

Investors' Paradox

Anita K. Krug*

For the first time in an era, new investment products for smaller (“retail”) investors are emerging. These products are mutual funds that engage in the types of trading and investment activities that have long been the province of sophisticated investors. Accordingly, the new funds (called “alternative funds”) promise to reduce the gulf between retail investors and their sophisticated counterparts, in terms of portfolio diversification and investment results. This Article describes the complex mix of factors that spawned alternative funds and critically evaluates the funds’ potential, the first scholarly work to do so. It additionally unearths the paradox that impedes the realization of that potential: although financial advisers counsel that portfolio diversification reduces investment risk, taking advantage of the opportunities that now make diversification possible could unduly increase that risk. This result, moreover, arises not from alternative funds themselves. Rather, it is a product of the fact that the primary regulatory tool for protecting investors—disclosure—is particularly ineffective in the alternative fund context. In addition, the profit-driven financial professionals that assist retail investors with their investment decisions need not, in many cases, do so in furtherance of their customers’ best interests and, in any event, may not have sufficient expertise about alternative funds to be useful. The Article contends that regulatory solutions should center not on disclosure, as the usual target of securities regulatory reform, but, rather, on the processes by which mutual fund shares are marketed and sold to investors. It proposes politically feasible reforms that would dissolve the paradox, enabling retail investors to take better advantage of the new investment universe.

I. INTRODUCTION	246
II. UNEQUAL OPPORTUNITIES	250
A. Regulation of Mutual Funds	251
B. Operational Structure of Mutual Funds	255
III. THE PROMISE OF ALTERNATIVE FUNDS	259
A. Liquid Alternative Funds	259
B. Multi-Manager Series Trusts	262
IV. THE RISKS OF REDUCING RISK	266
A. Disclosure	267
B. Distribution Channels	271
1. The Advice Channel	272

*Interim Toni Rembe Dean and Professor of Law, University of Washington School of Law. The author thanks Brad Bernthal, William Birdthistle, James Carroll, Mitch Hamilton, Kristin Johnson, Wulf Kaal, Summer Kim, Rafael Pardo, Zahr Said, Rick Sherley, Brian Torgerson, Anne Tucker, Melodie Zakaluk, and participants at the 2016 Annual Meeting of the Law and Society Association, the 2016 National Business Law Scholars Conference, and a 2016 faculty workshop at the University of Washington for their comments on prior drafts of this Article or the topics it addresses.

2. <i>The Retirement Plan Channel</i>	276
3. <i>The Direct and Supermarket Channels</i>	278
V. OVERCOMING THE PARADOX	280
A. <i>Regulatory Response</i>	280
B. <i>A New Direction</i>	283
1. <i>Reforming Distribution</i>	284
2. <i>Possible Challenges</i>	286
VI. CONCLUSION.....	288

I. INTRODUCTION

In the realm of commerce, goods and services that are “private” are often expensive or exclusive, while those that are “public” are often available to all and affordable. Although the divide between public and private reflects an income and wealth divide within the populace, it is the expected effect of the workings of capitalist society. Nonetheless, in many respects it is deeply troublesome. Perhaps the most problematic aspect of the gulf between those who have the most and those who have the least is that its very existence serves to widen it. As an obvious example, attending private schools often produces opportunities—whether in the form of mentors, job prospects, or other useful connections—that bolster one’s ability to collect additional resources at a markedly faster rate, as compared with those without similar opportunities.¹

In the financial markets, the division between public and private—more specifically, between public (“retail”) investors and private (“sophisticated”) investors²—is no different, in that it signals more than simply a division of investment opportunities based on investors’ relative resources. Rather, it signals also a dynamic in which those with relatively more resources are able to further increase those resources, as well as their lead over their less well-to-do counterparts. Put another way, the very distinction between investor groups widens the gap that separates them, demonstrating that, in fact, the rich do get richer, while the poor get poorer.³

Yet the investment status of the “excluded many” has begun to change, thanks to the creation of new investment products designed to meet the needs of retail investors. The products emerging most recently are in the form of mutual funds—that is, entities that “pool” many investors’ capital, deploying it on the investors’ behalf by investing or

1. See, e.g., Gerri Peev, *Best jobs still go to public school pupils as privately-educated workers are 7% more likely to get high-flying positions*, DAILY MAIL (Oct. 20, 2013, 7:48 PM), www.dailymail.co.uk/news/article-2469742/Private-school-students-likely-land-jobs-state-school-pupils-identical-degree.html (citing research showing that “[t]hree years after graduation, those from more advantaged socio-economic backgrounds and those who attended private schools are more likely to be in top jobs”).

2. Generally speaking, an investor is deemed sophisticated if she “is deemed to have sufficient investing experience and knowledge to weigh the risks and merits of an investment opportunity.” *Sophisticated Investor*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/sophisticatedinvestor.asp> (last visited Nov. 2, 2017). Under the securities laws, sophisticated investors are those that meet specified income, net worth, or investment assets tests, based on a notion that investors’ financial resources may serve as a proxy for their level of investment sophistication. Investors who are not deemed sophisticated under these tests are considered to be retail investors.

3. See Noah Smith, *The Rich Are Different. They’re Better Investors*, BLOOMBERG (Sept. 25, 2015, 7:00 AM), <http://www.bloomberg.com/view/articles/2015-09-25/the-rich-are-different-they-re-better-investors-> (discussing reasons why sophisticated investors accumulate capital at a faster rate than retail investors do).

otherwise transacting⁴ in securities and other financial instruments.⁵ Mutual funds are permitted to offer and sell their shares to retail investors because they are regulated in much the same way that Microsoft, Amazon, and other public companies are regulated.

One new product is the “liquid alternative fund,” which is a mutual fund⁶ that pursues investment and trading strategies that are similar in many respects to the types of strategies pursued by hedge funds,⁷ private equity funds, and other types of privately-offered funds.⁸ Because these strategies involve financial instruments beyond publicly-traded securities, they are widely known as “alternative” strategies. And because the primary statute regulating mutual funds—the Investment Company Act of 1940 (the “Investment Company Act”)⁹—requires all mutual funds to accept investor redemptions on a daily basis and to pay the proceeds of any redemption almost immediately, the securities and other instruments that liquid alternative funds hold in their portfolios must be readily sellable, giving rise to the “liquid” component of their moniker.

Liquid alternative funds give retail investors exposure¹⁰ to investments and trading positions that previously had been available only to sophisticated investors, through their

4. By purchasing a security, one might be said to have “invested” in the security, in that the person has “put money to use,” in hopes of realizing a profit when she sells the security. *Invest*, DICTIONARY.COM, <http://dictionary.reference.com/browse/invest?s=t> (last visited Nov. 2, 2017) (defining “invest” as “put[ting] (money) to use, by purchase or expenditure, in something offering potential profitable returns, as interest, income, or appreciation in value”). By contrast, in acquiring a short position in a security or a position in a derivative instrument, whether it be a swap, a stock option, or a commodity futures contract, one has “traded” or “transacted”—that is, entered into a contract or other arrangement whereby the person may receive a payout when she exercises her rights under the arrangement or otherwise terminates it. She has not, however, invested in anything. Moreover, just as transacting in derivatives and “shorting” securities cannot be considered “investing,” derivative contracts and short positions cannot be considered “investments.” Rather, they are simply instruments. See *infra* note 12 and accompanying text.

5. See *Mutual Fund*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mutualfund.asp> (last visited Nov. 2, 2017) [hereinafter *Mutual Fund Definition*] (defining “mutual fund” as “[a]n investment vehicle made up of a pool of [funds] collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and [similar] assets”). Mutual funds are not, however, the only type of investment companies registered under the Investment Company Act and, therefore, available to retail investors. Others include unit investment trusts, real estate investment trusts, and exchange-traded funds. See JOHN L. TEALL, *FINANCIAL TRADING AND INVESTING* 68–69 (2013) (discussing registered investment companies).

6. More specifically, a liquid alternative fund is an “open-end” mutual fund—that is, a mutual fund that does not limit the amount of shares that it will sell to investors and that permits investors to redeem their shares whenever they decide to do so. See *Open-End Fund*, INVESTOPEDIA, <http://www.investopedia.com/terms/o/open-endfund.asp> (last visited Nov. 2, 2017) (defining “open-end fund” as a fund that “does not have restrictions on the amount of shares the fund can issue” and the shares of which are purchased and redeemed “on demand”). In this Article, “mutual fund” means “open-end mutual fund,” unless the context otherwise indicates.

7. Because hedge funds’ investment and trading objectives often contemplate that the funds will hold positions in financial instruments *other* than securities, such as derivatives, their “investment strategies” are more appropriately called “investment and trading” strategies, see *supra* note 4 (noting that holding derivative and short positions does not involve “investing”). However, for the sake of brevity, this Article uses the term “investment strategies.”

8. See *infra* Part III.A (describing liquid alternative funds and their development).

9. 15 U.S.C. §§ 80a-1–80a-64 (2012).

10. “Exposure” to a particular financial instrument refers to one’s having an investment or trading position in the instrument and, more specifically, the monetary value that the person could potentially lose as a result of the position. See *Financial Exposure*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/financial-exposure.asp> (last visited Nov. 2, 2017) (defining “financial exposure” as “the amount that can be lost in an investment”).

investments in private funds.¹¹ Accordingly, a liquid alternative fund may buy and sell public securities, as most traditional mutual funds do. But it might also transact in commodity futures, swaps, options, or other types of derivatives; engage in investment and trading activities using borrowed funds; and sell securities “short,”¹² as many hedge funds do.¹³

A second new product is a subset of liquid alternative funds but serves dramatically to expand alternative investment options. It is the multi-manager series trust—or, more accurately, it is the group of mutual funds *within* a multi-manager series trust.¹⁴ Multi-manager series trusts are the offspring of changes in the private fund industry that recently have led investment advisers¹⁵ that manage private funds to move into the retail investment arena. The costs associated with organizing, or “sponsoring,” a mutual fund have often been prohibitive for these firms, given that many of them are smaller and less well-established than the investment advisers that seemingly dominate the mutual fund industry, such as Janus, Fidelity, and Vanguard.¹⁶ The series trust solves the cost problem by supplanting the traditional model, in which the investment adviser to the mutual fund (the fund’s “manager”) sponsors the funds that it manages, with one in which a third party serves as the sponsor.

Because the third party, rather than the fund manager, is responsible for creating each fund, registering it under the securities laws, and handling many other organizational matters, it also bears many related expenses that, for most mutual funds, the manager-as-sponsor would bear. In addition, because multiple managers are able to participate in a series trust, with each managing a separate fund—each fund being a separate “series” within the larger trust¹⁷—the managers are able to realize certain efficiencies that would

11. See Jason Zweig, *Do You See Yourself as a Sophisticated Investor?*, WALL ST. J.: MONEYBEAT (July 18, 2014, 12:49 PM), <http://blogs.wsj.com/moneybeat/2014/07/18/do-you-see-yourself-as-a-sophisticated-investor/> (noting that only sophisticated investors may participate in private offerings).

12. Short positions are an expression of a “pessimistic” outlook for the securities market as a whole or for a particular company, in that a short position increases in value as the market or a company’s stock declines in value. See Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT’L L. REV. 347, 358 (2008) (describing the process of selling securities short).

13. It is possible for them to do so because, although the Investment Company Act’s requirements are inconsistent with certain types of alternative strategies, the statute nonetheless permits mutual funds to invest in illiquid securities or transact in financial instruments other than securities. See *infra* notes 94–102 and accompanying text.

14. See *infra* Part III.B (describing multi-manager series trusts and their development).

15. “Investment adviser,” as used both in this article and in the U.S. securities regulatory regime, refers not to an individual but, rather, to an entity—one that typically is regulated as such by the SEC or by relevant state regulatory authorities.

16. See *100 Largest Investment Advisory Firms*, CREDIO, http://investment-advisors.credio.com/saved_search/Largest-Investment-Advisory-Firms (last visited Nov. 2, 2017) [hereinafter *Largest Investment Advisers*] (listing the largest U.S. investment advisers based on assets under management).

17. Each series of a series trust is effectively a separate (limited-liability) corporation within the trust, one that has its own shareholders and assets and is responsible only for its own debts and liabilities and not the debts and liabilities of any other series. See Eric A. Mazie & J. Weston Peterson, *Delaware Series Trusts—Separate but Not Equal*, INV. LAW. 3 (Feb. 2009), <http://www.rlf.com/files/CorpTrust01.pdf> (observing that most series trust statutes, including Delaware’s, “either provide series with many of the characteristics of separate legal entities or expressly provide that they should be considered separate legal entities”); Sue Asci, *Series Trusts Gain Popularity With Funds*, INVESTMENTNEWS (Mar. 24, 2008, 12:01 AM), <http://www.investmentnews.com/article/20080324/REG/438853815/series-trusts-gain-popularity-with-funds> (“A series trust is a single registered group comprising multiple, separate portfolios, each with its own assets and

not be present if each instead managed a stand-alone mutual fund. Most important, because series trusts introduce a wide range of private fund managers, as well as the alternative strategies they developed while managing private funds, to the mutual fund market, they constitute an important new locus of investment opportunities for retail investors.

Nevertheless, despite the risk mitigation opportunities and increased portfolio diversification that liquid alternative funds, series trusts, and other emerging retail investment products (together, "alternative funds") promise to retail investors, that promise cannot, without more, be realized. Because of the complexity of their portfolio investments and trading activities, alternative funds render investor knowledge more critical than it has ever been. Yet, perhaps more than ever before, knowledge remains the province of sophisticated investors.¹⁸

As an initial matter, for most retail investors, disclosure is largely ineffective, given both its length and complexity and human nature.¹⁹ That is particularly so in the alternative fund context because alternative funds' more complex portfolio activities logically necessitate additional pages and greater detail. In addition, any given "bundle" of disclosure pertains only to a single fund and does not address the role that an investment in that fund might play in furthering an investor's diversification needs.

These difficulties are punctuated by the mutual fund distribution process, by which shares of mutual funds, including alternative funds, are sold to retail investors. This process, which occurs through so-called distribution channels, has not been successful in filling the yawning gaps in investors' understanding of the investment options available to them or otherwise in countering the disclosure-related deficiencies noted above. However, it has been very successful at keeping the mutual fund ship afloat.²⁰ Indeed, the distribution process has steadily funneled investors into alternative funds, thereby creating the worst of all worlds. At the same time that investors lack a complete understanding of alternative funds' activities, purposes, diversification functions, and unique and substantial risks, too-effective mutual fund distribution machinery increasingly leads investors to hand over their capital to these funds.²¹

Given these concerns, the laudable promise of alternative funds seems more like a threat. And that is investors' paradox: the standard refrain from both securities regulators and financial advisers is that, to minimize investment risk, investors should diversify their portfolios by investing in a broad array of asset classes.²² At the same time, the new opportunities that now make such diversification possible are hampered by circumstances that may unduly *increase* investment risk.

Although the academic literature is replete with analyses of investor protection concerns in the mutual fund context, it has neither directed significant attention to

shareholders.").

18. See *infra* notes 142–48 and 196–200 (discussing the ways in which sophisticated investors remain advantaged in the investment process).

19. See *infra* notes 128–34 (discussing reasons why disclosure fails to achieve regulatory goals).

20. See *infra* Part IV.B (describing the various processes through which mutual fund shares are marketed and sold to investors).

21. Meanwhile, because sophisticated investors do not experience the same informational difficulties, they are not similarly hindered in their investment activities. See *infra* notes 142–48 and accompanying text (describing how sophisticated investors are situated differently from retail investors in the fund distribution process).

22. The notion is that, in a diversified portfolio, if some asset classes experience wide-scale losses, others will remain steady or experience offsetting gains, thereby lessening the impact of the losses on the portfolio as a whole. See *infra* notes 82–83 and accompanying text (describing the importance of portfolio diversification).

alternative funds nor recognized the seemingly intractable conundrum created by the combination of diversification opportunities and the risks those opportunities may create for investors. Perhaps more astonishingly, to date, no other scholarly article has even mentioned the series trust structure and its relevance for retail investors.

This Article addresses these gaps. It argues that, although retail investors increasingly have access to the same types of investment products that sophisticated investors do, structural factors prevent investors from using those products to their best advantage—and, indeed, they may inflict considerable harm on themselves to the extent they attempt to do so. As a result, despite the hope for retail investors that alternative funds bring, the investment arena continues to advantage the fortunate few to the detriment of the many.

In order for investors to realize the potential of alternative funds, they need to become better informed. Toward that end, this Article contends that the disconnect between an ineffective, disclosure-centered regulatory regime and an all-too-effective, profit-centered distribution regime must be eliminated. Instead of allowing distribution processes to exacerbate the deficiencies of regulatory disclosure processes, those processes should be made to counter disclosure deficiencies and “fill in” where disclosure falls short. In other words, the disclosure and distribution processes should work together, furthering the same objective.

This Article proposes that those who sell mutual fund shares to investors be required to provide their services with a view to investors’ best interests and to have expertise, or at least knowledge, about all types of mutual funds—those with alternative strategies and those that are more traditional. In light of special distribution concerns affecting retirement plan participants, it additionally proposes that regulatory impediments to the provision of investment advice to plan participants be dismantled and that plan sponsors be encouraged to ensure that participants have the benefit of advisory assistance. Of course, no solution can be perfect, but the approaches that this Article offers would make significant strides toward placing retail investors on the same footing as sophisticated investors.

Part II of this Article discusses the ways in which regulation incentivizes mutual funds to invest in public, liquid securities and prevents retail investors from enjoying the same investment opportunities as those available to sophisticated investors. It also details how the traditional way that mutual funds are structured has fortified the division between retail and sophisticated investors. Part III turns to a potential new dawn of investing for retail investors, describing groundbreaking developments in retail investment options—namely, the emergence of liquid alternative funds and series trusts. Part IV delves into the ways in which pertinent information is disclosed to investors and the mechanisms by which mutual funds are offered to investors—and how the disclosure and distribution processes combine for a one-two punch that hinders retail investors’ ability to use alternative funds to their best advantage. First describing regulators’ ill-considered responses to alternative funds, Part V sets forth proposals for alleviating the difficulties associated with these funds in a way that would effectively equip investors to select particular mutual funds based not only on the merits of the funds themselves, but also on the diversification role that the funds might play in their portfolios.

II. UNEQUAL OPPORTUNITIES

Retail investors constitute an investor class that not only is separate from the sophisticated-investor class but that also is subordinate to it. This stratification is a product

of two factors: regulation and operational structure. First, whereas applicable regulation allows sophisticated investors free reign to invest in almost any type of security and to transact in almost any other type of financial instrument, that same regulation often blocks or deters retail investors from doing so. Second, mutual funds' typical operational structure has circumscribed the pool of investment advisers managing mutual funds and, therefore, the types of investment strategies that mutual funds offer. Together, these factors limit the diversity of retail investment options. This Part discusses each of them in turn.

A. Regulation of Mutual Funds

Mutual funds are a well-established—if not the dominant—part of the investment terrain for retail investors. As of the end of 2014, approximately 24% of U.S. households' financial assets were invested in mutual funds and other registered investment companies.²³ In addition, U.S. households with investment retirement accounts ("IRAs") or participating in employer-sponsored defined-contribution retirement plans, such as 401(k) plans, held a substantial portion of those assets—approximately half in 2014—in mutual funds.²⁴

Indeed, mutual funds are perhaps the only realistic investment option for most retail investors.²⁵ Sophisticated investors, on the other hand, have substantially more options from which to choose. That discrepancy is traceable to the principle, embodied in the U.S. securities regulatory regime, that, because most investors do not have substantial experience in financial matters, they require more protection than their more sophisticated counterparts. Mutual funds are open to all investors precisely because they are subject to extensive, protective regulation.²⁶ They are, moreover, one of the few investment products, apart from direct investment in public companies,²⁷ that allow such broad participation.²⁸ By contrast, many types of investment products, including hedge funds and private equity

23. This figure includes household assets held through defined-contribution retirement plans, variable annuities, and investment retirement accounts. See *Investment Company Factbook*, 55 INV. CO. INST. 11 fig.1.3 (2015), https://www.ici.org/pdf/2015_factbook.pdf [hereinafter *Investment Company Factbook*] (showing the growth of household financial assets held in investment companies).

24. See *id.* at 12. Defined-contribution retirement plans include, in addition to 401(k) plans, "403(b) plans, 457 plans, Keoghs, and other DC plans without 401(k) features." See *id.* at 141 (defining defined-contribution retirement plans).

25. See Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 610 (2014) ("Mutual funds are the dominant investment vehicle for retail investors.").

26. See Douglas Cumming & Sofia Johan, *Hedge Fund Forum Shopping*, 10 U. PA. J. BUS. & EMP. L. 783, 791 (2008) ("Due to their accessibility to the general public or retail investors, mutual funds are subject to rather strict legal and regulatory oversight.").

27. Although public companies are, like mutual funds, subject to substantial regulation and therefore are likewise open to retail investors, in light of the risks associated with investing in them directly, financial experts often regard mutual funds as a better option for retail investors. See, e.g., *Stocks or mutual funds: Where should you invest?*, REDIFF BUS. (May 22, 2015, 3:31 AM), <http://www.rediff.com/money/report/perfin-stocks-or-mutual-funds-where-should-you-invest/20150522.htm> (highlighting risks associated with direct investing and noting that, "for an average investor, mutual funds are certainly a better bet" than investing directly in public companies).

28. Cf. Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 796 (2013) (noting that the private securities market has become "inefficiently large" and that, as a result, there are "too few investment opportunities as retail investors are crowded out from a market that is reserved principally for 'sophisticated' investors").

funds, are available only to sophisticated investors because they are subject to substantially less regulation.²⁹

The disparate regulatory posture toward investment products available to the few versus those available to the many has meant that mutual funds and private funds have differed in another important way, beyond their relative exclusivity: in their portfolio activities, hedge funds and private equity funds do many different things. By contrast, mutual funds have typically done just one.

To be sure, the thousands of mutual funds in the United States alone have great diversity in investment approaches, in that different funds focus on different types or categories of securities. Some funds invest entirely in securities issued by companies in particular parts of the world³⁰—the U.S. or Japan, for example—while others invest only in the securities of companies meeting certain size criteria, in terms of their market capitalization.³¹ In addition, some funds are value-oriented, concentrating on investments in the securities of companies with good prospects but that the stock market undervalues,³² while others are growth-oriented, investing in the securities of companies with strong appreciation prospects.³³ Still other funds invest predominantly in securities that generate income—namely debt securities, such as corporate and government bonds.³⁴

However, almost universally, mutual funds have invested only in *securities*, whether of the debt kind or the equity kind.³⁵ Furthermore, they have invested primarily in those securities that are traded in liquid markets—that is, securities for which market prices are readily available and that can be sold at virtually any time for a price approximating the price reflected in the relevant fund’s records at the time of sale.³⁶ Put another way, mutual funds’ investment portfolios have traditionally contained public securities, to the exclusion of other types of securities and non-security financial instruments, such as swaps and futures.³⁷

By contrast, private funds invest and trade in an array of financial instruments (dubbed “alternative” instruments), such as put and call options, commodity futures, and swaps—

29. See *The Differences Between Mutual Funds and Hedge Funds*, INV. CO. INST. (Apr. 2007), https://www.ici.org/files/faqs_hedge (observing that “[h]edge funds are private investment pools subject to far less regulatory oversight” than mutual funds are).

30. See Adam Hayes, *Mutual Funds: Different Types of Funds*, INVESTOPEDIA, <http://www.investopedia.com/university/mutualfunds/mutualfunds1.asp> (last visited Nov. 2 2017) [hereinafter *Different Types of Funds*] (describing different types of mutual fund investment strategies, including strategies targeting particular world regions).

31. See Mark Whistler, *Which Market Cap Suits You?*, INVESTOPEDIA, <http://www.investopedia.com/articles/mutualfund/06/mfmarketcaps.asp> (last visited Nov. 2, 2017) (describing the strategies of so-called large-, mid-, and small-capitalization mutual funds).

32. See *Different Types of Funds*, *supra* note 30 (describing so-called “income” and “value” funds).

33. See *id.* (describing the objectives of “growth” funds).

34. See *id.* (noting that some mutual funds invest “primarily in government and corporate debt”).

35. See *Mutual Fund Definition*, *supra* note 5 (defining “mutual fund” as an entity that pools investors’ money “for the purpose of investing in securities”).

36. See *Liquid Asset*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/liquidasset.asp> (last visited Nov. 2, 2017) (defining “liquid asset” as “[a]n asset that can be converted into cash quickly, with minimal impact to the price received” in the open market).

37. See Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 264 (2009) (“[T]he portfolio valuation requirements imposed by the 1940 Act and SEC rules implicitly compel mutual funds (especially open-end funds) to invest primarily in publicly-traded securities.”) (emphasis in original).

itself a category that comprises total return swaps, interest rate swaps, credit default swaps, and currency forward contracts.³⁸ Private funds may also buy large stakes in private companies,³⁹ participate in private offerings of securities by public companies (so-called PIPES offerings),⁴⁰ and even lend money to third parties, profiting from the associated interest payment obligations.⁴¹ To be sure, private funds also invest in public securities. However, those securities may or may not trade in completely liquid markets,⁴² and they may include securities of companies in “distress”—that is, on the verge of bankruptcy or experiencing other financial difficulties.⁴³ Additionally, private funds may sell securities short, based on a prediction that the securities will decline in value, rather than appreciate.⁴⁴ Simply put, private funds enjoy broad regulatory allowance to include almost any type of financial asset in their portfolios.

The diversity of strategies that private funds offer has been their primary attraction for sophisticated investors.⁴⁵ Indeed, today’s sharply bifurcated investment universe developed as hedge funds and private equity funds became more popular in the past few decades, with ever more investment advisers launching their own funds and ever more sophisticated investors clamoring after them.⁴⁶ Sophisticated investors could readily diversify their holdings by investing in private funds⁴⁷—as well as by pursuing investments and transactions directly, outside of the intermediating structure of an entity that pools

38. See *Alternative Investment*, INVESTOPEDIA, http://www.investopedia.com/terms/a/alternative_investment.asp (last visited Nov. 2, 2017) (defining “alternative investment” as “[a]n asset that is not one of the three conventional investment types, such as stocks, bonds and cash” and observing that “[a]lternative investments include private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts”).

39. See BENOÎT LELEUX ET AL., *PRIVATE EQUITY 4.0: REINVENTING VALUE CREATION* 27 (2015) (“Private equity and venture capital funds hold large stakes in [private] companies. . .”).

40. See Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 339 (2007) (“Hedge funds and other private equity also supplied \$27.7 billion in financing to public companies in 2006 through private investments in public equity (PIPES).”).

41. See Jenny Anderson, *Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES (Oct. 16, 2006), <http://www.nytimes.com/2006/10/16/business/16hedge.html> (describing how hedge funds increasingly act as lenders and noting certain regulatory concerns arising from these funds’ lending activities).

42. See OFFICE OF INV’R EDUC. AND ADVOCACY, *INVESTOR BULLETIN: HEDGE FUNDS* 2 (2013), http://www.sec.gov/investor/alerts/ib_hedgefunds.pdf (“Hedge funds may invest in highly illiquid securities that may be difficult to value.”).

43. See JOHN L. MAGNIN ET AL., *MANAGING INVESTMENT PORTFOLIOS: A DYNAMIC PROCESS* 568–69 (3d ed. 2007) (“With the explosive growth in hedge funds . . . and an abundant supply of troubled companies, by the 2000s, distressed securities investing had become well established as a set of skill-based strategies.”).

44. See *Short Selling Tutorial*, INVESTOPEDIA, <http://www.investopedia.com/university/shortselling/> (last visited Nov. 2, 2017) (explaining the concept of short selling and noting that “[h]edge funds are among the most active short sellers”).

45. See Stanford GSB Staff, *Using Hedge Funds as Alternative Investment Vehicles*, INSIGHTS BY STAN. BUS. (Nov. 1, 2001), <https://www.gsb.stanford.edu/insights/using-hedge-funds-alternative-investment-vehicles> (observing that hedge funds have substantial flexibility in their investment strategies and that they are “attractive to investors” for that reason).

46. See LOUIS P. CROSIER, *SELLING YOUR BUSINESS: THE TRANSITION FROM ENTREPRENEUR TO INVESTOR* 247 (2004) (noting that hedge funds “emerged fully into the mainstream” in the 1990s, “due to the very public successes of global macro hedge fund managers like George Soros and Julian Robertson”).

47. See François-Serge Lhabitant & Michelle De Piante Vicin, *Diversification in Funds of Hedge Funds: To Benefit, or Not to Benefit*, in *HEDGE FUNDS: STRATEGIES, RISK ASSESSMENT, AND RETURNS* 3, 4 (Greg N. Gregorieu, et al. eds., 2007) (discussing the diversification benefits of hedge funds).

investors⁴⁸—whereas retail investors could not. This was, and remains, an alarming discrepancy, given that experts routinely recommend that investors allocate ten to thirty percent (or more) of their portfolios to alternative strategies.⁴⁹

Nevertheless, the regulation to which mutual funds are subject under the Investment Company Act requires this result. In particular, mutual funds, unlike private funds, must allow daily redemptions,⁵⁰ meaning that, on a daily basis, they must allow their investors to return their shares to the fund in exchange for cash equal to the market value of the securities at that time.⁵¹ That requirement has two important implications.

First, it means that mutual funds must be able to determine, on a daily basis, the value of the assets they hold, based on the current market prices of those assets. If, for any reason, market values for particular securities in a fund's portfolio are not available—which could be the case if, for example, the securities did not trade in liquid markets—then determining the fund's net asset value, though not impossible, may become both difficult and, more importantly, unreliable.⁵² Typically, valuation of the troublesome securities relies on best estimates, usually provided by the fund's manager and possibly also by one or more brokerage firms familiar with the securities. Regardless of how informed or reasonable an estimate may be, however, the price assigned to the securities will remain but an estimate that may or may not be accurate.⁵³ To the extent that inaccurate prices are used to calculate a fund's net asset value, an investor that redeems her shares at that time may receive an amount of redemption proceeds that is greater or less than the amount she should have received.

Second, the requirement that mutual funds be able to redeem shares daily means also

48. Perhaps because of the risks associated with investing and trading directly in portfolio instruments, as opposed to investing in mutual funds, hedge funds, and other pooled investment entities, sophisticated investors are more likely than retail investors to do so. Cf. Marcin Kacperczyk et al., *Investor Sophistication and Capital Income Inequality* 4 (Nat'l Bureau Econ. Res., Working Paper No. 20246, 2014), www.nber.org/papers/w20246.pdf (“[S]ophisticated investors are more likely [than retail investors] to invest in and learn about more volatile assets . . .”). Sophisticated investors also place assets in so-called separately-managed accounts, which are custodial accounts that an investor arranges to have managed by her preferred investment adviser and according to her specific wishes. See Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1, 26 n.113 (2011) (noting that some investment advisers manage assets for their high-net-worth and institutional clients through non-pooled, separate account arrangements).

49. See Michael Coop, *Alternative Investments: How Much is Enough?*, MORNINGSTARADVISOR (Apr. 4, 2012), <http://www.morningstar.com/advisor/t/54130916/alternative-investments-how-much-is-enough.htm> (observing that an investor's allocation of ten percent of her portfolio to alternative products is the “bare minimum” for achieving diversification goals and that a twenty percent or even thirty percent allocation is more appropriate).

50. See *Mutual Funds and Exchange-Traded Funds (ETFs) - A Guide for Investors*, SEC, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last visited Nov. 2, 2017) (noting that all mutual funds will redeem investors' shares “on any business day” and must remit payment “within seven days”).

51. See 17 C.F.R. § 270.22c-1(a) (2016) (“No registered investment company issuing any redeemable security . . . shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security.”).

52. See *Illiquid*, INVESTINGANSWERS (Oct. 24, 2016), <http://www.investinganswers.com/financial-dictionary/investing/illiquid-2235> (observing that, “[b]ecause [illiquid] assets change hands infrequently, it is difficult for investors to agree on fair market value”).

53. See GINA VEGA & MIRANDA S. LAM, *ENTREPRENEURIAL FINANCE: CONCEPTS AND CASES* 293 (2016) (observing that “the output of any valuation model is only an estimate, regardless of the number of input variables and equations”).

that funds must be able to sell any or all of their portfolio assets at any time in order to pay the redemption proceeds.⁵⁴ However, completing any necessary sales may be all but impossible for a fund that holds illiquid securities: the fund not only may not be able to accurately value those securities and therefore may not be able to determine a reasonable sale price, it also may not be able to find a buyer.⁵⁵ Indeed, saying that a security cannot be accurately valued is, for all practical purposes, the same as saying that the security cannot be sold, at least not at a price that reflects its value.⁵⁶ Conversely, the availability of an accurate price for a security generally implies that there exists someone who is willing to pay that price for the security.⁵⁷

Given these considerations, one might conclude that, at least historically, the investment universe for retail investors has been both vast and constrained. It has been vast in the sense that there are thousands of mutual funds worldwide, offering thousands of investment strategies. However, as suggested above, it has been constrained in the sense that mutual funds' ever-proliferating strategies have been almost universally centered on public securities.⁵⁸ The retail investment universe, therefore, has been substantially less robust than the investment arena available to sophisticated investors.

B. Operational Structure of Mutual Funds

For decades, the way that mutual funds have come into being and operated has fortified the exclusion of retail investors from the range of investments available to sophisticated investors. Understanding why this is so begins with the fact that mutual funds are designed to be available to all investors, whether sophisticated or not.⁵⁹ That aspect means that they are heavily regulated, as the previous section describes. It also means that sponsoring a mutual fund—from forming it to managing its ongoing operations—is expensive.⁶⁰ After all, the more regulation there is governing an activity, the more

54. See *Frequently Asked Questions About Mutual Fund Liquidity*, INV. CO. INST. (Feb. 2017), https://www.ici.org/faqs/faq/mfs/ci.faqs_mf_liquidity.print (noting that mutual “[f]unds carefully manage their cash levels and holdings in other liquid investments to balance the need to meet both unanticipated redemption demands” and that “funds’ high levels of liquid investments mean that they can readily sell portfolio holdings to further enhance or maintain liquidity”).

55. See David Thorpe, *Why Illiquid Assets Aren't All Bad*, WHAT INV. (July 23, 2013), <http://www.whatinvestment.co.uk/why-illiquid-assets-arent-all-bad-2387348/> (“Almost by definition, it’s usually most difficult to find a buyer for an illiquid asset at the very time most people want to sell it.”).

56. Cf. Azam Ahmed, *For Sale: Illiquid Assets, Hard to Value*, N.Y. TIMES DEALBOOK (Mar. 28 2011, 3:09 PM), <http://dealbook.nytimes.com/2011/03/28/for-sale-illiquid-assets-hard-to-value/> (noting that the difficult part of selling illiquid assets is “matching the expectation of the buyer and the seller”).

57. Cf. Miranda Marquit, *Investing Basics: Why Liquidity Matters*, U.S. NEWS & WORLD REP. (Dec. 3, 2012, 8:36 AM), <http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2012/12/03/investing-basics-why-liquidity-matters> (observing that actively traded stocks can be readily sold “because there is almost always another investor willing to buy” them).

58. See *supra* notes 30–34 and accompanying text (providing examples of common mutual fund investment strategies).

59. See *supra* notes 25–29 and accompanying text (noting that mutual funds are one of the few investment products that are open to retail investors).

60. See John Waggoner, *What Impels Someone to Start a Stock Mutual Fund Today?*, USA TODAY: MONEY (Feb. 8, 2012, 9:10 PM), <http://usatoday30.usatoday.com/money/perfi/funds/story/2012-02-08/new-stock-mutal-funds-managers/53014508/1> (“It can easily cost \$100,000 for federal, state and other filings to register the fund and make it legal to sell shares to the public.”) (citing the Investment Company Institute).

expensive doing that activity will be.⁶¹

As an initial matter, a significant task in starting a mutual fund is to complete the same procedures that other types of public companies—think Facebook, Monsanto, or Sony—must complete to offer their securities to the public.⁶² Like those other public companies, a mutual fund must register its securities under the Securities Act of 1933 (the “Securities Act”),⁶³ which, in turn, requires that it compile a lengthy and detailed registration statement that the relevant regulatory agency—namely, the Securities and Exchange Commission (“SEC”)—must review and approve.⁶⁴ Although the mutual fund is formally responsible for bearing the costs of these activities, the person who initiated them (that is, the sponsor) will, in most cases, pay for them, at least initially.⁶⁵ Even after the fund has issued shares to investors and has begun operations, however, it may have only a small amount of assets for months or more. In that event, the sponsor may decline to be reimbursed for its expenditures, even on an amortized schedule.⁶⁶ After all, if the fund were to pay those expenses, its net asset value could be substantially impacted and, more importantly, so could its investment return—and, along with it, the fund’s ability to attract additional capital.

The ongoing operation of the fund may generate other considerable expenses for the sponsor—expenses that, in contrast to organizational expenses, are not appropriately borne by the fund.⁶⁷ These include costs associated with the sponsor’s hiring new personnel to handle all of the administrative and operational aspects associated with the fund’s activities.⁶⁸ They also include costs associated with marketing—called “distribution” in the mutual fund industry—including employing dedicated marketing personnel and paying brokerage firms to include the fund in their distribution networks.⁶⁹ Costs may additionally arise from the sponsor’s becoming subject to additional, and significant, regulatory

61. See William P. Albrecht, *Regulation of Exchange-Traded and OTC Derivatives: The Need for a Comparative Institution Approach*, 21 J. CORP. L. 111, 119 (1995) (observing that “regulation is an expensive way of accomplishing goals”).

62. See *Lawson v. FMR LLC*, 670 F.3d 61, 66–67 (1st Cir. 2012) (noting that mutual funds are public “in the sense that they have issued securities that may be sold to the public and are required to make periodic reports to their investors”), *rev’d*, 134 U.S. 1158 (2014).

63. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012).

64. See David E. Riggs et al., *Securities Regulation of Mutual Funds: A Banker’s Primer*, 113 BANKING L.J. 864, 875 (1996) (“Every mutual fund is required to file with the SEC a registration statement . . .”).

65. Its doing so is a practical necessity because, at the time the fund is organized, the fund has no investors and, therefore, no assets with which to pay expenses. *Cf. Treatment of Organization and Offering Costs For New Open-End Funds*, BBD (Apr. 15, 2014, 6:42 PM), <http://www.bbdcpa.com/investment-company-notebook/treatment-of-organization-and-offering-costs-for-new-open-end-funds/> (“In the process of establishing a new [mutual fund], . . . organization costs will be borne so that the entity is legally able to operate.”).

66. See *id.* (suggesting that a mutual fund sponsor may “intend[] to incur the organization and/or offering costs of the new fund, without the ability to recover them”).

67. Organizational expenses are typically deemed “fund expenses” because they are directly necessary for the fund’s operation.

68. *Cf. Henry Bregstein et al., Katten Discusses SEC’s Focus on Liquid Alternative Funds Market*, CLS BLUE SKY BLOG (Aug. 4, 2014), <http://clsbluesky.law.columbia.edu/2014/08/04/katten-discusses-secs-focus-on-liquid-alternative-funds-market/> (describing the myriad manager-focused regulatory requirements that accompany one’s status as a mutual fund manager).

69. See *The Retail Alternatives Phenomenon: What Enterprising Private Fund Managers Need To Know*, SEI 18 (2013), <http://www.sei.com/IMS/SEI-IMS-RetailAlternatives-US-2013.pdf> [hereinafter *Retail Alternatives Phenomenon*] (“[M]anagers that distribute funds through RIA networks are commonly required to pay asset-based fees averaging 40 basis points . . .”).

requirements as a result of its relationship to the fund.⁷⁰

Finally, if the manager is the sponsor, costs arise from the sponsor's agreement with the fund that, each period, the sponsor will bear the fund's operating expenses—that is, operating expenses otherwise appropriately borne by the fund—beyond a certain cap.⁷¹ These expenses consist primarily of compensation payable to the fund's many service providers,⁷² fees charged by the members of its board of directors or trustees,⁷³ and costs associated with periodic board and investor meetings.

The considerable expenses arising from a mutual fund's organization and operation have beget the practical imperative that sponsors start not one fund but many, each with its own investment and trading objectives.⁷⁴ Although starting multiple funds means generating additional absolute costs, the more funds (and strategies) there are under a sponsor's "umbrella," the less expensive each fund should be on average.⁷⁵ Thus arises the concept of the fund group. As Diagram 1 depicts, most mutual funds are not simply stand-alone entities that exist and operate separately from all other entities but, rather, are part of a larger operational structure containing other mutual funds.⁷⁶

DIAGRAM 1

70. For example, if the sponsor is also the fund's manager, it must become registered as such with the SEC under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1—80b-21 (2012), a step that entails, among other things, developing, adhering to, and periodically testing an array of compliance policies and procedures and engaging a chief compliance officer to oversee the firm's regulatory compliance. See 17 C.F.R. § 270.38a-1(a)(4) (2016) (discussing role of Chief Compliance Officer).

71. Most managers' objective in entering into such an agreement, known as an expense limitation agreement, is to "make a fund more attractive." *Expense Limit*, INVESTOPEDIA, http://www.investopedia.com/terms/e/expense_limit.asp (last visited Nov. 2, 2017).

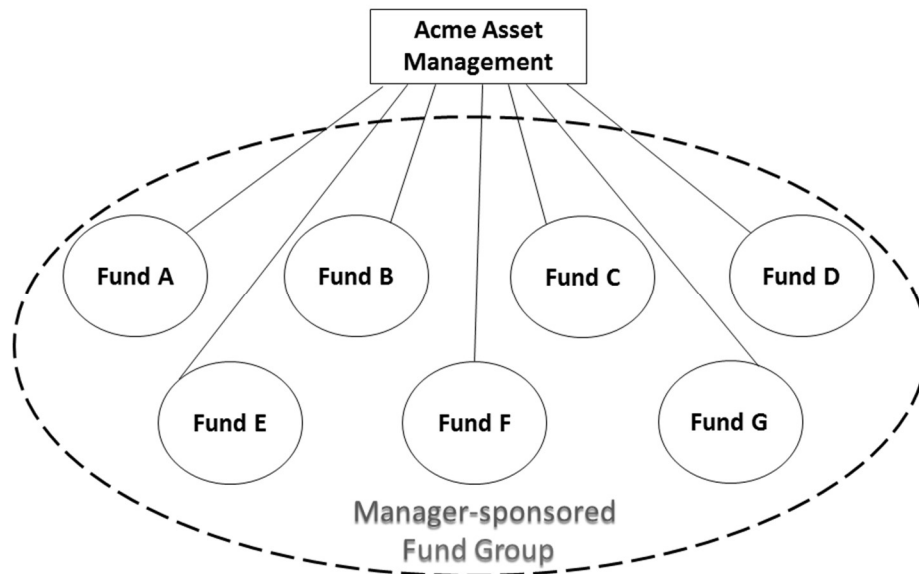
72. Typical mutual fund service providers are the principal underwriter—who arranges for brokerage firms to market the fund to prospective investors, fund counsel—who advises the fund on legal and regulatory matters, the auditor—who audits the fund's financial statements annually, the transfer agent—who maintains the shareholder roster and records of account balances, and the administrator—who provides many and varied "back office" services for the fund. See *Investment Company Factbook*, *supra* note 23, at 243–48 (describing how a mutual fund is organized and the roles of its various service providers).

73. See Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 168–69 (2006) (noting that each mutual fund must have "a board of directors (or its equivalent) to oversee" its activities and operations).

74. See *Brown v. Calamos*, 664 F.3d 123, 130 (7th Cir. 2011) (noting that "most advisors . . . run[] multiple funds").

75. Among other things, the registration statement of each fund organized after the initial one will likely be very similar to the initial fund's registration statement, thereby reducing average registration costs. In addition, each of the service providers to the initial fund will likely charge marginally lower fees for the services it provides to later funds, at least to the extent that it performs largely the same types of tasks for each fund. See *Overview of Mutual Fund Governance*, INDEP. DIRECTORS COUNCIL, https://www.idc.org/idc/issues/governance/composition/faqs/overview_fund_gov_idc (last visited Nov. 2, 2017) ("[A]ll of the funds within a fund complex usually receive necessary services from the same entities, are served by common personnel, and are organized around common operating features."). Moreover, contracts between a service provider and each fund can generally be "spun off" of the contract used for the initial fund, thereby obviating repeat rounds of negotiation between the funds and the service provider.

76. See *Brown*, 664 F.3d at 130 (describing features of mutual fund "complexes" and suggesting that they are pervasive).



The expenses associated with mutual fund sponsorship additionally produce the result that fund managers traditionally have been the parties who assume the role of sponsor. After all, managers, above all others involved in a mutual fund's operations,⁷⁷ have the greatest responsibility for—and ultimately stand to gain the most from—what the fund will do, in terms of its investment and trading activities. Although this circumstance has had a number of implications for the investment advisory industry, the pertinent one for present purposes is that the business of managing mutual funds has historically had formidable barriers to entry, in that smaller investment advisers have been all but locked out of it.⁷⁸ Instead, the mutual fund industry has been dominated by the giant mutual fund managers, such as Capital Group, BlackRock, and PIMCO.⁷⁹

However, the dominant parties in the alternative investment arena have been smaller investment advisers, primarily in their capacities as managers of private funds.⁸⁰ Indeed, many private fund managers came into being specifically to deploy the alternative

77. See *supra* note 72 and accompanying text (listing the various independent service providers that play a role in a mutual fund's operations).

78. See Dennis Hartman, *Can Anyone Create a Mutual Fund?*, POCKETSENSE (Apr. 19, 2017), <https://pocketsense.com/can-anyone-create-mutual-fund-2535.html> (observing that “the financial costs and complexities of mutual fund creation and regulation” make starting a mutual fund “prohibitive for all but a few would-be fund founders”).

79. See *Largest Investment Advisers*, *supra* note 16 (listing the ten largest U.S. investment advisers).

80. Cf. Kinjal A. Amin, *Why Many Investment Managers Struggle to Grab a Slice of the Pie*, LINKEDIN: BLOG (Aug. 11, 2015), <https://www.linkedin.com/pulse/why-many-investment-managers-struggle-grab-slice-pie-kinjal-amin-cpa> (observing that “[i]n the alternative investment industry, size has never been a determinant of success[.]” and that “[hedge fund] managers have achieved spectacular success with a two or three person operation”).

strategies that their principals had developed as portfolio managers within large financial firms and to reap the rewards of doing so successfully. By contrast, during the same years as the private fund “boom”—years in which securities market indices steadily rose and economies prospered—established mutual fund managers stayed the course, remaining extremely successful by continuing to focus on public securities.⁸¹ In short, while alternative-focused managers faced cost barriers to breaking into the mutual fund domain, established managers had little incentive to add an alternative component to that domain. The result was further to ossify investor stratification.

III. THE PROMISE OF ALTERNATIVE FUNDS

As Part II describes, the need for daily mutual fund share redemptions and an operational structure that supports the dominance of established managers have led most mutual funds to eschew alternative strategies. These factors have also reinforced the division between the retail and sophisticated investor classes. However, although that division is pronounced, some in the mutual fund industry recently have challenged the associated assumptions that it is either desirable or inevitable. This Part describes the most recent developments. Part III.A focuses on the emergence of so-called liquid alternative funds—mutual funds with alternative investment strategies. Part III.B turns to multi-manager series trusts, a new type of operational structure that caters to smaller investment advisers.

A. Liquid Alternative Funds

Whatever the relative risk of investing in public securities versus transacting in, say, interest rate swaps or investing in private companies, building one's investment portfolio using only one type of financial instrument creates non-diversification risks, as financial advisers have long warned.⁸² That is, in the event of a major economic downturn, investors whose portfolios hold only public securities are likely to fare more poorly than investors with more diversified portfolios.⁸³ At the least, then, there are plausible reasons to challenge traditional assumptions about what retail investors' portfolios should contain.

It is heartening, therefore, that the post-financial crisis years have been an evolutionary period for both investors and mutual fund managers. For several decades, investors had enjoyed a relatively strong securities market coupled with rising bond markets and a robust economy.⁸⁴ With the financial crisis, mutual fund investors—institutional investors, in particular—began to place less emphasis on strong portfolio performance driven by an appreciating market and instead became increasingly concerned about diversifying their

81. Cf. EZRA ZASK, WHITE PAPER, LIQUID AND NEAR LIQUID ALTERNATIVE INVESTMENTS: A COMPREHENSIVE GUIDE TO LIQUID ALTERNATIVE INVESTMENTS (EXCERPT VERSION) 14–15 (2014) (noting the “strong equity markets backed by strong economic growth and appreciating bond markets” in the years prior to the financial crisis).

82. See *Risk and Diversification: Diversifying Your Portfolio*, INVESTOPEDIA, <http://www.investopedia.com/university/risk/risk4.asp> (last visited Nov. 2, 2017) (observing that “most investment professionals agree that . . . diversification is the most important component to helping [investors]” reduce risk in their portfolios).

83. See *id.* (“Picking different investments with different rates of return will ensure that large gains offset losses in other areas.”).

84. See ZASK, *supra* note 81, at 14–15 (observing that investors “had the investment wind in their back for decades with strong equity markets backed by strong economic growth and appreciating bond markets”).

portfolios and protecting themselves from future steep market declines.⁸⁵ The fact that, post-crisis, economic growth—and, therefore, the prospect of returning to days of yore—remained unsteady only strengthened this concern.⁸⁶

Additionally, various constituencies increasingly criticized mutual funds—specifically, their status as actively-managed investment products—for being too expensive, given what they do and how well (or not) they have been able to do it. The claim, effectively, was that the performance that mutual funds had been generating after the crisis could not justify the management fees that their managers charged.⁸⁷ Mutual fund managers, for their part, began to experience relatively steady asset declines, largely a result of competition from passively-managed funds and market participants' increasing advocacy of investment opportunities permitting greater diversification.⁸⁸

Liquid alternative funds were the answer to this downward trending environment. As their label suggests, these funds' investment strategies are "alternative," in the sense that they involve complex trading strategies and focus on designated asset classes other than public securities. In addition, their aim is to generate returns that are uncorrelated to the returns produced by the public equity- and debt-focused strategies that mutual funds traditionally have used.⁸⁹ In other words, liquid alternative funds employ the types of strategies that private funds often use.⁹⁰ At the same time, however, they are "liquid," in the sense that they permit daily redemptions, as the Investment Company Act requires of mutual funds.⁹¹

Although liquid alternative funds emerged only within the past decade and, therefore, are relatively new, they already are well beyond the experimental stages. In May 2014, for

85. See *id.* at 14 (noting that, post-financial crisis, investors, "faced with extremely low interest rates and slow and uncertain economic growth," have been "rethinking . . . the traditional 60/40 stock/bond portfolio that has been the mainstay of investments"); *id.* ("The 2008 crisis has fundamentally changed investors' priorities from a main emphasis on investment returns and alpha generation to an emphasis on diversification and downside protection . . .").

86. See CRAIG K. ELWELL, CONG. RESEARCH SERV., R41332, ECONOMIC RECOVERY: SUSTAINING U.S. ECONOMIC GROWTH IN A POST-CRISIS ECONOMY 5 (2013) (observing that, after the financial crisis, "significant economic weakness remains evident").

87. See Madison Marriage, *Active Managers Defend Their Performance Record*, FIN. TIMES (Mar. 24, 2016, 7:32 AM), <http://www.ft.com/cms/s/0/d0b66944-f057-11e5-9f20-c3a047354386.html#axzz4EP0OvGfz> ("Finance professors and consumer groups have long argued that active managers charge too much and deliver too little for their clients.").

88. See ZASK, *supra* note 81, at 15 (highlighting "competition from hedge funds and ETFs" as a factor contributing to declining mutual fund assets); 7 *Myths About Liquid Alternative Mutual Funds*, THE ARBITRAGE FUNDS 2, https://arbitragefunds.com/restricted/get/7_Myths.pdf (last visited Nov. 2, 2017) ("After the 'lost decade' ending in 2009 . . . , many advisors recognized their clients needed alternate sources of investment return that go beyond stocks and bonds.").

89. See Bregstein et al., *supra* note 68 (describing the investment strategies and objectives of liquid alternative funds).

90. See ZASK, *supra* note 81, at 19 (noting that liquid alternative funds use investment strategies, tools, and markets "that have become identified with hedge funds and private equity funds").

91. See Bregstein et al., *supra* note 68 (noting that liquid alternative funds have the liquidity characteristics of "traditional mutual funds"). Although mutual funds are not the only category of fund registered under the Investment Company Act and, therefore, available to retail investors; see *supra* note 6, most registered funds that employ alternative strategies are, in fact, open-end mutual funds. See *Retail Alternatives Phenomenon*, *supra* note 69, at 4 ("Retail alternative products are most often offered as mutual funds . . .").

example, the SEC estimated that total assets in liquid alternative funds exceeded \$300 billion.⁹² Other, newer estimates are considerably higher.⁹³

Unlike many private funds' investment strategies, however, the investment strategies that liquid alternative funds pursue are not completely alternative. Indeed, they cannot be. This is a product of several reinforcing factors, which stem from the daily-redemption requirement to which mutual funds are subject,⁹⁴ combined with a notion that, as investments, mutual funds should be less risky than private funds.⁹⁵ First, a mutual fund may invest no more than 15% of its net assets in illiquid positions, such as real assets or securities issued by private companies.⁹⁶ Second, a mutual fund generally may not issue debt, such as bonds and notes.⁹⁷ Third, a mutual fund may enter into positions that have leverage embedded within them, such as most types of derivatives and any other position that could obligate the fund to pay its counterparty an amount exceeding the payment required to enter into the position.⁹⁸ It may do so, however, only to the extent that it has set aside sufficient assets to cover the potential liabilities arising from the positions.⁹⁹

In light of the portfolio limitations to which liquid alternative funds must adhere, these funds generally must avoid certain types of alternative strategies, such as those focusing heavily on highly-leveraged investments, private equity investments, and investments in distressed companies. However, liquid alternative strategies are nevertheless wide-ranging, with funds' portfolio activities centering on, for example, long *and* short securities

92. See Norm Champ, Dir., Div. of Inv. Mgmt., SEC, Remarks to the Practicing Law Institute, Private Equity Forum (June 30, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370542253660> (discussing the "growing use of alternative investment strategies by open-end mutual funds").

93. See, e.g., *Retail Alternatives Phenomenon*, *supra* note 69, at 2 ("Assets in U.S. alternative mutual funds and [ETFs] have more than doubled since 2008, and now represent 883 portfolios with more than \$550 billion in assets.").

94. See *supra* notes 50–57 and accompanying text (describing the implications of the requirement).

95. See Zweig, *supra* note 11 (suggesting that private offerings are much riskier than investment products that are available to retail investors).

96. See Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 12, 1992) (to be codified at 17 C.F.R. pts. 239, 274) (setting the limit on a mutual fund's illiquid positions at 15 percent of the fund's total assets); Bregstein et al., *supra* note 68 ("The 1940 Act limits a liquid alt from investing in excess of 15 percent of its assets in illiquid investments.").

97. See 15 U.S.C. § 80a-18(f)(1) (2012) ("It shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer . . ."). A mutual fund may, however, borrow money, provided that its lender is a bank and provided further that its aggregate borrowings do not exceed one-third of its net assets, excluding the amount of the borrowings. See *id.*

98. Leverage is, in essence, borrowed capital. Derivatives are deemed to create leverage because the profit (or loss) on a derivative contract may far exceed the amount of assets that the trader paid to enter into the contract. See *Leverage*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/leverage.asp> (last visited Nov. 2, 2017) ("Leverage is . . . the use of various financial instruments or borrowed capital to increase the potential return of an investment.").

99. See Bregstein et al., *supra* note 68 (observing that although "the SEC has allowed borrowing through certain leveraged investments (e.g., futures, written options and short sales)[,]" mutual fund managers must "mitigate the risks of leverage either by segregating assets or entering into offsetting transactions to cover possible liabilities"). Mutual funds' regulatory allowance to transact in derivatives may soon be narrowed, however. In December 2015, the SEC proposed a rule that would significantly curtail the extent to which mutual funds may trade in derivatives. See *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 Fed. Reg. 80,884 (Dec. 28, 2015) (to be codified at 17 C.F.R. pts. 270, 274) (explaining that the proposed rule, if adopted, would require a fund that transacts in derivatives to "comply with one of two alternative portfolio limitations").

positions;¹⁰⁰ positions in futures, including equity futures and currency futures; “event-driven” securities investments;¹⁰¹ and higher-risk fixed-income investments.¹⁰² Accordingly, whatever their limitations, liquid alternative funds have substantially broadened the menu of retail investment opportunities.

B. Multi-Manager Series Trusts

At the same time that investors and mutual fund managers were in transition after the financial crisis, the private fund industry experienced its own changes. Among other things, private fund performance waned and, therefore, so did investor appetite for each next big investment strategy.¹⁰³ Private fund managers, in turn, began to look beyond sophisticated investors for new avenues to pursue their crafts. Toward that end, many of them began exploring the possibility of cultivating a new, possibly more promising market—namely, the retail investor market.¹⁰⁴ The idea was that well-honed private fund strategies could be imported to mutual funds, thereby giving a much larger group of investors access to them and rewarding the managers with fees based on pools of assets potentially much larger than the private funds they had been managing.¹⁰⁵

Although some private fund managers could readily move into the mutual fund arena because they had sufficient resources to start their own manager-centered fund groups, many managers—smaller, newer ones—confronted formidable obstacles to doing so.¹⁰⁶ Among other things, these managers could not afford the price of admission. As Part II

100. As its label implies, a long/short equity strategy is one in which a fund takes both long (“buy and hold”) positions and short positions in securities. See *Long/Short Equity*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/long-shortequity.asp> (last visited Sept. 11, 2017) (defining “long/short equity” as “[a]n investing strategy of taking long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline”).

101. An event-driven investment is an investment made based on a decline in a company’s stock price that was triggered by a particular event and the belief that the decline is only temporary. See *Event-Driven Strategy*, INVESTOPEDIA, <http://www.investopedia.com/terms/e/eventdriven.asp> (last visited Nov. 2, 2017) (defining “event-driven strategy” as “[a] strategy . . . that attempts to take advantage of events such as mergers and restructurings that can result in the short-term mispricing of a company’s stock”).

102. See *Fixed-Income Investments and Bonds*, FIDELITY, <https://www.fidelity.com/fixed-income-bonds/overview> (last visited Nov. 2, 2017) (explaining that “[f]ixed income investments generally pay a return on a fixed schedule, though the amount of the payments can vary” and that “[i]ndividual bonds may be the best known type of fixed income security”).

103. See *Retail Alternatives Phenomenon*, *supra* note 69, at 8 (listing challenges facing hedge funds in recent years).

104. See *id.* at 4 (describing fund managers’ growing interest in the retail alternative investment market); ZASK, *supra* note 81, at 16 (observing that hedge funds are targeting “the \$30 trillion investment market that has been monopolized by mutual funds and other regulated management companies” for new sources of capital).

105. Although the fees that fund managers earn by managing liquid alternative funds are generally lower than the fees that most managers could earn by managing private funds, they generally are more steady and reliable. This is a particular advantage for managers of private equity funds, who typically are not paid as to any particular portfolio investment until the investment is sold, which could be ten or more years after the investment is made. See *Retail Alternatives Phenomenon*, *supra* note 69, at 9.

106. This discrepancy among fund managers has been particularly acute, moreover, given that the flagging enthusiasm for hedge funds has disproportionately affected smaller managers, who have had the greatest difficulty attracting additional assets from institutional investors. See *Retail Alternatives Phenomenon*, *supra* note 69, at 8 (observing that, in recent years, managers managing at least \$1 billion (per manager) of hedge fund assets have attracted more than 60% of hedge fund investments made by institutional investors).

details, the expenses associated with sponsoring a fund group are considerable¹⁰⁷ and, as one might expect, are substantially greater than the costs associated with sponsoring one or more hedge funds.¹⁰⁸ In addition, a mutual fund manager in a manager-centered structure must ultimately attract sufficient investor capital to realize cost efficiencies. This imperative is a particular obstacle for smaller managers, whose names and services are not widely known.

In light of the challenges confronting smaller managers, creative thinkers—in the form of fund administrators and others who stood to gain from being creative—developed a new operational structure: the multi-manager series trust. In many respects, the series trust structure, in which a number of funds (each, a series) are organized within an umbrella trust, is similar to a manager-centered fund group. The critical difference is the identity of the sponsor. Whereas, in the manager-centered context, the would-be fund group manager is the guiding force, in the series trust context sponsor responsibilities rest with a third-party firm that plays no role in managing any of the assets of any fund within the trust.¹⁰⁹

In this new model, the sponsor typically has another, usually primary, business that involves providing a particular service to mutual funds or their managers, and its intent in sponsoring a series trust is typically to provide that service to the trust and the funds within it. Often, the sponsor is a mutual fund administrator,¹¹⁰ which provides myriad critical back-office functions for mutual funds,¹¹¹ but, at least in theory, it could instead be a law firm whose clients are fund managers or a firm that provides custodial or transfer agent services to mutual funds. Although the sponsor plays no role in any particular fund's performance and, therefore, the fund's ultimate success or failure, its incentive is not unlike a mutual fund manager's in sponsoring a fund group, in that each fund that it forms is another source of revenues.

The genius of series trusts for private fund managers aiming to manage mutual funds is this: because the sponsor of a trust is a firm other than the manager, the trust can—and does—comprise funds managed by many different managers, rather than just one.¹¹² The further result is that each manager within the structure is able to participate in the cost efficiencies that a fund group structure permits and bears only a pro rata portion of the

107. See *supra* notes 62–73 and accompanying text (detailing the expenses that mutual fund sponsors typically bear).

108. See, e.g., *Hedge Funds Plodding into Mutual Funds*, HEDGE FUND ALERT (Apr. 10, 2013), (on file with author) (reporting that the cost of sponsoring a mutual fund may be up to \$200,000 higher than the cost of sponsoring a hedge fund).

109. See U.S. BANCORP FUND SERVICES, LLC, MSTs EXPERIENCE RECORD GROWTH 2 (2013), http://www.usbfs.com/usbfs/documents/2013/white-papers/USBFS_MST_whitepaper.pdf [hereinafter U.S. BANCORP, GROWTH OF MSTs] (observing that the sponsor in this alternative structure is typically a service provider to the fund).

110. See *Special Research Report: Selecting a Series Trust*, INFOVEST21, at 5 (Aug. 2013), <http://files.ctctcdn.com/f9e8414c001/0268f140-8479-41e6-8710-6691b2d6538d.pdf> [hereinafter *Selecting a Series Trust*] (observing that administrators are typically the sponsors of series trusts).

111. See *supra* note 72 and accompanying text (noting the role of a mutual fund administrator).

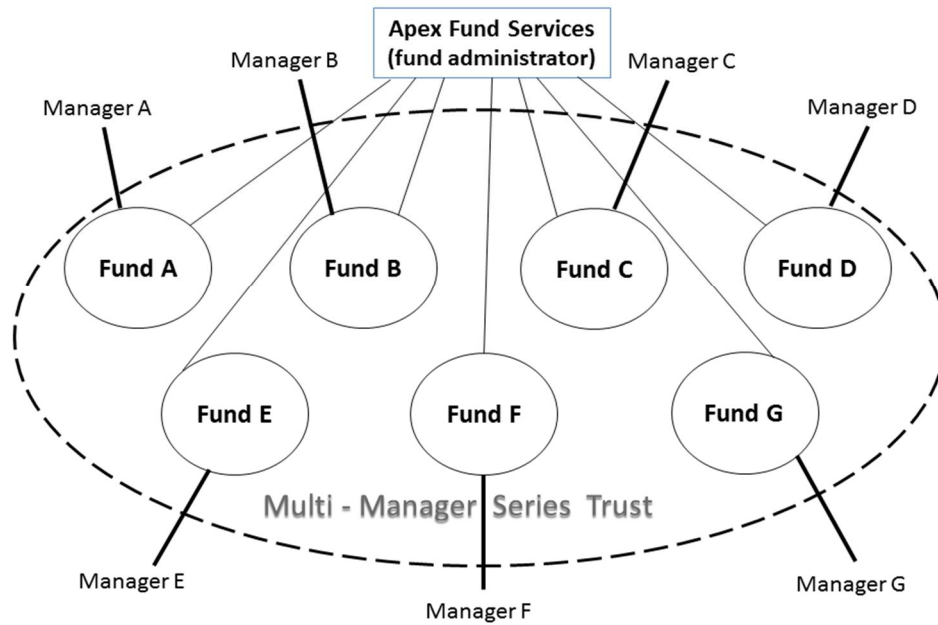
112. See Bob Kern, *Best practices in Mutual Fund Shared Trusts*, U.S. BANCORP FUND SERVICES, LLC 1 (2017), https://www.usbank.com/usbfs/documents/2016/White%20papers/USBank_Best%20practices%20mutual%20funds%20shared%20trust_whitepaper.pdf (“The [series trust] structure is . . . utilized by multiple, unrelated investment management firms to house their mutual fund products.”).

group's costs and expenses.¹¹³ It therefore need not raise the amount of investor capital that is typically necessary to support multiple funds' profitability and success. In effect, as Diagram 2 suggests, by becoming part of a series trust, a manager does something akin to leasing space in an office building, rather than buying the entire building and occupying all of its floors.¹¹⁴

DIAGRAM 2

113. U.S. BANCORP, GROWTH OF MSTs, *supra* note 109, at 3 (observing that an advantage of a series trust is that it "provides economies of scale for certain fund startup and annual operating costs" and that "certain annual operating expenses for a fund within [a series trust] are reduced due to the allocation of certain costs across all funds within the Trust").

114. *Cf. Selecting a Series Trust*, *supra* note 110, at 6 (noting that, when managers join a series trust, they "simply plug into the service model offered by the series trust sponsor").



In addition, given these efficiencies, substantially less time is required for a manager to organize a fund within a series trust, as compared with organizing the initial fund in a manager-centered fund group.¹¹⁵ Among other things, the manager need not concern itself with selecting an administrator, an underwriter, fund counsel, custodians, or an auditor because the trust's board of directors—which serves also as the board for each fund in the trust¹¹⁶—in conjunction with the sponsor, will have already appointed them.¹¹⁷ The manager also need not spend time overseeing each service provider as they perform their duties or addressing other trust-related matters, insofar as such tasks pertain to other funds in the trust or to the trust as a whole. As a result, managers are able to begin operating their funds much more quickly than would be possible in the manager-centered context.¹¹⁸

To be clear, many of the funds within series trusts are liquid alternative funds, which should not be surprising given that many of the managers seeking to manage an alternative

115. See *id.* (observing that “[t]ime saving is another plus” with a series trust and that “[s]etting up a series trust new fund launch can be as short as 3 1/2 months”).

116. See U.S. BANCORP, GROWTH OF MSTs, *supra* note 109, at 3–4 (noting that the funds within a series trust have a common board of trustees).

117. See *Selecting a Series Trust*, *supra* note 110, at 6 (“The [multi-manager] series trust typically provides fund administration, fund accounting and transfer agent services and has selected a team of other service providers to service the trust such as legal counsel, auditors, custodian and distributor.”).

118. See *Retail Alternatives Phenomenon*, *supra* note 69, at 21 (“[A] shared trust potentially offers lower operating costs, operational efficiencies through a leveraged platform, access to trust-level selling agreements, and a much shorter time to market.”); *Selecting a Series Trust*, *supra* note 110, at 6 (“Much of the [series trust] fund launch process is procedural and relatively easy to predict from a cost and timing perspective.”).

fund originated as private fund managers.¹¹⁹ In that sense, it may seem that the series trust structure does not contribute anything to the retail investment market beyond what liquid alternative funds sponsored by larger managers contribute. Yet the fact that these trusts provide a way for smaller managers to offer their investment services to retail investors and that many such managers have “grown up” pursuing alternative strategies means that series trusts substantially increase the variety of alternative investment options for retail investors. Additionally, the fact that the managers operating within series trusts generally would not be able to manage retail investor assets but for the lower-cost structure means that the trusts’ emergence should be considered a new development in the retail investment realm, separate from the broader development of liquid alternative funds. It is, moreover, an important development. Despite the fact that many outside of the mutual fund industry are not yet aware of the existence of series trusts,¹²⁰ the trusts have been extremely successful in the short time that they have existed, attracting more than \$64 billion in investor capital by mid-2013.¹²¹

Of course, one might wonder why, if series trusts are a panacea for smaller managers seeking to move beyond managing private funds, these trusts did not emerge considerably earlier than they did. The answer, once again, points to the monumental changes that the investment advisory industry has experienced over the past nine years. In pre-crisis years, the division between the investment products available only to sophisticated investors and those available to retail investors was not only relatively sharp but also seemingly sensible—or, at least, was in a point of stasis that was relatively satisfactory for all involved. When the bifurcated world lost balance, new possibilities were bound to present themselves.

IV. THE RISKS OF REDUCING RISK

The emergence of liquid alternative funds and series trusts opens a world of opportunities for retail investors. By giving retail investors access to investment strategies to which only sophisticated investors previously had access, the new investment products enable retail investors to diversify their portfolios in a way that only sophisticated investors previously could. Accordingly, although alternative funds cannot completely dissolve the dichotomy, in terms of diversification and investment choices, between investors deemed sophisticated and everyone else, they are poised to erode it—perhaps substantially.

However, alternative funds serve little purpose—and, indeed, harm those whom they are supposed to benefit—if investors take advantage of them without an adequate understanding of why an investment in any one of them is appropriate or how that investment might serve a diversification function within their overall portfolios. And, in fact, there is reason to be concerned: investors steadily evince scant understanding of why any particular fund might be a better choice than another, let alone why any particular mix of funds might be more optimal than another. The problems run deeply, moreover, because

119. See *Selecting a Series Trust*, *supra* note 110, at 4 (“More administrators are bringing out series trusts because it provides an easier entry for hedge fund managers to access retail channels.”).

120. Indeed, as of summer 2016, there were no published scholarly discussions of the structure and only scant coverage in the popular media.

121. See *Selecting a Series Trust*, *supra* note 110, at 15 (setting forth the amount of assets in series trusts sponsored by Atlantic Fund Services, ALPS, Gemini Fund Services, Ultimus Fund Solutions, and U.S. Bancorp Fund Services but not reporting asset information about several others, including SEI, one of the dominant trust sponsors).

they arise from two, mutually-reinforcing structural impediments—namely, disclosure requirements under the securities laws and the procedures by which investment products are offered and sold to investors. Each of these impediments, which Sections III.A and III.B discuss in turn, hinders investors' ability to make prudent investment decisions.

A. Disclosure

The promise of alternative funds cannot be realized if retail investors lack the knowledge required to use these funds effectively—and, indeed, it is likely that few investors presently have that knowledge.¹²² Critically, however, there are a number of factors, described below, preventing a more favorable result. These factors are wholly unrelated to alternative funds *qua* fund type; rather, they are obstacles to informed retail-investor decision-making in general and have been for decades.

Appreciating these obstacles begins with the fact that U.S. securities regulation has traditionally relied on disclosure as the primary regulatory tool for achieving its goals of promoting market integrity and protecting investors.¹²³ The driving principle is that these goals are best served not by regulators' passing judgment on the merits of any particular investment product—for how could regulators competently do that?—but, instead, by their ensuring that would-be investors are informed of the risks associated with the product.¹²⁴ The complementary principle is that investors will be able to become informed about an investment product if they are given disclosure documents that set forth specified facts about it.¹²⁵ With such information, an investor should be able to make an investment decision with open eyes and, furthermore, should be prepared for, or at least not surprised by, the success or failure of the investment.¹²⁶

And so it is with mutual funds. Every functioning mutual fund has prepared a registration statement that performs this disclosure function and that the SEC has reviewed and approved. Further, every mutual fund must deliver the “prospectus” component of that document to investors prior to or at the time of their investments.¹²⁷ However, although a

122. *Retail Alternatives Phenomenon*, *supra* note 69, at 3 (“[N]early half of individual investors say they have little or no understanding of alternatives . . .”).

123. See, e.g., Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1064 (2011) (“[D]isclosure has become the default remedy in many areas of securities regulation, as well as many other areas of public policy.”).

124. See Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741 (2012) (“The federal securities laws do not focus on the merits of investments but rather are based on disclosure to allow sufficiently informed investors to fend for themselves.”).

125. For example, companies effecting a public offering of securities “must file a registration statement with the [SEC] and distribute a statutory prospectus to potential investors.” Stephen J. Choi, *Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation*, 2 J. SMALL & EMERGING BUS. L. 27, 28 (1998).

126. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Information*, SEC, <http://www.columbia.edu/~hcs14/SEC.htm> (last visited Nov. 2, 2017) (noting that disclosure documents “disclose information about the companies’ financial condition and business practices to help investors make informed investment decisions”).

127. See Isaac C. Hunt, Jr., *Mutual Funds and the International Marketplace: A Regulatory Challenge*, 32 TULSA L.J. 747, 749 (1998) (“To sell shares, a mutual fund must have an effective registration statement on file with the SEC, and it must deliver a prospectus to each investor.”). If requested, the fund must also give the investor a second component of the registration statement, called the statement of additional information (“SAI”). See *Statement of Additional Information - SAI*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/sai.asp> (last

fund's prospectus could impart to investors any information they might wish to know about a fund, in fact, it typically tells them nothing.

This is so for several reasons.¹²⁸ First, time limitations deter investors from expending effort researching investment options. They also lead investors to ignore information that was handed to them and that thereby necessitates no research effort on their part at all.¹²⁹ Second, even if investors were to attempt to read the information they are given, they may not be able to proceed far because even simple information can be overwhelming if there is too much of it.¹³⁰ Third, because much of the disclosure aimed at retail investors, including mutual fund prospectuses, is extremely complex,¹³¹ even an investor who reads a prospectus cover to cover likely will not understand at least part of it. Fourth, even if she were to understand the prospectus completely, she likely would not know how to deploy the information it contains to her advantage.¹³² Finally, and separate from whether investors read or understand disclosure, is the fact that investors tend to be overconfident in making investment decisions, leading them to assume that disclosure can be safely ignored.¹³³

These insights are far from new or original. Scores of scholars have taken the SEC's current disclosure regime to task for being a singularly inadequate mechanism for protecting investors.¹³⁴ Among the primary reasons for disclosure's failure are those

visited Nov. 2, 2017) (“[S]ome investors find the SAI useful and although fund companies are not required to provide it, they must give it to investors upon request and without charge.”).

128. See Bevis Longstreth, *The Profile: Designer Disclosure for Mutual Funds*, 64 BROOK. L. REV. 1019, 1031 (1998) (“[M]ost retail investors do not read the prospectus or SAI, due to their length, complexity and lack of information useful in the selection of mutual funds.”).

129. This is often the case with mutual fund prospectuses. See Gary O. Cohen, *SEC Disclosure Report to Congress Mandated By Dodd-Frank Act as Applicable to Mutual Funds and Variable Annuities*, in CONFERENCE ON LIFE INSURANCE COMPANY PRODUCTS (Am. L. Inst. Continuing Legal Educ. 2012) (noting that “[t]wo-thirds of fund investors who received fund prospectuses rarely (28%), very rarely (14%), or never (21%) read [them] when received”).

130. See Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 687 (2011) (arguing that, when disclosures are too long and detailed, “disclosees do not read them and cannot understand, assimilate, and analyze the avalanche of information”); William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1465 (2006) (noting that “mutual fund shareholders are . . . overwhelmed by hundreds of pages of disclosure”).

131. See Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 185 (2006) (“The complexity and detail in disclosure documents can make them almost incomprehensible at times . . .”); Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 632–33 (1973) (discussing how “lay” investors do not understand the technical details and complexities of disclosure documents and concluding that “the securities prospectus is fairly close to worthless”).

132. See Joan MacLeod Heminway, *What is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 348 (2012) (observing that “[i]nvestors faced with th[e] flood of information” in disclosure documents required under the securities laws “often lack the skills to identify what the information means or how to use it effectively”).

133. See Ripken, *supra* note 131, at 167 (“Investors may ignore [disclosure] because they feel confident that their superior investment strategies will produce successful outcomes, regardless of the disclosed risks.”).

134. See, e.g., Steven M. Davidoff & Claire M. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 633 (2013) (analyzing “the limits of disclosure” directed at “sophisticated investors in the securities market”); Henry Hu, *Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1714 (2012) (suggesting that “financial innovation has helped create complexities that bedevil the longstanding disclosure regime”); Tamar Frankel, *The Failure of Investor Protection by Disclosure*, 81 U. CIN. L. REV. 421, 423 (2012) (evaluating “the disastrous failure of disclosure” to protect investors); Prentice, *supra*

described above. However, scholars generally have overlooked another, more important reason why disclosure would fail at its job, even if investors were not too time-constrained, confused, or overwhelmed by it and even if they could competently use it to make better investment choices: disclosure, as regulation presently conceives it, does not give an investor the one type of information that she most needs—namely, context-specific information about the role that a particular fund could play in the investor's overall portfolio. In other words, disclosure about a particular investment does not help investors achieve appropriate portfolio diversification.

Exacerbating retail investors' plight is the fact that many retail investors do not obtain help with the investment process from investment fiduciaries,¹³⁵ such as registered investment advisers.¹³⁶ Investors may simply deem the cost of doing so prohibitive or, in any event, not worth any resulting benefit, given their often-limited investment assets.¹³⁷ Additionally, many investment advisers do not accept retail investors as clients, given the advisers' requirements that clients have a threshold amount of assets as to which they are seeking advice.¹³⁸

Accordingly, most retail investors who have the benefit of advice obtain it, instead, from brokerage firms. Because brokerage firms are typically compensated by particular funds (or their managers) based on the firms' success in selling shares of those funds, this approach is considerably more economical for investors, as compared with paying out-of-pocket fees to investment advisers.¹³⁹ As the next section details, however, the trade-off is

note 123, at 1064–65 (“[A]utomatic resort to disclosure as a remedy for every problem is inadequate and occasionally counterproductive.”); Ben-Shahar & Schneider, *supra* note 130, at 742 (arguing that disclosure requirements are “prone to failure”); Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosure to Encourage Reasonable Investor Behavior*, 42 WAKE FOREST L. REV. 749, 751 (2007) (“Existing [public company] disclosure requirements place too much discretion in the hands of executives, cause pressure on important individual rights, and tend to cause investors and markets to overreact.”).

135. See Jeremy Burke & Angela A. Hung, *Do Financial Advisers Influence Savings Behavior?*, RAND CORP. 3, 5 (2015), https://www.rand.org/pubs/research_reports/RR1289.html (noting that “there is considerable research suggesting that those in most need of financial advice are the least likely to receive it” and that “individuals who engage financial advisers tend to be more financially healthy and sophisticated than individuals who forgo advice”).

136. See Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 710 (2012) (describing the legal standard that applies to brokerage firms in making investment recommendations).

137. See Letter From IRI to Employment Benefits Security Administration Re Definition of Fiduciary Proposed Rule (Feb. 3, 2011), in *INDIVIDUAL RETIREMENT ACCOUNTS AND ANNUITIES: THE EMERGING REGULATORY OUTLOOK* 117 (Am. L. Inst. 2014) (“[S]mall investors cannot afford to pay a fee-only adviser’s fixed rate fee.”); Mary Anne Waldron, *Spousal Guarantees and Conceptual Complexity: Can We Find a Better Solution?*, 16 BANKING & FIN. L. REV. 391, 418 (2000–2001) (noting that “first-class financial advice” is expensive).

138. See Geoff Williams, *How to Find a Financial Advisor If You’re Not Rich*, U.S. NEWS & WORLD REP. (Feb. 26, 2014, 11:56 AM), <http://money.usnews.com/money/personal-finance/financial-advisors/articles/2014/02/26/how-to-find-a-financial-advisor-if-youre-not-rich> (“[M]any financial advisors simply aren’t interested in working with the middle class.”). The proliferation of online advisers in recent years may be changing this situation. See Jonathan Clements, *It’s Time to End Financial Advisers’ 1% Fees*, WALL ST. J. (Jan. 18, 2015, 12:01 AM), <http://www.wsj.com/articles/its-time-to-end-financial-advisers-1-fees-1421545038> (“Thanks to online advisers, helping investors build globally diversified portfolios has become a low-cost, commodity service.”).

139. See Daisy Maxey, *Ruling Near on Fiduciary Duty for Brokers*, WALL ST. J. (Apr. 13, 2014, 4:51 PM), <https://www.wsj.com/articles/ruling-near-on-fiduciary-duty-for-brokers-1396894687> (suggesting that most retail investors that obtain advice do so from brokerage firms, which are compensated for that advice through receiving

that brokerage firms generally are not fiduciaries to the investors whom they advise.¹⁴⁰ This means that, in recommending investments, a brokerage firm's personnel may consider factors that conflict with a single-minded focus on their customers' best interests.¹⁴¹

The picture becomes bleaker still when one considers that the deficiencies associated with disclosure do not afflict all quadrants of the investor universe. In particular, sophisticated investors fare much better than retail investors in a disclosure-based securities regulatory regime.

For one thing, disclosure is a much less significant part of the regulatory backdrop of sophisticated investors' activities in the securities markets. As classic cases on the Securities Act's registration exemptions recognized, as compared to retail investors, sophisticated investors have less need for disclosure because they are better able to obtain necessary facts and data through other means.¹⁴² The SEC embedded this principle in Rule 506 of Regulation D under the Securities Act, the most frequently used "private placement" safe harbor.¹⁴³ Under Rule 506, a securities issuer need not provide extensive disclosure to investors who meet the "accredited investor" financial test,¹⁴⁴ presumably because those investors are able to negotiate for or otherwise procure whatever information about the issuer or its securities they might deem relevant.¹⁴⁵

In addition, to the extent that sophisticated investors rely on disclosure, they are generally better able than retail investors to understand it, as well as how best to use it.¹⁴⁶

commissions for executing transactions for their customers, rather than through charging separate fees).

140. See Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 FORDHAM J. CORP. & FIN. L. 203, 218 (2011) ("[B]roker-dealer customers are afforded less protection than investment adviser customers because broker-dealers are generally not held to a fiduciary standard.").

141. Although any investment recommendation that a brokerage firm provides to a client must, under applicable rules, be "suitable" for that client, that standard permits the firm to consider a number of factors in making the recommendation, including whether the firm will receive any compensation (such as a brokerage commission) in connection with executing the recommended transaction. See Laby, *supra* note 136.

142. See, e.g., *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 897, 905 (5th Cir. 1977) (holding that a purported private offering is valid only if "each offeree had been furnished information about the issuer . . . or . . . had effective access to such information" and that "the investment sophistication of the offeree assumes added importance" when the issuer "relies on the offeree's access").

143. See 17 C.F.R. § 230.506 (2016).

144. See 17 C.F.R. § 230.502(b) (2016) (providing that an issuer must furnish information only to "purchasers" who are not accredited investors); *id.* § 230.501(a) (defining "accredited investor"). Despite this exemption, issuers usually provide disclosure documents to prospective investors, whether accredited or not. However, those documents typically are not subject to regulatory review and do not include all of the types of information that must be included in a mutual fund's registration statement.

145. See Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (to be codified at 17 C.F.R. pts. 230, 239) (suggesting that Regulation D does not require that issuers deliver information to accredited investors because such investors are capable of "negotiating in their own interest").

146. This claim is effectively a truism, given that the standards by which an investor is deemed "sophisticated" are based on the notion that those who satisfy the tests are capable of competently evaluating prospective investments. Otherwise, the claim that the investors in a private offering "are likely to be sophisticated business people," has little foundation. *Private Placement of Securities, INC.*, <http://www.inc.com/encyclopedia/private-placement-of-securities.html> (last visited Nov. 2, 2017). Of course, even sophisticated investors experience difficulty grasping—or, in some cases, heeding—disclosed information. See, e.g., Steven Davidoff Solomon, *Reading the Fine Print in Abacus and Other Soured Deals*, N.Y. TIMES DEALBOOK (Nov. 2, 2012, 2:13 PM), <http://dealbook.nytimes.com/2012/11/02/reading-the-fine-print-in-abacus-and-other-soured-deals/> (detailing how some sophisticated investors incurred losses during the financial crisis as

Finally, sophisticated investors make greater use of investment advisers than do retail investors.¹⁴⁷ They do so not only because they have larger portfolios, for which they require greater assistance in “putting to work” in the financial markets, but also because they have the financial means to satisfy advisers’ minimum asset thresholds.¹⁴⁸

Accordingly, notwithstanding retail investors’ newly-found access to some of the types of investments that, for years, have been staples in sophisticated investors’ portfolios, there remains a formidable discrepancy between the two categories of investors. Whereas sophisticated investors have the resources and the connections to obtain critical information about prospective investments, retail investors do not. That fact is all the more problematic given that securities regulation aims to protect the retail variety of investors above all others¹⁴⁹ and that mutual funds are the mainstay of retail investment activity.¹⁵⁰

B. Distribution Channels

As Part III suggests, the deficiencies of disclosure have not deterred retail investors from investing in alternative funds.¹⁵¹ Indeed, the incongruity between what investors know about alternative funds and their apparent eagerness to participate in them is startling. Yet if retail investors face daunting obstacles to investing wisely, why have they seemingly flocked to alternative funds? The answer is that disclosure requirements are the province of regulators and may or may not work as they should. By contrast, selling shares of mutual funds is the province of financial firms that must pursue investors to ensure their ongoing revenue streams.¹⁵² In short, disclosure is a matter of public policy, while attracting retail investors’ capital is a matter of profit.

To be sure, this articulation of the dichotomy is likely too stark, in that a variety of factors contribute to investors’ particular investment choices. Still, the avenues by which mutual fund shares are marketed and sold to retail investors share a label that seems all but unrelated to investors’ best interests: distribution channels. Although the distribution channels that are primarily aimed at retail investors differ in many respects, as the rest of this section discusses, they have an important characteristic in common: none of them appreciably improves retail investors’ ability to invest in alternative funds on an informed basis or helps investors use alternative funds (or, indeed, traditional funds) to their best diversification potential. None, in other words, appreciably mitigates the concerns described in the previous section.

a result of their failure to read or properly use relevant disclosures).

147. See Burke & Hung, *supra* note 135, at 3 (noting that sophisticated investors are more likely than retail investors to use financial advisers).

148. See Williams, *supra* note 138 (noting that many financial advisers eschew working with lower-income investors).

149. See Brian G. Cartwright, *Whither the SEC Now?*, 95 VA. L. REV. 1085, 1103 (2009) (“The SEC’s core competence is protection of the retail investor.”).

150. See Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 780 (2013) (“Retail investors today hold equity largely through intermediaries such as pension funds and mutual funds.”).

151. See *supra* notes 92–93 and accompanying text (noting that investors have placed substantial capital with alternative funds).

152. See *infra* notes 153–174 and accompanying text (discussing the role that financial professionals play in selling mutual fund shares).

1. The Advice Channel

The advice channel is perhaps the most important distribution channel for retail investors who invest assets held outside of retirement plans.¹⁵³ It is defined by an intermediary that recommends particular funds to its customers or clients and, in most cases, helps them buy shares of selected funds. This intermediary is typically a brokerage firm, whose primary function is to execute securities trades on its customers' behalf, often giving them investment advice in connection with that service and usually earning a commission in return.¹⁵⁴ However, it might instead be an investment adviser or a financial planner, businesses that center on advising clients on portfolio allocation, typically for an agreed-upon fee.¹⁵⁵ Or, it might be one of any of a number of other types of financial professionals.¹⁵⁶ Yet despite the potential of its advisory function, the advice channel arguably does little to help retail investors make informed investment decisions.

As an initial matter, the individuals working on behalf of any given financial institution ("representatives" of that institution) may fail to adequately advise their clients about alternative funds.¹⁵⁷ That may be the case if a representative does not understand alternative products sufficiently to provide competent advice about investing in them.¹⁵⁸ If, for example, the representative's experience centers on advising clients about traditional public securities investments—say, mutual funds that invest primarily in large-capitalization stocks—then she almost assuredly will have less understanding of such matters as how the futures markets operate or the risks associated with trading call

153. In 2012, over half of all households with mutual fund investments made those investments through the advice channel. See *Sea of Change on the Horizon: U.S. Fund Distribution 2014*, EY 6 (2014), [http://www.ey.com/Publication/vwLUAssets/ey-the-state-of-us-fund-distribution-in-2014/\\$File/ey-us-fund-distribution-report.pdf](http://www.ey.com/Publication/vwLUAssets/ey-the-state-of-us-fund-distribution-in-2014/$File/ey-us-fund-distribution-report.pdf) [hereinafter EY]; see also Brian K. Reid & John D. Rea, *Mutual Fund Distribution Channels and Distribution Costs*, 9 INVEST. CO. INST. PERSP. 1, 3 (July 2003), <https://www.ici.org/pdf/per09-03.pdf> (observing that, "[a]s a share of mutual fund assets, the advice channel is the largest, accounting for an estimated 55 percent of all mutual fund assets at the end of 2002," and citing a 2001 household survey showing that 37 percent of respondents regarded the advice channel "as the primary purchase channel").

154. See *supra* notes 139–141 and accompanying text (noting that most retail investors who seek advice as to their investment decisions do so from brokerage firms); Laby, *supra* note 136, at 709 (observing that individuals often seek investment advice from brokerage firms).

155. See Jason Van Bergen, *Paying Your Investment Advisor—Fees or Commissions?*, INVESTOPEDIA, <http://www.investopedia.com/articles/basics/04/022704.asp> (last visited Nov. 2, 2017) (discussing how advisers that provide objective advice as to an investor's entire portfolio are typically "fee-only" advisers).

156. See EY, *supra* note 153, at 6 (observing that the advice channel "includes . . . financial advisors, private bankers, registered investment advisors, full-service brokers, independent financial planners, investment service representatives of banks and savings institutions, insurance agents and accountants").

157. See, e.g., Kirsten Grind, *Financial Advisers, Firms Spar Over Alternative Funds*, WALL ST. J. (May 27, 2014, 6:27 PM), <http://www.wsj.com/articles/financial-advisers-firms-spar-over-alternative-funds-1401229173?alg=y> (observing that some financial advisers are "avoiding" alternative funds).

158. See *id.* (quoting a financial adviser as saying that alternative funds "are like a black hole" and that she does not "like buying something when I don't understand what's in them"); see also Russ Alan Prince, *Liquid Alternatives: Hedge Funds and Private Equity Funds For the Masses?*, FORBES (Nov. 6, 2014, 6:15 AM), <http://www.forbes.com/sites/russalanprince/2014/11/06/liquid-alternatives-hedge-funds-and-private-equity-funds-for-the-masses/> (suggesting that the strategies and risks of liquid alternative funds are often difficult to understand and that financial advisers must expend time and effort to do so); Michael Winchell, *How Should Advisors Evaluate Alternative Strategies*, DAILYALTS (Mar. 16, 2015), <http://dailyalts.com/how-should-advisors-evaluate-alternative-strategies/> (noting that many financial advisers do not sufficiently understand how to evaluate liquid alternative funds).

options.¹⁵⁹ Alternatively, a representative may purposely avoid recommending alternative funds. For example, Edward Jones, a financial advisory firm, in 2015 instructed its personnel not to recommend or sell shares of alternative funds, reportedly because of the funds' relative complexity and because the funds may use leverage.¹⁶⁰

An additional difficulty with the advice channel is specific to brokerage firms that play the role of adviser, in that the regulatory requirements applicable to brokerage firms in connection with providing investment advice are less stringent than those to which investment advisers are subject. To be sure, brokerage firms are subject to extensive regulation in their own right, in their capacities as "broker-dealers" under the securities laws.¹⁶¹ Indeed, that regulation is the primary reason why Congress, in formulating the securities laws, permitted brokerage firms to provide any investment advice at all.¹⁶² However, because brokerage firms are not regulated as *investment advisers* in connection with doing so, they traditionally have not been required to act in the best interests of their clients—or, at least, they have been allowed simultaneously to act in their own interests.¹⁶³ In other words, unlike investment advisers, they have not been fiduciaries to their clients.¹⁶⁴

Brokers' non-fiduciary status has recently changed, at least in part. Thanks to a rule that the U.S. Department of Labor adopted in 2016, brokerage firms and their representatives have become subject to fiduciary obligations in connection with advising investors seeking to invest retirement plan or IRA assets.¹⁶⁵ More precisely, under the new

159. A representative's failure to understand alternative products to the same extent that she understands the nature and risks of investing in equity securities or bonds may either avoid advising its clients (investors) about mutual funds with alternative strategies or may nonetheless do so. Either way, the result is troublesome for the goal of producing informed retail investors, in that either the investor's portfolio will not include alternative products, or the ones that it does include may not be suitable for the investor's particular investment profile and objectives.

160. See Grind, *supra* note 157 (reporting that Edward Jones "advised its 13,150 financial [representatives] to avoid selling liquid-alternative funds"). This skepticism, moreover, is likely not merely sporadic or fleeting, given that the financial advisory firms that share it are among some of the largest and longest-operating ones. See *id.* (noting that Vanguard Group, which is "the largest mutual-fund firm in the U.S. by assets," is also wary of liquid alternative funds and has determined not to "expand[] into the sector").

161. Brokerage firms are primarily regulated by the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78o-1–78o-3 (2012), and the rules that the SEC has adopted pursuant to authority granted by the Exchange Act, 17 C.F.R. § 240 (2016).

162. See Laby, *supra* note 136, at 723. Under securities laws and rules, a brokerage firm may provide advisory services without being deemed (and, therefore, regulated) as an investment adviser, so long as it meets two requirements. First, the advice that the firm provides must be "solely incidental to" the brokerage services that it provides. See *id.* Second, the firm must not receive any "special compensation" for providing advice, meaning that it cannot receive any compensation beyond what it receives from performing brokerage services (usually a commission, calculated as a percentage of the value of securities traded). See *id.* Accordingly, brokerage firms may and do provide investment advice without thereby transforming themselves into investment advisers.

163. See *White House Fact Sheet: Strengthening Retirement Security By Cracking Down on Conflicts of Interest in Retirement Savings*, U.S. DEPT. OF LABOR, <https://www.dol.gov/newsroom/releases/ebsa/ebsa20160406-0> (last visited Nov. 2, 2017) [hereinafter *White House Fact Sheet*] (observing that not all investment professionals were "legally obligated" to "act[] in their customers' best interests" and that "the broken regulatory system had allowed misaligned incentives to steer customers into investments that have higher fees or lower returns—costing some middle-class families tens of thousands of dollars of their retirement savings").

164. See *id.* The Department of Labor has noted that conflicted advice provided by non-fiduciary advisers have "cost America's families an estimated \$17 billion a year." *Id.*

165. See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81

rule, representatives can no longer accept compensation that creates conflicts of interest, such as sales commissions based on the number of shares of a particular issuer—a mutual fund, for example—that a representative sells.¹⁶⁶ Although the election of President Trump spawned speculation that the new administration would repeal the rule¹⁶⁷—and, indeed, the administration delayed the rule’s compliance date¹⁶⁸—it now appears that the rule will survive largely intact.¹⁶⁹ It also appears that, even if the rule were repealed eventually, brokerage firms would not alter the business models and compensation practices that they adopted to comply with the rule.¹⁷⁰

Fed. Reg. 20,945, 20,977 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, and 2550) (defining a fiduciary conflict of interest).

166. *White House Fact Sheet*, *supra* note 163. Any brokerage firm wishing to continue to receive commission-based compensation may rely on an exemption for those who “commit to providing advice that serves customers’ best interests, “charge only reasonable compensation, and avoid misleading statements about fees and conflicts of interest.” *Id.*

167. On February 3, 2017, President Trump issued a memorandum directing the Department of Labor to “examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice.” See Memorandum for the Secretary of Labor on the Fiduciary Duty Rule, 82 Fed. Reg. 9675 (Feb. 7, 2017) (to be published in the Fed. Reg.), <https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule>.

168. Based on President Trump’s directive to the Department of Labor, *see supra* note 167, the Department postponed the rule’s original April 10, 2017 compliance date by 60 days, to June 9, 2017. See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016–02); Prohibited Transaction Exemptions 75–1, 77–4, 80–83, 83–1, 84–24, 86–128, 82 Fed. Reg. 16,902 (Apr. 7, 2017) (to be codified at 29 C.F.R. pt. 250). In addition, although the rule’s fiduciary requirements are now in effect, implementation of the associated “best-interest contract exemption that allows brokers to charge variable compensation . . . as long as they sign a legally binding agreement to put their clients’ interests ahead of their own” has been pushed back from the original implementation date of January 1, 2018 to July 1, 2019. Mark Schoeff Jr., *DOL Fiduciary Rule: Agency Says It Will Come Up With New Ways to Comply During Delay Period*, INVESTMENTNEWS (Aug. 30, 2017, 2:34 PM), <http://www.investmentnews.com/article/20170830/FREE/170839993/dol-fiduciary-rule-agency-says-it-will-come-up-with-new-ways-to-comply-during-delay-period>; *DOL Fiduciary Rule Explained as of August 31, 2017*, INVESTOPEDIA, <http://www.investopedia.com/updates/dol-fiduciary-rule/> (last visited Nov. 2, 2017) (“[F]ull implementation of all elements of the rule has been pushed back to July 1, 2019.”). However, one effect of the delay in implementing the fiduciary rule’s exemption provisions is a delay in implementing the private enforcement components of those provisions. See Ashlea Ebeling, *Will DOL Gut Fiduciary Rule By Latest July 1, 2019 Extension?*, FORBES (Aug. 9, 2017, 5:03 PM), <https://www.forbes.com/sites/ashleaebeling/2017/08/09/will-dol-gut-fiduciary-rule-by-latest-july-1-2019-extension/#1b1b7f235840>.

169. See Michael Kitces, *DoL Fiduciary [Rule] Not Yet Delayed By President Trump After All*, KITCES.COM (Feb. 4, 2017, 9:30 AM), <https://www.kitces.com/blog/president-trump-executive-order-memorandum-no-fiduciary-rule-delay/> (“At a minimum . . . it’s looking increasingly likely that the DoL fiduciary rule will be here to stay in some form.”); Jacklyn Wille, *Trump and the Fiduciary Rule: The Uncertainty of What’s Ahead*, BLOOMBERG BNA (Feb. 13, 2017), <https://www.bna.com/trump-fiduciary-rule-n57982083674/> (citing informed observers who believe that the rule will not be repealed).

170. See Michael Wursthorn, *New Retirement Rule Is Delayed, but Not Its Impact*, WALL ST. J. (Apr. 8, 2017, 8:00 AM), <https://www.wsj.com/articles/new-retirement-rule-is-delayed-but-not-its-impact-1491652800> (reporting that various financial firms will proceed with new business practices designed to comply with the fiduciary rule, regardless of whether the rule is repealed); *Trump to Direct DOL to Delay Fiduciary Rule: Sources*, THINKADVISOR (Jan. 31, 2017), <http://www.thinkadvisor.com/2017/01/31/trump-to-direct-dol-to-delay-fiduciary-rule-source> (noting that brokerage firms have “changed their brokerage operations in preparation for the [fiduciary] rule” and that “with it or without [the rule], . . . commission-based business models are on their way out”); Zeke Faux, *Trump’s Fiduciary Rule Order Seen Unlikely to Stop Fee Shift*, BLOOMBERG BNA (Feb.

Even so, despite the advice channel's dependence on brokerage firms' selling (and commission-producing) efforts and the relative dominance of retirement plan participants and IRA holders among mutual fund investors,¹⁷¹ the rule's effect on the advice channel may be limited. As described below, investors who invest in mutual funds through retirement plans typically do so without the benefit of investment advice, whether of the fiduciary variety or otherwise.¹⁷² Perhaps more important, however, is the fact that the new rule does not cover investment assets beyond those held through retirement plans or in IRAs. As a result, whatever may be the new rule's ultimate benefits, it leaves a considerable swath of investors and assets unprotected by fiduciary standards.

It is difficult to say with any precision how problematic brokerage firms' limited fiduciary status is for retail investors, in terms of the quality and objectivity of the advice they provide. Based on the publicity that the issue received from both scholars and the press in the aftermath of the financial crisis, however, one would be forgiven for believing that the absence of a broker-specific fiduciary obligation subjects investors to risks that most investors do not even realize exist.¹⁷³ And, indeed, brokerage firms have been known to pressure—or strongly encourage—their representatives to provide services based not on client needs but, instead, on the firms' financial objectives and associated compensation incentives.¹⁷⁴ Accordingly, the current regulation of brokerage firms, at the least, raises questions about whether that regulation sufficiently ensures that the advice brokerage firms provide to retail investors does, in fact, serve investors' interests.

3, 2017, 5:20 AM), <https://www.bloomberg.com/news/articles/2017-02-03/trump-s-fiduciary-rule-order-seen-unlikely-to-stop-fee-shift> (reporting that President Trump's initiatives to repeal the "fiduciary rule" are "unlikely to derail the . . . changes already under way in response" to the rule).

171. See, e.g., *Investment Company Factbook*, *supra* note 23, at 121 (noting that, in 2014, 82% of households that had invested in mutual funds did so through employer-sponsored retirement plans, "with 43 percent owning funds only [through] such plans").

172. See *infra* notes 183–84 and accompanying text (explaining why plan sponsors avoid engaging financial advisers for plan participants).

173. See, e.g., Timothy Noah, *Does Your Broker Love You?*, SLATE (Jan. 24, 2011, 7:33 PM), http://www.slate.com/articles/business/the_customer/2011/01/does_your_broker_love_you.html (reporting several reasons why "your broker [may not] want to put you into the best available investments"); Daniel Solin, *Report Says Ads Show Illusion of Fiduciary Duty*, U.S. NEWS & WORLD REP. (Mar. 27, 2015, 9:49 AM), <http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2015/03/27/report-says-ads-show-illusion-of-fiduciary-duty> (reporting that not only do brokers have no fiduciary obligations to their customers, but they also "mislead them about the nature of [their] legal commitment to them").

174. See, e.g., Aruna Viswanatha, *J.P. Morgan to Pay \$307 Million Over Client "Steering,"* WALL ST. J. (Dec. 18, 2015, 5:24 PM), <http://www.wsj.com/articles/j-p-morgan-to-pay-367-million-over-client-steering-1450457616> (reporting on the SEC's agreement with J.P. Morgan Chase & Co. to settle charges based on J.P. Morgan's failure "to tell wealth management customers it preferred to invest their money in its own mutual funds and hedge funds"); Michael Wursthorn, *Morgan Stanley Tweaks Brokers' Pay Plan for 2016*, WALL ST. J. (Nov. 20, 2015, 2:32 PM), <http://www.wsj.com/articles/morgan-stanley-tweaks-brokers-pay-plan-for-2016-1448047964> (observing that Morgan Stanley "is offering to pay between \$5,000 to \$50,000 to [advisory employees] who get their clients to have an average daily cash balance of \$50,000 or \$5,000 a month in direct deposits with Morgan Stanley"). Despite these concerns, some observers have noted that brokerage firms are subject to a number of requirements in connection with providing investment advice that serve to protect clients generally to the same degree as a formal fiduciary duty would. See Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 713 (2010) ("[T]he current approach to broker-dealer obligations is appropriate and provides an adequate basis for vigorous enforcement of broker-dealer obligations notwithstanding some apparent enforcement lapses in a few celebrated cases.").

2. The Retirement Plan Channel

The retirement plan channel is the distribution mechanism by which retail investors buy shares of mutual funds through their retirement plans.¹⁷⁵ Like the advice channel, it is a primary distribution mechanism for retail investors and, indeed, is the largest in terms of the number of investors relying on it.¹⁷⁶ At first blush, moreover, it may seem that this channel is the most suitable distribution channel for retail investors, given the extensive regulation and oversight to which it and its constituencies are subject. Not only are the funds offered through the channel, like all mutual funds, heavily regulated under the securities laws,¹⁷⁷ but the plans themselves and the employers sponsoring them (“plan sponsors”) also are substantially regulated under the Employment Retirement Income Security Act of 1974 (“ERISA”).¹⁷⁸

In fact, however, the retirement plan channel may be the least effective of the distribution channels. For one thing, the overwhelming majority of today’s retirement plans are “self-directed” plans, meaning that their participants must select the mutual funds in which their assets will be invested.¹⁷⁹ Although there may be various reasons why participant choice is desirable, choice has the effect, for regulatory purposes, of curtailing—if not virtually eliminating—the fiduciary obligations to which relevant plan sponsors would otherwise be subject.¹⁸⁰ That result derives from the notion that, if a plan sponsor does not make investment decisions on behalf of plan participants, then the sponsor cannot be deemed responsible for the choices that any particular participant makes.¹⁸¹ Accordingly, by deciding that plan participants must fend for themselves in choosing

175. See Reid & Rea, *supra* note 153, at 2 (“The retirement plan channel primarily consists of employer-sponsored defined contribution plans in which employers provide mutual funds and other investments for purchase by plan participants . . .”).

176. See EY, *supra* note 153, at 7 (observing that, as of 2014, the retirement plan channel was “the largest channel” and that “72% of American households own[ed] funds distributed through employer-sponsored retirement plans”); Reid & Rea, *supra* note 153, at 3 (observing that, in a “household survey of mutual fund owners conducted in 2001,” 48% of respondents “indicated that the retirement plan channel was their primary source of mutual fund purchases”).

177. Mutual funds are regulated primarily by the Investment Company Act, 15 U.S.C. §§ 80a-1–80a-64 (2012), and the rules that the SEC adopted under that statute, 17 C.F.R. §§ 270.0-1–270.60a-1 (2016). For their part, investment advisers are primarily regulated under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21 (2012), and the associated SEC rules, 17 C.F.R. §§ 275.0-2–275.222-2 (2016).

178. Employee Retirement Income Security Act, 29 U.S.C. §§ 1001–1461 (2012). ERISA requires, among other things, that retirement plan fiduciaries act solely in the interests of plan participants and in accordance with the terms and conditions of the relevant plan. See *Meeting Your Fiduciary Responsibilities*, U.S. DEP’T. OF LAB., <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meeting-your-fiduciary-responsibilities.pdf> (last visited Nov. 2, 2017) (describing the obligations of plan fiduciaries).

179. See Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 156 (2013) (“The average American employee saving for retirement does so through investments pooled in an individual account found in self-directed defined contribution plans, like the 401(k) . . .”).

180. See *id.* at 194 (“[I]n self-directed accounts where participants make investment choices, the ‘choice’ creates a safe harbor presumption for the employer and other fiduciaries shielding them against liability”) (citing 29 U.S.C. § 1104(c) (2006)).

181. See Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 33 (2000) (noting that if a participant in a self-directed retirement plan “fails to diversify his account and invests all the account assets in a single stock, the employer will not be liable for any resulting investment losses”).

investment options, a plan sponsor also decides that participants will bear the risks of making the wrong choices.¹⁸²

In addition, investing through retirement plans typically does not involve advice from any financial professional,¹⁸³ given that an employer that provides plan participants access to investment advice becomes subject to “co-fiduciary” liability for the professional’s fiduciary duty breaches.¹⁸⁴ This result is reinforced by other rules that prohibit certain types of transactions between a retirement plan and a fiduciary to the plan—which, under ERISA, the professional would be—including the fiduciary’s receipt of compensation from a mutual fund in which assets of the plan have been invested.¹⁸⁵ Under these rules, for example, an adviser could not receive compensation from a mutual fund in connection with providing other types of services to plan participants, even if the compensation were objectively reasonable and even if the services were in the participants’ best interests.¹⁸⁶ Thus, while the prospect of co-fiduciary liability incentivizes plan sponsors not to procure investment advice for participants, the “prohibited transaction” rules incentivize potential advisers to avoid being so procured.

Of course, as discussed above, any such advice may or may not be meaningful.¹⁸⁷ However, in the absence of any investment advice, unless a participant has independently engaged a financial expert, it is likely that her decisions will not have been guided by an informed analysis of what investments may best further her interests. This result is particularly disheartening given the severe limitations that plague most retail investors’ investment decision-making.¹⁸⁸

Finally, any given retirement plan offers only a relatively small number of mutual funds.¹⁸⁹ Given such a limited selection, it should be expected that many plans’ offerings do not include alternative funds and that, for the few that do, alternative funds comprise

182. See Tucker, *supra* note 179, at 154 (“Under self-directed defined contribution plans, but not defined benefit plans, [investors] bear the risks of poor market performance, longevity, and information asymmetries, as well as plan administrative costs and life-long responsibility of asset management.”). Despite the loss of fiduciary protection that accompanies investment choice, plan sponsors must nonetheless act in participants’ best interests in selecting the funds comprising the menu from which participants make their choices. See *Retail Alternatives Phenomenon*, *supra* note 69, at 13 (“[S]ponsors must act in the best interests of their workers as they assess the suitability and costs of plan options . . .”).

183. See 29 C.F.R. § 2550.404c-1(c)(4) (2016) (“A fiduciary has no obligation under part 4 of title I of [ERISA] to provide investment advice to a participant or beneficiary under an ERISA section 404(c) plan.”); Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 338 (2007) (observing that “many employers” decline to “provide investment educational materials to 401(k) plan participants”).

184. 29 U.S.C. § 1105(a) (2012) (providing that, in certain circumstances, “a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan”); see Medill, *supra* note 181, at 48 (“From the employer’s perspective, having a service provider render investment advice to plan participants subjects the employer to potential co-fiduciary liability.”).

185. 29 U.S.C. § 1106(b) (2012) (prohibiting certain transactions between a retirement plan and a fiduciary to the plan).

186. See Medill, *supra* note 181, at 43–46 (providing various examples of such prohibited transactions).

187. See *supra* notes 153–74 and accompanying text (describing why investment advice may not further investors’ best interests).

188. See *supra* note 133 and accompanying text (noting, among other things, that investors may be overconfident).

189. See Matt Bell, *8 Steps to Make the Most of Your 401(k)*, SOUND MIND INVESTING (June 1, 2014), <https://www.soundmindinvesting.com/articles/view/8-steps-to-make-the-most-of-your-401k> (“Today, the average 401(k) plan offers 19 investment choices.”).

only a small percentage of the already-circumscribed range of options. Moreover, any alternative funds that may be included on the menu almost certainly will not be ones that are appropriate for large numbers of participants, in terms of diversification.¹⁹⁰ After all, whether a proposed investment serves an investor's diversification goals depends on the particular mix of investments that the investor's portfolio already contains.

3. The Direct and Supermarket Channels

The direct and supermarket channels are substantially less important than the advice and retirement channels, in terms of the extent to which retail investors use them.¹⁹¹ The direct channel, as its name suggests, is a distribution mechanism by which a mutual fund sells its shares directly to investors.¹⁹² Because it involves only mutual funds and prospective investors in an unintermediated sales process, there are no third-party intermediaries that might advise investors about particular investments or combinations of investments.¹⁹³ The same deficiency characterizes the supermarket channel, in which discount brokerage firms offer investors a wide array of mutual funds through "supermarkets" that allow investors both to research funds and to buy shares.¹⁹⁴ Although intermediaries—namely, the brokerage firms that operate the supermarkets—stand between the offered mutual funds and prospective investors, the intermediaries do not provide any investment advice or recommendations that might help investors choose among funds.¹⁹⁵ Given these circumstances, the direct and supermarket channels, like the other channels, may be dismissed as possible salves for improving investors' investment capabilities.

* * *

The discussion above highlights the ways in which mutual fund distribution channels counter the investment goals of retail investors. By contrast, sophisticated investors fare

190. Cf. Kenneth G. Winans, *5 Big Mistakes Investors Make When They Diversify*, FORBES (Feb. 5, 2015, 1:49 PM), <http://www.forbes.com/sites/janetnovack/2015/02/05/5-big-mistakes-investors-make-when-they-diversify/> (opining that "many investors . . . misdiversify, resulting in higher investment fees, mediocre performance and potentially more risk").

191. See EY, *supra* note 153, at 5 (noting that, as of 2014, "[f]ewer than 30% of households in the US that owned funds over the last decade owned funds purchased through the direct market channel"); Reid & Rea, *supra* note 153, at 3 (observing that, as of 2002, the direct channel accounted for approximately 12% of mutual fund assets, while the supermarket channel accounted for approximately 5%).

192. See Reid & Rea, *supra* note 153, at 4 ("In the direct channel, investors buy and redeem shares directly from the fund or, more precisely, through the fund's transfer agent.").

193. Because the costs associated with the direct channel are lower than those associated with the other distribution channels, see Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 5 (2007), <http://people.brandeis.edu/~dberg/dbjchpt.pdf> (observing that "[f]unds sold through the direct channel have relatively straightforward financial arrangements with their investors" and that "[d]irect-channel investors generally do not pay front-end loads or back-end loads"), the direct channel arguably works best for investors who have substantial investment experience or are able to obtain sound advice from family, friends, or advisers.

194. See Reid & Rea, *supra* note 153, at 3, 6 (observing that "[i]n the supermarket channel, discount brokers offer a large number of mutual funds to investors from a broad array of fund companies" and that "supermarkets provide a convenient platform through which investors can research funds, obtain fund literature, and purchase fund shares").

195. See EY, *supra* note 153, at 7 (noting that, in the supermarket channel, "the product line from one manager will be thrown into a vast ocean of thousands of different products from dozens, if not hundreds, of other asset management firms—with no dedicated sales support").

somewhat better in the distribution process, even though they, like retail investors, invest in mutual funds¹⁹⁶ and, like retail investors, do so through distribution channels.¹⁹⁷ The distribution-related difficulties confronting retail investors are mitigated in the sophisticated investor context by sophisticated investors' greater access to information and investment advice, in addition to, in many cases, greater investment experience.¹⁹⁸ In addition, given sophisticated investors' designation as such, these investors typically have myriad investment options beyond buying mutual fund shares.¹⁹⁹ Those other options, moreover, do not present the same concerns. For example, private equity and hedge funds generally do not rely on public distribution mechanisms but instead sell interests through direct interaction with each prospective investor.²⁰⁰

We might say that the process by which sophisticated investors acquire information about prospective investments and the process by which they make their investments is a cohesive process, structured so as to be responsive to investors. It is more or less protective, depending on the relevant investor's knowledge and experience and the specific information she needs to make informed decisions. Accordingly, it is very different from the tandem, but equally defeating, disclosure and distribution processes characterizing the world of retail investing.

In the end, retail investors' apparent attraction to alternative funds suggests only that the distribution channels have been effective.²⁰¹ It cannot suggest anything about whether investors are using alternative funds to their advantage. Indeed, given how both traditional mutual funds and alternative funds are marketed and sold to investors, including in their

196. Despite their ability to invest in funds and other assets in which retail investors cannot invest, sophisticated investors nonetheless also invest in mutual funds. *See, e.g., Retail Alternatives Phenomenon*, *supra* note 69, at 13 (noting that "institutional investors have also exhibited some interest in alternative strategies registered under the [Investment Company] Act" and that, based on a 2013 survey, one-fourth of them planned to "direct part of their hedge fund allocations to registered products").

197. Although sophisticated investors may purchase shares through the same distribution channels that retail investors use, a fifth channel, called the institutional channel, is available to some sophisticated investors—namely, those that are institutions. *See Reid & Rea*, *supra* note 153, at 7 (describing the institutional channel).

198. *See Kacperczyk et al.*, *supra* note 48, at 1 (noting that "[s]ophisticated investors have access to better information" than their unsophisticated counterparts); Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *FORDHAM L. REV.* 1855, 1876 (1997) (claiming that "[l]arger, more sophisticated investors may enjoy greater economies of scale in researching securities and have correspondingly greater expertise" as compared with "[s]mall, individual investors").

199. In addition, sophisticated investors may be more inclined than retail investors to invest directly in securities rather than indirectly, through mutual funds and other pooled investment entities. *See supra* note 48 and accompanying text.

200. This circumstance is, in part, a product of the longstanding requirement under the private placement safe harbor. *See supra* notes 143–45 and accompanying text (describing rule 506 of Regulation D under the Securities Act). In particular, until 2013, rules 502(c) and 506 of Regulation D, together, provided that an issuer falls within rule 506 only if its offering does not involve any "general solicitation or general advertising." 17 C.F.R. § 230.502(c)(2) (2016). In 2013, the SEC amended rule 506 pursuant to a mandate in the Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)), that it allow issuers to advertise their securities offerings publicly if the issuers ensure that only accredited investors may purchase the offered securities. *See* 17 C.F.R. § 230.506(c) (2016) (describing the conditions to be met in offerings that are not subject to the limitation on the manner of offering). However, the extent to which private issuers are using this new marketing flexibility remains unclear.

201. This is supported by the fact that, in a recent survey of investors, almost two-thirds of those responding said that they "would need to learn more before investing" in alternative funds. However, approximately "half [of them] said [that] they would consider alternatives if recommended by their advisors." *Retail Alternatives Phenomenon*, *supra* note 69, at 3.

capacities as retirement plan participants, it would be reasonable to conclude, if only preliminarily, that alternative funds have not contributed, or have contributed only little, to retail investors' financial well-being.²⁰²

V. OVERCOMING THE PARADOX

Alternative funds foretell the next era of investing, in which smaller investors are able to diversify their portfolios, thereby mitigating the effects of downturns in the securities markets. They also promise to narrow the opportunity gap between retail and sophisticated investors. But there is a problem, as Part IV discusses. Although retail investors are increasingly investing in alternative funds, they remain insufficiently informed about the associated nature and risks, notwithstanding the substantial amount of regulatorily-mandated disclosure they receive.²⁰³ Moreover, distribution procedures bring retail investors and their capital to alternative funds without alleviating this information deficiency.²⁰⁴

Combined, these concerns produce an untenable situation, given that retail investors are the cardinal investor constituency that the securities laws aim to protect, above institutional investors and above high-net-worth individuals.²⁰⁵ This discord—between what securities regulation should do and what it presently does—is the domain of the regulatory agency tasked with enforcing and implementing the securities laws, namely the SEC. The SEC has thus far done little to improve the plight of retail investors vis-à-vis alternative funds, however, leaving the door open for better solutions to emerge. Addressing these topics, Part V.A discusses the SEC's response to date to the emergence and growth of alternative funds, while Part V.B turns to reform proposals that would better serve investor protection objectives.

A. Regulatory Response

Alternative funds emerged in an environment in which possibly everyone—mutual fund firms, investors, and regulators—seemed to have a particular, uniform notion of how mutual funds should be structured and what they should do.²⁰⁶ Why should they not?

202. See Attracta Mooney, *Mutual Hedge Funds Shunned By Investors*, FIN. TIMES (Nov. 27, 2015, 12:32 PM), <http://www.ft.com/cms/s/0/356d211c-92ce-11e5-94e6-c5413829caa5.html#axzz3uL2ym2q1> (noting that “research by the University of Alabama showed that liquid alternatives have not created any value for investors”). This contention—a criticism of mutual fund regulation and distribution procedures—is also a rebuttal of those who would use the objective popularity of alternative funds to conclude that these funds are playing a useful and deliberate role in retail investors' investment activities. See, e.g., Jesse Solomon, *Wall Street's New Happy Hour: Liquid Alts*, CNN MONEY (July 14, 2014, 4:13 AM), <http://money.cnn.com/2014/07/14/investing/liquid-alternatives/> (citing one portfolio manager's opinion that “investors have flocked to [liquid alternative funds] because they aim to guard against the ups and downs of the broader market”).

203. See *supra* notes 128–41 and accompanying text (describing investors' inadequate knowledge about alternative funds).

204. See *supra* Part IV.B (describing mutual fund distribution channels).

205. See Cartwright, *supra* note 149 (observing that the SEC deploys its regulatory efforts primarily for the benefit of retail investors).

206. In the usual description, a mutual fund pools many investors' money for the purpose of investing it in stocks, bonds, and other securities, as though a mutual fund can do nothing more than invest in securities. See, e.g., *Mutual Fund Definition*, *supra* note 5; *Mutual Funds: Investing in Mutual Funds*, CNN MONEY (Mar. 24, 2017, 4:18 PM), <http://money.cnn.com/pf/money-essentials-mutual-funds/> (“A mutual fund pools money from hundreds and thousands of investors to construct a portfolio of stocks, bonds, real estate, or other securities,

Although the mutual fund industry has grown over the years, it only rarely has generated wholly new types of products. Accordingly, given the growth of alternative funds and the types of investment and trading activities in which they engage, a reaction from the SEC could be expected.

The SEC has indeed reacted. For one thing, SEC representatives have criticized alternative funds on the basis that investors do not sufficiently understand the risks they pose.²⁰⁷ More significantly, the agency recently proposed an amendment to its rules under the Investment Company Act that would, if adopted, impose strict limitations on mutual funds' exposure to derivative positions, thereby curtailing alternative funds' ability to trade in derivatives.²⁰⁸ Such a rule would also, therefore, effectively require many alternative funds to modify their investment strategies substantially.²⁰⁹ In addition, over the past five years, the SEC has focused rigorously on alternative funds in its periodic examinations, in which SEC personnel review a subject fund's books and records for any compliance-related infractions.²¹⁰

Finally, and most importantly, the agency has seemingly targeted alternative fund groups in its enforcement actions against mutual funds and their managers. In a 2012 enforcement action, for example, it alleged that the board of directors of a group of alternative funds had failed to specify policies governing the "fair valuation" of securities in the funds' portfolios that could not be readily valued through market prices.²¹¹ In another enforcement action a year later, the SEC charged the board of a series trust with failing to ensure that information contained in the funds' periodic reports to shareholders accurately

according to its charter."); *What is a Mutual Fund*, WALL ST. J. BLOG, <http://guides.wsj.com/personal-finance/investing/what-is-a-mutual-fund/> (last visited Sept. 11, 2017) ("The underlying logic of mutual funds is that they provide diverse investments—in stocks, bonds and cash—without requiring investors to make separate purchases and trades.") (excerpting DAVE KANSAS, *THE COMPLETE MONEY AND INVESTING GUIDEBOOK* 131 (2005)). These descriptions incorrectly suggest that, under applicable regulation, a mutual fund (i) may engage only in *investing* activities and therefore may not, for example, hold short positions in securities or trade derivatives, and (ii) may invest only in *securities* and therefore may not invest in real estate, art, or other assets.

207. See Matthew Beaton, *Galvin Targets 25 Funds in Liquid Alt Sweep*, IGNITES, July 15, 2015 (on file with the author) (quoting Kara Stein) (citing SEC Commissioner Kara Stein's statement that "liquid alternatives' tactics are riskier than a lot of investors realize").

208. See Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,884 (Dec. 28, 2015) (to be codified at 17 C.F.R. pts. 270, 274) (summarizing the proposed rule's requirements). The purpose of the rule is to limit the amount of leverage that a mutual fund may undertake using derivatives. See *id.* (noting that the proposed rule is "designed to impose a limit on the amount of leverage the fund may obtain through derivatives transactions and other senior securities transactions").

209. See Robert A. Wittie et al., *SEC Proposes New Limits on Funds' Use of Derivatives*, K&L GATES (Dec. 29, 2015), <http://www.klgates.com/sec-proposes-new-limits-on-funds-use-of-derivatives-12-29-2015/> ("The SEC recognized in its Proposing Release that compliance with [the new rule] would require some funds to significantly alter their investment strategies . . .").

210. See *Compliance Alert*, SEC (June 2007), https://www.sec.gov/about/offices/ocie/complialert.htm#P110_20085 ("The SEC staff conducts compliance examinations of SEC-registered . . . investment companies . . . to determine whether these firms are in compliance with the federal securities laws and rules, and to identify deficiencies and weaknesses in compliance and supervisory controls.").

211. See J. Kenneth Alderman et al., Investment Company Act Release No. 30300, 2012 WL 6100223 (Dec. 10, 2012), at *2 (cease-and-desist order) (alleging that the board had not "specifi[ed] a fair valuation methodology pursuant to which the securities were to be fair valued"). Additionally, the SEC claimed that the board had no procedure for reviewing the value of fair-valued securities whose prices had not been adjusted for substantial periods. See *id.* at *4 (alleging that "the Valuation Procedure did not include any mechanism for identifying and reviewing fair-valued securities whose prices remained unchanged for weeks, months and even entire quarters").

reflected certain decisions that the board had made, as detailed in the minutes of the relevant board meetings.²¹² In a third action, brought in 2015, the agency charged the board of another series trust with failing to ensure that all of the board's questions about a prospective new manager for the trust had been fully answered before the board approved the manager.²¹³

These recent enforcement actions, and others, should cause concern, not because of the infractions noted, the claims made, or the punishment sought but, rather, because the SEC's posture in each of them is unrelated to one of the primary concerns that animates corporate law and that is usually a regulatory focal point. In particular, the SEC's typical worry is that a board of directors will act in its own interests rather than in the interests of the corporation that it oversees and that entity's shareholders.²¹⁴

In the mutual fund context, a similar worry is that a fund manager, being an enterprise that is separate from, and independent of, each of the funds that it manages, will have undue influence on the funds' board, given the manager's controlling role as to the funds.²¹⁵ The "control" factor is especially pronounced to the extent that the manager effectively hand-picked the directors, as is generally the case with the manager-centered structure described in Part II.²¹⁶ In those circumstances, the board may have compelling conflicts of interest, in that it may be inclined to act in accordance with the manager's wishes, even when doing so might counter the best interests of the funds and their investors—that is, the persons to whom the board owes its fiduciary duties.²¹⁷

That problem is no more acute or intractable for alternative funds than it is for traditional mutual funds. Moreover, the funds about which the SEC seems to have the greatest concern, those within series trusts, do not raise these governance concerns to the same extent as funds in manager-centered structures. In the series trust context, the role of the manager (or, more accurately, the *managers*) is muted, given that each manager is only one of many within the larger group, and no manager has responsibility for selecting the directors—a role that typically belongs to the trust's sponsor, which, in the case of series

212. See Northern Lights Compliance Services, LLC, et al., Investment Company Act Release No. 30502, 2013 WL 1835420 (May 2, 2013), at *2 (cease-and-desist order) (alleging that "on certain occasions . . . disclosures included in shareholder reports . . . contained boilerplate disclosures that were materially untrue or misleading in violation of . . . the Investment Company Act").

213. See Commonwealth Capital Management, LLC, et al., Investment Company Act Release No. 31678, 2015 WL 3760794 (June 17, 2015), at *2 (cease-and-desist order) (alleging that the board had approved advisory contracts between the funds and the manager even though the manager had not provided all of the information that the board had requested).

214. See, e.g., Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321, 360 (2001) (noting that "[t]he central problem of corporate law, and especially corporate governance, is to reduce . . . agency costs," which are the costs arising from directors' "shirking (laziness, playing excessive amounts of golf) or opportunistic (self-serving, self-dealing) behavior").

215. See John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 615, 617–18 (2001) (observing that a mutual fund's manager "typically controls all facets of fund life" and that the manager's "de facto control over the fund's board" creates conflicts "lead[ing] to the risk that well-understood obligations owed by board members may not be fulfilled").

216. See *id.* (noting that the manager's control typically extends "from the fund's incorporation through the selection of the initial board").

217. See Anita K. Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263, 283 (2013) (observing that, due to the usual relationship between a mutual fund's directors and its manager, the directors "may be deemed interested in transactions the [manager] proposes" and, therefore "may not act as strong fiduciaries" in various matters).

trusts, is usually the administrator.²¹⁸ Just as important, unlike in a manager-centered structure, which involves only one manager and therefore usually exists only as long as the manager continues to manage the funds' assets, a series trust is not dependent on the continued involvement of any of its many managers.

These differences between manager-dominated structures and series trusts means that boards of the latter, unlike boards of the former, have little or no incentive to accede to a manager's wishes, whether in assigning a price to hard-to-value securities (a process in which the manager may have an incentive to recommend inappropriately high prices), in determining what to include in disclosure to investors, or in approving managers for admission to the trust. The SEC, in its concerted focus on alternative funds' non-traditional investment strategies and the more limited track records of many of the managers spearheading them, does not seem to have recognized these distinctions. That it has not, however, leaves wide scope for creative thinking about how regulation should address alternative funds—how it should, in other words, overcome the limitations of investor knowledge and decision-making wherewithal detailed in Part IV. Doing so is critical, not only for the sake of allowing retail investors to achieve greater diversification, but also to steer securities regulation back to the track of furthering the goals for which it exists.

B. A New Direction

For those goals to be achieved, investors need more than the skeptical eye of regulators. Rather, the primary challenge for policymakers—whether Congress or executive agencies—is to improve investors' abilities to make sound investment decisions. Undoubtedly, the ideal way to accomplish this would be to start from scratch, in terms of the laws and rules that govern the way that investment advice is dispensed. A thoroughgoing reconfiguration of advisory services might, for example, dismantle the regulatory walls that separate brokerage firms from investment advisers and that prevent either from being flexible in defining their business objectives or creative in delivering their services.

However, achieving results within a reasonable timeframe, particularly in the current political climate, counsels in favor of focusing on what is politically feasible. Toward that end, it may seem that improving disclosure is the best solution—even if disclosure is very often ineffective—given regulation's longstanding and profound reliance on it as a tool for protecting investors. This is particularly so to the extent one believes that any other approach would be politically unworkable.

The topic of improving disclosure is recurring and well-worn, with the SEC repeatedly revising (or proposing to revise) the types of disclosures required of regulated financial

218. See *supra* notes 109–18 and accompanying text (describing the usual structure of series trusts).

institutions²¹⁹ and Congress proposing revisions of its own.²²⁰ Each of these adjustments and proposals is insufficient, however.²²¹ Moreover, their inadequacies share a common trait: by merely supplementing or augmenting disclosure or changing the way it is delivered or consumed, they remain lodged in a world where disclosure reforms will always “add” to investors’ decision-making abilities because investors will instinctively know what to make of them.²²² Yet, as many commentators have pointed out, this policymaking construct is far from realistic,²²³ which, in turn, means that changing the content or manipulability of disclosure is not the answer. Importantly, there is another way for investors to become better informed.

1. Reforming Distribution

Reform should focus not on disclosure requirements but, instead, on the mutual fund distribution process. More specifically, the profit-focused fund distribution machine should be transformed into an investor-centered one. Toward that end, *any* investment advice provided in the mutual fund distribution process should be given in furtherance of investors’ best interests. In other words, it should be fiduciary advice. In addition, “advice”

219. Among other things, the agency has proposed a new rule that, if adopted, would require mutual funds, on a monthly basis, to report their portfolio holdings to the agency, replacing the current quarterly reporting requirement. *See* Investment Company Reporting Modernization; Proposed Rule, 80 Fed. Reg. 33,590-01 (June 12, 2015) (proposing a rule that “would require certain registered investment companies to report information about their monthly portfolio holdings to the [SEC]”). In addition, it has required that mutual funds and other issuers draft disclosures using “plain English” rather than legal or regulatory jargon, thereby bolstering investors’ ability to understand the disclosed information. *See* Plain English Disclosure, 63 Fed. Reg. 6,370 (Feb. 6, 1998) (to be codified at 17 C.F.R. pts. 228, 229, 230, 239 & 274) (announcing rule requiring issuers to write certain components of their prospectuses in plain English). It has also adopted requirements that firms provide various types of information in interactive data format so that investors may download the information into spreadsheets and more readily analyze it. *See, e.g.*, Interactive Data to Improve Financial Reporting, 74 Fed. Reg. 6,776-01 (Feb. 10, 2009) (to be codified at 17 C.F.R. pts. 229, 230, and elsewhere) (requiring firms to provide “financial statement information” in interactive data format).

220. For example, the Dodd-Frank Act expressly authorized the SEC to implement procedures to test the efficacy of particular types of disclosure before adopting them for industry use. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 912, 124 Stat. 1376 (2010) (codified as amended at 15 U.S.C. § 77s (2010)) (authorizing the SEC to “engage in such temporary investor testing programs as the [SEC] determines are in the public interest or would protect investors”).

221. Periodic reports containing details of portfolio holdings cannot alleviate the problems if investors do not know how to use the information provided. *See supra* note 132 and accompanying text (discussing how investors may be unable to use available information to their benefit). Plain English disclosure cannot achieve its objective of straightforward, understandable communication if the message it is tasked with conveying remains obscure to average readers. *See supra* note 131 and accompanying text (noting that investors may not appreciate factors relevant to investment decisions). Pre-testing investors’ comprehension of disclosure, while possibly improving investors’ understanding of the risks associated with the particular service or product at issue, may nevertheless do little to assist them in understanding the role of the service or product in allocating their portfolio assets among services and products. *See supra* note 133 and accompanying text (observing that the ample disclosure provided to investors about any particular product does not help them to make sound portfolio allocation decisions). Finally, giving investors the ability to interact with disclosure so as to better compare the same type of information across funds does not affect the categories of information available to them or their ability to use information or to understand its significance.

222. *See* Ripken, *supra* note 131, at 146 (“The emphasis in securities law on providing information to the public is premised on the belief that individuals are rational, self-governing actors who are willing and able to process the information wisely.”).

223. *See supra* notes 128–34 and accompanying text (discussing reasons why disclosure is often ineffective).

in this context should have a special meaning, in that financial advisers should be obligated to advise an investor not only about the appropriateness of any particular mutual fund investment, but also regarding whether that investment might (or might not) contribute to appropriate diversification of the investor's overall investment portfolio.

This proposal is consonant with changes that are already occurring in the financial industry. As Part IV notes, the Department of Labor recently adopted a new rule that imposes fiduciary obligations on brokerage firms and their representatives.²²⁴ Under the rule, brokerage firms that sell mutual fund shares and other products to investors using retirement plan or IRA assets are required to ensure that any particular recommendation is in the investors' best interests.²²⁵

The effect of this rule is limited, however. Although the assets that most retail investors deploy in the capital markets are retirement assets,²²⁶ brokerage firms typically provide advice only as to certain types of retirement assets—those held in IRAs.²²⁷ That is the inevitable product of the fact that retirement plan participants usually do not have the benefit of investment advice as they make investment decisions, given that plan sponsors would have co-fiduciary liability for any fiduciary duty breaches committed by the person providing that advice.²²⁸ Moreover, because the amount of retirement plan assets that investors hold in mutual funds at least equals (and likely outweighs) the amount of IRA assets they hold in mutual funds,²²⁹ this exclusion is more than *de minimis*.

Accordingly, in addition to ensuring that all investment-related advice is fiduciary advice, policymakers should modify the regulation that is designed to protect retirement plan participants—namely, ERISA and rules adopted by the Department of Labor under ERISA. Given the scope and complexity of this regulatory regime, considerable consideration and analysis will be necessary to develop a specific blueprint for doing so. However, a couple of critical reforms come to mind.

First, policymakers should eliminate the possibility of heightened, co-fiduciary liability for plan sponsors that arrange for plan participants to have the benefit of investment advice as they select account investments.²³⁰ This change would likely encourage more plan sponsors to embrace advisory arrangements for the benefit of plan participants. Second, those who might provide investment advice to plan participants should be exempted from some of the onerous prohibited-transaction rules under ERISA that presently incentivize them to eschew advisory roles vis-à-vis plan participants.²³¹

224. See *supra* notes 166–72 and accompanying text (describing the new rule).

225. See *id.* (describing the new rule).

226. See *Investment Company Factbook*, *supra* note 23, at 121 (observing that, in 2014, the overwhelming majority of households with mutual fund investments had invested through retirement plans).

227. This is simply a product of the fact that participants in retirement plans typically do not have the benefit of advice as they invest through those plans. See *supra* notes 182–85 and accompanying text. Accordingly, to the extent that brokerage firms provide *any* advice regarding the investment of retirement assets, those assets will be held in IRA accounts.

228. See *supra* notes 183–84 and accompanying text (observing that plan sponsors typically do not engage an adviser to assist plan participants with their investment decisions).

229. See *Investment Company Factbook*, *supra* note 23, at 124 (showing that, as of the end of 2014, retirement plan assets invested in mutual funds exceeded IRA assets so invested).

230. See *supra* notes 183–84 and accompanying text (describing co-fiduciary liability for plan sponsors).

231. See *supra* notes 185–86 and accompanying text (describing certain prohibited-transaction rules to which advisers to plan participants become subject by virtue of assuming an advisory role).

These rules, which seem only tangentially related to protecting plan participants, have served as an additional deterrent to the provision of investment advice to those investors.

But these proposals are not enough. Providing advice intended to further an investor's best interests does little good if the adviser does not herself have adequate expertise in the subject of her advice. To the contrary, fiduciary obligations may be expected to benefit investors only to the extent that the person who is subject to them has a thorough understanding of both portfolio diversification principles and the wide range of investment products available to retail investors. Only with expertise in both of these arenas can an adviser help an investor build a robust portfolio of diverse investments with a reasonable level of risk.

Ensuring that advisers have this expertise need not involve wide-scale reform. For example, one approach might be for policymakers to broaden the use of a tool already used throughout the securities industry—namely, the competency exam. Many representatives of investment advisory firms—those registered with state regulatory authorities, primarily—and all brokerage firm representatives presently must pass one or more exams in order to act on behalf of their firms.²³² Those exams have been effective in ensuring that financial professionals have basic knowledge about the products they offer and general awareness of applicable law.²³³ However, they presently do not cover the full range of tasks that these professionals now perform, including advising retail investors about alternative funds and portfolio allocation.²³⁴ Expanding the scope of competency testing could be an effective way to ensure that brokerage firm representatives and other advisers are knowledgeable to the full extent of their professional roles.

2. Possible Challenges

It is a simple matter to say that intermediaries that sell mutual fund shares should have broad ranging fiduciary duties and be well versed in the matters that pertain most directly to sound portfolio construction. One might argue, however, that these solutions are only surface deep and do not speak to the ways in which mutual fund distribution channels may need to evolve to accommodate such broad-scale fiduciary requirements.

Indeed, some commentators have suggested with respect to the Department of Labor's new fiduciary rule that subjecting brokerage firms and their representatives to fiduciary obligations may upend the brokerage business model—a business model dependent on commissions earned on firms' successful distributions of particular securities.²³⁵ As a

232. See Peter Cherewyk, *Introduction to the Series 65 Exam*, INVESTOPEDIA, <http://www.investopedia.com/articles/professionaleducation/11/intro-series-65-exam.asp> (last visited Nov. 2, 2017) ("Most state securities regulators have set the Series 65 [exam] as the minimum requirement to become an investment advisor representative."); *1032.(a)(1) Categories of Representation Registration*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3585 (last visited Nov. 2, 2017) (providing that brokerage firm representatives must "register with [FINRA] as a General Securities Representative and [must] pass an appropriate Qualification Examination before such registration may become effective").

233. See Michael Kitces, *Are the Licensing and Other Requirements to Become a Financial Advisor Too Easy?*, KITCES.COM (Aug. 24, 2015, 7:01 AM), <https://www.kitces.com/blog/are-the-licensing-and-other-requirements-to-become-a-financial-advisor-too-easy/> ("[T]he licensing exams for financial advisors do little more than test basic product knowledge and awareness of the applicable state and Federal laws . . .").

234. See, e.g., *id.* (observing that none of the licensing exams for financial professionals "require[s] any substantive education in financial planning").

235. See Michael Kitces, *Reinventing the Broker-Dealer Business Model to Survive A DoL Fiduciary Future*, KITCES.COM (Feb. 15, 2016, 7:01 AM), <https://www.kitces.com/blog/reinventing-the-broker-dealer-business->

result, brokerage firms may ultimately cease to provide investment advice or may continue to do so but at fee rates that are prohibitive for many investors. Along these lines, some observers believe that the brokerage industry will become “advice-centric” and that brokerage firms will look and act much like registered investment advisers.²³⁶

Ultimately, how bestowing fiduciary status on brokerage firms will affect the firms’ ability or desire to maintain a semblance of their current business structures remains to be seen.²³⁷ It is to be hoped that, in the reconfigured world, steady investor demand for capable and affordably priced investment advice will fuel the development of new business models that are workable for all constituencies. In that regard, there is cause for optimism. If this Article has made no other point, it has at least shown that demand for new types of financial products and services does not go unheeded.

Another potential concern is that the proposed reforms will not affect those distribution channels, such as the direct and supermarket channels, that do not involve investment advice at all.²³⁸ Accordingly, investors that invest in mutual funds through those channels will continue to face, unaided, the risks that accompany the investment and diversification processes. This is particularly the case to the extent that alternative funds are involved, as they should be.

The direct response to this concern is that it may indeed be feasible to incorporate an advice component—perhaps an optional one²³⁹—into the channels that presently offer none, and policymakers should consider that approach. The more fundamental response to this concern, however, is that it misses the point. The driving thrust of improving investor decision-making should not be immediately to achieve a gold standard of investment advice whereby all investors are able to obtain the best or most thorough advice that may be had about an investment or their portfolio composition. Rather it should be to begin helping large segments of investors make investment and diversification decisions based on more information and expertise than what they would have in the absence of such assistance and also based on more information than what they would glean from attempting to parse lengthy and ponderous disclosure documents.

In other words, ensuring that investors have access to competent and truthful advice and information that they understand is an improvement on the current state of affairs, in which investments in mutual funds often seem based on the landing points of darts pelted at a bullseye. Presently, and notwithstanding the emergence of alternative funds, investors’ portfolios contain inappropriate investments within inappropriate *combinations* of investments, which do little to serve investors’ interests or those of the capital markets. Fiduciary requirements and improved competency among advisers would not necessarily

model-to-survive-a-department-of-labor-fiduciary-future (observing that, in the traditional business model, brokerage firms are “securities product salespeople”).

236. See *id.* (“[I]f forced to do so, brokers-as-financial-advisors can finally . . . become true financial advisors who get paid for advice instead of product distribution.”).

237. Any fiduciary rule that applies beyond the retirement context would be the province of the SEC, rather than the Department of Labor. Although the specific requirements of such a rule are beyond the scope of this Article, such a rule should improve upon the Department of Labor’s rule by achieving a better balance between, on the one hand, the need for brokers to continue performing their historical role in the financial markets and, on the other, the needs of investors for unconflicted investment assistance.

238. See *supra* notes 191–95 and accompanying text (describing the direct and supermarket channels).

239. Whichever channels ultimately serve as sources of advice, it will remain desirable to allow those investors who are not in need of advice to buy fund shares directly or through mutual fund supermarkets, without first having to receive an adviser’s recommendations.

be protective of all investors, all of the time, but, on the “protection” scale, they would be a substantial step up from nothing.

VI. CONCLUSION

That sophisticated investors are better equipped to use disclosure to profitable effect than are retail investors and have greater access to investment advice than do retail investors highlights what is perhaps the most formidable difficulty with the emergence of alternative funds: in terms of portfolio diversification, alternative funds may mark the beginning of a new era of investment opportunity and performance for retail investors. Yet, in terms of the important securities regulatory goal of investor protection, the world remains frustratingly risk-laden.

The regulatory task, however, should not be to excessively challenge alternative funds as being too risky for retail investors but should instead be to develop ways of helping retail investors both understand the relevant risks and make better investment decisions. Of course, better decisions in this context cannot mean decisions that ultimately prove profitable (such is not within regulators’ capabilities). Rather, it means decisions based on an actual understanding of an investment’s possible risks and anticipated rewards and the diversification function that the investment might serve in the investor’s overall portfolio. Much is occurring, and has occurred, in the financial industry that rightly causes worry. Increasing investment opportunities for investors that, for so long, have been excluded from so many of them—and doing so in a prudent and thoughtful manner—should not be among them.