

Trends in the Regulation of Investment Companies and Investment Advisers

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Statutes, rules and enforcement actions are tea leaves we can read to predict future trends of mutual fund regulation. While statutes and rules are specific, the trends they signify are far more speculative. This Essay engages in such speculation to envision the long-term implications of the recent new N-1A disclosure form,¹ the plain English Rule,² and the profile.³ More generally, the Essay speculates on future trends in Securities and Exchange Commission ("Commission") enforcement, and predicts a continued and stronger use of informal enforcement by the Commission.

I. THE LONG-TERM IMPLICATIONS OF THE NEW N-1A DISCLOSURE FORM, THE PLAIN ENGLISH RULE AND THE PROFILE

During the past decade, the Commission has made a fundamental change in its approach to determining mutual fund disclosure rules. Historically, the Commission relied on its own judgment and input from the industry to

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¹ See Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7,512, 63 Fed. Reg. 13,916 (March 23, 1998) [hereinafter Registration Form Release] (adopting amendments to Form N-1A to "improve fund prospectus disclosure and to promote more effective communication of information about funds to investors").

² See Plain English Disclosure, Securities Act Release No. 7,497, 63 Fed. Reg. 6,370 (Feb. 6, 1998) [hereinafter Plain English Release] (establishing plain English rules and principles for writing prospectus disclosure).

³ See New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 7,513, 63 Fed. Reg. 13,968 (March 23, 1998) [hereinafter Profile Release] (authorizing fund profile to provide summary of key information about fund).

determine the content and format of information that issuers should disclose to investors. More recently, however, the Commission has factored into its decision the wishes of investors, and has drawn disclosure contents and formats accordingly.

In order to ascertain investor preferences, the Commission has used focus groups and mass mailings that investors have answered on their own initiative or at the encouragement of others (for example, fund complex advisers). The Commission has also increased the use of the media, and polls and marketing methods designed to gauge public opinion. In sum, rather than relying only on its own judgment and industry suggestions on what investors need to know, the Commission sought investors' opinions about the substance, format and language of the information they want to receive, and those opinions have led to changes in disclosure requirements: modification of Form N-1A, emphasis on plain English, diverse forms of prospectuses, and permission to use profiles.

There are weighty arguments for paying attention to the desires of investors. Arguably, the securities acts covering securities transactions are designed to substitute for the rule of *caveat emptor* in contract law because investors cannot directly negotiate with issuers and ask them for information. Investors' questions are therefore determined by Congress and the Commission. To the extent that the Commission can determine (more or less) what information investors wish to receive, it should follow these wishes. One might argue, however, that the purpose of the securities acts is not merely to overcome the absence of direct negotiations but to entice investors to engage in securities transactions. These transactions are highly complex; investment decisions require a substantial amount of information, which may deter investors from engaging in securities transactions. Because securities markets are so important to our economy and political system, the government provides investors with support and incentives to engage in securities transactions. Government interference in this case is necessary as it is

in the case of the manufacture and distribution of drugs and poisons. Both can heal and kill. Because both arguments make sense, I suggest that the Commission's role is not fully abdicated to investors' desires (or the industry's desires), but that its decisions should present a mix of all three inputs: those of the investors, those of the industry, and those of the Commission as guardian of the public trust in the markets.

In addition to seeking investors' input on the substance and format of the information investors should receive from issuers, the Commission has initiated a movement to educate investors in investment decision-making. This new two-pronged approach can have serious implications for investors. The securities acts remove their protective mantle from investors that have relevant information about the issuers and the sophistication to evaluate this information. The movement to provide information that investors choose and to educate them may increase the number of investors who are not covered by the protection of the securities acts. This is designed to speculate about the implications of the Commission's new approach rather than to criticize it.

A. FROM LEGAL ENGLISH TO PLAIN ENGLISH AND INVESTOR EDUCATION

Investors have long complained that prospectuses are not readable. The Commission has recently responded by a requirement to substitute plain, everyday English for the legal English used by lawyers and the courts.⁴ The Commission has also taken the initiative to help investors understand the information on which they make their investment decisions by offering them educational materials and pressing issuers to educate investors by

⁴ See Plain English Release, 63 Fed. Reg. at 6.370 (establishing plain English disclosure rules).

accessible plain English information about investment options.⁵

A requirement that fund disclosure be in plain English has its drawbacks. It introduces legal uncertainty because the plain English of new disclosure documents may be subject to different judicial interpretations than the legal English of the past. This uncertainty may be detrimental to both issuers and investors, depending on the extent to which it would lead to litigation and the outcome of litigation based on the new texts.

B. FROM A UNIFORM FORMAT TO A DIVERSE DISCLOSURE FORMAT; FROM A SINGLE DOCUMENT (PROSPECTUS) TO A BIFURCATED DOCUMENT (PROSPECTUS AND A STATEMENT OF ADDITIONAL INFORMATION)

Heeding investor preferences, the Commission has allowed a diversity of disclosure documents, reflecting the diverse investor population and the varied information that different investors desire to receive before making their investment decisions. Some investors prefer detailed information while others seek simpler, more general information. Some investors buy or redeem shares after conducting their own research while others rely exclusively on the advice of investment advisers and brokers. Many investors fall within the two extremes. Consequently, the Commission allowed issuers to offer investors different types of disclosure documents in different sequences.⁶ Issuers have adopted the variety of

⁵ See generally James A. Fanto, *The Contribution of the Fund Profile to Investor Education*, 1 VILL. J. L. & INV. MANAG'T 59 (1999) (discussing benefits of investor education and plain English initiative).

⁶ There are two times when a fund can provide an investor with disclosure documents, before an investment decision is made, and after the decision is made. A fund may provide an investor with any and all types of disclosure documents before an investment decision is made — advertising, a fund profile, a prospectus with or without a Statement of Additional Information (SAI). However, a fund may not accept money from an investor (permit an investment decision to be made) without first providing the investor with a profile or prospectus. If an investor makes an investment decision without having received a prospectus

disclosure formats permitted by the Commission. In part, the diverse format benefits issuers by reducing their costs and increasing their flexibility in designing more effective marketing materials.

These changes also affected the priorities and placement of information. One example relates to disclosure of conflicts of interest, including soft dollar arrangements.⁷ Logically, disclosure of conflicts of interest helps investors

(but after receipt of a profile) the fund must provide the investor with a prospectus with confirmation of the purchase. See Profile Release, 63 Fed. Reg. at 13,969 ("An investor deciding to purchase fund shares based on the Proposed Profile would receive the fund's prospectus with the purchase confirmation."). A fund is not required to ever provide a potential investor with any document other than a prospectus. All other disclosure documents are optional. See *id.* at 13,971 (noting that profile is optional summary prospectus under section 10(b) of the Securities Act, but prospectus remains primary disclosure document). Section 10(b) of the Securities Act provides in part:

In addition to the prospectus permitted or required in subsection (a) of this section, the Commission shall by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors permit the use of a prospectus . . . which omits in part or summarizes information in the prospectus specified in subsection (a) of this section.

15 U.S.C. § 77j(b) (1998).

⁷ See Registration Form Release, 63 Fed. Reg. at 13,931 ("The Proposed Amendments also would no longer require a fund to state in its prospectus, if applicable, that the fund engages in brokerage transactions with affiliated persons and allocates brokerage transactions based on the sale of fund shares."). Disclosure of these soft dollar arrangements shifted to the SAI because "the Commission believes [they] are only of minimal importance to typical fund investors." *Id.*

The term "soft dollar arrangement" generally refers to a "triangular relationship between a money manager, his accounts and the broker." See Lee H. Pickard, *Institutional Portfolio Execution: Soft Dollar Arrangements*, 8 INSIGHTS 22 (Aug. 1990) (explaining that "money manager directs amount of portfolio commissions to broker . . . in return for execution services and research used by the money manager in making investment decisions on behalf of his client accounts."). These soft dollar arrangements are generally permitted under section 28(e) of the Securities Exchange Act. See 15 U.S.C. § 78bb(e) (1998) (providing that it is not unlawful to pay member of exchange, broker, or dealer a commission for "effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction").

In addition, the payment of commissions in these soft dollar arrangements is governed by section 17(e) of the Investment Company Act which provides:

choose their fiduciaries; investors may decide to avoid investing in funds whose advisers engage in conflicts of interest. In addition, such disclosure may preclude violations; if advisers must disclose their conflicts, they may avoid the conflicts altogether. Further, such disclosure facilitates legal enforcement actions; if advisers fail to disclose conflicts of interest, that failure *per se* constitutes a violation of the law.

However, many investors are not particularly interested in their fiduciaries' conflicts of interest. For the most part, in the United States investors trust the system, at least until they find that their trust in their fiduciaries was abused. Information about conflicts of interest is of interest after the fact, to the "private attorney generals" (the plaintiffs' bar), the enforcement arm of the Commission, and the courts.⁸

It shall be unlawful for any affiliated person of a registered investment company or any affiliated person of such person . . .

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

15 U.S.C. § 80a-17(e) (1998). Rule 17e-1 defines the "usual and customary broker's commission" as the term is used in section 17(e)(2)(A). See 17 C.F.R. § 270.17e-1 (1998) (providing in part that commission does not exceed usual and customary broker's commission, if it is "reasonable and fair" compared to commissions received by other brokers in comparable transactions).

⁸ The Investment Company Act of 1940 vested the Commission with the duty to determine whether conflict of interest transactions would benefit investors. In the 1980s, approval of many transactions of this sort was transferred to funds' boards of directors and enforcement was relegated to the plaintiffs' bar. Disclosure was one of the mechanisms to reduce the plaintiffs' information costs and facilitate enforcement of fiduciary duties. This technique was one of the reasons prospectuses became longer and less readable.

In light of investors' priorities, the Commission has banished the conflict of interest disclosure to the Statement of Additional Information (SAI),⁹ which reaches only a fraction of the investor population — those who ask for it. In the SAI, legal language is often still in bloom, for plaintiffs' lawyers to search for information on which to base claims, and the Commission's staff to look for evidence of wrongdoing. Thus, the SAI has retained to some extent the flavor of the prospectus of the past: the shield against, and basis for litigation.

C. FROM TRADITIONAL TEXTUAL RISK DISCLOSURE TO GRAPHIC PRESENTATIONS AND MORE SPECIFIC RISK DESCRIPTION

Risk disclosure is not only affected by the plain English requirement, but also by the new item in Form N-1A, requiring graphic presentations of volatility of the portfolio, and to a lesser extent, risk. Arguably, requiring plain English and graphic description of risk raises the issuers' risk of liability. Hedging language that describes risks seems to have been an effective strategy to protect issuers against liability, at least in some courts.¹⁰

⁹ See Registration Form Release, 63 Fed. Reg. at 13,929-931 (explaining that some disclosure of fund management and organization was moved to the SAI because it was "not necessary for a typical fund investor"). A mutual fund may, but is not required to, have an SAI as part of its registration statement. An SAI is not a prospectus, but if a fund includes information in the SAI that it would otherwise be required to include in its prospectus, the fund must offer to provide, and provide upon request, the SAI to investors. See *id.* at 13,917 (stating that goal of SAI was to provide investors "a prospectus that is substantially shorter and simpler, so that the prospectus clearly discloses the fundamental characteristics of the particular investment company").

¹⁰ Under the "bespeaks caution" doctrine, "where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections and expectations with adequate cautionary language, these statements are not actionable as securities fraud." *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994). Almost all circuit courts have adopted the doctrine in some form. See Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just A State of Mind*, 58 U. PITT. L. REV. 619, 629 & n.51 (1997) (noting that all circuits except Fourth, Tenth and District of

However, the judicial trend in the courts may shift to require more specific explanations.¹¹ Specific explanations facilitate investors' investment decisions.

Perhaps we might witness more emphasis by issuers on risk, as they become convinced that promising less (not merely hedging after promising more) may be a better long-term strategy. Unlike the sales force that may focus on "spot sales," issuers seek to build their credibility with investing communities. Issuer credibility is crucial today because investors have a continuous relationship with mutual funds and their investment advisers, and investors continuously make substantial investments in the volatile equity markets. By promising less and shifting the decision on the level of risk to investors, issuers are less likely to be blamed for losses, and more likely to be trusted by investors.

Columbia Circuits have adopted doctrine; district courts in Tenth Circuit have adopted doctrine; Fourth Circuit has cited approvingly cases applying doctrine); *id.* at 628 & n.45 (citing cases); *see also* 15 U.S.C. §§ 77z-2 & 78u-5 (Supp. II 1996) (codifying safe harbor for forward-looking statements).

¹¹ *See In re Trump*, 793 F. Supp. at 554 (limiting application of doctrine to "precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus"). In affirming the district court's holding, the Court of Appeals for the Third Circuit stated that "a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation." 7 F.3d at 371-72 (adding that "[t]o suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge"); *see also* Rubinstein v. Collins, 20 F.3d 160, 167-68 (5th Cir. 1994) (applying doctrine following fact- and case-specific approach and stating, "cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law"); *Furman v. Sherwood*, 833 F. Supp. 408, 415 (S.D.N.Y. 1993) (requiring disclosure of assumptions on which predictions are based); *Ballan v. Upjohn Co.*, 814 F. Supp. 1375, 1382 (W.D. Mich. 1992) (restricting application of doctrine to financial information; defendants allegedly concealed data concerning drug side effects); O'Hare, *supra* note 10, at 643 n.135 (noting disagreement over whether bespeaks caution doctrine "would protect an issuer if the issuer did not believe its forward-looking statement").

D. FROM COMMISSION AND INDUSTRY SUBJECT MATTER PREFERENCES TO EMPHASIS ON INVESTOR SUBJECT MATTER PREFERENCES

The substance of required information items has changed to accommodate investor preferences. For example, information about issuers' past performance, which the Commission has prohibited for decades, is now allowed, even though past performance is difficult to quantify and is not a predictor of future performance.¹² Yet, investors have consistently asked for this information. They may have done so perhaps because past performance may demonstrate the issuers' and advisers' ability to choose effective and creative portfolio managers. Past performance presented in a standard form may help investors compare the performance of funds long-term. The implication of this change is difficult to gauge. Whether this information is in fact misleading investors may never be known.

E. FROM THE PROSPECTUS AS AN INSTRUMENT FOR INVESTMENT PROFESSIONALS TO A TOOL FOR "DO IT YOURSELF" INVESTORS

The trend to provide investors' choice of information seems to imply that investors should make their own decisions as a matter of policy. The changes in the language, format and substance of the prospectuses and disclosure rules, and the emphasis on investor education seem to aim at encouraging investors to adopt a "do it yourself" mode. This new trend is likely to continue. Paternalistic designs, such as defined benefit plans, are replaced by 401(k) plans, which increase the involvement of savers-investors in investment decisions. The trend is also demonstrated by the proposed privatization of all or part of social security savings.

¹² *See* Registration Form Release, 63 Fed. Reg. at 13,951-952 (providing that management discussion of fund performance over the last ten years be included in Form N-1A).

There are two interesting related implications from this trend. One relates to the public policy concerning specialization and investors' reliance on the advisory and management industry and the importance of written information and advice to a large population of investors. The other implication relates to investors' protection.

The recent policy of encouraging "do it yourself" investors constitutes a fundamental shift from a strong public policy to promote specialization, supporting investors who rely on trained professionals. A large percentage of investors resort to broker-dealers and investment advisers to make investment decisions for them or with them. Such investors are either unsophisticated and hard to educate, or are not interested in devoting time and effort to self-education and self-investment management. These investors do not want a "do it yourself" package. They want reliable, trustworthy professional advice, oral or discretionary. For investors dependent upon such professionals, prospectuses are of little relevance, at least until investors decide to sue.

As to protection, these investors seek strict regulation of those who offer them advice. The new trend may help in this respect. Government cannot as strictly regulate oral disclosure by sales personnel and investment advisers as it can regulate disclosure. Educated investors with adequate information may help regulate the professionals. An alternative or at least supportive role can be played by the employers of the sales personnel. Thus, at the urging of the Commission, Congress authorized the Commission to sanction broker-dealers for failure to supervise their employees.¹³ The Investment Advisers Act of 1940 places a similar duty on investment advisers.¹⁴ To what extent

¹³ See Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 6(b), 78 Stat. 565, 571-72 (codified as amended at 15 U.S.C. § 78o(b)(4)(E) (1996)).

¹⁴ See 15 U.S.C.A. § 80b-3(e)(5) (West Supp. 1998). For a discussion of supervision in the securities regulatory regime, see John H. Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 COLUM. BUS. L. REV. 165, 171-206.

investor education will raise the level of protection remains to be seen.

At the same time, alternatives to disclosure as a means of enforcement seem to appear on the horizon. There is a growing focus on sales personnel, fund directors and investment advisers, by a possible increase of the strictness of their fiduciary duties, including a revision of their fees. Another trend that seems to point at strengthening the sales personnel's duties is already in sight involving the duties of employers to supervise their employees. These are not new areas of the law, but they seem to acquire attention, and that attention may continue.

A second implication of the trend to encourage investors to "do it themselves" relates to investor protection. A strong policy of encouraging investors to self-educate, self-inform, and self-regulate their advisers, and to make their own investment decisions, may reduce their protection, as the cost of protection shifts to investors. The fact that investors get the information they want in a readable form and obtain enhanced education implies a shift in responsibility to them. With this information and added sophistication, if they make the wrong decisions, they have only themselves to blame. Even with all its difficulties, the trend towards "do it yourself" investment decisions and responsibility is likely to continue in the foreseeable future.

II. TRENDS IN REGULATORY APPROACH

The Commission has increasingly refined and diversified its regulatory approach, and this trend is likely to continue. One can view the trend as a movement to reduce the Commission's direct regulation and use alternatives to achieve its regulatory goals.

The trend toward informal regulatory approaches by the Commission started long ago, perhaps from the day the Commission was established. For example, the drafters of

the Securities Act of 1933 envisioned a process in which issuers would file registration statements and the Commission would pass judgment on those registration statements. Soon thereafter, the Commission established a new process by which registrants had an opportunity to redraft the statements pursuant to staff comments.¹⁵

In the early 1970s, the Commission staff adopted a policy of publishing no-action letters which enabled it to obtain advance information about industry plans and prevent some violations of the law by providing industry with safe harbors before the fact and a source of law with a limited precedential value.¹⁶ About the same time the staff and the industry through the American Bar Association started a dialogue that resulted in more constructive comments on the Commission's proposed rules by the bar. These comments were more useful and therefore more acceptable to the staff. This type of relationship has encouraged the Commission's development and use of informal enforcement mechanisms.

A. INFORMAL ENFORCEMENT MECHANISMS

The Commission has continued to develop different means for informal enforcement. It has increased the use of a public expression of concern over certain industry practices in the news media or by a "Dear Matt" letter: a letter to Matthew Fink, the president of the Investment Company Institute (ICI). Similarly, the Chairman and the

¹⁵ Notwithstanding the different process, the Commission does not seem to have become a captive of the industry or the issuers. One explanation may be that issuers come and go and they have little opportunity to develop ongoing relationships with the Commission staff. However, the same may not be said with respect to the investment banking and investment management communities. Still, cooperation does not seem to result in capture perhaps because the industries as a whole are anxious to maintain the Commission's credibility as regulator and thereby the trust of investors in the industry communities.

¹⁶ See Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1021 (1987) (stating that importance of no-action process increased significantly in early 70s when the Commission determined that no-action letters should be public).

Commissioners accept speaking engagements. The Chairman holds "town meetings" to meet with investors. The staff appears at seminars, ALI-ABA courses, and ICI meetings, eagerly attended by industry, its lawyers and the media. In these communications the Commission and its staff state their positions, explain their decisions, and give fair warning about developing industry practices that are deemed violations. The Commission has also continued its monitoring of new problematic industry practices by noting industry's exemptions and no-action requests, and listening carefully to industry's presentations, and information from traditional sources.

Informal enforcement of this type has numerous advantages. First, it is effective in many cases. For example, after the Commission announced its decision to examine the soft dollar practices of the industry some lawyers experienced an avalanche of concerned clients' calls wondering how they could correct their practices, especially when they suspected that those practices were too lax. The mere announcement of the investigation produced substantial corrections.

To be sure, the announcement could have also produced more effective secret illegal practices. However, in an industry that is dependent on public confidence and recognizes the value of perceived tight regulation the chances of concealment on a large scale by successful fund advisers is unlikely. In addition, the industry recognizes that formal enforcement may lead to serious financial consequences; correcting lax practices is far more cost-effective and less risky.

Second, these communications are cost effective, relative to other enforcement mechanisms. They reduce enforcement costs for the Commission, industry and the courts. I believe, although I have no proof, that these announcements induce far more compliance and corrections than would after-the-fact, more formal proceedings.

Third, informal enforcement by way of public communications enhances the legitimacy of the Commission's formal enforcement actions. Such announcements meet many of the criteria for law: the announcements are usually clear and clarify the law, they are public, they are prospective, they put the industry and public on notice and they give fair warning about the Commission's future approaches with respect to perceived problems.

Fourth, informal enforcement of this sort sometimes helps the Commission sidestep serious mistakes highlighted by public reaction to informal communications.

Fifth, informal enforcement enables the Commission to design its enforcement and the law in a more flexible manner. This flexibility is crucial in light of the change in the Commission's regulatory focus dictated by Congress.¹⁷ The Commission is becoming a mediator among the conflicting interests in the marketplace (investors, the industry, the issuers) rather than an advocate of one market segment (small investors). It is difficult to articulate the reasons for choosing a particular balance among these interests. It is easier and more effective to test the waters before, or perhaps in lieu of, a formal statement of the law.

Informal law-making may present problems especially if informality is coupled with lack of transparency. The law may become less clear; some parties may obtain preferential treatment; decisions may be postponed, allowing regulators to avoid responsibility. These dangers seem to be avoided for now. Informal enforcement is only public and addresses the industry or a segment of the industry rather than individual actors, and law proper is rarely announced informally. In addition, rules preclude lack of transparency. For example, the staff of the

¹⁷ See H.R. REP. NO. 104-622, at 16 (1996) (stating that 1996 legislation "seeks to promote efficiency, competition, and capital formation in the capital markets without compromising investor protection" through a number of methods, including, "reducing regulatory burdens on the mutual fund industry"), reprinted in 1996 U.S.C.C.A.N. 3877, 3878.

Commission may not speak at meetings that are not open to the public.¹⁸

B. USE OF PRIVATE SECTOR ENFORCERS

Private sector enforcers have played an increasingly important role in the securities areas. Accountants certify an issuer's financial statements and attorneys can sue the institutional agents of the issuer (the board of directors and officers) on behalf of a class and the issuer. In addition, the staff of the Commission has at times conditioned exemptions under the Investment Advisers Act of 1940 on a reputable accounting firm certification that the investment adviser has put in place the necessary control mechanisms.¹⁹ A similar delegation of preventive enforcement power to rating agencies appears in rule 3a-7 under the Investment Company Act of 1940, exempting certain Special Purpose Vehicles used to securitize financial assets on condition that the securities of the exempt issuer are rated. Recently, the Commission proposed that accountants be required to certify as to the preparation of certain broker-dealers in solving the Year 2000 problem.²⁰ The Commission has also begun to emphasize the duties of investment bankers, investment advisers and other actors in the markets to supervise their

¹⁸ For example, the staff may not participate in meetings organized by law firms for clients. See 15 U.S.C. § 552b(b) (1998) (providing that except in certain instances, "every portion of every meeting of an agency shall be open to public observation"). Public meetings, however, may involve entrance fees.

¹⁹ See 15 U.S.C. § 80b-6a (1998) (stating that Commission may exempt persons or transactions from provisions of Investment Advisers Act if such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors").

²⁰ See Reports to be Made by Certain Brokers and Dealers, Exchange Act Release No. 39,724, 63 Fed. Reg. 12,056, 12,062 (Mar. 12, 1998) (proposing rule requiring accountant's opinion for broker-dealer's assertions regarding Year 2000 problem); see also Reports to be Made by Certain Brokers and Dealers, Exchange Act Release No. 40,164, 63 Fed. Reg. 37,709, 37,710 (July 13, 1998) (requesting additional comments).

employees and prevent violations of the law.²¹ This trend to delegation is likely to continue.

C. EXAMINATIONS

The Commission has also used a more formal enforcement tool through examinations of investment advisers and mutual funds. These examinations can be announced or unannounced. Examinations were less effective in the past because the Commission's resources could not match the need. In 1996 Congress reduced the Commission's burden by transferring the regulation of small investment advisers and investment companies to the states.²² Thus, examinations have become far more effective. In addition, the staff has developed examinations targeted to a particular problem, which results in an effective way to address the problem.

The Commission has recently created an Office of Compliance, and moved all of its examiners to that Office. This move indicates the Commission's increased attention to examinations. Examiners perform an educational function as well as a preventive enforcement function. They take the position that a transgression that is disclosed and that has been corrected will be treated with far more leniency than a transgression that has not been disclosed and has not been corrected but rather has been concealed.

²¹ See Walsh, *supra* note 14, at 171-206 (discussing supervision in securities regulatory regime, including Commission enforcement actions against broker-dealers and advisers).

²² See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code). One of the amendments made by the 1996 Act was the Investment Advisers Supervision Coordination Act which transferred the regulation of small investment advisers and investment companies to the states. See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1,633, 62 Fed. Reg. 28,112, 28,113 (May 22, 1997) (adopting new rules to implement provisions of Coordination Act that reallocate regulatory responsibilities for investment advisers between the Commission and the states).

Clearly, such concealment increases the Commission's enforcement costs and is discouraged. However, the disclosure and especially the correction sends a signal of approval and an incentive to industry to "self-correct." This signal is also strengthened by the Commission's incentives to the industry to "self-regulate." This means not only through a self-regulatory organization but mainly through encouraging compliance with the Commission's regulations by large fund complexes and other large industry actors. As these actors become larger, the cost to the Commission to monitor them far exceeds their internal costs for monitoring and prevention. Large industry actors also have at their disposal added sanctions for employees' violations; such as limitations on promotion and bonuses, and loss of employment.

D. TECHNOLOGY

Technology also affects both regulation and disclosure. While anti-fraud enforcement is more difficult on the Internet because the source of information can be anonymous, technology can be used to detect fraudulent statements and the Commission has enhanced its monitoring of the investment community through the use of new technologies, such as scanning the Internet.²³ The Commission has also provided investors with a Web site for information, answers to their inquiries and complaints.²⁴

²³ See Will Morrow, *Is the Internet Participating in Securities Fraud?: Harsh Realities in the Public Domain*, 72 TUL. L. REV. 2203, 2210 (1998). In addition, there is a strong movement by international regulators to cooperate in cross-border frauds. See Tanya Epstein, et al., *Securities Fraud*, 35 AM. CRIM. L. REV. 1167, 1209 (1998) (noting that the Commission "currently has entered into 29 agreements with foreign counterparts for information sharing and cooperation").

²⁴ See U.S. Securities and Exchange Commission (visited Nov. 24, 1998) <<http://www.sec.gov>> (providing an extensive Web site for investors).

III. CONCLUSION

Informal enforcement mechanisms suggest a strong undercurrent that is likely to continue for some time, barring catastrophic market breakdown. The Commission's current approach tends to limit its formal regulatory actions, in perception and reality.

Informality tends to obscure the enforcement power behind advice, suggestions, and educational materials. Coaching investors into a "do it yourself" mode and developing the use of technology and automation for trading in securities point to limitations on formal regulatory actions. In sum, the Commission's recent actions signal a preference for a cooperative mode of regulation, and an informal exercise of government power, backed by possible exercise of ultimate direct power.