. First, Stolt represented to the Justice Department that it was making complete and accurate disclosure to the government.\footnote{117 Stolt-Nielsen, S.A. v. United States, 352 F. Supp. 2d 553, 558 (E.D. Pa. 2005).} Stolt also represented that it had taken “prompt and effective action to terminate its part in the anti-competitive activity being reported upon
In addition, Stolt agreed to cooperate fully and completely with the Justice Department’s investigation and prosecution of employees involved in illegal activities. This cooperation provision required the company to give all information known to Stolt relating to the anti-competitive activity being reported on.119

Less than two months later, the Justice Department revoked amnesty and declared that it would proceed to indict Stolt.120 The basis for the amnesty revocation was the Justice Department’s assertion that the Company had misrepresented the date when it had ceased engaging in unlawful activities.121 The Justice Department concluded that while Stolt represented that it had ended its collusive activities upon learning of them in March of 2002, in fact, Stolt’s criminal collusive conduct continued well into the last half of 2002—well beyond the terminated date represented by Stolt.122 The government declared:

[The Justice Department Antitrust] Division received evidence that [Stolt] . . . had continued to meet with its competitors and participate in the conspiracy for months after discovering it, and that [Stolt] had withheld information about the true extent of the conspiracy.123

Stolt, in response to the renewed threat of indictment, sought to enjoin the Justice Department from revoking the agreement and indicting the corporation. The District Court granted injunctive relief.124 However, the Third Circuit reversed125 and the Supreme Court denied certiorari.126

118. Id. (citing Agreement between the Department of Justice and Stolt).
119. See id. (referring to Agreement between the Department of Justice and Stolt).
121. See Stolt-Nielsen, 352 F.Supp.2d at 559.
122. See id.; see also James Bandler & John McKinnon, Stolt-Nielsen is Probed for Traffic with Iran, WALL ST. J., Nov. 22, 2002, at A3. The events became public fact in an article published in the Wall Street Journal covering a lawsuit filed against Stolt by the company’s former general counsel, who resigned after the company refused to take corrective action to correct misconduct uncovered by the General Counsel. Id.
125. Stolt-Nielsen, S.A. v. United States, 442 F.3d 177, 178 (3d Cir. 2006). The Third Circuit held:

This case raises a significant constitutional question of first impression in this Circuit: whether federal courts have authority, consistent with the separation of powers, to enjoin the executive branch from filing an indictment. Although federal courts have this authority in narrow circumstances, we conclude that this is not such a case and therefore reverse the District Court’s judgment to the contrary.

Id. Then Judge Samuel Alito heard oral argument but was elevated to the Supreme Court and the decision was filed by quorum of the panel. See id.
On September 6, 2006, Stolt was indicted on conspiracy charges stemming from violations of the Sherman Act. The Third Circuit’s decision to uphold the Justice Department’s power to revoke amnesty and seek an indictment affirms that the Justice Department has full and complete control over defining compliance, cooperation and violation of a non-prosecution agreement which can trigger indictment. The Stolt amnesty revocation constitutes clear evidence that the Justice Department is fully prepared to indict entities who fail to meet the government’s criteria for complete cooperation. The Third Circuit’s opinion in *Stolt-Nielsen v. United States* makes clear that federal courts will not intervene in a Justice Department decision to revoke a non-prosecution agreement and seek indictment, noting:

> [S]eparation-of-power concerns thus counsel against using the extraordinary remedy of enjoining the Government from filing the indictments . . . . [W]e are guided by other cases from the Supreme Court and the Courts of Appeals that lead us to conclude that non-prosecution agreements may not form the basis for enjoining indictments before they issue.

**B. BOEING**

A second recent development, the Boeing Non-Prosecution Agreement, takes a strikingly different turn. On June 29, 2006, Boeing entered into a non-prosecution agreement and an accompanying civil settlement with the Justice Department to resolve the charges that Boeing had unlawfully violated conflict of interest laws and had unlawfully handled its competitors’ sensitive and trade secret information. More specifically:

Boeing has agreed to pay a total of $615 million dollars to resolve the government’s investigations and claims relating to the company’s hiring of the former Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management, Darleen A. Druyun, by its then Chief Financial Officer, Michael Sears, and its handling of competitors information in connection with the Evolved Expendable Launch Vehicle (EELV) Program and certain NASA launch services contracts.

128. See *Stolt-Nielsen*, 442 F.3d at 187 (noting both the government’s right to indict Stolt and Stolt’s post indictment remedies).
129. See id.
130. Id. See also supra text accompanying note 46.
At first glance, the Non-Prosecution Agreement between Boeing and the Justice Department appears standard enough; it includes with the requisite provisions dealing with financial penalties, compliance programs, hotlines, reporting, cooperation and disclosures. However, on the crucial issue of compliance and potential violations of the agreement, Boeing is the beneficiary of provisions absent from other deferred prosecution and non-prosecution agreements.

In a curious turn of events, functionally, one of the most interesting provisions states that Boeing gets a pass on employee misconduct if that conduct is not committed by a high level executive, as defined by Boeing. Specifically, the agreement provides:

For purposes of determining compliance with this Agreement (as opposed to legal responsibility), the commission of a Defined Offense by a Boeing employee classified at a level below Executive Management as defined by Boeing's internal classification structure in place at the time of the execution of this Agreement shall not be deemed to constitute the commission of a Defined Offense by Boeing.

Hence, even if the misconduct of a non-designated Boeing employee who is not designated by Boeing constitutes a crime, it nonetheless will not constitute a violation of the Non-Prosecution Agreement.

John Coffee, a professor at Columbia University School of Law, was quite right in concluding that "drawing the line between executives and other employees is a little crude." Professor Coffee also correctly asserts: "You [do not] want to tell non-executive employees they are legally immune and can’t get the company in trouble." He further states that in order for Boeing to successfully comply with the agreement, "you want the company monitoring all employees."

Most surprisingly, in another provision of the Boeing Non-Prosecution Agreement, the Justice Department gave Boeing an additional license to violate both the law and the agreement. Regardless of classification of executive level employee, as long as Boeing reports the violation to the Justice Department, it remains in good standing under the Agreement.

See also Boeing Non-Prosecution Agreement, supra note 131, at 2–3 (providing the terms of the Boeing agreement with the Government).

133. See Boeing Non-Prosecution Agreement, supra note 131, at 2, 3, 5–8.
134. See id. at 9.
135. Id. at 3.
137. Id. (quoting John Coffee, Columbia University Law Professor).
138. Id. (quoting John Coffee, Columbia University Law Professor).
139. Boeing Non-Prosecution Agreement, supra note 131, at 3, 5–8 ("[T]he commission of a Defined Offense by a Boeing employee shall not be deemed to constitute the commission of a})
Moreover, the agreement grants Boeing procedural rights in the event of notice of violation of the agreement—rights not present, or less favorable to the company, in other non-prosecution or deferred prosecution agreements. Specifically, upon written notice of violation, Boeing has forty-five days to make a presentation that no breach has occurred. Boeing can appeal an adverse decision to a higher authority within the Justice Department, but not a District Court, and if Boeing is found in breach, the company must immediately pay any balances on fines due, and the Justice Department, at its option, can either indict or impose a $10 million penalty.

The Boeing agreement constitutes a significant change from the Justice Department’s traditional approach to the resolution of corporate misconduct by deferred or non-prosecution agreement. Normally, those agreements call for sweeping corporate wide changes, compliance, and enforcement with the ultimate goal of creating a culture of honesty and law abiding corporate performance.

VI. FORTY-FOUR AGREEMENTS: PATTERNS, ACHIEVEMENTS AND COMMENTS

A. THE AGREEMENTS


Additionally, between 1993, when the Salomon Brothers agreement was executed, and June 2006, nineteen corporations have entered into twenty federal non-prosecution agreements (NPAs): Salomon Brothers, Aetna, Sequoia, John Hancock, Lazard Freres, Merrill Lynch (1995), Coopers & Lybrand, Aurora Foods, Merrill Lynch (2003), Symbol Technologies, MCI-WorldCom, Micrus, Shell Oil, Adelphia, Hilfiger, American Electric

Defined Offense by Boeing so long as the underlying allegation or conduct is reported by Boeing.

140. Id. at 9. See, e.g., Computer Associates Agreement, supra note 90, at 20 (providing Computer Associates a two-week period after notification of breach).
141. Boeing Non-Prosecution Agreement, supra note 131, at 9.
142. Id. at 9–11.
143. Thompson Memo, supra note 3.
These agreements, and a tabulation of the major provisions in the agreements, are specified in Tables I and II. The Tables identify the corporation, year of agreement, duration of the agreement, offenses charged, whether individuals were charged, financial penalties imposed (fines, forfeiture, restitution and civil penalties), and whether an agency settlement was also reached. The Tables also identify undertakings of the corporations, including, acceptance of responsibility, appointment of an outside monitor or examiner, an obligation not to make public statements that contradict a factual narrative in the agreement, cooperation with government investigations, discharge of culpable employees, establishment of a hotline, establishment of a new or improved compliance program, new internal controls, waiver of attorney-client and work product privileges, waiver of statute of limitations and speedy trial rights, creation of new management or board positions, and creating a new training program.

It is important to note that the Justice Department has not made public all of these agreements. The publicly available press releases in these cases do not specify all provisions of the agreements. But the information from the releases is included in the Tables for informational purposes.

B. ACHIEVEMENTS

The deferred prosecution agreements spawned by Prudential Securities and the non-prosecution agreements which followed Salomon Brothers have, in many respects, advanced important public interest objectives.

The Justice Department has succeeded in uncovering and dealing with a dismal pattern of corporate misconduct. Since 1993, forty-three American corporations have acknowledged serious wrongdoing in violation of a broad array of federal criminal statutes, including securities fraud, tax fraud, foreign corrupt practices, tax evasion, conspiracy, environmental offenses, wire fraud and defense procurement fraud.

These agreements resulted in the imposition of criminal fines totaling in excess of three quarters of a billion dollars. Restitution settlements total in excess of $3 billion, and civil penalties exceed one billion dollars.

In several important instances, the agreements facilitated the indictment and conviction of high ranking corporate executives. These indictments
spurred important changes in corporate governance, including replacement of senior management, restructuring of corporate boards, and the creation of hotlines for reporting corporate misconduct. Furthermore, in a number of important instances, outside monitors or examiners have been created to ensure requirements with the agreements and also with the requirements of law have been met.149 In addition, many corporations have been required to create or improve comprehensive compliance programs.150

Christopher J. Christie, in an analysis of the Bristol Myers deferred prosecution agreement, applauded the ability of deferred prosecution agreements to “achieve the goals of improved corporate governance and renewed market confidence without destroying corporations and losing American jobs in the process.”151 With considerable justification, Christie concludes that the “deferred prosecution agreement between Bristol-Myers and the United States Attorney’s Office for the District of New Jersey has all of the elements necessary to achieve these goals.”152

Wrongdoing was identified and admitted to by the company. Specific failures of governance were identified and remedies were suggested by both parties and agreed to by the company. A respected federal monitor was appointed to insure adherence to the agreement. Major steps were taken to change the corporate culture through educational programs for employees and directors and a new approach to the corporate budgeting process. Restitution was made to those shareholders who were harmed by the corporate crimes.153

Christie’s positive appraisal could well be applied to many of the agreements considered in this essay.

C. COMMENTS

While the details of the forty-four agreements may be gleaned from Tables I and II, several issues merit individual comment.

148. Id.; see also, e.g., Guilty, Not-Guilty, supra note 76 (noting several former executives who were found guilty).

149. See infra Tables I & II; see, e.g., Non-Prosecution Agreement, Letter from U. S. Attorney’s Office, Southern District of New York, to John T. Montgomery, Esq., Attorney for Aurora Foods, Inc. 3 (Jan. 22, 2001); Non-Prosecution Agreement Between Symbol Technologies, Inc. and the U. S. Attorney’s Office for the Eastern District of New York 7 (June 3, 2004).

150. See infra Tables I & II; see, e.g., KPMG DPA, supra note 102; Deferred Prosecution Agreement between U.S. Dep’t of Justice, Criminal Div., Fraud Section and InVision Technologies, Inc. (Dec. 3, 2004); United States v. The New York Racing Association, Inc. Cr. 03-1295 (E.D.N.Y. Dec. 10, 2003) (Deferred Prosecution Agreement).

151. Christie & Hanna, supra note 59, at 1061.

152. Id.

153. Id.
1. Monitors

The Prudential, KPMG, and Computer Associates agreements required appointment of outside monitors, and 11 of the 24 DPAs have a monitor requirement. External monitors, once the exclusive subject of criminal RICO convictions, have now become an accepted reality in corporate reform. However, the duties and responsibilities of these extra-judicial officials vary markedly and have become an important topic (and source of concern) in the corporate governance literature.

Corporate monitors have had, in some instances, a substantial impact on corporate governance. In a striking example of the power of federal corporate monitors, former Federal Judge Frederick B. Lacy, the corporate monitor for Bristol-Myers Squibb, recommended the removal of the company’s Chief Executive Officer, Peter R. Dolan; the Board accepted Monitor Lacey’s recommendation. “[T]he episode has set off a debate whether Mr. Lacey represents a tougher-style monitor who may put new teeth into that role in corporate America—as some admirers hope—or whether, in the view of some critics, he has overstepped his authority at Bristol-Myers.”

2. Public Statements

A new and important requirement appearing with increasing frequency is an undertaking that the corporations not contradict representations and factual statements in the agreement or a statement of facts appended to the agreement. This occurs in 17 of the 24 DPAs. The impact of these detailed admissions of culpability has generated litigation by indicted corporate executives (KPMG) and raises concerns over the impact of these statements in subsequent civil litigation against the corporation.

3. Waiver of Attorney-Client and Work Product Privileges

With increasing frequency, the agreements require the corporation to waive attorney-client and work-product privileges. A waiver of these privileges is present, overall, in 16 of the 24 DPAs and 9 of the 20 NPAs. The issue of governmental pressure to induce corporations to waive attorney-client and work product protection has received increased critical attention and is explored in Section VII, infra.

154. See infra Tables I & II.
157. See supra note 111 and accompanying text. See also Tables I & II.
4. Financial Penalties

At least one form of financial penalties exists in virtually every DPA and NPA. Fines as well as civil penalties are required in 10 of the 24 DPAs. Restitution is required in 9 of the 24 DPAs. Every DPA required some sort of financial penalty, but the allocation of these financial penalties between fines, civil penalties and restitution appears to be a matter of ad hoc negotiation.

5. Prosecution of Individuals

A common justification for resolving criminal investigations of corporations is that these modes of disposition enable the government to identify, prosecute and convict the “real wrongdoer.” But the majority of DPAs and NPAs do not reflect the indictment of individual executives. Indictment of executives is only reflected in 9 of the 20 NPAs and 8 of the 24 DPAs.

6. Governance Changes

Requirements that the corporation change corporate governance organization and responsibility appear with increasing frequency in both DPAs and NPAs. Tables I and II reveal a corporate governance change requirement in 12 of the 20 NPAs and 13 of the 24 DPAs. Seven of the 24 DPAs require new management. In cases where senior executives have been indicted, new management boards have been required in 2 of the 8 DPAs and only 2 of the 9 NPAs. The appropriateness of instituting far-reaching corporate governance change by threat of criminal indictment remains a lively topic in the corporate governance literature.

7. Cooperation and Acceptance of Responsibility

Cooperation is nearly a universal requirement (found in 21 of the 24 DPAs) coupled with explicit acceptance of responsibility (found in 18 of the 24 DPAs). Cooperation is also a universal requirement of publicly available NPAs (found in 14 of the 20 agreements), however, explicit acceptance of responsibility only appears in 8 out of the 20 NPAs. Notably, all of the NPAs and DPAs entered into after Thompson require full cooperation. But the question of how the government perceives genuine cooperation, and whether that cooperation must include waivers and non-assistance to non-cooperative and indicted executives remains a subject of continuing controversy as explained below in Section VII.158

158. See also Edward Iwata, Debate Heats up on Justice’s Deferred-prosecution Deals, USATODAY.COM, June 1, 2006.
VII. CONCERNS AND SUGGESTIONS FOR REFORM

A. MISSING EXPLANATIONS

Deferred prosecution and non-prosecution agreements, even when public, are not always easily available for public inspection and criticism. The decision to make an agreement public is left to the sole discretion of the United States Attorney’s Office. Furthermore, the Justice Department does not issue formal statements of policy as to why it selects a non-prosecution agreement over a deferred prosecution agreement. The absence of Justice Department explanation makes informed public evaluation quite difficult and raises concern because many of the non-prosecution agreements reflect serious violations of the law. Moreover, there are instances where a corporation has been the beneficiary of more than one agreement and the Justice Department is not forthcoming with a public statement as to why this approach is in the public interest.

There is a potential solution to this lack of public disclosure. Congress could create a statutory requirement that the Justice Department publicly announce its acceptance of a non-prosecution or deferred prosecution agreement accompanied by a brief statement of why this resolution is in the public interest. As it happens, there is a statutory precedent for this approach.

The Tunney Act (Tunney) was enacted in response to criticism during the Watergate era of the way the Antitrust Division of the Justice Department entered into consent decrees to terminate antitrust cases. Tunney requires the Justice Department, when it has achieved agreement with a defendant on an antitrust consent decree, to file the proposed decree publicly along with an impact statement. The impact statement details what the government sought to achieve by the litigation, what the decree

159. See supra note 144 and accompanying text.
162. See id.
actually achieves, and why the proposed decree is in the public interest. 164 Thereafter, public comment is invited and the court holds a limited hearing to determine if the decree is in the public interest. 165

Tunney is an attractive model to contemplate in thinking about ways to improve public understanding and confidence in the deferred and non-prosecution process. The Boeing Non-Prosecution Agreement provides a clear example of the need for a Tunney-like provision. If such a statute were in place, the Justice Department would have been required to publicly disclose what they sought to achieve by the criminal case, and why this settlement of charges is in the public’s best interest. Surely, the public is entitled to know why it is in its best interest that compliance is redefined for Boeing and why Boeing, unlike any other entity entering into a deferred or non-prosecution agreement, may be immune from liability for misconduct committed by Boeing employees who are not part of senior management.

Admittedly, some Tunney provisions may be inappropriate in the sphere of criminal enforcement, given the traditional judicial concern that judges should not review exercises of prosecutorial discretion. 166 But the core Tunney concept of requiring the government to announce its decision to dispose of a criminal case by a deferred prosecution or non-prosecution agreement would advance the public interest. The public is entitled to know that serious instances of corporate misconduct have been adequately dealt with by the Justice Department by measures short of corporate indictment and conviction. Public confidence would improve if the government were required to offer a brief statement of why it believes a given settlement is in the public interest. 167 This modest proposal could also assist federal judges in discharging their judicial responsibilities when presented with deferred and non-prosecution agreements needing judicial approval. Most importantly, this kind of statutory requirement assures the public that corporate misconduct is effectively addressed, thereby increasing public confidence in the criminal justice process.

164. See id.
165. See id. § 16(d), (e)(1).
166. Wayte v. United States, 470 U.S. 598, 607 (1985) (“[t]he decision to prosecute is particularly ill-suited to judicial review.”).
167. Indeed, the statements accompanying the Salomon and Prudential agreements could form models of the kind of statement and explanation that should be statutorily required in all cases. See supra note 71 and accompanying text.
B. OVER-AGGRESSIVE PROSECUTORS?

Despite the positive achievements and success of deferred and non-prosecution agreements in addressing corporate misconduct, the frequency of their use and the emphasis of government defined cooperation has recently garnered sharp criticism. The expressed concern is that corporations are being pushed too hard by overly aggressive prosecutors who insist on cooperation, waiver of privilege, acknowledgment of culpability, substantial corporate reform, and financial penalties, even in cases where indictments might not ensue. 168 As one former Justice Department official explained:

[P]rosecutors have the unbridled discretionary power to insist that in order to avoid ‘death,’ a corporation under investigation waive its privileges and disclose otherwise protected information and advi[s]e and assist the government in its investigation. Any corporation that tries to protect its interests in the intensely adversarial setting of a criminal investigation, as is its right, is likely to be punished. 169

The recent comments regarding the Justice Department’s current policy by Mary Jo White, the distinguished former United States Attorney for the Southern District of New York (who crafted the Prudential agreement), reflect a carefully weighted evaluation of these concerns. 170 Ms. White suggests that the automatic reaction to corporate misconduct should not be an indictment or a deferred prosecution agreement. 171 She notes instead that “the Thompson memo, which governs federal prosecutors in deciding what to do about a company, says it will be the rare case where a company should be indicted.” 172 Ms. White believes that “it should also be the rare case where the government seeks a deferred prosecution agreement from the company.” 173

Far harsher criticisms regarding prosecutorial power accuse Justice Department officials of exercising “unchecked power”—the equivalent of a “state-sponsored shakedown scheme in which corporations are exhorted to pay penalties grossly out of proportion to any actual misconduct.” 174 Former United States Attorney for the Southern District of New York, James B.

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169. Id. at 1229.
171. Id.
172. Id.
173. Id.
Comey, in an interview distributed to all United States Attorneys, defends Departmental policy: “[F]or a corporation to get credit for cooperation, it must help the government catch the crooks.”\textsuperscript{175} “In sum, the Department now contends that ‘there is nothing wrong’ with the Government using the waiver of the privilege ‘to piggy-back on the investigation conducted by the corporation.’”\textsuperscript{176} If the corporation seeks lenience, “it will have to figure out a way to tell the Government what it knows about the misconduct and to help us to catch the wrongdoers.”\textsuperscript{177}

Defenders of current Justice Department policies attribute the problem, in part, to a Rashômon-like difference of perception.\textsuperscript{178} Christopher A. Wray, former Assistant Attorney General of the Criminal Division and Principal Associate Deputy Attorney General, uses this idea of an “apparent disconnect” to explain why the controversy over the government’s consistent request for waiver of attorney-client privilege is really a simple “mutual misunderstanding.”\textsuperscript{179}

Ask a prosecutor and a defense attorney who have just concluded a negotiation session whether a waiver request was made, and you may well have different answers from each. Mutual misunderstandings between the two groups can help explain the chasm between the Justice Department’s accounts of the rarity of waiver requests and the defense bar’s vehement insistence that they occur routinely.\textsuperscript{180}

Regardless of the differing perceptions between prosecutors and defense lawyers, Tables I and II, infra, reveal that nearly 80\% of the deferred prosecution agreements contain a waiver of privilege. It is unlikely that corporate counsel would waive the privilege unless they believed that waiver was required by the government.\textsuperscript{181} This empirical data reinforces

\textsuperscript{175} Silbert & Joannou, supra note 168, at 1227 (quoting Interview with United States Attorney General James B. Comey Regarding Department of Justice Policy on Requesting Corporations Under Criminal Investigation to Waive The Attorney-Client Privilege and Work Product Protection, U. S. ATT’YS BULL., Nov. 2003, at 1 [hereinafter Comey Interview]).  
\textsuperscript{176} Id. at 1228 (quoting Comey Interview).  
\textsuperscript{177} Id. (quoting Comey Interview).  
\textsuperscript{178} RASHÔMON (Daiei Motion Picture Co. Ltd. 1951). Rashômon is a Japanese film about a murder mystery. The three main characters, the husband, the wife, and the bandit are called upon to testify against the murder of the husband, and each testimony is different. One may say that the underlying question presented in the film is “What is the truth?” For a description of the movie, see Bosley Crowther, Roshômon, N.Y. TIMES, Dec. 27, 1951.  
\textsuperscript{179} Wray & Hur, supra note 78, at 1177.  
\textsuperscript{180} Id. “[R]epresentatives of the Department dispute the underlying premise that prosecutors are routinely requiring waiver in the course of government investigations.” Id. at 1176. The Justice Department position on waiver is ably elaborated in Mary Beth Buchanan, Effective Cooperation by Business Organizations and the Impact of Privilege Waivers, 39 WAKE FOREST L. REV. 587, 588 (2004).  
\textsuperscript{181} See, e.g., Stephen W. Graffman & Jeffrey L. Bornstein, New Memo Won’t Help, NAT’L L. J., Nov. 14, 2005 (“In reality today, a corporation that does not waive these valuable privilege rights effectively is considered a noncooperator.”). See also Tamara Loomis, Justice Encourages Waiving Attorney-Client Privilege, N.Y.L.J., Feb. 20, 2003, at 1 (citing Roberto J. Anello, partner
the conclusion of the American Corporate Counsel Association that it is “the regular practice of U.S. Attorneys to require corporations to waive their attorney-client privileges and divulge confidential conversations and documents in order to prove cooperation with prosecutors’ investigations.”182

A related claim of overreaching by federal prosecutors in negotiating deferred prosecution agreements centers on the issue of whether a corporation should agree not to advance or reimburse legal fees for indicted executives after the corporation has entered into a deferred prosecution agreement. This issue has received substantial public attention in the upcoming criminal trial of former KPMG executives.183 The indicted executives of KPMG have charged that the government’s agreement with KPMG violated their Sixth Amendment right to counsel.184 The basis for the claim centers on conversations between United States Attorneys and KPMG regarding the payment of indicted employees legal fees and what constitutes government cooperation.185 The government asserted that KPMG’s decisions not to reimburse indicted executives was not due to government pressure, but a mutual misunderstanding.186 Judge Lewis Kaplan rejected the government’s position:

The government was economical with the truth in its early responses to this motion. It is difficult to defend even the literal truth of the position it took in its first memorandum of law. KPMG’s decision on payment of attorneys’ fees was influenced by its interaction with the USAO and thus cannot fairly to be said to have been a decision “made by KPMG alone,” as the government represented.187

Judge Kaplan went on to state, “Every court is entitled to complete candor from every attorney, and most of all from those who represent the United States. These actions by the USAO are disappointing. There should be no recurrence.”188

182. Wray & Hur, supra note 78, at 1175–76 (quoting Letter from the American Corporate Counsel Association to U.S. Dep’t of Justice (May 12, 2000)).
185. See id. at 351–52.
186. See id.
187. Id. at 381.
188. Id.
Judge Kaplan concluded that aspects of Thompson violated the Sixth Amendment constitutional right to legal representation:^189

[S]o much of the Thompson Memorandum and the activities of the USAO as threatened to take into account, in deciding whether to indict KPMG, whether KPMG would advance attorneys’ fees to present or former employees in the event they were indicted for activities undertaken in the course of their employment interfered with the rights of such employees to a fair trial and to the effective assistance of counsel and therefore violated the Fifth and Sixth Amendments to the Constitution.^190

On November 15, 2006, Judge Kaplan, expressing concern that “‘there is a real and growing possibility that some and perhaps all [of the KPMG defendants] lack funds necessary to their defense[,]’” indefinitely postponed the trial of the KMPG defendants. ^191 Judge Kaplan observed:

“This court found, after a full evidentiary hearing, that the government violated the rights of the KPMG defendants by inducing KPMG—which otherwise would have advanced defense costs—to cut off payments upon indictment. . . . If KPMG is obliged to pay, payment could greatly mitigate the impact of the government’s improper actions. This in turn could diminish the advisability of dismissal or other potentially serious sanctions. If KPMG is not obliged to pay, or if a prompt determination is not feasible, the issue of sanctions could be considered after exhaustion of that possibility.”^192

VIII. THE RENEWAL OF ORGANIZATIONAL INDICTMENT AND THE CONTINUING CONTROVERSY OVER PRIVILEGE WAIVER

The issue of governmental demands for privilege waiver was a central factor in the indictment of the law firm of Milberg Weiss Bershad & Schulman and two of its named partners.^193 The indictment of the law firm

189. See Browning, Judge Questions, supra note 111. Judge Kaplan granted limited discovery and an evidentiary hearing on defendant’s claim “that the government, through the Thompson Memo . . . has violated defendants’ [Sixth Amendment] right to counsel by improperly interfering with KPMG’s ability to choose to advance to defendants legal fees and other defense costs . . . .” United States v. Stein, 2006 WL 1063298, at *1 (S.D.N.Y. Apr. 12, 2006) (No. 05 Crim. 0888).


192. Id. (quoting Judge Lewis A. Kaplan).

comes after negotiations failed between the firm and the government for a deferred prosecution agreement. The underlying charge is that the firm and two named partners engaged in secret rebates to lead plaintiffs in class action cases. This indictment “represents the most prominent confrontation between the government and a law firm in years.” A statement from Milberg Weiss reveals that the negotiations failed because of “[t]he government’s insistence that the firm waive attorney-client privileges as a condition to avoiding indictment.” Milberg Weiss asserts this condition “is in derogation of one of the bedrock principles of American law.” The statement added: “The prosecutors also insisted that the firm make unfounded statements accusing its own partners of crimes and otherwise become an agent for the government. Unfortunately, the prosecutors insisted on indicting the firm unless it made these impossible concessions.”

A similar concern over the government’s policy on privilege waiver has been voiced in a Federalist Society paper:

[Government enforcement policies] have put companies on notice that any refusal to waive such [attorney-client and work-product] privileges and protections could be viewed as a failure to cooperate with a government investigation and be held against the company when determining whether to charge or how to sentence a company for its alleged wrongdoing. . . . Current DOJ policy thus forces businesses to choose between cooperation that may include privilege waiver, potentially providing other litigation adversaries with privileged material that they would otherwise not be entitled to receive, and facing the consequences of

194. See, e.g., Milberg Weiss Statement (May 18, 2006), http://www.milbergweissjustice.com/ourstatements.php. On the firm’s website, they provided statements made by Mel Weiss regarding the indictment:

The firm has held intense negotiations with government officials in Los Angeles and Washington over the past six months in an effort to avoid this unjust result. The government’s insistence that the firm waive attorney-client privileges as a condition to avoiding indictment is in derogation of one of the bedrock principles of American law and extended to parties the firm did not control . . . Unfortunately, the prosecutors insisted on indicting the firm unless it made these concessions.

Id.


197. Milberg Weiss Statement, supra note 194.

198. Id.

199. Id.
being deemed to have failed to cooperate in the government investigation.\textsuperscript{200}

The American Bar Association has asked the House Judiciary committee to encourage the Justice Department to end the “culture of waiver.”\textsuperscript{201} Responding to concerns about the waiver requirement, the U.S. Sentencing Commission voted on April 5, 2006 to submit to Congress a revision of the waiver of attorney-client privilege provision.\textsuperscript{202}

The controversy over the Justice Department policy on the waiver issue in negotiating the deferred prosecution agreements led to a Senate Judiciary Hearing in September 2006.

A coalition of business and legal organizations, including the U.S. Chamber of Commerce, American Bar Association, Association of Corporate Counsel and National Association of Criminal Lawyers, contends that the Thompson memo has created a “culture of waiver” in which federal prosecutors now routinely demand waiver of attorney-client and work product protections even where there are less intrusive means of getting information.\textsuperscript{203}

Former Attorney General Edwin Meese III urged that Thompson eliminate all references to waiver in making a charging decision.\textsuperscript{204} In response to a statement by Deputy Attorney General Paul McNulty defending current Department policy, Senator Arlen Specter countered: “As I read this policy, I think it is coercive and may even rise to the level of being a bludgeon. I would ask you to reconsider the policy.”\textsuperscript{205} At the

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\bibitem{202} Press Release, U.S. Sentencing Comm’n, U.S. Sentencing Commission Votes to Amend Guidelines for Terrorism, Firearms, and Steroids (Apr. 11, 2006), \textit{available at} http://www.uscc.gov/PRESS/red0406.htm. The Commission voted at that session to promulgate an amendment “deleting the 2004 commentary to the organizational sentencing guidelines stating that waiver of attorney-client privileges and work product protections is a not a pre-requisite for an organization to receive credit for cooperation at sentencing.” \textit{Id. See also} Patti Waldmeir, \textit{Companies Fight Over Waivers}, FIN. TIMES, Nov. 16, 2005 (“Responding to pressure from business and lawyers’ groups, the commission held hearings this week on whether to amend the guidelines to discourage compelled waivers.”).
\bibitem{204} \textit{Id.} (quoting Former Reagan Attorney General Edwin Meese III).
\bibitem{205} \textit{Id.} (quoting Arlen Specter, R-Pa.).
\end{thebibliography}
present time, it is difficult to predict whether the Justice Department will change its basic approach to the waiver issue.206

IX. CONCLUDING OBSERVATIONS

Decades ago, legal realists taught that the state of the law should be gleaned not simply from formal substantive legislative and judicial pronouncements but from the law as applied by enforcers, civil, criminal, and private. This perspective helps in understanding the American “law” of corporate criminal liability in the twenty first century.

The substantive law governing corporate criminal liability is derived from congressional enactments and Supreme Court pronouncements and has remained unchanged for more than a century. However, the operative rules of corporate criminal liability and their application have undergone profound change. That change derives from the actions of a unique federal “agency,” the United States Sentencing Commission, combined with the enforcement arm of our federal constitutional system, the United States Department of Justice and those who carry out Justice Department policy, the nation’s United States Attorneys. Together, these efforts resulted in a quiet legal revolution that made corporate indictment and conviction an extreme rarity, and the prosecution of culpable corporate executives commonplace.

The corporation is now typically seen by the federal government not as the culprit in need of punishment, but as the facilitator/cooperator in the task of indicting and convicting culpable executives. To discharge its newly created law enforcement partnership with the federal government, the corporation routinely abandons attorney-client privilege and agrees not to contradict a detailed statement of culpability that often becomes the blueprint for prosecution of indicted executives.

At the same time, in an era where the penal policy goal of rehabilitation has been abandoned in the prosecution of individuals,207 rehabilitation has


been rehabilitated, sub silento, as a goal in corporate prosecution. The rehabilitated corporation adopts codes of ethics and compliance programs, reports to and may be managed by outside monitors, files detailed reports to the government, and cooperates with the Justice Department in the prosecution of former senior executives. In short, it demonstrates, on pain of prosecution for failure to do so, that it is indeed a “good corporate citizen.”

Whether or not this approach will be an enduring feature of the American criminal justice system remains to be seen.

208. In explaining and defending the Bristol Myers Squib deferred prosecution agreement, the United States Attorney declared: “The action by the government was firm, decisive and geared toward rehabilitating a damaged corporation.” Christie & Hannah, supra note 59, at 1061.

209. Reflecting the widely held view in the Justice Department, United States Attorney Christie recently declared that “deferred prosecution agreements allow prosecutors and companies to work together in creative and flexible ways to remedy past problems and set the corporation on the road of good corporate citizenship.” Id. at 1043.
A NEW BUSINESS LAW JOURNAL FOR BROOKLYN LAW SCHOOL

It is with great pleasure, pride, and a healthy dose of gratitude that we introduce this first volume of the Brooklyn Journal of Corporate, Financial & Commercial Law, entitled New Models for Securities Law Enforcement: Outsourcing, Compelled Cooperation and Gatekeepers. This volume, and the symposium that preceded it, could not have happened without the devoted efforts of several classes of Brooklyn Law School students. In the spring of 2005, after students in Brooklyn Law School’s Corporate and Securities Law Association spent several years seeking the establishment of a new student journal in the business law area, the Brooklyn Law School faculty and Dean Joan Wexler approved the creation of a new business law journal at Brooklyn Law School, with the ambitious charge to hold a symposium in the spring of 2006 and publish the first volume of the new journal in 2006–07 academic year.

In June of 2005 a Planning Board was selected. The students on the Planning Board were: Aline Attiyeh, Christine Creamer, Adam Greene, Kimberly Featherstone, Christopher P. Ferrara, Brandon R. Johnson, Orly N. Nhaissi, Jessica A. Poropat, Brian P. Redding, Scott Selinger, and Erin Tobin. That group is largely responsible for getting the Journal up and running. They helped plan this symposium; developed the practices and procedures that the journal now follows; put the Journal on a sound operational footing; and, most importantly, selected the current editorial board from the members of existing journals and through an open note competition. They accomplished all of this from a very small office in unfinished space that was actually behind the janitor’s closet. Because of their efforts, the Journal’s first symposium was held at Brooklyn Law School on March 31, 2006, and, with the publication of this volume, the Journal has achieved the goal set for it by the Dean and the faculty.

This first issue of the Journal is dedicated to Irving M. Pollack, Brooklyn Law School Class of 1942. Mr. Pollack served as a Commissioner of the Securities and Exchange Commission from 1974 to 1980, and was an Assistant General Counsel and Director of Trading and Markets and Enforcement at the SEC from 1946 to 1974. Fulbright & Jaworski L.L.P., where Mr. Pollack is now Senior Counsel, has sponsored this issue of the Journal, and the NASD, Inc. also made a seed money contribution. The generosity of Fulbright & Jaworski and the NASD are greatly appreciated. The SEC Historical Society partnered on this symposium and also partnered on the Journal’s second symposium, entitled Securities Market Structure and Regulation: What Does the Future Hold?, held on November 10, 2006.
This dry factual recitation of the formation of the *Journal of Corporate, Financial & Commercial Law* cannot begin to reflect the excitement and energy of the students on the Planning Board and the first Editorial Board and staff throughout the process of getting this publication off the ground. We feel privileged to have been the advisors for this new venture and we are very proud of the students who worked so diligently to meet the schedule for producing this first issue. We believe it is an outstanding collection of papers and a great beginning.

*Roberta S. Karmel and Edward J. Janger*
THE USE OF THE CORPORATE MONITOR
IN SEC ENFORCEMENT ACTIONS

Jennifer O’Hare*

I. INTRODUCTION

It’s an unusual role where you have veto power over the audit-committee chairman and over the CEO.1

Statement of WorldCom’s Corporate Monitor

The WorldCom2 securities fraud led to numerous lawsuits, several criminal convictions, and the Sarbanes-Oxley Act of 2002 (SOX). It also led to a novel Securities and Exchange Commission (SEC) remedy, which significantly increases the enforcement power of the SEC. In the WorldCom enforcement action, the SEC sought, and obtained, the judicial appointment of a “Corporate Monitor.” About two years later, when the Corporate Monitor’s work was done, he had caused the company to overhaul its corporate governance completely and to adopt several unique governance provisions. He had also exercised oversight over all major business decisions, including the sale of the company to Verizon. Put simply, his primary responsibility was to ensure that the company would not commit securities fraud ever again.

The Corporate Monitor is something new in corporate and securities law and it represents the latest example of the SEC seeking to shift its enforcement responsibilities to the public companies it regulates.3 This

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2. Following the scandal, WorldCom was renamed MCI, Inc. and was eventually acquired by Verizon, Inc. See, e.g., Out of Chapter 11, WorldCom is Again MCI, N.Y. TIMES, Apr. 21, 2004, at C13; Stephen Labaton, Judge Looks Into Modifying Terms of 2 Phone Mergers, N.Y. TIMES, July 8, 2006, at C3. For ease of reference, this article refers to the company by its original name, WorldCom.

article explores this method of SEC outsourcing. Part II briefly discusses the SEC’s enforcement powers, including the use of ancillary relief in judicial enforcement actions. Part III reviews the role of WorldCom’s Corporate Monitor, beginning with his initial appointment and tracing the evolution of his authority at the company. In particular, this paper explores both the corporate governance changes that were imposed by the Corporate Monitor and his extended oversight of the company.

Part IV considers some of the dangers of the SEC’s use of the Corporate Monitor in its enforcement actions, such as the potential of a de facto expansion of the Corporate Monitor’s power beyond the authority defined in the court orders and the danger that a Corporate Monitor with far-reaching powers will interfere with the ability of a board and corporate officers to manage the company effectively. The appointment of a Corporate Monitor, accountable only to the court, raises interesting issues of corporate law. This article analyzes whether the use of a Corporate Monitor conflicts with state corporate law and whether the appointment of the Corporate Monitor constitutes impermissible overreaching by the SEC. Part V concludes by recommending that the SEC seek an appointment of a Corporate Monitor only in very rare cases and publish guidance explaining when it will seek this ancillary remedy. Similarly, courts should articulate clear judicial standards that must be met before granting this extraordinary remedy. The final recommendation is a suggested judicial standard under which a court should appoint a Corporate Monitor only if the danger that a company will not comply with a court order to obey the federal securities laws outweighs the significant dangers associated with the use of a Corporate Monitor.

II. SEC ENFORCEMENT PROCEEDINGS AND ANCILLARY REMEDIES

A. SEC ENFORCEMENT PROCEEDINGS

Section 21(d) of the Securities Exchange Act of 1934 (‘34 Act) empowers the SEC to seek injunctive relief in federal district court whenever it appears that “any person is engaged or is about to engage in acts or practices constituting a violation” of the federal securities laws.\(^4\) To obtain the injunction, the SEC must show that there is a “reasonable

likelihood” of future violations of the federal securities laws.5 When a court issues the injunction, it is required to provide a brief explanation of the reasons underlying the order.6

In addition to an injunction, the SEC is also expressly empowered to seek other remedies including monetary penalties,7 orders barring individuals from serving as officers and directors of public corporations,8 and other equitable relief,9 such as ancillary remedies.10

B. CONSENT DECREES AND SETTLEMENTS

Approximately 90% of SEC enforcement actions are settled. The SEC often files the complaint and the settlement simultaneously in federal court.11 The court is then asked to approve the settlement as a consent decree.12

The incentives for each party to settle are obvious. For the resource-strapped SEC, settlement is often preferable to a costly trial. For the defendant, settlement offers a variety of advantages.13 It is often cheaper for a defendant to settle than to go forward with a contested case. Settlements also limit bad publicity, especially because the SEC does not require the defendant to admit to any wrongdoing. In addition, a defendant may feel incredible pressure from the SEC to settle and, if the defendant refuses to settle, the SEC may claim lack of cooperation, which could impact the sanctions the SEC decides to seek if the case is contested. Finally, the

5. See MARC I. STEINBERG & RALPH C. FERRARA, 25 SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 5:5 (2006) (“[T]he test applied in practically all federal courts is whether there is a reasonable likelihood that the defendant, if not enjoined, will again engage in the violative conduct.”).
6. The Federal Rules of Civil Procedure provide that:

FED. R. CIV. P. 65(d).
8. See id. § 78u(d)(2) (stating that the court may prohibit any person from serving as officer or director “if the person’s conduct demonstrates unfitness to serve as an officer or director”).
9. See id. § 78u(d)(5) (“[A]ny Federal court may grant] any equitable relief that may be appropriate or necessary for the benefit of investors.”).
10. See infra Part II.C.
11. See STEINBERG & FERRARA, supra note 5, § 3:60.
12. Here, the term “consent decree” is used to mean a court-approved settlement between the defendant and the SEC. As one noted commentator has stated, a consent decree is “an agreement between the parties to end a lawsuit on mutually acceptable terms which the judge agrees to enforce as a judgment.” Larry Kramer, Consent Decrees and the Rights of Third Parties, 87 MICH. L. REV. 321, 325 (1988).
defendant may decide to settle to avoid the potential collateral estoppel effects resulting from a successful SEC injunctive action. All in all, even innocent defendants have good reasons to agree to a settlement.

Although the parties to a consent decree have by definition agreed to the injunctive relief, the court does not automatically approve the settlement. Because an SEC consent decree has the potential to impact the rights of third parties, the district court conducts a limited review of the agreement’s fairness. The standard set forth in most cases is that the court will approve the consent decree unless it is “unfair, inadequate, or unreasonable.” In making this determination, the court gives substantial deference to the administrative agency’s decision to settle the case. The limited nature of the review is understandable given the strong federal policy favoring approval of consent decrees. Moreover, because of the non-adversarial nature of the settlement process, a court would have difficulty receiving information tending to show that a settlement is unfair. Not surprisingly, courts approve most SEC consent decrees.

C. ANCILLARY RELIEF

In addition to seeking injunctions, the SEC commonly seeks “ancillary relief” to enforce the federal securities laws. The term “ancillary relief” refers to non-statutorily based remedies that supplement an injunction. Implicit in the ancillary remedy is the assumption that an order enjoining the defendant from future violations of federal securities laws will not be effective, so that more direction is needed from the court to ensure that the defendant will comply with the federal securities laws.

One commentator observed three different categories of ancillary relief: (1) remedies intended to correct past violations of the federal securities laws, such as disgorgement; (2) remedies intended to preserve the existing condition of the defendant during the pendency of the action, such as an asset freeze or the appointment of a receiver; and (3) remedies intended to discourage future violations of the federal securities laws by regulating certain aspects of the defendant’s future behavior, such as the institution of corporate governance changes, the judicial appointment of board members, or the appointment of special investigative agents.

This third type of ancillary relief has been the subject of a robust academic debate that began in the 1960s and 1970s when the SEC first

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14. See, e.g., SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984) (“Unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved.”).
15. See, e.g., SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991) (“[T]here is] already a strong federal policy favoring the approval and enforcement of consent decrees.”).
started to aggressively seek these remedies. Commentators have argued that the corporate governance reforms required by the SEC in its consent decrees can interfere with the effective management of a company. Similarly, court appointment of SEC-approved directors can be a significant intrusion on shareholder suffrage, while the appointment of special investigative agents can undermine attorney-client privilege. And, finally, because it is doubtful that the SEC has authority to promulgate rules with the same far-reaching effect as the ancillary remedies ordered by a court, the judicial grant of ancillary relief presents a real danger of SEC overreaching.

Despite these criticisms, the SEC has sought, and has usually obtained, ancillary relief from the courts. The courts have easily found the authority to order these remedies. Historically, courts have relied on their inherent equitable powers—as opposed to a grant of power under the federal securities laws—as the basis for ordering ancillary relief. Courts have reasoned that “[o]nce the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy.”

Although the courts in the past looked to their broad equitable powers to grant ancillary relief, courts now have statutory power to grant these remedies in SEC enforcement actions. As part of SOX, the ’34 Act was amended to authorize the granting of “any equitable relief that may be appropriate or necessary for the benefit of investors.” In enacting this provision, Congress signaled its approval of the use of ancillary relief in SEC enforcement actions.
WorldCom perpetrated one of the most massive accounting frauds in United States history. Over a period of several years, WorldCom managers improperly inflated the company’s income by over $9 billion. After WorldCom announced that it would be restating its financial results, the SEC brought an enforcement action against the company contending that it violated the anti-fraud provisions of the federal securities laws. In the complaint, the SEC sought an injunction against further violations and sought monetary penalties. The complaint also sought fairly typical ancillary relief, such as orders prohibiting the company from destroying any documents and from making any extraordinary payments to WorldCom employees. In addition, the SEC asked the court to appoint a so-called “Corporate Monitor.”

A. THE EVOLVING JUDICIAL AUTHORITY OF THE CORPORATE MONITOR

1. The Initial Appointment of the Corporate Monitor

On June 26, 2002, the SEC filed its initial complaint, asking the district court to appoint a Corporate Monitor to “ensure compliance” with any court orders prohibiting the destruction of evidence or the paying of excessive compensation. Two days later, pursuant to a stipulation between the SEC than limiting disgorgement to these gains, the bill will permit courts to impose any equitable relief necessary or appropriate to protect, and mitigate harm to, investors.

S. REP. NO. 107-205, Title III(E) (2002).
27. Specifically, the SEC requested the following relief from the court:

A. Permanently restraining and enjoining WorldCom from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

B. Permanently restraining and enjoining WorldCom from violating Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-3 thereunder;

C. Imposing civil monetary penalties on WorldCom pursuant to Section 21(d) of the Exchange Act [15 U.S.C. § 78u];

D. Prohibiting WorldCom and its affiliates, officers, directors, employees, and agents, from destroying, altering, or removing from the court’s jurisdiction any documents relevant to the matters alleged herein;

E. Prohibiting WorldCom and its affiliates from making any extraordinary payments to any present or former affiliate, or officer, director, or employee of WorldCom, or its affiliates, including but not limited to any severance payments, bonus payments, or indemnification payments;

F. Appointing a corporate monitor to ensure compliance with Items D and E, above; and

G. Granting such other and additional relief as this Court may deem just and proper.
and WorldCom, Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York ordered the appointment of a Corporate Monitor. The court did not immediately select the Corporate Monitor, but instead directed the parties to jointly propose a name to the court within five days.  

On July 3, 2002, the court appointed Richard C. Breeden, a former Chairman of the SEC, to act as WorldCom’s Corporate Monitor. Although the appointment was not accompanied by a written description of the selection process, a transcript from the hearing indicates that Judge Rakoff selected Mr. Breeden from a list of three names pre-approved by both the SEC and WorldCom.  

2. The Initial Authority of the Corporate Monitor

Initially, the WorldCom Corporate Monitor had fairly limited authority. He had two main charges: prevent the destruction of evidence and prevent the payment of excessive executive compensation. The court was concerned that, without court oversight, WorldCom managers would
continue to receive the excessive salaries and perks that had been the norm at the Bernie Ebbers-run company. Thus, the Corporate Monitor was expressly authorized to either approve or disapprove all compensation payments made by WorldCom.33

3. The Expanding Judicial Authority of the Corporate Monitor

Although the Corporate Monitor’s role began as a way to ensure that WorldCom did not continue its widely-reported practice of paying excessive compensation to its current (and former) managers, Mr. Breeden’s authority quickly began to expand.34 First, very early in the proceedings, the court issued an order significantly expanding the definition of “compensation.” According to the court, compensation included not only payments made to WorldCom executives, but also payments made to any “outside advisor” hired by WorldCom.35 For example, the Corporate Monitor was given oversight and approval authority over payments made to WorldCom’s investment bank, restructuring advisors, and attorneys.

Shortly after WorldCom’s bankruptcy filing, Judge Rakoff reiterated the breadth of the Corporate Monitor’s authority. He stated, “[t]o put it bluntly, it is the responsibility of the Corporate Monitor, among other responsibilities, to prevent unnecessary compensatory expenditures by the company, not only in the form of looting by miscreants but also in the form

33. The order provides that the Corporate Monitor has the discretion to “approve or disapprove” compensation payments. Id. at 2. It also states that if the Corporate Monitor does not promptly approve a compensation payment, WorldCom could seek approval from the court. Id. at 3.

34. Interestingly enough, the expansion of the Corporate Monitor’s role appears to have been contemplated by the court from the beginning. During the hearing at which Mr. Breeden was appointed as WorldCom’s Corporate Monitor, Judge Rakoff stated that:

[I]t may be . . . that he will have other functions to serve as time goes on. We don’t need to reach that today, because this will be a fluid situation that will evolve with the great assistance of both sides, and if and when it is necessary to have any discussions about the appropriateness of broadening the monitor’s role, we will, of course, have a public discussion here in court.

WorldCom Transcript of Record, supra note 30, at 4.

35. As the court stated:

Lest there be any doubt as to the scope of [the Corporate Monitor’s] access, it means, among much else, that “outside advisors” hired, retained, or consulted by the defendant or by any of its officers, directors, agents, or employees, or anyone acting in concert with any of them, to help advise the company or its board in the current circumstances must, upon pain of contempt, make full disclosure to the Corporate Monitor of any and all information the Corporate Monitor requests (including, by way of example, their own compensation arrangements with the defendant and their advice to the defendant or its Board). Among others, such advisors include, by way of example, investment banking advisors like Goldman Sachs & Co. and outside investigators like Wilmer, Cutler & Pickering.

of excessive compensation of those who mistake a damaged company for a broken piggybank.”

To determine what was “necessary” to WorldCom’s operations, the court determined that the Corporate Monitor should receive information well beyond simple compensation arrangements. According to the court, Mr. Breeden was entitled to receive “complete information about every aspect of the business he deems relevant to his assessments” in advance of any company action. In addition, the order specifically stated that the

37. See id. Specifically, the order provided that the Corporate Monitor be provided with the following information:

a. any document or information communicated by the company or any professional employed by the company to any of (i) the official committees, (ii) any debtor-in-possession (“DIP”) lender, (iii) any participant in the bank group or (iv) any other creditor (any such person being a “Covered Party”). This includes, inter alia, financial or other reports, projections, analyses, proposals, covenant tests, or other written (including electronic format) material.

b. any financial or other report, study, projection, analysis, proposal, presentation or other document relating in any way to material business decisions or the conduct of the bankruptcy (including any such item labeled “drafts” but nonetheless circulated) generated by any professional employed by the company and communicated to senior management of the company. This includes, inter alia, financial reports, restructuring proposals, downsizing analyses, disposition alternatives, “RIF” proposals and proposals to, or under discussion with, potential acquirors, lenders or investors.

c. any plan, proposal or study, including conceptual issue reviews, relating to compensation in any form, including severance and retention programs of any kind, and including, without limitations, retentions of outside professionals or other advisors, including restructuring, investment banking or bankruptcy professionals employed by the company.

d. any document or other material distributed to any one or more members of the board of directors (whether in that person’s capacity as a member of the board, any committee thereof, or of management).

e. any proposal, term sheet, agreement, letter of intent, plan, analysis or other communication relating to (i) sale of assets or securities out of the ordinary course, (ii) merger or consolidation of the company or any subsidiary thereof with any other person or entity, (iii) any shutdown of service, termination of activities or abandonment of property or assets, and/or (iv) any other business decision ultimately requiring Bankruptcy Court approval, including any draft study or multiple scenarios for internal review.

f. any business plan, plan of reorganization, plan of liquidation, or proposed recapitalization, or any draft or segment thereof (including exhibits, appendices, or material to be incorporated therein).

g. any cash flow reports or memoranda of any kind, including reports of all activity in the DIP loan facilities of the company, and of any draft financial statement or revision thereof.

h. copies of any proposed retention agreement or motion relating thereto.

i. copies of all filings with the Bankruptcy Court.
Corporate Monitor had to be granted access to any employee of WorldCom “to discuss any matter deemed relevant to the Corporate Monitor at any time”\(^3\) and had to be invited to any meetings or discussions between WorldCom and the persons involved in its bankruptcy proceeding, including, for example, the official creditors committees.\(^4\) Pursuant to this authority, Mr. Breeden was entitled to attend all WorldCom board and board committee meetings. The Corporate Monitor’s already expansive authority would soon increase even further, as a result of WorldCom’s consent decree with the SEC.

**4. The Effect of the Consent Decree**

In November 2002, WorldCom entered into a partial settlement with the SEC.\(^5\) As part of the consent decree, the Corporate Monitor was required to review WorldCom’s corporate governance\(^6\) and to issue recommendations concerning WorldCom’s future governance structure.\(^7\) In June 2003, several months before Mr. Breeden’s report was issued, WorldCom

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\(^3\) Id. at *5–*7.

\(^4\) See id. at 5.

\(^5\) See id. at 6.

\(^6\) See Judgment of Permanent Injunction Against Defendant WorldCom, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Nov. 26, 2002) [hereinafter WorldCom Permanent Injunction]. As part of the settlement, WorldCom agreed to be permanently enjoined from violating the federal securities laws. This settlement did not include any judgment regarding civil penalties. The parties later agreed that WorldCom would pay a penalty of $500 million in cash and $250 million worth of stock in the reorganized company. See Consent and Undertaking of Defendant WorldCom, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 7, 2003).

\(^7\) Specifically, the Corporate Monitor was required to determine:

(1) whether WorldCom is complying with recognized standards of “best practices” with respect to corporate governance;

(2) whether WorldCom has sufficient policies and safeguards in place (a) to ensure that WorldCom’s Board of Directors and all committees of WorldCom (including without limitation the audit committee and the compensation committee) have appropriate powers, structure, composition, and resources and (b) to prevent self-dealing by management;

(3) whether WorldCom has an adequate and appropriate code of ethics and business conduct, and related compliance mechanisms; and

(4) whether WorldCom has appropriate safeguards in place to prevent further violations of the federal securities laws.

WorldCom Permanent Injunction, supra note 40, at 5–6.

\(^5\) The Judgment of Permanent Injunction also required that, following the Corporate Monitor’s report, the WorldCom board was required to report back to the court and the SEC “with respect to the decisions and actions taken as a result of each of the” Corporate Monitor’s recommendations. Id. at 6.
stipulated that it would adopt each of the Corporate Monitor’s corporate governance recommendations in full.\textsuperscript{43}

5. The Corporate Monitor’s Report

In August 2003, Mr. Breeden issued his well-publicized corporate governance report, \textit{Restoring Trust}.\textsuperscript{44} In the 147 page report, the Corporate Monitor made 78 recommendations, including some that have been considered quite controversial.\textsuperscript{45} Many of the recommendations sought to increase shareholder power in the corporation by instituting provisions permitting shareholder nomination of directors,\textsuperscript{46} establishing an “electronic town hall” for shareholder communications,\textsuperscript{47} and requiring the company to include in its proxy statement certain shareholder proposals\textsuperscript{48}—even if they could be excluded under the SEC’s current proxy rules. Other recommendations were intended to strengthen the performance and effectiveness of the board of directors, including several rules relating to the composition of the board and board committees.\textsuperscript{49} Mr. Breeden also introduced board term limits with his recommendation that the board have at least one new member each year.\textsuperscript{50} In addition, because the Corporate Monitor traced many of WorldCom’s problems to its practice of paying excessive compensation to its management, the report contained several rules addressing the amount and form of executive compensation, including bans on the use of stock options\textsuperscript{51} and caps on annual executive compensation.\textsuperscript{52} The report also imposed several rules aimed at improving the accuracy and transparency of WorldCom’s financial reporting process, including the

\textsuperscript{43} Stipulation and Order at 2, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. June 11, 2003). If WorldCom later decided that it did not want to adopt one or more of the Corporate Monitor’s recommendations, the company would have to seek relief from the court. See \textit{id}.

\textsuperscript{44} See \textit{RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI INC.} (Aug. 2003).

\textsuperscript{45} For example, a noted corporate lawyer criticized the report, stating that many of the recommendations “have long since been rejected by the regulators and lawmakers who have spent much time and effort considering these matters.” Report by Martin Lipton, Mark Gordon, & Laura Muñoz, Wachtell, Lipton, Rosen & Katz, “\textit{Restoring Trust}” or Losing Perspective? 1 (Aug. 27, 2003), \textit{available at} http://www.realcorporatelawyer.com/pdfs/wlrk082803.pdf. See also Letter from Warren de Wied, Fried, Frank, Harris, Shriver & Jacobson, A New Voice in the Corporate Governance Debate: The Recommendations of WorldCom’s Corporate Monitor 2 (Sept. 8, 2003), \textit{available at} http://www.ffhsj.com/lememos/030909_worldcom_monitor.pdf (stating that many of the recommendations were “highly controversial”).

\textsuperscript{46} See \textit{BREEDEN}, \textit{supra} note 44, at 43.

\textsuperscript{47} See \textit{id} at 114.

\textsuperscript{48} See \textit{id}.

\textsuperscript{49} See \textit{id} at 49–60. For example, Mr. Breeden recommended that the WorldCom Board should ordinarily consist of ten directors. See \textit{id} at 49. All of these directors, other than the CEO, should be independent directors. See \textit{id} at 50.

\textsuperscript{50} See \textit{BREEDEN, supra} note 44, at 56.

\textsuperscript{51} See \textit{id} at 95–96.

\textsuperscript{52} See \textit{id} at 82–87.
adoption of a dividend policy with a target payout of annual dividends of at least 25% of the company’s annual income. Finally, the Corporate Monitor attempted to establish an honest corporate culture at WorldCom through a new legal and ethics program.

B. THE CORPORATE MONITOR’S ACTIVITIES

The above discussion traces the history of the expanding judicial authority of WorldCom’s Corporate Monitor, from a person initially charged with prohibiting the destruction of evidence and the payment of excessive executive compensation, to a person who was required to revamp the company’s corporate governance structure. As explained in more detail below, Mr. Breeden capitalized on this judicially-created authority and expanded his power even further to become arguably the most powerful person at WorldCom, a person involved in every important corporate decision.

These important corporate decisions included compensation packages for the new management team. In fact, one of Mr. Breeden’s first significant actions was the approval of the pay package for Michael Capellas, WorldCom’s new Chief Executive Officer. Initially, the Corporate Monitor rejected the WorldCom board’s proposed employment agreement with Mr. Capellas, opining that it was “grossly excessive.” Eventually, WorldCom agreed to reduce Mr. Capellas’s compensation. But the Corporate Monitor was not satisfied with merely obtaining this salary concession. Before he would approve the pay package, Mr. Breeden required Mr. Capellas to sign an “Undertaking and Pledge,” which required

53. See id. at 128.
54. See id. at 138–39.
55. See Andrew Backover, Judge Blasts New WorldCom CEO Capellas’ Salary Package, USA TODAY, Dec. 10, 2002, at 6B. Originally, the board proposed a compensation package that would pay Mr. Capellas $1.5 million in base salary, plus a signing bonus of $2 million and up to $1.5 million in performance-based bonuses. He would also receive $18 million in restricted stock in the post-bankruptcy WorldCom entity. See Debtors’ Motion Pursuant to Sections 363 and 105 of the Bankruptcy Code for an Order Authorizing the Employment of Michael D. Capellas as President, Chief Executive Officer and Chairman of the Board of Directors of the Debtors, In re WorldCom, Inc., Ch. 11 Case No. 02-13533, Ex. A at 2–3, 7–8 (Bankr. S.D.N.Y. Dec. 9, 2002). See also id. at 2, 7–9.
56. Under the new compensation package, Mr. Capellas received the same salary, signing bonus, and performance based bonus. However, his restricted stock award was reduced by $6 million to $12 million, contingent on the company emerging from bankruptcy, at which time he could receive an additional $6 million worth of stock, at the discretion of the Monitor and the company’s board. See Seth Schiesel, Revised Contract for WorldCom’s New Chief Executive Wins Approval From 2 Judges, N.Y. TIMES, Dec. 17, 2002, at C10. See also Supplement to Debtors’ Motion Pursuant to Sections 363 and 105 of the Bankruptcy Code for an Order Authorizing the Employment of Michael D. Capellas as President, Chief Executive Officer and Chairman of the Board of Directors of the Debtors, In re WorldCom, Inc., Ch. 11 Case No. 02-13533, Ex. A at 7–8 (Bankr. S.D.N.Y. Dec. 16, 2002).
Mr. Capellas to agree to numerous corporate governance initiatives as a condition to employment. 57

Given the Corporate Monitor’s judicial charge to prevent WorldCom from paying excessive compensation, Mr. Breeden’s participation in this important corporate decision is not surprising. But a review of Mr. Breeden’s activities at WorldCom demonstrates that his power extended well beyond compensation decisions. In fact, the Corporate Monitor actively participated in the general business operations of WorldCom. 58 His involvement was so significant that he has been described variously as an unofficial “company executive” and “unofficial board member” of the company. 59 In addition to attending all board meetings and controlling the company’s monthly budget, Mr. Breeden was a significant player in high-level corporate negotiations, including, for example, the negotiations that ultimately restored WorldCom’s ability to bid on government contracts 60 and negotiations with WorldCom’s creditors.

The Corporate Monitor also shaped WorldCom’s board of directors. He chose the new members of WorldCom’s board of directors 61 and was instrumental in obtaining the resignation of a shareholder-elected member of the board accused of a conflict of interest transaction during the Bernie Ebbers era, even after the board refused to remove him. 62

Perhaps the most significant example of the Corporate Monitor’s power at WorldCom was the extraordinarily active role he played in the ultimate decision faced by any corporation: the decision to be acquired by another company. During 2005, two companies—Verizon Communications, Inc. and Qwest Communications International, Inc.—fought for control of WorldCom and required the WorldCom board to choose between the two

57. For example, the Undertaking and Pledge required Mr. Capellas to develop disclosure policies beyond those required by the federal securities laws, to “support robust levels of capital investment in internal controls,” to help develop corporate governance mechanisms that will “advance the best interests of shareholders, creditors and the public at large,” and to help ensure that the board “has a membership that represents shareholder interests (and stakeholder interests broadly prior to emergence from bankruptcy).” See Order, Ex. A at 5, SEC v. WorldCom, Inc., No. 02 Civ. 4963, (S.D.N.Y. Dec. 16, 2002).

58. In fact, Mr. Breeden had an office at WorldCom’s headquarters, right down the hall from the company’s CEO. See One on One With Richard Breeden, Corporate Monitor for MCI, Interview on Nightly Business Report (Aug. 26, 2003), available at http://www.nbr.com/archive/transcript/2003/transcript082603.html#story2 (“[Breeden] has been sitting inside the company, two doors down from the CEO, watching everything that goes on there.”).

59. See Lublin & Young, supra note 1 (characterizing Mr. Breeden as an “unofficial board member”).

60. See id. (“Mr. Breeden was a key player in government negotiations that led to . . . restoration as a federal bidder [on government contracts].”).

61. See Barnaby J. Feder, Five are Chosen to Join Board of a Reorganized WorldCom, N.Y. TIMES, Aug. 30, 2003, at C2 (stating that Mr. Breeden recommended the new members of the board).

62. See Kurt Eichenwald, WorldCom Director Quits and Agrees to Pay For Using Plane, N.Y. TIMES, Oct. 29, 2002, at C3 (noting that Mr. Breeden urged the board to remove the director, but the board determined that it did not have the authority to remove a shareholder-elected director).
suitors. Mr. Breeden was directly involved in the company’s negotiations with both Verizon and Qwest. In fact, some investors criticized the extent of his involvement and alleged that the Corporate Monitor unduly favored Verizon over Qwest in the takeover battle, even though Qwest appeared to offer a higher short term value to WorldCom shareholders.

IV. POTENTIAL DANGERS PRESENTED BY THE USE OF A CORPORATE MONITOR

Although WorldCom is the most well-known example of a Corporate Monitor, the SEC has sought this ancillary remedy in several other recent cases and is likely to use this novel remedy again in the future. Therefore, it is important to consider the potential dangers associated with the use of a Corporate Monitor.

A. DE FACTO EXPANSION OF CORPORATE MONITOR’S POWER

The appointment of a Corporate Monitor leads to the potential for a de facto expansion of the Corporate Monitor’s power. “De facto” expansion means an expansion of the Corporate Monitor’s powers beyond those

63. According to WorldCom’s public documents, Mr. Breeden participated in the decision to reject Qwest’s bid in favor of Verizon. See, e.g., Letter from Nicholas deB Katzenbach, MCI Chairman of the Board, MCI to Richard C. Notebaert, Chairman & CEO of Qwest Communications International, Inc. (Mar. 1, 2005), available at http://www.verizonbusiness.com/about/news/releases/ (follow 1 March, 2005 MCI Chairman of the Board) (“MCI’s Board, with the participation of the court-appointed Corporate Monitor[,] . . . has reviewed all options . . . .”). Published reports also indicate that Mr. Breeden was deeply involved in the negotiations. For example, the Washington Post reported, “Every time [WorldCom] delves into delicate discussions over whether to merge with Qwest Communications International Inc. or Verizon Communications Inc., it is doing so under the close watch of the Corporate Monitor. Yuki Noguchi, The ‘Sheriff’ of MCI; Watchdog Laid Down Laws Now Affecting Merger Talks, WASH. POST, Apr. 28, 2005, at E1. See also Jesse Drucker & Almar Latour, Qwest Weighs Proxy Fight for MCI, WALL ST. J., Apr. 7, 2005, at A6 (reporting that MCI rejected Qwest’s bid after the Qwest CEO spoke with Mr. Breeden).

64. See, e.g., Noguchi, supra note 63 (“[S]ome shareholders arg[u]ed that [Mr. Breeden] has been biased towards Verizon’s offer from the start.”). See also Almar Latour et al., Verizon Regains an Edge, For Now, In Bid for MCI, WALL ST. J., Apr. 11, 2005, at A1 (“How could [WorldCom’s] corporate monitor and board allow this to happen?”) (quoting Leon Cooperman, the chairman and chief executive of Omega Advisors Inc., which owns about 12 million shares of MCI). In addition to Mr. Breeden’s direct influence on WorldCom’s decision to be acquired by Verizon, the Corporate Monitor also may have had a more subtle, indirect influence on the outcome. As part of the corporate governance changes made by WorldCom at the direction of the Corporate Monitor, the WorldCom board adopted certain guidelines. According to these guidelines, the WorldCom board’s role was to “maximize the long-term value of the Company for its shareholders” by, inter alia, “addressing the concerns of other interested parties including employees, customers, suppliers, government and regulatory officials, communities and the public at large.” See MCI, INC. CORPORATE GOVERNANCE GUIDELINES (on file with Brooklyn Journal of Corporate, Financial & Commercial Law). By permitting the WorldCom board to focus on long-term value and “other constituencies,” these guidelines may have helped defeat Qwest’s bid. See Ken Belson, Why MCI Is Turning Up Its Nose at $1.3 Billion, N.Y. TIMES, Apr. 10, 2005, at C3.

65. See supra note 3.
specifically defined by the relevant court orders. The judicial power to “monitor” or “oversee” a company’s management creates the danger of non-judicial expansion of the Corporate Monitor’s power.

An examination of WorldCom illustrates this phenomenon. The court orders defining the authority of the WorldCom Corporate Monitor did not expressly grant Mr. Breeden the power to participate in the business operations of WorldCom. Nor did the orders authorize Mr. Breeden to negotiate a merger agreement or to select the names of individuals who would serve on the new WorldCom board. Instead, it’s likely Mr. Breeden derived these powers from the Corporate Monitor’s general oversight authority. Judge Rakoff wanted Mr. Breeden to be his eyes and ears so that the court could determine whether WorldCom had changed its ways. Presumably, if Mr. Breeden was not satisfied with what he observed, he would report back to the court with recommendations, and the court would order WorldCom to comply with Mr. Breeden’s recommendations. This gave Mr. Breeden tremendous leverage to increase his power at the company beyond the scope of his defined authority, and he appeared to do this with the tacit approval of the court.

Mr. Breeden’s de facto power also increased because WorldCom was unlikely to challenge his role at the company. To recover from the tremendous scandal it was vitally important for WorldCom to convince the investing public that the company was fully committed to reform. Any conflict with the Corporate Monitor, no matter how justified, would lead the investing public to conclude that WorldCom was dragging its feet on its promise to become a good corporate citizen. Therefore, WorldCom had to avoid any public disagreement with Mr. Breeden. WorldCom’s strategic decision to accept Mr. Breeden’s active participation in its business permitted the Corporate Monitor’s power to expand to levels the court order had not contemplated. The danger of a de facto expansion of power is inherent in the use of a Corporate Monitor. Thus, any corporation that agrees to accept a Corporate Monitor would be in similar position.

B. POTENTIAL INTERFERENCE WITH MANAGEMENT

When the court appoints a Corporate Monitor with broad powers, he can interfere with the ability of the board and corporate officers to manage the company. The Corporate Monitor may interfere directly if a court defines the Corporate Monitor’s authority to trump decisions made by the

66. As Judge Rakoff explained:

The monitor’s client is a difficult, rather ornery client, namely me, and more abstractedly, the Court, and I want a hands-on monitor. I want a monitor who will report to me what is going on and, more importantly, feel free to look in any nook and cranny that is necessary to fulfill his functions.

WorldCom Transcript of Record, supra note 30, at 3.
board or corporate officers. The Corporate Monitor may also interfere indirectly.

The facts of WorldCom demonstrate the potential for direct interference by a Corporate Monitor. For example, although it is the board’s role to set executive compensation, the WorldCom judge placed that authority in the hands of the Corporate Monitor. Mr. Breeden used his judicial authority to veto Mr. Capellas’s compensation agreement. But by doing so, Mr. Breeden impeded what is arguably the board’s most significant responsibility, the selection of a CEO. Moreover, certain of his corporate governance reforms affected the discretion of WorldCom’s officers to manage the company. For example, the ethics pledge signed by Mr. Capellas as a condition to his employment contained several undertakings that restricted his discretion to manage the company. The CEO’s discretion was also impacted by the recommendations set forth in Mr. Breeden’s Restoring Trust report, which the company agreed to adopt as part of its SEC settlement. The report included a recommended dividend policy, which required WorldCom to set a target of paying annual dividends of at least 25% of annual income. This cash commitment undoubtedly affected the decisions made by WorldCom’s management.

The WorldCom Corporate Monitor also had an indirect—though no less significant—effect on management. The appointment of a Corporate Monitor with broad oversight authority means that a company’s management operates under close supervision. This supervision affects the way management performs. For example, in WorldCom, the decision to sell the company was made even more difficult for the directors because they had to consider the opinion of the Corporate Monitor. It is likely the CEO had an especially difficult time operating under a watchdog. As one WorldCom board member stated, Mr. Capellas “has sort of been playing with one hand tied behind his back.” The danger that a Corporate Monitor will interfere with the management necessarily accompanies the appointment of a Corporate Monitor.

C. ACCOUNTABILITY

A related concern is the accountability of the Corporate Monitor. Although a Corporate Monitor effectively may be managing a corporation, he is a court officer, answerable only to the court. The Corporate Monitor

67. And, in fact, Mr. Breeden’s insistence on a lower pay package for the new CEO created a real danger that this sought-after executive might take a different offer. See Andrew Backover, Overseer Confident WorldCom Will Come Back, USA TODAY, Dec. 30, 2002, at 4B (“Breeden’s veto irked some creditors who wanted a new CEO as fast as possible.”).
68. See supra note 57 and accompanying text.
69. See BREEDEN, supra note 44, at 8.
70. See Lublin & Young, supra note 1.
71. For example, in WorldCom, the judge clarified the Corporate Monitor’s status as follows:
is not an agent of the shareholders; he is an agent of the court. The Corporate Monitor’s primary responsibility is not to increase shareholder value, or even to benefit shareholders; his primary responsibility is to further the court’s order.

The Corporate Monitor’s allegiance to the court raises several obvious issues, which can be demonstrated by WorldCom. As discussed above, Mr. Breeden’s initial responsibility was to prevent the destruction of evidence and to preserve corporate assets by prohibiting excessive compensation. Eventually, his primary responsibility shifted to overhauling WorldCom’s corporate governance scheme to prevent future fraud. WorldCom shareholders were undoubtedly benefited by Mr. Breeden’s reforms. However, a corporation’s goals are typically much broader than this and include financial goals, such as increasing sales, decreasing expenses, or improving market share. To the extent that a Corporate Monitor is charged with focusing primarily on one goal, other important goals may be neglected to the detriment of the corporation and its shareholders. The idea that a court-appointed individual could be managing a public corporation for long periods of time without any accountability to the shareholders is troubling, to say the least.

D. EFFECT ON ABSENT SHAREHOLDERS

The concern that the Corporate Monitor is accountable only to the court is exacerbated by the fact that the corporation’s shareholders have no input into the decision to appoint a Corporate Monitor and are not necessarily even aware that a Corporate Monitor is being considered by the court. As discussed above, novel ancillary remedies are typically imposed as part of a consent decree between the SEC and the corporation. These two parties to the agreement have every incentive to articulate the advantages of the

The Corporate Monitor, Richard C. Breeden, is an agent of this Court with such oversight responsibilities as set forth in the Court’s Order... and as the parties may otherwise agree or the Court may otherwise direct. The Corporate Monitor is not an officer, director, employee, or agent of WorldCom and shall not owe any fiduciary duties or other duties or obligations of any kind to WorldCom or WorldCom’s directors, officers, employees, shareholders, bondholders or creditor, or any person or entity other than this Court.

Stipulation and Order at 1–2, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. July 17, 2002).

72. See supra Part III.A.2.

73. The argument that WorldCom’s management could have sought judicial relief if it believed that the Corporate Monitor’s actions were harming the corporation is not very persuasive. Even if the judge agreed, the judge would be forced to balance the goal of preventing securities fraud against other corporate goals. Balancing corporate goals is a difficult task, and a single judge would presumably be no better at it than the Corporate Monitor. Indeed, the recognition that these kinds of business decisions are best left to a corporate board is one of the foundations of the business judgment rule.

74. See supra Part II.C.
appointment of a Corporate Monitor—and no incentive to brief the court on
the possible disadvantages. Although the interests of shareholders are
significantly affected by the appointment of a Corporate Monitor who may,
in effect, be managing the corporation, no one represents the shareholders’
interests to the court, nor are the shareholders likely to represent
themselves. Absent shareholders ultimately bear the costs of the Corporate Monitor. These costs may be substantial, yet there is no real mechanism in place to control costs. The district court, which sets the terms of the Corporate Monitor’s engagement, has the power to disallow unnecessary or unreasonable Corporate Monitor bills, but it is doubtful that a corporation seeking to rehabilitate its public image would challenge the Corporate Monitor’s bills. The absent shareholders are the only group that would have reason to seek to control spending, but they do not have a voice in the SEC proceeding.

E. POTENTIAL SEC OVERREACHING

One of the primary responsibilities of the SEC is to enforce the federal securities laws, including the anti-fraud provisions. The SEC is assisted in its enforcement mission when it obtains the appointment of a Corporate Monitor charged with preventing the destruction of evidence. In addition, a Corporate Monitor who improves a company’s corporate governance could help prevent securities fraud, which also assists the SEC in its enforcement mission. But a Corporate Monitor who is empowered to overhaul a company’s governance structure also presents a danger of potential overreaching by the SEC. As the SEC more directly regulates corporate

75. In fact, shareholders seeking to be heard might not be permitted to intervene in the SEC enforcement action. Several courts have interpreted Section 21(g) of the Securities Exchange Act of 1934 to bar intervention absent SEC consent. See, e.g., SEC v. Wozniak, 1993 U.S. Dist. LEXIS 1241, at *2 (N.D. Ill. Feb. 8, 1993) (No. 92 C 4691) (“Only SEC’s consent can open a door in [the] wall to permit a private party . . . to have access to [the] federal court . . . .”).

76. Due to collective action problems and rational apathy issues present in most large corporations, shareholders have little incentive to appear in court to discuss the advantages or disadvantages of a Corporate Monitor.

77. For example, WorldCom agreed to pay Mr. Breeden his regular rate of $800 per hour, as well as to pay for appropriate staff and advisors. See WorldCom Transcript of Record, supra note 30, at 3. Mr. Breeden’s bills were not made public, but according to estimates, he submitted bills of $300,000 per month. See Jonathan D. Glater, In Scandals, Another High Price to Pay, N.Y. TIMES, Dec. 13, 2002, at C1. Published reports indicate he was paid more than $2 million for his work as WorldCom’s Corporate Monitor. See Lubin & Young, supra note 1.

78. Of course, if the company has sought the protection of the bankruptcy laws, the bankruptcy court may seek to control the Corporate Monitor’s bills, especially because there may be other constituencies—i.e., company creditors—who may have incentive to object to significant expenses incurred by the debtor company. However, this supervision by bankruptcy court may lead to other difficulties. See infra Part IV.H.

79. Possible overreaching by the SEC is not a new concern. As Professor Roberta Karmel has persuasively argued, “The Securities and Exchange Commission . . . has aspired to regulate corporate governance since its inception and, from time to time, has exploited scandals in the
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governance, it moves into areas traditionally regulated by state corporate law, raising significant federalism issues.

The federal securities laws have long been seen as disclosure statutes, while state corporate law has been viewed as governing the internal affairs of companies. Recently, this absolute distinction has changed, as SOX provided the SEC with limited power to regulate the internal affairs of public companies. However, nothing in SOX, or any other provision of the federal securities laws, provides the SEC with overarching power to regulate corporate governance. It is doubtful, for example, that the SEC would be able to promulgate rules requiring shareholder nomination of directors or rules placing caps on executive compensation. However, that is exactly what the Corporate Monitor did in WorldCom, which raises the concern of SEC overreaching.

The SEC may run afoul of basic procedural protections provided by federal administrative law by choosing the ancillary remedy of a Corporate Monitor to advance SEC initiatives. Ordinarily, administrative agencies, including the SEC, use the rulemaking process to implement the relevant federal statutes. According to the Administrative Procedure Act (APA), rules can be promulgated only after a statutorily-mandated notice and comment period. By using a Corporate Monitor to further SEC policy, the SEC could be viewed as making an “end run” around the notice and comment requirements of the APA.


For example, under SOX, the SEC was empowered to promulgate rules directing the national securities exchanges to amend their listing standards to require independent audit committees. See Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1 (Supp. II 2002).


Historically, the SEC has sought to regulate executive compensation, but has done so only through disclosure rules. Recently, for example, the SEC proposed rules that would require additional disclosure of compensation. See Executive Compensation and Related Party Disclosure, Securities Exchange Act Release No. 8655, Exchange Act Release No. 53185, Investment Company Release Act No. 27,218 (February 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 239, 240, 245, 249 & 274).

Commentators have noted that the SEC has attempted to articulate policy outside of the rulemaking process, through enforcement decisions and through no-action letters. See, e.g., ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 91–98 (Simon & Schuster 1982); Donna M. Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework, 83 Cornell L. Rev. 921, 948–67 (1998).


See id. § 553.

According to the APA, after the agency has published notice of a proposed rule in the Federal Register, “the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . . .” Id. § 553(c). The agency is required to consider any comments before adopting the final rule. See id. Commentators have
The SEC might argue that concerns of agency overreaching are unfounded. After all, the SEC should not be criticized for actions instituted by a judicially-approved Corporate Monitor. However, this argument is not persuasive for several reasons. First, as discussed below, the SEC plays a significant role in selecting the Corporate Monitor, which puts the SEC in a privileged position to appoint persons who will further agency policies. Second, although this is a relatively new ancillary remedy, most Corporate Monitors thus far have been individuals with close ties to the SEC, such as former senior staff or former Commissioners. And, finally, and perhaps most importantly, the scope of the Corporate Monitor’s work will be defined by the terms of a consent decree between the defendant corporation and the SEC. In WorldCom, for example, the SEC settlement authorized the Corporate Monitor to overhaul WorldCom’s corporate governance, which suggests that the SEC was seeking to regulate WorldCom’s corporate governance through the use of the Corporate Monitor.

The SEC might also argue that one case does not by itself establish overreaching. But it can set a precedent for future appointments of Corporate Monitors with similarly far-reaching powers. The SEC may not even have to seek a Corporate Monitor in order to obtain concessions from companies in enforcement proceedings. The SEC may employ the simple threat of a Corporate Monitor to encourage a company to agree to corporate governance changes as part of its settlement with the SEC. In fact, as discussed below, that has happened at least once already.

**F. SEC INFLUENCE IN SELECTION OF CORPORATE MONITOR**

The SEC’s influence over the selection of the Corporate Monitor is closely related to the danger of SEC overreaching. It is the court’s responsibility to select the Corporate Monitor, but the court will look to the SEC for guidance. There are numerous advantages arising from the SEC’s involvement, including the fact that the agency is well-positioned to identify what is probably a small pool of potential candidates for the job. But with those advantages also come some concerns. The candidates suggested by the SEC are likely to have close ties to the agency and thus might have an unconscious enforcement bias. As discussed above, the SEC may view the appointment of a Corporate Monitor as an opportunity to pursue broader agency initiatives and will therefore suggest individuals who share those beliefs. The Corporate Monitor might also have his own reasons identified several advantages of this process, including the production of better rules, “enhanced political accountability,” and fairness. See, e.g., Richard J. Pierce, Jr., Administrative Law Treatise 368–74 (4th ed. 2002).

87. See infra Part IV.F.
88. See supra Part III.A.5.
89. See infra Part IV.G.
90. See supra Part IV.E.
to advance the SEC’s agenda. Being selected as a Corporate Monitor can be a lucrative job. An individual who serves as a Corporate Monitor will understand that he needs to keep the SEC satisfied if he would like to see his name on an SEC “short list” for a Corporate Monitor position in the future. It is natural for the court to rely on the SEC for assistance in the selection process, but the court needs to recognize that the SEC may recommend candidates who see themselves as answerable to the SEC, as opposed to the court.

**G. CONFLICT WITH STATE CORPORATE LAW**

A Corporate Monitor may not be legal under state corporate law. As the scope of the Corporate Monitor’s power expands, there is a greater potential that his participation will interfere with the statutory scheme contemplated by state corporate law statutes. Although the Supremacy Clause would permit a federal district court to order an ancillary remedy that would cause a company to violate its law of incorporation, such an order would raise significant federalism concerns.

Several arguments can be made that a Corporate Monitor with far-reaching powers is illegal under state corporate law. First, if a Corporate Monitor can veto board decisions, there is an obvious clash with state corporate statutes that vest the management of a corporation with the board of directors. Similarly, if a board agrees to the appointment of a Corporate Monitor, the board might be seen as impermissibly delegating its powers. In addition, to the extent that the Corporate Monitor is able to overrule decisions of a board, shareholders are deprived of their statutory right to elect the individuals who are supposed to manage the corporation. The shareholder franchise can also be affected if, like Mr. Breeden, the Corporate Monitor chooses interim directors or forces shareholder-elected directors to resign from the board.

Because the Corporate Monitor is a relatively new remedy that has been ordered in very few cases, courts have not yet had to grapple with its legality. Two courts, a federal district court and the Delaware Chancery

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91. See supra note 77 and accompanying text.
92. U.S. CONST. art. VI, cl. 2 (“[T]he Laws of the United States . . . shall be the supreme Law of the Land.”).
93. See, e.g., DEL. CODE ANN. tit. 8 § 141(a) (“The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . .”).
94. See 1 Rodman Ward, Jr., Folk on the Delaware General Corporation Law § 141.1.3 (4th ed. 1999) (“The board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of the corporation.” (citing Ash v. McCall, C.C. No. 17132, slip op. at 17 (Del. Ch. Sept. 15, 2000))).
95. See, e.g., DEL. CODE ANN. tit. 8 § 211(b) (“[A]n annual meeting of stockholders shall be held for the election of directors . . . .”).
Court, have recently touched upon the issue in related actions. Both cases involve the battle between business tycoon Conrad Black and the independent directors of Hollinger International, Inc. (International), a public company indirectly controlled by Black. International was accused of making certain unauthorized payments to Black and later lying about these payments in public documents filed with the SEC. Following these accusations, the International board created a Special Committee to investigate Black. When Black’s misconduct was disclosed, the SEC brought an enforcement action against International, which ultimately entered into a consent decree with the SEC. As part of the settlement, International agreed to permit the Special Committee to continue its investigation into Black. To help effectuate this promise, International also consented to a “springing Corporate Monitor” provision, which provided that, upon certain triggering events, a “Special Monitor” would be appointed by the court “to protect the interests of the non-controlling shareholders” of International. These triggering events included actions by Black that might hinder the Special Committee’s investigation, such as the removal of any International director or the election of any new International director without the approval of 80% of the incumbent board.

In an emergency proceeding, a district court judge approved the consent decree. Several days later, Black intervened in the SEC’s enforcement action, seeking to have the Corporate Monitor provision vacated. He argued that the consent decree impaired his right to remove and elect corporate directors. The district court initially agreed, vacating the Corporate Monitor provision, primarily because the SEC had not given notice to Black of the emergency proceeding. In reaching this decision, the court was careful not to determine whether the Corporate Monitor provision violated state corporate law. It stated that “although [Black] has shown [his] voting rights, as protected under Delaware law, could be impaired, the Court, at this time, does not make a finding that the [consent decree] is in

100. Id. at 6.
101. The Special Monitor was a familiar name—Richard Breeden, who was also acting as a special advisor to International’s Special Committee.
contravention of Delaware Corporate law. The court then stayed its order to permit the parties to fully brief the issue.

At the same time the district court was hearing the SEC enforcement action, the Delaware Chancery Court was being asked to decide, among other things, whether Black had breached his fiduciary duties to International. In response, Black argued that a poison pill plan adopted by the International board, when combined with the springing Corporate Monitor provision, was illegal because it violated the Blasius compelling justification standard of review. This argument required the court to discuss the Corporate Monitor provision. Although Vice Chancellor Strine did not directly rule on the legality of the remedy, his observations are instructive. He focused on three factors. First, he pointed out that the Corporate Monitor provision was narrowly drafted, noting that it was “tailored to protecting the Special Committee process . . .”. Second, he observed that the Corporate Monitor did not have unilateral veto power. According to the court, the consent decree required the Corporate Monitor to go to district court “in order to stop what he perceived as wrongful actions” by Black. And, finally, he noted that the Corporate Monitor provision was of “limited duration,” lasting only until International’s Special Committee had completed its work.

Vice Chancellor Strine’s approach to the issue indicates that the legality of the position of Corporate Monitor turns on the grant of authority from the district court. Using the factors he identified in the Hollinger opinion, the appointment of a Corporate Monitor with far-reaching powers is arguably a

104. Id. at *24.
105. After the rehearing, the district court ultimately decided to deny Black’s motion to vacate the consent decree, relying on the related Chancery Court decision discussed below. The district court held that collateral estoppel precluded Black from re-litigating the legality of the consent decree. According to the district court:

[While the Delaware court did not actually address whether the Consent Judgment was properly entered, the validity of the Consent Judgment, as it operated with the Rights Plan, was actually litigated and essential to the court’s decision that International did not violate Delaware law in enacting the Rights Plan and the Consent Judgment.

107. In Blasius, the Delaware Chancery Court adopted a heightened standard of review for board action that is taken for the primary purpose of interfering with or impeding with the effectiveness of a shareholder vote. See Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). If a court determines that the Blasius standard of review should be applied, the board’s action will be struck down unless the board can show a compelling justification, which is an extremely difficult, if not impossible, task. Id. at 661.
108. As the Delaware Chancery Court noted, there was no direct challenge to the consent decree before it. See Hollinger, 844 A.2d at 1052 n.63.
109. See id. at 1089.
110. Id.
111. Id.
violation of Delaware corporate law. This conclusion is seen by applying the Hollinger factors to the WorldCom Corporate Monitor. The authority of WorldCom’s Corporate Monitor was not narrowly drafted. Although the judicial grant of authority to the Corporate Monitor was initially tailored to supplement the injunction against the destruction of evidence and the payment of excessive executive compensation,\textsuperscript{112} Mr. Breeden’s authority expanded dramatically to the point where he was re-writing the company’s corporate governance provisions\textsuperscript{113} and was participating in important business decisions.\textsuperscript{114} With this kind of authority, one cannot claim that the WorldCom Corporate Monitor’s authority was narrowly tailored.

Moreover, unlike the springing Corporate Monitor provision in the Hollinger case, WorldCom’s Corporate Monitor did have veto power over certain WorldCom business decisions. The court order expressly stated that all compensation decisions at WorldCom had to be approved in advance by Mr. Breeden.\textsuperscript{115} Thus, the WorldCom Corporate Monitor did not have to seek out court approval if he believed that the company was violating the terms of the court order.

Finally, the Corporate Monitor in WorldCom was not appointed for a limited term. Rather, the term was quite indefinite. According to the applicable court order, “[t]he term of the Corporate Monitor will cease no later than the date on which the Commission’s investigation of this matter concludes, the Court determines the function of the Corporate Monitor is no longer necessary, or the parties so agree.”\textsuperscript{116} In fact, Mr. Breeden continued as Corporate Monitor even after WorldCom settled with the SEC, after WorldCom adopted Mr. Breeden’s corporate governance proposals, and even after the company emerged from bankruptcy. It was only after WorldCom was acquired by Verizon that the Corporate Monitor position was terminated,\textsuperscript{117} approximately two and a half years after his appointment.

Thus, courts must weigh the circumstances of particular situations to determine whether the appointment of a Corporate Monitor is legal under state corporate law. The Chancery Court decision suggests that it depends on the power exercised by the Corporate Monitor.

\textsuperscript{112} See supra Part III.A.2.
\textsuperscript{113} See supra Part III.A.5.
\textsuperscript{114} See supra Part III.B.
\textsuperscript{115} See supra note 43 and accompanying text.
\textsuperscript{116} WorldCom June 28 Stipulation and Order, supra note 28, at 3–4.
\textsuperscript{117} See MCI Inc.: SEC Voices No Objection to End of Monitor Review Post-Merger, WALL ST. J., Dec. 15, 2005, at A12; Global Press Release, MCI, Washington is Final State to Approve Verizon-MCI Transaction (Dec. 23, 2005), http://global.mci.com/ca/news/press_releases/. If WorldCom had not been acquired, Mr. Breeden would probably be winding up his position right about now. See, e.g., Lublin & Young, supra note 1 (referring to Judge Rakoff’s statement, made prior to the corporate merger, that Mr. Breeden would probably continue as WorldCom’s Corporate Monitor for “another two years or so”).
H. POTENTIAL CONFLICTS WITH THE BANKRUPTCY COURT

If a corporation with a court-appointed Corporate Monitor has declared bankruptcy, the Corporate Monitor or the federal district court actions and powers may conflict with those of the bankruptcy court or the bankruptcy trustee. The potential for conflict arises because a company operating during bankruptcy does so under the supervision of the bankruptcy court. Two judges will therefore be supervising the company’s operations, which raises several questions. What would happen if the district court in an SEC enforcement proceeding authorized certain payments by the company, but the bankruptcy judge disallowed them under bankruptcy law? Or what would happen if the bankruptcy court permitted the debtor to make certain payments, but the Corporate Monitor, backed by the federal district court, would not approve them? This conflict could have easily arisen in WorldCom if, for example, the district court approved Mr. Breeden’s fees as Corporate Monitor, but the bankruptcy judge determined that these fees were not allowed under the Bankruptcy Code. Fortunately, in WorldCom, the Federal District Court Judge and the Bankruptcy Judge worked well together. However, there is no guarantee that judges in future cases would be in agreement on such issues. A disagreement between the two courts would raise significant jurisdictional issues that are beyond the scope of this article.

118. This is a realistic possibility. Companies that engage in securities fraud may be forced to seek the protections of bankruptcy law as their true financial condition is revealed. That certainly occurred with companies such as WorldCom, Enron, and Adelphia, each of which declared bankruptcy after the accounting fraud was uncovered.

119. In WorldCom, the District Court Judge actually recognized this danger. After WorldCom declared bankruptcy, the District Court Judge entered an order clarifying the authority of the Corporate Monitor. In that order, Judge Rakoff noted, “The fact that all compensation arrangements must be approved in advance by the Corporate Monitor does not eliminate the requirement that some or all of these expenditures may also need to be approved by the Bankruptcy Court, in accordance with the Bankruptcy Code.” See Memorandum Order at 3, SEC v. WorldCom, Inc., 2002 U.S. Dist. LEXIS 14201, at *3 (S.D.N.Y. Aug. 1, 2002) (No. 02 Civ. 4963). However, he raised the specter of a conflict by cautioning that “[w]hat is ‘normal’ for a company in bankruptcy reorganization may not necessarily be permissible for a company that stands accused of fraud.” See id. at 3–4.


121. Apparently, one near conflict did occur in WorldCom when several firms that had provided advice in connection with WorldCom’s bankruptcy case submitted bills to the bankruptcy court. These submissions were made in conformity with the Bankruptcy Code, but had not been previously approved by the Corporate Monitor as required by a budgeting order issued by the District Court. When this came to the attention of the District Court Judge, he issued an order barring WorldCom from paying any of these fees, but indicated he might grant relief from the budgeting order and recommended that the firms submit applications for relief to the court. The District Court Judge directed the Corporate Monitor to review the applications and make recommendations as to whether the firms should be paid. Order at 3–5, SEC v. WorldCom, Inc., No. 02 Civ. 4963 (S.D.N.Y. Nov. 24, 2004).
V. RECOMMENDATIONS

Although the use of the Corporate Monitor raises several significant concerns, this article does not recommend prohibiting the remedy altogether. If used correctly, and in a limited fashion, the Corporate Monitor can be an extremely effective remedy that helps the SEC in its enforcement mission. Instead, this article argues for restraint, both from the SEC in seeking this remedy and from the courts in granting this remedy.

A. THE SEC SHOULD EXERCISE RESTRAINT IN SEEKING A CORPORATE MONITOR

The concerns addressed above suggest that the SEC should exercise restraint in seeking the appointment of a Corporate Monitor. Indeed, it appears that the SEC is reserving this ancillary remedy only for extreme cases of securities fraud. A high-ranking SEC official stated that the SEC will consider a Corporate Monitor “in unusual circumstances where management has demonstrated it can’t be trusted to act in the best interests of the investors.”

Given the implications of the Corporate Monitor, the SEC’s caution in seeking the remedy is appropriate and should be commended. However, the SEC must provide more guidance as to when “unusual circumstances” are present and as to when the SEC would conclude that company management “can’t be trusted to act in the best interests of the investors.” Since securities fraud is allegedly involved in many enforcement cases, “unusual circumstances” must mean something more than ordinary corporate misconduct or disclosure violations. Does “unusual circumstances” mean situations where the management is suspected of obstructing justice? On the other hand, several of the Corporate Monitor cases involved allegations that

122. In addition, the appointment of a Corporate Monitor may offer other advantages. Professor James Fanto has recently proposed that the SEC should be empowered to “appoint a corporate governance monitor” for certain public companies, which would have a role similar to that of the bank examiner. James A. Fanto, Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation 4 (Brooklyn Law Sch. Legal Studies Research Paper Series, Working Paper No. 49, 2006), available at http://papers.ssrn.com/abstract=873667. Professor Fanto argues that the presence of an independent monitor will help break down certain psychological impediments preventing the effective supervision of corporate management. See id. at 41–44. In addition, according to Professor Fanto, it will have the advantage of:

- bringing into the open the paternalistic regulation that is already occurring through the SEC’s enhanced enforcement powers over public firm management and the increasing criminalization of management’s behavior, and of balancing this enforcement with guidance so that SEC regulation does not just punish firm executives without offering them any accompanying benefits.

Id. at 4–5.

123. Sue Reisinger, Corporate Monitors Catching On, NAT’L L. J., Oct. 4, 2004, at 8 (quoting Peter Bresnan, then Associate Director of the SEC’s Enforcement Division).
management was stealing from the corporation, either by paying excessive salaries or by outright misappropriation of funds. Does this amount to an “unusual circumstance” that would result in the SEC’s decision to seek this ancillary relief? Or does the SEC have other situations in mind as well?

Similarly, when can the company management no longer be trusted to act in the “best interests of investors?” Once again, the SEC must be envisioning behavior that consists of more than just corporate misconduct or disclosure violations; otherwise, the SEC could conceivably seek a Corporate Monitor in virtually every enforcement action. In several of the Corporate Monitor cases, managers were also accused of criminal violations of the securities laws. Obviously, criminal conduct makes it more difficult to trust managers to act in the “best interests of investors,” but does this mean that the SEC believes that corporate managers cannot be trusted only if their conduct is so egregious as to lead to a criminal investigation? If something less than a knowing or intentional violation of the federal securities laws will lead to this determination, what kinds of behavior will lead the SEC to seek a Corporate Monitor? Is the SEC looking for a long-standing pattern of securities fraud, so that there is real concern that the company will continue to violate the securities laws? If that is the case, what would be the effect of replacing the wrongdoers? A company that has cleaned house can be trusted to act in the “best interests of investors,” which suggests that the SEC should not seek a Corporate Monitor in this situation.

Although SEC representatives have publicly stated that the SEC will exercise restraint in seeking this remedy, additional guidance concerning their decision-making process would be helpful. Published guidance would assist those companies under SEC investigation in making informed litigation decisions, including the decision to consent to a Corporate Monitor or to other novel ancillary remedies. More importantly, by publishing guidance, the SEC will help ensure that it continues to exercise restraint in seeking a Corporate Monitor, reducing the danger of SEC overreaching and will reinforce the extraordinary nature of the remedy. In addition, before seeking the remedy, the staff will have to ascertain that the enforcement guidelines set forth by the SEC have been met.

B. COURTS SHOULD APPOINT A CORPORATE MONITOR ONLY IN RARE CASES

In the past, the district court’s power to order novel ancillary remedies had been questioned. Following SOX, the court’s power to appoint an independent director, or a special investigator, or a Corporate Monitor, is established. The only limitation on the court’s power, that the relief must be “appropriate or necessary for the benefit of investors,” is extremely narrow. But just because a court has the power to appoint a Corporate Monitor does not mean it should. As the above discussion demonstrates, appointing a Corporate Monitor raises several significant concerns. In recognition of these concerns, courts should exercise self-restraint when deciding whether to appoint a Corporate Monitor.

Courts should articulate clear judicial standards that must be met before a Corporate Monitor is appointed to help ensure that this ancillary remedy is used only in rare cases. The court should begin with a presumption that an injunction is ordinarily sufficient to enforce the federal securities laws. To obtain a Corporate Monitor, the court should require the SEC to demonstrate to the court that the injunction is not sufficient to ensure compliance and that there is reason to doubt that the corporation will comply with the injunction. The court should weigh this danger against the dangers that: (1) a Corporate Monitor can significantly interfere with the effective management of a company; (2) a Corporate Monitor is accountable only to the court, to the possible detriment of absent shareholders; (3) a Corporate Monitor can lead to potential overreaching by the SEC; and (4) a Corporate Monitor might conflict with state corporate law. The court should order a Corporate Monitor only if it finds that the danger of non-compliance outweighs these concerns. If a court decides to appoint a Corporate Monitor, it should issue a written order demonstrating that this discretion-limiting balancing test has been met. In WorldCom, Judge Rakoff did not disclose in writing why he decided to order the novel remedy. This lack of scrutiny contrasts sharply with the thorough and thoughtful analysis in the

125. See supra notes 25–26 and accompanying text.
126. There is a long history of courts creating rules to limit their equitable powers. The most obvious example is the injunction. Before ordering an injunction, courts ordinarily must find that the moving party would suffer irreparable harm without it. In addition, courts have articulated exacting standards that the SEC must meet before the court will order a receivership. See James R. Farrand, Ancillary Remedies in SEC Civil Enforcement Suits, 89 HARV. L. REV. 1779, 1784–86 (1976).
127. The need for clear judicial standards is especially important because it is unlikely that an order to appoint a Corporate Monitor will be reviewed by an appellate court. If the SEC obtains the appointment of Corporate Monitor through a consent decree, there will be no appeal. In the unlikely event that the Corporate Monitor is appointed in a contested case, the company will have to wait until the case has been heard and the judgment is final before it can appeal the order, meaning that the Corporate Monitor will be overseeing the company during the pendency of the enforcement action. Even if the order is ultimately appealed, the order will be reviewed under the forgiving abuse of discretion standard, which will be difficult for the company to overcome.
court’s decision to approve the penalty in the WorldCom case. In a 14-page Opinion and Order, the court assessed whether the penalty would be in the public interest and whether the settlement was “fair, reasonable, and adequate.”

The court should give careful scrutiny to its choice of Corporate Monitor. As discussed above, the SEC may exert too much influence on the selection process. This concern argues for a transparent selection process. To ensure transparency, the court should disclose the names of the potential Corporate Monitors, as well as their resumes. The court should determine whether the candidates have any ties to the SEC, including whether the SEC has recommended the candidate for any other court-appointed position. The court should also make the financial terms of the engagement of the Corporate Monitor public. The court should explain the choice for Corporate Monitor in reasonable detail.

Most importantly, the court should carefully define the scope of the Corporate Monitor’s duties. If the court expands the duties of the Corporate Monitor, it should be justified on the record. One of the most troubling aspects of the WorldCom Corporate Monitor was the de facto expansion of his power. Courts should be sensitive to this concern. Similarly, the duration of the Corporate Monitor’s appointment should be limited to a defined term. Given the concerns addressed above, courts should be hesitant to permit a Corporate Monitor to exercise broad oversight of a company for an unlimited amount of time.

VI. CONCLUSION

Enforcing the anti-fraud provisions of the federal securities laws is an extremely difficult task, and the SEC needs to have effective weapons in its arsenal to deter corporate misconduct and protect investors. As demonstrated by the Corporate Monitor’s role in WorldCom, the appointment of a Corporate Monitor can be an effective weapon for the SEC. However, there are significant dangers inherent in its use, which

129. See supra Parts IV.A, IV.F.
130. The appointment of a Corporate Monitor raises other disclosure issues, as well. Specifically, a public company must make adequate disclosure of the Corporate Monitor in its public reports. Such disclosure should accurately present the breadth of the Corporate Monitor’s authority and describe his influence on the company’s management.
131. The transparency of the selection process in WorldCom could have been better. Although there was a public hearing, there is very little information available about the actual selection process, except that Mr. Breeden was chosen by the court from a list of three names jointly provided by the SEC and the company. The transcript reveals very little of the court’s deliberative process. The applicable part of the transcript consists of three short paragraphs, noting (1) Mr. Breeden’s experience as former Chairman of the SEC and as head of company specializing in corporate turnarounds; (2) that he is a lawyer; and (3) that he owned 6,000 shares of WorldCom stock that he pledged to divest as soon as possible. See WorldCom Transcript of Record, supra note 30, at 2–3.
suggest that the SEC should seek a Corporate Monitor only in rare cases. In addition, in recognition of these dangers, courts should develop standards limiting their judicial discretion to order this extraordinary remedy. After all, as Mr. Breeden’s quote at the beginning of this article notes, it is an unusual role where a judicially-appointed officer has veto power over the audit committee chairman and the CEO, and it should stay that way.
INTRODUCTION

Collective blame for recent business failures has fallen on gatekeepers. The conventional view is that auditors, lawyers, underwriters, analysts, and others have shirked their responsibilities and permitted illegal conduct. If we clarify and enhance the responsibilities of gatekeepers, some say, we will avoid such debacles in the future.1 This claim traditionally depended on a rational actor model under which a gatekeeper would prevent misconduct by a primary violator because the gatekeeper’s expected liability or reputational harm from failing to prevent misconduct exceeded the benefits gained in fees.2 Because investors understand a gatekeeper would not act irrationally, his statements are to be believed.3 While this model has merits, it fails to distinguish among gatekeepers, who are likely to respond differently to incentives. It also fails to appreciate differences in the


character of a gatekeeper’s relationship with a primary violator and to consider whether such differences bear upon gatekeeper behavior.4

This paper examines gatekeepers by focusing not on their similarities, but on their differences. All gatekeepers are not alike. They vary widely in the functions they serve, skills necessary for the job, relationships with their principals, and duties they owe. There are differences in their approaches as well. Accounting determinations, for example, are often formalistic and unambiguous, while legal advice is said to be more nuanced, requiring an attorney to explore a range of options with a client, who evaluates the lawyer’s advice and then makes up her own mind.5 The securities analyst, unlike the accountant or lawyer, makes predictions, which are frequently wrong.6 Distinguishing among the character of gatekeepers’ evaluations is helpful, but it masks deeper differences in the structure of gatekeepers’ relationships with their clients.

This article focuses on one difference in particular that bears closely on whether the gatekeeper can be effective: whether, as a normative matter, the gatekeeper is meant to be independent of the client, acting as a neutral umpire,7 or whether the gatekeeper is meant to be dependent on the client, charged with promoting the client’s ends in a fiduciary or similar capacity. The label dependent is used because certain gatekeepers depend on the client to determine the nature, purpose, and scope of their agency.

Distinguishing between independent and dependent gatekeepers, however, is only a starting point. One also must ask why gatekeepers have not been more robust monitors. At least part of the answer is that the conventional view of the gatekeeper’s role is inadequate, focusing on the actions of a single individual, rather than the dynamics of the group. Similarly, until recently Congress, regulators, and courts have relied largely on a command and control philosophy of governance, rather than addressing biases that can cause one small misstep but lead incrementally to large scale disasters. Thus, rather than looking at the gatekeeper problem from the perspective of a rational actor, this paper explores it from a behavioral viewpoint.

4. Kraakman, supra note 2, at 586 (discussing accountants, underwriters, and lawyers); Coffee, supra note 1, at 309 (discussing auditors, rating agencies, analysts, investment bankers, and attorneys).

5. See Steven L. Schwarcz, Financial Information Failure: Redrawing the Boundary Between Lawyer and Accountant Responsibility 13–16 (Duke Law Sch., Working Paper No. 28, 2005); Coffee, supra note 1, at 353 (describing the auditor’s world as “relatively precise and rule bound”). Much of accounting is of course nuanced as well. Accounting literature, for example, requires the auditor to conclude that the financial statements, apart from technical reporting rules, “fairly present” an issuer’s financial position and operations. See, e.g., United States v. Simon, 425 F.2d 796, 805–06 (2d Cir. 1969).

6. Coffee, supra note 1, at 353 (“[T]he securities analyst is essentially a prognosticator whose predictions about the future are frequently wrong.”).

Advances in behavioral and social psychology demonstrate that individual behavior is strongly influenced by others. Commenters in this area have begun to pay attention to the institutional and interpersonal context in which gatekeepers formulate judgments about whether the conduct of others is appropriate. Joining this chorus, this article maintains that dependent gatekeepers, far more than independent ones, perform their responsibilities under the yoke of unconscious bias that affects the rigor they bring to the gatekeeping task and the accuracy of their judgments. Thus, the thesis advanced is that independent agents are better gatekeepers than dependent ones.

Drawing on this literature, however, does not suggest that people who make poor decisions or fail to guard against wrongdoing are not responsible. It is easier, however, to investigate harm after it occurs and assign blame than to conduct a searching inquiry into one’s underlying decision process with the aim of improving it. Furthermore, this paper does not attempt to provide a complete behavioral explanation of gatekeeper conduct, but rather raises, for future consideration, whether insights from behavioral psychology can be married with the understanding of the structure of gatekeeper relationships.

Part I of the paper distinguishes independent from dependent gatekeepers and discusses critical features that differentiate them. Gatekeepers are categorized as independent or dependent based on which features should predominate, recognizing that this split is not clear-cut and some gatekeepers, such as underwriters, share characteristics of both. Part II draws on research in the fields of behavioral and social psychology to demonstrate that fiduciaries such as lawyers and other advisors are less prone to the gatekeeping task than their independent counterparts. Part III


extends the argument by examining indeterminacy in corporate and securities law, which further complicates the gatekeeping role because it gives wide latitude to gatekeepers to claim that their principal’s conduct is appropriate. This “complex nature” of the law provides a “fertile breeding ground for the kind of motivated and self-serving interpretations that rationalize unethical actions.” Part III then addresses how these observations help explain recent reforms and discusses several additional potential reforms.

Understanding recent reforms and suggesting new ones is important and timely. Efforts are underway to scale back recent changes in the law, and the direction of future reforms is uncertain. Indeed, many commentators have addressed whether recent changes, including Sarbanes-Oxley, are worthwhile or have unintended costs exceeding their benefits. Over the past several years, gatekeepers have received careful consideration as corporate monitors and will likely continue to draw attention.

I. INDEPENDENT AND DEPENDENT GATEKEEPERS

A. DEFINING GATEKEEPER

Descriptions of gatekeepers typically focus on their ex ante role. One common definition of gatekeeper is a reputational intermediary who provides verification or certification services to investors. Another is one

15. Coffee, supra note 1, at 309.
Differentiating Gatekeepers

who is “positioned at a critical point in the flow of events” where approval is needed before a transaction can close. Gatekeepers, however, also engage in ex post monitoring designed to uncover misconduct after it occurs, initiate an investigation, and report the misconduct or take enforcement measures. Also, many gatekeepers perform an advisory role with respect to structural or regulatory issues regarding a transaction without necessarily providing verification, certification, or approval. Such advisors are gatekeepers too because we expect them to advise a client to avoid illegal conduct. Taking these considerations into account, gatekeeper is defined in this paper as a person or firm that provides verification or certification services or that engages in monitoring activities to cabin illegal or inappropriate conduct in the capital markets.

B. DIFFEREN\-TIALING INDEPENDENT FROM DEPENDENT GATEKEEPERS

The emphasis on gatekeepers in the financial markets is not new. The early securities laws recognized the difference between independent and dependent gatekeepers in the context of directors. The Securities Act of 1933 placed responsibilities on gatekeepers such as auditors, underwriters, and company directors, and the legislative history to the Securities Act highlighted their role. In the 1970s, Securities and Exchange Commission actions against gatekeepers such as lawyers and accountants were based on the so-called access or passkey theory of liability, under which access to the securities markets was controlled by certain professionals like lawyers and accountants. Today such actions often fall under the rubric of “aiding and abetting” or “secondary liability,” and the SEC has broad authority to impose sanctions against those who aid and abet violations of law. This

17. Kraakman, supra note 2, at 585. While not initiating wrongdoing, a gatekeeper may deter it or shift its costs away from investors. See id. at 583–84.
18. In the Investment Company Act of 1940, Congress placed responsibility on fund directors but, in doing so, it required that at least forty percent of a fund’s directors be independent of the advisory firm that typically establishes the funds it manages. 15 U.S.C. § 80a-10(a) (2000) (prohibiting more than 60 percent of a fund’s directors from being interested persons of the fund). The statute refers to directors who are not “interested persons,” as opposed to “independent” directors. Id. Congress entrusted to the independent directors the principal responsibility for protecting the fund’s shareholders. Burks v. Lasker, 441 U.S. 471, 475 (1979).
21. 3B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES & FEDERAL CORPORATE LAW § 14:31 (2d ed. 2006). In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), the U.S. Supreme Court ruled that a private plaintiff may not maintain an aiding and abetting action under section 10(b) of the Securities Exchange Act of 1934. As part of the Private Securities Litigation Reform Act, Congress amended the Exchange Act to allow the
section distinguishes independent from dependent gatekeepers by examining the roles of four types of gatekeepers: auditors, analysts, lawyers, and underwriters.

1. Independent Gatekeepers

Gatekeepers are retained as agents to perform a task or a series of tasks for a principal. In the course of doing so, they receive information, as the access theory suggests, that puts them in a unique position to evaluate whether the principal has violated, or is about to violate, the law. But the tasks they perform and the relationships with their principals vary. Some gatekeepers are supposed to be independent of their clients in order to critically evaluate a set of facts and render an unbiased opinion for an unknown audience. The normative qualities of independent gatekeepers are illustrated through a closer look at auditors and analysts.

a. Auditors

The auditor of a public company should be the archetypal independent gatekeeper. Federal law requires that financial information filed by public companies be audited by an independent public accountant. In the world of auditing, independence has a special meaning beyond exercising independent judgment required of most professionals. Independence calls for independence of the audit client. The Supreme Court contrasted the roles of the auditor and the lawyer with respect to independence. In deciding whether the work-product privilege applies to auditors, the Court explained:

The Hickman work-product doctrine was founded upon the private attorney’s role as the client’s confidential advisor and advocate, a loyal representative whose duty it is to present the client’s case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client.

An auditor cannot be the client’s advocate. The Court in the Arthur Young case concluded by saying that the “public watchdog” function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. Indeed, the

SEC to bring an action against a person who knowingly aids or abets a primary violation. 15 U.S.C. § 78(t)(e) (Supp. II 2002). The provision does not address actions by private plaintiffs.


24. Id. at 818.
Differentiating Gatekeepers

Courts have stated that accountants have disclosure obligations because of their “special relationship of trust vis-à-vis the public” and their duty to “safeguard the public interest.” An accountant who knows of, or recklessly disregards, fraud can be liable for aiding and abetting it.

The law discourages auditors and clients from developing long-term relationships. An auditor’s long-term relationship with a client can jeopardize independence, something accounting literature refers to as a trust threat. Under SEC rules required by Sarbanes-Oxley, audit partners must “rotate off” an audit engagement after no more than seven years—presumably to cut short the relationship between auditor and client before it can blossom into a trust relationship that can impair independence.

The contrast between auditors and lawyers also is seen by comparing rules of imputation used by accounting firms, as opposed to law firms. Unlike accounting firms, law firms have strict imputation rules that arise as a result of the lawyer’s duty of loyalty. If one lawyer in a firm has a conflict of interest with respect to a client, the conflict is imputed to the firm. With hundreds of clients and lawyers switching firms often, conflicts easily arise. Large law firms manage conflicts on a daily basis by imposing procedures to ensure that information gained by an attorney regarding one client does not fall into hands of another attorney at the firm.

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29. See Draft Letter from Richard I. Miller, General Counsel and Secretary, AICPA, Potential Impact of ABA Commission on Multidisciplinary Practice Proposal on Professional Service Firms: Comparison of ABA and AICPA Rules of Conduct (August 24, 1999) (on file with the author) (comparing ABA and AICPA rules regarding imputation, conflicts of interest, and confidentiality).
30. MODEL R. OF PROF’L CONDUCT R. 1.10 (2003) (“While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from serving by Rules [related to conflicts of interest].”).
31. Id. R.1.10, 1.7(a) (imputing knowledge of one lawyer to every lawyer in the firm).
32. In one recent case, Gibson, Dunn & Crutcher was disqualified from representing a limited partnership in a dispute with a private equity fund because a Gibson, Dunn lawyer, while working at another firm, had represented the private equity fund. The court noted the “especially heavy” burden to show the conflict should not be imputed. Casita, LP v. Maplewood Equity Partners (Offshore) Ltd., No. 603525/2005, 2006 WL 399796 (N.Y. Sup. Ct. Feb. 22, 2006).
who might be under a duty to use the information for the benefit of another client.

Accounting firms are not so constrained. A conflict by one member of an accounting firm will only preclude the firm from accepting an engagement if the conflict could be viewed as impairing another member’s objectivity. Similarly, AICPA rules impose duties of confidentiality, but they do not impute the knowledge of one member of the firm to everybody else. Accounting firms routinely audit the books of competitors or companies that have business relationships with one another.

b. Securities Analysts

A second example of an independent gatekeeper is the securities analyst. An analyst is supposed to research a company to judge its value as an investment. The analyst’s role should be to review corporate information and present an unvarnished view of the company to investors or potential investors. The analyst’s role should not be to advocate on behalf of the company, but rather, like the auditor, to objectively analyze the facts. Conflicts of interest must be disclosed. The Supreme Court noted that the analyst’s role in many cases is to expose negative facts the company may wish to withhold. Like with auditors, long-term relationships between analysts and issuers are discouraged. Evidence indicates that the longer an analyst follows a company, for example, the more likely he is to evaluate the company positively.

The view of the analyst as independent is under attack. Over the past several years, the principal criticism waged against analysts is that they have slowly lost their independence and become adjuncts of the investment banking departments of the firms that employ them. These criticisms are valid and reinforce the view that the norm for the analyst is independence.

34. Id. § 301.01.
35. HAZARD & DONDI, supra note 16, at 193.
37. The Securities Act requires that a research firm paid by a company for issuing research reports about that company must disclose the nature and amount of the compensation received. Securities Act § 17(b), 15 U.S.C. § 77q(b) (Supp. II 2002).
38. Dirks v. SEC, 463 U.S. 646, 658 n.18 (1983) (noting role analysts play in “revealing information that corporations may have reason to withhold from the public”).
40. See, e.g., Fisch & Sale, supra note 36, at 1043 (“[T]he traditional hands-off approach to analyst regulation, which was premised on the theory that analysts functioned as independent gatekeepers, is no longer appropriate.”).
41. Joe Nocera, The Anguish of Being an Analyst, N.Y. TIMES, Mar. 4, 2006, at C1 (“[A]nalysts were routinely selling investors down the river by promoting stocks purely to land banking business from companies.”).
If independence were not expected, analysts would not be denounced for losing their objectivity.

2. Dependent Gatekeepers

While some gatekeepers like auditors and analysts are supposed to be independent of their principal, others are not. Dependent gatekeepers provide advice and recommendations to assist a client in meeting its goals. They often act in a fiduciary capacity, owing both a duty of loyalty and a duty of care to the client. As a fiduciary, these agents must act for the client’s benefit, furthering its ends. Courts maintain that the essence of the fiduciary duty is to act with “utmost good faith for the benefit” of the principal and “single-mindedly pursue the interests of those to whom a duty of loyalty is owed.” Regardless of the context, fiduciary cases are replete with language about how the fiduciary must act to further the objectives of the principal.

A fiduciary relationship is characterized by values such as longevity and mutual trust, and fiduciary cases refer to a close bond that exists between the fiduciary and the principal. Those same bonds, however, are anathema to relationships held by independent gatekeepers, such as auditors and analysts. And an auditor is not considered a fiduciary to the client when performing the audit function.

The differences in the type of relationships independent and dependent gatekeepers have with their clients are striking. The characteristics of

42. See Restatement (Second) of Trusts § 2 cmt. b (1959) (noting that person in a fiduciary relationship has a duty to act for the benefit of another as to matters within the scope of the relationship).
47. See, e.g., VTech Holdings, Ltd. v. PricewaterhouseCoopers, LLP, 348 F. Supp. 2d 255, 268 (S.D.N.Y. 2004) (“In New York, the accountant-client relationship does not generally give rise to a fiduciary relationship absent special circumstances . . . .”). An accountant, however, can become a fiduciary by establishing a relationship of trust and confidence, and by providing advice to a client. Burdett v. Miller, 957 F.2d 1375, 1381–82 (7th Cir. 1992).
dependent gatekeepers are illuminated by examining more closely the role of attorneys and underwriters.

a. Attorneys

A prime example of a dependent gatekeeper is the lawyer. Lawyers have a special place in the adversary system, which recognizes that conflict is inevitable and cannot always be resolved through consensus. In the adversary system, lawyers are not meant to be impartial. An attorney is required to “advance the client’s lawful objectives and interests.” Every lawyer knows about the duty of zealous advocacy. As Geoffrey Hazard has written, “A lawyer’s service consists of guiding affairs for the client’s private and often selfish purposes, with an eye to legal requirements that have been designed for the very purpose of limiting or regulating selfish purposes.”

The relationship between client and lawyer is akin to an “informal partnership.” They work together toward a common goal, although the client, not the lawyer, ultimately calls the shots. This is particularly true of in-house lawyers because of their long-term role as employees or subordinates of the client. In describing the lawyer’s role, it is useful to contrast it with the role of the judge. The traditional figure of justice—blindfolded—represents the court or the judge, not the lawyer. The lawyer, particularly in litigation, seeks to achieve success for his or her client to the disadvantage of the opposing client; the judge interposes herself between the two positions, seeking justice. The judge’s ethical norm is impartiality; the lawyer’s is loyalty.

50. Model R. of Prof’l Conduct R. 1.3 cmt. 1 (2003) (“[A] lawyer must . . . act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client’s behalf.”).
52. Id. at 213.
53. Model R. of Prof’l Conduct R. 1.2(a) (2003) (“[A] lawyer shall abide by a client’s decisions concerning the objectives of representation and . . . shall consult with the client as to the means by which they are to be pursued.”).
54. See Kim, supra note 9, at 1004.
55. Stone v. Williams, 891 F.2d 401, 405 (2d Cir. 1989) (“The figure representing justice is blindfolded so that the scales are held even, but justice is not blind to reality. Plaintiff therefore should have her day in court and an opportunity to have a jury determine the merits of her claim.”).
56. Hazard & Dondi, supra note 16, at 64.
57. Id. at 80.
Notwithstanding the role of zealous advocate, the attorney’s duty of loyalty is not unlimited. Courts and commentators have recognized the tension between the lawyer’s fidelity to his client on the one hand, and his role as gatekeeper on the other—and lawyers are at the center of the corporate governance debate.\(^{58}\) ABA rules provide that a lawyer cannot “counsel a client to engage, or assist a client, in conduct the lawyer knows is criminal or fraudulent.”\(^{59}\) ABA rules permit an attorney to withdraw from representation where the client “insists upon taking action that the lawyer considers repugnant.”\(^{60}\) Recent changes to the ABA Model Rules, which expand the circumstances when a lawyer may breach client confidentiality, illustrate the complexity of the lawyer’s role.\(^{61}\) Certain states, such as New Jersey, go farther than the Model Rules and require lawyers to disclose information to prevent a client “from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another.”\(^{62}\)

Studies suggest that attorneys do not take this language completely seriously. Particularly with regard to financial injury, only a small


\(^{59}\) MODEL R. OF PROF’L CONDUCT R. 1.2(d) (2003).

\(^{60}\) Id. R. 1.16(b)(4).

\(^{61}\) Before 2003, the Model Rules provided that client information could not be revealed, without the client’s consent, unless necessary “to prevent imminent death or substantial bodily harm” or “to establish a claim or defense on behalf of the lawyer . . . .” MODEL RULES OF PROF’L CONDUCT R. 1.6 (1983) (amended 2003). In 2003, the ABA amended its rules in accordance with changes recommended by the Ethics 2000 Commission. Revised Rule 1.6 differs from the old rule in two ways. A lawyer now can reveal confidential information if necessary “to prevent reasonably certain death or substantial bodily harm” or “to prevent, mitigate or rectify substantial injury to the financial interests . . . of another.” Id. R. 1.6(b)(1) (2003). After some debate, the ABA determined that the rule would be permissive; disclosure is not required. See Lawrence A. Hamermesh, The ABA Task Force on Corporate Responsibility and the 2003 Changes to the Model Rules of Professional Conduct, 17 GEO. J. LEGAL ETHICS 35, 38–39 (2003).

percentage of lawyers make the required disclosure. This is not surprising as the overall role of the lawyer is to promote the aims and objectives of his client. The unwillingness to make such disclosures is consistent with the insights from behavioral psychology, explored below. As one writer noted, “In the law, bias is a professional obligation.” While lawyers are occasionally found liable for wrongdoing, the facts of those cases are generally egregious.

While this paper places lawyers in the dependent gatekeeper class, occasionally one hears that lawyers must be independent. What does independence mean in this context? Geoffrey Hazard has distilled a lawyer’s independence to four principles: independence from the state, independence from improper relationships (including other clients and colleagues), independence from personal views regarding politics or morality, and independence from the client. This last principle warrants a closer look because if lawyers are supposed to be independent of their clients, then they would fall into the category of other independent gatekeepers, like auditors.

A lawyer’s independence from the client, however, is different from the auditor’s or analyst’s independence. Hazard explains that a lawyer’s independence from the client means forbearing from assisting a client in violating the law or from rendering advice that encourages a violation. Such conduct ultimately would harm the client and be tantamount to a violation of the duty of loyalty. Independence in this special sense, therefore, is better described as a corollary of the duty of loyalty, not opposed to it. A lawyer also is said to be morally independent from his client in the sense that while the lawyer acts on behalf of the client, the actions and responsibilities of the two are distinct. Moral independence in that regard does not detract from the thesis of this paper; it supports it because it demonstrates that lawyers, as zealous advocates, make arguments that they may feel uncomfortable making on their own behalf.

The lawyer’s role as gatekeeper is clearest when giving legal opinions; it is there one should look to determine whether a lawyer is independent of his client. A legal opinion is an informed judgment, usually reduced to

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67. Id. at 159.
68. Id. at 116 (“A corollary of the principle of independence is the virtue of loyalty to client.”).
writing, on discrete legal issues. An opinion generally provides the recipient with the lawyer’s judgment on how a particular court would resolve a discrete issue. Lawyers provide opinions to clients and non-clients on a number of matters that allow a transaction to go forward. In giving an opinion, the lawyer does not function as a conventional advocate. Rather, the goal of the opinion giver should be to fairly and accurately provide a legal conclusion based on the relevant facts. When a lawyer gives an opinion and he knows or has reason to know that a third person is likely to rely on it, the lawyer owes the third person a duty of reasonable care.

The lawyer’s responsibility to a third person when preparing an opinion is in tension with his responsibility to his client. The lawyer as opinion-giver is not completely objective for several reasons. First, a lawyer rendering an opinion often serves a dual role as opinion-giver and engineer of the transaction about which he is opining. In that sense, the lawyer is passing on his own work, which, as discussed, is prohibited for the independent auditor. Second, opinions typically are negotiated documents whose terms are agreed in advance of the consummation of a transaction.

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70. See Special Committee on Legal Opinions in Commercial Transactions et al., Legal Opinions to Third Parties: An Easier Path, 34 BUS. LAW. 1891, 1896 (1979).
72. In public offerings, an underwriting agreement often will require outside counsel to give a negative assurance that nothing has come to counsel’s attention to lead them to believe that the registration statement or the prospectus is materially misleading. CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 102 (3d ed. 2004). SEC Regulation S-K requires an “opinion of counsel as to the legality of the securities being registered.” See Item 601(b)(5) to Regulation S-K, 17 C.F.R. § 229.601 (2006). In the case of private transactions, lawyers for broker-dealers often provide an opinion setting forth certain risk factors and the process the broker used to review the issuer’s offering memorandum, which the broker-dealer then uses in its sales efforts. JEANNE M. CAMPANELLI & BRADLEY J. GANS, SECURITIES OFFERINGS; THE MECHANICS OF 144A/REGULATION S UNDERWritings, WHAT ISSUERS’ & UNDERWRITERS’ COUNSEL NEED TO KNOW NOW (2001) (explaining that opinion recites investigatory process of issuer and offering memo that counsel undertook and gives negative assurance that following investigation nothing changed).
74. See JAY M. FEINMAN, PROFESSIONAL LIABILITY TO THIRD PARTIES 99 (2000).
75. See id. at 100.
76. Griffith, supra note 2, at 1225 (“[L]awyers not only pass judgment, as gatekeepers, on the validity of transactions, they also exercise a significant degree of authorship over those transactions.”); see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 152 cmt. e (Tentative Draft No. 8, 1997) (stating that in opinion-giving role, lawyer must provide a “fair and objective opinion”).
77. Qualifications of accountants, 17 CFR § 210.2-01(b) (2006) (Preliminary Note) (“[T]he Commission looks in the first instance to whether a relationship or the provision of a service places the accountant in the position of auditing his or her own work.”); see also Griffith, supra note 2, at 1225 (“The conflict between lawyer-as-gatekeeper and lawyer-as-transaction engineer thus parallels the conflict between accountant-as-auditor and accountant-as-consultant.”).
78. See JOHNSON & MCLAUGHLIN, supra note 72, at 103.
Third, unlike an audit, a legal opinion is considered one aspect of counseling a client who has requested that the lawyer provide the opinion to a third party.\textsuperscript{79} As Steven Schwarez notes, lawyers should have the right to issue opinions to facilitate lawful transactions. They should not be expected to assess the overall legality of the transaction.\textsuperscript{80} Finally, an opinion does not give rise to a lawyer-client relationship with the third-party recipient.\textsuperscript{81} Even those who advocate a more robust gatekeeping role for lawyers rendering legal opinions concede that opinion givers are not independent in the same sense as auditors.\textsuperscript{82}

\textit{b. Securities Underwriters}

An investment bank acting as an underwriter in a public securities offering plays an important gatekeeping role but, as we shall see, the underwriter is a dependent gatekeeper in many respects. This may be surprising because the underwriter is said to play a special role as the only participant who, as to matters not certified by the auditor, has the background and knowledge to conduct a sufficient investigation to protect the investor.\textsuperscript{83} Section 11 of the Securities Act names the underwriter, unlike the lawyer, as a potential defendant in a private lawsuit if a registration statement is misleading.\textsuperscript{84} Section 11 also provides a due diligence defense to the underwriter, who must undertake a “reasonable investigation” to assure itself that statements made in the registration statement are true.\textsuperscript{85} The underwriter must perform this responsibility on its own. It cannot rely on information provided by the issuer.\textsuperscript{86} “Tacit reliance on management assertions is unacceptable; the underwriters must play devil’s advocate.”\textsuperscript{87} Thus, there is a sense in which the underwriters are acting independently of the issuer to perform the due diligence required by the Securities Act. The role of the underwriter, however, is more complex.

Notwithstanding the emphasis on due diligence, the underwriter is not meant to be wholly independent of the issuer in the same way the auditor is independent. The issuer engages the underwriter to promote the distribution

\textsuperscript{79} Third-Party “Closing” Opinions, supra note 71, at 596.
\textsuperscript{80} See Schwarez, supra note 73, at 33 (analyzing lawyers’ duties in rendering opinions in structured finance transactions).
\textsuperscript{81} Third-Party “Closing” Opinions, supra note 71, at 596.
\textsuperscript{82} See Coffee, supra note 3, at 59 (“[T]he attorney’s role in this special context of third-party opinions is fundamentally that of a gatekeeper—a role that is midway between that of the attorney as advocate and that of the auditor.”).
\textsuperscript{85} Id. § 77k(b)(3).
\textsuperscript{87} WorldCom, 346 F. Supp. 2d at 675 (quoting Feit, 332 F. Supp. at 582).
of its securities. In that regard, the underwriter’s role, as an adviser to the issuer, usually predates the offering itself. In many cases, the managing underwriter provides advice on a number of issues pertinent to the offering, such as the type and amount of securities sold, the timing of the offer, and steps the issuer can take to make itself more attractive. As a result of advice given, some courts have begun to recognize a fiduciary relationship between an underwriter and an issuer.

In addition, an underwriter often has a direct or indirect financial interest in an offering. Some underwriters invest directly in their clients, which is prohibited for independent accountants. Also, many underwritings are performed on a so-called best efforts basis where the underwriter will not receive a fee unless some or all of the securities are sold. In a recent Second Circuit case, the court summarized the underwriter’s incentives as follows:

Underwriters have strong incentives to manipulate the IPO [initial public offering] process to facilitate the complete distribution and sale of an issue. Underwriting is a business; competitive forces dictate that underwriters associated with successful IPOs will attract future issuers. Moreover, because underwriters assume a large measure of risk in the event an IPO fails, they have a direct interest in the IPO’s success.

Moreover, underwriters perform multiple services for their clients. Performance of such services, notwithstanding the due diligence respons-

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88. Even where the issuer does not engage an underwriter, but one simply acts for the benefit of an issuer in furtherance of a distribution, that person is considered an underwriter. In the case of SEC v. Chinese Consolidated Benevolent Association, an association, which helped the Chinese government during a bond offering in soliciting and receiving funds from Chinese communities in the United States, was considered an underwriter although it had no contractual relationship with the issuer. SEC v. Chinese Consol. Benevolent Ass’n, 120 F.2d 738, 740 (2d Cir. 1941). Similarly, promoters, officers, and control persons who promote an offering are generally considered underwriters as well. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 351–52 (5th ed. 2006).

89. See COX, HILLMAN & LANGEVOORT, supra note 88, at 120–21.

90. The New York Court of Appeals held that while the underwriting agreement for an IPO did not itself create a fiduciary duty, the advisory relationship between the underwriter and the issuer was marked by trust and confidence and gave rise to a fiduciary relationship. EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31–33 (N.Y. 2005) (“eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO.”); see also Breakaway Solutions, Inc. v. Morgan Stanley & Co. Inc., No. Civ. A. 19522, 2004 WL 1949300, at *13 (Del. Ch., Aug. 27, 2004) (holding that issuer sufficiently alleged fiduciary relationship with its description of relationship with defendant underwriters).

91. Royce de Barondes, NASD Regulation of IPO Conflicts of Interest—Does Gatekeeping Work?, 79 Tul. L. Rev. 859, 862 (2005) (“[I]nvestment banks may, and occasionally do, have financial interests in an issuer or a securities offering in addition to receipt of underwriting fees.”).

92. 17 C.F.R. § 210.2-01(c)(1)(i)(A) (2006) (stating that an accounting firm is not independent if firm or immediate family member has “any direct investment in an audit client”).

93. See COX, HILLMAN & LANGEVOORT, supra note 88, at 121–22.

94. Billings v. Credit Suisse First Boston Ltd., 426 F.3d 130, 139 (2d Cir. 2005).
bility under section 11, distinguishes underwriters from auditors and makes them dependent in a way that auditors now cannot be. Unlike auditors, which are restricted in the performance of non-audit services, underwriters continue to have an interest in cultivating the client relationship to obtain additional consulting and other work. The very provision of advice can turn a non-fiduciary relationship into a fiduciary one by dint of reliance by the principal on the skills and expertise of the agent and the trust and confidence reposed in him.

Application of National Association of Securities Dealers (NASD) rules demonstrates an underwriter is a dependent gatekeeper. NASD rules require its members, in some cases, to hire an independent agent (known as a qualified independent underwriter) to conduct due diligence on a registration statement and provide an independent pricing opinion. If a conventional underwriter were independent, the NASD rules would be superfluous.

This Part demonstrates that all gatekeepers are not alike. Some, like auditors, are meant to be independent of their clients. Others, like attorneys, are dependent on the goals and objectives of their clients and often serve in a fiduciary capacity. Part II explores aspects of social and behavioral psychology with a view to determining whether these differences bear on how gatekeepers are likely to behave. Drawing on these insights, Part III discusses how dependent gatekeepers, charged with furthering the interests of their clients, are less likely to be effective gatekeepers than independent ones, and what we should do about it.

II. GATEKEEPER MOTIVATION AND BIAS

Intuition tells us that a dependent gatekeeper will be ineffective. The dependent gatekeeper faces a dilemma. He can act as a weak monitor, enhancing his potential liability, but preserving his client relationship and positioning himself for future business. Alternatively, he can act as a robust

95. See COX, HILLMAN & LANGEVOORT, supra note 88, at 125.
96. See Burdett v. Miller, 957 F.2d 1375, 1381–82 (7th Cir. 1992).
98. See Notice of Filing of Proposed Rule Change Relating to the Corporate Financing Rule and Shelf Offerings of Securities, 69 Fed. Reg. 70,731, 70,735 (proposed Feb. 4, 2004) (setting forth rules governing an underwriter participating in distribution of securities of issuer with which it has conflict of interest); see also Amendments to the Corporate Financing Rule, NASD NOTICE TO MEMBERS 04-13, Feb. 2004, at 114, available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasd_003258.pdf (noting that NASD member firms have expanded services provided to corporate financing clients including “venture capital investment, financial consulting, commercial lending, hedging risk through derivative transactions, and investment banking”).
monitor, shielding himself from potential liability, but possibly damaging
his client relationship and acting inconsistently with his fiduciary duty.99

Liability for breach of fiduciary duty could be overcome by fiat. Congress or regulators could draft laws or rules to trump state common law
and limit liability for certain violations of the duty of loyalty. The same
result might be achieved through contract, although such terms could be
difficult to negotiate and enforce. The SEC’s attorney conduct rules, which
require lawyers to report violations of law “up the ladder” in the business
organization, was a partial measure in this regard. In adopting the rules, the
SEC reaffirmed that they “shall prevail over any conflicting or inconsistent
laws of a state or other United States jurisdiction in which an attorney is
admitted or practices.”100 While the rules are controversial, the ABA
recognized that federal law may provide a basis for the pre-emption of
attorney-client confidentiality.101

Even if such protections are available, open-ended responsibilities
placed on fiduciaries to act as gatekeepers are unlikely to be effective. One
reason for this, Part I demonstrates, is that a dependent gatekeeper should
be committed to furthering the goals of his principal. This part explores a
related reason, namely whether a gatekeeper’s decision making process in
determining whether to act in a way that could harm his principal is con-
strained by unconscious bias. This Part begins with a short discussion of
how conventional analysis has failed and why incorporating lessons from
behavioral and social psychology is essential.

A. FAILURES OF CONVENTIONAL ANALYSIS

The primary failure of the traditional analysis of gatekeeper liability is
that it did not sufficiently consider the dynamics of the group. People are
motivated to act in the way they do out of biases deeper than an urge to
maximize their wealth, reputation, or another measure of well-being. They
are concerned about many other factors, such as how they are perceived by
peers, and they make decisions in many cases based on what will be accept-
able to the group. Moreover, most people stick to their decision, even if the

99. Acting as a robust gatekeeper may be inconsistent with the duty of care, by failing to
further the principal’s objectives, and inconsistent with the duty of loyalty, by acting against the
principal’s interests. Griffith, supra note 2, at 1234 n.43 (stating that vague duties “to ‘the public’
threaten to increase the agency costs of the legal representation as lawyers may seek to pursue
their own ideological goals in favor of client interests”).

100. Implementation of Standards of Professional Conduct for Attorneys, Securities Act
25,919, 68 Fed. Reg. 6296, 6296 n.7 (Feb. 6, 2003); Letter from Giovanni P. Prezioso, General
Counsel, SEC, to J. Richard Manning, President, and David W. Savage, President-Elect,
spch072303gpp.htm.

101. See Letter from Alfred P. Carlton, Jr., President, American Bar Assoc. to Jonathan G.
s74502/apcarlton1.htm.
decision turns out to be wrong-headed, long after they figure that out. These group dynamics, however, are only now getting significant attention in the literature regarding gatekeeper reform.\(^\text{102}\)

Focus on the individual, as opposed to the group, pervades our system of justice. Our system determines the guilt of an individual actor.\(^\text{103}\) This is consistent with the emphasis in corporate law on discrete rational individuals acting to maximize their own wealth.\(^\text{104}\) Ignoring group dynamics, however, is inconsistent with the way individuals operate in a business environment. This observation is not new. Law and economics scholars, often criticized by proponents of social psychology, recognized long ago that the nature of the corporation could be best understood by placing the individual into the group and recognizing the role of the individual within it.\(^\text{105}\) Ignoring group dynamics leads one back to a rational actor model of individualized action and stresses a “bad apples” approach to understanding corporate wrongdoing.\(^\text{106}\) It de-emphasizes the influence one person or group of persons has on another, such as the interaction of a board of directors or the relationship between and among gatekeepers and their principals. This de-emphasis elides the complicated causes of misbehavior and may prevent meaningful reform.

Second, analysts of gatekeeper liability have ignored certain root causes of corruption. Corruption can begin with certain small steps that “have their origins in actions that are not themselves corrupt.”\(^\text{107}\) Small or insignificant actions can spread within an organization with each subsequent actor rationalizing that his or her conduct is not much different from conduct that preceded it. If this is correct, wrongdoing cannot be alleviated in large organizations by screening out individuals deemed corrupt.\(^\text{108}\) The problems are deeper because many or most people are susceptible to the kinds of actions they ultimately might brand as wrong. And even if one is not susceptible to committing an action that could be considered corrupt in hindsight, conventional analysis has not accounted for how loyalty in an organization can cause some persons to fail to question others.

A related, frequently ignored concern is the haste with which individual decisions in large organizations are often made. This phenomenon is masked by the time it takes for tangible results to be achieved, such as the

\(^\text{102}\) See supra note 9 and accompanying text.
\(^\text{103}\) See James A. Fanto, Perspectives From Law and Social Psychology, 70 Brook. L. Rev. 1165, 1166 (2005).
\(^\text{107}\) Id. at 1180.
\(^\text{108}\) Id. at 1183.
introduction of a new product or service. But hundreds or thousands of smaller decisions are made within an organization for the tangible result to be achieved, often with little or no reflection. John Darley has explained that improper decisions “may be overridden by the more deliberate thinking of the reasoning system, but only if something triggers that system into action.”

Third, in addressing gatekeepers’ behavior, ideas of agency cost theory and the nexus-of-contracts approach are overemphasized. This approach focuses on purported contractual relationships, such as the relationship between an individual director and the corporation. It recognizes that a director’s interests may diverge from the shareholders’ and it considers ways shareholders can ensure that a director’s interests are aligned with shareholders’ interests. Under this view, a manager or director’s fiduciary duty is nothing more than a safeguard to ensure he makes the right decisions on behalf of investors, as the residual claimants of the firm. The individualism characteristic of the contractualist view, however, is inconsistent with board experience and fails as an explanatory theory of the recent business failures.

Finally, conventional analysis remains largely wedded to a “command and control” (as opposed to a self-regulatory) model of corporate governance. Where a command and control model relies on external sanctions and rewards, a self-regulatory model relies on shaping employees’ internal motivations. Behavioral and social psychologists have shown that people

109. Id.
are not profit maximizers.\textsuperscript{113} As a result, external sanctions and rewards often are not effective strategies for influencing behavior.\textsuperscript{114}

\textbf{B. SOCIAL PSYCHOLOGY}

Lessons from the fields of social and behavioral psychology address many of these shortcomings. Social psychology bridges the fields of psychology, which emphasizes the mental processes and behavior of the individual, and sociology, which emphasizes social structure, social institutions and processes, and human interaction. In general terms, social psychology addresses the influences people have on the beliefs and behavior of others.\textsuperscript{115} Much of the work in this area focuses on an individual’s behavior in a social environment and motivations that affect the individual’s decision making.\textsuperscript{116} It is a broad field with, by one count, some 600 theories to explain human behavior.\textsuperscript{117}

The research suggests that unconscious bias can affect gatekeeper decisions. Social psychology teaches that goals and motives influence reasoning—the way people process information—and the judgments they make.\textsuperscript{118} Motives affect reasoning by inducing people to rely on a biased set of cognitive processes that reflect the goals we seek to achieve. Cognitive processes that can become corrupted include the way one accesses information and the way one constructs and evaluates beliefs.\textsuperscript{119}


\textsuperscript{114} Id. at 1295–96.

\textsuperscript{115} ARONSON, supra note 10, at 6.


\textsuperscript{117} See Fiske, supra note 8, at 14,420.

\textsuperscript{118} A motive in this context is any wish, preference, or desire concerning the outcome of a reasoning task.

Gatekeeper decisions also can be biased because of a related reliance on heuristics, which are shortcuts or rules of thumb we use all the time to aid decision making. Most work in the area of heuristics and biases concerns facts. Heuristics, however, also are used in moral and legal decision making.\(^{120}\) By utilizing heuristics, one can avoid the hard cognitive work of receiving, understanding, and interpreting complex information and analyzing the costs and benefits of alternative courses of action.\(^{121}\) Heuristics work well most of the time, but not always.\(^{122}\) They fail us when a generalization that results from a heuristic is taken out of context and used as a universal principle where it no longer applies.\(^{123}\)

**C. REDUCING DISSONANCE**

Psychologists explain that goals and motives influence reasoning because people seek to maintain consonance between relevant cognitions. The lack of consonance, or dissonance, produces pressure to avoid situations and information that increase the dissonance. One type of dissonance is post-decisional dissonance, which arises where a person must choose between two alternatives with positive and negative features.\(^{124}\) Most people typically choose the alternative that will result in less, not more, dissonance after the decision is made. In making such decisions, research demonstrates that reasoning can be driven by accuracy goals on the one hand or directional goals on the other. When one has accuracy in mind, the motive is to arrive at an *accurate* conclusion. When one has a directed goal in mind, the motive is to arrive at a *particular* conclusion. Accuracy goals yield better reasoning; directional goals yield strategies intended to reach the conclusion desired.\(^{125}\)

The distinction between accuracy goals and directional goals goes to the core of the difference between independent and dependent gatekeepers.

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122. The pioneers in this area of research were Daniel Kahneman and Amos Tversky. They explained that people rely on a small number of heuristic principles, which reduce the difficult task of assessing probabilities and predicting values to simple judgments. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in *JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 3 (Daniel Kahneman et al. eds., 1982); see also Tetlock, Skitka, & Boettger, supra note 121, at 633 (describing people as “cognitive misers”).
123. Sunstein, supra note 120, at 1558.
discussed in Part I. Independent gatekeepers should be concerned with accuracy. They owe duties of objectivity and accuracy to the public. They should not be motivated by the clients’ goals and ends in the same way that dependent gatekeepers are. Dependent gatekeepers, by contrast, are interested in reaching a particular result. A dependent gatekeeper, as discussed in Part I, must act for the client’s benefit, furthering its ends and presenting the client in “the most favorable possible light.”

D. MOTIVATIONAL GOALS

This section discusses mechanisms that result in thought processes to reduce dissonance that are closely related to accuracy versus directional goals that arise in the context of group dynamics. The focus is on two mechanisms—accountability and commitment—that are likely to bear on gatekeepers’ decisions, and that likely bear differently on dependent and independent gatekeepers as well as related heuristics that may lead to bias.

1. Accountability

   a. The Perils of Accountability in Decision Making

    Generally, accountability refers to an expectation to justify one’s beliefs, feelings, or actions to others. Accountability enhances accuracy because people who are held accountable will avoid making arbitrary or incorrect decisions. Politicians, teachers, supervisors, and colleagues are often called upon to be more accountable. Failure to provide sufficient justification for a decision can result in negative consequences. Providing compelling justifications results in positive ones.

    But researchers have uncovered a negative side to accountability as well. Accountability in some cases can negatively affect the formation of attitudes and the accuracy of judgments. One way to understand accountability is that it acts as a constraint on everything we do. Constraint caused by accountability can lead people to censure particular views and to short-circuit their decision process, omitting important considerations. We short-change accuracy goals for the sake of directional goals. Students, for example, are asked to complete evaluations of faculty anonymously to ensure that the students will not be held accountable. Imagine how

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127. See Karen Siegel-Jacobs & J. Frank Yates, Effects of Procedural and Outcome Authority on Judgment Quality, 65 ORG. BEHAV. & HUM. DECISION PROCESSES 1, 1 n.1 (1996); see Kim, supra note 9, at 1010–11 (discussing accountability in gatekeeper context).
128. See Lerner & Tetlock, supra note 121, at 255 (reviewing literature).
129. Id. at 270 (summarizing 20 years of research and concluding that accountability is complex phenomenon that interacts with decision-makers and environment and produces “an array of effects—only some of which are beneficial”).
130. See Tetlock, Skitka, & Boettger, supra note 121, at 632.
131. See id.
inaccurate evaluations would be if we told students they must affix their signature and justify their beliefs to the faculty they are evaluating.

This example suggests that the effect of accountability on accuracy differs depending on whether the views of the audience to whom one is accountable are known or unknown to the decision maker. In the example, the views of the audience (the faculty) are known to the decision maker (the student) because the student would be justifying her evaluation to the same faculty she is rating. People generally are motivated to seek approval from their audience and are biased in favor of conclusions that conform to the audience’s views. When the views of the audience are known to the decision maker before she forms an opinion, she will redirect her opinion to conform to them. Directional goals take over. People adopt positions that are likely to be pleasing to those to whom they are accountable.

When the audience’s views are unknown, conformity is not possible and accuracy goals predominate. In that case, people are more likely to consider multiple objectives and engage in a more thoughtful, deliberate, self-critical analysis. As Jennifer Lerner and Philip Tetlock explain, “When participants expect to justify their judgments [to an unknown audience], they want to avoid appearing foolish in front of the audience. They prepare themselves by engaging in an effortful and self-critical search for reasons to justify their actions.” Thus, in our example, accountability could promote accuracy if we held students accountable to an independent board whose views about the faculty were unknown.

Closely related to the motivation to conform one’s views to those of a known audience is what psychologists call the acceptability heuristic. Adopting the position of one’s audience circumvents hard cognitive work. Studies demonstrate that when participants were unaware of the audience’s views, they engaged in more complex information processing. When one expects to discuss one’s views with an audience whose views are known, one will shift attitudes toward those of the audience, even if the results are inefficient. People do this in several ways. One possibility is to rely on

132. See Lerner & Tetlock, supra note 121, at 257; see also Tetlock, Skitka, & Boettger, supra note 121, at 633 (explaining that when people do not know audience’s views and are unconstrained by commitment, people engage in preemptive self-criticism, processing information from self-critical perspective and anticipating objections of critics); see also id. at 638 (stating that when audience views are unknown, decision makers think about issues “in more integratively complex and evaluatively inconsistent ways”).
133. See Lerner & Tetlock, supra note 121, at 263.
135. See Lerner & Tetlock, supra note 121, at 256. In one study, persons making financial aid determinations, who had to justify their decisions to recipients, allocated funds inefficiently. They provided some money to all recipients, with the result that many had insufficient funds to cover costs. Those who were not accountable to recipients, provided enough money to some recipients to meet their needs rather than trying to please all. Id. In another study, subjects who knew the
irrelevant information in making a decision. In one study, when asked to predict grade point averages of a student audience, participants who were accountable short-circuited their reasoning and relied on irrelevant information, such as the number of plants a student keeps, as opposed to the number of hours the student studied. This allowed the participants to pursue their directional goals—predicting high GPAs—at accuracy’s expense.

b. Accountability and Gatekeeper Bias

How do accountability and audience views bear on decisions made by independent and dependent gatekeepers? Independent gatekeepers should be accountable to an audience whose views are unknown. The audience for independent gatekeepers, such as auditors and analysts, is a diverse public with heterogeneous views. Financial statements, for example, are necessary not only for management to get a complete snapshot of the company’s affairs, but also for use by creditors, suppliers, analysts, employees, competitors, and, perhaps most importantly, public investors. While some of these may wish to see a clean opinion from an auditor or a “buy” recommendation from an analyst, others may want the opposite. Empirical studies of auditors confirm that when audience views were known, auditors were animated by directional goals and conformed their conclusions to them. When the views were unknown, auditors were accuracy-oriented and engaged in a more deliberative process.

While an auditor may be retained by the issuer, it must conduct itself independently of the issuer. As Robert Haft has explained, “[T]here is a greater tendency for courts to decide that a duty to disclose material facts to nonclient investors exists for accountants than for attorneys . . . .” Similarly, analysts should be independent of the companies they research and should present the company to the public in an objective fashion. These gatekeepers cannot know the views of their audience as the audience comprises public investors.

Dependent gatekeepers, by contrast, are accountable to an audience whose views are known, the clients who hired them. The lawyer’s primary audience is his client; the same is true for an underwriter. As discussed in Part I, dependent gatekeepers advocate on their clients’ behalf and, in some cases, owe them fiduciary duties. The dependent gatekeeper is charged with furthering the client’s goals, which the gatekeeper appreciates and understands because the purpose of his engagement is to promote those views of their audience “expressed more liberal views to the liberal audience and more conservative views to the conservative audience.” Tetlock, Skitka, & Boettger, supra note 121, at 638.

136. See Lerner & Tetlock, supra note 121, at 265.
137. See id. at 257.
goals. Sung Hui Kim refers to lawyers’ “ethical ecology,” explaining that “alignment pressure can distort the lawyer’s judgments.”

Underwriters, while subject to section 11 liability, assume substantial risk if an offering fails. Thus, while the underwriter’s dependence may not be as clear at the lawyer’s, the underwriter faces alignment pressure just like the lawyer. By contrast, lawyers are exempt from section 11 liability—Congress simply did not include them in the list of potential defendants. Moreover, lawyers generally are accountable to their clients, not third parties, for their legal opinions. As one court stated, “[T]he law, as a general rule, only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions.” The comment to the relevant section in the Restatement of the Law Governing Lawyers explains, “Making lawyers liable to nonclients, moreover, could tend to discourage lawyers from vigorous representation. Hence, a duty of care to nonclients arises only in . . . limited circumstances.” Thus, in the case of dependent gatekeepers, the views of the audience are known and the gatekeeper has a strong desire to maintain views consistent with them.

2. Commitment

a. Commitment and Bias

Once people commit to a course of action, they tend to escalate their enthusiasm. Even after it becomes clear that the disadvantages of pursuing a course of action outweigh the advantages, people refuse to let go. “Groups may stick to a consensus view, even in the face of changing information, because consensus assures them their assessment or decision is correct.” Social psychology teaches that when an individual is a group member, committed to the purposes and tasks of the group, the task of the individual is to first become a “prototypical member of that group, and then help the group as best she can in reaching its goals.” Moreover, after committing to a decision, if called upon to justify the choice, people are highly...

139. Kim, supra note 9, at 1008.
140. In re Enron Corp. Sec., Deriv. & ERISA Litig., 235 F. Supp. 2d 549, 601 (S.D. Tex. 2002) (citing Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124 (5th Cir. 1988)). Lawyers can be liable to third parties if an opinion was prepared for a third party’s use or the lawyer knew or should have known a particular person would rely on it. Id. According to the Restatement, a lawyer owes a duty of care to third parties to the extent the lawyer or client “invites the nonclient to rely” on the opinion or other services, “the nonclient so relieves[,]” and the nonclient is not “too remote from the lawyer to be entitled to protection.” RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 51(2)(a), (g) (2000). See generally Feinman, supra note 74, at 99 (stating that lawyer owes third party duty of reasonable care); see also Jay M. Feinman, ATTORNEY LIABILITY TO NONCLIENTS, 31 TORT TRIAL & INS. L.J. 735, 756–60 (1996).
141. Abell, 858 F.2d at 1124.
143. Khurana & Pick, supra note 111, at 1277.
144. Darley, supra note 106, at 1191.
motivated to avoid self-criticism and justify their original decision. Studies show that subjects concern themselves with thinking up as many reasons they can for why they were right and their critics wrong. Psychologists refer to this as retrospective rationality or defensive bolstering.

The presence of commitment marks an important distinction between independent and dependent gatekeepers and between accuracy versus directional goals. Commitment to the interests of the principal is the cornerstone of the fiduciary relationship which, as discussed, describes the link between dependent gatekeepers and their principals. Dependent gatekeepers, as fiduciaries, owe a duty of loyalty to their clients to act on their behalf. They are directed to advance the client’s lawful interests and must single-mindedly pursue those interests. The traditional model of lawyering often is referred to as the total commitment model.

To see how commitment might take hold, consider the role of gatekeepers in a securities offering. The process begins with the issuer who will look to an investment bank as a lead underwriter. The lead underwriter will investigate the issuer and decide whether to underwrite its securities. After the issuer and underwriter sign a letter of intent, the underwriter’s experts and its lawyers labor, along with the issuer and its attorneys, to understand the company from several perspectives and assess its future prospects. The effort is a joint commitment by the issuer, the underwriter, and their respective lawyers. They have a joint stake in seeing the project through; they share the same directional goal. This group dynamic is important to understanding gatekeeper behavior. The role of the auditor, however, is more circumscribed. The auditor, after undertaking its own investigation, issues a certificate under its name as to the accuracy and completeness of the financial statements—the goal is accuracy.

Commitment once established can affect decision making in several ways. Continuing with the example of an offering, it is likely that the decision to participate entails some dissonance because not all aspects of an engagement are likely to be positive and most transactions entail some risk.

144. Tetlock, Skitka & Boettger, supra note 121, at 638.
145. Id. at 633.
146. See Lerner & Tetlock, supra note 121, at 257.
147. See Marie A. Failinger, Face-ing the Other: An Ethics of Encounter and Solidarity in Legal Services Practice, 67 FORDHAM L. REV. 2071, 2103 (1999); see also Roger C. Cramton, Professionalism, Legal Services, and Lawyer Competency, in AMERICAN BAR ASSOCIATION, JUSTICE FOR A GENERATION 144, 149 (1985); Roger C. Cramton, Furthering Justice by Improving the Adversary System and Making Lawyers More Accountable, 70 FORDHAM L. REV. 1599, 1602 (2002); Charles P. Curtis, The Ethics of Advocacy, 4 STAN. L. REV. 3, 18 (1951) (referring to the “entire devotion” principle).
148. For a review of the offering process still relevant today, see United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953); see also HAROLD S. BLOOMENTHAL & SAM WOLFF, GOING PUBLIC AND THE PUBLIC CORPORATION § 2:3 (West 2004).
149. See Fanto, supra note 103, at 1169.
150. See Haft, supra note 138.
After making decisions, one way people reduce dissonance is to reassure themselves they made the right choice by focusing on information that will lead them to that conclusion.\textsuperscript{152} Once a dependent gatekeeper has agreed to an engagement, he has committed himself to the client’s ends and is more likely to focus on positive aspects of the choice and downplay negative ones.\textsuperscript{153}

This commitment has important consequences. After executing an underwriting agreement, which generally occurs immediately before the offering closes, an underwriter must continually assess whether the prospectus should be updated or revised so as to not be materially misleading. But since directional goals predominate over accuracy goals, an underwriter committed to the transaction has an incentive to filter information to avoid amending the registration statement with negative information, which would impede selling efforts.\textsuperscript{154} This was the context of the famous case of \textit{SEC v. Manor Nursing Centers, Inc.}\textsuperscript{155} The court held that the appellants, including the underwriters, were under a duty to amend the prospectus to reflect developments that occur after the SEC declares the registration statement effective, and the failure to do so was a violation not only of the registration provisions, but also the anti-fraud provisions.\textsuperscript{156}

\textit{b. Commitment to Outcome Versus Process}

Recent research bridging accountability and commitment reinforces the negative relationship between commitment and accuracy. This line of research distinguishes \textit{outcome} accountability from \textit{process} accountability. Outcome accountability is accountability for the outcome of a decision; it is goal directed. Process accountability is accountability for the quality of the process used to arrive at a decision.\textsuperscript{157} Outcome accountability increases commitment to previous decisions about what the outcome should be and leads to defensive bolstering. Outcome-accountable subjects in decision making displayed what is known as more scatter (the presence of irrelevant judgments) than subjects who had to account for procedures, or subjects who were not accountable at all.\textsuperscript{158}

\begin{thebibliography}{99}
\bibitem{152} ARONSON, \textit{supra} note 10, at 194.
\bibitem{153} \textit{Id}.
\bibitem{154} John J. Jenkins, \textit{Recirculation of the Preliminary Prospectus: Statutory Basis and Analytical Techniques for Resolving Recirculation Issues}, 55 \textit{BUS. LAW.} 135 (1999); see also COX, HILLMAN & LANGEVOORT, \textit{supra} note 88, at 211.
\bibitem{155} SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).
\bibitem{156} \textit{Id.} at 1100 (holding that by failing to amend, prospectus was no longer Securities Act section 10(a) prospectus and therefore appellants violated Securities Act section 5(b)(2)); see also Gray v. First Winthrop Corp., 82 F.3d 877, 886 (9th Cir. 1996). The SEC more recently has addressed a similar problem in new Rule 159 under the Securities Act. See Joseph McLaughlin, \textit{Securities Offerings, Late-Breaking Information and the SEC’s Rule 159}, 38 \textit{SEC. REG. & LAW REP.} 1077 (2006).
\bibitem{157} Siegel-Jacobs & Yates, \textit{supra} note 127, at 2.
\bibitem{158} \textit{Id.} at 14.
\end{thebibliography}
Process accountability by contrast leads to a better decision making process, such as more consideration of alternatives and less self-justification.\footnote{159} If justification focuses on the process used to make judgments, then accountability can be helpful. Outcome accountability, however, had no beneficial effects whatsoever, and in fact was harmful compared to no accountability.\footnote{160} The distinction between outcome and process accountability mirrors the distinction between directional goals and accuracy goals.

The distinction between outcome and process accountability explains the rules in place with respect to gatekeepers discussed below, and it demonstrates the difference between them. Independent gatekeepers are not held accountable for outcomes in the same way dependent gatekeepers are. Special protections exist for independent gatekeepers—particularly auditors—when the client disagrees with the outcome. It is difficult for a public company to terminate an auditor when the client disagrees with the outcome. Terminating an auditor is a public event and must be reported on an SEC form designed to disclose certain material events at the time they occur.\footnote{161} No such protections exist for lawyers.

The dependent gatekeeper’s commitment to outcome is closely related to a heuristic called anchoring and adjustment. Anchoring and adjustment describes the phenomenon that, in making decisions, we begin with a starting point and adjust our estimates upward or downward insufficiently relative to where we started. Insufficient adjustments result in bias. If a sale item costs $1 and the sign says “limit 10 per customer,” you are more likely to leave with seven or eight, although you need only one.\footnote{162} Similarly, when executives forecast a project’s completion, they adjust the estimates based on new information, but they prepared the original estimates making their case for success, which skews subsequent forecasts toward optimism.\footnote{163}

Dependent gatekeepers are likely to be more prone to bias through anchoring and adjustment than independent gatekeepers. Think again about

\footnote{159. Lerner & Tetlock, \textit{supra} note 121, at 258.}
\footnote{160. Siegel-Jacobs & Yates, \textit{supra} note 127, at 9; see also \textsc{Tom R. Tyler \& Stephen L. Blader}, \textit{Cooperation In Groups: Procedural Justice, Social Identity, and Behavioral Engagement} 77–89 (2000); Tyler, \textit{supra} note 112, at 1309.}
\footnote{161. Instructions to Form 8-K clarify that “[t]he resignation or dismissal of an independent accountant, or its refusal to stand for reappointment, is a reportable event separate from the engagement of a new independent accountant.” \textit{Sarbanes-Oxley SEC Rules & Regulations} § 490-13, Item 4.01, Instruction (2002).}
\footnote{162. Brian Wansink, Robert J. Kent, \& Stephen J. Hoch, \textit{An Anchoring and Adjustment Model of Purchase Quantity Decisions}, 35 J. \textit{Marketing Res.} 71, 79 (1998) (“A consistent finding in these studies is that consumers purchase more units when they see high anchors in POP [point of purchase] promotions.”).}
\footnote{163. Dan Lovallo \& Daniel Kahneman, \textit{Delusions of Success: How Optimism Undermines Executives’ Decision}, \textit{Harv. Bus. Rev.} 56, 60 (2003) (“Because the initial plan . . . [is] designed to make the case for the project—it will skew the subsequent analysis toward overoptimism. This phenomenon is the result of anchoring, one of the strongest and most prevalent of cognitive biases.”).}
the offering example. The issuer and its lawyers are the ones who generally draft the initial version of a registration statement.\textsuperscript{164} In doing so, they are preparing a document they hope will result in a successful distribution. With the assistance of the underwriters, they come up with an initial draft that will then be adjusted based on comments from third parties and the SEC staff. It is the initial draft of the registration statement, however, that serves as the anchor, and any amendments must be justified as departures from the original.

Accountants performing an annual audit or analysts researching a public company do not have the same anchors to contend with. They are not wedded to the issuer’s numbers. Under Auditing Standard No. 2, auditors must obtain independent evidence, employ professional skepticism, and use the work of others only in limited circumstances.\textsuperscript{165} The same is true for analysts. As opposed to using financial data provided by an issuer as an anchor, an analyst may choose instead to use industry averages against which to measure an issuer’s performance. In that regard, an underwriter may seek out analysts’ views, in the context of an offering, to learn of the strengths and weaknesses of the competition.\textsuperscript{166}

Given that dependent gatekeepers are accountable to their principals and committed to furthering their ends, careful consideration should be paid to how directional goals and bias may affect their decisions. One cannot ignore the powerful draw that motivations have on judgment and the unconscious bias that can result. Moreover, everyday heuristics like acceptability and anchoring can bias judgments as well. If gatekeepers’ decisions about whether to stop a transaction from going forward or report wrongdoing to a third person were clear-cut, one would have little cause for concern. Such decisions, however, are highly indeterminate. Part III addresses the indeterminate nature of such decisions and, drawing on Parts I and II, what to do about them.


III. REFORMING GATEKEEPER BIAS

The observations in Parts I and II advance the understanding of gatekeeper behavior. This Part considers recent and potential reforms. The discussion so far suggests two possible paths for reform. One path is to discount the work of dependent gatekeepers. To the extent they are charged with promoting their clients’ ends, as discussed in Part I, they are prone to directional goals as opposed to accuracy goals, as discussed in Part II, and destined to fail. This appears to be the path suggested by some commenters, who discuss shrinking the scope of underwriter liability. Another path is to expand the scope of liability of dependent gatekeepers precisely because of the biases discussed.

The observations in Parts I and II regarding the differences among gatekeepers and the tendency to self-justify are magnified because of indeterminacy in the law. One result of indeterminacy is that when one wants to reach a particular result, one often can reach it, and then defend the result as reasonable. This is not true to the same degree for independent gatekeepers. While auditors face some ambiguity in the course of an audit, as a general matter, auditors use relatively objective rules that contain few principles and standards leaving wide latitude for interpretation. If managers sought to improperly influence financial statements, Generally Accepted Accounting Principles (GAAP) inhibit such conduct even if the auditors were willing to oblige. This Part, therefore, begins with a discussion of the indeterminacy inherent in the corporate and securities area.

A. INDETERMINACY IN CORPORATE AND SECURITIES LAW

Securities and corporate law is inherently ambiguous for a number of reasons. First, notwithstanding many technical provisions, the responsibilities of issuers and market professionals often turn on state common law fiduciary duties—a notoriously ambiguous area of the law. This is particularly true for the duty of care, which is an open-ended requirement to exercise the care and skill of an ordinary prudent person. Courts, particularly in the corporate law area, recognize that the duty to pay attention to corporate matters is inherently ambiguous. In *Barnes v.*

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168. See Cox, Hillman & Langevoort, supra note 88, at 547 (explaining that managers’ temptation to distort financial statements is checked by outside auditor).


Andrews, Judge Learned Hand remarked, “The measure of a director’s duties in this regard is uncertain; the courts contenting themselves with vague declarations, such as that a director must give reasonable attention to the corporate business.”\(^{171}\) The latitude inherent in the duty of care is embodied in the business judgment rule, which provides that, in the absence of fraud or bad faith, courts will not second guess directors’ decisions if they turn out badly.\(^{172}\)

1. Standard of Care

The ambiguity of the duty of care renders the gatekeeper’s responsibilities highly indeterminate. Under the Securities Act of 1933, the underwriter (and others) can defend against a claim of liability if it conducted a “reasonable investigation” into the facts disclosed in the registration statement.\(^{173}\) There is little or no guidance, however, on what a reasonable investigation entails and few litigated cases have been decided on this point. The leading case, *Escott v. BarChris Construction Company*, is nearly 40 years old and, in that case, the court stated, “There is no direct authority on this question, no judicial decision defining the degree of diligence which underwriters must exercise to establish their defense under Section 11.”\(^{174}\) The court could not arrive at a rule: “It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case.”\(^{175}\) More recent cases addressing whether due diligence should be decided by a judge or jury make the same point.\(^{176}\) In the end, the standard required for due diligence under the Securities Act is the vague duty of care. This standard is now codified in section 11(c) of the Act, which reads, “In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.”\(^{177}\)

2. Materiality Requirement

A second reason the law is hard to pin down is that at the heart of every disclosure requirement, and every claim of fraud under the securities laws, is a materiality requirement. The materiality standard turns on the following:

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175. Id. at 697.
177. 15 U.S.C. § 77k(c).
[Whether] there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.\textsuperscript{178}

The standard is ambiguous. It depends on what a reasonable investor would decide, which is often dependent on how a particular judge or regulator views the facts.\textsuperscript{179} Attempts to quantify materiality or provide a bright-line rule have been rejected.\textsuperscript{180} The Supreme Court in \textit{Basic Inc. v. Levinson} rejected a bright-line rule to determine when merger negotiations would be considered material stating that “ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”\textsuperscript{181}

3. Form of Rules

In addition to these substantive points, corporate and securities law is indeterminate because of the form of the rules themselves. First, securities regulation is often promulgated through standards as opposed to bright-line rules. The conventional distinction between rules and standards is that rules are clear cut and set forth the law \textit{ex ante} whereas standards provide only general principles that judges can apply to a particular set of facts. Rules constrain judicial discretion more than standards.\textsuperscript{182} Yet standards are common in the securities area. A frequent criticism of the SEC is that it has always resisted bright-line rules to preserve flexibility in enforcement cases.\textsuperscript{183} The SEC in many cases refuses to adopt bright-line rules and instead provides factors that apply flexibly depending on the facts. In the due diligence context, for example, the Commission sought to provide guidance in Securities Act Rule 176. In doing so, however, the Commission only set out factors to be considered in a determination of whether due diligence was met.\textsuperscript{184} The rule is inconclusive, and the Commission

\textsuperscript{180} SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211) (rejecting rule that five percent is appropriate cut off for materiality); see also KARMEL, \textit{supra} note 20, at 236–38 (noting historical forces that have caused SEC to abandon quantitative materiality in favor of qualitative).
\textsuperscript{181} Basic, Inc. v. Levinson, 485 U.S. 224, 236 (1988).
\textsuperscript{182} Kamar, \textit{supra} note 169, at 1914.
\textsuperscript{183} See KARMEL, \textit{supra} note 20, at 97 (“[T]he Commission has always resisted requests for guidelines, expressing the need for flexibility and the belief that guidelines are a roadmap for fraud.”).
\textsuperscript{184} 17 C.F.R. §230.176 (2006).
explicitly left the ultimate conclusion regarding the satisfaction of due diligence to the courts.\footnote{Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, 1981 WL 31062, at *13 (Aug. 6, 1981) (“The Commission also believes that only a court can make the determination of whether a defendant’s conduct was reasonable under the circumstances of a particular offering.”).}

A second reason why the form of rules in the securities area leads to ambiguity is that litigation is rare. In many cases, rules are pronounced through settled enforcement cases, as opposed to through litigated cases or administrative rulemaking. The vast majority of SEC actions and many state law corporate cases, particularly in Delaware, are settled. A legal rule announced through a settlement necessarily lacks the level of specificity that would attend a decision after a litigated case on the merits with a fully developed record.\footnote{See KARMEL, \textit{supra} note 20, at 220 (“There are fewer clear wins or losses. More cases are disposed of and less money is spent in the disposition, but the law becomes cheapened in the process.”).} Moreover, when cases do not settle, many are decided at a preliminary stage in the proceedings where, again, the record is not fully developed. Such opinions are likely to be more indeterminate than cases decided at a later stage in the proceedings when the record is complete.\footnote{For a discussion, see Jill E. Fisch, \textit{The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters}, 68 U. CIN. L. REV. 1061, 1082–84 (2000); KARMEL, \textit{supra} note 20, at 220 (“[T]he adversary system, for all its faults, is a preferred way to ascertain facts and develop the law.”).} Finally, a settlement sidesteps the need for the government to articulate the legal theory on which the action is based and leaves potential questions about its precedential effects.\footnote{\textit{Cf.} KARMEL, \textit{supra} note 20, at 166.}

Indeterminacy has important implications for gatekeepers. Consider two examples of the kinds of decisions gatekeepers must make. First, under new SEC rules governing attorney conduct, the duty to report “up-the-ladder” is triggered when the attorney “become[s] aware of evidence of a material violation” by the issuer, and material violation is defined as “a material breach of fiduciary duty.”\footnote{Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, 68 Fed. Reg. 6296, 6296 n.7 (Feb. 6, 2003).} The attorney, therefore, must interpret what constitutes “evidence,” what constitutes a “violation” and whether the violation is “material.” Since the definition of violation includes breach of fiduciary duty, the attorney is left to determine when a fiduciary breach has occurred.\footnote{See Kim, \textit{supra} note 9, at 1049 (noting that the standard the SEC adopted for “an attorney’s reporting obligation” is “difficult to understand, interpret and apply”). For a general discussion of ambiguity in legal analysis, see HAZARD & DONDI, \textit{supra} note 16, at 159–60, 164, 230–31.} Second, in the context of public offerings, the underwriter must determine whether the registration statement “contained an untrue statement
of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."\(^{191}\) The underwriter therefore, must determine when a fact is “untrue,” whether it was “material,” or whether an omitted fact was “required” or necessary to make other statements “not misleading.” In these cases, the gatekeeper consciously or unconsciously may arrive at a conclusion acceptable to the client because of ambiguity in the law.

Finally, it is important to distinguish the \textit{ex ante} from the \textit{ex post} perspectives when assessing gatekeepers’ conduct. One could always argue that, from an \textit{ex post} perspective, gatekeepers’ actions or inactions were not appropriate because they assisted the client with an improper end. From an \textit{ex ante} perspective, a dependent gatekeeper has other values to consider. One such value is client autonomy. The legal system accommodates individual autonomy by giving significant latitude for individual decision making above a floor of clear illegality.\(^{192}\) Dependent gatekeepers have multiple considerations in deciding whether to “report up” in the organization or force an issuer to make certain disclosures. As mentioned, federal securities laws do not require disclosure of all material information; disclosure is only required if an omission renders something that was said misleading. If the attorney discovers something wrong, it must not necessarily be disclosed.\(^{193}\) It is precisely in the vagary of trying to determine whether the omission is necessary to render other information not misleading that the gatekeeper’s biases are likely to take hold.

\section*{B. Gatekeeper Reform}

\subsection*{1. Focus of Recent Reforms}

The Sarbanes-Oxley reforms and their aftermath have accounted for some of the lessons from behavioral and social psychology. Discussions on the Senate floor suggest that the Sarbanes-Oxley Congress sought to go beyond an approach of punishing individual wrongdoers. Senator Sarbanes stated:

\begin{quote}
The bad apples ought to be punished. There is no question about it. They ought to be punished severely. But it is very clear, as this issue has unfolded, that we need to make structural changes. We need to change the system so that the so-called gatekeepers are doing the job they are supposed to be doing. That has not been happening. That is why we need to remove these conflicts of interest on the part of auditors who are also consultants for the same company, collecting huge fees. And they are supposed to come in as outside auditors and be very tough on
\end{quote}

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the company, which at the same time is giving them large fees for consultancy . . . . We have to put in place a framework, a system which tightens up and begins to screen out these things.194

The new framework departs from the “command and control” model mentioned above. While one cannot force a change in attitudes, Congress and regulators attempted to make compliance a priority. Much of the emphasis in reform over the past five years has been enhancing policies and procedures to ensure compliance and getting information into the hands of the persons making decisions. The 2004 changes to the Federal Sentencing Guidelines set forth what organizations must do to have an effective compliance and ethics program. The changes respond to requirements in the Sarbanes-Oxley Act, which directed the Sentencing Commission to review and amend its guidelines to ensure they are sufficient to deter and punish criminal misconduct.195 Under the revised guidelines, company directors must be knowledgeable about the ethics program, and they must receive reports “on the effectiveness of the compliance and ethics program.”196

Similarly, according to the SEC, “Companies also must have internal communications and other procedures to ensure that important information flows to the appropriate collection and disclosure points on a timely basis.”197

In the area of mutual funds and investment advisers, the SEC now requires codes of ethics198 and compliance programs, including the appointment of a chief compliance officer.199 In adopting these rules, the SEC observed that compliance failures have occurred when service providers to a mutual fund deny information to the board or provide incomplete information because complete disclosure would harm the service providers’ own interests. Under the rules, the chief compliance officer is “responsible for keeping the board apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund’s compliance program.”200 The SEC’s lawyer rules, also mandated by Sarbanes-Oxley, were intended to enhance the likelihood that companies will act at an early stage to remedy violations internally. “By mandating up-the-ladder reporting of violations, the rule helps to ensure that evidence of material violations will be addressed and

remedied within the corporation, rather than misdirected or ‘swept under the rug.’”201 The emphasis is less on sanctioning individualized improper conduct after it occurs and more on promoting structural changes to strengthen a culture of compliance and address problems at an earlier stage.

2. Independent Gatekeepers

a. Auditors

Congress and federal regulators recognized that, in the case of auditors, the ties that bound auditors to their clients had to be severed. As Part II discussed, accountability to the client, whose views are known to the auditor, can result in an auditor redirecting his opinions to conform to the client’s views. People adopt positions that are likely to please others. By performing a significant volume of non-audit services for the audit client, the auditor had an overwhelming desire to please the client in the course of the audit itself and continue to generate non-audit business.

The SEC recognized this conflict in its own administrative rules adopted before Sarbanes-Oxley and sought to insulate the auditor from improper influence. The SEC prohibited auditors from providing certain non-audit services, such as consulting services, to audit clients because the large fees generated by such services could jeopardize the auditor’s independence.202 The Commission stated that its rules were “designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance.”203 “If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor’s opinion and will be far less likely to invest in that public company’s securities.”204 The auditor, as an independent gatekeeper, must


203. Preliminary Note, Qualifications of accountants, 17 C.F.R. § 210.2-01 (2006). The rules attempted to ameliorate bias that some argued could never be eliminated completely. Max Bazerman, for example, argued against the possibility of auditor independence because of self-serving bias. He argued that calls for independence were naïve because auditor misrepresentations occur not because of any willingness to mislead, but rather because of unconscious and unintentional bias in decision making. When auditors are called on to make independent judgments, they will act in a way that is commensurate with self interest. Max H. Bazerman, Kimberly P. Morgan & George F. Loewenstein, The Impossibility of Auditor Independence, 38 SLOAN MGMT. REV. 89, 91 (1997).

resist an advocacy role, which characterizes dependent gatekeepers, like lawyers. In evaluating independence, SEC rules state, “The Commission looks in the first instance to whether a relationship . . . places the accountant in a position of being an advocate for the audit client.”

Sarbanes-Oxley went further than the SEC’s own independence requirements and prohibited auditors from providing eight categories of non-audit services, such as bookkeeping, actuarial, investment, and legal services. Sarbanes-Oxley also included a provision placing responsibility on the audit committee, which must be composed solely of independent directors, to be “directly responsible” for the appointment, evaluation, compensation and replacement of the independent auditor for a listed company.

Understanding the difference between independent and dependent gatekeepers illuminates the auditor’s role. The auditor serves to correct the biases of managers, who are themselves dependent gatekeepers. Managers are chosen by the board to further the ends of the corporation as a profitable enterprise to the benefit of the shareholders. Bias on the part of the managers is appropriate. Unchecked, however, such bias can lead to abuse. Thus, the bias of the dependent gatekeeper is held in check by the independent gatekeeper.

Since the audit firm is compensated by the client, some argue it will always defer to the client to ensure future business. While this may be true to some degree, the requirement to report the termination of the auditor on Form 8-K reduces this risk. Moreover, this risk was far worse before the SEC’s auditor independence rules were adopted. The termination of a consulting agreement, unlike the termination of the auditor relationship, is not disclosed on Form 8-K. As a result, an issuer could quietly threaten to terminate a consulting agreement as a club to pressure the auditor to provide a clean audit. If the auditor were not performing non-audit services for the company, there would be no club. While the issuer could threaten to fire an auditor, that event is publicly disclosed and most companies resist making such a filing. The SEC’s auditor independence rules began to

205. Preliminary Note, Qualifications of accountants, 17 C.F.R. § 210.2-01.
207. Id. § 78j-1. Under section 301 of the Sarbanes-Oxley Act, only independent directors may serve on an audit committee of a listed company. Id. § 78j-1(m)(3)(A).
208. See Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,015 n.79 (noting that commenters to SEC rule argued there has always been potential for conflict of interest, since auditor is paid by client).
address this concern by limiting the non-audit services that an auditor could perform for its audit client.

One question in the wake of Sarbanes-Oxley is whether auditor independence requirements have gone too far or not far enough. Above I discussed the need, with respect to independent gatekeepers, to counter the bonding that often characterizes a fiduciary relationship. Characteristics like trust and longevity can threaten independence. The Public Company Accounting Oversight Board (“PCAOB”), using rulemaking authority in section 103 of Sarbanes-Oxley, has gone further than Congress or the SEC in some respects. Under new rules, for example, a public accounting firm is not independent if it gives tax services to certain persons, such as members of management who fill a financial reporting oversight role at an audit client. Performing such services can create the appearance of a “mutual interest between the auditor and those individuals” and impair independence.211

Should all non-audit services be banned? Sarbanes-Oxley now requires all non-audit services the auditor proposes to perform to be pre-approved by the issuer’s audit committee.212 With respect to certain tax services still permitted, the PCAOB has made the process more deliberate by requiring the auditor to play a role in seeking the audit committee’s pre-approval. The audit firm must describe to the audit committee, in writing, the nature of the services to be provided, discuss with the audit committee the effects on the auditor’s independence, and document the firm’s discussion.213

Placing additional limits on non-audit services is consistent with addressing inappropriate bonding between issuers and auditors. Moreover, this specified deliberation is consistent with Darley’s discussion of addressing the small decisions that can grow into large scale corruption. By slowing the process and requiring the audit firm to describe, in writing, the services it seeks to perform and the effects on independence, it is unlikely that a series of quick decisions will be made by either the auditor or the issuer that will impair independence, at least with respect to tax services. Requiring the auditor to play a role in the issuer’s deliberation also is consistent with the overall program of enhancing policies and procedures that focus less on individualized wrongdoing and more on instituting compliance norms at both the audit firm and the issuer.

One could consider requiring this sort of deliberative process for all non-audit services. The suggestion was put forward by certain commenters on the PCAOB’s rule, but the PCAOB determined to gather experience

213. See Ethics and Independence Rules, supra note 211, at 40–41.
with respect to tax services first.\(^\text{214}\) While gathering experience with respect to tax services is laudable, it may not be necessary if the PCAOB could obtain the information it needs from a separate request for comment. Indeed the tax services area is different from other areas of permissible non-audit services, so the PCAOB would likely have to publish a separate request for comment before applying the deliberation rule more broadly.\(^\text{215}\) Since the deliberation rule does not seem unduly burdensome and would likely have positive effects, the PCAOB may wish to consider such a request for comment at this time.

\textbf{b. Securities Analysts}

Securities analysts are subjected to new rules passed not only by Congress and the SEC, but also by state prosecutors, the self-regulatory organizations, and others—all with an eye toward ensuring independence. The concern, like in the case of auditors, was that the analysts were tied too closely with the issuers they were supposed to be researching.

Congress sought to strengthen analyst objectivity in Sarbanes-Oxley. The law required new administrative rules restricting when the broker-dealer arm of an underwriter engaging in a public offering can publish research on the security offered, and it required analysts to disclose certain conflicts.\(^\text{216}\) SEC rules now require analysts to include in a research report a certification stating that the opinions expressed in the report accurately reflect the analysts’ personal views, and that their compensation was not related to their recommendations.\(^\text{217}\) The touchstone for the SEC rule is independence. While the new rule applies to broker-dealer firms, the Commission has stated that the rule shall not apply to research performed by an affiliate of the broker-dealer with a “sufficient level of independence” from the firm. Those meeting this criteria should have “a sufficient level of independence so that pressures from the broker-dealer . . . should not compromise their research.”\(^\text{218}\)

\(^{214}\) See \textit{id}. at 42.

\(^{215}\) See \textit{id}. (stating that the PCAOB would seek additional information before expanding the rule).


\(^{217}\) If compensation is related to the recommendation, the certification must include the source, amount and purpose of the compensation, and a disclosure stating that the compensation may influence the recommendation in the report. Regulation Analyst Certification, 68 Fed. Reg. 9482 (Feb. 27, 2003).

\(^{218}\) \textit{id}. at 9484 (defining “covered person”). The technical provisions of the rule make it applicable to broker-dealers and to associated persons of broker-dealers, which include other firms controlling, controlled by, or under common control with the broker-dealer. The SEC made an exception, however, for associated persons that do not share officers or employees with the broker-dealer, and so long as the broker-dealer maintains and enforces policies and procedures to prevent the broker dealer from influencing the activities of the analysts and the content of the research. The Commission stated, “Where the broker-dealer has informational and structural
The securities analyst settlements entered into by ten large investment banking firms in 2003 contained regulatory requirements to help ensure “that research provided to investors is objective.”\footnote{219} Similarly, the New York Stock Exchange brought actions against analysts for failing to establish procedures adequate to maintain independence.\footnote{220} The Self-Regulatory Organizations (SROs), namely the NYSE and NASD also have adopted rules barring investment banking departments from supervising analysts.\footnote{221} An analyst’s compensation may not be tied to investment banking transactions, and new rules impose a 40-day cooling off period after an initial public offering before an analyst whose firm managed the offering can issue a report on the security. To guard against analysts making an overwhelming number of buy recommendations compared to sell recommendations, analysts must now disclose the distribution of buy, sell, and hold recommendations.\footnote{222} The goal of these reforms has been to promote independence.\footnote{223} In approving rules proposed by the SROs, the SEC made clear that the goal of independence has not been abandoned:

The Commission believes that the SRO proposals are designed to promote the objectivity and independence of research analysts by explicitly requiring that all research analyst written and oral communications with customers, as well as with internal firm personnel, must be fair, balanced and not misleading, considering the context of the communications. These requirements build on existing SRO standards for research analyst communications with the public and provide additional safeguards for research communications with personnel within the broker-dealer.\footnote{224}

These rules are designed to combat accountability to a known audience and enhance accuracy-based goals, discussed above. Certifying that an


\footnote{221. See NASD RULES OF THE ASSOCIATION R. 2711 (2006); see also NYSE RULES, OPERATION OF MEMBER ORGANIZATIONS R. 351 (2006); see also NYSE RULES, COMMUNICATIONS WITH THE PUBLIC R. 472.}

\footnote{222. See generally COX, HILLMAN & LANGEVOORT, supra note 88, at 145.}

\footnote{223. Fisch & Sale, supra note 36, at 1038 (“The goal of these various measures was to implement a more thorough regulatory regime to alleviate the conflict of interest problems that have plagued analyst recommendations in recent years.”)}

\footnote{224. Order to Prohibit Participation by a Research Analyst in a Road Show Related to an Investment Banking Services Transaction and to Require Certain Communications About an Investment Banking Services Transaction to be Fair, Balanced and Not Misleading, Exchange Act Release No. 51593, 85 SEC Docket 739 (Apr. 21, 2005).}
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Analyst’s opinion represents his personal views helps ensure the analyst is not accountable to a third party, such as the issuer he is researching or the investment banking arm of the firm that employs him, which, acting as securities underwriter or strategic advisor, has its own directional goals in mind.

Whether recent reforms have caused analysts to become independent once again is unknown. Evidence continues of retaliation and pressure on analysts from both company officials and institutional investors to avoid sell recommendations. Some have suggested that independent research departments will not survive because, without investment banking revenue, financial firms must pay securities analysts out of revenue obtained from trading commissions, which are not as lucrative as they once were.

In the meantime, the SEC, NASD, or others, could consider educating the public on how to interpret research calls or other information from sell-side analysts, analysts who typically work for brokerage firms and generate research for the investing public. One should recognize that sell-side analysts have little incentive to issue a “sell” recommendation. Issuers generally do not like a “sell” recommendation because it might cause the stock to decline in value. Some evidence indicates that, in many cases, if enough analysts downgrade the stock, it can cost the CEO his or her job. Similarly, most investors do not like a “sell” recommendation because they are “long” in the stock. Investors who already own shares also may not like a sell recommendation for the deeper reason that it could call into question their previous decision to buy and, as discussed, once people commit to a decision, they usually do not change their minds—even in the face of evidence to the contrary.

The rule which now requires analysts to disclose the ratio of buy-to-sell recommendations is an important start toward educating the public on how to interpret analysts’ recommendations, but additional education is needed. Sell-side analysts, for example, are generally not compensated based solely on investment performance. Buy-side firms rate, and presumably pay, sell-side analysts based on factors other than performance, including timeliness of information, responsiveness, innovation, and comprehensibility of

225. Gretchen Morgenson, Downgrade a Stock, Then Duck And Cover, N.Y. TIMES, March 12, 2006, at BU1; Nocera, supra note 41 (“[B]uy recommendations still vastly outnumber sells—and most analysts still spend far more time currying favor with companies than analyzing them.”).

226. It also is possible that the recent failure of analysts to be independent can be traced to the elimination of fixed commissions in the 1970s. After commissions were deregulated, brokerage firms could not afford to pay analysts, and they went to work instead for investment banks and underwriters, who funded their research. Healy & Palepu, supra note 39, at 80 (explaining how research costs were covered through fixed commissions). Regardless of whether such research is economical, the norm of independence is not diminished.

research reports. Additional education on some or all of these issues could be valuable to the public.

3. Dependent Gatekeepers and Lawyer Certifications

The problem of how to enhance the monitoring role of dependent gatekeepers is more intractable because of the reasons discussed in Parts I and II. Others have recognized that dependent gatekeepers play a role as advocate for a client, which is in tension with the role as gatekeeper. How does this tension arise? Because attorneys often are closely aligned with their clients in an “informal partnership” to accomplish their clients’ objectives, requiring attorneys to act as gatekeepers may place them in a situation where they are required to audit their own work. Similarly, once a client and an attorney have committed to a particular course of action, the attorney may be biased toward the client’s directional goals at the expense of accuracy and fail to put a halt to the course of action previously determined.

John Coffee has suggested that the SEC could adopt a rule requiring a securities lawyer to certify that he has reviewed the non-financial disclosure in publicly filed reports, and that the attorney believes the statements are true and he is not aware of any material omissions. Such a certification, Coffee says, is consistent with certifications required of auditors, analysts, and senior officers, and it would simply fill a void for Exchange Act filings that is currently filled by standard negative assurance letters in the case of Securities Act filings. Moreover, the certification, according to Coffee, ideally would include a statement that the attorney undertook reasonable inquiry, which would establish a due diligence obligation. While this proposal has merit, it is narrow in scope because it would be limited to the relatively small group of lawyers who are principally responsible for preparing a document or report filed with the SEC.

A more ambitious reform may be appropriate. Congress in the Sarbanes-Oxley Act was concerned about all “attorneys appearing and practicing before the Commission in any way in the representation of issuers.” This language includes a larger group of attorneys than those principally responsible for preparing a document filed with the SEC. In adopting rules under this provision, the SEC defined the scope of appearing and practicing before the Commission as: (i) transacting any business with

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229. Coffee, supra note 1, at 353.
230. See supra Part I.B.2.b.
232. Coffee, supra note 1, at 357.
233. Id. at 358.
the SEC; (ii) representing an issuer in any SEC investigation, inquiry, or request; (iii) providing securities laws advice regarding any document the attorney knows will be filed with the SEC; or (iv) advising an issuer on whether information, under the securities laws, must be filed with the SEC. Thus, the scope of the attorney conduct rules is relatively broad.

One possible solution is to marry these two approaches and require an annual certification under section 307 of Sarbanes-Oxley. Under the SEC’s rules, an attorney appearing and practicing before the SEC already is subject to a reporting requirement. Under the SEC’s rule as adopted, an attorney who “becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer . . . [must] report such evidence to the issuer’s chief legal officer . . . or to both the issuer’s chief legal officer and its chief executive officer . . . forthwith.” Thus, lawyers already have a clear obligation to make a report if they become “aware” of certain evidence. One possibility, therefore, is to require an annual certification to the SEC or the bar that a lawyer, covered by this rule, is either not aware of such evidence or has made the required report.

This proposal should entail only modest tangible costs by attorneys (although it would likely result in emotional distress). Those appearing and practicing before the SEC already must make the determinations that would be required by a certification. Under current law, an attorney who is aware of evidence of a material violation must make a report of the evidence “forthwith.” For those attorneys who spend no time considering whether a report is needed, the proposal would require some action on their part. The SEC or state bar associations would of course incur costs in processing the certifications, which would have to be received and tracked on a regular basis.

The proposal would have important salutary effects for at least four reasons. First, it would require securities lawyers, who are not yet aware of the requirements of section 307, to not only become aware, but to undertake the inquiry expected by the Act and the SEC’s rules. Second, requiring a certification would require securities lawyers to reflect on their current matters, and state of awareness, and deliberate over whether they could make the required certification or whether a “reporting up” was called for. This could be the triggering mechanism to which Darley refers when he indicates that improper decisions can be overridden by deliberate thinking if something can trigger the deliberate thinking into action. Third, the proposal would counter the biases that arise from the perils of accountability, discussed above. To the extent that the attorney is required to make a truthful, objective filing to a regulator or state bar, the attorney will

236. Id. § 205.3(b)(1) (2006).
237. Id.
238. Darley, supra note 106, at 1183.
necessarily have accuracy and not directional goals in mind. Finally, requiring a certification would mean that an attorney, who violated the rule, would make a false filing, which is qualitatively different than failing to make any filing at all. I have discussed elsewhere the difference between a wrongful act on the one hand and a wrongful omission on the other, which some call “omission bias.” The prospect of making a false filing would likely have deterrent effects absent where the harm amounted to failing to make a filing.

This proposal also is consistent with the rationale for CEO and CFO certifications required by Sarbanes-Oxley. That rationale, drawn from the 1980 requirement for certain senior officers and a majority of the board to sign the annual report, is that people are more likely to pay attention to disclosures made in a report, and to participate more closely in the preparation of a report, if they have to sign them.

CONCLUSION

Gatekeepers are not alike, and the distinction between independent and dependent gatekeepers is important to an understanding of gatekeeper behavior. Independent gatekeepers, like auditors and analysts, should critically evaluate a set of data and render an opinion for an unknown audience. Dependent gatekeepers, such as lawyers and underwriters, act on a client’s behalf providing advice and recommendations to a known audience—the client itself—in reaching its goals. Consequently, independent gatekeepers will be better monitors than dependent gatekeepers, and perform a more robust gatekeeper role. That conclusion is consistent with research in the area of social and behavioral psychology, which teaches that people’s behavior is influenced by others and that goals and motives can influence our thinking. Accountability to a known audience and commitment to a course of conduct can alter a rational evaluation of the facts. These phenomena appear more starkly in the case of dependent gatekeepers and are more likely to influence their behavior.

The differences between independent and dependent gatekeepers, and the lessons from social and behavioral psychology, help explain many of the recent reforms for gatekeepers, including auditors and analysts.

239. Arthur B. Laby, Resolving Conflicts of Duty in Fiduciary Relationships, 54 Am. U. L. Rev. 75, 130–31 (2004) (discussing reasons the common law holds an actor more responsible for an act than a failure to act); see also Vincent Di Lorenzo, Does the Law Encourage Unethical Conduct in the Securities Industry?, 11 Fordham J. Corp. & Fin. L. 765, 789 (2006) (“Omission bias, sometimes referred to as regret theory, refers to the finding that individuals regret adverse consequences stemming from their actions more than adverse consequences stemming from their inaction.”); Kim, supra note 9, at 1033–34 (explaining that “omission bias” is relevant for securities lawyers who choose not to prevent misconduct and later shift blame to others as proximate cause of harm).

Moreover, the same lessons can help with additional reforms in the case of dependent gatekeepers, such as lawyers. One tentative proposal that bears additional consideration is to require certifications to the SEC or state bar by securities lawyers stating positively that they are unaware of evidence that would necessitate a “reporting up” under the SEC’s lawyer rules. This affirmative obligation would combat the biases discussed in this paper and have other salutary effects.
THE MUTUAL FUND BOARD: A FAILED EXPERIMENT IN REGULATORY OUTSOURCING

Alan R. Palmiter∗

There is no there there.1

Mutual fund boards are a curious institution. Mandated by the Investment Company Act of 1940, they are tasked as “watchdog” supervisors of the management firms that organize, administer and market mutual funds.2 The fund board and its “independent” directors approve fund transactions with the management firm and ensure compliance with the 1940 Act and implementing SEC rules. Fund directors thus function as outsourced regulators, with their selection and compensation in the hands of the management firm they supervise.

This essay argues that the outsourcing to mutual fund boards of key regulatory functions—principally the review and approval of management contracts—has not lived up to the hopes of the 1940 Act. Fund boards have been weak and even feckless protectors of fund investors, their deficiencies exacerbated as mutual funds have grown into the leading investment vehicle for private retirement savings in the United States.

Gauged by the important metric of management fees—whose negotiation is delegated to fund boards—the experiment in regulatory outsourcing has failed. As the mutual fund industry has grown in size and scope, the fund board has shown itself to be mostly ineffective in negotiating on behalf of fund investors to realize the value from improved information technologies and growing economies of scale. Study after study finds fund expense ratios growing over a period when fund assets have exploded.

Just as significant as their poor performance in negotiating lower management fees, fund boards have also failed in their supervision of fund design and marketing. Fund boards, charged with the approval of fund mergers and dissolutions, have acquiesced in the strategy of many fund groups of creating a stable of “above average” funds by merging losers into winners. Fund groups then heavily market the resulting winners (also an activity subject to board supervision) by appealing to the “past is prologue” mentality of many fund investors. Fund boards have failed to respond to the “cognitive biases” of fund investors, a problem aggravated by the shift of

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1. GERTRUDE STEIN, EVERYBODY’S AUTOBIOGRAPHY 298–300 (1937) (describing how, after returning to California from a lecture tour, Stein sought to visit her childhood home in Oakland, but could not find the house).

retirement savings from employer-managed defined-benefit plans to employee-managed defined-contribution plans.

Why has the fund board failed? The structure of the board has hobbled its ability to function as originally envisioned. “Independent directors” are selected and nominated by the management firm, subject to a perfunctory “rubber stamp” by fund investors. The fund board is composed of part-timers who rely on the fund’s management firm for information, direction and compensation. Even if they wanted to, the fund directors cannot realistically threaten to take the fund’s business elsewhere. Negotiation on behalf of fund investors is understandably an empty ritual.

More deeply, the fund board operates without meaningful oversight. Each overseer envisioned by the 1940 Act—the SEC, federal courts and state courts—has deferred to fund directors on the hopeful assumption that oversight will come from elsewhere. Despite regular and continuing attempts by the SEC to strengthen board independence, the agency has failed to create true board independence or to give the board clear guidance. Federal courts, though called on to oversee the board’s setting of management fees, have refused to become mired in valuing management services. State courts accept the bedrock principles of the business judgment rule, thus presuming that fund directors act on an informed basis with a rational basis, in good faith, and without a conflicting personal interest.

Director professionalism, part of a relatively recent “best practices” movement in the mutual fund industry, offers some promise—but at most can only be aspirational. It does not correct the structural impediments of the fund board or create mechanisms that would oversee fund directors. Although fund directors have become more aware of their functions and responsibilities, they continue to be diffident, highly-paid actors in the face of a fund management culture that focuses on building market share, asset size, and profits. Against these odds, director professionalism has little chance.

Ultimately, the mutual fund regulatory regime places its faith in the fund investor market—despite the animating premise of the 1940 Act that disclosure-based market protection is inadequate. Recent studies make clear that fund investors continue to be inept consumers, plagued by informational and cognitive biases. Fund investors are largely ignorant of fund expenses, the relationship of expenses to fund performance, and the mixed relevance of past performance to future returns. They respond only weakly to no-load funds and low fees, and even less to changes in fees and fund risk. The dysfunctional investor market is fueled by fund marketing (approved by fund boards) that shapes and reinforces investor biases.

This essay first reviews the creation and development of mutual fund boards, examining their composition and their intended regulatory role. It considers the institutions charged with overseeing fund boards (the SEC
and courts) and the deference they have shown to fund boards. The essay then presents empirical data on the performance of fund boards drawn largely from the finance literature, data that uniformly suggest that fund boards have failed to adequately supervise fund management firms. Finally, the essay considers various proposed reforms to mutual fund governance and offers a comparison to foreign mutual funds, whose regulatory systems operate without fund boards. Imagine!

I. MUTUAL FUND BOARDS—OUTSOURCED SUPERVISOR

The board of directors is a defining feature of the corporate structure that was adopted by the U.S. mutual fund industry at its inception. The Investment Company Act of 1940 built on this edifice, giving special gatekeeper functions to the board and its “independent directors.” Over time, the SEC has delegated additional responsibilities to the fund board. Under the resulting board-centric structure, the fund board (in theory) supervises the activities of the mutual fund management firm.3 The fund board carries out its supervisory functions with minimal oversight.

A. CORPORATE STRUCTURE: FROM THE BEGINNING

Investment companies in the United States are a relatively recent phenomenon. The first was organized as a corporation in 1924. U.S. investors were more comfortable with the corporate form, with its supervisory board of directors, compared to the British model of investment trusts that had developed in the late nineteenth century.4 The corporation, unlike the trust, offered an internal supervisory mechanism to oversee the discretion of the portfolio manager. In the late 1920s investment companies flourished.

Besides supplying a supervisory board of directors, the corporate form offered other advantages. It permitted the investment company to issue various classes of securities—common and preferred stock, debentures, and mortgage bonds. This facilitated leverage for equity investors, promising them above-market returns in a booming market.5


5. The 1940 Act prohibits leverage by open-end mutual funds, both for investors and in the fund’s portfolio. See 15 U.S.C. § 80a-18(f) (2000) (prohibiting open-end funds from issuing senior (debt) securities to investors); Id. § 80a-18(f), (g) (prohibiting open-end funds from borrowing money except temporarily, but not in excess of 5% of the total fund assets, or from a bank unless subject to a 300% asset-coverage condition).
In addition, corporate law (unlike the more rigid law of trusts) permitted a wide range of self-dealing transactions—if approved by the corporation’s disinterested board of directors. The sponsor, typically a financial services firm that had brought the investment company into existence, could manage the investment portfolio and receive fees. Sponsoring investment banks could sell securities to their investment companies, often securities the banks themselves brought to market. Sponsoring securities firms could sell brokerage services, while commercial banks could lend money, to their captive investment companies.

In 1940 when Congress got around to regulating investment companies, it grafted its regulatory scheme onto the existing corporate structure and placed its faith in the fund board as a substitute for investor self-reliance. Congress noted that disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934 had not deterred “the continuous abuses in the organization and operation of investment companies.” Generally these acts provide only for publicity, but “the record is clear that publicity alone is insufficient to eliminate malpractices in investment companies.”

Having found supervision by fund boards inadequate in the 1920s, Congress oddly chose to strengthen the hand of the board. For many abuses identified by Congress—such as preferential trading by insiders, dilutive pricing of portfolio shares, exorbitant selling charges, undisclosed and unapproved changes in investment policies, unauthorized transfers to new management firms, self-dealing sales of worthless securities, borrowings by insiders without repayment, and lack of transparency on fund finances—the solution was greater board supervision.

Although the 1940 Act does not require the corporate form, the regulatory regime effectively assumes that mutual funds will be organized as (or along the lines of) a corporation. There must be a board of directors (or its equivalent) to oversee fund operations and approve contractual arrangements with the fund’s service providers. There must be shareholder voting to elect board members and approve fundamental

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8. Id.


10. Investment Company Act of 1940, in 6-83 SECURITIES LAW TECHNIQUES § 83.01 (Matthew Bender 2006).
changes. These requirements apply whether the fund is structured as a corporation or another form such as a business trust.

Outsourcing to the fund board of a supervisory/regulatory function was consistent with the general approach of the securities laws. The Securities Act of 1933 delegated supervision of public securities offerings to nongovernmental watchdogs—namely, the directors and officers of the issuer, the underwriter and the financial auditor. The Securities Exchange Act of 1934 delegated supervision of trading in public markets to self-regulated stock exchanges and the National Association of Securities Dealers. In each case, the SEC and the courts retained a significant oversight role.

Oversight of the fund board, however, is lacking in the 1940 Act. There was—and still is—no self-regulatory oversight body. The SEC is not tasked with reviewing the fund board’s ongoing approval of the fund’s management contracts and marketing arrangements. The courts, though later assigned a role to oversee management fees, have shunned the responsibility. For both the SEC and the courts, more daunting than the volume of fund transactions has been the problem of valuation of management services. The federal securities regime assiduously avoids delegating questions of value to the SEC or the courts, instead leaving them to markets. In the case of mutual funds, given the doubts about the efficiency of the investor market, the question of value was left to private negotiations between the fund board and the management firm. It was a desperate (and overly hopeful) delegation.

**B. FUND BOARDS: COMPOSITION AND SELECTION**

The 1940 Act regulates the composition and election of fund directors. A centerpiece of the 1940 Act is the requirement that at least 40 percent of the board be independent of the management firm. Beyond the statutory requirement, current SEC rules condition the use of the more important exemptions on a board composed of a majority of independent directors—creating a de facto regulatory minimum. A proposed rule, still in limbo, would increase the proportion to 75 percent and require an independent board chair.

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11. Mutual funds must adopt fundamental policies as to key investment activities—capital structure, permissible investments, investment strategies, risk-reward profile of securities issued by the fund—which can then be changed only by shareholder vote. See 15 U.S.C. §§ 80a-8(b), 80a-13(a) (2000).

12. *Id.* § 80a-10(a) (providing that at least 40% of board of directors of registered investment company must consist of individuals who are not “interested persons”).


14. See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (July 27, 2004). In June 2005, the D.C. Circuit found that the SEC had acted within its authority in adopting the governance rules, but had violated the Administrative Procedures Act by not adequately considering (1) the costs of complying with the governance
The 1940 Act dictates that shareholders elect fund directors, but only for the initial board and to fill vacancies if less than a majority of the board is shareholder-elected.\textsuperscript{15} Thus, funds operate without annual board elections.\textsuperscript{16} Independent directors must be nominated by a majority of independent directors and elected by shareholders, though vacancies can be filled by the board in the case of the death, disqualification, or bona fide resignation of an independent director where there remain sufficient shareholder-elected directors.\textsuperscript{17}

These rules have not, however, created an independent institution of fund supervisors. The definition of “interested person” makes it relatively easy to seat outside directors sympathetic to management firm interests.\textsuperscript{18} Independent directors are typically securities industry executives and professionals whose firms provide direct or indirect services to mutual funds. There are no qualification standards for fund directors.\textsuperscript{19} Compensation for service on mutual fund boards, particularly for larger mutual fund families, is typically much higher than for service on boards of rules and (2) disclosure requirements as an alternative. Chamber of Commerce v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005). After compiling a more developed record of the costs of the new rule, the SEC re-adopted it. See Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (June 30, 2005). In April 2006, the D.C. Circuit vacated the rule on the ground that the Commission had not adequately considered its cost, but withheld the issuance of the mandate for ninety days to afford the Commission an opportunity to reopen the record for comment. Chamber of Commerce v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006).

\textsuperscript{15} 15 U.S.C. § 80a-16(a) (2000) (permitting board vacancies to be filled by the board so long as at least two-thirds of the board remains shareholder-elected). The SEC has taken the position that, beyond the election of the initial board and the filling of vacancies when required by the statute, the requirement of annual meetings is generally a matter of state law. \textit{JOHN NUVEEN \& CO. INC., SEC No-Action Letter [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,383 (Nov. 18, 1986).}

\textsuperscript{16} 16. The fund must be organized in a state that does not require an annual shareholders meeting—a dispensation offered by states looking to attract mutual fund incorporation. \textit{DEL. CODE ANN. tit. 12, § 3806 (2006) (generally permitting voting practices that comply with federal rules); MD. CODE ANN., CORPS & ASS’NS § 2-501(b)(1) (2006) (same).}

\textsuperscript{17} 17. 15 U.S.C. § 80a-16(b).

\textsuperscript{18} For example, executives of brokerage firms are considered “not interested,” so long as their firm has not executed trades for the mutual fund group in the previous six months. See \textit{U.S.C.A. § 80a-2(a)(19)(A)(v), (B)(v) (West 2006).} The same six-month waiting period applies to executives of banks and other lenders to the mutual fund group. See \textit{id. § 80a-2(a)(19)(A)(vi), (B)(vi).} In addition, former officials or business associates of the management firm are considered independent after a two-year waiting period. See \textit{id. § 80a-2(a)(19)(A)(vii), (B)(vii) (permitting SEC by order to determine that executives who had a “material business or professional relationship” with the mutual fund group lack independence, but only if the relationship arose in the prior two years). See generally Larry D. Barnett, \textit{When is a Mutual Fund Director Independent? The Unexplored Role of Professional Relationships under Section 2(a)(19) of the Investment Company Act,} 4 DEPAUL BUS. & COMM. L.J. 155 (2006).

\textsuperscript{19} Chris Tobe, \textit{Mutual Fund Directors: Governance Changes Proposed for Independent Directors in the U.S.}, 8 CORP. GOVERNANCE 25, 28 (2000) (pointing out that fund experience is not a prerequisite to board service).
operating companies. Moreover, the rules on director tenure discourage new blood on the board. Thus, most fund boards are composed of industry-friendly, highly paid, long-serving directors. The lack of independence of mutual fund directors, even those who carry the label “not interested,” has long been an open secret.

When the election of directors does occur, the process is “largely ritualistic.” The management firm selects the initial board, and new directors (including independent directors) are vetted by the management firm. In the 60 years of mutual fund regulation in the United States, no director nominees have ever been presented to oppose the management slate. Fund shareholders have little choice (if they bother to vote) but to rubber stamp nominees proffered by the management firm. There is no incentive to undertake the expense of a proxy fight. Any fund shareholder dissatisfied with the management firm’s directors would have sold long before.

C. FUND BOARD: SUPERVISORY FUNCTIONS

The fund board has two essential functions: (1) negotiating and approving the contract with the management firm (thus setting the terms and price of the asset management and marketing services provided fund investors) and (2) supervising the compliance of the management firm and other service providers with the legal requirements of the 1940 Act regulatory scheme.

20. For example, the compensation of the seven independent directors of T. Rowe Price was increased for 2005 from $150,000 per year to $190,000 per year (the independent chair from $215,000 to $290,000). See T. Rowe Price Family of Funds 17 (Feb. 28, 2006), available at http://sec.gov/Archives/edgar/data/75170/00008718390600015/finalproxy06.htm.

21. Since shareholders must elect new directors only when the number of shareholder-elected directors falls below two-thirds of the board, there is a premium on long-serving incumbents and a penalty against installing new directors. See supra note 15 and accompanying text.


25. As the SEC has noted, passivity of fund shareholders is the norm. Mutual funds often find it difficult to obtain a quorum for shareholder meeting, and the voting outcome is almost always consistent with the wishes of the management firm. DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 272 n.82 (1992) [hereinafter SEC Staff Report Protecting Investors].

In each area, independent directors have a critical monitoring role. As explained in a recent report by the SEC staff on the virtues of an independent board:

[R]eliance is placed on the independent directors, rather than the Commission, to oversee any conflicts of interest in the transactions permitted by the rules and to protect the interests of fund investors.27

Ultimately, the fund board insulates the management firm from direct regulatory oversight.28 The fund board relieves the SEC (or another oversight body) from responsibility for supervising the management firm and reviewing its fee arrangements with the fund. The board legitimates the management firm as a profit-seeking business.

1. Contract Negotiation and Approval

The 1940 Act requires that the fund board annually approve the investment advisory and underwriting agreements between the fund and the management firm.29 This board is responsible for negotiating and setting the advisory fees and responsibilities of the management firm, the arrangements for buying and selling portfolio investments, and the fund’s marketing approach.

The regulatory scheme places the fee-setting responsibility on the board—rather than fund investors, the SEC or the courts. Given the “ponderous task” of evaluating fees and other costs, the regulatory scheme assumes that fund investors are incapable of valuing fund management services and the task would overwhelm the SEC.30 Over time, fund fees

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27. See U.S. Sec. & Exch. Comm’n, Exemptive Rule Amendments of 2004: The Independent Chair Condition, A Report in Accordance with the consolidated Appropriations Act 16 (Unpublished Working Paper, April 2005), available at http://sec.gov/news/studies/indchair.pdf [hereinafter SEC Staff Report on Independent Chair]. This reliance on independent directors reflects the policy decision in the 1940 Act to subject conflicts transactions in the mutual fund not to “fairness” review by an external decision-maker, such as the SEC or the courts, but rather to oversight by the relatively untested institution of outside directors. Id. at 9–11.

28. The fund board also insulates the management firm from investor litigation. Under state corporate law, shareholder derivative suits can be commenced only after the shareholder makes a demand for board action or pleads the futility of demand. Thus, the board serves as a gatekeeper for investor litigation. If an investor challenges illegal conduct by the management firm, the board (or a committee of independent directors) can conduct an investigation and make a business judgment as to the merits of the claim. See Donald C. Langevoort, Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty, 83 WASH. U. L.Q. 1017, 1026–28 (2005).


30. See Wang, supra note 3, at 988.
have become increasingly complex, with different kinds of sales charges (front-end, contingent deferred, and 12b-1 fees) and expense ratios.31

Fee setting by the fund board involves a negotiation ritual that begins with the management firm proposing fees that the board (sometimes) suggests be lowered. The management firm then accepts whatever marginally lower fees it concludes the market can bear. Take the recent fee negotiation at AIM, a large mutual fund group targeted in the market-trading scandals that came to light in 2003. To resolve charges that the fund group had allowed favored clients to skim profits from long-term investors through rapid trading in and out of funds, AIM (and its affiliated Invesco group) agreed to reduce fees charged to investors by $75 million over 5 years.32 In 2005, management proposed a fee reduction of $17 million. When independent directors demanded further cuts of $3 million, management “winced” and agreed.33 These amounts, however, pale in comparison to the $742 million in annual revenues for the fund group on $64 billion in assets under management.34

The fund board’s cabined role is not for lack of formal authority. Delegation to the management firm does not strip the board of its authority under state law to “manage and direct” the business and affairs of the fund.35 Nonetheless, the board is ill equipped and ill situated to do more. It has no independent staff to advise it on matters of investment policy, fund operations, or fund design. It has no realistic option (or threat) to hire a new investment adviser or management firm. And the regulatory structure of the 1940 Act prevents the board from undertaking radical reforms like changing the fee structure from asset-based fees to performance-based fees.36

31. There are two primary visible fees: sales charges and expense ratios. Sales charges are paid by the investor when shares are purchased (front-end load) or when shares are redeemed (contingent deferred sales load). Beyond the load, funds can charge for marketing and advertising expenses through “12b-1” distribution fees. See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16,431, 41 SEC Docket 207 (June 13, 1988) (describing legislative and administrative history leading to adoption of Rule 12b-1).

The expense ratio covers the operational services provided by the management firm—namely, investment management, administration (record-keeping and transaction services to fund investors), and operating expenses (custodial fees, taxes, legal and auditing expenses, and directors’ fees). See JOHN C. BOGLE, BOGLE ON MUTUAL FUNDS 197–201 (1994). In addition, funds pay for trading costs (brokerage fees) that are charged against fund assets. See U.S. GEN. ACCOUNTING OFFICE, GAO-03-551T, MUTUAL FUNDS: INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE 1 (2003) [hereinafter GAO Mutual Fund Fee Report].

33. Id.
34. Id.
35. See DEL. CODE ANN. tit. 8, § 141(a) (2006).
36. See generally John C. Bogle, Founder and Former Chairman of the Vanguard Group, Remarks to the Boston College Law School, Re-Mutualizing the Mutual Fund Industry—The Alpha & The Omega (Jan. 21, 2004), available at http://www.vanguard.com/bogle_site/sp20040121.html (discussing fund directors’ refusal to change the fee structure).
2. Compliance Office

The fund board also functions as a compliance office, a role outlined in the 1940 Act and enlarged significantly by SEC rules. The board is tasked with reviewing and approving specified fund practices to regulate conflicts between the fund and the management firm, and to ensure the management firm is in regulatory compliance. By the SEC’s count, the fund board is called on under the 1940 Act and its rules to review and approve fund transactions in 27 different situations, some of which are delegated to the full board, while others are delegated only to independent directors. Some compliance functions delegated to the full board include:

- valuation of portfolio securities that do not have a readily-ascertainable market price
- setting the time of day when net asset value is determined
- approval of custody contracts (annually) with members of national securities exchanges, clearing agencies, book-entry systems, and foreign custodians
- approval of the fund’s code of ethics, which must be designed to prevent fraudulent, deceptive, or manipulative practices by management firm insiders in connection with personal securities transactions.

Other compliance functions are delegated only to independent directors, on whom the SEC has “relied extensively” to exempt funds from prohibitions under the 1940 Act:

- approval of 12b-1 fees (marketing fees paid from fund assets, as opposed to loads paid by fund investors when buying and selling shares)
- approval of the fund’s auditor (which must be an independent public accountant)
- approval of securities transactions with the management firm (or its affiliates) as permitted by various SEC rules


38. See Paul G. Mahoney, Manager-Investor Conflicts in Mutual Funds, 18 J. OF ECON. PERSP. 161, 162 (2004) (describing cash flow in mutual funds and the resulting incentives facing fund managers, brokers, and other third parties and the associated conflicts of interest).


40. SEC Staff Report on Independent Chair, supra note 27, at 16.

41. In adopting Rule 12b-1 (which permits use of fund assets to defray marketing expenses), the SEC commented that “the more capable the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce the regulatory restrictions.” Bearing of Distribution Expenses by Mutual Funds, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 21 SEC Docket 324 (Oct. 28, 1980).
determination (annually) whether participation in joint liability insurance policies is in the best interests of the fund

- review and approval of fidelity bonds.

The compliance function is largely ministerial, with the board checking off items on the SEC-provided checklist. Recognizing the emptiness of the compliance function, the SEC has tried to relieve boards of some of the tedium, replacing annual review in a number of areas with board action “only when necessary.”

Compliance outsourcing to the board and independent directors, however, is not all encompassing. Certain conflict transactions cannot be approved by the board or its independent directors, but instead require SEC approval. For example, transactions with the management firm beyond those specified in the advisory agreement are prohibited unless they receive prior approval from the SEC. Authorization by the board is not enough.

In performing its compliance function, the board is under no obligation to set up internal controls and rarely acts as an investigator of management firm compliance. Not surprisingly, fund directors rarely discover compliance lapses. Instead, illegality is typically uncovered by the auditor or government regulator with the help of a whistle-blower in the management firm. For example, fund boards were largely absent in identifying or moving to correct the late-trading and market-timing scandals that shook the mutual fund industry in 2003. It was the New York

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42. See Frankel, Jurisprudence of Regulation, supra note 37, at 986 (summarizing the 1993 change, which was “intended to enhance the effectiveness of investment company boards by substituting more meaningful requirements for an annual review requirement” such as requiring “that directors make and approve changes only when necessary”).

43. See 15 U.S.C. § 80a-17(a), (b) (2000). Under § 17(a), the management firm cannot “knowingly” sell or purchase securities to or from the mutual fund, except when the fund is redeeming its own shares or selling them to its investors. Similar restrictions apply to borrowing from and lending to the mutual fund. Id. Under § 17(b), however, the management firm can apply to the SEC for an order exempting a proposed transaction. By statute, the SEC is to consider whether the proposed terms are reasonable and fair and do not involve overreaching, and whether the proposed transaction is consistent with the mutual fund’s investment policies. Id.

44. Some have speculated that board passivity is a product of the mind-numbing compliance functions entrusted to it. See, e.g., Tamar Frankel, Money Market Funds, 14 REV. SEC. REG. 913, 915 n.18 (1981) (suggesting that increased compliance tasks and fees paid by fund advisors causes directors to become more susceptible to control by the management firm).


46. See Paul E. Kanjorski, Congressman, Remarks during House Hearing, Mutual Funds: Who’s Looking Out for Investors? 109, 127 (Nov. 6, 2003), available at http://commdocs.house.gov/committees/bank/hba92982.000/hba92982_1.htm (“[W]e really do not have inside capacity to understand what these organizations are doing until a whistleblower comes forward or until an extreme situation occurs where we focus a great deal of light on the subject.”).

47. Mercer E. Bullard, Comments on Martin Lybecker’s Enhanced Corporate Governance, 83 WASH. U. L.Q. 1095, 1098–1101 (2005) [hereinafter Bullard, Comments on Corporate Governance]. “[M]utual fund scandal was the best evidence that in practice [independent directors] are not effective watchdogs.” Id. at 1102–03.
Attorney General, followed by the SEC, who investigated and exposed most of the illegal and fraudulent practices.\textsuperscript{48}

The attitude of management firms toward the compliance function is captured by a vignette told by Professor Tamar Frankel:

It was rumored that Securities and Exchange Commission’s examiners would form monitoring groups. These groups would sit at the offices of large mutual fund Managers, and supervise their operations, the way FDIC agents sit at large bank offices. Asked for a reaction to this action, I was told in confidence how a senior Manager in one large fund complex reacted. He said something like: “That is sheer waste of money. No one would speak to these monitors and they will be put in a box and forgotten.” I was astounded. Here was a golden opportunity to gain the best guarantee of honesty at no cost. It was an opportunity to show the world and the regulators that this fund complex had nothing to hide. I expected the Managers to receive the government monitors with open arms, show them around, and offer them a comfortable office from which to supervise and hopefully report and advertise the fund complex’s compliance with the law. This Manager did not expect the investors to value trust.\textsuperscript{49}

The SEC has implicitly acknowledged the inadequacies of the fund board in its compliance function. In the rules responding to the late-trading and market-timing scandals of 2003, the SEC required management firms to appoint a compliance officer with significant authority and direct access to the fund board.\textsuperscript{50} The SEC stated the hope that these internal compliance officers would serve as whistle-blowers and alert the SEC to non-compliance by recalcitrant management firms. The implicit doubts about the fund board could not have been more obvious.

\textbf{D. DIRECTORS’ DUTIES: EXTERNAL OVERSIGHT}

The fund board performs its supervisory and compliance functions with only minimal external oversight. The 1940 Act gives the SEC only limited authority, and fund investors even less, to challenge fund directors in federal court. Federal courts, consistent with the apparent intent of the legislation, have shunned meaningful review of board activities, particularly with respect to the setting of management fees. Instead, the 1940 Act

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\textsuperscript{48} Mercer Bullard, \textit{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) (noting that the scandals resulted in dozens of civil and criminal prosecutions and billions in monetary sanctions). Mutual fund scandals revolved around fund practices that allowed favored institutional traders to engage in fund arbitrage, which involves buying fund shares at a discount and redeeming them once the price has been corrected, with profits coming from other fund shareholders. \textit{Id.} at 1285.

\textsuperscript{49} Frankel, \textit{Jurisprudence of Regulation}, supra note 37, at 956.

The Mutual Fund Board

assumes that directors will be accountable as a matter of state fiduciary law and directorial professionalism. State courts have deferred to fund boards under the business judgment rule and state procedural rules on pre-suit demand. A fledgling movement for more professionalism on fund boards offers some hope, but is constrained by the structural weaknesses of the fund board—and ultimately carries no legal weight.

1. SEC Oversight

The SEC has been diffident in its oversight of the fund board.\(^{51}\) Besides regular (mostly hollow) calls for greater board independence and authority, the SEC has done little to make fund governance more responsive to investor needs. The SEC has not armed directors with the information and other resources to effectively bargain on behalf of fund investors.\(^{52}\) The SEC has not brought enforcement actions against fund directors for nonfeasance in negotiating fund fees or controlling excesses in fund marketing.\(^{53}\) The SEC has neither sued management firms to challenge their fees nor filed amicus briefs in support of investor litigation making such charges.\(^{54}\) In short, the SEC has stood by the design of the 1940 Act regime to outsource regulatory supervision of the management firm to the fund board.

The SEC’s recent efforts to increase board independence,\(^{55}\) far from introducing major reforms in board governance, largely codify existing industry practices:

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\(^{51}\) Tobe, supra note 19, at 27 (“‘[F]und directors have done an outstanding job.’” (quoting SEC Commissioner Steven Wallman)).

\(^{52}\) For example, the SEC does not require that management firms disclose their profits to their fund boards. See John P. Freeman & Stewart L. Brown, Mutual Fund Advisory Fees: the Cost of Conflicts of Interest, 26 J. CORP. L. 609, 656–58 (2001) (itemizing SEC inaction).

\(^{53}\) Under § 36(a) of the 1940 Act, the SEC has (limited) authority to seek injunctive action against fund directors for the “breach of fiduciary duty involving personal misconduct.” 15 U.S.C. § 80a-35(a) (2000) (originally enacted as Act of Aug. 22, 1940, ch. 686, Title I, § 36) (action in federal court against any person who “serves or acts” for a registered investment company). Section 36 of the 1940 Act is hereinafter cited as 15 U.S.C. § 80a-35. Under § 36(b) of the 1940 Act, the SEC (along with fund investors) can also sue fund directors and the management firm “for breach of fiduciary duty in respect of [management] compensation.” Id. § 80a-35(b). In addition, the SEC could also sue fund directors to enjoin the “violation of any provision of this title, or of any rule, regulation, or order hereunder.” Id. § 80a-41(d) (Supp. II 2002).

\(^{54}\) Freeman & Brown, supra note 52, at 656.

\(^{55}\) In 2001 the SEC conditioned its ten most commonly used exemptive rules on a board composed of a majority of outside directors. Role of Independent Directors of Investment Companies, Securities Act No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001). The rule also required that funds disclose the fund shares held by directors, including independent directors. In 2004 the SEC sought to increase the proportion of disinterested directors to 75% and add a requirement that the board chair be a disinterested director. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (July 27, 2004). The rule also would enable disinterested directors to hire their own staff and lawyers, and to caucus among themselves.
The rule [mandating a majority of independent directors] will accomplish little. The board majority requirement is nothing but a warmed-over rehash of an SEC Investment Management Division proposal advanced eight years ago. Worse it is beside the point. Today, many, if not most, funds have a majority of directors who are supposed to be independent of the external advisor to keep fees and expenses in line. In many cases, funds’ independent directors already populate funds’ nominating committees [since funds with Rule 12b-1 plans must have self-nominating independent directors].\(^{56}\)

The SEC has also turned its attention to improving disclosure to fund investors. Since 1988, the SEC has required that mutual fund prospectuses include a fee table showing fund fees and charges as a percentage of net assets.\(^{57}\) In 2004, the SEC required that funds disclose in tabular form (in their semi-annual and annual reports) the cost in dollars of an investment of $1,000 that earned the fund’s actual return and incurred the fund’s actual expenses during that fiscal period.\(^{58}\) Funds must also explain the types of costs charged to the fund, not just provide an operating expense ratio—though the SEC does not require a break-down of different fees and operating expenses.

The SEC, however, has rejected individualized disclosure in account statements of actual expenses paid by investors—disclosure strongly recommended in a 2004 GAO report on fee transparency.\(^{59}\) The GAO asserted “seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund’s expenses to those of other funds and make more informed investment decisions on this basis.”\(^{60}\) The SEC concluded such disclosure would not show fees at comparable funds and was concerned about costs for

\(^{56}\) Freeman & Brown, supra note 52, at 657–58. In addition, the use of outside counsel is widespread, given the encouragement of the practice by federal courts. See Tannenbaum v. Zeller, 552 F.2d 402, 428 (2d Cir. 1977) (recommending that independent directors receive advice from independent counsel, rather than counsel for the management firm).


\(^{60}\) Id. at 8.
assembling the information when investor accounts are held by financial intermediaries, such as brokers and financial advisers.61

While the SEC showed concern about costs, absent from its releases on enhanced fee disclosure is “how investors can, in light of the newly disclosed information, proceed to the next step . . . whether their interests are best served by doing some comparative shopping.”62 Without “processable” information that can be understood and used, the benefits of disclosure are wasted. As Professors Cox and Payne argue:

Learning that your expense ratio is 1.29% is helpful but more so if this number can easily be placed in context. What investors wish to know is how this expense ratio compares with comparable investment opportunities. Learning that you rate a nine on a scale of ten in a competition is much more informative than to receive a numerical score when the boundaries of the scale are unknown. Thus, much like unit pricing information for grocery products, providing operating expense and return disclosures in a truly comparative framework is much more likely to elicit an informed choice on the part of investors than if operating expenses or return disclosures are made in isolation.63

Of course, this makes sense. But the SEC (like the fund boards it oversees) seems more concerned with industry sensibilities than protection of fund investors. True regulatory reform to empower fund investors (and endanger industry profitability) remains off the table.

2. Federal Judicial Oversight

The 1940 Act does not create a comprehensive system of fiduciary duties and gives federal courts only narrow authority to oversee fund boards.64 In the one area where the 1940 Act explicitly permits fund

61. See SEC Fund Expense Adopting Release, supra note 58, at 89,253 (relying on a 2000 industry estimate that individualized disclosure would entail on-going costs of $65 million while the procedures adopted by the SEC would entail costs of $16 million annually).


63. Id. at 935–36.

64. The 1940 Act carefully cabins federal judicial review of fund boards. Section 36(a) permits the SEC (but not explicitly fund investors) to bring actions challenging “a breach of fiduciary duty involving personal misconduct” by fund directors. 15 U.S.C. § 80a-35(a) (2000). Section 36(b) authorizes the SEC and fund investors to sue the management firm and fund board with respect to compensation paid the management firm, which is deemed to have federal fiduciary duties with respect to the compensation. Id. § 80a-35(b). Congress, however, deftly avoided defining the standards of “reasonableness” for reviewing management compensation. See Cox & Payne, supra note 62, at 922–23 (citing INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. No. 91-184 (1969); INVESTMENT COMPANY AMENDMENTS OF 1970, H.R. REP. No. 91-1382 (1970)).

The § 36(b) action, although procedurally a derivative suit, is not subject to a demand requirement. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 527 (1984). Nonetheless, it is burdened by a host of impediments: (1) plaintiffs are not entitled to a jury trial; (2) plaintiffs have the burden of proof, reversing the usual common law burden on self-dealing fiduciaries to prove fairness; (3) damages are limited to the year before the action was instituted; (4) damages are
investors to seek judicial review—the compensation of the fund’s management firm—the federal courts have refused to involve themselves in valuing management services and effectively shunned an oversight role.65

Under the articulated standard, management compensation fails review only if it is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”66 This means that fee comparisons become largely irrelevant and that fund directors need not bargain for the least expensive investment advisory services for the fund. Fee comparisons are left to fund investors.67

Federal courts reviewing allegations of excessive fees have focused on director qualifications and the board’s fee-setting process.68 Fund directors who meet the statutory standards of independence need only show they followed a prescribed script: frequent meetings (some without representatives of the management firm), fulsome information (including presentations, documents, and legal advice from separate counsel), and documentation of their efforts (negotiation position and strategy, and evaluation of data).69

In a critique of federal judicial review under the 1940 Act, Professors Freeman and Brown point out the consistent reluctance of federal courts to engage in any comparative fee valuation:

Post-Gartenberg courts have improperly denied the relevance of advisory fee structures actually set by arm’s-length bargaining (as in the pension fund advisory fee analogy). Low-cost fee structures charged by other funds (like Vanguard’s) are likewise found essentially irrelevant, if for no other reason than the fact that, because fund advisors refuse to compete against each other for advisory business, lower prices are not available to the fund. . . . The absence of a competitive market has not become a

limited to those resulting from the fiduciary breach, thus preventing punitive damages; and (5) federal courts have exclusive jurisdiction. See Freeman & Brown, supra note 52, at 642.


66. Id.

67. During the hearings on the 1940 Act, the Chief Counsel of the SEC testified, “There is not a single provision in section 15 [requiring board approval of the management firm’s advisory and underwriting agreements] which even remotely assumes to fix what [the management firm] should be paid as compensation. We feel that is a question for the stockholders to decide.” Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Section).

68. Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), aff’d 875 F.2d 404 (2d Cir. 1989) (rejecting contentions that § 36(b) of the 1940 Act requires fund directors to negotiate the “best deal” possible and that excessive profitability alone proves a breach of duty).

reason for enhanced scrutiny, but a justification for fitting the judiciary with blinders.\(^70\)

Not surprisingly, fund boards (and their management firm sponsors) have a perfect record in more than twenty years of litigation challenging fund fees. No management firm, much less a fund director, has been assessed damages in a case alleging excessive fees.\(^71\) Although some cases have been settled, with payments coming from the management firm or fund-paid D&O insurance, the settlements only reinforce the prevailing view that fund directors are not subject to meaningful federal judicial oversight. The courts have declared the question of “value” to be intractable, and left it to the professional judgment of fund directors—and the marketplace.\(^72\)

Recent attempts to open other avenues of federal judicial review have fallen on deaf ears. Federal courts have refused to imply private actions for the “breach of fiduciary duty involving personal misconduct.”\(^73\) Leaving no doubt that the door is closed, some lower courts have explained that even if a private action could be implied it would not cover board nonfeasance that did not involve self-dealing or bad faith.\(^74\)

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\(^70\) Freeman & Brown, supra note 52, at 651.
\(^71\) Id. at 642 n.116.


The Committee wishes to make plain that it expects the courts to imply private rights of action under this legislation, where the plaintiff falls within the class of persons protected by the statutory provisions in question. . . . In appropriate instances, for example, breaches of fiduciary duty involving personal misconduct should be remedied under Section 36(a) of the Investment Company Act.

Id.

\(^74\) See Davis, 2005 U.S. Dist. LEXIS 38204, at *15 n.1 (stating that even if § 36(a) authorized private actions, it would not reach a claim for nonfeasance—namely, the failure of mutual funds to collect settlement moneys in securities fraud class actions—since the section only reached “personal misconduct”).
Federal courts asked to imply greater federal judicial oversight have pointed to the availability of SEC enforcement and the existing judicial review of advisory fees as foreclosing broader judicial intervention. The Supreme Court has given its blessing to this judicial state of affairs, regularly and uniformly denying review of lower court decisions that deny review of fund boards. It seems the Court believes its “watchdog” rhetoric.

3. State Judicial Oversight

State courts, responsible for enforcing state-based fiduciary duties, have adopted an even more deferential approach than their federal counterparts. Imposing a demand requirement on investor derivative suits, state courts have refused to even hear cases of board nonfeasance. Plaintiffs bear the nearly insuperable burden of showing that a majority of the board—and thus some of the independent directors—have personal conflicts that would prevent them from deciding a shareholder demand in good faith.

Otherwise, the fund board receives the benefit of the doubt under the business judgment rule. Since independent directors, by definition, do not have direct financial interests in management fees, the chances of overcoming the business judgment presumption are close to nil. Absent a showing of payola (beyond regular board compensation) or other corrupt behavior, state law effectively disavows fiduciary review of mutual fund activities.

The faith generally placed in independent directors under corporate law rests on justifications that are inapposite to the mutual fund. In the corporate context, efficient capital markets price corporate governance and react to

Some have pointed out the inconsistency of this cautious judicial attitude and the 1940 Act policy of protecting fund investors. See William K. Sjostrom, Tapping the Reservoir: Mutual Fund Litigation under Section 36(a) of the Investment Company Act of 1940, 54 KANSAS L. REV. 251, 278–82 (2006) (arguing for broad interpretation of “personal conduct” beyond self-dealing and personal impropriety, to encompass any board decision not made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the fund).

75. See Gabinet & Gowen, supra note 73, at 58–59.


77. See Werbowsky v. Collomb, 766 A.2d 123, 144 (Md. 2001) (dismissing derivative litigation unless plaintiff can show that “majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule”). The standard is the same whether the question is demand futility or board termination of derivative litigation. See Langevoort, supra note 28, at 1029.

78. Werbowsky, 766 A.2d at 144.

79. Navellier v. Sletten, 262 F.3d 923 (9th Cir. 2001) (affirming jury finding that fund trustees had not violated their fiduciary duties in terminating the investment advisory contract).
board governance failures; executive compensation is tied to stock performance and aligns management interests with those of shareholders; institutional investors can use (or threaten to use) their voting rights; and markets in corporate control serve as a backstop if the other mechanisms fail. Although each mechanism has shortcomings, they nonetheless have served to justify a judicial attitude of abstention.

None of the justifications for judicial abstention, however, applies in the mutual fund context. Mutual funds do not operate in efficient markets in which investors price the value of fund management services. Management compensation is based on asset size and directors are paid in cash, thus compensation for neither is linked (given the dysfunctional investor market) to the value of the services provided. Since institutional investors purchase their management services independently of retail investors, they do not modulate pricing of retail fund services. Other intermediaries, such as Morningstar and the financial press, have not been effective in informing investors and valuing fund management services. To the contrary, they have exacerbated investor biases. And no control market exists for mutual funds, since any change of management firms would require board approval or a shareholder insurgency.

4. Professional Oversight

Fund directors have lately been viewed as a professional corps—with special professional, though largely aspirational, responsibilities. The mutual fund industry has promoted this view.

Proposals for fund governance reform have come from various quarters, most tellingly, the industry itself. For example, in 1999 an ICI advisory group recommended:

1) at least two-thirds of each fund board be independent directors, and independent directors designate one of their own as “lead” independent director;

2) former officials of the management firm or its affiliates not serve as independent directors, independent directors be selected and nominated by incumbent independent directors, independent directors complete an annual questionnaire on their business, financial and family relationships with the management firm and other service providers, and fund boards adopt policies on retirement of directors;

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81. As Professor Langevoort points out: “Thinking about mutual funds by imagining them simply as a species of ‘corporations’ in a way that is directly informed by contemporary corporate law theory is completely misguided.” Langevoort, supra note 28, at 1032.
3) independent directors establish director compensation, fund directors invest in funds on whose boards they serve, and fund boards obtain D&O insurance and/or indemnification from the fund “to ensure the independence and effectiveness of independent directors;”

4) independent directors meet separately from management when considering the fund’s advisory and underwriting contracts, and independent directors have qualified independent counsel and have express authority to consult with the fund’s independent auditors or other experts, as appropriate;

5) fund boards establish an audit committee (composed entirely of independent directors) that would supervise the fund’s independent auditors; and

6) fund directors evaluate periodically the board’s effectiveness, new fund directors receive appropriate orientation, and all fund directors keep abreast of industry and regulatory developments. 82

Many of the “best practices” proposals, however, simply call for conduct that is already the industry norm. 83 For example, many fund groups have moved on their own to increase the proportion of independent directors on their boards. The SEC estimates that at least 60% of fund boards meet the 75% independent-directors threshold. 84 The shift to independent chairs has been even more pronounced, with 43% of fund boards led by an independent chair, up from less than 20% only a few years ago. 85

Has the director professionalism movement borne fruit? The industry says yes. For example, in 2005 fees were reduced on 808 mutual funds, while they rose on 263 funds. In comparison, fees rose on 417 funds and fell on 367 in 2003. 86 But the net 545 funds that reduced fees in 2005 represent less than 10% of the 8000-fund industry.

Ultimately, gains in independent board membership and more active negotiation of fund fees do not change the essential dynamic of mutual fund governance. Fund boards can negotiate only at the margin. The threat to buy fund services elsewhere, always present in a real negotiation, is mostly empty (sometimes even ludicrous) in a negotiation of fund fees or other terms of the management contract. Moreover, the composition of fund boards with executives sympathetic to the profit motives of the


83. See Freeman & Brown, supra note 52, at 659 n.221.


85. Id.

86. Id. at R1 (reporting data from Lipper, Inc.).
management firm, cemented by the high levels of compensation for many fund directors, is hardly a harbinger of reform. For example, the $3 million in fee reductions wrangled by the AIM board in 2005 came at a not insignificant cost. In 2005, the AIM independent trustees received total pay, including deferred retirement benefits, of approximately $4.4 million, with the independent chair receiving $359,000 for his board service.

II. EVALUATION OF OUTSOURCING

Has outsourcing to the mutual fund board worked? The mutual fund industry has argued that mutual fund boards, and the funds they supervise, operate in a “vigorous and highly competitive” market. But many outside the industry, including the SEC, have questioned the power of the market and the effectiveness of fund boards in supervising management firms—primarily as relates to fees and costs. More recently, some have also pointed to the failure of the board in reining in aggressive and misguided marketing practices devised by management firms that prey on investor cognitive biases.

Consider the assumptions that undergird the regulatory outsourcing to mutual fund boards and the evidence of how that outsourcing has worked.

A. DEBATE OVER THE FUND BOARD

Oversight of mutual fund boards is built on certain hopeful assumptions. The fund industry regularly trumpets its efficiency and the market pressure that fund investors can wield. To the extent there are market inefficiencies, the SEC has sought to empower the fund board by reforming the rules governing fund board composition. Thus, courts reviewing the performance of fund boards have been inclined to use the same standards of deferential review applied to corporate boards, on the assumptions that market discipline by investors and regulatory oversight by the SEC make judicial intervention unnecessary.

1. Market Efficiency

At first glance, the mutual fund industry shows the classic hallmarks of market competitiveness. The supply side of the market has low barriers to entry and has shown great fluidity, with small funds regularly displacing

87. Id. at R4.
larger funds. The demand side is characterized by potent information and liquidity rights that allow fund investors easily to ascertain fund performance and to redeem their shares and move to better-performing or lower-cost funds.

The industry’s argument for market efficiency, repeated by some finance theorists, has superficial appeal. SEC disclosure rules arm investors with extensive information about fund investment policies, returns, management fees, and other costs. And for those investors unwilling to wade through the disclosure documents, information intermediaries (such as Morningstar, newsletters, financial press) provide “extensive coverage and analysis of mutual funds.” The asset-based compensation structure, which allows the management firm to share in superior investment results as the asset base increases, provides incentives to both attract and retain fund investors.

The industry, until the late-trading and market-timing stories broke in 2003, regularly trumpeted its mostly scandal-free record. By all appearances, portfolio securities seemed to be in safe hands and management firms (under the watchful eye of majority-independent boards) complied with the rules of the game—multitudinous and ample as they are.

Ultimately, the proof is in the pudding. The record of mutual fund fees, expenses, portfolio turnover, investment strategies, fund design, and marketing has received a good deal of attention in the finance literature. The picture that emerges (described below) is not flattering for the industry. At almost every level, it seems that fund management firms have been systematically taking advantage of the informational and cognitive deficiencies of fund investors. Market efficiency, plausible in theory, seems not to have functioned in practice.

91. William J. Baumol, Stephen M. Goldfeld, Lilli A. Gordon & Michael F. Koehn, The Economics of Mutual Fund Markets: Competition Versus Regulation 117 (Karl Brunner & Paul W. MacAvoy eds., 1990) (finding that under the Justice Department’s antitrust guidelines, mutual fund advisers compete in an unconcentrated market, with the 30 largest complexes experiencing a declining market share, and new smaller entrants taking market shares from larger rivals).


95. Wang, supra note 3, at 965–66.
2. Structural Critique

The SEC, on a regular basis, has questioned the structural effectiveness of the board and, specifically, its independent members. The SEC’s solution to the fund board’s perceived weaknesses has been to strengthen the board’s structural independence and authority.

Most recently, the SEC has proposed rules that would effectively require that the board be composed of 75 percent independent directors and that the board chair be an independent director. The SEC proposal, which has met judicial resistance, reflects the long-standing regulatory belief (even faith) in the ability of independent directors to serve the interests of fund investors unable themselves to discipline wayward or faithless fund management.

Observers have long noted the structural bias inherent in the fund board, given the method by which non-management directors are selected and their professional and personal ties of directors to the management firm.

In a recent study of fees charged by mutual funds, Professors Freeman and Brown concluded:

Scholarly articles published by finance academics have ridiculed board-approved 12b-1 fees paid by fund shareholders. Law review commentators offer uncomplimentary evaluations of those who control fund management and policies. The SEC has weighed in, questioning “whether changes are needed in the current system.” Another federal agency, the General Accounting Office, recently issued a detailed report finding that mutual funds generally do not attempt to compete on the basis of costs (i.e., price competition is muted). . . . [D]ecades of SEC-commissioned studies, rule-making, and jawboning have led to a system that, for the most part, works

96. SEC Staff Report Protecting Investors, supra note 25, at 266 (examining existing governance model to increase board effectiveness, and concluding that board governance is “fundamentally sound”).

97. See SEC REPORT ON PUBLIC POLICY IMPLICATION OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966) (finding inadequate the independence standard under the 1940 Act, since independent directors are often close to the adviser through business or family relationships). In response, Congress amended the 1940 Act in 1970 to tighten the standards of independence and to permit fund investors to seek judicial review of management compensation. 15 U.S.C.A. § 80a-2(a)(19) (West 2006) (defining “interested person”); id. § 80a-35(b) (providing a private action to remedy fiduciary breaches involving fees paid management firm).

98. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004). Curiously, the SEC has stated that its rule mandating an independent board chair was not adopted “as a means of enhancing fund financial performance or reducing fund expenses.” SEC Staff Report on Independent Chair, supra note 27, at 2. Instead, the change was said to improve compliance and ensure fund boards focus on the long-term interests of fund investors. Id. One is left to wonder why improved compliance and an investor focus should not produce financial results.

99. See Brudney, supra note 45, at 612.
beautifully for those who sell funds to the public, or sell services to funds, but much less admirably for the industry’s investors.  

In the end, fund directors may perceive their role as supercilious. Fund investors receive disclosure, have available comparative information, and can move their mutual fund investments as they choose. On the assumption of consumer sovereignty, the board is at most a bureaucratic compliance office.

3. Doctrinal Critique

More recently, academic commentators have identified the doctrinal deference to fund boards, even when composed by a majority of independent directors. They have criticized the judicial approach of federal courts (which defer to state law on questions of board demand and termination of investor suits) and state courts (which defer to independent directors under the business judgment rule).

The transliteration of traditional corporate governance norms to the mutual fund context is simplistic—and misplaced. Unlike their counterparts in operating companies, fund directors are not subject to the threat of shareholder insurgencies or takeover pressures; they lack the realistic power to replace fund management; and they generally rely on the management firm for information, direction, and compensation. And the linking of compensation to performance—as with stock-based compensation in operating companies or performance-based compensation in hedge funds—is diluted by the asset-based compensation in mutual funds.

The doctrinal gap, rather than narrowing, has been widening. Recently, courts have largely sidestepped the wave of investor litigation arising from the spate of late-trading and marketing-timing scandals. Federal courts have refused to imply federal fiduciary duties, and state courts have refused to relieve investors of the board demand and termination procedures of state corporate law.

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100. Freeman & Brown, supra note 52, at 611–13 (citations omitted).
101. See Langevoort, supra note 28, at 1017–18.
102. Federal judicial abstention in this area is not new. In a line of Supreme Court cases on whether fund boards are bound by federal law or state law, the resounding answer has been in favor of state law. See Burks v. Lasker, 441 U.S. 471, 472 (1979) (finding that state law governs termination of derivative suit, unless inconsistent with policies of 1940 Act); see generally Kamen v. Kemper Fin. Servs. Inc., 500 U.S. 90 (1991) (finding that state law controls question of board demand). Only when there is clear federal policy, such as the express private action under § 36(b) to overcome the perceived inability of independent directors to control overreaching management, does federal law control. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 527 (1984) (finding no demand requirement under § 36(b)).

Even if the federal courts were to expand their currently cabined view of implied private actions under the 1940 Act, fund investors would face the daunting challenge of bringing derivative claims in the face of board demand and dismissal tools available under state law—primarily, Delaware and Maryland where most mutual funds are organized. See Scalisi v. Fund Asset Management L.P., 380 F.3d 133, 142 (2d Cir. 2004) (applying Maryland’s approach that
Summarizing the sad state of the fund board, Professor Wang in a comprehensive article on the board-centric structure of U.S. mutual funds concluded:

To evaluate the institutional competence of the board, it is essential to inquire into the board’s independence and informational advantage. . . . Because directors are not truly independent, they are vulnerable to coalition politics. In addition, because directors have a limited informational advantage over investors, it may not be realistic to expect them to strike the best deals for investors. In this respect, traditional monitoring devices such as fiduciary duties and incentive-compatible contracts are not effective devices to discipline the performance of the board.103

B. EMPIRICAL DATA ON MUTUAL FUND MARKETS

How has the mutual fund market performed? Rather than consider the structural and doctrinal effectiveness of the fund board, the more relevant question is how fund directors have measurably fulfilled their role as “watchdogs” for fund investors. Viewing fund governance as a black box, the question is how well fund boards have performed their functions.

Even if fund governance (the supply market) is not working, it is possible that fund investors (the demand market) have exercised their informational and liquidity rights to protect themselves. Again, the question is whether fund investors have exercised their buy/sell rights to demand good performance at low cost. The rich finance literature on the functioning of the mutual fund markets over the past several years provides some answers. The studies reveal a largely dysfunctional supply market with fund boards performing poorly nearly all the tasks assigned to them.104 The same is true for the demand market, where fund investors by and large possess neither the information nor acumen to protect themselves. Although some recent data suggest greater consumerism among fund investors, the change appears to be at the margin.

1. Board Performance

Academic studies tell a consistent and disturbing story of the failure of fund boards to negotiate lower fees in the face of economies of scale generated by rising fund assets and enhanced computer and tele-

demand and termination by independent directors is subject to review under the business judgment rule).

103. Wang, supra note 3, at 1008.

104. To date, no studies look at the performance of fund boards in supervising late-trading and market-timing practices. The brazen nature of the practices in some fund families raises questions about the effectiveness of fund boards at this, their most basic, task. Nonetheless, whether because of board pressure or management firm response to the SEC’s and Attorney Elliot Spitzer’s enforcement actions, there is reason to believe the industry has responded to ameliorate the practices.
communications technologies. After reviewing some of the academic literature, the General Accounting Office (GAO) concluded that fund boards “may be keeping fees at higher levels because of [a] focus on maintaining fees within the range of other funds.”

Fund boards have also failed investors in the supervision and approval of marketing by management firms. The studies surveyed by the GAO found that “the information currently provided does not sufficiently make investors aware of the level of fees they pay.” As one study concluded, perhaps kindly, “funds do not compete primarily on the basis of their operating expense fees.” Instead, funds seem to compete on the basis of marketing—with advertisement focused on recent performance results.

**Board hiring/retention of management firm**

- Business connections between fund directors and advisory firms affect hiring, compensation, and performance. Fund boards preferentially hire advisory firms having more business relationships with fund directors. Fund advisors receive higher pay when more connected to the fund directors. Preferential hiring and pay is not compensated by higher performance. In fact, greater connections correspond to a decrease in fund return, before and after advisory fees, of about 1% per year.

**Board negotiation of advisory contracts and fees**

- Expense ratios have risen, even as fund assets have grown and fund management has become more efficient. Weighted average expense ratios for all mutual funds (stock and bond funds) rose from 0.73% in 1979 to 0.94% in 1999—a nearly 30% increase. Weighted average expense ratios for equity funds grew from 0.64% in 1980 to 0.92% in 2004—an increase of more than 40%—even as equity fund assets rose from $45 billion to $4,034 billion.

- Negotiation of advisory contracts appears to be perfunctory. Contractual renegotiations are “rare event[s]” that happen in only 10%

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106. Id. at 7, 76 (“[A]cademic researchers [and others] saw problems with the fee disclosures” by mutual funds).

107. Id. at 62.


109. SEC Division of Investment Management: Report on Mutual Fund Fees and Expenses 20 Table 2 (2000), http://www.sec.gov/news/studies/feestudy.htm. The report determined that the increase in average expense ratios was primarily due to greater use of 12b-1 fees to pay for fund distribution costs. Id. at 21.

110. Bogle, supra note 90, at 155 Box 7.2 (finding that unweighted expense ratios have risen even faster than weighted expense ratios, from 0.94% in 1980 to 1.56% in 2004).
of funds. When they do happen, they produce lower fees for bottom and mid-performing funds that correlate to later positive performance, as well as net inflows. It is “puzzling” that fund boards do not actively renegotiate advisory contracts, given the apparent benefits.

- Fund boards accept higher expense ratios for high-performance funds. Although overall management fees decline somewhat as fund size increases, administrative costs decline more rapidly. That is, advisory fees constitute a profit center for management firms.

- Advisory fees charged mutual funds are not competitive with advisory fees charged pension funds. Advisory fee ratios for public pension clients are roughly half of that for comparable actively managed equity mutual funds—even though the average such mutual fund has assets that are nearly three times larger than the average pension portfolio. On a size-standardized basis, the average actively managed mutual fund pays advisory fees of 0.67%, compared to 0.28% paid by pension portfolios.

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113. Jerold B. Warner & Joanna Shuang Wu, Changes in Mutual Fund Advisory Contracts 2 (Simon Graduate School of Business Administration, Working Paper No. FR 05-14, 2005), http://ssrn.com/abstract=841565 (“[H]igh asset growth increases the likelihood of a contract change.”). Advisory “contract changes often shift the percentage fee up or down by more than a fourth, with fee increases and decreases roughly equally likely.” Id. “[F]unds with superior market-adjusted performance are able to raise fees,” yet “[i]t is more likely that decreases reflect economies of scale associated with growth.” Id. at 6, 2.

114. Freeman & Brown, supra note 52, at 625 (using a sample of 2161 funds in 1999, with a total market value of $2.2 trillion, finding that “advisory and administrative costs decline as fund size increases, but with administrative costs declining much more rapidly”). The authors calculated that if advisory costs had declined by the same percentage as administrative costs, average advisory fees for funds with assets above $5 billion would have been 28 basis points, rather than 46 basis points. Thus, assuming equal economies of scale for advisory fees and administrative fees, the larger funds charge excess advisory fees of about $2.5 billion annually. Id.

115. Management firms charge retail mutual funds “systematically higher” advisory fees than they charge their pension fund clients, for essentially the same reason. Freeman & Brown, supra note 52, at 628, 630–32 (analyzing fee data collected in 1999 from 36 public pension funds that had placed 220 equity portfolios under active management with outside investment advisers, representing $97.5 billion in assets, finding that comparable mutual funds pay about half as much as the pension fund clients, with the differences more pronounced as the fund/portfolio size increases). The disparity has existed over time. A Wharton study conducted in 1962, looking at a sample of 54 management firms with both mutual fund clients and other clients, found that fee rates charged mutual funds were at least 50% higher in 39 out of the 54 cases, 200% higher in 24 of the cases, and 500% or more higher in 9 of the cases. WHARTON SCHOOL OF FINANCE & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274-87, at 489–94 (1962).

116. Freeman & Brown, supra note 52, at 633. The findings are dramatic for large-capitalization funds, where mutual funds pay weighted average advisory fees of 52 basis points, compared to 21 basis points for comparable pension fund portfolios. The fee differential is further exacerbated in view of average fund size, with the average large-cap mutual fund ($2 billion) almost four times larger than the average pension fund portfolio ($555 million). Id. at 635. That is,
Higher advisory fees do not buy better performance. High-fee funds under-perform low-fee funds—even before factoring in fees. Advisory fee levels, generally a percentage of fund total net assets, increase as a result of recent superior fund performance.\textsuperscript{117}

Actively managed mutual funds are more expensive than they appear. Most actively managed funds engage in shadow indexing, while charging fund investors for active management. On average, most of the variance between the fund’s stated active managed assets and the fund’s actual shadow indexed assets is explained by the fund’s benchmark index.\textsuperscript{118} Separating active assets from passive assets, the mean expense ratio for the active portion of the portfolio of actively-managed large-cap equity mutual funds of “5.14% runs more than 500% higher than the published expense ratio of 0.77%.”\textsuperscript{119}

Board approval of loads

Nearly two-thirds of equity funds impose distribution fees, as load charges paid directly by fund investors or as annual marketing fees paid pursuant to Rule 12b-1. The true cost of distribution fees to investors is hard to measure because “fund companies have developed distribution arrangements that differ in both the magnitude and timing of fees paid.”\textsuperscript{120} While 12b-1 fees (paid from fund assets) increase the fund’s market share, there is “no evidence” current or new investors derive any benefit from 12b-1 fees.\textsuperscript{121} Funds with 12b-1 fees have higher expense ratios and are more likely to fail. Fund investors pay for additional marketing, but garner no additional investment returns—a “dead weight cost.”\textsuperscript{122}

management firms charge the average large cap mutual fund $10.4 million, while they charge the average pension fund portfolio $1.2 million—for essentially the same service.

\footnote{Warner & Wu, supra note 113, at 26-27. Also finding that advisory fee rates decrease when economies of scale exist and they are associated with growth. Id. at 6.}


\footnote{Id. at 12.}

\footnote{Miles Livingston & Edward S. O’Neal, The Cost of Mutual Fund Distribution Fees, 21 J. FIN. RES. 205, 206 (1998). The study produced a “simple methodology” that expresses “present value of distribution costs as fraction of original investment for multiple-class fees” during any potential holding period, allowing direct comparison of the effect on investors of distribution fees for different sales arrangements. Id. at 214.}

\footnote{Ajay Khorana & Henri Servaes, Conflicts of Interest and Competition in the Mutual Fund Industry 1–2 (Unpublished Working Paper, 2004), available at http://ssrn.com/abstract=240596 (studying the period from 1979 to 1998, when mutual fund industry assets grew enormously, the number of active funds tripled, and the market share of each fund declined).}

\footnote{Stephen P. Ferris & Don M. Chance, The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note, 42 J. FIN. 1077, 1082 (1987) (describing 12b-1 fees as “a dead-weight cost”); Robert W. McLeod & D.K. Malhotra, A Re-examination of the Effect of 12b-1 Plans on Mutual Fund Expense Ratios, 72 J. FIN. RES. 231, 239 (1994) (stating that 12b-1 fees are “a dead weight cost” to fund investors that has been increasing over time); Antonio Apap & John M. Griffith, The Impact of Expenses on Mutual Fund Performance, 11 J. FIN. PLAN. 76, 80 (1998) (concluding that for variety of equity funds, 12b-1 fees do not add to funds’ performance).}
The number of funds with 12b-1 fees is growing, as is the level of 12b-1 fees. Increasingly, 12b-1 fees are charged in funds closed to new investors, “almost all of which are load funds.”

Load funds, which directly charge investors for marketing expenses, do not out-perform no-load funds. Even before adjusting for loads in returns, no-load funds beat their load counterparts. When loads are figured in, no-load funds perform much better than load funds. And comparing load funds, there is no significant difference in performance between high-load funds and low-load funds even after adjusting for loads.

Load funds target less-knowledgeable investors and charge higher expenses. The average annual expense ratio of load equity funds has widened since the early 1990s and by 2000–2004 was 50 basis points higher than no-load equity funds.

In the 1990s, most funds with front-end loads added new share classes, which allowed investors instead to pay annual fees and/or back-end charges. Multiple-class funds attracted shorter-horizon investors, resulting in an increase in fund volatility and a significant drop in fund performance.

Expensive load funds, without minimum-balance requirements, are targeted at investors in less affluent, less educated, and ethnic minority neighborhoods—a kind of “predatory” money management.

Board supervision of fund marketing

Fund investors who purchase through brokers or financial advisors pay “unjustified” higher costs. Broker customers are often directed to hard-to-find funds, which charge substantially higher fees and provide lower risk-adjusted returns than directly placed funds. “[B]roker-channel funds exhibit no superior asset allocation. . . . While we cannot seem to
locate tangible benefits delivered by brokers, we remain open to the possibility that substantial intangible benefits exist.” 129

- Fund families create the illusion of high-rated funds by merging low-performing funds into high-performing funds—marketing the survivor’s healthy past performance. Funds disappear at a rate of approximately 3.6% a year primarily because of multi-year poor performance. 130 The resulting “survivor bias” results in overstatement of fund family performance, by air-painting out below-average funds from the family portrait. 131

- Fund boards rarely close funds to new investors, even when the fund has reached an optimal size. For actively managed funds, returns (both before and after fees and expenses) decline with lagged fund size. The relationship is most pronounced in funds that invest in small and illiquid stocks, where scale adversely affects liquidity. 132

- Funds with front-end loads have recently introduced additional share classes, “allowing investors to replace front-end loads with higher annual fees and/or back-end charges.” 133 While increasing fund cash flows by attracting shorter-horizon investors, the result has been a significant drop in fund performance. In fact, fund performance drops and volatility rises as funds increase the proportion of short-horizon investors. 134

Board supervision of fund investment strategies

- Morningstar ratings, on which fund investors irrationally rely, skew the behavior of fund managers. Funds that achieve high ratings tend to increase their risk levels, resulting in a “significant fall off” in performance as managers are unable to “load on momentum stock” after the fund receives the initial five-star rating. 135


130. Mark M. Carhart, Jennifer N. Carpenter, Anthony W. Lynch & David K. Musto, Mutual Fund Survivorship, 15 REV. FIN. STUD. 1439, 1443–45 (2002). “[The survivor bias is] 0.07% for one-year samples, but a significantly larger 1% for samples longer than 15 years.” Id. at 1460.

131. Id. at 1439.

132. Joseph S. Chen, Harrison G. Hong, Ming Huang & Jeffrey D. Kubik, Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, 94 AM. ECON. REV. 1276 (2004). The study found that even after adjusting returns by various performance benchmarks, fund performance “increases with the size of the other funds in the same family.” Id. at 1293.


134. Id. at 22.

• Fund managers adapt their investment strategy in the last part of a calendar year according to their performance in the first part, in particular taking greater risk to keep a high Morningstar rating from the beginning of the year.136

• Annual trading costs for equity funds average 0.78% of fund assets. Trading costs are negatively related to fund returns, and there is no evidence that average trading costs are recovered in higher overall fund returns. Trading appears to have a greater drag on fund returns than turnover.137

• Fund over-trading often occurs because of the presence of short-term investors in long-term funds. Fund managers can use observable investor characteristics to predict investment horizons when investors open an account. The pooling in the same fund of long-term investors and short-term investors costs long-term investors 0.51% in foregone annual returns.138

• Larger fund families aggressively market their “winning” funds (the previous year’s best performers) and allocate extra manager resources to these funds.139 In fact, an investment strategy that purchases a fund family’s past-year winners and shorts its past-year losers produces abnormal positive returns. The strategy is particularly successful in larger fund families, suggesting the latitude of larger families to allocate resources unevenly between funds.140

• Fund families strategically allocate performance across member funds to favor those more likely to generate future inflows and higher fee income. Strategic cross-fund subsidization of “high” funds at the expense of “low” funds is between 6 to 28 basis points of extra net-of-style performance per month.141 This preferential allocation occurs with respect to IPO deals and opposite trades (sometimes actual cross-


139. See Donald W. Glazer, A Study of Mutual Fund Complexes, 119 U. Pa. L. Rev. 205, 228 (1970) (finding investors are more concerned with the relative performance of aggressive mutual funds).


trading) among “high” and “low value” funds in the same fund complex.142

- Fund boards with a greater proportion of independent directors seem to supervise the management firm more diligently than low-proportion funds. Fund performance and the likelihood of replacing underperforming fund managers increases as the proportion of independent directors increases.143

2. Empirical Data on Investor/Market Effectiveness

Not only does the finance literature raise doubts about fund governance, it also reveals the investor market to be informationally inefficient—the same finding that motivated the 1940 Act and its outsourcing of fund supervision to the fund board.144 Recent studies show fund investors continue to lack the investment acumen, relevant information, and ability to protect their own interests.145 The notion, powerful in theory, that mutual fund investors can discipline wayward management firms by exercising their easy “entry/exit” rights has proved mostly empty in practice. Study after study makes clear that most fund investors are unable to fend for themselves.146

Investor response to fund fees

- Investors are often ignorant of expenses charged by their funds. According to a survey of fund investors, fewer than 20% could estimate expenses for the largest fund they held.147 Even sophisticated fund

142. Id.
144. From the beginning, it has been understood that disclosure to investors is not enough. As SEC Commissioner Robert Healy testified in the hearings on the Investment Company Act, “there are certain practices that have happened in connection with investment companies that I think everybody agrees . . . ought to be stopped, and they cannot be stopped by mere disclosure.” SEC Staff Report on Independent Chair, supra note 27, at 28 n.14.
146. Reviewing the academic literature, the General Accounting Office came essentially to the same conclusion. GAO Mutual Fund Disclosure Report, supra note 105, at 7, 76 (“[Academic studies] indicated that the information currently provided does not sufficiently make investors aware of the level of fees they pay,” and some academic researchers and others “saw problems with the fee disclosures [by mutual funds].”)
investors lack a good understanding of the historical returns of their fund investments.\(^\text{148}\)

- Investors are often unaware that higher fund expenses are a drag on fund performance. In one survey, about 20% of surveyed investors believed that high-fee funds produced better results; more than 60% believed funds with higher expenses produced average results; and fewer than 16% believed higher expenses led to lower than average returns.\(^\text{149}\) In another survey, 84% of respondents believed that higher fund expenses correlate with higher fund performance.\(^\text{150}\)

- Fund investors are relatively insensitive to advisory fees, paying some attention when they buy, but not as they hold. Funds that reduce their fees gain market share, but only if their fees were above average to start. Low-cost funds do not lose market share by charging higher fees.\(^\text{151}\)

- Fund investors have become more sensitive to front-end loads and commissions, but remain insensitive to operating expenses. Over the last 30 years, front-end loads (as well as commissions charged by brokerage firms) have had a consistently negative relation to fund flows.\(^\text{152}\) There is no relation (or even a perverse positive relation) between operating expenses and fund flows. Investors purchase “funds that attract their attention through advertising and distribution. . . . mutual fund advertising works.”\(^\text{153}\)

- In relatively homogenous fund sectors, such as S&P index funds, investors find it difficult to identify bargains. Investors tend to go with recognized “name brands” based on fund age and family size, with a marked shift in sector assets to more expensive (often new entry) funds.\(^\text{154}\)


\(^{149}\) See Alexander, Jones & Nigro, supra note 147, at 310.


\(^{151}\) Khorana & Servaes, supra note 121, at 3–4.


\(^{153}\) Id. at 2099.

\(^{154}\) Ali Hortacsu & Chad Syverson, Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds, 119 QUARTERLY J. ECON. 403 (2004). Fund investors also have difficulty identifying the advantage of index investing. See Moore, Kurtzberg, Fox & Bazerman, supra note 148, at 96 (hypothesizing that common traits of over-optimism and framing of choices against past performance contribute significantly to investors eschewing index funds, which over time outperform actively-managed funds).
Investor response to market changes

- Fund investors over-trade. In turn, investor short-termism drives the short investment horizons of fund managers, not the other way around.\(^{155}\)

- Fund investors systematically engage in a “buy high, sell low” trading strategy. Monthly data from 1984-2003 show a negative relationship between aggregate net flows into and out of the funds and the returns of the funds in subsequent periods.\(^{156}\) As a result, fund investors realize lower long-term accumulated return than the “long-term accumulated return on a ‘buy and hold’ position in these funds.”\(^{157}\)

- Fund investors over-react to market volatility—the “grass is greener” phenomenon. Stock fund investors withdraw assets in response to market volatility—both concurrently and based on past semi-annual and annual volatility.\(^{158}\) Fund investors over-react both to downside volatility and upside volatility. Stock fund flows, in turn, contribute to market volatility—as “noisy traders” destabilize the overall stock market.\(^{159}\)

- Fund investors follow the crowd. Net aggregate equity fund flows typically track general investor sentiment. Moreover, there is a self-reinforcing aspect to investor sentiment as higher equity fund flows induce newsletter writers to become more bullish.\(^{160}\)

Investor response to past performance

- Fund investors respond to the heuristic “past is prologue.”\(^{161}\) Past performance is at best a weak predictor for anticipating fund performance. While one-star and two-star Morningstar ratings generally predict relatively poor future performance, Morningstar’s five-star

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157. *Id.*


159. *Id.* at 8.


161. The heuristic, valuable in other consumer activities, reflects the likelihood that fund performance (like that of any randomly constructed stock portfolio) regresses to the mean. This is not true for other consumer goods. For example, a five-star automobile safety crash rating (based on the performance of a sample car in a controlled crash test) is a useful predictor that other cars of the same model and year will perform well in real-life crashes. See Consumer Reports, *Annual Auto Issue: Safety Feature Comparison* 35–38 (Apr. 2006), http://www.consumerreports.org/cro/index.htm.
funds generally do not outperform four-star and three-star funds. In fact, a 5-star Morningstar rating may be a “kiss of death.” Three years after a fund receives its initial 5-star rating, fund performance severely falls off across different performance measures and different samples of funds.

- Fund directors, contrary to anecdotal evidence, often hold shares in the funds they oversee. But there is evidence that directors chase performance in their ownership choices, just like other fund investors.

- The “past is prologue” mentality extends to the financial press. Fund rankings by the leading financial publications (Barron’s, Business Week, and Forbes) based on past performance do not predict superior future performance. Most ranked funds (65%) have lower performance in the post-ranking period compared to the pre-ranking period.

Investor response to scandals
- Response by fund investors to mutual fund scandals has been mixed. Funds affected by scandals experience significantly greater outflow of assets, with the outflow greater the more severe the scandal (as measured by size of regulatory settlement/fine, press coverage, and filing of formal charges). Outflows are greater where the scandal involved a penalized entity, as opposed to individual wrongdoers no longer associated with the fund. But fund scandals first discovered by the SEC do not result in significant outflows. Lastly, strengthened

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163. Morey, supra note 135, at 41.

164. Id. at 49–50.


166. Id. at 38.

167. Miranda L. Detzler, *The Value of Mutual Fund Rankings to the Individual Investor* 4 (Unpublished Working Paper, 1999), available at http://ssrn.com/abstract=170851 (looking at 757 funds that were ranked between 1993–1995; finding that ranked funds had higher excess returns compared to peer funds during the pre-ranking period, but similar excess returns in the post-ranking period; finding also that ranked funds had higher risk, measured by standard deviations, in both the pre- and post-ranking periods).

Corporate governance controls have no impact on the amount of outflows from a scandal fund.169

C. EVALUATION OF DATA

The data paint a dismal picture of fund board performance. Fund boards have failed in their function to negotiate management fees. In fact, the recent slowing growth of \textit{weighted average fees} (compared to the continuing growth in \textit{unweighted average fees}) highlights the inability of fund boards to lower fees, even as some fund investors have moved to lower-cost funds. That is, fund boards have been less effective in lowering fund fees than fund investors. Even worse than their performance on negotiating management fees, fund boards have achieved nothing for their investors by approving loads—especially 12b-1 fees.

The data tell an equally sad story about fund investors. Fund investors are often ignorant of fund expenses and unaware of their relation to performance. They suffer from cognitive biases, for example that "past is prologue"—a belief they share with the financial press and even fund managers. Fund design and marketing pander to this belief and over-emphasize high Morningstar ratings, which studies show represent a statistical guarantee the fund will regress to the mean. Many fund investors shun index funds, even though they are a proven long-term investment vehicle. Instead, they engage in pathological "buy high, sell low" trading strategies that over-optimistically aim to out-perform the market. Fund managers mirror (or induce) a "grass is greener" bias in their over-trading of portfolio assets and widespread belief that they too can beat the market. Not everyone can be above average.

Even those studies that suggest independent directors provide some value—that is, that fund performance and the likelihood of replacing under-performing fund managers increases as the proportion of independent directors rises—do not establish a causal relationship between board independence and fund results. Instead, it seems more likely that investor-friendly management firms (i.e., those that adopt strategies of low fees, long-term investment policies, responsiveness to failed investment strategies, and investor-appropriate marketing) are more likely to have truly independent directors advising on these matters. In fact, the studies that suggest funds with independent chairs out-perform their management-chaired counterparts lead only to the conclusion that management firms focused on their own profits under-perform firms with an investor focus.170

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170. In fact, the SEC has been unable to point to any evidence that greater board independence has been effective under the SEC’s exemptive rules. Bullard, \textit{Comments on Corporate Governance}, supra note 47, at 1106. Indeed, there is “no evidence that the Commission knows
III. OPTIONS FOR REFORM

Can the fund board be rehabilitated? The mutual fund industry has strong reasons to resist having the board structure dismantled. Outsourcing of regulatory supervision to an internal monitor gives the industry great freedom—particularly when compared to the alternative of external regulation. In areas of fund management subject to board oversight, management firms have the discretion to test the limits of the market.

Not surprisingly, there is no impetus for fundamental reform. The mutual fund industry is quite pleased with the fund board and the results it has produced. Fund directors, without questioning their own value, have supported calls for greater independence and greater role clarity. The SEC willingly parrots the mantra that the fund board is an essential component of fund regulation, particularly since the job falls outside the agency. Perhaps the only mutual fund constituents that might have reservations about the fund board—fund investors—are mostly unaware that there is a fund board or that it has failed them.

After surveying the data on the higher investment advisory fees charged mutual funds compared to pension plans, Professors Freeman and Brown concluded:

The fund industry is over-regulated and under-policed. The absence of a strong corrective influence should not be surprising. Those in control of an industry boasting over $7 trillion in liquid assets can afford superb lawyers, lobbyists, and public relations specialists. . . . Congress has not shown interest in improving investors’ remedies and cannot be counted on to alter the way the fund industry chooses to conduct itself. The SEC generally has contented itself with presenting proposals destined to have little impact on the way most mutual funds do business.172

To the extent that some mutual funds have shown a “reform mentality”—lowering management fees, offering life-cycle funds intended to encourage proven long-term investment strategies, and cautioning investors against over-trading—the new attitudes seem driven more by greater investor sophistication than by awakened fund boards. The industry recognizes the scandal-induced skepticism about its product and has every reason to show that its house is in order and that the current regulatory structure is adequate.

But given the long-standing failure of the fund board and the continuing inability of investors to discipline industry excess, the time is ripe for a fundamental re-appraisal of the fund board.

\footnote{whether the independent directors have been effective in the context of the operation of the exemptive rules . . . , and there is “no evidence that the Commission knows if the exemptive rules themselves have been effective in protecting investors.” \textit{Id.} at 1096.}

\footnote{171. \textit{Wang, supra} note 3, at 958–59.}

\footnote{172. \textit{Freeman \& Brown, supra} note 52, at 641–42 (citations omitted).}
A. ALTERNATIVES TO BOARD-CENTRIC STRUCTURES

The recent mutual fund scandals and a slowing stock market have led many to question the efficacy of the fund board. Reform proposals, most of which seek to create additional structures to compensate for the board’s failure, have become a cottage industry.

Consider some recent proposals:

New SRO. Some reformers have proposed a new self-regulatory organization to oversee mutual funds, thus augmenting fund boards and taking pressure off limited SEC resources. Rather than the current reliance on internal mechanisms, the SRO could engage in more focused rule making, with the SEC (and state attorneys general) using their enforcement powers as a “residual mechanism.”

New oversight board. Others have suggested a Mutual Fund Oversight Board, modeled on the Public Company Accounting Oversight Board, which would be responsible for (and only for) establishing uniform minimum standards for fund governance. The new board would perform an investigative and rule-making function, providing the flexibility that the SEC lacks to keep standards current.

New “expert” directors. Others would seek to make the fund board more independent and qualified by mandating that the board include a certified financial analyst (CFA)—much like the Sarbanes-Oxley requirement of a financial expert on the audit committee of public companies. The CFA would presumably be better able to recognize excessive fund fees.

Invigorate mutual fund litigation. Others would call on courts to make derivative litigation a “serviceable mechanism for serious judicial review in cases of fiduciary breach.” Given the deficiencies of investor market oversight, courts should look at the merits of fund over-pricing.

175. Tobe, supra note 19, at 28 (suggesting CFA, a designation awarded by the Association for Investment Management and Research; also pointing to studies showing that public pension plans with CFA officers have lower fees).
177. Tobe, supra note 19, at 28.
178. Langevoort, supra note 28, at 1043.
More investor-usable disclosure. Others have urged the SEC to mandate greater disclosure of fund expenses—as is required in other financial service industries and consumer markets. Some would require individualized disclosure in account statements that show actual fund expenses, with a break down of fees and other expenses.\textsuperscript{179} Some would require that the statements also include how the actual expenses compared with industry ranges and averages.\textsuperscript{180}

But others—mostly practicing lawyers—doubt whether the board can be salvaged. Some assert that the SEC’s initiatives to buttress board independence are of “questionable efficacy” and implicitly conclude that the board cannot fulfill its watchdog function.\textsuperscript{181} A few have called for the fund board to be eliminated, describing it as “paraphernalia.”\textsuperscript{182} As one reform proponent pointed out a fund without directors would not make “an awful lot of difference and would be cheaper to operate.”\textsuperscript{183}

Even the SEC has imagined mutual funds without directors. In a 1992 study the SEC staff considered a board-less fund structure, called a unitary investment fund (UIF), as part a comprehensive review of existing fund governance.\textsuperscript{184} The concept was a mutual fund that would be treated as a proprietary financial product sold by a sponsor and governed by the terms of a trust indenture. As proposed, the UIF would have a corporate trustee (the sponsor/management firm) that would sell interests in the trust to investors. The trust indenture would spell out fundamental investment policies and the management fee, and could be changed only with some difficulty. A single management fee would cover all fund-related expenses and would be subject to a statutory maximum. The UIF would have no board of directors or shareholder voting, nor would there be judicial review

\textsuperscript{179} See U.S. Gen. Accounting Office, Mutual Fund Fees Additional Disclosure Could Encourage Price Competition 97–98 (2000), http://www.gao.gov/archive/2000/gg00126.pdf (proposing disclosure of total dollar amount of expenses in quarterly statements); Freeman & Brown, \textit{supra note} 52, at 669–670 (proposing that mutual funds be required to itemize their different fund expenses, such as: advisory fees, operating costs, and trading costs).

\textsuperscript{180} See Cox & Payne, \textit{supra} note 62, at 929. The proposal is similar to one considered by the SEC staff in 1992. \textit{See SEC Staff Report Protecting Investors, supra} note 25, at 337 (outlining Unified Fee Investment Company (UFIC), which would have a simplified fee computed as a percentage of fund assets, permitting ready comparison to other similar funds; the fee would cover all fund expenses other than extraordinary expenses and brokerage commissions on the fund’s own transactions).


\textsuperscript{182} Phillips, \textit{supra} note 23, at 903.


\textsuperscript{184} SEC Staff Report Protecting Investors, \textit{supra} note 25, at 283–84. The idea of a UIF, which was first floated by Stephen West of Sullivan & Cromwell, led to the SEC requesting public comment on the UIF in 1982. \textit{Advance Notice and Request for Comment on Mutual Fund Governance}, 47 Fed. Reg. 56,509 (Dec. 10, 1982).
of fund fees. The 1940 Act prohibitions against self-dealing transactions would apply, without exception.\(^{185}\)

Ultimately, the staff rejected the UIF concept as not offering an adequate substitute for board review of fees and other fund operations. The SEC staff seemed unwilling to imagine a model without an independent monitor. Instead, the staff concluded that the board-centric governance structure is fundamentally “sound” and should be retained.\(^{186}\)

But the idea of a board-less mutual fund is not far-fetched. In fact, the fastest-growing mutual funds in the United States—private hedge funds and some exchange traded funds organized as unit trusts—do not have board structures.\(^{187}\) Like registered mutual funds, these financial intermediaries pool money that investors entrust to professional managers to make investments on their behalf. Fee setting is a matter of contract, and regulatory compliance is an internal responsibility of the management firm.

Even though hedge funds are subject to nearly identical internal conflicts as registered mutual funds, the idea of a fund board to ensure hedge fund compliance and to regulate management activities were not even considered in the recent SEC rule-making to require hedge fund registration.\(^{188}\) Instead, the SEC rules (which were recently invalidated) would have required that hedge funds registered with the SEC have a compliance officer.\(^{189}\) The compliance officer, unlike the mutual fund board, would have no authority to validate self-interested activities of the fund manager. The compliance officer—whose functions were to parallel those performed by in-house legal departments and compliance offices in brokerage firms, banks and insurance companies—would have simply been charged with establishing control systems to ensure legal compliance.

The SEC explained the compliance officer’s function in much the same terms as it has described the mutual fund board:

Hedge fund advisers . . . must develop and implement a compliance infrastructure. . . . Our examination staff resources are limited, and we

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185. See Wang, supra note 3, at 1024–25 (summarizing UIF proposal).
186. See SEC Staff Report Protecting Investors, supra note 25, at 283.
187. Insurance separate accounts are also exempt from the board requirements. The performance of equity funds managed by insurance companies gives reason to pause. In a recent study, insurance funds under perform non-insurance peers by more than 1% in average annual returns. Perhaps, as speculated by the authors of the study, this is due to insurance industry conservatism or lack of investor-driven incentives to pursue superior performance. Or perhaps, a possibility not mentioned by the authors, the weak performance is due to the absence of a fund board. See Xuanjuan Chen, Tong Yao & Tong Yu, Prudent Man or Agency Problem? On the Performance of Insurance Mutual Funds 1–3 (Aug. 28, 2004), available at http://ssrn.com/abstract=589801.
cannot be at the office of every adviser at all times. Compliance officers serve as the front line watch for violations of securities laws, and provide protection against conflicts of interests.\(^{190}\)

For hedge funds, external regulatory oversight ultimately resides with the SEC under its powers to regulate securities fraud and the fiduciary responsibilities of investment advisers under federal and state law, as well as with investors through contractual protections and their ability to “enter” and “exit” the fund.

**B. MUTUAL FUND STRUCTURES OUTSIDE OF THE UNITED STATES**

Mutual fund boards are largely a U.S. phenomenon. Most other countries treat mutual funds as an investment “product” offered by investment management firms. The regulatory focus elsewhere is on the management firm, not the investment pool or its legal supervisor. Regulation of product terms (fees and management services), custodial responsibilities, and fund marketing is a matter of government agency supervision, with residual oversight by self-regulatory organizations and courts under a regime of fiduciary duties that fall on the management firm.

Consider the regulation of mutual funds in Germany, Japan and Britain. In Germany mutual funds are not separate entities, but instead segregated asset pools managed by an investment management firm that is regulated by the German Federal Banking Commission (BAKred).\(^{191}\) Investors enter into a contract with the management firm and acquire participatory units in the segregated assets, with the management firm obligated to repurchase the units if redeemed by the investor. The assets must be kept with a custodian bank, which is obligated to supervise the management firm on behalf of fund investors. Thus, protection of fund investors in Germany is primarily the responsibility of the management firm, which has a statutory duty to act in the interests of fund investors. The management firm, in turn, is supervised by the custodian bank and the BAKred, both of which may bring suit against the management firm for failures to act. The BAKred may dismiss a fund manager who is unfit professionally or who violates the mutual fund rules.

In Japan mutual funds exist as investment trusts, with a trustee that must be a trust company or bank.\(^{192}\) The trustee enters into a “contract of trust” with an investment trust management company, which must be licensed and is subject to statutory standards. The management company gives advice with respect to trust assets and has fiduciary duties in relation

\(^{190}\) See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,063.

\(^{191}\) Wang, supra note 3, at 951. The BAKred, among other things, specifies the qualifications for the mandatory managing directors of the management firm. Id. at 951–52.

\(^{192}\) Id. at 953–55.
to the assets, though not necessarily to fund investors. The trustee keeps custody and administers the trust assets. Fund investors have beneficial interests in the trust. The Ministry of Finance regulates the trustee, as well as the terms of the trust contract entered into with the management company. The management company is subject to the rules of a self-regulatory group, the Investment Trust Association.

In Britain mutual funds are unit trusts, constituted under trust law. The trustee contracts with a manager (a firm or individual) that manages the trust assets, though the trustee retains custody and control of the assets. The trustee oversees the manager, though the manager typically appoints the trustee. To qualify as an authorized unit trust, the trust must comply with detailed regulations that cover its constitution, the power and duties of the trustee and manager, investment and borrowing powers, and pricing and valuation. The trustee and manager are both subject to regulation by self-regulating organizations. Government oversight comes from the Department of Trade and Industry, which has delegated most of its powers to the non-governmental Securities and Investment Board.

In addition, since 1997 mutual funds in the United Kingdom can be operated as open-ended investment companies (OEICs), which can be marketed elsewhere in the European Union. An OEIC is established under company law rather than trust law. The OEIC owns the underlying assets and investors own shares that reflect their interests in those assets. The OEIC must have a board, though the only board member required is the authorized fund manager. Although independent directors are permitted, in practice nearly all OEIC boards are comprised of the manager alone. In addition, there must be a depository who has the same responsibilities for custody and oversight that the trustee has in the unit trust.

OEICs were designed to replicate the characteristics of unit trusts but with a corporate structure. For all practical purposes, the two are identical from the investor’s standpoint. The OEIC provides a vehicle recognized in continental Europe; there were no other advantages seen to the corporate form. In both the OEIC and unit trust, the authorized fund manager makes the day-to-day investment decisions of the fund, prices portfolio assets, and maintains financial records. The role of the trustee and the depository are essentially identical, to safeguard portfolio assets, oversee the manager’s activities, and ensure compliance with FSA rules. FSA regulation is the cornerstone of investor protection in the United Kingdom.

193. Id. at 955–56.
Investors in each country have, at best, a minimal role in fund governance. In Germany and Japan, investors have no voting rights. In the United Kingdom, investors of unit trusts can vote on only four matters: changing the trust deed, approving departures from stated investment policy, removing the manager, and approving trust mergers.

The “product” structure, compared to the “board” structure, of mutual fund regulation makes clear that investors are purchasing services from an investment management firm. The buck stops with the government regulator, who has collateral support from courts that enforce the fiduciary duties of the management firm and (in some countries) from self-regulatory organizations that set standards of professional conduct.

IV. CONCLUSION

At the time of the 1940 Act, it was inconceivable that the fund board would oversee fund families with hundreds of different funds, spanning the full range of modern investment styles, some with over $1 trillion in assets under management. Equally unimaginable was the reality that mutual funds would become the primary investment vehicle for private retirement savings—surpassing company pension plans, bank accounts, and brokerage investments. And still more far-fetched was the likelihood, or so it seems, that mutual funds would supplant or even absorb the federal social security system as the funding vehicle for retirement income.

Regulatory outsourcing was an innovation of the 1940 Act—in marked contrast to the multi-faceted regulatory approach applied to public offerings under the 1933 Act and the nod to self-regulation of securities firms and stock exchanges under the 1934 Act. Rather than external supervision by the SEC or a self-regulatory organization (none existed), Congress delegated supervision to an internal regulator.

At best, the mutual fund board is an anachronism, a throw back to the time that the mutual fund was seen as an investment holding company (on the model of Berkshire-Hathaway) and the fund board a servant of investor interests. But the board suffers from fundamental structural flaws. Independent directors are neither independent of the management firm nor truly capable of being directors. They are selected by the management firm, rely on it for information and direction, and are paid (sometimes handsomely) not according to the results for fund investors, but based on currying continuing favor with the firm they are supposed to supervise. They are effectively limited in their power to fire the management firm, to revamp the business or sell it to outside buyers, or to enter into tough negotiations on behalf of fund investors.

195. Wang, supra note 3, at 962.
196. Id.
The evidence bears out the fund board’s inherent weakness and leads to the unavoidable conclusion that internal regulation cannot but fail. In a market that lacks effective arbitrage mechanisms to bring fund expenses into line, the board has no effective means to truly regulate management fees and ensure that fund marketing is in the interests of fund investors. Not surprisingly, as the mutual fund industry has exploded in size, and during a period of unparalleled advances in computer and telecommunications technology, the economies of scale and operational efficiencies have redounded to the benefit of management firms, not fund investors. Likewise, fund boards have approved loads and marketing fees that increase market share, thus boosting fees for the management firm, but without any benefit for fund investors. Rather than focusing fund marketing on investor education, the fund board has permitted advertising that exploits the informational defects and cognitive foibles of fund investors.

It is remarkable that in an industry widely described as heavily regulated, the board-centric structure faces so little accountability. Each of the potential sources of board monitoring—the SEC, federal courts, state courts—has adopted the attitude that somebody is doing the job. The SEC ultimately assumes that fund investors acting in markets will discipline wayward boards; the federal courts defer to the investor market and the regulatory function of the SEC; and state courts apply the business judgment rule, which assumes that markets are more discerning than judges.

At worst the fund board creates an illusion of investor protection. It allows the industry to tell the appealing story (however false) that the board serves as a “watchdog” against internal malfeasance, while fund investors exercise their powerful “entry/exit” rights to discipline management firm over-charging, over-trading, and over-marketing. The very existence of an internal monitor may actually be counter-productive. Rather than constraining management excesses, the presence of the supposedly independent board may actually embolden management firms to disregard their responsibility to fund investors, on the glib belief that the board performs its functions. Behavioral studies show that fiduciaries led to believe that someone else is protecting the interests of their beneficiaries tend to minimize and slacken their own fiduciary performance. A lackadaisical watchdog may be worse than no watchdog at all.

Look again there.

197. Daylian M. Cain, George Loewenstein & Don A. Moore, The Dirt on Coming Clean: The Perverse Effects of Disclosing Conflicts of Interest, 34 J. LEGAL STUD. 1, 9 (2005) (finding that when subjects asked to guess the amount of money in a jar, with the help of an “adviser” who had disclosed conflicting interests, the subjects were more likely to trust the adviser on the theory disclosure evidences good faith, and the adviser feels greater moral freedom to act selfishly on the theory the subject has been put on notice).
NOTES

WHO’S FEELING LUCKY?
SKEWED INCENTIVES, LACK OF
TRANSPARENCY, AND MANIPULATION
OF GOOGLE SEARCH RESULTS
UNDER THE DMCA

I. INTRODUCTION
In March of 2002 Google, the popular search engine, received a letter from the Church of Scientology demanding that Google remove several links to pages within the Web site www.xenu.net (Xenu) from Google search results. The Xenu Web site publishes some harsh criticism of Scientology, but according to the Church of Scientology Xenu also displayed documents to which Scientology claimed exclusive rights under copyright law. The Church of Scientology’s argued that posting hyperlinks to infringing Web sites was a violation of the Digital Millennium Copyright Act of 1998 (DMCA).

The Church of Scientology acknowledged that Google was protected from liability under the DMCA, but only so long as Google expeditiously removed the material in question. Google removed the pages from its search results, including the Xenu.net home page, even though the home

1. The term “search engine” is used here in reference to providers of online search technology that index the Internet, such as Google, Yahoo, MSN, AOL or Ask.
5. See Xenu Complaint, supra note 3.
6. Section 106 of the U.S. Copyright Act grants the owner of a valid copyright exclusive right to reproduction, adaptation, distribution, performance, and public display of the underlying work. See 17 U.S.C. § 106 (Supp. II 2002). Someone who violates one of those exclusive rights may be liable for copyright infringement. See id. § 501(a) (Supp. II 2002). Where copyrighted material is published on a website such as Xenu.net without authorization, the copyright owner can claim violation of her reproduction and distribution rights.
8. See Xenu Complaint, supra note 3 (referencing 17 U.S.C. § 512(d) (2000)).
9. Id.
page did not appear to include any infringing material. In a subsequent email to Xenu, Google explained that if it had not removed links to the allegedly infringing pages, Google would have risked being sued for copyright infringement.

Scientology’s use of copyright law to secure protection for its materials on the Internet has attracted media attention. The Church of Scientology has adopted a legal strategy of aggressively targeting Web sites that publish anti-Scientology materials. They have sent cease and desist letters not only to the allegedly infringing properties, but also to Internet Service Providers that host the pages and to search engines that link to the alleged infringers in search results. As a result, Web sites that were created to criticize the Church of Scientology have had their content removed by service providers. The Church of Scientology has also targeted online community discussion boards with cease and desists.

The fact that Google could be sued at all for linking to third party Web sites is problematic. It would be unreasonable to hold Google responsible for all the content on the Web. Congress attempted to deal with this problem by including a “safe harbor” provision in the DMCA, granting search engines and other online service providers (OSPs) limited liability for copyright infringement by third parties. Still, to preserve this limited liability OSPs must “take down” infringing material after receiving proper notice. This seems like a fair solution for the clear cases of unadulterated

References:
12. See Matt Hines, Scientology Loss Keeps Hyperlinks Legal, CNET NEWS, Sept. 8, 2003, http://news.com.com/2100-1028_3-5072581.html (“Scientologists have taken a vigorous approach to squelching critical Web sites, pressuring site operators, ISPs and even Internet heavyweights such as Google into removing links to Web pages.”).
13. Id.; see also Hiler, supra note 10.
16. Letter from Moxon & Kobrin, Church of Scientology Legal Counsel, to Google, Inc. (Aug. 15, 2002), available at, http://chillingeffects.org/dmca312/notice.cgi?NoticeID=388 (requesting the removal of content from online discussion boards that, according to Scientology, contained copyrighted material).
17. The limitations on liability of service providers for copyright infringement are codified in section 512 of the U.S. Copyright Act, 17 U.S.C. § 512 (2000).
18. Id. § 512(c). Section 512(c) contains what are commonly known as the “notice and takedown” provisions of the DMCA. These provisions dictate that in order to maintain limited
infringement such as downloadable versions of well-known pop music or movies. But for the ambiguous cases, the incentive remains for Google to quickly remove the allegedly infringing content in order to preserve the safe harbor protection. There is a clear and present danger that non-infringing material will be removed from search results.

The Xenu.net case was typical in that there was no judicial determination of actual copyright infringement. Rather, Google alone carried the responsibility of evaluating the validity of the infringement claim. However, the Act does not provide OSPs with standards for investigating and responding to takedown letters. Google was left to balance the apparent validity or invalidity of the Scientologists’ claim against Google’s own interest in avoiding a lawsuit. This situation presents the OSPs with a Hobson’s choice between:

a) refusing to remove the information and risking liability for infringement;

b) conducting costly inquiries into the validity of infringement claims, diverting resources from core business goals; or

c) removing information from the Internet with minimal investigation.

In the interest of efficiency, an OSP in this situation may opt to take down material first and ask questions later. This suggests that Google and other OSPs might comply with even far-fetched infringement notices. Oddly enough, one cannot know for sure whether this is happening with any frequency. Because there is no official public record of how much material has been taken down in response to DMCA notices, by whom, or at whose request.

This note argues that the lack of transparency in the current notice and takedown regime hobbles Internet speech, commerce, and technology by perpetuating a lopsided set of incentives for the removal of non-infringing material from the Internet. Part II of the note outlines the current Internet copyright laws and briefly discusses the shift from ISPs to search engines as prime targets for DMCA takedown requests. Part III raises potential problems with the current regime including a potential for abuse and a chilling effect on speech. Part IV argues that there is no underlying liability for Google regardless of DMCA safe harbor. Part V is an economic analysis of the current system’s problems for industry, consumers, and government. Part VI suggests that the skewed incentives of the current notice and takedown scheme could be handled without direct government regulation.
by standardizing OSP industry practices and creating a complete public record of DMCA takedown requests.

II. BACKGROUND

A. GOOGLE: A NEW TARGET

Search engines have emerged as an ideal target for copyright owners trying to find and stop infringement. Early Internet copyright litigation focused on Internet service providers (ISPs) (those companies that actually hosted the infringing material on their servers). But publishers whose web sites were taken down by ISPs were able to migrate to new servers and reappear online relatively quickly. More recent legal disputes have focused on search engines. Since the mid 1990’s, search engines have become an essential and dominant source for Internet content. Internet users are increasingly reliant on search technology for direct and immediate access to particularized information. Google has emerged as the most popular search engine. Google’s market hegemony may have helped bring about a new strategy for copyright owners: combating small-time copyright infringers by affecting removal of infringing content from search engines and thus preventing users from finding it. Since 2002, Google has reported approximately 1000 DMCA take down requests.

21. See ALS Scan, Inc. v. RemarQ Cmtys., Inc. 239 F.3d 619 (4th Cir. 2001); Sega Enterprises Ltd. v. Maphia, 857 F. Supp. 679 (N.D. Cal. 1994) (finding an online bulletin board service (BBS) operator liable for allowing a user to upload copyrighted video games onto the BBS).
22. See Xenu Complaint, supra note 3. The Church of Scientology complained, “www.xenu.net has been removed five times by well known internet service providers.” This indicates, that while the Church of Scientology may have been successful in persuading several ISPs to remove the Xenu.net site from their servers, Xenu could still obtain new hosting services.
23. While search engines were popular in the early days of the Internet economy, their importance has become much greater in recent years. See Brian Morrissey, Search Guiding More Web Activity, INTERNET NEWS, Mar. 12, 2003, http://www.internetnews.com/IAR/article.php/2108921 (“[A]long with going directly to Web sites, people are more likely to go to a search engine. . . . There’s less meandering around the Web. The Web’s becoming an efficient utility . . . The search engines apparently are becoming the card catalog to the Web. . . .”).
24. See Google voted best brand of 2003, BBC NEWS, Feb. 3 2004, http://news.bbc.co.uk/1/hi/business/3456363.stm (“The company now has more than 70% of the global market, meaning that seven out of 10 people will click onto Google’s webpage when they are looking for information on the Internet.”). Underscoring Google’s synonymy with Internet search, the verb “to google” is established in the lexicon. See Jonathan Duffy, Google calls in the language police, BBC NEWS, June 20, 2003, http://news.bbc.co.uk/1/hi/uk/3006486.stm (“Singletons will ‘google’ a new boyfriend or girlfriend—run their name through a search engine—to check them out. People now talk about ‘googling’ and ‘being googled.’”). Ironically, as Duffy points out, Google has made efforts to keep the term out of dictionaries in order to maintain control of its trademarks and brand identity.
25. While the Church of Scientology may have been successful in persuading several ISPs to remove the Xenu.net site from their servers, Xenu could still obtain new hosting services. See Xenu Complaint, supra note 3 (noting that xenu.net had previously been removed by several ISPs). The Church of Scientology may have concluded that the most effective way to prevent Internet users from viewing the Xenu site was not just to temporarily remove it from the Internet,
B. DIGITAL MILLENNIUM COPYRIGHT ACT

The DMCA’s two chief sections, the anti-circumvention and safe harbor provisions, seek a balance between the interests of copyright holders and the risk of overburdening service providers with the task of actively policing networks for infringement. While the anti-circumvention provisions of the Act seek to prevent frustration of copy protection systems, the safe harbor provisions limit liability for certain tools necessary to the operation of the Internet such as “information location tools,” “passive conduits,” and “system caching.”

The safe harbor protections, however, come with qualifications and strings attached. A service provider is only immune from liability if it lacks actual knowledge of the infringing behavior and “does not receive a financial benefit directly attributable to the infringing activity.” But most importantly, upon receiving notice of infringement the provider must “act expeditiously to remove, or disable access to, the material.” An OSP is not liable to the alleged infringer even if it removes non-infringing material, so long as the removal is part of a good faith response to a takedown letter. Instead, a web site publisher whose content has been removed may file a counter-notification with the provider and request that her content be “put back.” Finally, if either the copyright owner or the alleged infringer

but rather to prevent users from finding it through Google. Also, since § 512(d) of the DMCA, which applies to search engines, does not provide for notice to alleged infringers, Google may be an even more convenient target for takedown requests because the complaining party can potentially obviate the need for any direct communication with the alleged infringer.


31. Id. Section 512(a) creates safe harbor for “transitory digital network communications,” commonly referred to as “passive conduits.” These include service providers who, for example, provide technology to facilitate sending email.

32. Id. § 512(b).

33. Id. § 512(c)(1)(A).

34. Id. § 512(c)(1)(B).

35. Id. § 512(c)(1)(A)(iii).

36. 17 U.S.C. § 512(g). Under this section, the OSP must make a good faith effort to locate and notify the subscriber whose content was taken down. Also, if the subscriber files a counter-notification contesting the takedown, the OSP must provide the original complainant with a copy of the counter-notification and notice that the OSP will replace the material within ten business days. Last, the OSP must replace the material within ten to fourteen days after receipt of the counter-notification, unless the complainant files a lawsuit seeking injunctive relief against the subscriber.

37. Id.
makes knowing material misrepresentations about the infringing or non-infringing character of the material, § 512(f) of the Act provides liability for damages including costs and attorney’s fees.38

C. COPYRIGHT LITIGATION AND SECONDARY LIABILITY BEFORE AND AFTER THE DMCA.

Before the DMCA, copyright cases involving the liability of ISPs had varying outcomes. In one pre-DMCA case, Playboy Enterprises v. Frena,39 the district court found that the operator of an Internet bulletin board service (BBS) had directly infringed the plaintiff’s distribution rights. The problem stemmed from users of the defendant’s service posting digitized images of Playboy centerfolds. The court noted that copyright infringement is a strict liability offense and found the defendant liable, reasoning that while the defendant had acted passively, the system itself had contributed to the infringement. This approach, however, was largely abandoned. In Religious Technology Center v. Netcom On-Line Communication Services, Inc.40 the court refused to find direct infringement without a showing of “some element of volition or causation which is lacking where a defendant’s system is merely used to create a copy by a third party.”41

Although Netcom’s “volitional act” test was largely accepted and applied,42 it would not equip service providers with an impermeable shield from liability.43 Netcom’s standard of application remains murky today. After the DMCA became law, one of the first cases to apply it was ALS-Scan v. RemarQ Communities, Inc.44 In that case, an ISP ignored the plaintiff’s requests to remove entire Internet newsgroups where users were transmitting pornography despite the plaintiff’s claim to exclusive distribution rights.45 Despite the plaintiff’s failure to meet the statutory

38. Id. § 512(f).
41. Id. at 1370.
42. See, e.g., CoStar Group Inc. v. Loopnet, Inc., 373 F.3d 544 (4th Cir. 2004). The court in CoStar said:

There are thousands of owners, contractors, servers, and users involved in the Internet whose role involves the storage and transmission of data in the establishment and maintenance of an Internet facility. Yet their conduct is not truly “copying” as understood by the Act; rather, they are conduits from or to would-be copiers and have no interest in the copy itself.

Id. at 551.
43. See Perfect 10, Inc. v. Cybernet Ventures, Inc., 213 F. Supp. 2d 1146, 1173 (C.D. Cal. 2002) (finding Cybernet liable for vicarious infringement where Cybernet failed to implement a policy of terminating users that were repeat infringers).
44. ALS-Scan v. RemarQ Cmtys., Inc., 239 F.3d 619 (4th Cir. 2001).
45. Id. at 621.
requirements in providing notice of the infringement, the fourth circuit held that the safe harbor provisions of the DMCA did not exempt RemarQ from secondary liability. The court held that safe harbor did not apply, even in the absence of a “volitional act.”

Given an OSP’s option of preserving limited liability, Congress might have predicted a dearth of litigation over application of the DMCA safe harbor provisions. However, Congress may not have anticipated the neglect of the § 512(g) “putback” provision and the obsolescence of the § 512(f) penalties for misrepresentation. Indeed, both of these provisions are almost never used. Preliminary analyses of takedown letters collected by Chillingeffects.org have indicated that § 512(g)’s counter-notification provisions are rarely used. A survey of the two thousand notifications reported to chilling effects since 2002 reveals only seven instances of counter-notifications. Successful § 512(f) claims for fraudulent misrepresentation are also few and far between. While the plaintiffs were successful in one such claim in Online Policy Group v. Diebold, the courts have set a very high standard for showing “knowing misrepresentation,” a critical element of fraud. As a result, except for the clearly sinister case of copyright law manipulation, § 512(f) fails to act as a deterrent against spurious takedown requests.

III. THE SCOPE OF THE PROBLEM

In the 2003 article, How Liberty Disappeared From Cyberspace, the authors conducted a “mystery shopper” test. They posted public domain excerpts from philosopher John Stuart Mill’s On Liberty on free web site hosts from both U.K. and U.S. ISPs. Then, posing as the Chairman of the (fictitious) John Stuart Mill Heritage Foundation, they sent cease and desist letters to both ISPs claiming copyright violation and demanding that the

46. See Raphael A. Gutiérrez, Save The Slip For The Service Providers: Courts Should Not Give Short Shrift To The Safe Harbors Of The Digital Millennium Copyright Act, 36 U.S.F. L. REV. 907, 934 (2002) (arguing that ALS Scan court misconstrued the statute by accepting ALS Scan’s website address as substantial compliance with the statutory notice requirements, rather than requiring a representative list of all the allegedly infringed works).
47. ALS-Scan, 239 F.3d at 626.
48. Id.
49. See Urban, supra note 29, at 679.
51. See Urban, supra note 29, at 630 (“[F]or a complainant to ‘know’ with legal certainty that its complaint targets a non-infringing or fair use is often unrealistic, given the complexity of copyright infringement analysis and the famed unpredictability of the fair use defense.” (citing Rossi v. Motion Picture Ass’n of America, 391 F.3d 1000 (9th Cir. 2004); Dudnikov v. MGM Entm’t., Inc., 410 F. Supp. 2d 1010 (D. Colo. 2005))).
53. Id. at 17.
54. “On Liberty” was first published in 1859 and has passed into the public domain under U.S. and U.K. law. Id. at 3.
The U.S. ISP responded to the complaint by requesting that notice of infringement be given in a way that satisfied the statutory requirements of the DMCA (including swearing under penalty of perjury to the truth of the complaint). The U.K. ISP, on the other hand, promptly took down the site with minimal investigation.

The “mystery shopper” research highlights concerns about the notice and takedown regime. First, there is a lack of standards for responding to complaints, particularly in the EU. Second, service providers have an economic motivation to take down materials with minimal investigation. Third, the potential for abuse is high.

A. STANDARDS FOR RESPONSE

The EU’s legislative analog to the DMCA, the European Directive On Electronic Commerce (EU Directive), states the law in language similar to the DMCA. The EU Directive states, “upon obtaining actual knowledge or awareness of illegal activities [a provider] has to act expeditiously to remove or to disable access to the information concerned.” In the application of both U.S. and U.K. law, a fundamental question is the standard for “actual knowledge or awareness.” Arguably, receipt of a complaint does not constitute actual knowledge of illegal activities, but merely a notice of the complaint. The DMCA sets out specific mechanical criteria for proper notice, but not for actual knowledge. Neither the EU

55. Id.
56. See 17 U.S.C. § 512(c)(3)(A)(vi) (2000) (“A statement that the information in the notification is accurate, and under penalty of perjury, that the complaining party is authorized to act on behalf of the owner of an exclusive right that is allegedly infringed.”). Since the details in the complaint were quite false, Ahlert and his colleagues chose not to pursue this complaint further with the U.S. ISP. See Ahlert, supra note 52, at 23.
57. Id. at 9.
58. Id. at 11 (“It does not create an incentive for the ISP to properly investigate whether content is illegal, but rather to remove the content expeditiously.”).
59. Id. at 10 (“[T]he current regime may actually promote unfair competition in some situations where companies engage in a form of commercial war on the internet, putting bad faith claims against their competitor’s Web content.”).
61. Id.
62. Id.
63. The DMCA’s language raises the same question of the standard for “actual knowledge.” For a discussion of this distinction as applied to the DMCA, see generally Zarins, supra note 19.
64. See 17 U.S.C. § 512(c)(3) (2000). The statute requires for notice: i) the signature of someone authorized to act on behalf of the copyright owner; ii) identification of the copyrighted work or works claimed to have been infringed; iii) identification of the materials claimed to be infringing, and information sufficient to locate those materials; iv) contact information for the complaining party; v) a statement that the complaining party has a good faith belief that use of the material is not authorized by the copyright owner, its agent, or the law; and vi) a statement that the
Directive nor the DMCA sets a standard for how much proof a complaining party must present in a request for removal. In practice, under the EU Directive, providers tend to treat the complaint as actual knowledge of infringement. Indeed, although the mystery shopper test was constructed so that even minimal investigation would reveal that the complaint was fictitious, the U.K. provider removed the material anyway. Under the DMCA, once the minimum notice requirements are met, a provider can simply take the complaining party’s word without further investigation, no matter how farfetched the claim. Had the “mystery shoppers” been willing to falsely swear under penalty of perjury, the U.S. ISP may have been willing to take their word for it.

B. LOW INCENTIVES FOR DUE DILIGENCE

There are two reasons why a provider might not question takedown requests. First, there is the threat of losing safe harbor protections and being exposed to liability for failure to remove infringing material after receiving notice. Second, thoroughly investigating each of these claims can be terribly arduous and expensive. Even in the EU, where there is a threat of liability for wrongfully removing legal content, the incentive to take down content still outweighs the risks of not taking down. Copyright owners are more likely to take legal action against a deep-pocketed third party provider than against an individual Web site publisher.

Reviewing the validity of takedown requests demands significant work and legal training. Although some disputed Web pages clearly violate copyright laws, most fall in a gray area. Further, many disputes involve large amounts of material. For example, one complaint submitted to Google by Perfect 10, Inc. set forth approximately 200 individual claims of

information in the notification is accurate, and under penalty of perjury, that the complaining party is authorized to act on behalf of the copyright owner.

65. See Ahlert, supra note 52, at 9–10.

66. In the United States, the DMCA excludes such liability, providing:

a service provider shall not be liable to any person for any claim based on the service provider’s good faith disabling of access to, or removal of, material or activity claiming to be infringing or based on facts or circumstances from which infringing activity is apparent, regardless of whether the material or activity is ultimately determined to be infringed.

17 U.S.C. § 512(g)(1).

67. Individual operators often have no assets, eliminating the deterrent value of large judgments. Moreover, Web site operators are often intimidated into removing content without the need for litigation. See Lisa M. Bowman, Free Speech Feels Net copyright chill, CNET NEWS, Oct 24, 2002, http://news.com.com/2102-1023_3-963122.html?tag=st.util.print (“[L]egitimate sites were being shut down by legal threats. People who don’t have legal training or lots of money often back down when they receive threatening letters from lawyers.”).

68. Id.
infringement for unauthorized use of adult content. The resources that Google would need to devote to parsing through each of the individual claims would be significant, even without any legal investigation into actual infringement. Verifying the authorship of each work and ascertaining whether rights to each have in fact been infringed would be unworkable. Congress probably did not intend that a provider such as Google should maintain a staff of copyright lawyers and pornography connoisseurs in order to respond to such claims. The alternative, however, is that Congress meant for providers to take each complaint on its face as actual knowledge of infringement. While the investigative measures that Google took in response to Perfect 10’s claims are unclear, Google did ultimately remove several of the links.

It is arguably impossible for a service provider like Google to effectively police its search results for infringing content. The Church of Scientology and others have submitted several complaints to Google not only for search results, but also for postings in Google Groups, Google’s newsgroup service. Service providers have argued that saddling technology providers with comprehensive policing duties will hamper technology services and dramatically raise costs for consumers.


70. Perfect 10 complained that a Google search for “Vibe Sorenson” (the model in several of the allegedly infringed photographs) brought up search results containing links to infringing websites. Google removed the links to the infringing sites. The same search now reveals several messages stating, “In response to a complaint we received under the US Digital Millennium Copyright Act, we have removed 2 result(s) from this page. If you wish, you may read the DMCA complaint that caused the removal(s) at ChillingEffects.org.”


Google’s point of view, as expressed in an e-mail provided to internetnews.com, was that he should take his complaint to the offending publishers. “Google is a provider of information, not a mediator. . . . Even if we were able to eliminate the offending page from our index, it would still be on the Web. Every few weeks, our robots sweep the Web for content. If the site is still available on the Web when we crawl, we will likely pick it up and add it to our index again.”


73. See Zarins, supra note 19, at 266; see also Cassandra Imfeld and Victoria Smith Ekstrand, The Music Industry And The Legislative Development Of The Digital Millennium Copyright Act’s Online Service Provider Provision, 10 COMM. L. & POL’Y 291, 305 (2005).

[Service providers] in performing their various system functions, simply cannot review and monitor all the data that is transmitted over and stored in their networks or bulletin boards. Indeed, trillions of bits of data—representing millions of individual messages—travel across the country and around the world each day. . . . Providers of online services do not know what is being uploaded onto, transmitted through, stored upon, and downloaded from their systems.

Id.
C. POTENTIAL FOR ABUSE

It is not surprising that many service providers have chosen to cut off liability by presuming validity and complying with takedown requests rather than struggling to investigate each request. As the mystery shopper test proves, a party could lodge spurious infringement complaints and manage to have content removed. Without a requirement for a judicial determination of infringement, the door is open for abuse of the notice and takedown system for purposes of interfering with competitors, or silencing criticism, or just out of arbitrary vindictiveness.

The absence of a public record of takedown requests raises the potential for abuse. Since the public is not generally made aware of takedown requests, senders of such requests have far less motivation to behave scrupulously than if they were filing a lawsuit, for example. The public will never know who sent a typical takedown request, who received it, what works have allegedly been infringed or who the alleged infringer was.

One response to this problem has been the creation of the Chilling Effects Clearinghouse (Chillingeffects.org). Chillingeffects.org asks its users to forward cease and desist letters. Those letters are compiled into a searchable database and made available to the public. In 2002 Google agreed to forward all the cease and desist letters it received to Chillingeffects.org, and to post notices wherever it removes content from its search results. Since Google adopted this policy, Chillingeffects.org has published almost a thousand cease and desist letters sent to Google.

D. EFFECTS ON SPEECH AND THE UTILITY OF INTERNET SEARCH

Free speech advocates are concerned that abuse of the notice and takedown regime could unjustly chill speech and reduce public access to information on the Internet. This occurs when non-infringing content is

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74. See Ahlert, supra note 52, at 6–7.
75. See Bowman, supra note 67 (“Free speech advocates also fear that many companies and organizations are trying to shoehorn their trademark claims into DMCA claims in the hopes of persuading ISPs to quickly take down the sites.”).
77. See Chris Sherman, Google Makes Scientology Infringement Demand Public, SEARCHENGINEWATCH.COM, Apr. 15, 2002, http://searchenginewatch.com/searchday/article.php/2159691 (“Google’s policy is now to send copies of all notices of alleged infringement to third parties, such as Chillingeffects.org, that will make them available to the public, confirmed Google spokesperson David Krane.”).
78. Id.
79. In addition to the cease and desist letters that Google has received, ThePlanet.com, an Internet hosting provider, has recently agreed to provide Chillingeffects.org with access to the 1600 requests that it has received since 2004. See Urban, supra note 29, at 643.
taken down in response to flawed complaints that do not meet the statutory requirements of §512. Removing information from search engines also makes Internet search technology less useful. Google users cannot be sure that search results do not exclude important contrasting views. This undoubtedly contributed to Google’s decision to forward the takedown letters to Chillingeffects.org and to publish notices of removal within search results. Google has recognized the value of transparency in the notice and takedown process and of avoiding wrongful takedowns. However, other search engines, like most OSPs, neither forward takedown letters to Chillingeffects.org nor publish notices of takedown.

Wrongful removal of material from Google search results upsets the balance of information more than it affects the volume of available information. The number of previous DMCA takedowns is probably small relative to the billions of pages on the Internet today. But with the potential for wrongful takedowns of controversial information, users of search engines cannot be sure that search results include all available contrasting views—that search results were not manipulated to obscure detractors or competitors from view. Thus, the removal of controversial material strikes a blow to Internet speech, undermining the Internet’s capacity to act as a forum for the free exchange of ideas.

IV. GOOGLE COULD IGNORE TAKEDOWN REQUESTS

Google could ignore takedown requests for three reasons. First, Google could ignore complaints that do not satisfy the notice requirements of §512(c)(3). Surprisingly, one out of every eleven notices sent to Google exhibited significant statutory flaws. Many of the cease and desist letters sent to Google exhibited one or more common statutory flaws. For example, many complaints were invalid because they involved non-copyrightable materials and fair use. Other flawed complaints do not

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81. Legislative history indicates that Congress not only recognized the usefulness of search engines when it enacted the DMCA, it acted in order to preserve this utility. See H.R. REP. No. 105-551, pt.2, at 58 (1998) (“Information location tools are essential to the operation of the Internet; without them, users would not be able to find the information they need.”).

82. See Sherman, supra note 77.

83. See Hiler, supra note 10.


86. See Urban, supra note 29, at 674. This one-out-of-eleven figure does not include those minor flaws that would not render a complaint invalid such as stating a good faith basis and providing a signature.

87. Id. at 667. See id. at 666 for a list of these flaws and an analysis of their frequency.

88. Section 102 of the U.S. Copyright Act affords protection for “original works of authorship,” 17 U.S.C. § 102 (2000). Therefore, a complaint could be ignored where it regarded...
comply with the technical requirements of § 512(c)(3). Another common flaw involves § 512(a) takedown letters sent to an OSP acting as a passive conduit, such as an upstream provider used for sending email. Unlike BBSs and information location tools such as Google, passive conduits are not obligated to take down content under the provisions of §512(c). In nearly half of the non-Google notices collected by Chillingeffects.org, the OSPs were acting as conduits, and were not obligated to take down content. Moreover, they could have ignored those complaints without any loss of safe harbor.

The second reason Google might ignore takedown notices is that Google would not be liable even if it were sued. The DMCA does not alter the infringement analysis. It only seeks to foster a system that deals efficiently with disputes over Internet property rights. Therefore, a provider may waive its safe harbor protections without necessarily becoming liable. Where safe harbor does not apply, the infringement analysis remains and a court would analyze the facts accordingly. It is not surprising that Google and other providers choose to keep their own liability limited by following notice and takedown procedure. But ignoring certain requests would probably not result in liability. This means little in practice because businesses generally prefer “no-risk” to “low-risk” and so choose to preserve their safe harbor privilege.

un-authorized use of an idea alone, or something similarly undeserving of protection under copyright law.

89. Some unauthorized uses of copyrighted materials for “purposes such as criticism, comment, news reporting, teaching, . . . scholarship, or research” constitute fair use and are therefore non-infringing. Id. § 107 (2000).

90. Where a party substantially complies with § 512(c)(3)(A)(ii), (iii) and (iv) (identification of the allegedly infringed and infringing works, and contact information for the complaining party), but fails to satisfy the other notice requirements of § 512(c)(3)(A), the OSP is not free to ignore the request. Instead, the OSP is still obligated to take reasonable steps to assist in receipt of notice that substantially complies. Id. § 512(c)(3)(B)(ii). This implies, however, that where the complaining party does not: a) identify the allegedly-infringed work; b) identify the allegedly-infringing work; c) provide a way to locate the allegedly infringing work; and d) provide contact information for the complaining party, the OSP would be free to ignore the complaint altogether. See Urban, supra note 29, at 674 (defining these subsections as necessary for “substantial compliance,” and arguing that any failure to meet them is a “significant” statutory flaw rending the notice invalid).

91. See Urban, supra note 29, at 674–76.

92. Id. at 674. The legislative history for § 512 states:

The Committee emphasizes that new Section 512 does not specifically mandate use of a notice and take-down procedure…[T]he service provider is free to refuse to “take down” the material or site-even after receiving a notification of claimed infringement from the copyright owner. In such a situation, the service provider’s liability, if any, will be decided without reference to new Section 512(e).

H.R. REP. NO. 105-551, pt. 2, at *58 (1998); See also Ellison v. Robertson, 357 F.3d 1072, 1077 (9th Cir. 2004) (“Congress provided that OCILLA’s ‘limitations of liability apply if the provider is found to be liable under existing principles of law.’”).
Very few cases in the United States have found liability for creating hyperlinks to infringing content. Two cases that did were *Universal City Studios v. Reimerdes*,93 and *Intellectual Reserve v. Utah Lighthouse Ministry*.94 In both of these cases, the court found that the defendant had acted with the purpose of disseminating infringing material.95 In a case about hyperlinks in search results, a court would probably not see Google’s purpose as the dissemination of infringing material. Since Google’s technology automatically sifts vast amounts of Internet content (ostensibly the entire Internet) for the purpose of creating a searchable index of that content, a court may be unwilling to define Google’s purpose as “disseminating” material at all.96 Indeed, Google’s stated mission is “to organize the world’s information and make it universally accessible and useful.”97 If a court accepted this as Google’s purpose, the court could distinguish cases like *Reimerdes* or *Utah Lighthouse Ministry* where the defendants’ purposes were clear and illicit in comparison.98

A third reason why Google could decline to take down involves complaints under foreign law. Several cease and desist letters in the ChillingEffects.org database pertain to European defamation law.99 In the

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93. *Universal City Studios v. Reimerdes*, 111 F. Supp. 2d 294 (S.D.N.Y. 2000). In *Reimerdes*, eight major motion picture studios sued the publisher of *2600: The Hacker Quarterly*, an online magazine, after the defendant published code which allowed users to ‘rip’ and copy encoded DVDs. *Id.* at 308.

94. *Intellectual Reserve v. Utah Lighthouse Ministry*, 75 F. Supp. 2d 1290 (D. Utah 1999). In *Utah Lighthouse*, defendants were held liable for linking to three websites where users could download plaintiff’s copyrighted material. Finding contributory liability, the court found that the defendants contributed not to the infringing behavior of the websites offering the material for download, but rather for the actual downloading by the users. *Id.* at 1295.

95. In *Reimerdes*, the defendant was found contributorily liable under the DMCA’s anticircumvention provisions. After being enjoined from posting the code on his own website, defendant urged other sites who had not been enjoined to post the material and then linked to those sites for the purpose of facilitating downloads. *Reimerdes*, 111 F. Supp. 2d at 324. Similarly, in *Utah Lighthouse Ministry*, the court emphasized: “After being ordered to remove the Handbook from their website, defendants posted on their website: ‘Church Handbook of Instructions is back online!’ and listed the three website addresses.” *Utah Lighthouse Ministry*, 75 F. Supp. 2d at 1295.

96. See Kuchinskas, *supra* note 71 (quoting an e-mail from Google).

“Even if we were able to eliminate the offending page from our index, it would still be on the Web. Every few weeks, our robots sweep the Web for content. If the site is still available on the Web when we crawl, we will likely pick it up and add it to our index again.”

*Id.*


98. In both *Reimerdes* and *Utah Lighthouse* the defendants were facilitating the illegal copying or downloading of copyrighted material. Google, on the other hand, operates a search engine.

99. See, e.g., Notice from Google to ChillingEffects.org, German Complaint of Illegal Material in Google Search (Sept. 24, 2006), http://chillingeffects.org/international/notice.cgi?NoticeID =2382 (“On September 24, 2005, Google received a complaint via email regarding a site that is allegedly illegal according to German law. In response to this complaint, we have removed the site from the www.google.de domain.”). Among the cease and desist letters that Google has reported
United States, ISPs are shielded from defamation claims by the § 230 of Communications Decency Act.\textsuperscript{100} Therefore, DMCA Safe harbor protection is irrelevant to foreign defamation claims.\textsuperscript{101} This is not to say that Google could not be sued in a European court under European defamation law. However, foreign parties can masquerade foreign law claims as DMCA complaints to obtain the quick results that are common in the DMCA notice and takedown regime.

Finally, international takedown requests involving foreign law could lead to actions in non-U.S. courts under non-U.S. defamation law. However, in such cases a foreign court might lack personal jurisdiction over Google. Even if a non-U.S. court exercised jurisdiction, the First Amendment might render a foreign judgment unenforceable in the United States.\textsuperscript{102} Google may be subject to jurisdiction in several countries because of its international business contacts. Nevertheless, if Google had no assets in the foreign jurisdiction, the judgment might be unenforceable in the U.S. and Google could choose to ignore the complaint.

V. AN ECONOMIC APPROACH TO THE CHILLING EFFECT

A. MARKET FAILURE

Although elements of the law of secondary liability on the Internet remain unsettled, the safe harbor provisions of the DMCA and of the EU Directive on Electronic Commerce seem to have helped create a stable system of self-regulation in the day-to-day operation of Internet business. In the absence of a corpus of case law, an economic analysis of the current system of incentives may provide insight into the problems with the notice and takedown system, and into the usefulness of available alternatives. These problems are externalities (costs or benefits to people other than the individuals making decisions) produced by the DMCA’s system of self-regulation. They can be seen as a form of market failure.

Failure in the market’s self-regulatory mechanisms include: “[m]onopoly, pollution, fraud, mistake, mismanagement, and other unhappy

\textsuperscript{100} 47 U.S.C. § 230(c) (2000); see, e.g., Zeran v. America Online, Inc., 129 F.3d 327 (4th Cir. 1997) (declining to hold ISP liable for failure to remove defamatory material from BBSs).

\textsuperscript{101} See Symposium, Metamorphosis of Artists’ Rights in the Digital Age, 28 COLUM. J.L. & ARTS 397, 412 (2005) (“Where no copyright subsists, the protections in the DMCA do not apply.”).

\textsuperscript{102} See Yahoo! Inc. v. La Ligue Contre Le Racisme et L’Antisemitisme, 169 F. Supp. 2d 1181, 1184 (N.D. Cal. 2001). After plaintiffs obtained an order from a French court requiring Yahoo! to block French citizens’ access to any Nazi material displayed or offered for sale on Yahoo’s United States auction site, Yahoo! filed suit in U.S. district court arguing that enforcement of the order would constitute a deprivation of its First Amendment rights. See id.
byproducts of the market." 103 In the conventional view, any of these failures would justify public regulation. 104 While the current system of self-regulation appears to protect copyrights reasonably well, those protections have a social cost in the potential for wrongful removal of information from the Internet. Market incentives exacerbate the problem. Offering insulation from liability encourages removal of content. The incentive for unjustified takedowns, combined with a lack of transparency in the takedown process results in a chilling effect on Internet speech. This reduces public access to information on the Internet and limits free discourse on the Web.

Two common methods of regulation used to remedy market failure are the common law method and direct (or administrative) regulation. 105 The common law method relies chiefly on private parties as opposed to public officials. 106 Private parties can sue those causing the harm and receive compensation for the injuries suffered. In addition, the threat of a costly lawsuit may deter further harm. In contrast, direct regulation relies more on public officials and seeks to prevent injuries before they occur rather than to compensate injured parties. 107

A classic illustration of market failure is air pollution. 108 The common law method will probably not solve problems such as pollution from cars because each individual injury is small and the sum of the injuries is spread thinly across many parties (both injured and injuring). 109 As a result, the victims are unlikely to bring lawsuits because their recoverable damages will be small in each instance. This problem is analogous to the notice and takedown regime’s chilling effect. Single incidents of wrongful removal go unreported 110 and are not noticed by the public. 111 In both contexts, while the individual harm is small, the total number of occurrences can multiply to yield a very high aggregate social cost.

104. Id. Posner goes on to qualify this statement, noting that these indications of market failure do not necessarily warrant public regulation, and that direct regulation can be costly financially and politically. See id. at 385.
105. Id. at 383.
106. Id.
107. Id.
109. See id. at 429 (“Environmentalists also argue that common law liability rules, such as nuisance law, are incapable of enforcing the polluter pays principle.”).
111. Just as one is unlikely to immediately perceive the polluting effect of a single car driving by, the public may not notice the removal of a single web site from Google search results. However, just as the aggregate effect of millions of cars is apparent, the effects of many takedowns would have a noticeable effect on the availability of information.
There are three administrative approaches to regulating pollution: input control, output control, and tax control. With input control, the legislature sets mandatory remedial steps that polluters must take to avoid penalties. Output control focuses on ends rather than means, leaving the choice of means up to the regulated party while setting a maximum amount of pollution that will be allowed without punishment. The third approach is to tax pollution—setting a “price” for pollution equal to the social cost of the pollution. These three approaches represent different philosophies for correcting market failure, with varying levels of emphasis on self-regulation, market incentives and economic efficiency.

Output control and tax control approaches to the notice and takedown problem are impracticable. Unlike pollution, the notice and takedown externalities are inherently unquantifiable. No public record documents DMCA complaints. As a result, no government agency can measure the problem to cap or tax it. For air pollution both output control and the tax control treat some underlying harm as a “necessary evil.” Even if some air pollution is necessary to even the most environmentally friendly manufacturing process, wrongful takedowns are not needed for efficient operation of the Internet. The “necessary evil” view embodied in the tax approach does not translate to the problem at hand.

B. HAS SELF-REGULATION FAILED OUTRIGHT?

Discussing this problem in terms of market failure requires working around the subjectivity of the notion of “failure.” Common signals of market failure (e.g., monopoly, pollution, and fraud) are not necessarily litmus tests for a failure of public regulation. Instead, they may indicate merely that the market is “failing” only in the sense that “it is failing to be perfect.” Indeed, the presence of negative externalities may be

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112. POSNER, supra note 103, at 390–91.
113. For example, a polluter might be required to install special sewage treatment plants, emission control devices or taller smokestacks. Id. at 390.
114. A municipality might set a maximum number of pounds per square inch of pollution, leaving the polluter to decide whether it will install new equipment, alter its method of production or cease a particularly costly behavior. Posner points out that output control might appear more flexible and efficient than input control, but it also creates an incentive to reduce the costs of compliance as much as possible, which could allow too much pollution. Id. at 391.
115. Id. The tax approach represents a departure in the comparison of pollution and Internet self-regulation. The tax approach assumes that a certain level of pollution is not only inevitable but necessary and desirable for efficient operation. The tax acts not as a punishment, but as a cost of doing business, and an incentive to minimize pollution. Unjustified removal of Internet content on the other hand, is not integral to the successful operation of an OSP, but rather is a by product of a statutory scheme that creates too great of an incentive for complying with takedown complaints. Nevertheless, the pollution analogy helps illustrate the parallel between the topic at hand and more traditional examples of market failure.
116. NEIL KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY 103–04 (1994) (“Since all alternatives are also imperfect, the existence of market ‘failures’ cannot determine policy outcomes.”).
unfortunate, but the alternatives may well present bigger, more harmful externalities.\textsuperscript{117}

The alternatives for regulation of OSPs with regard to copyright infringement may not have proven any better for any of the parties concerned. One such alternative was embodied by the proposed measures in the \textit{White Paper}, circulated by the Working Group on Intellectual Property Rights September of 1995.\textsuperscript{118} The \textit{White Paper} which had been heavily influenced by the music and film industries,\textsuperscript{119} recommended that service providers be held strictly liable for user copyright infringement. The effect of these changes would have greatly exaggerated the current problems with notice and takedown.\textsuperscript{120}

On the other hand, limiting incentive for service providers to respond to the takedown requests presents a different set of problems. The production of copyrighted media like music, TV, and film, plays a huge role in the U.S. economy.\textsuperscript{121} Failure to protect the exclusive rights of copyright owners would undermine the basic incentives for creation of works under copyright law and would place the country’s economic interest at risk.

From Google’s perspective, continuing to self-regulate under the current DMCA regime presents some annoyances, but also offers a degree of security. Fielding complaints such as Perfect 10’s\textsuperscript{122} (i.e. comparing hundreds of allegedly infringing pornographic photographs to the originals) may be an inefficient use of any technology company’s resources. Moreover, removing anything from search results arguably runs counter to

\begin{footnotesize}
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\item[117.] For example, both Posner and Komesar point out that regulation involves serious information problems. \textit{Posner, supra} note 103, at 385 (“If accident victims have nothing to gain from bringing an unsafe condition to the government’s attention, the regulators may have difficulty finding out what exactly the problem is.”). Komesar also suggests that high costs of information (cost of acquiring basic data, as well as the costs of understanding that data) as a potential root cause of market failure. \textit{See Komesar, supra} note 116, at 102–03 (“Where low per capita transaction benefits combine with high information costs, we get ignorance that can be manifested in a failure to act or in a mistaken choice that would not be made given better information.”).
\item[119.] \textit{See Lawrence Lessig, Free Culture} 126 (2004) (referring to “copyright warriors”).
\item[120.] \textit{See Zarins, supra} note 19, at 266.
\item[121.] \textit{See International Intellectual Property Alliance, Copyright Industries in the U.S. Economy, the 2004 Report,} http://www.iipa.com/pdf/2004_SIWEK_FULL.pdf. In 2002 the value added by the copyright industry to the U.S. economy was $626 billion or six percent of the U.S. economy. \textit{Id.}
\item[122.] \textit{See} Letter from Perfect 10 to Google, \textit{supra} note 69.
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a search engine’s function of providing search technology that indexes all available information. On the other hand, a constant need to actively police content for copyright violations by users would have a crippling effect on OSPs and the technology that they create. Additionally, direct regulation by an administrative agency would present a whole new set of transaction costs from Google’s perspective. Google would probably prefer to continue to self-regulate. Most importantly, the limitation on liability that Google enjoys under the safe harbor provisions allows it to properly allocate resources for responding to takedown requests without too much concern over being sued for infringement.

Copyright owners are possibly the most content under the current system. Though a strict liability system like that proposed in the White Paper would have provided for aggressive protection of copyrights, the notice and takedown regime also provides for very strong protection. It is possible that the copyright industry is really in a comparable position to what might have occurred under a White Paper system, given evidence of over-enforcement in responses to takedown requests.

From the government perspective too, self-regulation is less costly than a more direct method of administrative regulation. The status quo appears to function properly in terms of the DMCA’s principal concern—regulating copyright infringement. The government would probably not be eager to adopt a more invasive system of regulation, particularly since the associated transaction costs could hinder OSPs in their development of technology. In light of the alternatives, it is possible that the notice and takedown problem does not constitute the level of market failure that would require a new system of public regulation. However, this is not to say that Internet users, publishers or OSPs should be content with the notice and takedown regime as it exists today.

VI. CONCLUSION AND PROPOSED REMEDIAL MEASURES

Despite its lack of clear standards in terms of the proper response to a § 512 complaint, the DMCA has achieved some success in balancing its two principal goals: protection of the rights of copyright owners and limiting liability of online service providers. However, an examination of the application of the DMCA’s notice and takedown process reveals negative externalities. Byproducts of the notice and takedown regime include an incentive for OSPs to remove content without careful scrutiny. This

123. See Zarins, supra note 19, at 266 (“[An OSP’s] ability to monitor the ‘trillions of bits of data—representing millions of individual messages’ that travel through their systems every day is virtually impossible without considerably slowing down the hailed ‘Internet speed’ or burdening consumers with dramatically increased costs.”).


125. See White Paper, supra note 118, at 114–24.
incentive increases the potential that flawed or disingenuous complaints will still result in the removal of content from the Internet.\textsuperscript{126} Indeed, flawed complaints are common.\textsuperscript{127} The potential for abuse of the notice and takedown system may not rise to the level of market failure requiring the introduction of direct government regulation. However, consumers, providers and the government need not and should not be content with the current system’s externalities. Steps should still be taken to balance the incentives and minimize the potential for wrongful takedowns.

A. INTERNATIONAL STANDARDIZATION OF INDUSTRY BEST PRACTICES

One measure for minimizing the problems of notice and takedown without the need for administrative regulation is the development of international standards of industry best practices for online service providers. Since judicial determination of infringement is not part of the notice and takedown process, OSPs act as de facto judges and juries, ultimately deciding the validity of complaints. Since the DMCA does not provide guidelines for OSPs, creating a workable standard for evaluation of complaints would contribute to uniform results and reduce the appearance of arbitrariness. Such standards would also act as self-imposed measures against unwarranted takedowns. This could include following Google’s lead by forwarding DMCA complaints to the Chillingeffects.org database, as well as a heightened level of scrutiny for the types of complaints that are likely to be questionable, such as complaints about content that is published for the purpose of criticism of the complaining party, or by business competitors.\textsuperscript{128}

B. DEVELOPMENT OF A PUBLIC RECORD

In light of the potential for fraud, abuse and mistakes, the need for greater transparency in the notice and takedown process is evident. Despite the public interest in making (and keeping) information available on the Internet, there is no effective way for the public to monitor the takedown process. Complaining parties have had little reason to expect that their complaints would be subject to significant scrutiny. Indeed, the service providers that receive complaints are not adversaries to the complaining copyright owners, but merely intermediaries with an interest in preserving their limited liability.

\textsuperscript{126} See Ahlert, supra note 52.
\textsuperscript{127} See Urban, supra note 29, at 674.
\textsuperscript{128} This is not to say that all complaints in these categories are ill-founded. On the contrary, most DMCA complaints about copyright infringement are genuine and may indeed warrant a takedown. However, the categories of complaints that are most likely to include false complaints deserve closer scrutiny.
Chillingeffects.org has taken the first steps toward the creation of a searchable database of § 512 takedown requests. However, since this database only contains complaints that have been voluntarily submitted, the scope of the data is limited. To give the public a greater opportunity to monitor removal of information from the Internet it is necessary to expand the pool of available data. One solution would be for the Copyright Act to provide a central mechanism for simultaneously sending and recording § 512 complaints. This would not require the government to act as an intermediary in the resolution of the complaints. It could merely require complaining parties to enter the pertinent information into an online form and submit it via the Internet to the intended recipient. In the process, all complaints could automatically be recorded in a public database.

This mechanism would allow for a complete public record of all § 512 takedown requests. Second, requiring submission of DMCA complaints through a public channel would add formality to the process. This could deter unfounded or fraudulent complaints by adding additional gravity to the § 512(c) requirement of swearing under penalty of perjury to the veracity of a complaint. Making these complaints available to the public would also check service providers’ incentive to remove content too quickly by encouraging greater care in evaluating DMCA complaints. In addition, a complete public record could enhance copyright owners’ ability to observe patterns of infringement on the Internet and adopt informed policies for the protection of their rights. Finally, a public record of takedown complaints could also act as a deterrent for infringers.

The Xenu story underscores the need for increased transparency in the takedown process to curb abuse. In a recent article about Google, a Norwegian newspaper retold the story of Xenu.net and its operator, Andreas Heldal-Lund:

“[T]he removal of Heldal-Lund’s site from Google did not pass unnoticed… American newspapers started writing about Scientology’s and Google’s censorship of the Norwegian website… ‘Google reopened almost all of my pages, says Heldal-Lund. At the same time the company also published all complaints from the Church of Scientology. My case was solved, but only because the world media helped. A small organization who gets no public attention will get run over. Google might have censored more web sites without us knowing. We need a watchdog to defend freedom of speech on the Internet,’ says Andreas Heldal-Lund.”

Heldal-Lund’s experience demonstrates the benefit of holding parties who seek swift justice under the DMCA accountable. Accountability is facilitated by moving the notice and takedown process out from behind the closed doors, and into public view with defined standards.

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* B.A. University of Michigan; J.D. Brooklyn Law School (expected 2007). I would like to thank the following people: My wife, Lisa, for loving support and encouragement; my daughter, Evelyn, for inspiration and perspective; my parents, Rochel and Jeffrey Urist, for everything, and Professor Lawrence Solan for generosity and guidance.
A PROPOSAL TO REFINE THE SUITABILITY STANDARD BY QUANTIFYING RECOMMENDATION RISK AND CLIENT APPROPRIATE RISK LEVELS

Unsuitable recommendation of securities is one of the most common and costly claims in the brokerage industry.¹

Perhaps the clearest example of a suitability violation occurs where a broker recommends speculative securities to a customer whose financial situation clearly calls for conservative investments (for example, a retired person who needs the income from his investments for his living expenses and who has no reasonable expectation of being able to replace any substantial trading losses).²

The current standard for determining “unsuitability” is subjective: Whether the broker reasonably believed his recommendation to be suitable for his client when he made it. The enormous quantity of claims³ suggests that such a subjective standard may not be satisfactory and that refinement of the applicable laws and rules may be necessary. Without a clear standard, brokers may not know whether their recommendations are suitable. Similarly, attorneys for claimants and respondents have difficulty assessing their own cases. An objective standard based on financial data currently available to brokers is a better solution and would better guide brokers in making recommendations to their clients. Such a standard would improve the ability of lawyers to assess their clients’ cases, thus reducing the quantity of claims filed by investors and increasing the amount of settlements when claims were filed.

Unsuitable recommendations are proscribed by securities industry self-regulatory organization⁴ (SRO) rules which require that a broker “have reasonable grounds for believing that the recommendation [of a security] is

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In an Avoidance and Prevention Advisory (Advisory) distributed to its member firms in May 1998, the National Association of Securities Dealers, Inc. (NASD) disclosed that unsuitability claims account for ninety-five percent of filings under NASD members’ errors and omissions insurance policies. “Because they are the most common yet most ambiguous of all client accusations,” the Advisory said, “‘unsuitability’ claims can often create significant problems for your firm. This is because what constitutes a viable unsuitability claim is open to debate.”

Id.

2. NORMAN POSER, BROKER DEALER REGULATION § 3.03 (3d ed. 2005).


4. The Securities and Exchange Commission sanctioned and approved the self-regulatory organizations including the National Association of Securities Dealers and the New York Stock Exchange to propose, implement, and enforce rules of conduct for the securities industry.
suitable for such customer." The Second Circuit requires five elements to prove a claim of unsuitability under §10(b) of the Securities Exchange Act of 1934 (the ‘34 Act) and Rule 10b-5 promulgated thereunder. Federal courts have required scienter in the recommendation of an unsuitable security, and that damages resulted from the investor’s justifiable reliance on that recommendation.

The current standard for proving unsuitability, under federal law and SRO Rules, requires proof that the broker lacked a reasonable belief that the recommended security was suitable for his client. This standard is unsatisfactory because it is “nebulous and amorphous.” This lack of a clear standard causes problems of proof for claimants, rebuttal for respondents and fails to establish satisfactory prophylactic direction.

This article proposes a standard which quantifies the amount of risk inherent in a broker’s recommendation and compares that risk to the client’s appropriate risk level, and that certain objectively determined levels of risk are presumptively suitable or unsuitable for brokers to recommend to clients based upon their risk profile.

Part I of this article discusses the development and current state of unsuitability claims under SRO and federal law. Part II suggests that the suitability standard should be objective and weigh the level of risk inherent in a broker’s recommendation against the client’s appropriate risk level. Part III proposes an objective standard for determining suitability: the comparison of Risk Quotient (RQ) to Client Appropriate Risk Level (CARL); and discusses brokers’ and investors’ responsibility to explain and understand risk; and investors’ acceptance of market risk when they invest in securities.

5. NASD RULES OF THE ASSOCIATION R. 2310; NYSE RULES R. 405.
7. Brown, 991 F.2d at 1031.
8. Id.
9. Lowenfels, supra note 1, at 1557 (“The suitability doctrine, always somewhat nebulous and amorphous with respect to its content and parameters. . . .”).
10. Roger W. Reinsch, J. Bradley Reich and Nauzer Balsara, Trust Your Broker?: Suitability, Modern Portfolio Theory, And Expert Witnesses, 17 ST. THOMAS L. REV. 173, 173 (Winter, 2004) (“The issues in and surrounding suitability claims are complex, yet surprisingly little has been written on this topic.”); Stuart D. Root, Suitability—The Sophisticated Investor—and Modern Portfolio Management, 1991 COLUM. BUS. L. REV. 287, 289 (1991) (“The problems of ‘unsuitability’—what does it mean, how is it measured, who should bear the risk of determining suitability—are not new. But these problems will most certainly become more frequent and arcane as the architecture of investment securities and strategies becomes more exotic.”).
11 Risk Quotient (RQ) is a term proposed by the author in this article. It is a measure of the risk of a position or portfolio of equity securities where the numerator is the volatility or beta and the denominator is the percentage of equity, which recognizes the impact of leverage on risk.
12 Client Appropriate Risk Level (CARL) is also a term proposed by the author in this article. It signifies the objectively determinable amount of risk appropriate for a client despite her subjective view or her broker’s opinion.
Part IV of this article proposes that an RQ less than or equal to one (RQ \( \leq 1.0 \)) is presumptively suitable for any investor; that an RQ greater than or equal to 2.0 (RQ \( \geq 2.0 \)) is presumptively unsuitable for any investor; discusses the impact of an objective standard for suitability claims; and concludes that a clear, well-defined standard is necessary for meaningful review of unsuitability awards. This article concludes that a clear, well-defined standard is necessary to avert a developing crisis where both claimants and respondents are bound to arbitrate, but have no meaningful review of awards available to them.

I. SRO AND FEDERAL UNSUITABILITY CLAIMS

A. SRO RULES PROHIBIT UNSUITABLE RECOMMENDATIONS AND MAY RESULT IN DISCIPLINARY ACTIONS AND SANCTIONS

Investors may bring a claim of unsuitability before an arbitration panel\(^{13} \) under NASD Rule 2310\(^{14} \) or under NYSE Rule 405.\(^{15} \) “Although the NYSE does not have a general suitability rule, its ‘know your customer’ rule requires NYSE members to use ‘due diligence to learn the essential facts relative to every customer [and] every order.’”\(^{16} \) The NASD, on the other hand, specifically addresses unsuitable recommendations:

Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer’s financial status;

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13. Under NASD Rule 10302, a panel of three arbitrators hears cases that have claims of damages in excess of $25,000, while amounts under $25,000 are decided by a single arbitrator on the basis of pleadings, and are known as “paper cases.” NASD RULES OF THE ASSOCIATION R. 10302.
15. NYSE RULES R. 405 (“Rule 405. Diligence as to Accounts. Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization. Supervision of Accounts (2) Supervise diligently all accounts handled by registered representatives of the organization.”).
16. POSER, supra note 3, § 3.03, at 3-89.
(2) the customer’s tax status;

(3) the customer’s investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. 17

Additional NASD broker duties are found in the, so called, “Know Your Customer Rule” where, “Members’ responsibilities include having a reasonable basis for recommending a particular security or strategy. In addition, the know-your-customer requirement . . . requires a careful review of the appropriateness of transactions in low-priced, speculative securities, whether solicited or unsolicited.” 18  Thus, a broker is required to learn about the investor’s financial condition, 19 including the investor’s source of funds for the account, the investor’s goals for these funds, and the investor’s ability to sustain risk 20 before making any recommendation.

The Second Circuit has found that NASD Rules “prohibit[] the sale to a customer by a broker or dealer of unsuitable securities.” 21 In furtherance of this end, the NASD rules state that, “[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.” 22 Accordingly, to make a suitable recommendation, 23 a broker must

17. NASD RULES OF THE ASSOCIATION R. 2310.
18. Members Reminded to Use Best Practices When Dealing in Speculative Securities, SPECIAL NASD NOTICE TO MEMBERS 96-32, May 9, 1996, at 233 (emphasis added); Lowenfels, supra note 1, at 1560.

Four months later, in response to protests from discount brokers, the NASD purported to “clarify” the above reference to “unsolicited transactions” by issuing Notice to Members 96-60: “A member’s suitability obligation under Rule 2310 applies only to securities that have been recommended by the member. It would not apply, therefore, to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member.”

22. See NASD RULES OF THE ASSOCIATION R. 2110. The rule also requires members and their brokers to “observe high standards of commercial honor and just and equitable principles of trade.” Id.
23. Because what constitutes a recommendation may also be the subject of a claim or defense, the NASD issued the following statement:

[A] broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as “solicited” or “unsolicited.” In particular, a transaction will be considered to be recommended when the member or its associated
understand the risks inherent in the investment and believe that such risks are justified by the potential rewards in light of the investor’s financial situation.24

Arbitration panels often cite the “speculative nature of a stock;”25 when determining suitability. In recent years, that an investment was a “tech stock” or “technology stock;”26 and most commonly that the investment was “high risk,” “risky” or “volatile”27 has been cited. Currently, only two available SRO arbitration awards cite considerations of objective statistical comparison between recommended securities and the broader markets.28

The descriptions of the securities at issue in suitability claims are arbitrary, and “[n]o securities industry standard of conduct is more frequently cited, person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.

NASD NOTICE TO MEMBERS 96-60, Sept. 1996, at 474.


[A Broker] cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.

Id.

25. On November 14, 2006 the following LexisNexis search produced 56 results, composed of NASD and NYSE reported awards and disciplinary decisions: “Source: Securities > Self-Regulatory Organizations (SRO) Materials > Combined NYSE & NASD materials,” “Terms: ‘speculative nature’ w/50 suitab!.”

26. On November 14, 2006 the following LexisNexis search produced 81 results, composed of NASD and NYSE reported awards and disciplinary decisions: “Source: Combined NYSE & NASD materials,” “Terms: ‘suitab! w/50 (‘tech stock’ or ‘technology stock’).’”

27. On November 14, 2006 the following LEXIS search produced 2,842 results, composed of NASD and NYSE reported awards and disciplinary decisions: “Source: National Association of Securities Dealers (NASD) Arbitration Awards,” “Terms: suitability & (risk! or volatil!)”. Lowenfels, supra note 1, at 1575–1576 (“The SEC agreed that the broker’s recommendations, taken as a whole, were unsuitable for the customer’s account. The broker’s firm, at one time or another, had been an underwriter for each of the eleven securities at issue. The vast majority of these companies had operating losses and no anticipation of paying dividends. In addition, at least seven of these companies had offerings that were characterized by the prospectus as involving substantial or a high degree of risk. The SEC wrote: . . . ‘The concentration of high risk and speculative securities in Bradley’s account, which were predominately underwritten by Paulson [broker’s firm], was not suitable.”

28. In the Matter of the DeNicola v. First Union Brokerage Services, Inc., 2004 NASD Arb. LEXIS 1072 (May 21, 2004) (“The objectivity of the use of the Beta analysis as a tool to assess past performance outweighs Mr. Lyman’s essentially unsupported, subjective, if not speculative, approach to determining suitability.”); In the Matter of Roger and Mary Candace Brush v. Merrill Lynch Pierce Fenner & Smith, Inc., 2004 NASD Arb. LEXIS 3073 (Dec. 10, 2004) (“Considerable energy was expended during the hearing on the question of using either standard deviation or beta as tools in choosing and explaining choices of securities. As aids to brokers in choosing stocks, both standard deviation and beta are helpful, but as aids in explaining to unsophisticated clients which stocks were chosen, they are very likely useless.”).
Brokers and broker-dealers are subject to disciplinary actions by the SEC and SROs for making unsuitable recommendations. In *Bartholomew*, the respondent . . . sold high-risk direct investments to several retired or close-to-retirement investors. The investors had expressly informed Bartholomew that they desired liquid, income-producing, low-risk investments. The respondent . . . misrepresented to these customers the liquidity, risks, and benefits of the direct investments. The SEC found that the respondent had violated Section 10(b) and Rule 10b-5 by selling investments that were unsuitable for the purchasers in view of their age, modest financial condition, and conservative investment objectives.30

The NASD Sanction Guidelines for violation of Rule 2310 include “monetary sanction, suspension, bar, or other sanctions.”31 Adjudicators of disciplinary actions are instructed to consider monetary fines ranging from $2,500 to $50,000 and to consider

[s]uspend[ing] respondent [broker-dealer] in any or all capacities for a period of 10 business days to one year. In egregious cases, [adjudicators should] consider a longer suspension (of up to two years) or a bar of an individual respondent. Also [adjudicators should] consider suspending respondent member firm with respect to any or all activities or functions for up to two years.32

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30. Poser, supra note 3, § 3.03, at 3-97.
32. *Id.* at 2 n.1 (“This guideline also is appropriate for violations of MSRB Rule G-19.”); id. at 2 n.2;

As set forth in General Principle No. 6, Adjudicators should increase the recommended fine amount by adding the amount of a respondent’s financial benefit or require respondent to offer rescission to the injured customers. In this instance, the factors to be considered in the calculation of financial benefit should include the amount of any commissions or other profits that the respondent derived from the unsuitable trading.

*Id.* at 1.
The standard of proof required for sanctions may be higher than that for recovery of damages by claimants, but is subjective nonetheless. For example, “[a] broker who knowingly engages in unsuitable trading violates the antifraud provisions of the federal securities laws. [The broker’s] trading [of] highly speculative options in customer accounts, in disregard of customer objectives, resources, and sophistication, clearly constituted unsuitable trading in violation of the antifraud provisions.”

B. THE DEVELOPMENT OF UNSUITABILITY CLAIMS UNDER FEDERAL LAW

Claims based on unsuitable recommendations began to appear in federal courts more than forty years ago. Since then, a Rule 10b-5 violation has been found in two situations, described as the “fraud by conduct” theory and the “misstatement or omission” theory. Fraud by conduct exists, as in Clark v. John Lamula Investors, Inc. where the


34. Lowenfels, supra note 1, at 1581.

Suggestions that section 10(b) and Rule 10b-5 may impose a suitability requirement on broker-dealers not simply as an ethical, but as a legal obligation appeared in a few early 1960s SEC cases. The SEC reasoned that a violation of the suitability doctrine may constitute a violation of Rule 10b-5 based upon the shingle theory. When a broker-dealer hangs out his shingle he impliedly represents, among other things, that he will recommend securities only if he has a reasonable basis for believing that they are suited to a customer’s financial circumstances. The SEC utilized this application of the suitability doctrine incorporated into the shingle theory in a large number of boiler room cases. The SEC also utilized this application of the suitability doctrine incorporated into the shingle theory in cases involving intensive selling efforts with respect to low-priced speculative securities which were not necessarily part of a boiler room operation. In these earlier cases, a variety of other violations of Rule 10b-5 were also present, including false or misleading representations regarding the security, excessive markups, and control or domination of the market.

Id. (citations omitted).


36. Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1032 (4th Cir. 1997) (explaining that while the Court “has never considered an unsuitability claim under § 10(b), several courts have recognized an unsuitability claim in certain circumstances”).


The plaintiff was a retired school teacher with little investment experience or sophistication, who had received a divorce settlement of $138,000. She told the defendant broker that she wished to invest $100,000 of the divorce settlement, in order to obtain an annual yield of $12,000. The broker recommended that the plaintiff buy certain debentures, and she agreed. The defendant purchased the debentures for $94,360 and resold them to the plaintiff for $105,250 (a markup of over 11 percent of the amount actually invested on the plaintiff’s behalf). When the debentures declined in value, the plaintiff sued under Rule 10b-5, claiming that the debentures were unsuitable and that the markup charged by the broker was unreasonable. The jury, in
broker committed fraud by executing an unsuitable trade for a client. On the other hand, prosecution of a claim under the misstatement or omission is conceptually similar to most other 10b-5 claims,\textsuperscript{38} where the broker misrepresented or omitted the suitability of the recommendation to his client, because suitability is information that a reasonable investor would want to have before making an investment decision, as recognized in 1993 by the Second Circuit in \textit{Brown v. E.F. Hutton Group, Inc.} \textsuperscript{39}

The Second Circuit was the first federal appeals court, in 1978, to recognize unsuitability as a violation of Rule 10b-5 in \textit{Lamula}.\textsuperscript{40} “\textit{Lamula} require[d] that to establish a 10b-5 claim the investor must prove only (1) that the recommended securities were unsuitable and (2) that the defendant acted with scienter. Or, put another way, an unsuitability claim is made out if the trier of fact finds that the recommended securities were unsuited to the investor’s needs, and that the broker knew or reasonably believed that [the securities] were unsuitable but recommended the securities to the plaintiff anyway.”\textsuperscript{41}

response to interrogatories, found that the defendant failed to inform the plaintiff of the following material facts: (1) how the leading rating services rated the debentures; (2) that the plaintiff could not expect to receive annual income of $12,000 from a $100,000 investment unless she bought speculative securities involving great financial risk; and (3) the extent of the risks involved in purchasing the debentures. The court concluded that the defendant acted with scienter and that if the plaintiff had been informed of the omitted facts she would not have purchased the debentures. The court, however, did not stop with its conclusion that the defendant had ‘omitted to state facts material to an informed purchase’ by the plaintiff, in violation of subsection (b) of Rule 10b-5; it also held that the defendant’s intentional recommendation of an unsuitable security was ‘an act, practice or course of business which operated as a fraud or deceit’ upon the plaintiff, in violation of subsection (c) of the rule.

Poser, supra note 3, § 3.03, at 3-92.1.

38. Banca Cremi, 132 F.3d. at 1032. A claim for § 10(b) suitability fraud “is a subset of the ordinary § 10(b) fraud claim.” Id. \textit{See also} O’Connor v. R.F. Lafferty, 965 F.2d 893, 897 (10th Cir. 1992) (recognizing that this type of suitability claim could be analyzed “simply as a misrepresentation or failure to disclose a material fact. In such a case, the broker has omitted telling the investor the recommendation is unstable for the investor’s interests. The court may then use traditional laws concerning omission to examine the claim.”).

39. Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993); Poser, supra note 3, § 3.03, at 3-93.


41. Poser, supra note 3, § 3.03, at 3-92.2. The SEC repealed in 1983 a suitability rule actionable under federal law which applied to broker-dealers who were not members of an SRO. Former 17 C.F.R. § 240.15b10-3 enacted in 1967 and repealed in 1983. Lowenfels, supra note 1, at 1584. “Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of a security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer.” Id. “The SECO regulations, including Rule 15b10-3, were rescinded in 1983 and virtually all broker-dealers were required to join an SRO and thereby become subject to its rules.” Id.
1. The Five Elements of a 10b-5 Unsuitability Claim Under Brown

In Brown, the Second Circuit opinion defined five elements of unsuitability within the misstatement-omission violations of § 10(b) and Rule 10b-5. The court stated:

A plaintiff must prove (1) that the securities purchased were unsuited to the buyer’s needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer’s needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant’s fraudulent conduct.

The first Brown element is the subject of this article, so discussion on this topic is reserved for later. The second Brown element queries whether or not the broker knew or should have known that the securities were unsuitable for the client, requiring a finding of the first element. Thus, the first two Brown elements hinge on the same subjective reasonable belief standard.

The third Brown element can generally be proved through documentary evidence and the records of the clients’ accounts along with the records that are required to be kept by broker-dealers in conformance with § 17(a) of the ‘34 Act, which include: records of communications with clients, records of communications about client activities, commission records for the broker that may show similar transactions in other clients’ accounts (parallel trading). Respondents may show evidence that the claimants engaged in the same or similar trading in other brokerage accounts as rebuttal evidence. According to the NASD, “a broad range of circumstances may cause a transaction to be considered recommended,” including both oral and written communication with a client. Although not binding law, SRO

42. Brown, 991 F.2d at 1031.
43. Id. (citing Lamula, 583 F.2d at 600–01; National Union Fire Insurance Co. v. Woodhead, 917 F.2d 752, 757 (2d Cir. 1990)).
44. See Hanly v. Sec. & Exch. Comm’n, 415 F.2d 589, 595-596 (2d Cir. 1969) (“Brokers and salesmen are ‘under a duty to investigate, and their violation of that duty brings them within the term ‘willful’ in the Exchange Act.’ Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein.”).
45. The ‘34 Act’s Rule 17a-3 Records to Be Made by Certain Exchange Members, Brokers and Dealers, requires Broker-Dealers to maintain records of each purchase, sale, call, put, cash balance, margin balance, etc. for each and every customer and transaction, or communication. SEC Rule 17a-3, 17 C.F.R. § 240.17a-3 (2006).
46. See generally ROBBINS, supra note 20, § 5-5, at 5-19.
47. NASD NOTICE TO MEMBERS 96-60, Sept. 1996, at 474.
Rules may be used in federal courts as evidence of standards of professional conduct. 48

Scienter, the fourth Brown element, “may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor’s needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend or purchase the securities anyway.” 49 An inability to prove scienter is not a bar, however, because “in appropriate circumstances recklessness satisfies the scienter requirement.” 50 “Reckless conduct is, at the least, conduct which is ‘highly unreasonable’ and which represents ‘an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.” 51 Although some dissension remains, “[b]y 1990, eight Circuit Courts of Appeal had adopted standards of ‘recklessness’ to support Rule 10b-5 claims.” 52 Thus, the determination of scienter or recklessness also hinges on a finding that the recommendation was unsuitable.

The fifth Brown element of justifiable reliance contains two components. First, “[a] plaintiff’s burden with respect to the reliance element of an unsuitability claim . . . varies depending on whether the claim alleges fraudulent representations or [] omissions.” 53 This reliance aspect begs comparison between the complexity of the recommended security and the sophistication of the client, and further with that of the broker. 54 Here it may presumed that an unsophisticated client relied on her

51. Id. at 47 (citing Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).
53. Brown, 991 F.2d at 1031 (citing Burke v. Jacoby, 981 F.2d 1372, 1378–79 (2d Cir. 1992)).
54. Id. at 1032.

An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth. Under this standard, § 10(b) liability will not be imposed when an investor’s conduct rises to the level of recklessness. To determine whether an investor acted recklessly, and therefore without justifiable reliance, no single factor is dispositive, and all relevant factors must be considered and balanced. In Royal American we considered the plaintiff’s sophistication and expertise in finance and in the subject matter of the securities transaction; the plaintiff’s representation by counsel; the plaintiff’s opportunity to detect the fraud; whether the fraud was concealed; and the nature of the fraud. This Court has never established a list of all relevant factors, although many courts have been guided by the following: (1) The sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of longstanding business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7)
broker’s recommendation because of the broker’s exposure to sophisticated investment matters through licensing requirements and the Shingle Theory, which states that by advertising investment services to the public, a broker-dealer holds itself out as a competent expert in investing. The second component of the fifth Brown element requires a showing of

whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

Id. (citations omitted).

55. Cash v. Frederick & Co., 57 F.R.D. 71, 78 (D. Wis. 1972) (“A defendant must exercise a higher standard of care when he knows or has reason to know that the plaintiff has relied almost exclusively upon his advice.”).

56. Brokers are required to pass the Series 7 licensing exam to become Registered Representatives in the sales of securities. NA SD.com, Registration and Qualifications - NASD Registration and Examination Requirements, http://www.nasd.com/RegistrationQualifications/BrokerGuidanceResponsibility/Qualifications/NASDW_011051. (“This registration qualifies a candidate for the solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts.”). For further discussion of the scope of material covered by Registered Representative licensing exam, see Content Outline for the General Securities Registered Representative Examination (Test Series 7), http://www.nyse.com/pdfs/series7.pdf.

The Series 7 Examination is the Qualification Examination for General Securities Registered Representatives. As a qualification examination, it is intended to safeguard the investing public by helping to ensure that registered representatives are competent to perform their jobs. Given this purpose, the Series 7 Examination seeks to measure accurately and reliably the degree to which each candidate possesses the knowledge, skills and abilities needed to perform the critical functions of a registered representative (RR). Candidates should note that the duties and functions of the RR must be performed in accordance with just and equitable principles of trade, federal and state laws, and industry regulations. Furthermore, it is the responsibility of the RR to be aware of changes in current legislation, regulation and policy. The RR’s primary responsibility is to the client. When advising the client, the RR must do so fully and honestly. The RR must make a diligent good-faith effort to obtain essential facts prior to making appropriate recommendations. Soliciting clients and counseling established clients are intrinsic duties of an RR, and these tasks must never be performed in a deceptive or fraudulent manner for any purpose. An RR who violates industry regulations is subject to disciplinary action, including censures, fines, suspension, and/or permanent loss of registration.

Id.


A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders. While this implied warranty may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon his unfounded representations, n13 its applicability in the instant proceedings cannot be questioned.

Id. (citing Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961)) (providing approval regarding the “shingle theory”); BLACK’S LAW DICTIONARY (8th ed. 2004) (“[Shingle theory definition:] The notion that a broker-dealer must be held to a high standard of conduct because by engaging in the securities business (‘hanging out a shingle’), the broker-dealer implicitly represents to the world that the conduct of all its employees will be fair and meet professional norms.”).
damages, such as the trading losses sustained as a result of the broker’s recommendation.\textsuperscript{58} However, a broker-respondent may counter with a showing that other factors caused all or part of the losses complained of or that his client failed to mitigate her losses. In a bear market,\textsuperscript{59} a broker may use the well-managed account theory of losses\textsuperscript{60} as a defense by showing, for example, that the losses suffered in his client’s account were less than the proportionate declines in broad market indices during the same period.

3. The Suitability of the Recommended Security is the Focal Issue\textsuperscript{61}

Decisions about whether a recommendation was made, whether reliance was justifiable, and the broker’s scienter or recklessness may in many cases be reserved until after the suitability of the investment for the claimant has been determined. It is practical to reserve such findings because the existence of a recommendation, scienter, and justifiable reliance may flow logically from, a finding that the security was unsuitable for the client. For example, a finding that a thinly traded stock underwritten by the broker’s firm and traded by the broker’s other clients was unsuitable could be useful in determining that the recommendation was made with scienter or recklessness, and that the client justifiably relied on that recommendation.\textsuperscript{62}

\textsuperscript{58} Recommendations for unsuitable purchases are the most straightforward in terms of proving damages. It is theoretically possible, but practically far more difficult to prove losses resulting from an unsuitable recommendation to sell, although \textit{Affiliated Ute Citizens v. United States}, 406 U.S. 128 (U.S. 1972), does show this to be a credible claim in some instances. Other forms of loss include: margin interest, commissions, and the “well-managed account” theory of damages which compares the performance of an index to the performance of an account or investment to determine whether the customer lost more or less than they would have if widely invested. See \textit{Rolf v. Blyth}, 570 F.2d 38, 44 (2d Cir. 1978).

\textsuperscript{59} Bear market, ia.com, http://investopedia.com/terms/b/bearmarket.asp (last visited Nov. 21, 2006) [hereinafter Bear Market Definition] (“A market condition in which the prices of securities are falling or are expected to fall.”).

\textsuperscript{60} The well-managed account theory can be used in a bear, or declining, market to show that losses suffered by a client were commensurate with market losses and that the client would have fared no better, or little better, if invested in broad market indices or mutual funds. See \textit{ROBBINS, supra} note 20, § 5-2, at 49–52.

\textsuperscript{61} Rapp, \textit{supra} note 29, at 192.

Individual recommendations or a specific recommended strategy are typically evaluated against an indicated investment objective and financial profile, with liability determinations flowing from a third-party ex post facto assessment of whether the characteristics of a particular recommendation comported with the stated objective and were consistent with the level of “risk” considered appropriate for the investor’s profile. The focal point becomes the risk characteristics of an individual security rather than the risk characteristics of a portfolio in which the particular security is recommended to be a component.

\textit{Id.} (emphasis added).

\textsuperscript{62} By way of illustration: At times the complexity or obscurity of an investment recommendation in and of itself suggests that it may be unsuitable for any but the most sophisticated investor. Imagine, for example, that a broker executed purchases of “naked calls” in
Thus, under either Lamula or Brown, the determination as to whether the security was suitable for the client is both a threshold question and often the ultimate determining factor.\textsuperscript{63} Paradoxically, the least guidance is provided for the determination of whether "the securities purchased were unsuited to the buyer's needs."\textsuperscript{64}

**C. WHETHER THE BROKER REASONABLY BELIEVED THAT THE RECOMMENDED SECURITY WAS SUITABLE FOR THE CUSTOMER IS THE CURRENT STANDARD, AND FURTHER DEVELOPMENT HAS BEEN FORESTALLED BY ARBITRATION OF SUITABILITY CLAIMS**

The subjective standard of reasonable belief of the broker is used to determine whether a recommendation was suitable under Hanly,\textsuperscript{65} Lamula,\textsuperscript{66} and Brown.\textsuperscript{67} Reasonable belief is too subjective and amorphous a standard in determining the unsuitability of investment recommendations.\textsuperscript{68} As stated by Lowenfels and Bromberg in their article *Suitability in Securities Transactions*:

The present problem for the industry is that this broad ethical standard embodying a laundry list of unacceptable activities has become in effect a quasi-legal standard which forms the basis for the award of private damages to customers against brokers in arbitration. In practical reality—in part because securities industry arbitration panels normally do not render reasoned decisions in writing, in part because an approach of equitable fairness rather than strict legal doctrine drives these arbitration

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\textsuperscript{63} Exceptions to this statement include dismissal of the claim for failure to plead with specificity, or disposal for lack of recommendation, reliance, or damages. See DeBruyne v. Equitable Life Assur. Soc'y, 920 F.2d 457, 465–466 (7th Cir. 1990) ("[A]llegations as to . . . risk and volatility . . . appear more likely to raise a genuine issue of fact as to mis-representation," but dismissing securities claim for other reasons").

\textsuperscript{64} Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).

\textsuperscript{65} Hanly v. Sec. & Exch. Comm'n, 415 F.2d 589, 597 (2d Cir. 1969) ("In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.").

\textsuperscript{66} Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600–601 (2d Cir. 1978) ("Mr. Lamula, therefore, was required to have reasonable grounds to believe that the securities sold were suitable for [his client] "). "The jury specifically found that the debentures were unsuited to appellee's needs, that appellant Lamula knew or reasonably believed they were unsuitable, but that he recommended them to her anyway." Id.

\textsuperscript{67} Brown, 991 F.2d at 1031.

\textsuperscript{68} Lowenfels, *supra* note 1, at 1557.
panels, and in part because there is no effective right of appeal from the
decisions of arbitration panels—the exposure of the industry to private
damages for violations of NASD suitability rules has expanded in
exponential fashion.69

“Ultimately, suitability rules require only good faith assessments by
brokers,”70 but subjective, amorphous standards lead to uncertainty and to
inefficient application of the law. Similarly, it is difficult and expensive for
the industry, and its customers, to apply and expect a standard which is so
amorphous. This is especially true as common law respondeat superior
liability is compounded by statutorily defined duties which require broker-
dealers to design procedures and compliance guidelines and supervise
broker conduct.71

The lack of new cases which would further develop a standard for
unsuitable recommendation liability is due, at least in part, to the fact that
almost all unsuitability claims are heard in arbitration.72 The reason for this
result is that arbitration awards do not have precedential value and tend not
to contain instructional analyses of law or facts. Further, “the bounds of a
broker’s suitability responsibility are . . . left for largely intuitive
determination by panels comprised of individuals having widely disparate
legal and finance backgrounds, and whose charge expressly includes ‘wide
latitude in their interpretation of legal concepts’ involved in matters put
before them.”73

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69. Id. at 1567.
70. Rapp, supra note 29, at 258–60.

Larry Ira Klein illustrates that the examination of good faith begins with the process
whereby an investment objective is identified and the risk associated with it is then
assessed. In Larry Ira Klein, the expected return of high yield debt securities was
significantly greater than the certificates of deposit or tax-deferred retirement funds in
which customers’ funds had previously been invested. Still, as the SEC opined, it was
decidedly unreasonable to conclude that the commensurate risk of a portfolio
constructed to achieve that return was suitable. It did not help that the broker was also
found to have materially misled his customers concerning the degree of risk actually
involved.

71. ROBBINS, supra note 20, § 5-6f (Failure to Supervise); see also Securities Exchange Act of
72. Renee Barnett, Online Trading And The National Association Of Securities Dealers’
Suitability Rule: Are Online Investors Adequately Protected?, 49 AM U.L. REV. 1089, 1104
(2000) (“Second, virtually all brokers require customers to sign pre-dispute arbitration agreements
prior to opening a brokerage account. By entering into a pre-dispute arbitration agreement,
customers waive their right to commence judicial proceedings against their broker and instead
must settle disputes through arbitration.”).
73. Rapp, supra note 29, at 191–192. Lowenfels, supra note 1, at 1584–85 (“[W]ith this shift
in the legal basis for unsuitability claims has come a shift in the legal elements that must be
proven to establish a suitability violation, from fraud under Exchange Act section 10(b) and Rule
10b-5 which requires scienter (or at a minimum recklessness) to a nebulous quasi-legal, quasi-
ethical test for breaches of standards of duty and care under SRO rules which does not require
scienter or recklessness.”).
Changes proposed by the NASD may increase the instructional value of arbitrators’ awards: “The purpose of the proposed rule change is to amend the Code of Arbitration Procedure . . . to provide written explanations in arbitration awards upon the request of customers, or of associated persons in industry controversies.”

Federal courts continue to adhere to the Brown elements, as in Louros v. Kreicas where the court stated that “[a] plaintiff asserting such a claim must prove: (1) that the securities purchased were unsuited to the buyer’s needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer’s needs . . . .” The Louros court described the continuing relevance of Brown because, although it does not mention loss causation, Brown was rendered before the Private Securities Litigation Reform Act codified the causation requirement for Section 10(b) cases. In any case, Brown does require that “the buyer justifiably relied to its detriment on the defendant’s fraudulent conduct.” This element comprehends a requirement of causation, and with it the jurisprudence on loss causation in securities fraud cases.

The lack of an objective standard for determining suitability under SRO Rules continues to be problematic under federal securities laws. Court challenges to arbitration awards in suitability claims are largely ineffective, at least partly because manifest disregard for the law is the standard for vacating an arbitration panel’s award. Thus, to vacate an award, a court must find that the panel manifestly disregarded the law when it found, based on a subjective standard, that a broker had a reasonable belief that his

74. On submission to SEC, the NASD is proposing to codify this policy in NASD Rules of the Association Rule 10330(i).
76. Id. at 585 (emphasis added).
77. Id. at 592.
78. GMS Group, LLC v. Benderson, 326 F.3d 75, 81–82 (2d Cir. 2003) (“GMS neither points this court to case law interpreting the terms ‘recommendation’ or ‘suitability,’ nor points to anywhere in the record where such law was brought to the attention of the arbitrators.”).
79. Id.; Goldman v. Architectural Iron Co., 306 F.3d 1214, 1216 (2d Cir. 2002).
recommendation was suitable for his customer. The result is a dearth of meaningful reviews of arbitration awards. 80

II. THE SUITABILITY STANDARD SHOULD BE OBJECTIVE AND WEIGH THE RISK OF A BROKER’S RECOMMENDATION AGAINST THE CLIENT’S APPROPRIATE RISK LEVEL

An objective standard is necessary to judge the suitability of a broker’s recommendation to his client. Currently, brokers are required to make their suitability determinations based on objective measures in order to establish a reasonable belief. Rational thought is required to make a reasoned determination, and “[t]he broker’s suitability obligation does not rest on intuition, it rests on a formal statistical process.” 81 Under the shingle theory, it can be expected that brokers will use finance theory in assessing the suitability of securities for their clients. 82 Among the many tools available to brokers, “Modern Portfolio Theory (MPT) is a set of formulas used to determine, objectively, whether a portfolio is suitable for a particular client’s objectives and circumstances.” 83

An objective measure is also needed to guide broker-dealers and to protect investors. In fact, “it is essential that there be a suitability paradigm within which stockbrokers may comfortably operate and against which their professionalism may fairly be evaluated in the face of a challenge. That is not the case today.” 84 The SEC has supported some objective standards in determining suitability in disciplinary settings, including inadvisable concentration of a client’s assets in the stock of one company, especially if

80. Here the primary trier of fact is an arbitration panel, although a panel’s “award,” as a panel’s decision is known in arbitration, is subject to review by courts. The standard of review is “manifest disregard for the law” and is infrequently found in client-broker claims. Arbitration awards are “vacated” upon a motion for vacature by a party to the arbitration. Telephone interview with Professor Marcella Silverman of Fordham Law School (Sept. 2006). An unpublished Fordham Law School study found only one such award was vacated in New York in the last twenty years. Id.

81. Reinsch, supra note 10, at 199.

82. For information on the Series 7 exam, see supra note 56.

83. Reinsch, supra note 10, at 173. The Second Circuit has also made reference to objective measures in affirming a finding of unsuitability in Lamula when “the jury found that Lamula failed to inform [the client] . . . how the leading rating services rated the debentures.” Clark v. John Lamula Investors, Inc., 583 F.2d 594, 599 (2d Cir. 1978).

84. Rapp, supra note 29, at 262–63 could be characterized to disagree with some propositions of this article. The article explains that:

‘Suitability rules’ set ethical conduct expectations, but articulate no standard of care against which portfolio oriented recommendations of brokers can be adequately and fairly judged. This is not to say that there should, or could, be a litmus test for judging broker conduct. Wooden notions of any sort cannot suffice to articulate a standard of care in a world populated by such a vast array of investment opportunities and risks and the many and varied strategies for their use.

Id.
that stock is “speculative”. In affirming an NASD disciplinary ruling, evidence was presented in that:

[Broker] Faber recommended that [his Client] McKinzie purchase approximately $52,000 of Interbet shares. These funds constituted nearly all of her SC portfolio and more than two-thirds of her total liquid assets. Interbet had no revenues and had never showed any profits. Moreover, [Broker] Faber recommended that [his Client] McKinzie concentrate her entire portfolio at SC in one speculative security. This concentration created a substantial risk that [his Client] McKinzie could lose all, or virtually all, of her account balance. We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.85

A. MOST UNSUITABILITY CLAIMS ARE BROUGHT BY INDIVIDUAL INVESTORS UNDER NASD RULE 2310, TO RECOVER PRINCIPAL LOST IN COMMON STOCK INVESTMENTS

The overwhelming majority of unsuitability claims are arbitrated due to the enforcement of the arbitration clauses contained in almost every account opening document86 signed between an investor and her broker.87 The enforceability of these clauses was assured by two Supreme Court decisions, Shearson/American Express v. McMahon88 in 1987 and Rodriguez de Quijas v. Shearson/American Express89 in 1989, which

86. See Barnett, supra note 73 (“[V]irtually all brokers require customers to sign pre-dispute arbitration agreements prior to opening a brokerage account.”).
87. The account opening document is a contract between the customer-investor and the broker/dealer, and defines the respective rights and obligations of the parties, the inclusion of a pre-dispute agreement to arbitration is governed by NASD RULES OF THE ASSOCIATION R. 3110(f) and NYSE RULES R. 637, and require significant disclosures as to the implications of arbitration and the procedural distinctions from a court action. See generally ROBBINS, supra note 20, § 2-3.

Once the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not such essential features of the Securities Act that § 14 is properly construed to bar any waiver of these provisions. Nor are they so critical that they cannot be waived under the rationale that the Securities Act was intended to place buyers of securities on an equal footing with sellers. Wilko identified two different kinds of provisions in the Securities Act that would advance this objective. Some are substantive, such as the provision placing on the seller the burden of proving lack of scienter when a buyer alleges fraud.

Id.
upheld application of the Federal Arbitration Act as it pertained to securities claims brought under the Securities Act of 1933\(^{90}\) (‘33 Act) or the ‘34 Act.\(^{91}\)

The choice of arbitration fora available to investors depends upon the language in the account opening contract. The most common securities arbitration fora are: NASD Dispute Resolution,\(^{92}\) New York Stock Exchange Dispute Resolution/Arbitration,\(^{93}\) and the American Arbitration Association.

The NASD hears 90% of all investor-broker arbitration cases,\(^{94}\) including suitability claims. Between January 1, 2001 and October 31, 2005, 55% of NASD claims involved common stock.\(^{95}\) Unsuitability claims


Following the dictates of the U.S. Supreme Court in the landmark decisions of Shearson/American Express, Inc. v. McMahon, and Rodriguez de Quijas v. Shearson/American Express, Inc., the principal forum where customer damage claims for unsuitability are heard has shifted within the last decade from the courts to arbitration, primarily the arbitration tribunals provided by the NASD. Additionally, the specific provisions relied upon by customers pursuing unsuitability claims in these arbitration forums have shifted within this past decade from the anti-fraud provisions of the federal securities laws, primarily section 10(b) and Rule 10b-5 of the Exchange Act, which mandate a legal standard of intent to defraud or recklessness, to the unsuitability rules of the self-regulatory organizations (SROs), primarily NASD Rule 2310, which embody a comparatively nebulous, quasi-legal, quasi-ethical standard of due care and fair dealing between brokers and customers. This shift in forum and in governing standards has eased meaningfully the customer’s path to recovery and consequently has increased the customer’s leverage to compel a significant settlement.

\(^{92}\) “NASD operates the largest dispute resolution forum in the securities industry to assist in the resolution of monetary and business disputes between and among investors, securities firms, and individual registered representatives.” NASD.com, Arbitration & Mediation, http://www.nasd.com/ArbitrationMediation/index.htm (last visited Nov. 18, 2006); “NASD ranks by far the most active forum today, administering 90% or more of the [brokerage industry] cases filed each year.” ROBBINS, supra note 20, at app. N. 1.

\(^{93}\) New York Stock Exchange arbitration is described on the NYSE website.

For more than 125 years, the NYSE has used arbitration to resolve disputes between investors and brokers. Arbitration enables a dispute to be resolved quickly and fairly by impartial arbitrators, who are knowledgeable and trained in the art of resolving controversy. When a customer chooses arbitration to resolve the dispute, he waives the right to pursue the matter in court. Arbitration is final and binding.


before NASD arbitrators are very frequent, in fact, 11,718 such claims were
filed between January 1, 2001 and October 31, 2005, making unsuitability
one of the most common civil claims in securities. Thus, discussion of a
suitability standard for common stock recommendations to individual
investors under NASD Rule 2310 would be applicable to a very high
proportion of unsuitability claims.

In determining whether a broker’s recommendation was suitable for an
investor, the issue should be restated as: “Whether the level of risk inherent
in the recommendation was greater than the appropriate level of risk for the
investor.” Thus, two separate sub-issues present themselves: the level of
risk inherent in the recommendation and the appropriate level of risk for the
investor (e.g., whether investors assume market risk when entering the
securities markets).

The risk that an investor will lose her invested principal is central to
determining a suitability claim. When the risk of investing in a security is
excessive for an investor, recommendation of that security is unsuitable for
that investor. This is not the only reason that a recommendation may be
unsuitable, but practically, it is the loss of principal which drives investors
to take action against their brokers. “A broker may assure a client that the
broker will only make ‘safe’ investments, and then spend the client’s
money on extremely risky securities, which lose value; in such cases, the
client is harmed when the concealed risk—the volatility of the actual
investments—lowers the value of her portfolio.”

Most unsuitability cases discuss risk, for the simple reasons that: 1)
damages claimed or losses actually realized by the claimant did have a level
of risk at the time of recommendation; 2) that the gravamen of an
unsuitability claim is whether the amount of risk at the time of
recommendation was suitable for the investor; and 3) whether the broker
knew or should have known of that risk and its suitability for the
investor.

Risk of loss is the foundation of an unsuitability claim because brokers
may only make recommendations if they have a reasonable basis for the
belief that the recommended security is suitable for their client. “As a retail

96. Id.
97. Because “[e]ach case can be coded to contain up to four controversy types,” the quantity of
claims relative to each other is somewhat uncertain, as many claimants bring multiple claims. At
least a third of the NASD arbitration filings have contained claims of unsuitable recommendations
during the 2002 to 2005 period. Id.
98. See, e.g., Lowenfels, supra note 1, at 1595 (“In Aaron v. Paine Webber, Inc., the brokerage
firm was ordered to pay its seventy-one-year-old customer, a former art supplies dealer, $500,000
in damages for failing to ‘take reasonable steps to limit or otherwise safeguard the extent of [the
customer’s] risks and possible losses.’”).
99. Id.
brokerage industry observer has counseled: ‘Almost nothing is more important than understanding a client’s risk tolerance. How well will this person weather the ups and downs—especially the downs—of the market? Is the client’s idea of safety having aggressive growth investments with some market timing mixed in? Or money under the mattress?’ Thus, a broker can be liable for making an unsuitable recommendation if the risk of loss is too great for a particular client, and the broker knew or should have known of that risk.

B. IDENTIFYING AND QUANTIFYING THE RISK OF A RECOMMENDATION

The risk component of a suitability claim is related to the volatility of a given security’s price. The risk of loss is greater in investments that have a higher degree of volatility, as explained in In re Merrill Lynch & Co. Research Reports Securities Litigation where the court cited a document stating that certain types of ‘securities ‘historically have been very volatile’ which ‘increases the risk that the securities may lose value.’ That court also noted that ‘smaller companies . . . ‘may be less financially secure than larger, more established companies,’ and that as a result ‘such companies may be subject to abrupt or erratic price movements and more unpredictable price changes than the stock market as a whole.’ This is why “[l]egal approaches are concerned exclusively with risk of loss.”

“Inadequate (or fraudulent) advice on risks is the gravamen of complaints about unsuitability. . . . Hence risk analysis and suitability are inextricably linked.” Therefore, “if a broker cannot make any estimate of

102. Rapp, supra note 29, at 276.

103. Perry v. Markman Capital Mgmt., 2002 U.S. Dist. LEXIS 19103 (E.D. Pa. 2002). (“First, [plaintiffs] allege that they told defendants on numerous occasions that the assets under Markman Capital’s management constituted their entire life savings. Second, Markman Capital was aware that capital needed to be preserved for plaintiffs’ retirements, which explained their desire for conservative investments with low risk and moderate volatility as set forth in the agreements. Finally, plaintiffs aver that defendants never informed them of the risks involved in the type of trading that defendants conducted with plaintiffs’ accounts.”).

104. Suitability claims require damages. There are few exceptional cases which claim as damages underperformance. Almost all suitability claims have a loss of principal as damages. Therefore, the assessment of suitability begins with a loss, and looks back to whether or not that loss was foreseeable at the time of recommendation. Because a degree of risk is inherent in any investment, the issue is usually reformed as whether the risk of loss of principal was greater than what was appropriate for the investor at the time she made the purchase.


106. Id.

107. Id.

108. Root, supra note 10, at 352 (emphasis added). Id. at 351–52 (“Inadequate (or fraudulent) advice on risks is the gravamen of complaints about unsuitability (i) by institutional investors taken over by the RTC, (ii) by so-called sophisticated investors in government securities, (iii) in actions arising under the federal securities laws and commodities laws, (iv) in federal diversity and state court actions.”).
the risk and expected returns associated with a given security, then he
clearly lacks an adequate basis for evaluating its prospects and so is
prohibited by the ‘shingle theory’ from ever recommending so-called
uncertain investments.” 109 Thus, this risk that brokers must assess in
forming a reasoned belief as to the suitability of a recommendation can be
objectively quantified.

Thus, quantification of the risk inherent in a recommendation can lead
to an objective standard for determining the suitability of a recommendation
made by a broker to his client.110 Further, recommendation risk can be
quantified with a simple mathematical calculation using two measures
accessible to brokers. Beta ($\beta$) is a measurement of the volatility of a
specific security relative to the securities market generally. The volatility of
an investment is increased proportionally by the use of borrowed funds
(leverage), thereby magnifying the effect of a security’s losses and gains in
value. The risk level of a recommendation can be calculated by dividing the
recommended security’s beta by the equity ratio of the recommendation
(the percentage of equity of a security position). The resulting number is the
“Risk Quotient.”

“An accurate determination of beta is the most important single element
in predicting the future behavior of a portfolio.”111 Beta is “[a] measure of
[a security’s or portfolio’s] volatility, or systematic risk, in comparison to
the market as a whole.”112 “Although [beta] is the product of arcane analysis
of historic data, beta information for [almost all exchange] traded securities
is easily accessed by investors and investment professionals alike.”113
Because “[r]etail stockbrokers have the resources to make, or at least fairly
estimate, the needed determinations in regard to particular
recommendations”114 it is reasonable to use beta information in determining

1607–08 (1971).
110. The NASD supports this theory as well, as it told its members in a Fall 1998 Regulatory
Short Take on Suitability Issues.

When considering “suitability,” one often thinks in terms of a customer’s financial
status, investment background, and investment objectives. It is equally important to
consider the factors relevant to the security and/or product being recommended.
Before making any recommendation, the firm should perform adequate due diligence
to ascertain essential facts such as financial status of issuer, degree of risk,
maturity date, and withdrawal penalties. It is important that suitability standards be reviewed
with each and every trade.

NASD, REGULATORY & COMPLIANCE ALERT 13 (Sept. 1998) (emphasis added).
111. Reinsch, supra note 10, at 196.
14, 2006) [hereinafter Beta Definition].
113. Rapp, supra note 29, at 252.
114. Id. at 251–52.
whether or not a recommendation was suitable, or at least whether a broker
had a basis for a reasonable belief that the recommendation was suitable.\footnote{115}{See Central Nat’l Bank v. United States Dep’t of Treasury, 912 F.2d 897, 901–02 (7th Cir. 1990). In \textit{Central}, Circuit Judge Posner recognized beta as a quantification of investment risk. \textit{Id.}}

Beta is calculated by comparing the historic fluctuation of a security’s
price relative to changes in the market as a whole.\footnote{116}{“Beta is calculated using regression analysis, and you can think of beta as the tendency of a security’s returns to respond to swings in the market. A beta of 1 indicates that the security’s price will move with the market.” Beta Definition, \textit{supra} note 113.} If a security has a beta lower than 1.00, that security’s historic price has been less volatile than the overall market over the same period. A beta higher than 1.00 signifies that security’s price has been more volatile than the market. “For example, if a stock’s beta is 1.2 it’s theoretically 20\% more volatile than the market.”\footnote{117}{\textit{Id.}} The Standard & Poor 500 index (S&P 500) is “the [most popular, but not only] standard for calculating beta . . . where the S&P 500 has a beta equal to 1.00.”\footnote{118}{The Major American Equity Indices, \url{http://www.benbest.com/business/indexusa.html} (last visited Nov. 18, 2006).}

Volatility is “a statistical measure of the tendency of a market or security to rise or fall sharply within a period of time.”\footnote{119}{RealNetworks, Inc., Glossary (V), \url{http://investor.realnetworks.com/glossary.cfm?First Letter=v} (last visited Nov. 18, 2006).} “Volatility is typically calculated by using variance or annualized standard deviation of the price or return. . . . A highly volatile market means that prices have huge swings in very short periods of time.”\footnote{120}{Volatility, \textit{TheFreeDictionary.com}, \url{http://financial-dictionary.thefreedictionary.com/Volatility} (last visited Nov. 18, 2006).} Standard deviation is a statistical measure “of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation. . . . A volatile stock would have a high standard deviation.”\footnote{121}{Standard Deviation, \textit{Investopedia.com}, \url{http://www.investopedia.com/terms/s/standarddeviation.asp} (last visited Nov. 14, 2006).} Standard deviation is symbolized by the Greek letter sigma ($\sigma$). Sigma squared ($\sigma^2$) is beta.
These measurements are used in financial analysis to determine the value of risk, which is defined as “the chance that an investment’s actual return will be different than expected.” This includes the possibility of losing some or all of the original investment. It is usually measured using the historical returns or average returns for a specific investment. As is commonly understood, “higher risk means a greater opportunity for high returns... and a higher potential for loss.”

There are several types of risk associated with securities investment, which can be categorized into one of two types: “Systematic Risk” and “Unsystematic Risk.” Systematic Risk is “[t]he risk inherent to the entire market or entire market segment. [It is a]lso known as ‘un-diversifiable risk’ or ‘market risk’” because the entire market is susceptible to this type of risk and no strategy of diversification can protect an investor from a global market decline. Thus, this is a type of risk that cannot be avoided by any investor, and therefore is not compensated for.

Unsystematic Risk is “[r]isk that affects a very small number of assets. Sometimes referred to as specific risk.” This type of risk affects individual securities or investment sectors, “[f]or example, news that is specific to a small number of stocks, such as a sudden strike by the employees of a company,” or the dramatic negative effect of increasing fuel prices on airlines’ stocks, as opposed corresponding increase to the shares of oil drilling supply companies.

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Risk-Return Tradeoff [Definition:] The principle that potential return rises with an increase in risk. Low levels of uncertainty (low risk) are associated with low potential returns, whereas high levels of uncertainty (high risk) are associated with high potential returns. In other words, the risk-return tradeoff says that invested money can render higher profits only if it is subject to the possibility of being lost. [Example:] Because of the risk-return tradeoff, you must be aware of your personal risk tolerance when choosing investments for your portfolio. Taking on some risk is the price of achieving returns; therefore, if you want to make money, you can’t cut out all risk. The goal instead is to find an appropriate balance - one that generates some profit, but still allows you to sleep at night.

Id.


124. Id.


126. Id. (“[i]nterest rates, recession and wars all represent sources of systematic risk because they will affect the entire market and cannot be avoided through diversification. Whereas this type of risk affects a broad range of securities, unsystematic risk affects a very specific group of securities or an individual security. Systematic risk can be mitigated only by being hedged. Even a portfolio of well diversified assets cannot escape all risk.”).


128. Id.
Brokers have a duty to disclose these types of risk to investors, especially when there are specific risks inherent in particular investment types and, especially, in specific securities.129 Among the many rules requiring such disclosure are NASD Rule 2310130 and NYSE Rule 405.131 Case law elaborates that a broker must inform a client of the risks of an investment.132 Measuring the recommendation risk of an individual security, the broker must take that security’s volatility or beta into account to determine whether it may be suitable for the investor at the time he makes such a recommendation.133

Another component in quantifying the risk inherent in a recommendation is the leverage or “margin”134 recommended in purchasing such a security, as leverage will increase the volatility of a position.135 “[T]he

Suitability is apparent only by comparison with other possible investments. To determine whether the investments are suitable, one must know the spectrum of possible investments to which the ones in issue are compared. The significance of statistical measurements of account activity, such as the turnover rate, is apparent only in comparison to activity in other accounts. If an expert is not allowed to testify that given statistics evidence excessive trading, the jury is left with meaningless numbers from which they cannot judge the appropriateness of the transactions.

Id. (emphasis added).

134. See Margin, Investopedia.com, http://investopedia.com/terms/m/margin.asp (last visited Nov. 14, 2006). Definitions of ‘margin: 1. Borrowed money that is used to purchase securities. This practice is referred to as ‘buying on margin’. 2. The amount of equity contributed by a customer as a percentage of the current market value of the securities held in a margin account.” Examples include:

1. Buying with borrowed money can be extremely risky because both gains and losses are amplified. That is, while the potential for greater profit exists, this comes at a hefty price—the potential for greater losses. Margin also subjects the investor to a number of unique risks such as interest payments for use of the borrowed money.

2. For example, if you hold futures contracts in a margin account, you have to maintain a certain amount of margin depending on how the market value of the contracts change.

Id.

135. NASD Dept. of Enforcement v. Raghavan Sathianathan, 2004 NASD Discip. LEXIS 55, 60–61 (NASD Discip. 2004) (“Sathianathan did so because he used margin and options trading in his clients’ accounts without consideration of the suitability of those strategies for his customers. This is a grave departure from the standards governing his duty to ensure that his recommendations are suitable for his customers.”).
extent to which the broker used margin was unsuitably risky” for the investor. The amount of margin affects suitability because a drop in the recommended security’s price will affect the value of the position attributable to both the portion owned with the investor’s own funds and also the portion controlled with borrowed funds.

There are two distinct types of recommendations that may occur in a broker-client relationship: the recommendation of an individual security (or securities) and the recommendation of an individual security (or securities) in the context of allocating the assets of a portfolio. When measuring the recommendation risk of a security in the context of a portfolio, the broker must take into account the weighted average beta of the portfolio (portfolio beta) and what the impact of the recommendation will be on the portfolio beta at the time he makes a recommendation as to whether it may be suitable for the investor. Thus, a broker who makes recommendations based on a portfolio approach must take ongoing measures of the portfolio’s volatility into consideration, and may recommend adjusting components’ weights or adding more or less volatile securities to achieve the best distribution for the investor.

136. Lowenfels, supra note 1, at 1577–78. In In re Rangen, the broker recommended that three unsophisticated, inexperienced investors, two of them elderly and all with limited means, concentrate their investments in margin purchases of non-income-producing U.S. Treasury (STRIP) securities and speculative over-the-counter securities. These recommendations were subsequently adjudged unsuitable on three grounds. First, the recommendations were unsuitable because the customers were “seeking safe, income-producing investments and did not wish to speculate.” Second, the extent to which the broker used margin was unsuitably risky for inexperienced customers seeking to generate additional income through their investments. Third, the concentration of so much of the customers’ equity in particular securities “increased the risk of loss . . . beyond what is consistent with the objective of safe non-speculative investing.”

137. The beta of a portfolio can be measured by multiplying the weight, or percentage, of each portfolio component by its individual beta and adding the weighted betas of each component. For example, Pfizer common stock, accounts for 50% of a given portfolio’s value, Google common stock, accounts for 25% of that portfolio’s value, and the remaining 25% in Microsoft common stock. If Pfizer’s beta was 0.8 x 50% = 0.4; Google’s beta that day is 1.6 x 25% = 0.4; and Microsoft’s beta that day is 1.2 x 25% = 0.3, the portfolio beta would equal 0.4 + 0.4 + 0.3 = 1.1, or 10% more volatile than the S&P 500.

138. The broker in a non-fiduciary capacity is under no overt duty to monitor the performance or volatility of the portfolio, but only to make recommendations that are suitable at the time that they make them. Therefore a Broker, who claims to use the portfolio approach, will be bound to re-assess the volatility each of the existing components when making any further recommendations. See generally Rapp, supra note 29, at 271 (“Only after the suitability of risk/return parameters is established does it matter what recommendations for the construction of or addition to a portfolio are made. At that point, however, the stand-alone characteristics of a particular recommendation matter only as to the contribution of the asset to the performance of the portfolio, which now has its own risk/return profile. A recommended asset which adds to the efficiency of the portfolio, i.e., one which moves the entire portfolio to maximum return associated with the established risk level of the portfolio, or which is made in order to maintain
C. RISK QUOTIENT (RQ)

The Risk Quotient measures the volatility of a particular investment or portfolio at the time of recommendation by taking the relative volatility and the leverage of the position both into account. These two measures are easily identified by the broker and are significant factors in making any investment decision because leverage proportionally impacts the beta’s volatility measure. RQ is calculated by dividing the beta of the individual security by the equity percentage recommended (RQ = β / equity %). The equity percentage is calculated as 100 percent less the percentage of loan recommended to make the purchase. Thus, β is the numerator and the equity percentage is the denominator. The resulting RQ reflects the impact of “leverage,” as the use of borrowed funds amplifies the risk inherent in any investment.

For example: A broker recommended American International Group common stock, listed as AIG on the NYSE, on December 5, 2005 when it had a beta of 0.79. The broker recommended that the purchase be made with one-half cash and one-half borrowed funds from the broker’s firm, yielding an equity percentage of 50%. The RQ formula would be 0.79 ÷ 50% = 1.58. Thus, the recommendation of AIG, a stock less volatile than the S&P 500 by 21% (where the beta of the S&P 500 is 1.0), is rendered 58% more volatile than the S&P 500 by the use of leverage.

If a broker is recommending a change to a position or positions within a portfolio, reassessment of the existing portfolio components is required for the RQ to be meaningful. Because “[s]uitability . . . is an ongoing...
obligation [the broker-dealer may be liable if it] failed to maintain any ongoing supervision of the Claimant’s suitability.\footnote{143}

A portfolio’s RQ is the weighted average RQ of each component, with existing components reassessed at the time of recommendation at the then-current beta\footnote{144} and then-current equity percentage.\footnote{145} A broker who undertakes such analysis would have a defense to a claim of unsuitability as he would have used a portfolio approach to client recommendations. The broker would have known the portfolio’s level of risk and would have been able to manage the amount of risk his client was exposed to.

\section*{D. The Client’s Appropriate Risk Level (CARL) Should Be the Basis of Comparison to the Recommendation Risk\footnote{146}}

As part of the Know Your Customer duties, a Broker must determine what level of risk is appropriate for the client before making any recommendations.\footnote{147} To appropriately determine his client’s CARL, a broker is required under NASD Rule 2310(b) to “make reasonable efforts to obtain information concerning:

\begin{enumerate}
\item the customer’s financial status;
\item the customer’s tax status;
\item the customer’s investment objectives; and
\item such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.”\footnote{148}
\end{enumerate}

“Such other information” may include: 1) the client’s age, as it may be indicative of the amount of time that she will hold the investments contemplated, or when the principal amount invested may be needed to sustain her or provide income; 2) the client’s employment or other income

\begin{itemize}
\item See also Lowenfels, \textit{supra} note 1, at 1594 (discussing “dram shop” cases).
\item See Reinsch, \textit{supra} note 10, at 196 n.111 (“The beta of an individual component is subject to change over time, as an earnings report or other news may put unsystematic pressure on a company’s securities and drive it away from market trends.”).
\item The equity percentage of a component is subject to change over time, as the rise in a component’s value will increase the equity percentage and conversely, a decrease in value will decrease the equity percentage.
\item Reinsch, \textit{supra} note 10, at 193 (“The broker must ensure that the investor’s risk profile is given due consideration in terms of the beta of the portfolio. The most common violations by a broker are recommendations or purchases of securities that are not suitable for an investor’s stated risk level because the broker is required to create and maintain a suitable portfolio for each particular investor.”).
\item Id. at 175 (“A broker must understand the investor’s financial needs in order to determine what would suit those needs. In order to do that, the broker must complete an investor profile. The profile consists of what the client wants the investment to accomplish and the level of risk the investor is willing to undertake. Rule 2310 and the other suitability rules require a broker to create an accurate “investor profile” and then use that profile to make proper investments or recommendations.”).
\item NASD RULES OF THE ASSOCIATION R. 2310.
\end{itemize}
producing activities because her ability to generate income apart from the contemplated investment is central to the amount of risk she may be prepared to sustain, since typically, a professionally employed individual or family is better suited to put invested capital at risk than one who is disabled or without ready ability to replace or contribute additional principal for investment purposes; 3) the client’s other assets because of the general desire to preserve a core of assets that can be sustained in a relatively risk-free investment, since often a client who owns a home or other significant investments is better suited to sustain risk in an investment account than one who has no other assets.

“In a section entitled, ‘Know Your Customer,’ the Series 7 study guide advises that before making a recommendation, a broker should appreciate the customer’s balance sheet, the customer’s income statement, non-financial investment considerations, and the customer’s investment outlook.”

Risk tolerance in financial terms is “[t]he degree of uncertainty that an investor can handle in regards to a negative change in the value of their portfolio.”

A familiar example provides that because “[a]n investor’s risk tolerance varies according to age, income requirements, financial goals, etc. . . . a 70-year-old retired widow would generally have a lower risk tolerance than a single 30-year-old executive.”

In Louros v. Kreicas, the client’s “risk tolerance was ‘aggressive’ (the other choices were ‘moderate’ and ‘conservative’).” Another example of risk tolerance can be stated in terms of investment goals.

Preservation of capital—“A person with this as his most important objective would not be willing to invest in most equity securities. ... In general, when clients speak of safety, they usually mean preservation of capital from losses due to credit or financial risk. Financial risk is the danger of losing all or part of the principal amount a person has invested.”

“All investments involve some degree of risk. According to the oft-quoted maxim, ‘The greater the risk assumed by the investor, the greater the potential reward.’ But just what are the risks inherent in an investment? What risks should be considered in determining the suitability of an investment recommended by a broker?”

The most important considerations in determining CARL do not have to do with goals, but with a client’s ability to sustain and recover from losses,

149. ROBBINS, supra note 20, § 5-5, at 5-14.
151. Id.
153. ROBBINS, supra note 20, § 5-5, at 5-14 (citing PASSTRAK SERIES 7, a study guide on Know Your Customer duties).
154. Id.
or “risk tolerance.” If a client expresses goals that are incompatible with her risk profile, it is the broker’s duty to reconcile the expectations of return with the anticipation of risk before making any recommendation. Accordingly, without such reconciliation of goals and risks, a broker is not positioned to make any recommendations to the client, as such recommendation would either fail to meet the investor’s goal or exceed her risk expectation.

A survey of risk tolerance options available for selection on account opening documents of broker-dealers shows a wide diversity in the way that firms allow clients to describe their own vision of risk tolerance. Discussions of client risk in legal and arbitration fora tend to focus on three general categories: conservative, moderate, and aggressive (or speculative).

155. An example of contradictory goals and risk expectation would be a goal 20% annual, tax-free income without risk of loss of principal. A Broker could explain that 20% returns may be achieved, but can not be anticipated without a high degree of risk, possibly including leverage; that tax-free income is only available in a limited number of investments, namely municipal bonds, which tend to offer only slight premiums above US Government-backed bonds, and are not likely to approach 20% in normal circumstances; or that the only “risk-free” investments in securities are US Government-backed bonds which offer a modest return nowhere near 20% annually, historically. The Broker could further suggest that a goal of 8% annual returns might be possible, with a portfolio comprised of US Government-backed bonds, Municipal Bonds, and equities that would not put all of the client’s principal at risk.

156. Cohen, supra note 110, at 1607–08.

157. ROBBINS, supra note 20, § 5-5, at 5-13–5-14.

Few opening account forms delineate an investor’s true investment objectives because the categories to check off on the forms are either too general or not applicable or otherwise cannot define the customer’s needs. A survey of the “investment objectives” portion of many opening account forms found a myriad of possibilities: income, income and growth, businessperson’s risk, speculation, investment grade, growth, investment hedge, safety of principal, tax-sheltered income, long-term growth, short term trading, trading, appreciation with safety, appreciation with risk, tax free income, trading profits, intermediate term, good quality, high risk, conservative growth, and aggressive growth. “Unfortunately, many new account forms are limited in their ability to accurately describe a customer’s objective. This can cause real problems when the testimony surrounding the issue of investment objectives occurs many years later . . . compounded by the fact that until recently, customers were not sent copies of their new account forms unless the forms were for an options account.” It is important for a customer’s attorney to appreciate the various investment objectives a broker should have discussed with a customer so that if a loss took place based on a recommended investment, counsel can determine whether the broker engaged in a substantive conversation on this issue.

158. On November 14, 2006 the following LexisNexis search produced 129 results, composed of NASD and NYSE reported awards and disciplinary decisions: “Source: Securities > Self-Regulatory Organizations (SRO) Materials > Combined NYSE & NASD materials” “Terms: client w/25 (conservative or moderate or aggressive or speculative).” On November 14, 2006 the following LexisNexis search produced 26 results, composed of federal and state suitability decisions and disciplinary decisions reviews: “Source: Securities > Cases & Court Rules > Federal and State Securities Cases” “Terms: client w/25 (conservative or moderate or aggressive or speculative) & suitab! w/25 securit!”
The client’s description of her own risk tolerance, however, is not the end of the inquiry for a broker, as he is still bound by the Know Your Customer duties. It may be the case that a broker’s dutiful investigation leads him to discover that his client has not honestly described her financial condition or situation, or that such a condition or situation may have changed due to factors such as illness, divorce, or unemployment. Additionally, a client may not be in a position to accurately describe her own risk tolerance, while the trained broker can make such an assessment.

The broker is bound to make recommendations suitable for the CARL, regardless of the client’s subjective opinion of what suitable risk may be. This is not to say that the broker may not place unsolicited orders for a client, but only that recommendations by the broker should not conveniently fit the client’s self-assessed risk level, when the broker knows the CARL to be lower, or more conservative.

As a general rule, it is not appropriate for a broker to determine that a client’s CARL is higher than she suggests, or more aggressive or speculative, regardless of the client’s financial condition or situation, because it should be the client’s informed decision as to the maximum amount of risk she wants to take on with her funds. In fact, the over-estimate of his client’s risk tolerance is what often leads to claims of unsuitability. Another situation where the broker’s estimate of his client’s CARL is different than her selected CARL may occur when a client elects to have multiple accounts with divergent goals and risk tolerances (e.g., one account with broker X invested solely in money market funds and another account with broker Y in which she chooses to make more speculative or aggressive investments). In such a situation, the broker is restricted to making recommendations that conform with his clients’ selected CARL.

Thus, the client may set the higher bound of risk for herself, and the broker may be bound to make recommendations of a more conservative nature. This duty may be owed to any investor, but certainly more so in

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159. See supra note 18.

160. Root, supra note 10, at 298 ("’Risks involved in a change in investment objectives must be explained, and the broker-dealer should not solicit a customers purchase of securities “inappropriate in light of the customer’s financial situation.”’ (quoting Fishman, Broker-Dealer Obligations to Customers—The NASD Suitability Rule, 51 MINN. L. REV. 233, 243 (1966))). “The courts in Tiernan v. Blyth Eastman Dillon & Co. . . . and Alton . . . both use the term ‘inappropriate’ to be interchangeable with ‘unsuitable.’” Id. at 298 n.38.


In 1971, Stephen Cohen argued for integration of economic theory into a legal standard for suitability determinations in a manner that addresses the essential point. He asserted that a suitability determination should be based upon an assessment of investor risk preferences: Willingness to bear risk being the first consideration and then, incorporating earlier work of Mundheim, the capacity to bear it. This produces the notion of a ‘risk threshold’ as the critical constraint on the freedom of brokers to make recommendations to their customers. Thus, “A widow with a moderate amount of capital . . . might be anxious to speculate and to incur high risks. But such
the case of an individual investor as compared to an institutional investor. Prof. Poser discussed a California Court of Appeals interpretation of a broker’s duty in regard to an institutional investor in the case of Duffy v. King Cavalier:

It is true that the decision requires the broker to “second guess” his customers’ expressed wishes; however, the customer in Duffy was an institution, whose true investment objectives may not have been identical to the investment objectives as they were understood by the representatives who dealt with the broker. In this situation, it is not unreasonable to impose on the broker a duty to inquire whether the stated investment objectives are in the customer’s best interests. The broker, as a professional, may have been in a better position than the representatives of the institution to determine the suitability of the recommended investments.

III. COMPARING RQ TO CARL IS AN OBJECTIVE STANDARD FOR DETERMINING SUITABILITY

Because a broker has a responsibility to understand the risk inherent in a recommendation, to know his client’s CARL, and to only recommend securities that appropriate are appropriate for her, an objective standard for determining suitability can be established using fundamental financial theories.

A. BROKER’S RESPONSIBILITY TO EXPLAIN RISK

Among the broker’s duties to an investor is the duty to explain the risks of a recommended security. The omnipresent legends that adorn a vast quantity of a broker-dealer’s or issuer’s literature include warnings such as: “past performance is not indicative of future results,” “results can not be guaranteed,” “deposits are not guaranteed by the FDIC,” “investments may lose value, including the principal amount invested,” and many others. All such warnings are intended to put the investor on notice that there is risk in making investments in the securities markets. These must be displayed prominently on prospecti, analysts’ reports, advertisements, and other documents, to comply with government and SRO rules and regulations.

speculation would be beyond her ability or capacity to bear risk if a prudent investor in her situation would not adopt that strategy.”

Id.

162. Poser, supra note 3, § 3.03, at 3-100–3-101 (emphasis added).
164. See generally Rule 482 of the Securities Act of 1933.
B. INVESTORS ALSO HAVE A RESPONSIBILITY

When an investor determines to enter the securities markets, it is presumed that she has been made aware of the risks inherent in making such an investment. Accordingly, an investor is not absolved of the responsibility for thought, contemplation, and decision-making that such an investor must entertain before depositing a check into an investment account. The manifold notices, disclaimers, and legends are designed to assure that this determination is made knowingly and—notwithstanding exceptional circumstances such as fraudulent inducement—that such a presumption is legally plausible.

The SEC’s execution of its mandate under the ‘34 Act was interpreted by the Second Circuit when it stated that “[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks.” Thus, both Congress and courts have recognized that the gains anticipated by investors are accompanied by risks. The numerous disclosures and legends that accompany securities materials are clearly intended to convey the risks and dangers associated with investing in securities to all investors, and prospective investors.

C. SECURITIES INVESTORS ACCEPT MARKET RISK

Investors are deemed to have been warned about the risks associated with investing, and that they themselves are subject to the market risks. This presumption follows from a broker’s duty of informing his client. Therefore, “an investor [] implicitly assumes the commercial risk that a change in market conditions may produce adverse economic consequences.” Thus, an investor takes on market risk by investing in the securities markets unless she instruct her broker that she was only willing to sustain lesser levels of risk. Stated differently, investors assume a market-

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167. See, e.g., id. at 1032–33.
169. Id. (The SEC’s Rule 10b-5, promulgated under its 1934 Act authority, elaborates on the types of conduct prohibited in connection with the purchase or sale of a security). See also Bluebird Partners, L.P. v. First Fid. Bank, N.A., 279 A.D.2d 239, 244 (N.Y. App. Div. 2001) (“[R]ecovery is unavailable even in the face of actual loss where such loss results from an inherent market risk assumed by the investor” (emphasis added) (quoting Nat’l Union Fire Ins. Co. v Robert Christopher Assocs., 257 A.D.2d 1, 12–13 (N.Y. App. Div. 1999))); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974)).
170. Robert Christopher Assocs., 257 A.D.2d at 12–13. “Finally, as a fundamental principle, a contracting party—especially one denominated an investor—implicitly assumes the commercial risk that a change in market conditions may produce adverse economic consequences.” Id. (emphasis added). These risks, however, are distinct from the risks of individual securities.
level of risk by investing in the securities markets, unless they specify otherwise to their brokers.

Broker-dealers and claimants alike cite the well-managed account theory of damages which can be used to argue for a reduction of a firm’s liability in a bear market \(^{171}\) or a boost to the claimant’s damages in a bull market. \(^{172}\) The theory was explained by the Second Circuit in *Rolf v. Blyth* as such:

> The district court should then reduce Rolf’s gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor’s Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with Stott’s aiding and abetting and terminating with its cessation. Thus if during the relevant period the stock market declined in value by 25%, then Rolf’s gross economic loss should be reduced by 25%. \(^{173}\)

As investors accept market risks upon entering the securities investment arena, this establishes a threshold of acceptable risk for investors, because “recovery is unavailable even in the face of actual loss where such loss results from an inherent market risk assumed by the investor.” \(^{174}\) Whether or not an investment is suitable can be determined by comparing the risks of the recommended investment with the amount of risk the investor accepted by entering the markets.

**IV. SUGGESTED STANDARDS COMPARING RQ & CARL TO DETERMINE SUITABILITY**

Because “[t]he professional intermediary must be oriented in his or her investment recommendations either by the creation or existence of a portfolio with identifiable risk/return characteristics and then by the expected impact of a particular recommendation on the performance of that portfolio,” \(^{175}\) he should be judged accordingly.

The . . . suitability rule[s may] be violated in two different ways. First, a broker may violate the suitability rules if he fails so fundamentally to comprehend the consequences of his own recommendation that such recommendation is unsuitable for any investor, regardless of the investor’s

\(^{171}\) Bear Market Definition, *supra* note 59.

\(^{172}\) Bull market, Investopedia.com, http://investopedia.com/terms/b/bullmarket.asp (last visited Nov. 21, 2006) (“A financial market of a certain group of securities in which prices are rising or are expected to rise.”).


\(^{175}\) Rapp, *supra* note 29, at 268.
wealth, willingness to bear risk, age, or other individual characteristics. More commonly, however, the suitability rules will be violated by a recommendation that might be suitable for some investors but is unsuitable for a specific investor to whom the recommendation is directed.176

Because these two types of suitability violations can be objectively described and broad parameters can be laid, the field of what suitability cases can be argued in good faith can effectively be narrowed.

A. AN RQ ≤ 1.0 IS PRESUMPTIVELY SUITABLE FOR ANY INVESTOR

Any recommendation, either of an individual security or for a portfolio, with a Risk Quotient less than or equal to one (RQ ≤ 1.0) should be presumed suitable for any investor because any investor who enters the securities market should be prepared and able to sustain market losses, unless she made her low tolerance for risk known to her broker.177 Some clients may not be able or willing to accept market risk, and may choose not to accept such risk with some or all of their funds. If a client is not able or willing to accept market risk with their funds, her broker should reject any and all orders to avoid potential liability.

B. AN RQ ≥ 2.0 IS PRESUMPTIVELY UNSUITABLE FOR ANY INVESTOR

Despite the fact that “[i]f the investor’s risk tolerance is high, he or she can be expected to assume higher non-diversifiable systematic risk given by higher beta stocks,”178 there is a limit to the amount of risk that is reasonable for most investors. A Risk Quotient of greater than two (RQ ≥ 2.0) should be presumed unsuitable for a “conservative” or “moderate” CARL investor, unless the recommendation is made as a component of a portfolio179 which has a CARL-appropriate Risk Quotient. This is true

177. Reinsch, supra note 10, at 199.
178. Reinsch, supra note 10, at 195
179. Rapp, supra note 29, at 272 (“Portfolio-driven recommendations must be treated differently than those that are only security-driven.”).

The standard of care against which the suitability responsibility of brokers is to be measured should be grounded in the dichotomy between stand-alone and portfolio recommendations. The inquiry should begin with the question of whether a
because excessive risk fails to provide incremental returns under Modern Portfolio Theory, and is therefore unsuitable. The burden of such objective standards on broker-dealers must be weighed against their certainty and freedom to operate and also against the potential benefits to

recommendation is reasonably designed for the creation of, or to contribute to, a portfolio, the risk/return characteristics of which are reasonably matched to the investment objective, which is in turn a function of financial profile and risk preference of the investor. Where there is no identifiable and reasonable portfolio orientation for a recommendation, the isolated consideration of that recommendation is entirely appropriate. But a recommendation that is shown to be reasonably based as a portfolio component should not be evaluated on the basis of its stand-alone risk in isolation from the portfolio. In its most practical application, as a defense against unsuitability claims, MPT compels this result.

Id. at 273.

According to MPT, individual stock risk can and should be reduced or diversified away by combining stocks that are not positively correlated. If an investor consciously chooses to over-concentrate his or her resources in a single stock or a set of correlated stocks, the investment strategy is clearly unsuitable and he or she alone is responsible for the consequences that might follow. However, market risk, which affects the stock market as a whole and is also called systematic risk, cannot be diversified away. The entire stock market could conceivably be pulled down by some unexpected bad economic or political news and this is likely to have an adverse effect on all stocks in one's portfolio regardless of the care taken to create a well-diversified holding. For example, a terrorist attack will cause an immediate collapse of the stock market, pulling down all stocks.

Id.

Erlich set the stage for two cases from the Seventh Circuit. In 1988, that court reasoned that when investment advisors make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given investment is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.

Id. at 176.

181. In a search for the highest current and long-term risk-rated mutual funds by Morningstar ("Morningstar Risk Score" of "5" and "Rating for Morningstar Risk Score" 10Yr of "5"), seven mutual funds had the highest rating in both categories. Out of this group the highest β was 3.4 by the Rydex U.S. Government Bond Inv. Fund ("RYGBX"), which had achieved a year-to-date return of -13.34% by December 2, 2005. The second highest β was 3.31 by the Apex Mid Cap Growth ("BMCGX"), which had posted 24.02% losses by December 2, 2005. As a group, the seven had an average 3-year β of 2.575 and an average year-to-date return of -2.80% as of December 2, 2005. The risk of loss from high β investments has been real for these investors. Meanwhile, the highest performance for 2005 has been turned in by the BlackRock Global Resources Instl. Fund ("SGLSX") which has a β of 0.83 and "Year to Date Return" of 44.63% and "5-Year Average Return" of 34.29%. Morningstar Ratings CD-ROM (2005); Yahoo!, Finance, http://finance.yahoo.com for 3-year β and performance statistics and rankings (last visited Nov. 20, 2006).
investors. Whatever the burden, it is less now than in the past due to the development of electronic oversight and compliance programs.\footnote{182}

\section*{C. The Impact of an Objective Standard for Suitability}

A clear and well-defined standard for suitability would have a significant impact on the brokerage industry. Many claims would be prevented by more reasoned recommendations by brokers and with an opportunity for better supervision by broker-dealers of the recommendations their brokers make. Further, electronic supervision could be effective if boundaries for conduct are set. In addition to the prevention of client losses due to more reasoned recommendations, claimants’ attorneys would be better positioned to determine what claims would be colorable and respondents’ attorneys would likely settle a larger proportion of those colorable claims. Remained claims could be decided on the basis of objective comparison of conduct to a clear and well-defined standard.

\subsection*{1. Thousands of Claims Could be Prevented When the Next Market Correction Occurs}

As discussed above, actual losses to investors’ accounts precipitate the vast majority of unsuitability claims. The quantity of investors who lose enough principal to make a claim increases dramatically during bear markets,\footnote{183} when losses outpace gains, and during market corrections.\footnote{184} If an objective standard has been adopted before the next market correction occurs, thousands of claims could be prevented.

\begin{quote}
In fact, suitability review technology is already in existence. E*Trade has been looking for a vendor to provide the online broker with technology that would enable it to conduct suitability reviews of online trades. Suitability review technology would use algorithms and mathematical formulas to determine whether a specific trade is appropriate for a particular customer. With this type of review, online brokers could identify unsophisticated online investors attempting to purchase securities that are too risky for their financial position and notify the investors about their findings. Some industry participants believe that online technology enables brokers to assess customer suitability more easily than if a customer traded via a traditional broker.\footnote{n164} Additionally, online brokers would only be required to run these suitability checks on a portion of their customers who are classified as unsophisticated. This limitation will reduce the additional costs that online brokers anticipate as a result of running suitability checks. Furthermore, it is arguably better for online investors and the economy as a whole to pay slightly higher prices in exchange for suitability checks, which provide investor protection and promote investor confidence.
\end{quote}

\footnote{182} Barnett, \textit{supra} note 73, at 1122–23.

\footnote{183} Bear Market Definition, \textit{supra} note 59.

\footnote{184} Unsuitability claims doubled from 2001 to 2003, attributable in large part to the burst of the so-called “tech bubble” in 2001. The reason for the delay, from March 2001 when the NASDAQ peaked, to 2003 can be explained by the time required by investors to realize their losses, retain attorneys, and file claims.
If the proposed standard is implemented and enforced by broker-dealers, the majority of investors would remain within the bounds of broad market declines and gains, and thus would be more likely to realize the long-term benefits of investment in the securities markets. Such a result would undoubtedly be positive for individual investors and for the securities industry as a whole.

2. More Reasoned Recommendations by Brokers

At the present time, brokers are required to have a reasonable basis for the belief of the suitability of their recommendations, but proving such belief is difficult without objective evidence. Under the proposed standards, brokers would be better able to support their recommendations by reproducing the analysis they engaged in when they originally made the recommendations. This contrasts with the current standard. Reasonable is relative and whether or not a security is later determined to have been suitable depends on many factors. Most troubling for brokers, this analysis comes with the clarity of hindsight and a security’s actual performance which, in most arbitration claims, is a significant financial loss.

Brokers make recommendations to their clients that have CARL appropriate RQs, will be better positioned to inform their clients as to why those recommendations are suitable and to defend their recommendations should a claim be brought against them months or years later.

3. An Opportunity for Better Supervision by Broker- Dealers

Broker-dealers are charged with supervision of their brokers, and can be held liable for negligent supervision if their brokers’ recommendations are determined to be unsuitable. The “red flags” which signal that an investigation is required for a certain account depend on monitoring the signals of executed trades and the actual performance of the clients’ accounts. Broker-dealer supervision would be greatly aided by a clear, well-defined standard for judging the suitability of these trades before losses are realized. Broker-dealers could assign a CARL level for every account by using the questions regarding the client’s desired level of risk currently on account opening applications and the brokers’ input.

Only with an objective standard for brokers can the broker-dealer’s duty of supervision be objectively judged. Without a clear and well-defined standard, the broker-dealer is subjectively determined to be liable to their clients regardless of the level of care exercised.

185. The use of so called “comfort letters” by broker-dealers is an example of retrospective supervision, where contact is initiated with a customer after she has realized significant losses to her account.

186. See supra note 159 (regarding risk determinations based on account opening documents).
4. Electronic Oversight of Recommendations

Effective electronic oversight of recommendations would be possible with the objective measure of suitability proposed by this article. Such systems have already been developed and are in use by some broker-dealers, but for such oversight to be effective, meaningful parameters need to be set for the systems to monitor.

With the proposed CARL and RQ levels, a broker-dealer would be able to monitor the accounts of all clients on an ongoing basis. The systems could measure the individual recommendation’s RQ against the appropriate account’s CARL, and notify the broker, supervisor and client along with the trade confirmation which is already required to be prepared and sent to the client. In addition to the individual recommendation, broker-dealers could monitor clients’ portfolio RQs at the time of every trade or upon periodic review, and notify their clients of the amount of risk that their principal is exposed to at that time.

5. Claimants’ Attorneys Would Bring Fewer Claims

Whether or not broker-dealers changed their recommendations to conform to the proposed standards, claimants’ attorneys would not file as many unsuitability claims. This would occur because claimants’ attorneys would be able to determine in advance whether or not the trades that their clients complained of had RQs that were appropriate for their client’s CARL, and whether their clients’ portfolio RQ was appropriate.

There would be two distinct results of the application of the proposed standard by claimants’ attorneys. First, attorneys would be effectively barred from bringing claims that they did not have a good faith belief to be unsuitable as judged against the proposed standard. Second, those claims filed would be vetted for at least a colorable claim of unsuitability. As a result, there would be fewer filed claims and those claims would better plead cases for unsuitability.

6. Respondents’ Attorneys Would be Able to Settle the Better Claims

Broker-dealers faced an average of 2,516 unsuitability claims through the NASD during the 2001 through 2004 calendar years. With the significant decrease in the quantity of claims contemplated above, through more reasoned recommendations, better supervision, electronic oversight,
and claimants’ attorneys bringing only better pled claims, broker-dealers could see a dramatic reduction in the number of claims against them. As a result, broker-dealers would be in a position to settle a larger proportion of the claims that were made, and dispose of the remainder more quickly. The quick disposition of ill-advised claims would be possible with the application of an objective standard by arbitrators analogous to summary judgment relief.

7. Arbitration Panels Would Objectively Determine the Remaining Claims

With a clear, well-defined standard of conduct for brokers, and the historical data available to both claimants and respondents, an objective determination by arbitration panels would be possible. Whether or not a recommendation was suitable alone or within a portfolio would be presumptively determined based on verifiable facts about which parties to the arbitration could stipulate, as the beta of a security, the amount of equity in the position at the time of purchase and the portfolio’s RQ would not be subject to argument. This opportunity for objective comparison is in sharp contrast to the determination of current claims where the actual loss and the current financial position of the investor-client are surely more influential factors than they need to be.

D. THE NECESSITY OF A CLEAR, WELL-DEFINED STANDARD FOR MEANINGFUL REVIEW OF UNSUITABILITY AWARDS AND THE CONTINUED APPLICABILITY OF THE FAA

As the Supreme Court noted in McMahon, when securities claims were held to be within the enforcement powers of the Federal Arbitration Act, 189 “although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.” It may, therefore, be argued that the enforceability of predispute agreements to arbitrate requires the opportunity for “sufficient” judicial review. If, however, review of arbitration awards is not sufficient, securities claims, specifically unsuitability, may not be subject to arbitration due to § 29(a) of the ‘34 Act, which states that “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.”

1. The Conflict Between McMahon and the Benderson and Wallace Decisions

In Wallace v. Butar the Second Circuit held that “[a]n arbitral award may be vacated for manifest disregard of the law ‘only if a reviewing court . . . finds both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case.’”\(^{190}\)

The Second Circuit has applied this reasoning in reviewing the securities arbitration awards in Wallace and Benderson.\(^{191}\) In Benderson, the court stated that “GMS [the broker,] neither points this court to case law interpreting the terms ‘recommendation’ or ‘suitability,’ nor points to anywhere in the record where such law was brought to the attention of the arbitrators.”\(^{192}\)

The current subjective reasonable belief of the broker standard for determining suitability is not what the Second Circuit held was required for vacation of an arbitration award on the grounds of manifest disregard. Thus, because the current standard is not a well-defined and explicit law, the ‘34 Acts’ restriction on contracting away protections are at odds with the sufficient review component of the Supreme Court’s McMahon and decision.

2. Averting a Crisis for Securities Arbitration

It appears that a crisis is brewing in securities arbitration because of the lack of legally sufficient review of awards. Therefore, the very enforceability of arbitration agreements is in question unless a well-defined and explicit standard is adopted to avert this brewing crisis.

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\(^{190}\) Wallace v. Butar, 378 F.3d 182, 189 (2d Cir. 2003).

\(^{191}\) GMS Group, LLC v. Benderson, 326 F.3d 75, 75 (2d Cir. 2003).

\(^{192}\) Id.

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