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Cover Page Footnote

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CONSTRAINING CORPORATE LAW PRINCIPLES IN AFFILIATE WORLD

Anita K. Krug[*]

ABSTRACT

A defining characteristic of the financial industry is the overwhelming presence of affiliates—entities that are connected with one another through ownership, management, or a contractual relationship. Although the relationships among affiliated entities serve the business needs of financial enterprises, they give rise to conflicts of interest that create significant risks for investors, whether they be investment advisory clients, mutual fund shareholders, or brokerage customers. Reflecting this fact, the regulation of financial intermediaries under the securities laws focuses on mitigating these conflicts. However, when harm to investors occurs, the tools available to courts to provide remedies fail to do so because they are founded not on the special nature of the financial industry but, instead, on corporate law principles. Corporate law is incapable of helping harmed investors because it concerns itself only with relationships within an entity—primarily the relationship between a firm's shareholders and its board of directors. Accordingly, it cannot address concerns arising from extra-entity actors that are affiliated with one another. Although this incongruence has persisted for decades, no scholar has previously offered a workable solution to it. That is the project of this Article. It proposes that, to remedy investor harms, courts and policymakers ought to move past the entity-centrism of corporate law and its imperative to respect entity boundaries.

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INTRODUCTION

The world of financial services is a world of affiliates.[1] Almost by definition, key players in this realm—including those who manage investments and the intermediaries who bring together buyers and sellers of financial assets—have affiliates, often many of them. For example, an investment advisory firm that operates scores of mutual funds and other investment products, such as Fidelity[2] or Blackrock,[3] necessarily has many affiliates. That is, the "firm" consists of numerous entities, with some entities owning others and some entities being under common control with each other. The same is true of mutual funds,

[1] Although different statutes define "affiliate" in different ways, in general, affiliates may be thought of as entities that are connected with one other through ownership or management or, in some cases, a contractual relationship.

[2] *See* FMR LLC; DUN AND BRADSTREET CORPORATE FAMILY TREE (Oct. 6, 2021) (on file with Emory Law Journal) (listing, on 22 pages, affiliated entities of Fidelity Investments, Inc.).

[3] *See* BlackRock, Inc., Annual Report (Form 10-K) exhibit 21.1 (Feb. 25, 2021) (listing over 150 "direct and indirect subsidiaries of BlackRock, Inc. as of December 31, 2020").

exchange-traded funds ("ETFs"), and other publicly offered investment entities (collectively, "public funds"), which are affiliated with other entities not only by virtue of "control" relationships, but also as a result of contractual relationships. Then there are broker-dealers, which are also entities, most of which have multiple lines of business in numerous markets and, therefore, consist of numerous affiliates.

The ubiquity of affiliate relationships in the financial industry sets the industry apart from other regulatory subjects falling under the heading "business law." It also creates special risks for investors—a term that encompasses investment advisory clients, public fund shareholders, and brokerage customers—who necessarily rely on entities known as investment advisers, public funds, and broker-dealers to help them achieve their investment objectives.[4] For example, if an investment adviser uses an affiliated broker-dealer to execute a client's securities transactions, there is a risk that the adviser will cause the client to pay inflated commissions to the broker for those trades, thereby harming the client and, if the client is a public fund, the fund's shareholders.

This circumstance has important implications for the regulation of entities that provide financial services, regardless of the particular roles they play. Indeed, it is largely due to the webs of affiliates in the financial industry that financial services regulation is so complex.[5] Much of this regulation, which includes the regulation of investment advisers, public funds, and broker-dealers, focuses on the ways in which the existence of affiliates may create conflicts of interest that, if acted upon, counter the cause of investor protection, which is financial services regulation's signal objective.[6] That affiliate relationships create conflicts that harm investors is especially problematic given the fiduciary obligations that many financial intermediaries owe to those they serve.[7] Regulation exists as a prophylactic measure to prevent financial intermediaries

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4 *See* Jason Bingham, *Everything to Know About Financial Intermediaries*, LUCID UX (Mar. 4, 2020), https://lucidux.com/everything-to-know-about-financial-intermediaries/ (referring to financial intermediaries as "essential middle men").

5 *See* STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 12, 13 (2011) [hereinafter SEC STUDY], https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

6 *See* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 43 (2011) ("Congress' principal intent in enacting the securities laws was investor protection . . . .").

7 *See infra* notes 114–17 and accompanying text (describing the fiduciary duties that investment advisers owe their clients).

from acting on these conflicts and furthering their own interests at the expense of investors' interests.[8]

Regulation is incomplete, however—a yin without a yang, a heads without a tails. As its name implies, financial services regulation governs financial intermediaries—and it has, for the most part, gotten it right. For example, regulation of public funds, which is set forth primarily in the Investment Company Act of 1940 ("Investment Company Act"),[9] has as its overarching goal mitigating, if not eliminating, specific types of conflicts of interest.[10] The statute recognizes that affiliates are a defining feature of the financial industry and, on that basis, requires investment advisers and other service providers to public funds to follow stringent procedures designed to ensure that those who serve public funds (and, indirectly, their shareholders) do not also take advantage of them.[11] Accordingly, law does what it needs to do on the front end—meaning in the day-to-day operations of the financial industry.

Unfortunately, however, law gets it wrong on the back end. The web of relationships that gives rise to laws and rules to prevent financial intermediaries from acting on conflicts of interest is all but ignored for purposes of compensating investors for injuries when something goes awry.[12] This is because financial services regulation itself often does not provide the remedy, which instead comes from a range of sources. These other sources are separate from, and independent of, financial services regulation and, as a result, do not embody the principles or share the goals of financial services regulation. Putting it simply, front-end law and back-end remedies do not match. The former is focused on the peculiar, affiliate-heavy universe that is the financial industry, while the latter are part of the doctrine of corporate law, which concerns itself with the relationship between corporate directors and shareholders.[13] More specifically, corporate law is the body of laws and rules that govern such things as derivative shareholder litigation and fraud claims against corporate

[8] *See* Carlo V. di Florio, Dir., Off. Compliance Inspections & Examinations, SEC, Conflicts of Interest and Risk Governance (Oct. 22, 2012), *in* Speeches and Statements, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/news/speech/2012-spch103112cvdhtm (discussing the SEC's focus on conflicts of interest and noting that they are "a key area for [the SEC's] risk analysis").

[9] 15 U.S.C. §§ 80a-1 to 80a-64.

[10] *See Laws and Rules*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/investment/laws-and-rules (May 13, 2020) (observing that Congress designed the Investment Company Act "to minimize conflicts of interest that arise" in the operation of mutual funds and other public funds).

[11] *See infra* notes 119–30 (describing certain Investment Company Act provisions aimed at eliminating abusive affiliate transactions involving public funds).

[12] *See infra* Part III (detailing courts' reluctance to interfere with the structure of legal entities).

[13] *See infra* Part III (setting forth three case studies demonstrating how both the law and precedent used to address investor harms do not reflect the way that financial firms operate).

management and that are based on the principle that each corporate entity is a web of relationships unto itself, one in which affiliates are irrelevant.

The realm of corporate law is not part of affiliate world, and it does not understand it. And why should it? Corporate law was developed to apply to the core relationships within public companies—a term this Article uses to refer to businesses that produce goods or provide (non-financial) services to customers. By implication, then, corporate law is unrelated to investors' relationships with financial intermediaries. For public companies, affiliates are generally not important for remedying shareholder harms, except to the extent a court evaluates whether the corporate "veil" should be pierced.[14] This doctrine typically applies only where a company's management improperly uses an affiliate to further the company's objectives, leading the court to conclude that entity boundaries, and the limited liability they provide to management, should be disregarded for purposes of addressing creditor claims.[15]

In short, corporate law is defined by the entity, and its entity-centrism is the problem. When an entity-centric perspective is the starting point for evaluating instances of investor harm in the financial industry, the resulting conclusions fall short because they fail to take account of the ways that financial firms often encompass multiple affiliated entities that work together as a broader enterprise. We might say that corporate law doctrine is incapable of seeing the forest for the trees because it necessarily can see only one tree at a time. Entity-centrism, therefore, is the theme that connects each of the three case studies that this Article presents.

That corporate law has been co-opted to cover situations that fundamentally lie beyond the entity is not an indictment of corporate law. It is, rather, an instance of profound oversight. When, for example, brokerage customers are harmed, courts necessarily must use the tools that are available to them to address that harm. Because appropriate tools have not been crafted for the financial industry, corporate law will simply have to do. This approach is troubling not only in its own right; it is problematic also because courts do not stop to think about how putting a square peg (corporate law doctrine) into a round hole (financial harm) undermines the cause of justice.[16] Investors will

[14] *See infra* Part III (describing back-end remedies available to shareholders).

[15] *See Piercing the Corporate Veil*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/piercing_the_corporate_veil (last visited Dec. 31, 2021) ("'Piercing the corporate veil' refers to a situation in which courts put aside limited liability and hold a corporation's shareholders or directors personally liable for the corporation's actions or debts.").

[16] *See infra* Part III.

continue to be harmed so long as the mismatch between the front end and the back end is not corrected.

This Article aims to be the first step toward correcting the mismatch, tackling the problem of the deployment of corporate law in a realm where it does not fit, to the detriment of investors. In the process, it describes how courts' and policymakers' failures to understand affiliate world is harmful to those who rely on others to help them invest their capital and transact in securities. This discussion both unearths specific contexts in which investors are at risk and shows that there needs to be a new paradigm for remedying harm caused by financial intermediaries.

The starting point for that new paradigm is the foundation of corporate law. Since *Trustees of Dartmouth College v. Woodward*,[17] the nature of the corporation and the notion that a corporation can be a legally recognized being with rights and responsibilities have been ongoing subjects of legal theorists.[18] Nevertheless, the principle that an entity is a legal person is reasonably well-established.[19] It is that principle that shows how law might aid investors who have been harmed by corporate law's failure to acknowledge and accommodate investors' experiences with financial intermediaries and their affiliates.

The solution begins with recalling that corporations-as-persons is a fiction that has been key to economic growth in capitalist societies. Indeed, this fiction exists *because* of its purpose.[20] An entity is created to perform a particular productive function, and it is dissolved when it is no longer needed. Accordingly, the question arises: Can entities not also be used in a way that serves the interests of investors and others who rely on financial intermediaries? As this Article contends, in contexts in which the fiction of the entity does not serve the purpose of the entity, such as when maintaining the fiction will perpetuate harm to investors, the fiction should be temporarily suspended. This idea may seem immoderate, to be sure. However, given the very purpose-

[17] 17 U.S. 518 (1819). *Dartmouth College* was the first case to recognize that, for legal purposes, a corporation is a person. *See id.* at 667 (noting that a corporation is "an artificial person, existing in contemplation of law, and endowed with certain powers and franchises which . . . subsist[] in the corporation itself, as distinctly as if it were a real personage").

[18] *See* Elizabeth Pollman, *Corporate Law and Theory in* Hobby Lobby, *in* THE RISE OF CORPORATE RELIGIOUS LIBERTY 149, 155 (Micah Schwartzman et al. eds., 2016) (describing various scholars' views on the nature of the corporation).

[19] *See Entity*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/entity (last visited Dec. 31, 2021) ("An entity refers to a person or organization possessing separate and distinct legal rights, such as an individual, partnership, or corporation.").

[20] *See* Virginia Harper Ho, *Theories of Corporate Groups: Corporate Identity Reconceived*, 42 SETON HALL L. REV. 879, 893–94 (2012) (describing societal needs that corporate entities serve).

oriented nature of the corporate fiction itself, it is only reasonable to move beyond that fiction when its deployment counters the purpose of financial services regulation and its primary objective of investor protection.

This Article proceeds in four Parts. Part I describes the ways in which affiliate relationships pervade the financial industry, focusing on three types of financial intermediaries: investment advisers, public funds, and broker-dealers. It additionally discusses risks to investors that arise from affiliate relationships in each of these contexts. Part II turns to regulation and, specifically, how the laws and rules that govern financial intermediaries address the ways that affiliate relationships may create conflicts of interest that, if acted upon, could adversely affect investors.[21] Turning to the regulation-remedy misalignment described above, Part III sets forth a series of short case studies that demonstrate how corporate law principles are unable to achieve outcomes that address—or even acknowledge—harms that ought to have remedies. Although the subjects of these case studies are wide ranging, each involves conduct in the financial industry that damages investors, and the resolution of each relies on the entity-focus of corporate law. Part IV presents a new approach—one that, by eschewing corporate law principles, escapes the inherent entity-centrism of current adjudicatory tools and suggests an alternative that recognizes how affiliate relationships fundamentally shape the world of investing. A brief conclusion follows.

I. OMNIPRESENT AFFILIATES

One distinctive characteristic of the financial industry is its broad array of affiliated entities. To be sure, affiliates exist in all industries. In this regard, one need only consider the hundreds of entities that comprise Microsoft Corp., Siemens, Ltd., and Amazon.com, Inc., all of which are sprawling multinational enterprises.[22] However, the proliferation of affiliates arguably is not as profound in non-financial industries as it is in the financial industry. For one thing, certain financial intermediaries, including investment advisers and broker-dealers, almost by definition have affiliates—sometimes hundreds of them.[23] For another

[21] Importantly, although the regulation of investment advisers, public funds, and broker-dealers is within the purview of the U.S. securities laws, other laws and rules similarly are part of the universe of financial services regulation, including the U.S. Commodity Exchange Act of 1936, 7 U.S.C. § 6d(a)(l), and the rules thereunder and the U.S. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–1461, and associated rules.

[22] *See, e.g.*, Harper Ho, *supra* note 20, at 885 ("Most major public corporations are in fact part of corporate groups that contain hundreds or even thousands of affiliated companies around the world.").

[23] *See supra* notes 1–3 and accompanying text (providing, as examples, affiliate information about certain financial enterprises).

thing, even small financial intermediaries often have numerous affiliates.[24] Finally, affiliates are especially noteworthy in the financial industry because they present particular challenges for the laws and rules that govern them.

There is much at stake, moreover. Without careful oversight of affiliates' relationships with each other, those who rely on the industry for the management and custody of their financial assets may be harmed, as the 2008 financial crisis amply revealed.[25] This Part provides the background for Part II's discussion of the ways that financial services regulation addresses the risks posed by affiliate relationships and Part III's case studies showing the harm that can occur in the judicial realm, which has failed to follow suit. Section I.A delves into the ways that affiliates pervade the financial services world, focusing, in particular, on investment advisers, public funds, and broker-dealers. Section I.B describes how relationships among affiliated entities place investors at risk.

A. Affiliate Proliferation

The investment adviser, public fund, and broker-dealer sectors are not alone in the financial industry in being replete with affiliated entities. However, they represent three sectors that most investors—including most retirement investors—rely on for their investment activities, in some form or another.[26] This section discusses each in turn, describing the nature of affiliate relationships in each sector and some of the reasons they exist.

1. Investment Advisers

Investment advisers do many different things. Some of them provide advice on an individual basis, meaning they separately advise each investor they serve—known as a "client" for regulatory purposes—on what securities to buy

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24 This is evident in the fact that even starting a private fund often requires that the investment adviser form three affiliated entities, including a general partner or managing member entity, *see infra* note 40 and accompanying text, a U.S.-based fund, and, if the adviser desires, a so-called master-feeder structure, which requires a non-U.S. entity to serve as the master fund.

25 *See* Richard Moberly, Jordan A. Thomas & Jason Zuckerman, *De Facto Gag Clauses: The Legality of Employment Agreements that Undermine Dodd-Frank's Whistleblower Provisions*, 30 ABA J. LAB. & EMP. L. 87, 87 (2014) (noting that the Dodd-Frank Act, which was enacted following the 2008 financial crisis, is designed to "detect, investigate, and prosecute the kind of financial misconduct that has caused repeated and substantial harm to investors").

26 Those who invest directly in securities (as opposed to indirectly, through a public or private fund) without the assistance of an investment adviser still require the services of broker-dealers to execute their transactions. *See What Is a Brokerage Account?*, CHARLES SCHWAB, https://www.schwab.com/brokerage/what-is-a-brokerage-account (last visited Jan. 9, 2023). Only investors in commodities or other hard assets—that is, non-securities assets—are able to avoid all three sectors.

and what securities to sell.[27] In some cases, they leave it up to their clients to decide whether to follow that advice, while, in other cases, they are responsible for making the investment decisions on their clients' behalf. These "separately managed account" arrangements are exactly what the name implies, namely, engagements by clients—whether individuals or institutions—of investment advisers to manage the clients' assets pursuant to specific investment strategies.[28] By contrast, many other investment advisers' clients are investment entities, or funds, which pool contributions of capital from numerous investors and manage the contributed assets as a single account, on a fully discretionary basis.[29] Some of these funds are private and therefore offered only to so-called sophisticated investors, a category that includes hedge funds and private equity funds.[30] Others are public, meaning they are registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act and offered publicly to all investors regardless of net worth or sophistication.[31] Mutual funds and ETFs fall within the latter category.

Regardless of what an investment adviser does, if it manages enough assets, two things are likely to be true. First, it is subject to regulation by the SEC under the Investment Advisers Act of 1940 ("Advisers Act"),[32] which, like the Investment Company Act, was part of the suite of securities statutes adopted in the wake of the stock market crash nearly a century ago.[33] This means, among other things, that any investment adviser that manages a public fund must not only be mindful of its regulatory obligations under the Advisers Act but must also concern itself with the obligations to which the fund is subject under the

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[27] SEC, REGULATION OF INVESTMENT ADVISERS 3–4 (2013), sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf (explaining what it means to advise others about securities, as used in the Advisers Act's definition of "investment adviser").

[28] *See* Ian Salisbury, *SMAs Beat Funds in 2008*, WALL ST. J. (Mar. 12, 2009, 12:01 AM), https://www.wsj.com/articles/SB123679669243098151 (describing separate account arrangements).

[29] *See* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Advisers Act Release Nos. IA-5325, IC-33605, 2019 WL 12251787 (Aug. 21, 2019) ("Many investment advisers have multiple clients, including funds, other pooled investment vehicles, and individual investors, with differing investment objectives and strategies.").

[30] *See, e.g.*, Sean Ross, *Can You Invest in Hedge Funds?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/011915/can-you-invest-hedge-funds.asp (Sept. 30, 2021) (noting that "hedge funds are only accessible to sophisticated investors").

[31] *See* Wulf A. Kaal & Bentley J. Anderson, *Unconstrained Mutual Funds and Retail Investor Protection*, 36 REV. BANKING & FIN. L. 817, 833 (2017) ("Mutual funds can be marketed to retail investors through a public offering.").

[32] 15 U.S.C. §§ 80b-1 to 80b-21.

[33] *See* THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH III, 1 REGULATION OF INVESTMENT COMPANIES §§ 2.01–2.08 (2009).

Investment Company Act. Second, the adviser has one or more affiliates that likewise operates in the financial industry.[34]

That investment advisers very often have a number of affiliates is a product of the services advisers perform. Many advisers desire to provide advisory services as to investment products that do not fit well within a stand-alone investment advisory platform and, accordingly, form affiliated broker-dealers to provide the necessary infrastructure. For example, an adviser that counsels clients regarding variable annuities as an investment option may need an affiliated broker-dealer to enable those clients to purchase the products.[35] Other investment advisers create affiliated entities regulated as broker-dealers simply to produce efficiencies in trade execution.[36] Conversely, some investment advisers were created by already-existing broker-dealers to perform advisory services for the broker-dealers' customers. This may occur for a number of reasons, including to meet customers' demands for investment advice provided within a fiduciary relationship, given that broker-dealers are not themselves deemed fiduciaries to their customers.[37]

Finally, investment advisers may have affiliates by virtue of the fact that some of their clients are funds, whether public or private, that the advisers created to enable them to manage investor assets more efficiently than what is possible with separate account arrangements.[38] Their management of these funds creates yet additional affiliate relationships for a few reasons.[39] First, if an investment adviser creates a U.S.-based private fund, which typically would be

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[34] *See* Anita K. Krug, *Rethinking U.S. Investment Adviser Regulation*, 87 ST. JOHN'S L. REV. 451, 459 (2013) ("[M]any advisory firms are not themselves stand-alone entities but, instead, are part of a group—be it large or small—of affiliated entities.").

[35] *See Variable Annuities: What You Should Know*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/investor/pubs/varannty.htm (Apr. 18, 2011) ("A variable annuity is a contract between you and an insurance company, under which the insurer agrees to make periodic payments to you, beginning either immediately or at some future date.").

[36] *See* SEC STUDY, *supra* note 5, at 7 ("Many investment advisers also engage in other non-advisory businesses, such as insurance broker or agent, or as a registered broker-dealer or registered representative of a broker-dealer.").

[37] *See* Ryan Furhmann, *Suitability vs. Fiduciary Standards: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/articles/professionaleducation/11/suitability-fiduciary-standards.asp (Sept. 20, 2021) (noting that registered investment advisers are fiduciaries to their clients, while broker-dealers are not subject to fiduciary obligations).

[38] *See, e.g.*, *Investment Trusts and Investment Companies: Hearing on S. 3580 Before the Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 700 (1940) (statement of James N. White, Investment Counsel, Scudder, Stevens & Clark) (suggesting that advisers pool investor assets into funds to efficiently make their services available to retail investors).

[39] Despite these affiliate relationships that arise for an investment adviser that manages public or private funds, under the securities laws, the funds themselves are not affiliates of the adviser. *See* 15 U.S.C. § 80a-2(a)(3) (defining "affiliated person" of a public fund).

structured as a limited partnership or a limited liability company, for practical reasons the adviser might also create a separate entity to serve as the fund's general partner or managing member, as the case may be.[40] In this case, the general partner or managing member typically is an affiliate of the investment adviser because it is owned by the same individuals or entities that own the adviser.[41] Second, as suggested above, if an investment adviser creates and manages a mutual fund or other public fund, which itself produces an affiliate relationship,[42] the adviser may also create a broker-dealer to serve as the fund's "distributor" or to perform other services for the fund, including brokerage services.[43] Third, and also in the public fund context, investment advisers are often themselves created by other financial intermediaries, including other investment advisers, that desire to enter the public fund arena.[44] For example, a large investment adviser with an array of advisory activities and clients may create a wholly-owned affiliate specifically to serve as the investment adviser to one or more public funds it wishes to operate.[45] In this case, the new adviser's sole business purpose is to manage public funds.

2. *Public Funds*

Public funds have their own affiliate relationships that are worthy of discussion. This is particularly the case because a public fund has a number of one-way affiliate relationships, meaning that, although certain individuals and entities are statutorily deemed affiliates of any public fund with which they are associated, the public fund is not deemed an affiliate of those individuals and entities.[46] This is a wrinkle of the Investment Company Act, which sets forth an

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40 *See*, *e.g.*, Am. Bar Ass'n Section of Bus. Law, SEC Staff No-Action Letter, 2005 WL 3334980, at *9, *28 (Dec. 8, 2005) (discussing requirements for an investment adviser to establish a separate entity to be the general partner of one or more hedge funds that the adviser creates).

41 *See id.* at *9.

42 *See infra* notes 45–49 and accompanying text (describing how some affiliates of public funds are defined by statute).

43 *See* James Chen, *Third-Party Distributor*, INVESTOPEDIA, https://www.investopedia.com/terms/t/thirdpartydistributor.asp (Jan. 1, 2021) (observing that "[a] third-party distributor is an institution that sells or distributes mutual funds to investors for fund management companies" and that "[t]hese entities generally have no direct relation to the fund itself").

44 This observation is based on the author's personal experience as a member of the board of trustees of a number of public funds. *See also* INV. ADVISER REGUL. OFF. DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 2, 10 (Mar. 2013).

45 *See* Joseph A. Franco, *Commoditized Governance: The Curious Case of Investment Company Shared Series Trusts*, 44 J. CORP. L. 233, 239 (2018–19) ("[I]t is common in the fund industry for funds to be affiliated in a group or family advised by the same investment advisers or affiliated advisers.").

46 *See* 15 U.S.C. § 80a-2(a)(3) (setting forth the categories of "affiliated person" of a public fund).

atypical definition of "affiliate person" for the purpose of furthering the goal of investor protection.[47]

Pursuant to this "wrinkle," two types of relationships give rise to affiliate relationships. On the one hand are those that are based on ownership, where two entities are affiliated if one has a substantial ownership interest in the other or if they are commonly owned by a third entity. On the other hand are those that are statutorily defined. Specifically, the Investment Company Act deems public funds to be affiliated with certain persons, despite the fact that there may not be—and usually is not—any ownership relationship between the funds and those persons.[48] As a result, an investment adviser is an "affiliated person" of each public fund that it manages, even though there is typically only a contractual relationship between the two entities.[49] This type of affiliate relationship, though neither common nor intuitive, is a distinctive component of U.S. regulation of mutual funds and other public funds.

Although perhaps an unusual approach in most other realms, this statutory add-on to the definition of affiliate makes good sense because any given public fund exists solely because its investment adviser decided it should be created. Although the investment adviser may have no ownership interest in the fund, it effectively controls all aspects of the fund's operations—managing the portfolio, selecting all vendors and contractors to the fund (administrator, distributor, compliance consultant), and selecting the members of the fund's initial board of directors.[50] In addition, although the fund has no employees, the employees of its investment adviser perform the duties that any employees of its own would perform.[51] Finally, in most cases, the fund exists only for as long as its investment adviser desires that it exist.[52] Indeed, there is a sense in which the existence of the fund as a distinct entity from its investment adviser is simply a technicality because each of the two entities embodies one of the key corporate

[47] *See id.*

[48] *See id.*

[49] *See id.*

[50] *See* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 158 (2007) (observing that "[a] mutual fund is created and operated by the fund's investment adviser, who also appoints the fund's initial board of directors," and that "[t]ypically, a fund's board of directors contracts out all services to the investment adviser").

[51] *See* Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 503 (2008) ("Management of investment company assets . . . is not provided internally but by an external investment adviser pursuant to an advisory contract negotiated and approved by the fund's board of directors.").

[52] To be sure, a public fund's board of directors could instead decide to terminate the fund. Based on this author's personal experience, however, a public fund's investment adviser typically makes the termination decision. *See also id.* at 504 & n.37.

constituencies that ordinarily would be contained in a single entity—namely, "ownership" (the fund and, indirectly, its shareholders) and "control" (the adviser).[53] Viewed through this lens, it is little surprise that the Investment Company Act declared a public fund and its investment adviser to be affiliates.

In light of the Investment Company Act's creation of affiliate relationships, a public fund has numerous affiliates simply by virtue of its existence.[54] These include not only its investment adviser but also its board of directors, which, for regulatory purposes, is part of the fund itself but does not have the level of "control" that the board of a typical public company does.[55] Moreover, the number of affiliates a fund has may quickly increase after the fund begins operations, given that its statutory affiliates also include anyone owning five percent or more of its shares, as well as any other public fund in which it has a five percent or more ownership interest.[56] As described in Part II, the designation of affiliates is an important tool the Investment Company Act uses to protect those who rely on public funds to grow their capital.

3. Broker-Dealers

Broker-dealers carry out a diverse array of business functions across the financial industry. Individual investors encounter them as the firms that employ the financial advisors that assist them with their retirement investments and financial planning.[57] Investment advisers, including those that manage private or public funds, encounter them as the intermediaries that carry out their clients' securities trades or that assume the role of their clients' counterparties on swap contracts and other derivative instruments.[58] Public funds use them in their capacities as distributors that buy the shares the funds issue and sell the shares

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53 *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 1–2, 5 (1932) (observing that the division of ownership and control of an entity is an important factor of modern society's reliance on corporations as a means of "organizing economic life").

54 *See* 15 U.S.C. § 80a-2.

55 *See id.*

56 *Id.* (including these persons in the definition of "affiliated person" of a public fund).

57 *See* Sean Ross, *Stockbroker vs. Financial Advisor Careers: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/articles/professionals/092915/career-advice-stockbroker-vs-financial-advisor.asp (July 31, 2019) (noting that some financial advisors are "registered representatives who work for a broker-dealer").

58 *See* MICHAEL KOFFLER, SUTHERLAND ASBILL & BRENNAN LLP, THE BRAVE NEW WORLD OF FIDUCIARY DUTY FOR BROKER-DEALERS AND INVESTMENT ADVISERS, ENVESTNET 3 (2010), https://www.fiduciaryregulatory.com/portalresource/TheBraveNewWorldofFiduciaryDutyforBrokerDealersandInvestmentAdvisers ("Broker-dealers often are involved in underwriting securities offerings, serving as syndicate members or wholesalers, matching buyers and sellers of securities, acting as market makers, selling securities to the public from inventory, and clearing and settling trades.").

to prospective shareholders, while private companies doing initial public offerings use them—under the label "underwriters"—for the same purpose.[59] Entities of all stripes and pursuits that are seeking to raise capital in the securities markets rely on them as "marketers" or "finders," which solicit investments from third parties.[60]

Any firm performing any of these roles is regulated as a broker-dealer under the Securities Exchange Act of 1934 ("Exchange Act").[61] A broker-dealer that serves in an agent capacity in effecting securities transactions and that receives commissions for doing so is a broker,[62] while one that enters into securities transactions in a principal capacity—that is, for its own account—and, in return, receives a premium on the sale price (if the seller) or discount on the purchase price (if the buyer) is a dealer.[63] Whatever their activities, broker-dealers have in common being in the business of buying and selling securities in service of investors—who are known as their "customers" for regulatory purposes—rather than to further their own investment objectives.[64] Because the same regulation applies to all broker-dealers, whatever their specific activities may be, many broker-dealers assume different roles at the same time.[65] For example, at the same time as Morgan Stanley acts as an agent in executing securities trades for funds and other investors across the globe, it also acts as principal in buying securities for its own account from the same constituencies. The "hats" a broker-dealer may wear as both agent and principal—underwriter, financial advisor,

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59 *See id.*

60 *See id.*

61 15 U.S.C. § 78c.

62 *See* Lisa Smith, *What Is a Broker-Dealer and Why Should You Care?*, INVESTOPEDIA, https://www.investopedia.com/articles/investing/072913/what-brokerdealer-and-why-should-you-care.asp (June 21, 2020) (noting that a broker "facilitates security trading as an agent acting on behalf of investors" and that "[t]he terms agent and broker can be used interchangeably").

63 *See id.* ("While a broker facilitates security trades on behalf of investors, a dealer facilitates trades on behalf of itself. The terms 'principal' and 'dealer' can be used interchangeably."); Paulina Likos, *What Is a Broker-Dealer?*, U.S. NEWS & WORLD REP. (June 29, 2021), https://money.usnews.com/investing/investing-101/articles/what-is-a-broker-dealer [https://web.archive.org/web/20210629201555/https://money.usnews.com/investing/investing-101/articles/what-is-a-broker-dealer] ("Unlike a broker who acts as an agent facilitating trades of securities on behalf of others, a dealer is a broker who executes the trades and acts as the principal or person who buys and sells securities for their own account.").

64 *See* KOFFLER, *supra* note 58 ("In contrast to investment advisers, broker-dealers generally have been viewed as salesmen *vis-à-vis* the investing public.").

65 *See e.g.*, Adam Hayes, *Broker-Dealer*, INVESTOPEDIA, https://www.investopedia.com/terms/b/broker-dealer.asp (May 29, 2021) (noting that broker-dealers "perform a dual role in carrying out their responsibilities," by acting as agent and as principal in securities transactions, depending on the situation, and that many broker-dealers "also engage in the underwriting of securities offerings").

executing broker, swap counterparty, finder, or market-maker—fill a broad spectrum indeed.

Given the range of functions that broker-dealers perform, it may not be surprising that broker-dealers often comprise numerous entities, with the largest ones—think Merrill Lynch, Goldman Sachs, J.P. Morgan—comprising scores of them.[66] Although, in theory, a single entity could perform multiple functions, such as acting as a financial advisor for individual investors while acting as an underwriter for the private companies going public, that typically does not happen for the same reasons that any firm, whether in the financial industry or otherwise, forms subsidiary entities. Firms often choose to situate different business functions in separate entities to maintain separation among brand identities, to achieve optimal tax treatment (such as when a firm deploys losses from failing subsidiaries to offset income from profitable ones), or to enable part of the firm to raise capital (by offering stock), without impacting the parent company's stock price.[67] Finally, using different subsidiaries for different business segments allows the parent company to determine that some segments should be public, while others remain private, which is important when some business operations, but not others, are suitable for public investment and the accompanying disclosure obligations.[68]

In other words, there is nothing unusual about the proliferation of affiliates in the broker-dealer realm, in that it occurs in that realm for the same reasons as it does in any other business realm. Just as Microsoft may form a new subsidiary to house a newly developed line of business, so might Merrill Lynch. If the broker-dealer arena differs from others in terms of subsidiary formation, it is due to the sheer number of subsidiaries in that arena and because the various lines of business that a broker-dealer may have creates special risks for investors.

B. Risks to Investors in Affiliate World

As Section I.A describes, affiliate relationships are a fundamental component of the financial industry because many of the activities performed by financial intermediaries throughout that realm necessitate affiliate relationships. In addition, that public funds have so many affiliates is, in part, a result of the

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[66] *See, e.g.*, The Goldman Sachs Grp., Inc., Annual Report (Form 10-K) exhibit 21.1 (Feb. 22, 2021) (listing over 70 "significant subsidiaries of The Goldman Sachs Group, Inc." as of December 31, 2020).

[67] *See* Denise Sullivan, *Reasons Companies Have Subsidiaries*, CHRON.COM, https://smallbusiness.chron.com/reasons-companies-subsidiaries-81965.html (last visited Sept. 4, 2022) (listing reasons why companies establish subsidiaries).

[68] *See id.* ("Not all business operations are suitable for public investment and disclosure requirements.").

fact that the Investment Company Act has defined as fund affiliates certain individuals and entities that otherwise would not be so characterized under the usual understanding of affiliates, which centers on persons related to one another through ownership or control.[69] Regulation's broad view of who and what is deemed an affiliate exemplifies a regulatory concern about individuals and entities that work together, share information, and have common financial objectives.

In particular, the concern is that financial intermediaries may seek to benefit their affiliates at the expense of the advisory clients, public fund shareholders, and brokerage customers (collectively, "investors") they are in the business to serve.[70] Simply put, affiliate relationships create conflicts of interest that, if acted upon, harm these constituencies.[71] This section describes a key example of a conflict in each of the investment adviser, public fund, and broker-dealer contexts that harms investors. In the process, it shows how affiliate relationships interweave the activities of all three categories of firms.

1. Front-Running

As described above, a single investment adviser may perform a variety of services for its clients, including advising separate accounts or managing private funds for the benefit of wealthier investors or public funds that accept contributions from all investors.[72] To the extent an investment adviser manages multiple accounts—whether they be public or private funds or separate accounts—a practice known as frontrunning presents a particular concern. When an adviser engages in frontrunning, it seeks to further its, or, as is often the case,

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69 *See* 15 U.S.C. § 80a-2 (including the investment adviser to a public fund among the fund's affiliates, even though there may be no ownership relationship between the two entities).

70 *See, e.g.*, Daisy Maxey, *How to Pay Your Financial Adviser*, WALL ST. J.: WEALTH MGMT. (Dec. 11, 2011), http://www.wsj.com/articiles/how-to-pay-your-financial-adviser-1378302678 ("When advisers act as brokers, they have an incentive to sell the product that pays the best commission."); Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act After Seventy-Five Years*, 10 BROOK. J. CORP., FIN. & COM. L. 405, 435 (2016) ("Conflicts of interest are common in every fiduciary relationship in the financial services industry.").

71 The 2011 bankruptcy of MF Global Holdings, Ltd. presents a stark example of affiliate conflicts of interest. In that case, MF Global Holdings had siphoned funds from the customer accounts of its subsidiary, MF Global, Inc., a registered futures commission merchant and broker-dealer, to pay off its debts. *See* Jason M. Breslow, *MF Global Trustee Hints at Negligence Suit Against Jon Corzine*, PBS FRONTLINE (June 4, 2012), https://www.pbs.org/wgbh/frontline/article/mf-global-trustee-hints-at-negligece-suit-against-jon-corzine/ (reciting conclusions of MF Global Inc.'s trustee, including that customer funds had been used for "margin calls on European sovereign debt positions").

72 *See supra* notes 28–43 and accompanying text (describing the functions of investment advisers).

an affiliate's, financial interests by taking advantage of those who have entrusted their assets to it.[73]

Consider, for example, an investment adviser that manages multiple private funds. A private fund is simply a pooled investment entity that, by virtue of complying with various regulatory requirements, need not be registered with the SEC under the Investment Company Act and regulated as a public fund.[74] Among those requirements are that the fund's investors have a certain level of financial sophistication and that the fund accept only a limited number of investors.[75] Because such a fund is not subject to the myriad constraints and requirements set forth in the Investment Company Act, it is allowed to invest in a much wider range of assets, and otherwise transact in a much wider range of instruments, than is the case for public funds.[76]

Investment advisers to private funds—as well as their employees, families, and friends, in many cases—often invest substantial personal assets in one or more funds that they manage in order to benefit personally from the investment strategy they are executing on behalf of the funds.[77] There is nothing inappropriate about this practice, particularly where an adviser manages only one private fund. However, it is often the case that advisers create multiple private funds with similar strategies, or even multiple funds with the same strategy, to cater to different investors with differing investment needs.[78] Because private funds are relatively simple to create and operate, as compared

[73] *See Investment Rules that Do Apply to Your Financial Advisor*, AVANTAX.COM (June 8, 2021), https://www.avantax.com/blog/investment-rules-that-do-apply-to-your-financial-advisor/ ("Front running occurs when an advisor buys or sells ahead of their customers. Trading ahead of another trader or their clients can get an advisor a better price than their clients.").

[74] *See* 15 U.S.C.§ 80a-3(c), 80a-3(c)(7) (exempting entities that would otherwise be required to register with the SEC as public funds but for having a limited number of investors or limiting investors only to those meeting certain financial thresholds).

[75] *See id.*

[76] *See* James Chen, *Alternative Investment*, INVESTOPEDIA, http://www.investopedia.com/terms/a/alternative_investment.asp (Feb. 26. 2022) (defining "alternative investment" as "a financial asset that does not fall into one of the conventional investment categories" and observing that "[a]lternative investments can include private equity or venture capital, hedge funds, managed futures, art and antiques, commodities, and derivatives contracts").

[77] *See* George B. Raine & Angela C. Jaimes, *Regulatory Pitfalls and Practicalities in Side-by-Side Management of Registered and Private Funds*, 26 INV. LAW. 1 (Aug. 2019) ("An adviser may make a substantial investment in a private fund it advises, in part in order to conform with investor expectations, which may result in a potential conflict of interest.").

[78] Chris Carsley & John Canorro, *Alternative Investments: Investment Allocations 5 Questions to Ask*, CAIA ASS'N (Jan. 14, 2022), https://caia.org/blog/2022/01/14/alternative-investments-investment-allocations-5-questions-ask (describing reasons why a private fund manager may establish multiple funds).

to public funds, creating multiple variations on a theme often makes good business sense.[79]

Having multiple advisory clients, as each fund is considered under the Advisers Act,[80] raises conflicts concerns for advisers, especially where an adviser or, more likely, its principals own substantial interests in one of those funds but not the others. In those cases, the adviser has incentives to cause the fund in which its principals have invested—which therefore is an affiliate of the adviser—to buy or sell securities ahead of the non-affiliated funds so that the affiliated fund will receive better prices.[81] After all, because the purchase of the securities by the non-affiliated funds may increase the price, by going first, the affiliated fund can buy at the price available prior to the increase.[82] Likewise, the sale of the securities by the non-affiliated funds may decrease the price, so by going first, the affiliated fund can sell at the price available prior to the decrease.[83] In both cases, the adviser and other owners of the affiliated fund will benefit at the expense of those whose interests the adviser has a duty to protect—namely, the non-affiliated funds and their investors.

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79 *See How to Create a Hedge Fund*, ADVOCATETANMOY L. LIBR. (May 12, 2020), https://advocatetanmoy.com/2020/05/12/how-to-create-a-hedge-fund/ (noting that "it is easy to build and launch" a hedge fund).

80 *See* 17 C.F.R. § 275.202(a)(30)-1 (2012) (including in the definition of "client" under the Advisers Act "[a] corporation, general partnership, limited partnership, limited liability company, trust . . . , or other legal organization . . . to which [an adviser] provide[s] investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries").

81 The SEC administrative proceeding, *In the Matter of Christopher M. Gibson*, Initial Decision Release No. 1398, slip op. at 45–46 (ALJ Mar. 24, 2020), contains a discussion of the practice of frontrunning:

> The exact contours of front running need not be defined to capture or contemplate every form of misconduct. . . . [T]here is a potential conflict of interest when an investment adviser's personal trading or recommendation to close friends or relatives coincides with the adviser's possession of confidential information about a client's forthcoming trading plans in the same security. . . . The point is that front running poses the potential for the adviser's outside interests to conflict with those of the client.

Id.

82 *See* SEC v. Cap. Gains Res. Bureau, 375 U.S. 180, 196 (1963) (observing that one who "secretly trades on the market effect of his own recommendation may be motivated—consciously or unconsciously—to recommend a given security . . . because of its potential for short-run price increase in response to anticipated [client] activity from the recommendation (which would profit the adviser)").

83 *See supra* note 73 (noting that frontrunning occurs when an investment adviser sells ahead of its clients).

2. *Cross-Transactions*

Among the array of affiliates of a public fund are other funds within the same "fund family"—that is, other funds managed by the same investment adviser.[84] Public funds within the same fund family frequently have similar investment strategies, with each strategy embodying a slight modification to the adviser's overarching approach to investing.[85] As a result, the various funds often transact in many of the same securities.[86] In such a context, the concept of cross-transactions becomes relevant.

In one type of cross-transaction, funds within a fund family buy or sell securities from one another.[87] This could occur when one fund is "over-weighted" in a particular security while a sister fund is seeking to acquire the same security.[88] These transactions may be desirable from the investment adviser's perspective, as well as from the perspective of the funds' shareholders, primarily because they may allow both sides to minimize transaction execution costs.[89]

The prospect of a public fund transacting with an affiliated fund presents conflicts of interest and potential harm to fund shareholders, however.[90] These

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84 It is typical for an investment adviser that manages one public (or private) fund to manage a number of funds. *See, e.g.*, Brown v. Calamos, 664 F.3d 123, 130 (7th Cir. 2011) ("Like most advisors Calamos Advisors runs multiple funds . . . .").

85 *See* Carsley & Canorro, *supra* note 78 ("Investment firms typically manage multiple funds where the underlying strategies of those funds have some degree of overlap.").

86 *Cf. id.* (noting that "parallel" funds "may trade in the same investments as the primary fund").

87 *See* CROSS TRADES AND PRINCIPAL TRANSACTIONS—NEW SEC GUIDANCE FOR PRIVATE FUND MANAGERS, AKIN GUMP INV. MGMT. ALERT 1 (Aug. 3, 2021), https://www.akingump.com/a/web/rZGHyEF96gfLMhVjaSikrp/33JTfu/cross-trades-and-principal-transactions.pdf ("A cross trade occurs when an investment adviser causes a trade to occur between two or more of its advisory clients' accounts.").

88 *See* Vincent Pitaro, *As Cross Trades Between Client Accounts Continue to Draw SEC Scrutiny, Fund Managers Should Review Internal Policies and Client Disclosures*, HEDGE FUND L. REP. (Sept. 27, 2018), https://www.hflawreport.com/2616041/as-cross-trades-between-client-accounts-continue-to-draw-sec-scrutiny-fund-managers-should-review-internal-policies-and-client-disclosures.thtml ("With appropriate disclosures and controls, an investment adviser can use cross trades to balance client accounts and save transaction costs.").

89 *See* Gardner Russo & Gardner, SEC Staff No-Action Letter, 2006 SEC No-Act. LEXIS 482, at *15 (June 7, 2006) (suggesting that cross transactions benefit clients because they can lower transaction costs and "minimize the impact to the market for those securities"); Letter from Sec. Indus. Ass'n to Off. of Exemption Determinations, Pension and Welfare Benefits Admin. 3 (May 19, 1998) (noting that an investment adviser "can reduce or eliminate commissions for [two] clients by 'crossing' their trades").

90 *See SEC Continues Scrutiny of Private Fund Cross Trades*, CSS.COM (Mar. 10, 2020), https://cssregtech.com/2020/03/sec-continues-scrutiny-of-private-fund-cross-trades (noting that cross-transactions "give[] rise to the opportunity to favor one fund over another by, for example, moving a position, perhaps a losing position, to another fund to improve the return of the original fund").

conflicts arise when the investment adviser favors one fund over another, which could be the case when the management fee that the favored fund pays the adviser is higher than the fee paid by the non-favored fund.[91] Conflicts could also arise when the adviser is particularly focused on achieving good performance in the favored fund in hopes of attracting or retaining a large institutional shareholder.[92]

These conflicts of interest may be actuated in a number of ways. As one example, if the favored fund is the buying fund in a cross-transaction, the price it pays to the non-favored fund may be a discounted price, meaning a price that is lower than the market price.[93] Likewise, if the favored fund is the selling fund, the non-favored fund may pay a premium purchase price, meaning a price that is higher than the market price.[94] It follows, then, that these concerns also arise if the securities being traded are debt securities, rather than equity securities. If the favored fund is buying the debt security—that is, it is effectively lending money to the non-favored fund—the rate of interest the non-favored fund must pay to the favored fund may be higher than benchmark interest rates, and if the favored fund is selling the debt security, the rate of interest it must pay the non-favored fund may be lower than benchmark rates.

In each of these cases, the shareholders of the out-of-favor fund are harmed. In the context of a cross-transaction involving equity securities, the value of the non-favored fund's shares is less than it would be if the fund, as the buyer, had paid the market price for the securities purchased or, as the seller, had received the market price for the securities sold. Similarly, in the context of a cross-transaction involving debt securities, the value of the non-favored fund's shares is less than it would be if the fund, as the borrower, had not paid interest at a rate that is higher than the benchmark rate or, as the lender, had not received interest at a rate that is lower than the benchmark rate. Either way, but for the affiliation

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[91] Investment advisers to public funds are typically compensated for managing the fund based on the amount of assets within the fund, such that advisers often receive 0.5% to 1.5%, on annual basis, of the value of the assets, calculated and paid on a monthly or quarterly basis. SHELDON JACOBS, INVESTING WITHOUT WALL STREET 273 (2012); *see also* U.S. Sec. & Exch. Comm'n, *Management Fee*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/management-fee (last visited Aug. 30, 2022) (defining "management fee" as "[a] fee paid out of fund assets to the fund's investment adviser for investment portfolio management").

[92] *See SEC Continues Scrutiny of Private Fund Cross Trades*, *supra* note 90.

[93] *See* DIVISION OF EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, RISK ALERT: OBSERVATIONS REGARDING FIXED INCOME PRINCIPAL AND CROSS TRADES BY INVESTMENT ADVISERS FROM AN EXAMINATION INITIATIVE 4 (July 21, 2021), https://www.sec.gov/files/fixed-income-principal-and-cross-trades-risk-alert.pdf (observing that "conflicts of interest associated with cross trades" are evidenced in advisers' failing to use "best price and best execution efforts").

[94] *See id.*

between the buying and selling funds, the transaction would not have occurred, and, therefore, the harm also would not have occurred.

3. Brokerage Arrangements

Many broker-dealers have an affiliated investment adviser and vice versa.[95] These two financial intermediaries are perhaps the most important players in the financial industry, in that the project of investing assets on behalf of others requires not only decision-makers—that is, those that decide how best to deploy investor assets in the market—but also effectuators, meaning those that execute an adviser's decisions.[96] Given that circumstance, it might be expected that a single financial firm may encompass both an advisory branch and a brokerage branch because carrying out the dual functions of deciding and executing within a single enterprise is (or can be) efficiency-enhancing.

Indeed, where a broker-dealer is affiliated with an investment adviser, it is common for the adviser to execute its clients' securities transactions through the affiliated broker-dealer—that is, on an agency basis, where the broker-dealer acts as a broker—or with the broker-dealer—meaning on a principal basis, where the broker-dealer acts as a dealer.[97] This is often desirable because the affiliated broker-dealer may charge commissions (in the case of an agency transaction) or impose premiums or discounts (in the case of a principal transaction) that are in line with those charged or imposed by broker-dealers in the open market.[98] In these cases, the benefit of using the affiliated broker-dealer is that the profit made by the broker-dealer in executing trades by the affiliated investment adviser are kept "in the family," so to speak.

The conflicts presented by this affiliate arrangement are not difficult to discern when one remembers that, like any other business, the brokerage business is competitive, with different broker-dealers offering different services—some better, some worse—at different prices.[99] An investment adviser's having an affiliated broker-dealer gives rise to conflicts, in that the

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95 According to the Financial Industry Regulatory Authority ("FINRA"), in 2010, 1,734 broker-dealers, or 37% of all broker-dealers, had investment adviser affiliates. *See* SEC STUDY, *supra* note 5, at 8.

96 *See* Mark P. Cussen, *Broker-Dealers vs. RIAs: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/articles/active-trading/100915/rias-and-independent-brokerdealers-comparison.asp (Sept. 15, 2022).

97 *See, e.g.*, Emily Norris, *Principal Trading vs. Agency Trading: What's the Difference?*, INVESTOPEDIA, https://www.investopedia.com/articles/03/012403.asp (Sept. 29, 2021).

98 *See id.*

99 *See* John W. Schoen, *Why Are 'Buy' and 'Sell' Prices Different?*, NBCNEWS.COM (Mar. 10, 2005, 8:29 PM), https://www.nbcnews.com/id/wbna7148606 ("While fees are regulated, they vary a great deal . . . .").

adviser has an incentive to execute trades through or with the affiliated broker, even though other broker-dealers may offer better prices or may offer better services for comparable prices.[100] The adviser's acting on those conflicts by executing trades through the affiliate where better pricing or service is available elsewhere harms its clients, who must pay too much for execution services or receive lower quality services.[101]

The affiliate relationship between an investment adviser and a broker-dealer presents some of the more intractable conflicts for financial services regulation, perhaps because these relationships are so common and because transacting through an affiliate is convenient. Regardless, when clients and fund shareholders pay more for a service than they need to, that higher cost reduces the return they receive on their invested assets. Fortunately, as is the case with the conflicts of interest described above, the securities laws recognize and seek to address these conflicts. Among other things, investment advisers are subject to fiduciary duties that obligate them always to act in their clients' best interests, and all financial intermediaries, including investment advisers, public funds, and broker-dealers, are subject to an array of rules that, much like fiduciary obligations, are designed to prevent them from acting against the interests of those they serve. That is the subject of the next Part.

II. FRONT-END REGULATION

Fortunately for investors, in formulating the securities laws, Congress recognized that financial firms operate through numerous affiliates. Accordingly, the securities laws and rules that govern investment advisers, public funds, and broker-dealers seek to manage these affiliations. The formal term that the statutes use, however, is not "affiliates" but, rather, "affiliated persons," which has a multi-part definition that, for any entity, encompasses an individual or entity that has ownership or other means of control of the entity; another entity that is under common control with the entity; and any director-

[100] *See* Tina Mitchell, *Identifying and Mitigating Advisory Conflicts of Interest*, CORE COMPLIANCE (Dec. 18, 2018), https://www.corecls.com/risk-management-updates-rmu/identifying-and-mitigating-advisory-conflicts-of-interest/ (listing conflicts of interest, including "placing client trades with an affiliated brokerage firm that charges a higher commission rate").

[101] *See* STEVEN W. STONE & MICHELE HAWKINS, TRADING CONFLICTS OF INTEREST 1–2 (2008), https://www.morganlewis.com/~/media/files/publication/presentation/speech/currentbestexecution2.ashx (observing that an investment adviser's failure to seek "best execution" of client transactions violates its fiduciary duty to those clients).

officer of the entity.[102] In addition, a public fund's affiliates include its investment adviser, among others.[103]

The relevant statutes, and the rules the SEC adopted pursuant to them, rely on different approaches for mitigating conflicts, with some more tailored to particular types of conduct than others. In addition, investment advisers are subject to (amorphous) fiduciary duties. This Part describes how the regulation of investment advisers, public funds, and broker-dealers seeks to mitigate or eliminate conflicts of interest by expressly recognizing the risks of affiliate relationships.

A. Investment Advisers

The Advisers Act addresses conflicts of interest arising from affiliate relationships using tools that are, in part, reflective of the various ways in which conflicts may arise. Several of these tools can be identified in the statute's approach to addressing the conflict identified in Part I, where an investment adviser may be tempted to cause an affiliated client account to trade ahead of other client accounts. These tools are largely general obligations and prohibitions that nevertheless serve to address abusive behavior stemming from affiliate relationships.

The provision of the Advisers Act that has the most "teeth" for purposes of addressing conflicts of interest arising from affiliate relationships is section 206, a general antifraud provision.[104] Section 206 prohibits investment advisers from, among other things, "employ[ing] any device, scheme, or artifice to defraud any client or prospective client" or "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[105] Although this section does not refer to or expressly prohibit frontrunning, it prohibits the practice by virtue of its focus on deception. In the context of frontrunning, the deception parallels the deception necessary for the practice of insider trading, in which someone trades securities ahead of others based on non-public, material information.[106] Under insider trading doctrine, the fact that the material information is non-public—that is, the trader did not

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102 *See* U.S. Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(3) (defining "affiliated person").

103 *See id.* ("'Affiliated person' of another person means . . . if such other person is an investment company, any investment adviser thereof . . . .").

104 *See id.* § 80b-6 (covering "[p]rohibited transactions by investment advisers").

105 *Id.*

106 *See* Akhilesh Ganti, *Insider Trading*, INVESTOPEDIA, https://www.investopedia.com/terms/i/insidertrading.asp (Dec. 15, 2021) ("Insider trading involves trading in a public company's stock by someone who has non-public, material information about that stock for any reason.").

disclose it either to counterparties or to the public before trading—satisfies the element of deceit, so long as there is a showing of the trader's intent.[107] In the case of frontrunning, that the adviser plans to buy or sell a security on behalf of its non-affiliated clients is the material information, while the failure to disclose to those clients that it will trade its affiliated accounts ahead of the non-affiliated accounts makes the adviser's scheme "non-public."[108]

Section 206 is buttressed by one of the rules the SEC adopted pursuant to that section. Rule 206(4)-7 under the Advisers Act renders it unlawful within the meaning of section 206 for an investment adviser to operate as such unless it implements written policies and procedures that are designed to prevent the adviser and its employees from violating the statute and the SEC's rules under the statute.[109] In its 2003 announcement of the final version of the rule, the SEC stated that, in implementing its policies and procedures, an investment adviser should identify "conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures to address those risks."[110] Accordingly, advisers must consider the range of conflicts of interest that arise from their business operations and implement policies that prohibit their acting on those conflicts.[111]

The implications of this seemingly mundane rule are extensive. Among them are that every investment adviser must have a policy prohibiting frontrunning and other practices whereby the adviser or its associates may benefit personally from their relationship with the adviser's non-affiliated clients.[112] To be sure, by virtue of the fact that rule 206(4)-7 is merely that—a rule adopted pursuant to

[107] *See* Adam Hayes, *Misappropriation Theory*, INVESTOPEDIA, https://www.investopedia.com/terms/m/misappropriation_theory.asp#:~:text=Though%20not%20expressly%20forbidden%20by,using%20material%20non%2Dpublic%20information (Jan. 5, 2021) ("[I]nsider trading is considered to fall under the prohibition against deceptive trading practices and is thus illegal when committed using material non-public information.").

[108] *See* CFI Team, *Front Running*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/front-running/ (Oct. 18, 2022) ("Front running is considered as a form of market manipulation and insider trading because a person who commits a front running activity expects security's price movements based on the non-public information.").

[109] 17 C.F.R. § 275.206(4)-7 (2021). Beyond that, the rule requires that advisers review, at least annually, the adequacy of these policies and procedures and designate an employee or contractor to be the firm's Chief Compliance Officer, with responsibility for administering the policies and procedures and annually reviewing them. *See id.*

[110] Compliance Programs of Investment Companies and Investment Advisers, Final Rule, 68 FED. REG. 74714, 74716 (Dec. 24, 2003) (codified at 17 C.F.R. pts. 270, 275 & 279) (finalizing the proposed compliance program rule).

[111] *See id.* (listing the issues that an adviser's compliance program should address, if relevant).

[112] *See id.* (stating that advisers should implement policies and procedures addressing, among other things, "[p]roprietary trading of the adviser and personal trading activities of supervised persons").

power given to the SEC by the Advisers Act—it logically cannot prohibit anything that section 206 does not already prohibit. Yet its benefit lies in the fact that it clarifies that section 206 is far-reaching and delineates what section 206's antifraud mandate means. Perhaps most important is the rule's enforcement teeth. An adviser's violation of its own policies and procedures constitutes a violation of the securities laws themselves, subjecting the adviser to administrative proceedings on that basis.[113]

Still another tool at the SEC's disposal for protecting clients from advisers that engage in affiliate-related trading practices is the longstanding doctrine that investment advisers are fiduciaries to their clients.[114] The definition of "fiduciary" in the investment adviser context is closely aligned with the definition in other contexts, in that an investment adviser has a duty to act in the best interests of those to whom it provides advice.[115] Accordingly, the adviser must not engage in practices that systematically advantage one client over another and, importantly, must not put its or its affiliates' interests ahead of those of its non-affiliated clients.[116] Combined with section 206 of the Advisers Act and rule 206(4)-7 thereunder, the fiduciary obligation constitutes a meaningful prohibition on frontrunning and other trading practices through which an adviser uses affiliate relationships to disadvantage clients. This conclusion is apparent from frequent SEC enforcement actions against advisers that fail to heed their fiduciary and statutory obligations.[117]

B. Public Funds

While the Advisers Act relies on broad prohibitions rather than specific ones to address conflicts of interest arising from affiliate relationships, the Investment Company Act—a much longer and more detailed statute than the Advisers Act—focuses on specific practices, either prohibiting them or setting forth

113 *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Penalizes Investment Advisers for Compliance Failures (Nov. 28, 2011), [hereinafter SEC Enforcement Actions] https://www.sec.gov/news/press/2011/2011-248.htm ("The failure to adopt and maintain adequate compliance policies and procedures is a significant violation of the federal securities laws . . . .").

114 *See* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 716 (2010) ("[U]nder federal law, investment advisers . . . are always considered fiduciaries to their clients.").

115 *See id.* at 718 ("[T]he fiduciary standard generally employed by the courts requires that an adviser must act in the 'best interest' of its advisory client.").

116 *See* THOMAS P. LEMKE & GERALD T. LINS, 19 REGULATION OF FINANCIAL PLANNERS § 4:48 (Nov. 2022) (noting the SEC's position that an investment adviser must "[a]lways place client interests ahead of its own").

117 *See, e.g.*, SEC Enforcement Actions, *supra* note 113 (reporting enforcement actions against three investment advisers that failed to comply with applicable compliance obligations, including those set forth in rule 206(4)-7).

procedures for conducting them.[118] Accordingly, the associated SEC rules expressly address cross-transactions, which are transactions in which an adviser causes a public fund that it manages to buy or sell securities from an affiliate, usually an affiliated, "sister" fund.[119] Although the statute prohibits cross-transactions, the SEC's rules reflect that these transactions may be beneficial (or, at least, not harmful) to each of the transacting funds.

The regulation of cross-transactions begins with section 17(a) of the Investment Company Act, which prohibits any affiliate of a public fund (or any affiliate of an affiliate) from buying securities or other property from, or selling such property to, the fund or entering into similar transactions with the fund.[120] With this prohibition as the baseline, the SEC adopted rule 17a-7 under the Investment Company Act to permit cross-transactions in certain circumstances.[121] Specifically, the rule provides that public funds with a common investment adviser or with affiliated investment advisers may enter into cross-transactions with one another so long as (1) the transactions are at market price and consistent with the funds' respective investment strategies, (2) no brokerage fee or other transaction fee is charged in connection with the transaction, and (3) the board of directors of each fund determines, on a quarterly basis, that all cross-transactions effected during the quarter complied with "its"[122] fund's policies and procedures governing cross-transactions.[123]

There are two additional aspects of rule 17a-7 that are worthy of consideration. First, beyond the procedures the rule sets forth for permitting otherwise-prohibited transactions between two affiliated funds, the rule exemplifies securities regulation's defining approach to addressing conflicts of interest arising out of affiliate relationships. As the discussion in this Part shows, the securities laws and rules reflect that the actors within the securities realm often have numerous affiliates that perform various roles within that realm. However, they also recognize that, in some cases, affiliate relationships, and transactions among affiliates, can be efficiency-enhancing, such that strict prohibitions on affiliate transactions can create inefficiencies that can harm

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118 *See, e.g.*, 15 U.S.C. § 80a-12 (setting parameters for a fund's use of leverage).

119 *See* 17 C.F.R. § 270.17a-7 (2013) (setting forth an "[e]xemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof").

120 *See* 15 U.S.C. § 80a-17a.

121 *See* 17 C.F.R. § 270.17a-7 (specifying the procedures that an investment adviser and a fund's board of directors must follow in connection with cross-transactions).

122 "Its" is an imprecise term in this context because it implies that a public fund's board of directors actually owns the fund, which is not the case. The word's use in this context is intended to reflect only that each fund in a cross-transaction has its own board of directors.

123 *See* 17 C.F.R. § 270.17a-7.

investors, perhaps as much as conflicted transactions might. Recognizing the good and the bad of affiliate relationships has been a critical insight of policymakers in crafting the body of rules that govern these relationships.

Second, rule 17a-7 demonstrates the extent of the interconnectivity among financial affiliates: Although the regulation of cross-transactions is a subject of the Investment Company Act—the statute that governs public funds—and the SEC's rules pursuant to the Investment Company Act, the actors that typically cause violations of the relevant provisions are not actually public funds but, rather, the investment advisers that manage them.[124] In particular, by virtue of the requirements of the Investment Company Act, virtually every public fund is managed by a registered investment adviser.[125] And a fund's adviser is the actor responsible for buying and selling securities and other instruments on behalf of the fund (as well as for controlling almost all aspects of its operations).[126]

Therefore, the fund's adviser is also responsible for the decision to cause one fund that it manages to buy securities from or sell securities to a second fund that it manages. This is so even though rule 17a-7 is phrased broadly, referring only to cross-transactions themselves, not to the entity that causes them to happen.[127] Nevertheless, as noted in Part I,[128] a fund of any sort, public or private, has no officers or employees. Accordingly, it cannot act—cannot buy or sell securities, comply with regulatory obligations, or authorize additional shares—without the action of a third party, which, in most cases, is its

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[124] *See Compliance Corner*, NORTON ROSE FULBRIGHT (Dec. 31, 2015), https://www.nortonrosefulbright.com/en-us/knowledge/publications/d54cf154/compliance-corner (describing situations in which the SEC brought enforcement actions against investment advisers for violations of the Investment Company Act).

[125] *See, e.g.*, *What Are Mutual Funds?*, CAP. GRP., https://americanfundsretirement.retire.americanfunds.com/basics/what-is-a-mutual-fund.html (last visited Sept. 8, 2022) ("Mutual funds have investment advisers, which typically include professionals such as portfolio managers and investment analysts who do research on their shareholders' behalf.").

[126] *See* James Chen, *What Is a Fund Manager, Responsibilities, Career Path*, INVESTOPEDIA, https://www.investopedia.com/terms/f/fundmanager.asp (Feb. 17, 2021) ("A fund manager is responsible for implementing a fund's investing strategy and managing its portfolio trading activities."); *see also supra* notes 49–51 and accompanying text (describing the extensive control that investment advisers have over the public funds that they manage).

[127] The rule states, in relevant part, that:

> A purchase or sale transaction between registered investment companies . . . [that] are affiliated persons . . . of each other . . . solely by reason of having a common investment adviser or investment advisers which are affiliated persons of each other, common directors, and/or common officers, is exempt from section 17(a) of the [Investment Company] Act; [*p*]*rovided*, [t]hat . . . .

See 17 C.F.R. § 270.17a-7. The rule goes on to list several contingencies. *See id.*

[128] *See supra* notes 50–51 and accompanying text.

investment adviser.[129] Accordingly, when an adviser determines to cause two funds that it manages to transact with one another and, as a result, triggers the requirements of rule 17a-7, it is the adviser's de facto responsibility to notify the funds' boards of directors to begin the review process described above. If the adviser fails to do so, it will cause the funds (and their respective boards) to violate the Investment Company Act.

This interconnectedness of affiliates within the securities realm points to yet another circumstance that is unique to financial services. Public companies can act for themselves and, if they violate applicable laws, are responsible for those violations and can be held accountable by regulators and the public.[130] This is not the case in the financial industry—at least not within the large segment of that industry comprising public funds, which are the financial services counterpoint to public companies. The management of a public fund comes from an external entity—the fund's investment adviser—that may or may not have any ownership interests in the fund.[131] This means not only that the fund and its shareholders are disconnected from the entity that controls the fund's activities, but also that the fund's formal oversight mechanism—its board of directors—is similarly disconnected from that locus of control. As Part IV shows, this mutation of the corporate governance duo of ownership and control, which are usually components of a single entity,[132] has important implications for investor safety in affiliate world.

C. Broker-Dealers

The interconnections the previous section highlights are present also in the context of broker-dealer affiliations and the conflicts of interest arising from them. There is an important distinction between the public fund and broker-dealer contexts, however. In the case of public funds, the funds themselves are the direct subjects of regulation, even though that regulation may impose

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129 *See* Chen, *supra* note 126 (describing the role of investment advisers in managing public funds).

130 *See The Subtle Art of Holding the Board of Directors Accountable*, IBABS.COM (Oct. 26, 2021), https://www.ibabs.com/en/governance/holding-the-board-of-directors-accountable/#Financial_institutions_investors_and_other_stakeholders (describing the ways through which public companies and their boards of directors are held accountable).

131 *See supra* notes 49–51 and accompanying text.

132 *See What Is Corporate Structure?—Definition, Types & Examples*, STUDY.COM (Oct. 11, 2021), https://study.com/academy/lesson/what-is-corporate-structure-definition-types-examples.html#:~:text=In%20a%20corporation%2C%20these%20characteristics,is%20vested%20in%20the%20officers (noting that the primary functions of a corporation "are represented by three groups: shareholders, directors, and officers").

numerous obligations on the funds' investment advisers.[133] By contrast, in the case of broker-dealers that are affiliated with investment advisers, the regulation of affiliated brokerage activity occurs not through the formal regulation of broker-dealers themselves but via statutory and rule-based requirements governing both the affiliated investment advisers and the public funds those advisers manage.

The Advisers Act forthrightly addresses situations in which an investment adviser may wish to execute client trades using an affiliated broker-dealer. Once again, section 206 of the statute does the work, as an encompassing antifraud provision.[134] That section is relevant not only for the circumstance in which an adviser or an affiliated entity trades in the same securities as the non-affiliated funds that it manages, which is the subject of Section II.A, above.[135] It also encompasses a situation in which the adviser desires to cause an advisory client to buy securities from or sell them to an affiliated broker-dealer acting as principal—that is, for its own account.[136] The section prohibits these transactions unless the adviser, before completing the trade, discloses to the relevant clients the capacity in which it is acting—namely, as a conflicted party given the affiliate relationship—and obtains the clients' consent to proceed with the transaction.[137]

Although section 206 does not expressly address transactions in which an affiliated broker-dealer acts as an agent, rule 206(3)-2 under the Advisers Act fills that gap on the basis that, like principal transactions *with* an affiliate, agency transactions *through* an affiliate present risks to investors.[138] The rule prohibits an adviser from executing a transaction using an affiliated broker-dealer on an agency basis unless, among other things, the adviser provides written disclosure to its clients, obtains "best execution" from the affiliated broker—meaning the broker provides the most advantageous execution terms as compared with terms available from other brokers—and obtains client consent prior to the completion

133 *See supra* notes 127–29 and accompanying text (describing how the compliance obligation in connection with cross-transactions rests with a fund's investment adviser, rather than the fund itself).

134 *See supra* notes 127–29.

135 *See supra* notes 103–16 and accompanying text.

136 *See* 15 U.S.C. § 80b-6.

137 *See id.* (prohibiting an investment adviser's "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction").

138 *See generally* 17 C.F.R. § 275.206(3)-2 (1986).

of the transaction.[139] A second, more streamlined option that is not available for principal transactions is for the adviser to obtain, from each relevant client, blanket, prospective consent for all agency transactions that the adviser may wish to execute through a broker-dealer affiliate.[140]

Regardless of whether an adviser uses an affiliated broker-dealer for agency transactions, principal transactions, or both, the idea behind section 206 and the associated rules is similar to the concept that inspires the regulation of cross-transactions by public funds. If a client consents to a conflicted transaction after knowing the relevant information, that fact dissipates any risks posed by the conflict. In other words, the securities laws not only recognize the conflicts of interest inherent in an industry dominated by affiliate relationships but also seek to manage those conflicts to the benefit of both investors and financial intermediaries.

Other statutes also play a role in managing conflicts of interest arising from affiliations between investment advisers and broker-dealers. For example, if the relevant advisory client is a public fund, rule 17e-1 under the Investment Company Act comes into play.[141] That rule provides a safe harbor from the restrictions in section 17(e)(2) of the statute, which prohibits a broker-dealer from receiving compensation from an affiliated public fund that exceeds the "usual and customary" brokerage commission.[142] Under the terms of the safe harbor, the brokerage commissions that the fund pays must be reasonable and fair, and the fund's board must determine on a quarterly basis that any transactions implicating section 17(e)(2) during the previous quarter complied with the fund's policies relating to affiliated broker transactions.[143]

There are a number of other conflicts of interest that may arise from an affiliation between an investment adviser and a broker-dealer. However, as in the other circumstances discussed in this Part, the securities laws and associated rules attempt to mitigate those conflicts and ensure that they do not harm investors. Beyond what the statutes and rules are themselves able to achieve in

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139 *See id.* § 275.206(3)-2(a), (c) (setting forth the requirements for agency trades using an affiliated broker-dealer).

140 *See id.* § 275.206(3)-2(a)(1) (permitting agency trades if, among other things, "[t]he advisory client has executed a written consent prospectively authorizing the investment adviser, or any other person relying on this rule, to effect agency cross transactions for such advisory client").

141 17 C.F.R. § 270.17e-1 (1986).

142 *See* 15 U.S.C. § 80a-17(e) ("It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person . . . acting as broker, in connection with the sale of securities to or by such registered company . . . to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds . . . the usual and customary broker's commission . . . .").

143 *See* 17 C.F.R. § 270.17e-1 (describing the conditions of the safe harbor).

this regard, there remains the fact that the SEC examines all registered investment advisers, public funds, and broker-dealers on a regular basis.[144] Moreover, the existence of an affiliate relationship between an investment adviser and a broker-dealer increases the likelihood of the SEC's examinations of those firms, which provides a backstop to their regulatory obligations.[145] Although the focus of SEC oversight is ensuring that firms' day-to-day procedures and protocols comply with relevant laws and rules,[146] as the next Part shows, this oversight cannot easily help investors that are harmed by affiliate relationships.

III. BACK-END REMEDIES

Investors are harmed by affiliate relationships when the conflicts of interest created by those relationships require them to pay inflated prices for securities or interest at above-benchmark rates when they borrow funds from others. Investors are also harmed by affiliate relationships when they are required to accept deflated prices when they sell securities or discounted interest rates when they lend funds to others. Because these relationships are so common in the financial industry, investors—whether in the form of advisory clients, public fund shareholders, or brokerage customers—bear the risk of this harm whenever they rely on investment advisers, public funds, or broker-dealers to help them invest their capital in the securities markets. Fortunately, as the previous Part discusses, the securities laws contain various mechanisms to contain this risk.

Yet there are circumstances that are the product not of everyday life in the securities markets but of fraud, recklessness, and negligence. These are the situations in which the securities laws will not necessarily come to the rescue because the resolution of them relies on remedies outside of the securities realm, usually sounding in corporate law and its unavoidable focus on the entity. Accordingly, when these situations arise, investors may be harmed in ways that the securities laws have no means of addressing, at least not at present. What these situations are and how they harm investors is the subject of this Part, which presents three case studies that reveal the limits of corporate law principles.

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144 *See ComplianceAlert*, U.S. SEC. & EXCH. COMM'N (Jul. 2008) [hereinafter SEC ComplianceAlert], https://www.sec.gov/about/offices/ocie/complialert0708.htm ("The SEC staff conducts compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents and other types of registered firms 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.").

145 *See* 2021 EXAMINATION PRIORITIES: DIVISION OF EXAMINATIONS, U.S. SEC. & EXCH. COMM'N 19 (2021), https://www.sec.gov/files/2021-exam-priorities.pdf (noting that "dually-registered or affiliated firms" were among the SEC's 2021 examination priorities).

146 *See* SEC ComplianceAlert, *supra* note 144 (describing the purpose of SEC examinations).

A. Derivative Litigation

One way the securities laws address investment advisers' conflicts of interest that stem from affiliate relationships is through the fiduciary duty that it imposes on all advisers.[147] However, when an adviser breaches its fiduciary duty to clients and, as a result, injures them, the question arises as to what remedies may be available. Although an SEC enforcement action against the adviser may produce an end to the breach, it does not have a means of aiding investors.[148] Because of this limitation, the lever that investors may pull to seek redress is the same as that available to anyone: a lawsuit.[149] Because courts rely on corporate law doctrine in adjudicating these actions, however, the usefulness of this tool for investors has been limited.

An investment adviser's failure to uphold the fiduciary duty it owes to a public fund that it manages does not also constitute a breach of a fiduciary duty owed to the fund's shareholders because the adviser owes no such duty directly to shareholders.[150] After all, for regulatory purposes, they are not clients of the adviser.[151] The harm that shareholders experience, therefore, is indirect, a consequence of the harm to the fund as a result of the breach.

In these cases, courts have generally determined that any lawsuit brought by shareholders against the adviser should proceed in the first instance as a derivative action,[152] meaning as a lawsuit brought by the shareholders to enforce a claim on behalf of the fund.[153] Typically, because of the so-called demand requirement, the shareholders must bring the claim against the fund itself and,

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[147] *See supra* notes 113–16 (describing the fiduciary duty to which investment advisers are subject).

[148] *See Investor Bulletin: How Victims of Securities Law Violations May Recover Money*, U.S. SEC. & EXCH. COMM'N (June 21, 2018), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_recovermoney.html.

[149] *See id.* (noting that "private class action lawsuits" are among the tools investors may use to remedy harms).

[150] *See* George T. Lee, *SEC Clarifies Fiduciary Duty of Private Equity Fund Managers*, CARRINGTON COLEMAN (Feb. 1, 2020), https://www.ccsb.com/sec-clarifies-fiduciary-duty-of-private-equity-fund-managers/ (observing that an investment adviser owes a fiduciary duty to its clients and noting that the duty requires, among other things, that a "fund manager serve the best interest of the fund and not subordinate the *fund's* interest to those of the manager or its affiliates" (emphasis added)).

[151] *See, e.g.*, *Enforcement Proceedings*, SEC NEWS DIG. (Feb. 5, 2010), https://www.sec.gov/news/digest/2010/dig020510.htm (referring to investment advisers' "hedge fund clients").

[152] *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1025–26 (2005) ("By and large, courts have found most claims of breach of fiduciary duty under the [Investment Company Act] to be ones where the harm is to the fund rather than shareholders and hence must be brought derivatively, which is consistent with corporate law as generally understood." (footnote omitted)).

[153] *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 398–99 (6th ed. 2010) (noting that a derivative claim is "an action on behalf of the corporation for harm to it").

more importantly, its board of directors.[154] In such circumstances, the claim seeks to compel the board to sue the investment adviser on behalf of the fund.[155] In effect, the derivative action doctrine ensures that the entity that suffered the harm directly—the fund—is also the entity with the cause of action against the investment adviser. If the independent members of the board of directors determine not to pursue the litigation, then, in most cases, the derivative lawsuit terminates.[156]

The requirement that public fund shareholders pursue claims against the fund's investment adviser derivatively, rather than directly, is neither contained in the securities laws nor endorsed by them. Rather, the concept of derivative litigation is a distinctly corporate law concept, with the specific procedures for such litigation set forth in each state's corporation statute and associated case law.[157] That shareholders usually must follow demand procedures in seeking redress for the harm the adviser did to the fund parallels the procedures that shareholders of a public company must follow in seeking remedies for harms against the company by its management or others, to the extent the company does not pursue those remedies itself.[158]

There are significant differences between the public fund context and the public company context, however, which arise from the fact that financial intermediaries, including public funds, have extensive affiliate relationships and that most states' demand requirements effectively allow a fund's board of

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154 *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 386 (2002) ("Although the demand requirement looks like a mere procedural formality, it has evolved into the central substantive rule of derivative litigation.").

155 *See* Allright Mo., Inc. v. Billeter, 829 F.2d 631, 638 (8th Cir. 1987) ("The demand requirement . . . serves the purpose of notifying management so that it can make the initial decision as to the type of action that should be taken, be it a lawsuit or some other form of corrective action, to resolve the problem at hand.").

156 *See* Spiegel v. Buntrock, 571 A.2d 767, 775 (Del. 1990) ("[O]nce a demand has been made, absent a wrongful refusal, the stockholders' ability to initiate a derivative suit is terminated." (quoting Stotland v. GAF Corp., 469 A.2d 421, 422 (Del. 1983))). Despite the demand requirement, in some states, investors are exempted from complying with it and may pursue the lawsuit directly if the court determines that demand is futile, meaning that the board is not sufficiently disinterested or independent to make an unbiased determination as to the merits of the action. *See* WILLIAM MEADE FLETCHER, 13 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5965 (perm. ed., rev. vol. 2004 & Supp. 2011) ("In some jurisdictions, demand on directors . . . to pursue litigation on a corporate cause of action or take other suitable action is not a precondition to a derivative proceeding if the plaintiff can establish the futility of demand.").

157 *See Shareholder Derivative Litigation*, BOTTINI & BOTTINI, INC., http://www.bottinilaw.com/shareholder-derivative-litigation (last visited Jan. 23, 2022) (noting that "[s]hareholder derivative actions are based on state corporate law").

158 *See* Langevoort, *supra* note 152, at 1026–27 (noting the Supreme Court's holding in *Burks v. Lasker*, 441 U.S. 471, 478 (1979), that "[Investment Company Act] claims touching on corporate governance should look to state law where the matter is not specifically addressed in the Act" and pointing out that "there is no federal common law of corporations for mutual funds").

directors to terminate a derivative lawsuit by refusing to pursue it on behalf of the fund. As discussed in Part II, entity boundaries are not as meaningful in the financial industry as they are in others. The investment adviser to a public fund plays an outsized role in the creation and operation of the fund simply because of how public funds are structured. Unlike a public company, they have no founding entrepreneurs, no officers, and no employees.[159] A public fund is simply a shell in which investors place assets to be managed by the fund's adviser, and it is the adviser that effectively serves as the fund's officers and employees.[160] In addition, as noted previously, the adviser determines who will be on the fund's initial board of directors[161]—and, indeed, it is not a leap to suggest that the adviser might be deemed an affiliate of the board, just as it is an affiliate of the fund. This is the case even though most or all of the board members may be nominally "disinterested," with no relationships or connection to the investment adviser or its employees beyond their board memberships.[162]

Nevertheless, courts have not regarded these factors as sufficiently important to alter the principle that the demand requirement governs lawsuits brought by public fund shareholders in the same way that it governs lawsuits brought by shareholders of a public company. In the 1979 case, *Burks v. Lasker*,[163] the Supreme Court set forth the governing doctrine. The Court's task in that case was to determine whether state law governs the power of the disinterested members of a public fund's board of directors to terminate a derivate lawsuit brought by the fund's shareholders or whether, by contrast, federal law—meaning the Investment Company Act and the Advisers Act—governs that power.[164] In *Burks*, the plaintiffs had alleged violations of both the Investment Company Act and the Advisers Act against both the investment adviser and the

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[159] *See* Burks v. Lasker, 441 U.S. 471, 480–81 (1979) (observing that "[m]utual funds, with rare exception, are not operated by their own employees" but instead are "formed, sold, and managed by external organizations" (citing S. Rep. No. 91-184, at 5 (1969))).

[160] *See* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977) (observing that "[a] mutual fund is a 'mere shell,' a pool of assets consisting mostly of portfolio securities that belongs to the individual investors holding shares in the fund" and that "[t]he management of this asset pool is largely in the hands of an investment adviser, an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff").

[161] *See supra* notes 50–52 and accompanying text (describing the extensive control that investment advisers have over the public funds that they manage).

[162] For purposes of the Investment Company Act, a director of a public fund is disinterested if, among other things, neither he nor she nor any member of his or her immediate family is otherwise an affiliated person of the public fund. *See* 15 U.S.C. § 80a-2(a)(19) (defining "interested person" of a public fund).

[163] 441 U.S. 471.

[164] *Id.* at 473 ("The question presented in this case is whether the disinterested directors of an investment company may terminate a stockholders' derivative suit brought against other directors under the Investment Company and Investment Advisers Acts . . . .").

board of directors of a public fund of which they were shareholders.[165] The Court determined that, in such suits, federal courts should apply state corporate law concerning the board's authority to terminate a derivative suit to the extent that that law is consistent with the policies behind the investment statutes.[166] It reached this conclusion on the basis that the statutes do not prohibit state or federal courts from terminating these types of actions, including ones that are likely meritorious.[167]

The Court's reasoning was based on the logic that the Investment Company Act "does not purport to be the source of authority for managerial power" within a public fund "but instead functions primarily to impose controls and restrictions" on public funds' internal management.[168] The Court further reasoned that, because corporations, including public funds, are "creatures of state law," it is state law that is the source of boards' powers.[169] Federal law, by contrast, is mostly "regulatory and prohibitory in nature," frequently limiting directors' authority but "rarely" creating it.[170] Because of these considerations, the Court further determined that the appellate court had erred in concluding that state law governing derivative actions is consistent with the statute only if it forbids the board's termination of meritorious lawsuits.[171]

This result should not be surprising. Given that public funds are a type of public entity and that, as the Court notes, the relevant securities laws do not purport to govern the relationship between fund directors and shareholders—a relationship that is fundamentally the subject of corporate law—the Court merely went where precedent and public policy led. Nevertheless, that ending point and the doctrine that lends it support counter investor interests.

The difficulty with extending to public funds the doctrine that applies to public companies is that, in terms of how public funds and public companies

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[165] *Id.* (noting that "[t]he action was brought against several members of the company's board of directors and its registered investment adviser" and that "[t]he complaint alleged that the defendants had violated their duties under the Investment Company Act . . . , the Investment Advisers Act . . . , and the common law" (footnotes omitted)).

[166] *Id.* at 471.

[167] *Id.* at 486 ("[W]e hold that Congress did not require that States, or federal courts, absolutely forbid director termination of all nonfrivolous actions.").

[168] *Id.* at 471–72.

[169] *Id.* at 478 (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).

[170] *Id.*

[171] *Id.* at 475 (noting disagreement with the appellate court's holding that "disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties" (quoting Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978))).

operate internally, comparing one to the other is akin to comparing apples and oranges. As suggested above, in the public fund context, the entity almost does not matter other than as an efficiency mechanism that enables an investment adviser to simultaneously manage the capital of multiple investors. If the entity did not exist, in theory the adviser would be left to manage, separately but inefficiently, each investor's separate account. But the result would be nearly the same. This is the case especially because all but the largest investment advisers manage all assets under their management, whether through public funds or otherwise, using similar investment strategies. Public companies, by contrast, are not merely tools of convenience but instead contain within them functioning business operations and officers and employees to carry out those operations. In other words, public companies are essential to their purpose, whereas public funds are not.

The fact that control of a public company rests within the company—specifically, with the company's officers and board of directors—as opposed to deriving from a wholly independent entity should matter for purposes of holding that independent entity accountable. Indeed, Congress has seemingly concurred with this proposition, observing that, because a public fund cannot terminate its relationship with its investment adviser, "the forces of arm's-length bargaining do not work in the [public] fund industry in the same manner as they do in other sectors of the American economy."[172] There are simply too many conflicts of interest.[173]

The problem with the *Burks* holding is not that the Court failed to consider these factors. It did.[174] The problem is that, in regarding these factors as insufficient to uphold the appellate court's decision, the Court leaned heavily on the notion that the Investment Company Act addresses the conflicts-of-interest problem by requiring that at least 40% of a public fund's directors be independent outside directors[175] and by making the board responsible for such things as approving the fund's contracts with its investment adviser, appointing other disinterested directors to fill board vacancies arising from the adviser's assignment of its contract with the fund, and selecting the fund's accountant.[176]

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[172] S. REP. NO. 91-184, at 5 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.

[173] *See* Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976) ("The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest.").

[174] *See Burks*, 441 U.S. at 481–82.

[175] *See* 15 U.S.C. § 80a-10 (providing that no public fund can have a board of directors with more than 60% "interested persons"); *Burks*, 441 U.S. at 481–83.

[176] *See Burks*, 441 U.S. at 483 ("[The Board] ha[s] the duty to review and approve the contracts of the investment adviser[;] . . . the responsibility to appoint other disinterested directors to fill vacancies resulting from the assignment of the advisory contracts; and [is] required to select the accountants who prepare the [investment]

In focusing on the board independence requirement, the Court seemingly ignored the point that it was ostensibly refuting, namely that, in the public fund context, there can be no truly independent directors because all board authority ultimately stems from the investment adviser. In addition, the Court's pointing to specific statutorily mandated board responsibilities adds nothing to its reasoning because those responsibilities are not unique to public fund boards but are instead appropriate functions of *all* corporate boards.[177] Again, however, in arriving at its decision, the Court merely used the doctrinal tools at its disposal.

More broadly, the problem with *Burks v. Lasker* and courts' continuing support of the demand requirement in the public fund context is the intractable assumption that an entity that is only formally a public company, which describes a public fund, must be treated as a public company for all purposes, rather than as a convenience mechanism that should be disregarded for purposes of adjudicating investor allegations of harm. The problem is also that the entity-centrism of U.S. jurisprudence pervades a context that is regulatory in nature, rather than corporate-governance oriented, and requires all but ignoring the extensive relationships among affiliated financial intermediaries. Only by moving beyond the entity and the associated corporate law doctrine can courts align their evaluation of investor claims with the policies animating financial services regulation.

B. Compensating Investor Losses

As the previous section demonstrates, courts often look to corporate law to provide remedies for harms to investors in the financial industry. Nevertheless, the securities laws themselves also provide remedies for certain types of investor harm. Indeed, one statute, the Securities Investor Protection Act of 1970 ("SIPA"),[178] has as its sole purpose compensating investors in their capacities as customers of a broker-dealer that has become insolvent.[179] The appropriateness of such a statute is apparent when one considers how some brokerage firms operate. As discussed in Part II, firms that are regulated as broker-dealers may

company's Securities and Exchange Commission financial filings." (first citing 15 U.S.C. § 80a-15(c); then citing 15 U.S.C. § 80a-16(b); and then citing 15 U.S.C. § 80a-31(a))).

[177] *See* Business Roundtable, *Principles of Corporate Governance*, HARV. L. SCH. F. CORP. GOVERNANCE (Sept. 8, 2016), https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance/ (describing the key responsibilities of a public company's board of directors).

[178] 15 U.S.C. §§ 78aaa–78lll.

[179] *See Securities Investor Protection Act (SIPA)*, U.S. CTS. [hereinafter *SIPA*, U.S. COURTS], https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/securities-investor-protection-act-sipa (last visited Sept. 2, 2022) (noting that SIPA "is designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of financial failure of the member").

have a range of business activities.[180] One important service they provide is executing transactions on behalf of investors who have opened brokerage accounts and placed capital in those accounts.[181] Such a brokerage firm, therefore, is deemed to have "custody" of investor funds and securities.[182] In these contexts, when an investor notifies the firm that she wishes to buy or sell particular securities, the firm deploys assets in her account to effect the trade, whether that means selling securities from the account or purchasing securities using cash held in the account.[183]

Executing trades on behalf of investors is not the only function custodial broker-dealers typically perform, however. To the extent an investor requires additional funds to complete her desired securities purchase, she is typically able to borrow those funds, called "margin," from the brokerage firm.[184] Likewise, if the investor desires to sell certain securities "short," she is able to borrow the necessary securities from the firm, eventually paying off the loan with replacement securities that she buys in the open market.[185] The deal that a brokerage firm usually strikes with its customers who wish to leverage their accounts through borrowing funds and securities is that, in exchange for allowing them to do so, the firm has the authority to borrow securities and cash from the customers' accounts to use in connection with its own trading activities.[186] Just as a customer may be indebted to the firm, therefore, the firm may also be indebted to the customer.

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[180] *See supra* notes 57–65 and accompanying text (describing various functions performed by broker-dealers).

[181] *See, e.g.*, Brian Beers, *How to Choose a Broker*, INVESTOPEDIA, http://www.investopedia.com/articles/younginvestors/06/firstbroker.asp (June 30, 2022) ("Because securities exchanges only accept orders from individuals or firms who are members of that exchange, you need a broker to trade for you—that is, execute buy and sell orders.").

[182] *See* Nikhilesh De, *The SEC Is Still Working Out what 'Qualified Custodian' Means for Crypto*, COINDESK.COM (Nov. 16, 2020, 5:13 AM) ("The term 'qualified custodians' is a legal one, defined by the SEC as a bank, broker-dealer, futures commission merchant or other entity that maintains client funds and securities in specific ways.").

[183] *See* Beers, *supra* note 181 (describing broker-dealers' role in buying and selling securities).

[184] *See Margin: Borrowing Money to Pay for Stocks*, U.S. SEC. & EXCH. COMM'N (April 17, 2009), www.sec.gov/investor/pubs/margin.htm ("'Margin' is borrowing money from your broker to buy a stock and using your investment as collateral.").

[185] In a short sale, an investor sells securities she does not own based on the belief that they will decrease in value, at which point she will buy the securities in the open market, pay off her loan from the brokerage firm, and profit from the difference between the cost of the securities at the time she sold them and their cost at the time she bought them to cover her loan. *See* Brian Beers, *Short Selling Basics*, INVESTOPEDIA, http://www.investopedia.com/articles/investing/100913/basics-short-selling.asp (June 28, 2021).

[186] *See* Julia Kagan, *Rehypothecation*, INVESTOPEDIA, http://www.investopedia.com/terms/r/rehypothecation.asp (May 27, 2020) ("Rehypothecation is a practice whereby banks and brokers use, for their own purposes, assets that have been posted as collateral by their clients.").

That a brokerage firm is able to use customer accounts in this manner is generally not problematic to the extent the firm remains solvent. By the same token, if the firm becomes insolvent at a time when it holds debt owed to its customers, insolvency may be devastating because, at the time of insolvency, the firm, by definition, has insufficient assets to pay its debts.[187] In those circumstances, SIPA steps in to make the customer-lenders whole, subject to certain limitations.[188] Its tool for doing so is an insurance pool of sorts, funded by custodial broker-dealers in their capacities as mandatory members of the Securities Investor Protection Corporation ("SIPC"), a non-profit entity that, pursuant to SIPA's requirements, operates SIPA's insurance scheme.[189]

This approach makes sense as far as it goes. However, because SIPA is entity-focused and does not contemplate the sorts of affiliate relationships that characterize the financial industry, the statute cannot fulfill the investor-protection objectives that were the foundation of Congress's adoption of it. This became evident during the resolution of investor claims after the 2009 revelation of the Ponzi scheme carried out by Stanford Financial Group ("SFG"), a financial services enterprise comprising multiple entities and performing varied tasks.[190]

The relevant facts in the Stanford case involved two entities within the Stanford enterprise, which Allen Stanford owned and controlled.[191] One entity, Stanford Group Company ("SGC"), was a U.S.-based broker-dealer.[192] It was also a SIPC member and therefore made the required contributions to the SIPA insurance pool, even though it did not accept customer deposits and, because of

187 *See* Noah Melnick, Gary Barnett, Stephen Culhane, Stanford Renas & Don Macbean, *Prime Broker Insolvency Risk: After the Fall: What Next?*, HEDGE FUND J. (2008), https://thehedgefundjournal.com/prime-broker-insolvency-risk/. At that point, like all unsecured creditors, customers must resort to the court system to retrieve what is owed to them, by submitting a claim to the estate's administrators. *See SIPA*, U.S. COURTS, *supra* note 179 (describing the claim process for brokerage customers).

188 *See SIPA*, U.S. COURTS, *supra* note 179.

189 *See* Will Kenton, *Securities Investor Protection Corporation (SIPC)*, INVESTOPEDIA, https://www.investopedia.com/terms/s/sipc.asp (Apr. 29, 2022); *see SIPC Mission*, SEC. INV. PROT. CORP., https://www.sipc.org/about-sipc/sipc-mission (last visited Sept. 22, 2022) ("In a liquidation under the Securities Investor Protection Act, SIPC and the court-appointed Trustee work to return customers' securities and cash as quickly as possible."). As an acronym, SIPC is pronounced "Sip-ick."

190 *See* Peter J. Henning, *Compensating Stanford's Investors*, N.Y. TIMES: DEALBOOK (June 20, 2011, 3:04 PM), http://dealbook.nytimes.com/2011/06/20/compensatingstanfords-investors/ (describing Allen Stanford's Ponzi scheme and the SEC's efforts to help Stanford's investors recover losses suffered as a result of the scheme).

191 *See* SEC v. Sec. Inv. Prot. Corp., 872 F. Supp. 2d 1, 2 (D.D.C. 2012).

192 *See id.* (describing SGC and its role in the Stanford enterprise).

that, was not required to be a SIPC member.[193] The second entity, Stanford International Bank Limited ("SIBL"), was an Antiguan bank that was not subject to SIPA because it was not a U.S. entity.[194] However, unlike SGC, SIBL accepted investor deposits.[195]

The activities of SGC and SIBL were coordinated, in that Mr. Stanford used SGC to promote certificates of deposit ("CDs") issued by SIBL, which thus was the entity with which purchasing investors deposited their capital.[196] Given that SIBL performed no promotion function of its own, SGC's role was critical for procuring purchasers for the CDs.[197] Like most CDs, the Stanford CDs were to have produced earnings based on an advertised interest rate over a specified period.[198] However, rather than cause SIBL to use investor deposits for legitimate purposes—in this case, conservatively investing them to realize the returns promised to investors—Mr. Stanford used them for his own purposes and relied on new investor deposits to pay investors who wished to redeem their CD holdings.[199]

Upon regulators' discovery of the fraud in 2009 and investors' concurrent realization that they had lost whatever principal they had deposited with SIBL to buy the CDs, one urgent question was whether Stanford's victims were entitled to compensation under SIPA. Believing that they were—after all, SGC had held itself out as a SIPC member—the SEC asked SIPC to commence liquidation proceedings under SIPA,[200] which was a critical element given that,

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193 *See id.* at 7–8 ("Stanford Group Company ('SGC') was a . . . broker-dealer that was registered with the Commission and a member of SIPC.").

194 *See id.* at 5, 7 (noting that SIBL, "the Antiguan entity that issued the fraudulent CDs[,] was not a SIPC member" and that "SIBL's products" were not "covered by the investor protection or securities insurance laws of any jurisdiction such as the U.S. Securities Investor Protection Insurance Corporation").

195 *See id.* at 7 (observing that "SIBL offered [CDs] to investors" and that, "[i]n order to purchase a SIBL CD, . . . investors wrote checks that were deposited into SIBL accounts").

196 *See id.* at 2 ("The [SIBL] CDs were marketed by Stanford Group Company . . . .").

197 *See id.* at 2, 7–8, 11 (describing SGC's role as "introducing broker" in the Stanford Ponzi scheme).

198 *See* James Quinn, *FBI Believes Stanford Was Running Massive Ponzi Scheme*, TELEGRAPH (Feb. 20, 2009, 8:51 PM), https://www.telegraph.co.uk/finance/financetopics/sir-allen-stanford/4737012/FBI-believes-Stanford-was-running-massive-Ponzi-scheme.html ("More than 50,000 customers are understood to have invested in Sir Allen's certificate of deposits (CDs), which are essentially medium-term savings products usually offering a fixed rate of interest.").

199 *See Sec. Inv. Prot. Corp.*, 872 F. Supp. 2d at 2 (noting that Mr. Stanford allegedly "misappropriated billions of dollars and operated a fraudulent 'Ponzi scheme'—in which obligations of the CDs were paid using the proceeds from the sale of new CDs rather than from earnings, liquid assets or reserves").

200 *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Concludes That Certain Stanford Ponzi Scheme Investors Are Entitled to Protections of SIPA: Analysis of Securities Investor Protection Act Coverage for Stanford Group Company 14 (June 15, 2011), https://www.sec.gov/rules/other/2011/stanford-sipa-analysis.pdf ("[T]he Commission has authorized its staff to file in district court an application under Section 11(b) of SIPA to compel SIPC to initiate a liquidation proceeding in the event SIPC refuses to do so.").

under SIPA, victims have no right independent of the SEC to seek SIPC compensation.[201] Nevertheless, for the first time in its history, SIPC declined to comply with the SEC's request on the basis that the harmed investors had suffered no losses at the hands of SGC, which was the only SFG entity that was a SIPC member.[202] Rather, SIBL, as the entity that served as custodian by accepting investors' deposits, was the source of the losses—and, as a non-U.S. entity, was not and could not be a SIPC member.[203] Both the U.S. District Court for the District of Columbia and the D.C. Circuit Court of Appeals agreed with SIPC's conclusion, while also noting that they were "truly sympathetic to the plight of the SGC clients who purchased the SIBL CDs and now find themselves searching desperately for relief."[204]

Despite the apparent unfairness of the outcome in the Stanford episode, that outcome is surely correct. SIPA covers losses experienced by investors that have "entrusted cash or securities to a broker-dealer that becomes insolvent."[205] Because investors did not entrust their assets to SGC, the only SIPC member within the Stanford enterprise, under the statute they were not entitled to compensation.[206]

The takeaway is that, in a (fictitious) world in which financial firms are disparate entities, unconnected to one another through affiliate relationships, SIPA does what it is supposed to do. Had Stanford's investors paid sufficient attention to entity distinctions, they might have discerned that the entity to which they directed their funds was not the same entity as the one with the "SIPC" notation under its name. Indeed, at least some of them may have understood this distinction; the record is not clear on the point.[207] Yet even if they did, should they have been expected also to understand that the protection provided by SIPA

201 *See* Sec. Inv. Prot. Corp. v. Barbour, 421 U.S. 412, 412 (1975) ("Customers of failing broker-dealers have no implied right of action under the SIPA to compel the SIPC to act for their benefit, the SEC's statutory authority to compel the SIPC to discharge its obligations being the exclusive means by which the SIPC can be forced to act.").

202 *See* SEC v. Sec. Inv. Prot. Corp., 758 F.3d 357, 358 (D.C. Cir. 2014) (noting SIPC's conclusion that the CD investors did not qualify as "customers" of SGC under SIPA); *Sec. Inv. Prot. Corp.*, 872 F. Supp. 2d at 2, 7 ("[T]his proceeding is the first instance since SIPA was enacted 42 years ago in which the SEC has sought to use its 'plenary authority' to compel the SIPC to file an application for a protective decree.").

203 *See supra* note 191 and accompanying text (describing SIBL's status as a non-U.S. entity that was not a SIPC member).

204 *Sec. Inv. Prot. Corp.*, 758 F.3d at 369 (quoting *Sec. Inv. Prot. Corp.*, 872 F. Supp. 2d at 12).

205 *In re* Brentwood Sec., Inc., 925 F.2d 325, 327 (9th Cir. 1991).

206 *See Sec. Inv. Prot. Corp.*, 872 F. Supp. 2d at 8, 12.

207 *See Sec. Inv. Prot. Corp.*, 758 F.3d at 368 (noting SIPC's contention that "investors could not *reasonably* have believed they were depositing funds with SGC in light of CD disclosure statements clearly stating that the CDs were issued by a non-SIPC member").

to customers of SGC—the entity that convinced them to buy the CDs—did not extend to customers of SIBL? Perhaps, in formulating SIPA, Congress believed that investors would understand these nuances. It is more likely, however, that Congress simply did not consider them.

The better question may be whether Mr. Stanford appreciated the likelihood that investors would not understand the risk they would bear by sending funds to an affiliate of SGC, rather than to SGC itself. Perhaps he did realize the peril but proceeded anyway, on the basis that, for marketing purposes, it was desirable for the firm charged with selling the CDs to investors—namely, SGC—to have the imprimatur of SIPC membership. In this scenario, Mr. Stanford, as a Ponzi-schemer, may not have cared whether investors would actually have the benefit of SIPA coverage. Or perhaps, like the investors themselves (presumably), he himself did not understand the problematic interplay between SIPA and a multi-entity enterprise. Although it is impossible to speculate about Mr. Stanford's knowledge or his motives in organizing the Stanford enterprise, there is no speculation that, in affiliate world, SIPA falls far short of accomplishing its objectives.

C. Securities Fraud

The relationship among affiliates is likewise not accounted for in addressing claims of securities fraud—that is, fraud against investors in connection with their purchases and sales of securities. Although Congress designed the antifraud provisions of the securities laws specifically to apply to fraud committed by financial intermediaries,[208] in applying those provisions, courts have deployed the entity-centrism of corporate law in ways that do not acknowledge the dominance of affiliate relationships in the financial industry. Accordingly, in this context, too, courts have inappropriately denied recoveries that investors should have received given the interwoven activities of financial intermediaries.

Section 10(b) of the Exchange Act[209] and rule 10b-5 under the Exchange Act[210] are the provisions that support most investor fraud claims because they are all-purpose and because they impliedly create a private right of action.[211] Section 10(b) renders unlawful using deception in any securities transaction in

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[208] *See supra* Part II.

[209] 15 U.S.C. § 78j(b).

[210] 17 C.F.R. § 240.10b-5 (2014).

[211] *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), was the first case that read an implied right of action into rule 10b-5. *See id.* at 514 ("[I]n view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies.").

contravention of the SEC's rules adopted pursuant to that section.[212] Rule 10b-5, for its part, prohibits anyone from, among other things, making "any untrue statement of a material fact" in connection with a securities transaction.[213] Investors in both public entities and private ones routinely rely on these provisions in lawsuits against companies and their management where the claims are that deceptive company press releases or other public statements caused them to take action—usually buying or selling the company's securities—that produced losses when the truth eventually came to light.[214]

Janus Capital Group, Inc. v. First Derivative Traders,[215] a 2011 Supreme Court case, presents a prominent example of investors' reliance on section 10(b) and rule 10b-5. The complaint in that case was brought by shareholders of Janus Capital Group, Inc. ("JCG"), a public company that operates a mutual fund business, against JCG and Janus Capital Management, LLC ("JCM"), one of JCG's wholly-owned subsidiaries whose purpose was to serve as the investment adviser to Janus mutual funds, each of which was organized as a series of shares within a Massachusetts business trust, Janus Investment Fund (the "Fund").[216] As suggested in Part II, this organizational structure, in which a holding company (JCG) creates other entities to directly provide investment advisory or brokerage services, is common in the public fund industry, particularly where the holding company is publicly-held.[217] In addition, typical of almost all public fund structures, JCM was an affiliate of the Fund by virtue of the contractual relationship between the two entities.[218] Also typical of most public fund

212 *See* 15 U.S.C. § 78j(b).

213 17 C.F.R. § 240.10b-5(b).

214 *See* James Chen, *Rule 10b-5*, INVESTOPEDIA, https://www.investopedia.com/terms/r/rule-10b5.asp (Mar. 31, 2021) ("Violations of the rule include executives making false statements in order to drive up share prices, a company hiding huge losses or low revenues with creative accounting practices, or actions taken to grant current shareholders a better return on their investments—as long as the deception remains undiscovered."); Jay B. Kasner & Mollie M. Kornreich, *Section 10(b) Litigation: The Current Landscape*, BUS. L. TODAY, Oct. 2014, at 1, https://www.skadden.com/-/media/files/publications/2014/10/business-law-todaysection-10-b-litigation-the-curr.pdf (stating that cases brought under section 10b-5 "are often triggered by nothing more than a drop in stock price, after which shareholder plaintiffs allege that the change in price reflects newly public information that the company previously and improperly concealed").

215 Janus Cap. Grp., Inc. v. First Derivative Traders, 564 U.S. 135 (2011).

216 *See id.* at 138, 140 (observing that "Janus Capital Group, Inc. (JCG), is a publicly traded company that created the Janus family of mutual funds"; that "[t]hese mutual funds are organized in a Massachusetts business trust, the Janus Investment Fund"; and that "Janus Investment Fund retained JCG's wholly owned subsidiary, JCM, to be its investment adviser and administrator").

217 *See supra* notes 43–44 and accompanying text.

218 *See supra* notes 45–47 and accompanying text (discussing that the Investment Company Act, by virtue of the contract between a public fund and its investment adviser, deems the investment adviser to be an affiliate of the fund).

structures, the contracts between the Fund and JCM gave JCM control over most aspects of the Fund's operations.[219]

The plaintiff, First Derivative Traders ("First Derivative"), had alleged on behalf of a class of JCG shareholders that statements made by JCG and JCM in the mutual funds' prospectuses were false and that those falsehoods adversely affected the price of JCG's stock.[220] Specifically, according to First Derivative, although the prospectuses had contained statements to the effect that the Fund was "not suitable for market timing,"[221] JCG and JCM had allegedly entered into arrangements with third parties to permit market timing in a number of the mutual funds.[222] When that fact became public, the mutual funds' shareholders withdrew a substantial amount of capital, which, in turn, reduced the management fee paid by the Fund to JCM for advisory services.[223] As a consequence, JCG's stock price declined because the compensation paid by the Fund to JCM constituted a substantial portion of JCG's revenues.[224] This result, in turn, allegedly harmed JCG's shareholders.[225]

The question before the Court concerned what entity made the statements in the prospectuses: Was it the Fund or was it JCM and JCG?[226] The Court concluded that, for purposes of rule 10b-5, the person who "makes" a statement is the person with "ultimate authority" over it,[227] "including its content and

219 *See Janus Cap. Grp.*, 564 U.S. at 149 (Breyer, J., dissenting) ("Janus Management prepares, modifies, and implements the Janus Fund's long-term strategies. And Janus Management, acting through those employees, carries out the Fund's daily activities.").

220 *See id.* at 140 (majority opinion) ("First Derivative contends that JCG and JCM 'materially misled the investing public' and that class members relied 'upon the integrity of the market price of [JCG] securities and market information relating to [JCG and JCM].'" (alterations in original)).

221 *Id.* at 138–39 ("The prospectuses for several funds represented that the funds were not suitable for market timing and can be read to suggest that JCM would implement policies to curb the practice.").

222 *See id.* at 139 ("In September 2003, the attorney general of the State of New York filed a complaint against JCG and JCM alleging that JCG entered into secret arrangements to permit market timing in several funds run by JCM.").

223 *See id.* at 139–40 ("After the complaint's allegations became public, investors withdrew significant amounts of money from the Janus Investment Fund mutual funds. Because Janus Investment Fund compensated JCM based on the total value of the funds and JCM's management fees constituted a significant percentage of JCG's income, Janus Investment Fund's loss of value affected JCG's value as well." (footnote omitted)).

224 *See id.* at 140 ("JCG's stock price fell nearly 25 percent, from $17.68 on September 2 to $13.50 on September 26.").

225 *See id.* at 148–49 (Breyer, J., dissenting) (noting that the Fund's investors had relied on the "materially false or misleading statements that appeared in prospectuses issued by the Janus Fund" and that "they suffered resulting economic harm").

226 *See id.* at 141 (majority opinion) ("To be liable, . . . JCM must have 'made' the material misstatements in the prospectuses.").

227 *See id.* at 142 ("For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.").

whether and how to communicate it," as opposed to others who provide "substantial assistance" to another in making a statement but do not actually make the statement themselves.[228] In reaching its conclusion, the Court reasoned that, because the person who delivers a statement is the person who "controls" the statement, and the person who controls the statement is the statement's maker, JCM and JCG could not have been the makers of the prospectus statements.[229] In this case, because the Fund, through the mutual funds' prospectuses, was the deliverer of the statements, it necessarily had control over the statements and therefore was the person who made them.[230] Consistent with its conclusion, the Court rejected the appellate court's contrary determination that "JCG and JCM, by participating in the writing and dissemination of the prospectuses, *made* the misleading statements" contained in them.[231] The Court pointed out that subjecting to rule 10b-5 liability those who assist with a statement but do not themselves make it would obviate the concept of aiding and abetting.[232]

The *Janus* Court's decision was detached from the realities of how financial intermediaries operate. This is evidenced in three ways. First, the Court suggested, in reliance on inapplicable precedent, that, because the Fund was the person with ultimate authority, it was neither "necessary [nor] inevitable" that the false statements would be included in the prospectuses, despite the role that JCG and JCM played in producing the prospectuses.[233] Second, the Court rejected the government's contention that "make" in this context has the same meaning as "create."[234] According to the Court, "[t]he Government's definition would permit private plaintiffs to sue a person who 'provides the false or

[228] *See id.* at 142–43 (observing that "Rule 10b-5's private right of action does not include suits against aiders and abettors" and that "[s]uch suits—against entities that contribute 'substantial assistance' to the making of a statement but do not actually make it—may be brought by the SEC . . . but not by private parties" (internal citations omitted)).

[229] *See id.* at 142 ("Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right.").

[230] *See id.* at 146–47 ("Under this rule, JCM did not 'make' any of the statements in the Janus Investment Fund prospectuses; Janus Investment Fund did.").

[231] *See id.* at 140–41 ("The Court of Appeals . . . reversed, holding that First Derivative had sufficiently alleged that 'JCG and JCM, by participating in the writing and dissemination of the prospectuses, *made* the misleading statements contained in the documents.'" (quoting *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 121 (4th Cir. 2009))).

[232] *See id.* at 143 ("If persons or entities without control over the content of a statement could be considered primary violators who 'made' the statement, then aiders and abettors would be almost nonexistent.").

[233] *Id.* at 144 ("Without such authority, it is not 'necessary or inevitable' that any falsehood will be contained in the statement.").

[234] *See id.* (noting that "[t]he Government contends that 'make' should be defined as 'create'" but that this definition "fails to capture its meaning when directed at an object expressing the action of a verb").

misleading information that another person then puts into the statement.'"[235] Third, the Court discounted First Derivative's contention that a fund's investment adviser should generally be regarded as the maker of the statements in the fund's prospectuses because of the "uniquely close relationship between a mutual fund and its investment adviser."[236] Declining First Derivative's "invitation to disregard the corporate form,"[237] the Court noted that "corporate formalities were observed"[238] and that the Fund's board of directors, having only one non-independent director, had greater independence than the 40% required by the Investment Company Act.[239]

The difficulty with the Court's reasoning is that, although a fund theoretically produces prospectuses and releases other information—its name, after all, is on those documents as the author—it has no agency. It is incapable of acting and therefore necessarily relies on another person to speak in its name and on its behalf. That other person, of course, is the fund's investment adviser. This state of affairs cannot be otherwise, given how funds are structured and their inevitable affiliate relationships.[240]

Therefore, it is impossible for a fund to have actual authority—"ultimate" or otherwise—and it is both necessary and inevitable that any false statements made by the adviser or others in connection with the production of the fund's prospectuses will, in fact, be included in those prospectuses. In addition, in this context, "create" has exactly the same meaning as "make" because, if the adviser provides false or misleading information in the production of a prospectus, that information *will* be put into the prospectus. The Janus Fund, like any public fund, had no ability whatsoever to decide whether to include any particular information in the mutual funds' prospectuses because it, like any public fund, did not have the decision-making authority that the Court suggested it did.[241] Finally, the Court's discounting the unique relationship between a fund and its investment adviser depended on irrelevant facts.[242] It does not matter whether JCM observed corporate formalities because that fact does not alter JCM's complete and necessary control over everything the Fund did. Similarly, it does

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[235] *Id.* at 144–45.
[236] *Id.* at 145.
[237] *Id.*
[238] *Id.* at 146.
[239] *See id.* ("JCM and Janus Investment Fund remain legally separate entities, and Janus Investment Fund's board of trustees was more independent than the statute requires.").
[240] *See supra* notes 49–51 and accompanying text (describing the role of investment advisers in the operations of public funds).
[241] *Janus Cap. Grp.*, 564 U.S. at 149 (Breyer, J. dissenting).
[242] *Id.* at 145 (majority opinion).

not matter whether the Fund's board was, in theory, more independent than what the Investment Company Act requires because that fact does not alter the directors' conflicted status as JCM's de facto appointees.[243]

At least part of the reason why the Court went so far astray is that, for each of its arguments, it relied on a prior case, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[244] which had dissimilar facts. The plaintiff shareholders in *Stoneridge* had sued customers and suppliers of a public company, where those customers and suppliers had agreed to arrangements relating to their transactions with the company that allowed the "company to mislead its auditor and issue a misleading financial statement."[245] The *Stoneridge* Court had affirmed the lower courts' dismissal of the case, reasoning that (in the words of the *Janus* Court) "the public could not have relied on the [customers' and suppliers'] undisclosed deceptive acts" because those acts did not necessitate that the company would "record the transactions as it did."[246]

Stoneridge was inapt precedent for *Janus* because, unlike a public fund, which has no ability to "record transactions"—or do anything else—in any particular way, the company at issue in *Stoneridge* did have that ability. After all, it was not under the complete control of an external entity like public funds are. Instead, it was a public company whose operations were under the control of its own employees and officers, rather than the control of a separate external entity. In other words, it had agency, and the content of its financial statements was wholly within its control.

That the Court could not identify the stark and legally meaningful differences between public funds and public companies in terms of how they operate further demonstrates courts' unfortunate reliance on corporate law principles to remedy investor harms. In the fund context, separateness of entities does not matter; that a particular entity has its name printed on a prospectus cover does not matter; corporate formalities do not matter. Echoing First Derivative, what matters is something alien to corporate law principles: the unique affiliate relationship between a fund and its adviser.[247] Law ought to do better at understanding and reflecting that relationship and the fact that corporate law principles are not suitable to address claims arising from it.

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243 *See supra* notes 49–51 and accompanying text (describing the role of investment advisers in the operations of public funds).

244 Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

245 *Id.* at 152–53.

246 *Janus Cap. Grp.*, 564 U.S. at 144 (quoting *Stoneridge*, 552 U.S. at 167).

247 *See id*. at 145.

IV. CONSTRAINING CORPORATE LAW PRINCIPLES

The case studies presented in this Part show that investors are at risk when law fails to acknowledge the importance of financial intermediaries' affiliate relationships. Moreover, this failure has become evident in a variety of contexts beyond those described above. In these contexts, law is caught up by an entity focus, corporate formalities, and other concepts that inform corporate law. However, in addressing investor harms wrought by financial intermediaries, these concepts are mostly irrelevant, the trees that prevent courts and policymakers from seeing the forest.

One solution might be for policymakers, in formulating laws or rules, to focus on why they are adopting any particular law or rule. If their objective is to protect investors rather than to modulate the relationship between an entity's management and shareholders—the fundamental concern of corporate law—then they should be alert to ways in which the project might incorporate entity-centric assumptions. By viewing a law or rule through this lens, policymakers can excise those assumptions such that the law or rule is made to accommodate the commonplace circumstance that financial intermediaries are part of larger groups of affiliated entities. There at least two ways that they can accomplish this.

The first approach is to direct the law or rule's strictures toward entire multi-entity enterprises, rather than regard the regulated actor as a single, disconnected entity. Under such an approach, for example, the status of any entity within the enterprise as a registered investment adviser, broker-dealer, or other type of financial services provider could also subject the other entities within the enterprise to the requirements of the law or rule. This might be similar to, but broader than, the doctrine in banking regulation, in which the Bank Holding Company Act of 1956[248] subjects both banks and their parent companies to the Federal Reserve's oversight, a concept known as "consolidated supervision."[249]

The second approach is to do the opposite. That is, rather than subject an entire group of interconnected entities to the regulation at issue, the law or rule might home in on the small number of individuals or entities that controls each of the entities within the group, whether directly, such as through direct

[248] 12 U.S.C. § 1841 *et seq.*

[249] *See* Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 118 (2011) (observing that, pursuant to the Bank Holding Company Act, an entity that owns or controls a U.S. bank "[is] required to register with, and become subject to consolidated regulation and supervision by, the Federal Reserve").

ownership, or indirectly, such as by controlling one or more entities that control other entities. In the Stanford case, either of these approaches may have required SIBL, in addition to SGC, to contribute to the SIPA insurance fund. And either approach may have resulted in the courts' concurrence with the SEC that Stanford's investors were entitled to SIPA insurance coverage, notwithstanding that SIBL was not itself a SIPA member.[250]

Yet neither approach is ideal. One difficulty is that, because multi-entity financial enterprises may comprise hundreds of entities, it would be overinclusive to subject all of those entities to the regulation and obligations that may be targeted at only a small number of the entities. For example, it may be that only a limited number of entities within the Morgan Stanley enterprise are public funds, broker-dealers, or investment advisers. To extend the regulation to which these entities are subject to all entities within the larger group would be to unnecessarily impose costly obligations on entities that, by virtue of their role within the enterprise, have no connection to or interaction with investors. Presumably, policymakers could specify that the entities within an enterprise that are covered by a law or rule are only those that have such a connection or interaction. Even so, however, the law or rule still may be insufficiently customized to both serve the investor-protection function of the securities laws while avoiding the imposition of unwarranted compliance costs associated with subjecting irrelevant entities to regulatory obligations.

A second difficulty pertains to focusing regulation on those who are in controlling positions within an enterprise. To the extent that direct control of each of the entities rests with different combinations of individuals or entities, and given the concern noted above that many entities within an enterprise may be irrelevant for investor-protection purposes, determining who among the players should be subject to the new regulatory obligations may be difficult. Beyond that, this determination within any enterprise would be a moving target as the enterprise's organizational structure changes over time.

These difficulties are really the same one. In particular, any law or rule under either approach would need to be sufficiently tailored to each firm to further investor protection goals but do so without imposing unreasonable compliance costs on either regulators or those to whom the law or rule will apply. Although one cannot discount the skills and creativeness of policymakers in search of a solution, this project would be a formidable challenge, at best.

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250 *See* SEC v. Sec. Inv. Prot. Corp., 758 F.3d 357, 358, 364 (D.C. Cir. 2014) (describing the SEC's argument that Stanford's investors should be treated like customers).

In addition, the super-entity approach would not have addressed the concerns at issue in the *Burks* and *Janus* cases. The key issue in the Stanford case was almost simple in comparison to the key questions in *Burks* and *Janus*, in that the former had nothing to do with the locus of decision-making authority within the Stanford enterprise, as was the case in *Burks* and *Janus*.[251] After all, the court in that case needed only to decide whether the CD purchasers should receive compensation under SIPA, with SIPA itself providing a clear answer—albeit an unfortunate one.[252] By contrast, *Burks* and *Janus* each addressed fundamental questions of control and governance in financial enterprises, with the Court in both cases inappropriately evaluating the facts using norms applicable to the internal operations of public companies but much less well-suited for adjudicating investor claims against multi-entity financial firms.

These differences mean that correcting the recurring mismatch between financial services regulation and corporate law principles is not as straightforward as expanding the swath of persons subject to regulation because that will not help. The problem in *Burks* and *Janus* was not that relevant law was insufficiently broad to cover all relevant actors, which describes the Stanford case, where SIBL had been excluded from the obligations to which its registered affiliate, SGC, was subject.[253] Rather, the problem was that law had no tools to address the usual corporate law concern—namely, preventing managerial "control" from acting on conflicts of interest to the detriment of "ownership"—when ownership and control happen to be situated within different entities.

In *Burks*, fund shareholders had claimed that the entity in control—meaning the fund's investment adviser, among others—had violated the Advisers Act and the Investment Company Act to their detriment and that of the fund.[254] Meanwhile, in *Janus*, the claim was that the entities in control—meaning JCG and JCM, as the investment adviser to Janus Investment Fund—had allowed certain shareholders in the mutual funds within the Fund to engage in market-timing activity, to the Fund's detriment and, therefore, also to their detriment, as shareholders of JCG, which owned JCM.[255] As this Part suggests, the Court in both cases might be faulted for failing to recognize and accommodate the types of affiliate relationships that characterize the financial industry. Nevertheless, any placement of such fault should be tempered by the fact that the Court had

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[251] *See supra* notes 160–64 and 213–23 and accompanying text (setting forth the facts in *Burks* and *Janus*).
[252] *See Sec. Inv. Prot. Corp.*, 758 F.3d at 369.
[253] *See id.* at 368–69 (concluding that SIBL investors were not "customers" of SGC even if they reasonably believed SGC and SIBL were one entity).
[254] *See supra* notes 160–64 and accompanying text.
[255] *See supra* notes 213–23 and accompanying text.

little basis in either precedent or policy for reaching alternative conclusions. In deciding the cases, it was simply applying age-old corporate governance norms to situations that likely seemed fundamentally to be about corporate governance.

Accordingly, there needs to be a basis for courts to reach alternative conclusions. Formulating such a policy, most importantly, requires moving beyond corporate governance norms, which focus on the director-investor relationship that defines and constitutes corporations and other entities. The policy would require courts to take into account the ways that affiliate relationships within the financial industry impact the accepted understanding that an entity is controlled and operated by its own directors and officers, as opposed to an external, affiliated entity. It would also be reflected in SIPA and other relevant statutes. This shift, in turn, would require moving beyond the entity itself.

As for what "moving beyond the entity" might look like, fortunately, there are some situations in which law already disregards entity boundaries to achieve policy goals that would otherwise be hindered by those boundaries. For example, in the bankruptcy context, the "substantive consolidation" equitable doctrine permits courts overseeing a bankruptcy to disregard entity boundaries in certain circumstances.[256] These circumstances include when the debtor entity tricked its creditors into believing that it owned assets that were actually owned by its affiliates or when the debtor's assets and those of its affiliates are irredeemably intermingled.[257] Similarly, the doctrine of corporate veil piercing allows courts to disregard entity boundaries in debt cases where the debtor entity and its affiliates did not sufficiently maintain good corporate "hygiene," such that the debtors' assets were intermingled by with those of its affiliates.[258]

Courts rarely apply either of these doctrines, however, largely because doing so is radical: In setting aside their deference to entity boundaries, even for the cause of furthering justice, courts also must suspend an entity's legal personhood. In particular, in the creation of a corporation or other legal entity,

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[256] *See* J. Stephen Gilbert, Note, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 208 (1990) ("Substantive consolidation is a powerful vehicle in bankruptcy by which the assets and liabilities of one or more entities are combined and treated for bankruptcy purposes as belonging to a single enterprise.").

[257] *See* Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 539–42 (2006) (describing cases in which courts have applied the doctrine of substantive consolidation).

[258] *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L REV. 1036, 1036 (1991) ("'Piercing the corporate veil' refers to the judicially imposed exception to [the] principle [of limited liability] by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own.").

the state endows that entity with rights and obligations and allows it to function in society in many of the same ways that individuals function.[259] Like individuals, entities are obligated to file tax returns and can be punished for criminal acts or be liable for committing torts.[260] Conversely, like individuals, they have the right to make political contributions, own property, sue others for wrongdoing, and borrow money.[261] The notion that a court might counter the rigidity and, indeed, sanctity of a legal person in certain exceptional situations requires accepting that it is sometimes acceptable to ignore entity personhood and the benefits and burdens associated with it.

Overcoming entity boundaries, therefore, may seem to be a fraught enterprise. The important counterpoint, however, is that courts apply doctrines that deny entity boundaries only in circumstances in which an entity's managers have themselves denied those boundaries, whether through fraud or sheer sloppiness. Put another way, courts deny entity boundaries only where they exist in theory but not in practice.

This insight is the key to solving the affiliate "problem" that arises in courts' adjudication of investor claims in the financial industry. Where an entity, such as a public fund, is managed and controlled by an affiliated entity—its investment adviser—rather than its officers or board of directors, the entity exists in theory (as well as in government records), there is no doubt. It does not exist in practice, however, to the extent that the decisions that it "makes"—whether regarding the identity of the "independent" directors on its board or the statements it includes in its prospectus—are in fact made by someone outside of itself.

Connecting the anomalies that result from applying corporate law norms in cases adjudicating investor harm to similar anomalies arising from applying those norms to bankruptcy or debt cases involving managerial abuse of the entity structure is revealing. The latter context shows that the solution in the former context need not be complicated. Rather, the solution is the suspension of state-

[259] *See* The Investopedia Team, *Corporation*, INVESTOPEDIA, https://www.investopedia.com/terms/c/corporation.asp (Jan. 3, 2022) (noting that "corporations are created under the laws of the individual states" and that "[u]nder the law, corporations possess many of the same rights and responsibilities as individuals").

[260] *See id.* (noting that corporations can "pay taxes" and "sue and be sued"); JODI AVERGUN, ELLEN V. HOLLOMAN, LEX URBAN, HYUNGJOO HAN & CHRISTIAN LARSON CORPORATIONS, DIRECTORS, AND OFFICERS: POTENTIAL CRIMINAL AND CIVIL LIABILITY 1 (2018), https://www.cadwalader.com/uploads/books/a64d249c326e1db7c52c10d4985f6e2d.pdf ("Corporations can be charged with committing crimes.").

[261] *See* The Investopedia Team, *supra* note 259 (noting that corporations "can enter [into] contracts, loan and borrow money, . . . hire employees, [and] own assets").

granted rights, such as the right of autonomy and managerial control, where those rights exist in only a modified, weakened manner—that is, they exist in theory but not in practice. Had the *Burks* Court, in deciding the case, used the opportunity to define and apply this proposed doctrine, it would have recognized that the directors in *Burks* were independent in name only, given that they were likely chosen by the fund's investment adviser. Had the *Janus* Court done so, it would have recognized that the Fund could not have created or made the statements in its prospectus because, controlled by its investment adviser as it was, it lacked ability to do so. Finally, had the court in the Stanford case relied on such an approach, as supported by an amendment to SIPA, it would have "consolidated" SIBL and SGC, in the manner of bankruptcy consolidation, such that SIPA insurance would have covered the CD investors' losses. In all three cases, the result would have been substantially different for the plaintiff investors.

Succinctly put, in the financial industry, characterized by webs of affiliates, the fiction of legal personhood ultimately requires another fiction, one that denies that personhood. This point is important: The second fiction—of dissolving entity boundaries, if only momentarily—is, at its base, an affirmation of the relationships and practices that actually govern financial services activities. It is a return to reality. In the financial industry, moreover, there is no reason to avoid reality because there is nothing about providing financial services, insofar as those services affect investors, that requires that the dominant actor be an entity. To the contrary, in the case of public funds, the entity is merely a convenience mechanism that allows investment advisers to provide services to large numbers of people simultaneously—and in the case of brokerage enterprises, such as Allen Stanford's, it serves no discernible purpose at all.

CONCLUSION

The risks to investors in affiliate world—that is, the financial industry—have stood as a longstanding and seemingly intractable problem for law and regulation. The financial industry is characterized by the magnitude of affiliate relationships among investment advisers, public funds, broker-dealers, and other financial intermediaries. Although there is no available data comparing the affiliate relationships of these entities with those of public companies that provide goods and services, there seem to be few, if any, sizable financial firms without scores of affiliates. That fact is not remarkable, however, until one considers the range of risks that financial affiliations create.

These risks stem from the circumstance that financial industry affiliations produce conflicts of interest that may incentivize financial intermediaries to further their own interests at the expense of investment advisory clients, public fund shareholders, and broker-dealer customers. They also present an unusual mismatch between regulation of the day-to-day activities of financial intermediaries on the front-end and adjudication of investor harms on the back end. Put another way, although the day-to-day compliance obligations set forth in the securities laws and associated SEC rules reflect and address the many conflicts of interest that characterize the financial industry, the corporate law principles that courts and statutes rely on to address investor harms inevitably fail to accommodate risks that are unique to the financial industry.

In this sense, corporate law represents a square peg for the round hole of the financial industry. And although this Article presents only three examples of the ways that the mismatch between the financial industry and the corporate law principles that courts apply to it, those three examples show that the problem—the inability of corporate law to remedy investor harms—is evident in a range of contexts. What has been less evident is how law and policy might correct this mismatch in a way that produces congruence between investor harms and remedies for those harms.

There is an answer, however. It does not involve modifying or reshaping corporate law or creating elaborate new requirements under the securities laws. Rather, the answer is to move past the entity-centrism of corporate law, which, in the financial industry context, where affiliated entities play the usual roles of directors and shareholders in a self-contained corporation, no longer serves a purpose in this age of sprawling financial intermediaries—assuming it ever did. To be sure, this solution may seem radical. Yet it is no more radical than the long-established and seldom-questioned notion that entities are "persons," with many of the rights and obligations of individuals.