

Investment Management Regulation

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An Introduction to Principles and Practice

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To Brenda, my constant inspiration.

JAF

For Brigitte, my love, for all of her patience and support!

KOH

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Preface

The subject of investment management regulation is a burgeoning area of law. The business conservatively accounts for \$25 trillion in assets under management by money managers in the United States alone, and trillions more internationally. And this number does not even begin to include assets held in accounts that receive investment advice, but are not managed, by market professionals. In 2016, the Investment Company Institute estimated that over 95 million retail investors in the U.S. are directly affected by investments in mutual funds or exchange-traded funds held in individual fund accounts, retail brokerage accounts, or employee retirement accounts. Countless more are indirectly affected by returns from the many varieties of pooled investment vehicles (registered and unregistered) in which institutions (including insurance companies, pension funds, endowments, and foundations) participate.

The enormous economic footprint of the investment management business coupled with the dramatic increase in its size have produced corresponding regulatory changes. Basic animating fiduciary principles have not changed, but their application has had to adapt to new circumstances as the scale of the business has grown, financial strategies have become increasingly complex, and the technical operational aspects of the business have become more interconnected. In addition, legislators and regulators have responded to this changing environment both by extending existing principles to new activities and practices through vigorous enforcement and by introducing new regulatory mandates. Thus, although the basic regulatory pattern was set in 1940 and remains intact, significant legal developments in the ensuing years have made the regulatory scheme more robust and responsive to the financial world of today. Does this mean that the regulatory scheme is adequate to the challenges presented by the financial world of today? No, but the issue of regulatory adequacy or, conversely overreach, is very much fair game for a course on investment management regulation.

This textbook provides students an introduction to investment management regulation as it has evolved. Based on our experience in teaching this course, the authors have deliberately approached the topic differently from the standard legal text to make it more accessible for the typical student. The first major difference for users is that the first five chapters provide a basic primer (an investment management boot camp of sorts) for the uninitiated. Unlike the typical law school subject, we believe students benefit from a preliminary tour of the regulated industry that is the subject

of the course and from an understanding of how that industry operates as a business. Investment management, especially its business dimensions, is not intuitive in the way that torts, criminal law, or contracts are. In those subjects, students can draw on their own everyday experience, augmented by popular media, to have a ready intuitive sense of the affected parties' interests. In contrast, the investment management industry is a specialized setting whose workings are largely opaque to the outsider. This primer occupies the first five chapters and resembles more of an undergraduate text than a legal casebook.

The remainder of the book, beginning with Chapter 6, resembles more closely a conventional legal casebook, but also adopts a significantly different presentational style. While the guts of each chapter are excerpts from cases, administrative proceedings, or administrative releases, we use significant framing summaries at the beginning of each chapter and each excerpted item to ensure students understand how topics discussed fit into a broader regulatory tapestry and the purpose of reading the materials that have been selected. There is no attempt to hide the ball. On the contrary, we have selected materials that exemplify current issues and challenges (the majority of the materials excerpted are less than 25 years old). However, the selections are used not merely to illustrate basic legal and regulatory principles, but also to educate students descriptively about the reality and challenges that investment businesses encounter. A good example of this is our reliance on findings from settled SEC administrative proceedings. The administrative orders lack the explicit adversarial dimension typical of adjudicated cases, but invariably they carefully describe the circumstances that serve as a predicate for an order's legal determination. Students, just as practitioners, must derive guidance from these orders regarding conduct that is deemed unlawful. What is left unstated in these administrative orders are the orders' implications for other market participants.

Third, we have consciously designed this book as an introduction to the topic of investment management regulation and have omitted many additional topics that are clearly germane to practitioners. Instead, based in part on our experience, we have tried to create a clear roadmap with respect to the basic foundational legal topics in the investment management sphere. Thus, we have limited ourselves to topics that any instructor would surely touch on, even though there are additional, more specialized topics, such as money market funds or capital structure limitations, that we believe are best pursued on a course-by-course basis and possibly in the context of research papers. We have found that an organizational structure tied to foundational simplicity greatly improves overall accessibility of the subject matter for students.

Finally, we have deemphasized to some degree policy analysis in our presentation, not because policy is unimportant, but rather, given its importance, policy analysis is likely to be more sure-footed from a vantage point that reflects the backdrop of legal principles and practice as exemplified by the type of issues and business practices that have arisen. In other words, we don't dwell on the question, "Is there a need for regulation in this area?" The text accepts the policy premise that regulation should work to protect the interests of investors in terms of the specific instances identified,

and in the wider sense of creating a framework that allows regulated activities and entities to advance the interests of investors generally. It further assumes that, as a starting point, students should maintain a healthy skepticism simultaneously of both the utility and adequacy of regulatory policies, and also a measure of skepticism regarding the motivations of industry participants. In exploring how regulation in fact operates, however, we leave for the individual course the task of assessing the overall effectiveness of regulation.

The textbook is set forth in 18 chapters divided into three parts. Not all chapters are of equal importance. We have found that chapters 4 and 5 can be relegated to background reading, as can chapter 8, without seriously affecting the text's basic presentation. Two chapters, 9 and 18, took shape in drafting the textbook as indirect regulation of private funds under the Investment Advisers Act developed a momentum of its own (Chapter 9) and the explosive growth of ETFs has injected a disruptive competitive effect on the existing status quo within the investment management business (Chapter 18). These areas promise to be a source of continuing regulatory dynamism in the years to come.

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