

Collective Branding and the Origins of Investment Management Regulation: 1936-1942

Abstract: This paper examines how market and political forces interacted to create the American mutual fund industry and its regulation between 1936 and 1942. Contrary to previous scholarly work, this paper argues that the key elements of regulation that now differentiate modern mutual funds from modern hedge funds had their origins in lobbying by the mutual fund industry itself, rather than in populist or public-spirited forces in the SEC or the Roosevelt administration. The largest funds desired to maintain an industry-wide brand for a passive, low-risk style of investing and they sought regulation to maintain this brand. They did so even though some investors rationally might have preferred risky or active styles of investing that regulation ultimately prohibited. An understanding of the industry's brand-building motivations can explain several puzzling features of mutual fund regulation, including restrictions on borrowing, redemption rights and control over portfolio companies. The mutual fund industry was able to achieve strong agreement on how to influence regulation because the industry had grown into its modern shape well before Congress adopted the current regulatory regime. Evidence from portfolios, for example, shows that mutual funds in the late 1930s were just as passive with respect to the governance of their portfolio companies as mutual funds are today. This paper also examines the key distinguishing feature of modern mutual fund taxation—actual, rather than nominal, distribution of income to shareholders—and shows that it may have originated in an attempt by open-end mutual funds to drain assets from closed-end mutual funds.

Collective Branding and the Origins of Investment Management Regulation: 1936-1942

I. The mutual fund industry in the late 1930s.....	10
A. The state of the industry.....	10
1. Closed-end funds.....	10
2. Open-end funds.....	17
B. Competition from substitute forms of saving and investing.....	19
II. The Investment Company Act and the Revenue Acts of 1936 and 1942.....	19
A. The Revenue Acts of 1936 and 1942.....	19
1. A brief introduction to mutual fund taxation.....	20
2. The Revenue Act of 1936.....	21
3. The Revenue Act of 1942.....	25
B. The Investment Company Act of 1940.....	27
III. The need for substantive regulation.....	31
A. Collective brand-building.....	32
B. The growth of industry support for substantive regulation.....	34
C. The inadequacy of alternative solutions.....	38
D. Other explanations.....	40
IV. The origins of particular provisions.....	41
A. Control over portfolio companies.....	41
1. Minimal control over portfolio companies in the 1930s.....	43
a. Closed-end funds.....	43
b. Open-end funds.....	47
2. Emphasis on sales.....	48
3. Motivations for seeking legal restrictions on control.....	50
4. Evidence of industry involvement.....	51
5. Limits of populist influence.....	52
B. Leverage and capital structure.....	58
C. Redemption.....	60
D. Income distribution requirement to avoid corporate income tax.....	61
V. Conclusion: implications for modern policy.....	64

This paper considers a simple but foundational question: why do we regulate investment managers and investment vehicles? The importance of the question is enormous. Mutual funds, hedge funds, private equity funds and other investment vehicles collectively hold trillions of dollars in investment securities. Indeed, mutual funds alone hold assets worth \$12 trillion—almost as much as the commercial banking industry¹—and they own a quarter of American public companies’ common stock and almost half of America’s short-term corporate debt.² Mutual funds now comprise one fifth of America’s household financial assets and are the primary vehicle through which families and individuals invest in the financial markets.³

Questions about why we regulate investment managers are particularly urgent at this moment in the nation’s history, because the regulatory status of many types of investment vehicles has recently become deeply unsettled and open to question. The last two decades have witnessed explosive growth among hedge funds, private equity funds and other alternative investment vehicles. Like mutual funds, these alternative vehicles are pools of stocks, bonds and other investment securities. But unlike mutual funds, these alternative vehicles solicit investments only from wealthy individuals and institutions, rather than from the general public, and are therefore not subject to the extensive federal regulation that applies to mutual funds. These alternative vehicles’ freedom from regulation gives them the ability to engage in a wide range of activities that would be prohibited to mutual funds. Since these alternative vehicles did not exist at the time the foundations of investment management regulation were laid, their spectacular growth in recent years has raised basic questions about what mutual fund regulation is supposed to accomplish and whether its original purposes continue to be relevant.

¹ INVESTMENT COMPANY INSTITUTE, 2010 INVESTMENT COMPANY FACTBOOK, 9 fig.1.1 (2010); Federal Reserve Statistical Release, Large Commercial Banks, September 30, 2009, *available at* <http://www.federalreserve.gov/releases/lbr/>.

² INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 11 fig.1.4 (2009)

³ INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 10 fig. 1.2 (2010); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009).

The goal of this paper is thus to recover those original purposes. I describe the political and market forces that shaped the early mutual fund industry and brought into being the laws that now form the backbone of investment management regulation. These laws include the Investment Company Act of 1940 and a contemporaneous series of tax statutes passed between 1936 and 1942.

Because the regulatory regime established by these statutes is highly invasive and reaches well beyond disclosure, it is commonly believed that the origins of these statutes lay in political forces outside of the investment management industry.⁴ Most prominently, Mark Roe has argued that restrictions on mutual funds' ability to take control stakes in the companies in which they invest reflected, at least in large part, anti-Wall Street populists' and industrial company managers' efforts to prevent the Wall Street barons who controlled mutual funds from also gaining control of Main Street operating businesses by using mutual funds to buy up controlling stakes in those operating businesses.⁵ Roe argues that the influence of populism on mutual fund regulation was so profound that populism is one of the key elements responsible for having "created" the mutual fund industry as we know it today.⁶

This paper focuses, in contrast, on the way that the mutual fund industry created its own regulation. I show that by the late 1930's, market forces had spontaneously produced a version of the mutual fund that looked surprisingly similar to modern mutual funds. These funds had fundamentally different business models from the holding companies with which they have often

⁴ See, e.g., Mercer Bullard, *Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen*, 13 STAN J.L. BUS. & FIN. 286, 289 (2008) ("Congress designed the Act to address the particular abuses associated with companies comprised of liquid pools of securities, including disadvantageous transactions with affiliates, extreme leveraging, excessive fees, inordinately complex capital structures, unfairly differential treatment of shareholders, and inflated values.")

⁵ See, e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 102-123 (1994); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991). Stuart Banner has argued that popular suspicion of securities markets underlay nearly all Anglo-American securities regulation initiatives since the late-17th century. Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U.L.Q. 849 (1997).

⁶ Roe, *supra* note 5, at 1484.

been confused by Roe and others, and they had almost no interest in exercising control over the companies in which they invested. These funds thus comprised a clearly distinct industry. And rather than watching as regulation was shaped by outside forces, the mutual fund industry actively controlled the design of its regulation. Indeed, it appears, somewhat paradoxically, that mutual funds actually desired for their own purposes many of the most invasive restrictions on borrowing, control over portfolio companies, and redemption rights. There is also evidence that elements of industry sought the annual income distribution requirement that has become the key distinguishing feature of mutual funds' tax status and which now places heavy burdens on the industry. The vigor of the mutual fund industry's support for invasive aspects of regulation is surprising, because the industry had substantial political power to oppose regulation between 1936 and 1942.

The industry's puzzling support for regulation has many possible explanations.⁷ This paper highlights a kind of industry-wide standardization or "collective branding" effort. Mutual funds were marketed broadly to the general public in the 1930s, and many funds responded to popular tastes, as well as to practical realities in the funds' management structures, by self-consciously cultivating images of passivity and conservatism. Many funds lacked faith in their capacity to build this image individually, however, because they believed that mass-market investors lacked the time and sophistication to distinguish among various types of funds. Fund managers believed that investors' perceptions of individual funds could affect their perceptions of the whole industry. The industry's reputation was therefore viewed as a kind of collective asset. And like many collective assets, this asset posed collective action problems.

⁷ There may be some room for populism in explaining this phenomenon, but not in precisely the way Roe and others have argued. I argue below that if populism influenced mutual fund regulation, it did so indirectly through the influence of the mutual fund industry. That is, populism may have shaped investors' preferences and the industry may have then responded by using law to help build a brand that would appeal to those preferences. Even this role for populism is limited, however, since the industry also had practical reasons for structuring itself the way it did in the era before regulation.

The solution to these problems was mandatory industry-wide standardization. This standardization reached beyond the disclosure and anti-fraud measures that are present in the ordinary securities laws and prohibited many operational strategies that at least a few investors might rationally have preferred, such as high borrowing, less frequent redemption and control over portfolio companies. Mutual funds, in other words, sought more than just “bonding” or “certification” to establish a reputation for honesty; they sought “branding” to establish a reputation for a particular and contestable approach to asset management.

This paper also explores the origins of a provision of tax law that forces mutual funds to distribute their income every year, rather than merely to pass through gains and losses on a notional basis, the way hedge funds are allowed to do.⁸ The requirement generates significant costs for modern taxable mutual fund investors and has propelled the recent rise of exchange-traded funds (or “ETFs”).⁹ The requirement’s origins may lay partly in an effort by one set of mutual funds (open-end funds) to bleed away the assets of another set of mutual funds (closed-end funds) and also partly in the accidental coincidence in 1936 of mutual fund tax reform with an attempt by the Roosevelt administration to force *all* corporations to distribute their income annually.

This historical analysis has several implications for modern theory and policy. The most important is that it provides a broad framework for understanding and evaluating the general purposes of modern investment management regulation. It suggests that the branding and standardization dynamic that initially shaped key elements of mutual fund regulation may now

⁸ The tax code relevant to modern investment company taxation appears at 26 U.S.C. §§ 851-855. See generally M. Barclay, N. Pearson & M. Weisbach, Open-end Mutual Funds and Capital Gains Taxes, 49 J. FIN. ECON. 3 (1998); BNA Tax Management Portfolio, Taxation of Regulated Investment Companies, No. 740-2nd.

⁹ John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 5-18 (2008) available at <http://ssrn.com/abstract=1311945>; William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69 (2008).

have ambiguous consequences for investors. Mutual funds and the regulation that apply to them were developed for the mass market. This is why mutual funds are now the primary vehicles through which households invest in the financial markets. The brand-building elements of regulation therefore almost certainly help investors to some extent by standardizing many features of mutual funds and thereby making it easier for unsophisticated investors to identify and understand the differences between funds. Indeed, the overlap between brand-building and investor protection purposes is one of the most remarkable—and encouraging—aspects of the story of how investment management regulation began. But branding-building and investor protection are not exactly the same thing. Standardization carries significant costs because many investors rationally might prefer funds that engage in many of the practices that mutual fund regulation now prohibits. That is, some investors might prefer a brand different from the one that regulation adopted.

This study also has much to tell us about the governance of modern large public operating companies. Mutual funds invest heavily in public companies and own about a quarter of their outstanding equity. Mutual funds nevertheless tend overwhelmingly to be passive and uninvolved in the governance of these companies. Because greater activism by mutual funds might help to remedy some of the agency conflicts that plague these companies, the reasons for mutual funds' passivity have been debated extensively. Regulation is commonly blamed as the source of mutual funds' passivity, and the impact of regulation at the time that it was adopted has thus become an important element of modern debates.¹⁰

¹⁰ See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225 (2007); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991). *But see* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1336 (1991).

This paper presents data from mutual funds' portfolios in 1940 as well as other evidence to show that no companies that were at any risk of being swept up in the mutual fund regulatory and tax regime had any significant interest in controlling the operating companies in which they invested. Unlike the entrepreneurs who built holding companies that took large control stakes in subsidiaries, the entrepreneurs who built mutual funds were not managers or shareholders, but salesmen and securities dealers. They therefore had neither the ability nor the desire to control the companies in which their funds invested; their expertise lay only in sales.

Lastly, the insights in this paper about the political origins of the annual income distribution requirement in tax law add urgency to recent calls for reform of this requirement.¹¹ The fact that the requirement originated partly in rent-seeking and historical accident suggests that proposals for reform should be taken seriously.

This paper offers several other insights, including, for example, an explanation of why the modern closed-end mutual fund industry is so much smaller than the modern open-end mutual fund industry, a demonstration that closed-end mutual funds in the late-1920s bore an eerie resemblance to modern securitized mortgage pools, and a description of how the sudden outbreak of World War II at a key moment in the legislative history of the Investment Company Act imperiled the Act's passage and forced the mutual fund industry to lobby hard to save it.

This paper builds on descriptive work on the history of asset managers by Tamar Frankel and Ann Taylor Schwing, Matthew Fink, Natalie Grow, Joel Seligman, and Michael Yogg.¹² The primary contribution of this paper is to document the extent of the mutual fund industry's

¹¹ Coates, *supra* note 9.

¹² MATTHEW FINK, *THE RISE OF MUTUAL FUNDS* (2007); TAMAR FRANKEL & ANN TAYLOR SCHWING, *1 THE REGULATION OF MONEY MANAGERS* § 1.02[B]; Roe, *supra* note 5; JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (3d ed. 2003); MICHAEL R. YOGG, *PASSION FOR REALITY: PAUL CABOT AND THE BOSTON MUTUAL FUND* (2008); Natalie R. Grow, *The "Boston-Type Open-End Fund"—Development of a National Financial Institution: 1924-1940* (April 30, 1977) (unpublished Ph.D. dissertation, Harvard University). As I was working on this paper, John Armour and Brian Cheffins also documented a dearth of corporate activism by early mutual funds that supports my findings here. John H. Armour & Brian R. Cheffins, *Origins of "Offensive" Shareholder Activism in the United States*, in *ORIGINS OF SHAREHOLDER ADVOCACY* 253 (2011).

support for regulation and to construct a political economic account, centered in the collective branding theory, for how and why this support became so powerful. I also construct a more focused narrative of how modern mutual funds came to differ from modern hedge funds and I document for the first time mutual funds' passivity with respect to their portfolio companies. Because this paper relies mostly on primary sources, it also contributes many purely historical and narrative insights.

I. The mutual fund industry in the late 1930s

The chief source of data on the mutual fund industry in the 1930s is the SEC's study on Investment Trusts and Investment Companies.¹³ The study was commissioned by Congress in Section 30 of the Public Utility Holding Company Act of 1935. The political operations that gave rise to Section 30 are unclear,¹⁴ but the section gave the SEC the authority and momentum to write and propose to Congress the initial draft of the Investment Company Act (the "ICA").

A. The state of the industry

1. Closed-end funds

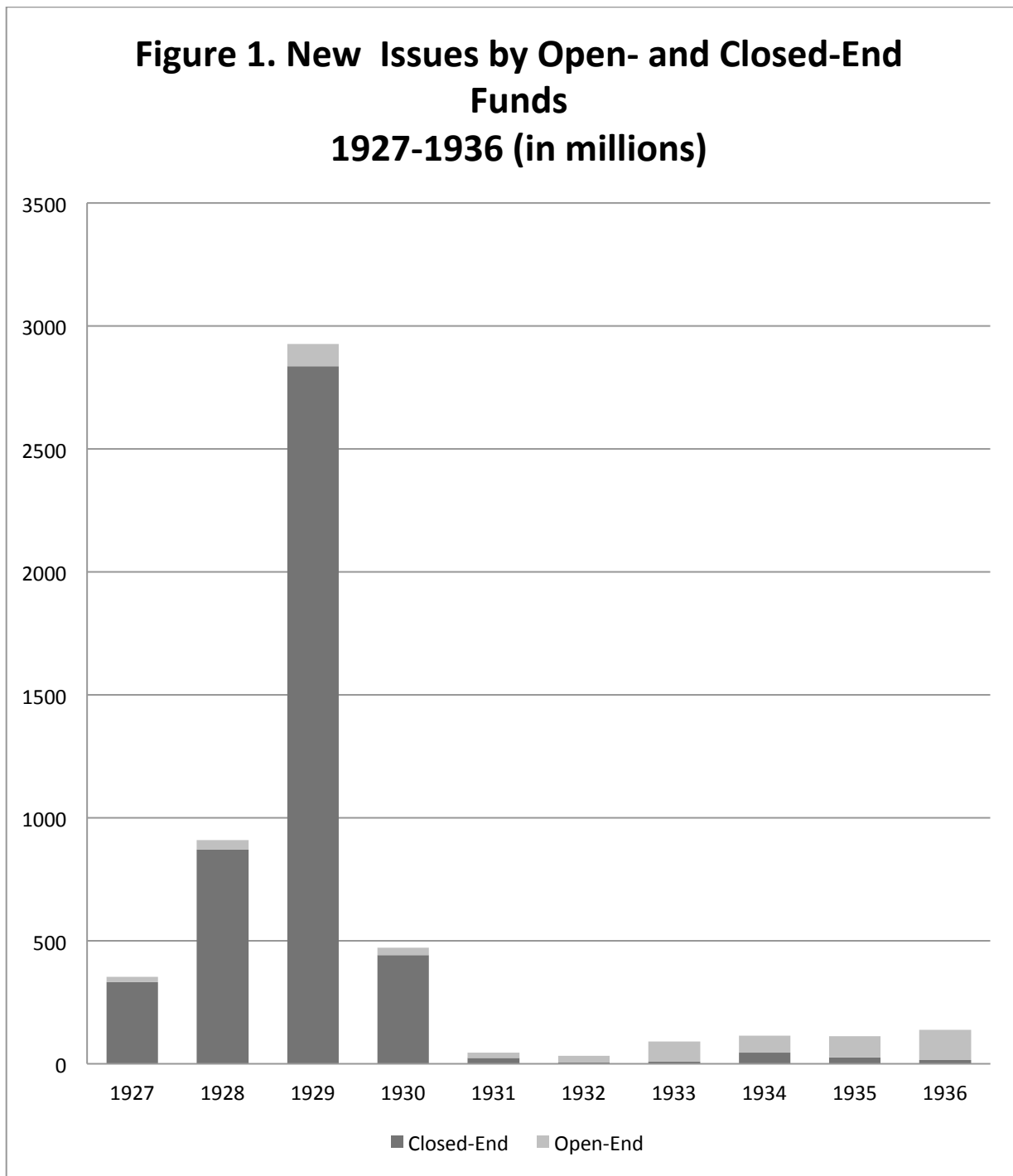
Figures 1 and 2 (on the next two pages) distill the mutual fund industry's changes from 1927 to 1940. Prior to 1927, mutual funds comprised a new and very small industry.¹⁵ The industry began growing quickly in 1927 with the rise of closed-end funds. Closed-end funds are pools of investment securities similar to the ordinary open-end funds that now dominate the mutual fund industry. The primary difference between closed- and open-end funds is that open-

¹³ The entities now known as "mutual funds" were generally known as "investment trusts" in the 1920s and early 1930s, and "investment companies" in the late 1930s and 1940s. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939-1942) [hereinafter SEC Study].

¹⁴ Robert Healy, the SEC Commissioner who oversaw the investment trust study, suggested that Congress was moved to pass Section 30 of the PUHCA not just by concern for investment company investors "but also by the suspicion that there might exist upstairs, above the utility holding companies, various investment trusts which had not been examined by the Federal Trade Commission in the public utility field." *A Bill to Provide for the Registration of Investment Companies and Investment Advisers, and for Other Purposes: Hearing Before a Subcomm. Of the Comm. on Banking and Currency, 76th Cong.* 36 (Statement of Robert Healy) [hereinafter Senate Hearings].

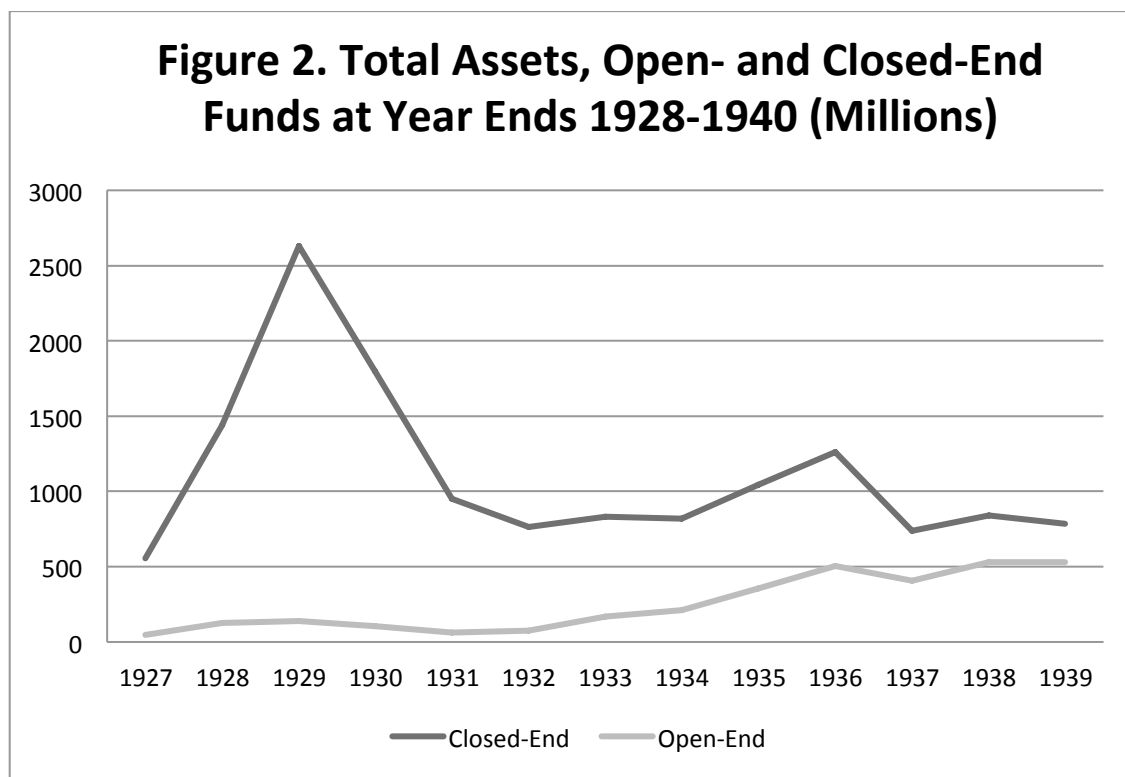
¹⁵ SEC Study, pt. 1, at 56-107.

end funds allow shareholders to redeem their shares, and closed-end funds do not.¹⁶ Closed-end fund investors must buy and sell their shares in markets.



Source: SEC Study, Part 2 190 tbl.60.

¹⁶ For a general exploration of the consequences of redemption rights, see John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*. 120 YALE L.J. 84 (2010).



Sources: SEC Study Part 2 at 112-113 tbl.17; INVESTMENT COMPANY INSTITUTE, MANAGEMENT INVESTMENT COMPANIES, 96 (1962)

While the open-end fund industry remained very small throughout the 1920s, the closed-end fund industry grew spectacularly. In 1929—the year of the great bull market—interests in closed-end funds comprised more than 30% of all new corporate securities issues in the United States.¹⁷ Closed-end funds generally sold a mix of equity, funded debt and preferred stock of varying levels of seniority.¹⁸ The SEC estimated that debt and preferred stock accounted for approximately 56% of the total assets of all leveraged closed-end funds in 1929.¹⁹ This probably understates the actual degree of economic leverage, however, because closed-end funds were

¹⁷ SEC Study Part 2, at 186 tbl.59.

¹⁸ SEC Study, Part 2, at 45, 47.

¹⁹ SEC Study, Part 2, at 140 tbl.33.

owned through elaborate pyramid structures that magnified leverage at each level of the structures.²⁰

Prior to the stock market crash in October 1929, almost all leveraged closed-end funds traded at premiums to the net asset value (NAV) of their securities. NAV is the pro rata portion of a fund's assets that corresponds to each share. Shares in closed-end funds were commonly worth more than the securities that ultimately underlay them. Premiums averaged about 50% in 1929, and the hottest new issues sometimes traded at 200% of NAV.²¹ Pyramidal holding structures magnified the premium to NAV at each level.²²

Closed-end funds relied on a very different business model from the holding companies with which they have often been compared, and closed-end funds formed a naturally distinct industry that was easily identifiable by contemporary observers.²³ Unlike closed-end funds' founders, holding companies' founders were shareholders and operations managers. Holding company founders generated value by managing and capitalizing their operating subsidiaries effectively and by participating in the profits by owning shares in the holding companies. Holding companies therefore only sold shares as a way of financing their operating businesses so that they could operate at the optimal scale. The primary goal of the people who built holding companies, in other words, was operating profit, and they sold securities merely as a means to this end.

²⁰ See generally SEC Study, Part 2, at 527-600. To see why the SEC's statistic understated economic leverage, imagine that the public contributes \$100 to Fund A, which in turn invests the full amount in Fund B, which has no other equity. Fund A borrows \$50 and so does Fund B. Assuming for the sake of simplicity that these funds are not consolidated, on paper they have \$300 in combined total assets and \$100 in debt—a ratio of debt to total assets of 33%. The actual equity contributed by the public, however, is only \$100, so the effective ratio of debt to total assets in the combined companies is 50%. This is how pyramiding magnified leverage.

²¹ See SEC Study Part 2, at 805-818; FINK, *supra* note 12, at 10 n.5; JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929*, 43-65 (1988).

²² If Fund A traded at two times net asset value and bought shares in Fund B, which also traded at two times net asset value, Fund A investors would, in effect, pay four times the value of the assets that ultimately underlay their shares.

²³ See, e.g., Roe, *supra* note 5.

Closed-end funds, in contrast, made the sale of securities an end in itself. Unlike the holding company managers, closed-end fund managers had a separate corporate existence and a separate set of owners from the entities that held the funds' assets. The overwhelming majority of closed-end fund assets in 1929 resided in funds sponsored by sales experts who had their own corporate existences: professional underwriters, brokerages, commercial banks and trust companies, bank affiliates, and investment counselors, as well as combinations of these.²⁴ Closed-end funds were the first pooled investment vehicles to target household investors, and in the 1920s and 1930s, closed-end funds developed extensive nationwide sales forces that made buying shares very simple. As explained below,²⁵ the sales experts who built closed-end funds had little interest in operating or influencing the businesses in which they invested because such activities lay far outside the boundaries of these sales experts' abilities. Closed-end funds were simply a vehicle for harnessing their promoters' expertise in sales and marketing.

Since the value that closed-end funds generated lay in the superior marketing and sales expertise of their promoters, their revenue was tied primarily to the success of their sales efforts, rather than to the success of their investments. Underwriting fees were typically on the order of 6% of the value of new issues.²⁶ Ongoing management fees were much smaller, but they also rewarded sales because they were charged as a percentage of the total amount of assets a fund managed. This encouraged the accumulation of additional assets through sales of new shares. Closed-end fund promoters also profited from the spread between the cost of assembling closed-end funds and the prices at which the funds could be sold. Since closed-end funds traded at a premium to NAV, their creation and sale involved a simple form of arbitrage.

²⁴ SEC Study Part 2, at 57.

²⁵ *Infra* Section IV.A.

²⁶ SEC Study Part 2, at 205; *see generally id.* 193-210.

In fact, closed-end funds in the 1920s and 1930s bore an astonishing resemblance to modern securitized mortgage and financial asset pools, which are commonly known as collateralized debt obligations, or CDOs. Like modern CDOs, closed-end funds piled multi-layered capital structures on top of pools of assembled securities. Additionally, like promoters of securitized mortgage pools, the promoters of closed-end funds were sales experts and underwriters, rather than portfolio or operations managers, and they had a separate corporate existence and a separate set of owners from the vehicles they assembled. Closed-end fund promoters profited mostly from the fees and arbitrage opportunities that lay in the funds' packaging and sale, rather than from the funds' ongoing management or financial success. Closed-end funds were also marketed on a massive scale—recall that closed-end funds comprised 30% of all new issues in 1929.²⁷ Closed-end funds' tendency to invest in other closed-end funds caused them even to resemble modern CDOs-squared. And like modern CDOs, closed-end funds surely helped to inflate the prices of the assets (common stocks) that underlay them. They also turned out to be very hard to value.²⁸

The closed-end fund industry collapsed spectacularly in 1929, as the value of the common stocks in their portfolios plummeted in the great crash. By the end of 1930, most leveraged closed-end funds were insolvent.²⁹ Additionally, the shares of the funds that had managed to avoid insolvency began trading at prices below their NAVs. By the end of 1931, the average discount for closed-end funds without significant leverage was 40% from the value of their

²⁷ SEC Study Part 2, at 186 tbl.59.

²⁸ To be sure, the reasons for valuation problems in CDOs and closed-end funds are quite different. In CDOs, the trouble is that the underlying assets are hard to value. In closed-end funds, the underlying assets were supremely easy to value—they were usually exchange-listed stocks with readily available quotations.

²⁹ *Id.*, at 76 tbl.9, 323.

portfolios.³⁰ Most closed-end funds continue to trade at a discount even today for reasons that modern financial economists are still debating.³¹

The market crash of 1929 exposed a range of practices that damaged the public reputation of closed-end funds for years afterward. Many of these practices were simply fraudulent. Some funds turned out to be Ponzi schemes.³² Others changed managers without notifying shareholders, became “dumping grounds” for unmarketable securities issues underwritten by affiliated bankers, dealt directly with managers in undisclosed transactions on clearly unfair terms and gave sponsors and managers shares at below-market prices without disclosure.

As Figure 1 indicates, the discount made issuing new common stock virtually impossible for closed-end funds after 1930. The assets required to produce a new closed-end fund share cost more than the share could be sold for in the market. The persistence of the discount up to the present time is very likely the main reason why the closed-end fund industry has become insignificant in comparison to the open-end fund industry.³³ The discount also reversed the incentives that originally produced pyramidal ownership and byzantine capital structures. Pyramidal ownership magnified discounts to NAV in the same way it had magnified premiums before the crash. The period after 1930, therefore, saw the purchase and subsequent liquidation of many closed-end funds by other closed-end funds or other buyers.³⁴ The discount also dramatically reduced closed-end fund borrowing.³⁵

³⁰ SEC Study Part 2, at 322.

³¹ See generally Charles M. C. Lee, Andrei Shleifer, and Richard H. Thaler, *Anomalies: Closed-End Mutual Funds*, 4 J. OF ECON. PERSPECTIVES 153 (1990); Elroy Dimson & Carolina Minio-Kozerski, *Closed-End Funds: A Survey*, 8 FIN. MARKETS INSTITUTIONS AND INSTRUMENTS No. 2 (1999).

³² Part 3 of the SEC study devoted several thousand pages to describing the practices mentioned here.

³³ This is also why proposals by Gilson and Kraakman and others to make closed-end funds into active participants in corporate governance are unworkable. Gilson & Kraakman, *supra* note 10. It is simply too difficult to convince anyone to buy newly issued shares in a closed-end fund.

³⁴ Two closed-end funds, in particular, Atlas Corporation and The Equity Corporation, grew rapidly after the crash by exchanging their common stock for that of target closed-end funds trading at large discounts and then merging with the target funds, realizing a gain on the difference between price paid for the target funds' common stock and

2. Open-end funds

In the mid-1930s, the gap left by the collapse of the closed-end fund industry was filled by open-end funds.³⁶ Open-end funds solved the discount problem by making a standing offer to redeem and sell their shares at NAV.³⁷ Open-end mutual funds now dominate the mutual fund industry.³⁸ Figure 2 (above) shows that open-end funds were minor players in comparison to closed-end funds when the Revenue Act of 1936 was passed, but had become major players by the time of the Investment Company Act of 1940.³⁹

Open-end funds were also distinguished from closed-end funds by the simplicity of their capital structures. Unlike closed-end funds, open-end funds generally issued only common stock until the late 1930s.

Although open-end funds were not built by professional brokers or underwriters, as closed-end funds were, they were built by professional managers who maintained separate corporate existences and separate sets of owners from the funds they managed. The fund managers' business models also emphasized sales in a manner similar to those of closed-end funds. Through the 1930s, open-end funds were mostly organized by small groups of individuals whose primary business was the sale and management of the funds they organized. Fee structures heavily emphasized sales. At the end of 1935, sales loads higher than 9 percent were common

the value of the assets underlying the stock. Senate Hearings, at 81-131; SEC Study Part 2, at 85-88; HUGH BULLOCK, *THE STORY OF INVESTMENT COMPANIES*, 52-55, 59, 61 (1959).

³⁵ SEC Study Part 2, at 195 tbl.61.

³⁶ The early 1930s saw the marketing of several types of more exotic instruments that became unmarketable by 1936. Fixed trusts were similar to modern index mutual funds, with redeemable shares and fixed portfolios. The reasons for their decline are unclear, but by 1933, they had effectively stopped issuing securities. SEC Study Part 1, at 29-31. Face-amount installment certificates and installment investment plans had also enjoyed brief periods of popularity in the early 1930s, but had also become insignificant forces in the industry by 1936. SEC Study Part 1, at 31-33. Common trust funds were not important in the late 1930s.

³⁷ See Morley & Curtis, *supra* note 16.

³⁸ INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 9 fig.1.1.

³⁹ See also SEC Study Part 2, at 410 tbl.24; see also Senate Hearings, at 459-463.

among open-end funds.⁴⁰ And annual management fees were charged as a percentage of total assets under management—usually on the order of 1.5 percent annually—which encouraged the accumulation of additional assets through sales of new shares.⁴¹ Shares were sold primarily through professional dealers.⁴² By 1940, the largest open-end funds had shareholders all across the country⁴³ and had attained their size primarily through the effectiveness and national scale of their sales operations.

From open-end funds' inception in the mid-1920s and up through the early 1940s, the open-end fund industry was heavily concentrated among a few funds centered in Boston.⁴⁴ In 1936, three Boston-based funds—Incorporated Investors, State Street Investment Corporation and Massachusetts Investors Trust, or MIT—collectively held more than 60% of all open-end fund assets, and MIT alone held more than 30%.⁴⁵

In the late-1930s, as now, both open- and closed-end funds appealed primarily to small individual investors.⁴⁶ More than half of the outstanding common stock of the five largest open-end mutual funds was held by investors owning shares worth \$1,000 or less and 90 percent of the outstanding stock was in the hands of investors holding shares worth \$5,000 or less.⁴⁷ Closed-end funds had ceased marketing their shares by the early 1930s, but their shares nevertheless appear to have remained primarily in the hands of small investors.⁴⁸

⁴⁰ SEC Part 2, at 217 tbl.63.

⁴¹ *See, e.g.*, Senate Hearings, at 226-227.

⁴² Grow, *supra* note 12.

⁴³ SEC Study Part 2, at 397.

⁴⁴ Grow, *supra* note 12 at 421 tbl.26.

⁴⁵ See SEC Part 2 at 126 tbl.26; Grow, *supra* note 12, at 304 tbl.18. For a history of these three funds, see generally *Id.*, at 335-442.

⁴⁶ *See generally* SEC Study Part 2, at 378-398.

⁴⁷ *Id.*, at 386 tbl.116.

⁴⁸ *Id.*; J. Bradford De Long and Andrei Shleifer, *The Stock Market Bubble of 1929: Evidence from Closed-end Mutual Funds*, 51 J. ECON. HIST. 675 (1991).

B. Competition from substitute forms of saving and investing

The mutual fund industry was still struggling for a significant share of the total market for individual saving and investing, however. In the mid-1930s, individuals who invested in securities tended overwhelmingly to do so directly, rather than through mutual funds. The SEC estimated that at the end of 1935 only approximately 15% of individuals who invested in the stock market did so even partly through mutual funds.⁴⁹ Additionally, many individual savers simply chose not to invest their savings in any form of security.⁵⁰ Mutual funds have a far larger share of the household investing market today.⁵¹

II. The Investment Company Act and the Revenue Acts of 1936 and 1942

This part describes briefly the histories of the three statutes that laid the foundations of modern mutual fund regulation and taxation: the ICA and the Revenue Acts of 1936 and 1942. This basic history lays the groundwork for the discussion of the interplay between industry and non-industry political forces in Parts III and IV.

A. The Revenue Acts of 1936 and 1942

There are two major themes to this section: First, the annual income distribution requirement that originated in 1936 was proposed by open-end funds and was made politically feasible partly by the Roosevelt Administration's attempt that same year to apply the distribution system to all companies. Second, although both neither open- nor closed-end funds requested the limits on control over portfolio companies that first appeared in 1936, both types of funds accepted and significantly shaped these limits. There is very little evidence that the administration or anyone else imbued these control limits with populist political meaning.

⁴⁹ *Id.*, at 369.

⁵⁰ Julia Cathleen Ott, *When Wall Street Met Main Street: The Quest for an Investors' Democracy and the Emergence of the Retail Investor in the United States, 1890-1930* (May 2007) (unpublished Ph.D. dissertation, Yale University).

⁵¹ INVESTMENT COMPANY INSTITUTE, *supra* note 1.

1. A brief introduction to mutual fund taxation

In the absence of special tax treatment, mutual fund shareholders would be subject to triple taxation: once at the portfolio company level, once at the fund level and once more at the shareholder level. Today, to avoid paying corporate income tax, mutual funds must register under the ICA and meet two requirements.⁵² First, they must distribute their income annually.⁵³ Mutual funds achieve pass-through status only by deducting from their income the amounts they actually distribute to shareholders. In contrast, true “pass-through” tax status, such as that enjoyed by partnerships (including hedge funds), allows an entity to pass through tax liabilities and benefits to its owners in a purely notional fashion, without ever actually transferring ownership of any assets.

The tax burden generated by the distribution requirement creates a set of well-known problems for open-end funds.⁵⁴ For example, unlike hedge funds and other partnerships, mutual funds are unable to pass through net tax losses to their shareholders, since there is no literal way to distribute losses (hedge funds and other partnerships pass through losses on a purely notional basis).⁵⁵ Exchange-traded funds are appealing primarily because of their claimed ability to minimize portfolio turnover and thus the tax realization events that generate taxable distributions.⁵⁶

⁵² The tax code relevant to modern investment company taxation appears at 26 U.S.C. §§ 851-855. *See generally* M. Barclay, N. Pearson & M. Weisbach, *Open-end Mutual Funds and Capital Gains Taxes*, 49 J. FIN. ECON. 3 (1998); Coates, *supra* note 9.

⁵³ 26 U.S.C. § 852.

⁵⁴ Coates, *supra* note 9, at 5-18.

⁵⁵ Tax losses are not always reflected in share prices, since realization requirements divorce the timing of tax gains and losses from the timing of actual gains and losses. It is possible, for example, for a fund’s NAV to rise in a given year even while it realizes tax losses in excess of its realized tax gains. In such a circumstance, the tax losses will go to waste. Jack Mintz and Michael Smart

⁵⁶ *See generally* Birdthistle, *supra* note 9. Exchange-traded funds minimize distributions by minimizing portfolio turnover. They do so primarily by allowing redemptions only in very large blocks and only in-kind.

The second important requirement of modern mutual fund taxation is that mutual funds must fragment their portfolios in ways that restrict what I call the “breadth” and “depth” of investing.⁵⁷ Fifty percent of a mutual fund’s portfolio is divided into a regulated bucket, in which investments in no single issuer’s securities can comprise more than 5% of the mutual fund’s total portfolio (a “breadth” requirement), and in which the mutual fund does not own more than 10% of the outstanding voting securities of any single issuer (a “depth” limitation). There is also a separate requirement that not more than 25% of a fund’s portfolio can be invested in the securities of any one issuer or the securities of two or more issuers which the mutual fund controls.

2. The Revenue Act of 1936

The mutual fund tax provisions in the Revenue Act of 1936 were the products of a tightly organized lobbying effort by three open-end funds based in Boston that together dominated the open-end fund industry in 1936: State Street Investment Corporation, Incorporated Investors and Massachusetts Investors Trust (MIT).⁵⁸ The influence of these three funds on the mutual fund taxation provisions in 1936 was so substantial that Paul Cabot, the President of the State Street Investment Corporation, was not exaggerating when he said many years later, “God, I practically wrote the law.”⁵⁹

Prior to 1935, the triple taxation issue presented problems for mutual funds because they had to pay capital gains tax.⁶⁰ These problems were aggravated in June of 1935 when the President proposed for the first time requiring corporations to pay tax on ordinary income in the form of

⁵⁷ I.R.C. § 851(b)(3).

⁵⁸ The managers of these three funds all knew each other from having grown up in the business together in Boston since the mid-1920s. *See* Grow, *supra* note 12 at 4, 71-76; Transcript of Interview with Paul C. Cabot, Conducted by R.J. Tosiello, 9, Oct. 22, 1978 [Hereinafter Tosiello-Cabot Interview]. Grow, Yogg and Fink have all written generally about the history of the Revenue Act of 1936. *Supra* note 12 and accompanying text.

⁵⁹ Tosiello-Cabot interview.

⁶⁰ *Revision of Revenue Laws 1938: Hearings on H.R. 9682 Before the H. Comm. On Ways and Means, 75th Cong. 866 (1938); Capital Gains Tax Irks Trust Chiefs, N.Y. TIMES, Dec. 29, 1935, at F10.*

dividends received from other corporations.⁶¹ In his message to accompany the proposed bill, the President said unapologetically that part of the intercorporate dividend tax's purpose was to discourage large holding company structures.⁶² But the President stated expressly that mutual funds were not a target. He said, "Bona fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risk may well be exempted from this tax."⁶³

For reasons that are unclear, the Revenue Act of 1935 passed without an exemption for mutual funds. But by the end of 1935, the three large Boston-based funds that dominated the open-end fund industry had begun devising a legislative strategy to avoid corporate income tax.⁶⁴ The funds saw a concrete opportunity when the President proposed a new tax bill in 1936 that included the now-infamous undistributed corporate earnings tax.⁶⁵ Before the debate over the 1936 Act began the three open-end funds sought influence with David Walsh, a Democratic Senator from Massachusetts who sat on the Senate Finance Committee.⁶⁶

When the Revenue Act of 1936 first passed the House, it appeared that the mutual funds' tax problems would largely solve themselves. As originally proposed to the House, the bill would have allowed *all* corporations—including ordinary operating companies—to deduct from income

⁶¹ *The President's Message to Congress Urging Increased Taxes on Wealth*, WASH. POST, June 20, 1935, at 1; For general background on the Revenue Act of 1935, see Harley L. Lutz, *The Federal Revenue Act of 1935*, 26 AM. ECON. REV. 161 (1936).

⁶² *The President's Message to Congress Urging Increased Taxes on Wealth*, WASH. POST, June 20, 1935, at 1. See also Randall Morck, *How to Eliminate Pyramidal Business Groups—the Double Taxation of Inter-Corporate Dividends and other Incisive Uses of Tax Policy*, NBER Working Paper No. 10944 (December, 2004).

⁶³ *The President's Message to Congress Urging Increased Taxes on Wealth*, WASH. POST, June 20, 1935, at 1.

⁶⁴ The effort began in August 1935, when Cabot met with James Landis, then chair of the SEC. Senate Hearings, at 1076. According to Cabot's account, Landis said that because of its imminent investigation, the SEC would not take a formal position on the tax measure. Cabot later heard through a friend who worked for Landis that Landis opposed the open-end funds' efforts in 1936. Transcript of Interview with Paul C. Cabot, Conducted by Jessica Holland, 68-69 (1980).

⁶⁵ JOHN MORTON BLUM, FROM THE MORGENTHAU DIARIES: YEARS OF CRISIS, at 305 (1959). *Text of President Roosevelt's Tax Message*, Washington Post, at 7 (Mar. 4, 1936).

⁶⁶ Grow, *supra* note 12, at 456-457.

all amounts they distributed to shareholders.⁶⁷ This proposal would have effectively ended the corporate income tax. The House passed the bill in the form proposed by the Administration and when the bill first reached the Senate, the open-end funds supported it with only one proposed revision that is unimportant for my purposes.⁶⁸

The special tax treatment for mutual funds came into being because the Senate rejected the House bill and insisted on retaining the basic income tax even for companies that distributed their income. The Senate proposed instead to impose the undistributed earnings tax only as a kind of penalty in addition to the basic income tax. With the basic income tax appearing likely to remain intact, the open-end funds had to shift their efforts to obtaining some special provision that would allow them to avoid it.

The funds asked Walsh to submit for the record a memorandum proposing that the distribution requirement as originally requested by the Administration for all companies should be retained just for open-end mutual funds.⁶⁹ The memo notably suggested that favorable tax treatment be given to open-end funds and not to closed-end funds.⁷⁰

Five days after Walsh entered the new memorandum into the legislative record, Arthur H. Kent, acting Chief Counsel of the Bureau of Internal Revenue, introduced a draft of the mutual fund provision.⁷¹ The draft gave the funds the distribution-based system they desired and limited it to open-end funds by expressly disqualifying closed-end funds. The draft also restricted

⁶⁷ See generally Steven A. Bank, *The Story of Double Taxation: A Clash Over the Control of Corporate Earnings*, in BUSINESS TAX STORIES (Steven A. Bank & Kirk J. Stark eds., 2005); BLUM, *supra* note 65, at 305-319; Roy G. Blakey and Gladys C. Blakey, *The Revenue Act of 1936*, 26 AM. ECON. REV. 466 (1936); William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727 (1994);

⁶⁸ The open-end funds wanted to treat a smaller portion of capital gains as income, reducing the amount of capital gains that would have to be distributed to avoid income tax. Senate Hearings, at 1079-1080.

⁶⁹ *Id.*, at 1081.

⁷⁰ The suggestion was indirect, but the memo's proposed language for excluding closed-end funds ultimately made its way into the bill verbatim. *Id.*, at 1082.

⁷¹ *An Act to Provide Revenue, Equalization Taxation and for Other Purposes, Hearing Before the S. Comm. on Fin., Part 11*, 74th Cong. 10 (1936).

controlling investments in portfolio companies. It prohibited qualifying funds from holding more than 10% of any class of any single issuer's securities. Although the open-end funds did not object to this provision, there is also no evidence that they requested it and it seems to have originated with the administration. Curiously, the first draft had no corresponding breadth provision requiring a fund to spread its portfolio among a large number of different companies.

The bill that ultimately passed the Conference Committee on June 18⁷² produced the versions of the breadth and depth provisions that have made their way into modern mutual fund taxation: mutual funds could invest no more than 5% of their portfolios in any one issuer and could own no more than 10% of any class of a portfolio company's outstanding securities. Unlike the corresponding provision in the Revenue Act of 1942, however, which endures today and applies only to *half* of a fund's portfolio, the provision in the 1936 Act applied to a fund's *entire* portfolio. Representatives from the open-end funds were present in the conference committee meeting and were repeatedly asked for their preferences about the bill's language.⁷³

There is no evidence that any significant political player thought of the portfolio restrictions in the Revenue Act of 1936 as having any symbolic value. It was clear to everyone after the bill had been passed that the mutual fund provisions had been drafted exclusively for the benefit of the open-end fund industry. The SEC and the closed-end fund industry did not even know the provisions had been proposed until they were enacted. David Schenker, chief counsel for the SEC's investment trust study, said several years later at the hearings on the 1940 Act that "there is no legislative history upon [the 1936 tax provision]. As I remember it, it was introduced on the floor, and the first thing we knew was that the open-ended companies, as counterdistinguished

⁷² 1936 Act Conference Committee Report, page 21.

⁷³ Tosiello-Cabot Interview, at 9-10.

from the closed-end companies, had this tax preference.”⁷⁴ *Businessweek* magazine reported shortly after the bill was passed that “New York and Chicago [i.e., the closed-end funds] blame it on those ‘smart Boston boys,’” and characterized the amendment, including the distribution and open-end provisions, as a “last-minute insertion” to the revenue bill.⁷⁵ No major newspapers mentioned the provision as it progressed through the Senate committee, and there does not appear to have been any public comment on the provision by any administration official prior to or shortly after the Act’s passage.⁷⁶ No witness from the closed-end fund industry ever testified on the Act, and the closed-end funds appear to have been all but ignorant of the fact that anything about mutual fund taxation had been proposed.⁷⁷

3. The Revenue Act of 1942

The history of mutual fund taxation over the next six years is dominated by the closed-end funds’ struggle to obtain favorable tax treatment. The story picks up with the Revenue Act of 1938.⁷⁸ With the help of two Massachusetts representatives on the House Ways and Means Committee, the open-end funds successfully resisted an attempt to extend favorable tax treatment to closed-end funds,⁷⁹ along with an attempt to undo open-end funds’ favorable tax treatment.⁸⁰

⁷⁴ Senate Hearings, at 802. The open-end funds later claimed that Schenker had been copied on a memo describing a meeting between the executive secretary of SEC Chairman Landis and the open-end funds. Senate Hearings, at 1077.

⁷⁵ *Investment Dilemma: Trusts Forced to Choose Between Drastic Reorganization and High Tax, Under New Law*, BUS. WK. July 11, 1936, at 45-47.

⁷⁶ Arthur Kent’s comments, *infra* note 169 and accompanying text, occurred in an executive session closed to the public.

⁷⁷ Cabot and Merrill Griswold, of MIT, recalled many years later that a lawyer representing a closed-end fund came to Washington to observe the hearings, and Cabot and Griswold distracted him by getting him drunk or playing cards with him. Grow, *supra* note 12, at 468 n.63.

⁷⁸ Revenue Act of 1938, 52 Stat. 447, 552, Pub. L. No. 75-554 §361-362

⁷⁹ Both open-end and closed-end fund witnesses appeared in public testimony before the committee, but the two Massachusetts representatives on the committee brutally cross-examined the closed-end funds’ only witness and explained to their fellow committee members various reasons why they believed closed-end funds did not deserve favorable tax treatment. *Revenue Revision 1938, Hearings Before the H. Comm. on Ways & Means, 75th Cong.* 842-843 (1938).

⁸⁰ *Mutual Investment Companies May Lose Special Tax Treatment*, WALL ST. J., at 10 (Jan. 6 1938); *Subcommittee’s Action on Investment Trusts of Interest to Boston*, WALL ST. J., at 8 (Jan. 10, 1938). COMPARATIVE PRINT SHOWING CHANGES FROM EXISTING LAW MADE BY THE BILL AS PASSED THE HOUSE, REVENUE ACT OF 1938 H.R. 9682, 75th Cong. (March 14, 1938).

In the end, the Revenue Act of 1938 passed the House with the 1936 provision, and the open-end funds' exclusive ability to rely on it, intact.

Closed-end funds finally received tax relief in 1942. By then, the political dynamic surrounding mutual fund taxation had changed. In return for the closed-end fund industry's support of the ICA, which was enacted in 1940, the SEC had apparently agreed to offer its support for tax reform in 1942.⁸¹

The history of the portfolio depth limits in the Revenue Act of 1942 suggests that even though these provisions did not originate with the mutual fund industry, the industry strongly influenced them and had little objection to their final shape. In its initial proposal to the House, the Treasury wanted to use the same depth and breadth standards as the ICA had for the definition of the term, "diversified investment company." The ICA allowed a fund to advertise itself as "diversified" only if it met the 5% breadth and 10% depth standards in 75% of its portfolio. When witnesses from the industry testified before the Senate in July of 1942, however, the version of the bill they submitted loosened the breadth and depth standards.⁸² The version the industry submitted applied the breadth and depth standards only to 50% (rather than 75%) of the portfolio, and made up for the loosening by adding in a set of complicated but less demanding restrictions, including the limit that not more than 25% of a fund's assets could be invested in the securities of any one issuer or any two issuers that the fund controlled. Witnesses from both open- and closed-end funds were unanimous in their support for the bill. The breadth and depth limits in the final bill mirrored exactly the industry's proposal.

⁸¹ *Revenue Revision of 1942, Hearing before the H. Comm. on Ways & Means, 77th Cong. 93 (1942)* (Statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury).

⁸² Senate Hearings, Part 1, 899-907 (Statement of William F. Morton, Vice President of State Street Investment Corporation).

B. The Investment Company Act of 1940

The centerpiece of mutual fund regulation is the ICA. Although the ICA was initially drafted and proposed to Congress by the SEC, the industry exercised substantial influence over many of the key provisions that now distinguish mutual funds from hedge funds. The final version of the ICA conformed very closely to the wishes of both open-end and closed-end funds and the industry supported the bill vigorously in spite of having had substantial political power.

Cooperation between the SEC and the industry began with the SEC's attempt to collect information for its study.⁸³ When the information-gathering phase of the study had ended and the staff of the study turned to drafting recommendations, the SEC sought and received extensive drafting suggestions from individual funds and from committees that the industry had organized to help gather information.⁸⁴ Representatives from the Commission stressed repeatedly in public how helpful these committees were.⁸⁵

All of the politically meaningful hearings on the bill took place in the Senate.⁸⁶ These hearings began on April 2, 1940 and ended on April 26.⁸⁷ Nearly every witness from the open- and closed-end funds began or ended his comments to the Senate by emphasizing his desire not just for mandatory disclosure, but also for operating restrictions that went beyond disclosure.⁸⁸

⁸³ Senate Hearings, at 175 (Statement of David Schenker)

⁸⁴ *Id.*, at 41 (Statement of Robert Healy). Some funds published their recommendations in pamphlets for circulation to the public and among the industry. *See, e.g.*, EARLE BAILIE, INVESTMENT COMPANY REGULATION (1937) (on file with author and with MFS Investment Management); FLOYD B. ODLUM, GENERAL STATEMENT AND RECOMMENDATIONS ON INVESTMENT TRUST LEGISLATION (1937) (on file with author and with MFS Investment Management).

⁸⁵ Senate Hearings, at 175 (Schenker).

⁸⁶ Grow, *supra* note 12 at 421 tbl.26.

⁸⁷ The House held no hearings until after the Senate had held an initial round of hearings and the bill had been redrafted in consultation with the industry. By then the industry offered no opposition and hearings were a formality.

⁸⁸ Among just the first few speakers, for example, see Senate Hearings, at 326 (Bunker), 370-371 (Quinn), 476 (Cabot), 440 (McGrath), 458-459 (Traylor), 488 (Griswold), 510 (Bullock), 538 (Adler), 568 (Eberstadt). The most prominent exception was William Parker, President of Incorporated Investors. *Id.*, at 545 ("I disapprove entirely of this bill in its present form..."). Even Parker, however, eventually became a convert to substantive regulation. *Infra* notes 93-94 and accompanying text.

Arthur Bunker, the Executive Vice President of the Lehman Corporation and the most influential figure from the closed-end fund industry in the drafting of the ICA, typified the general attitude.

At the outset I want to make it perfectly clear that I am in favor of Federal legislation for the regulation of investment companies....

Over 3 years ago at the public hearings before the Securities and Exchange Commission, when my corporation was being examined in connection with the investigation of the industry, we proposed regulations which in the light of knowledge then available appeared adequate as a cure for such abuses as were then known to exist. They embraced, in general, a requirement for the most detailed publicity and disclosure, coupled with standard accounting practices.

Since then, knowledge in the matter has expanded. By virtue of the 4 years' study made by the S.E.C....a mass of data on the subject of investment trusts has been assembled...I am free to admit that the disclosure of the abuses which have existed in the past among some investment companies, has brought home to me the necessity for a greater measure of regulation than I had originally thought necessary or desirable.⁸⁹

The industry opposed several aspects of the original bill, however. The industry attacked the extensive delegation of authority to the SEC,⁹⁰ the registration requirement for individual officers and directors, the SEC's authority to deny plans of reorganization, restrictions on board members' outside (rather than inside) affiliations, restrictions on mutual fund size, and restrictions on promotions of multiple mutual funds by the same individuals.

Bunker was chosen by a committee comprising both halves of the industry to present a definitive list of requests at the end of the hearings. After the hearings ended on April 26, 1940, Schenker and Robert E. Healy, the SEC Commissioner with primary oversight of the mutual fund study and bill, met with lawyers for the closed-end and open-end companies to work out a new draft. The hearings reconvened a few weeks later and the new draft was ultimately enacted by Congress with only a handful of technical changes.

Bunker's requests were granted to a remarkable extent. The only requests that were not either clearly granted or mostly granted were unimportant. They related either to the organization of the

⁸⁹ Senate Hearings, 326.

⁹⁰ Senate Hearings, 382 (Quinn).

statute, such as the request that a separate title be created for unimportant instruments like face-amount certificate companies, or to delegations of authority to the SEC, which turned out not to matter a great deal since the industry conceded the primary sources of authority for the SEC.

It appears that the industry affirmatively desired much of the regulation for its own purposes and not merely as a capitulation to political reality or as a quid pro quo in exchange for some favorable tax status or other treatment. This can perhaps be inferred from the sudden increase that occurred in the industry's political power as a result of the sudden outbreak of war in Europe. When the first round of Senate hearings ended and the SEC and industry representatives began gathering behind closed doors to redraft the bill on April 26, 1940, Germany had taken no overt military action for more than a year. But two weeks later, on May 10, while the redrafting was still under way, Germany invaded Belgium. Dunkirk was being evacuated on May 31 when the second round of Senate hearings began, and the House hearings ended on June 14, the day Germany occupied Paris. Congress was still meeting by the time of the House hearings only because the Congressional session had been extended indefinitely to prepare for war.

The effect of the war on Congress' docket was significant. News sources blamed the outbreak of war for the tabling of several pieces of domestic legislation that had had good chances of passing in April and early May of 1940. These included the La Follette-Thomas Labor Espionage Bill, amendments to the National Labor Relations Act, a wage-hour law, a transportation bill, the Cole Oil bill, the Silver Purchase Act, and the Walter-Logan bill.⁹¹

⁹¹ *What Congress Will Do This Session*, BUS. WK., at 7 (June 29, 1940); *Washington Bulletin: No Other Legislation*, BUS. WK., May 25, 1940 7-8; *Bill for Review of Agencies Draws Fire; Rayburn Challenges Inclusion of SEC As House Debates*, WASH. POST, Apr. 16, 1940, at 2; *Agency Curb Passes House; Vote, 280-97*, WASH. POST, Apr. 19, 1940, at 1. The effect of war on the Walter-Logan bill was particularly dramatic. By mid-April the bill had passed the House by a 3-to-1 margin and had swiftly passed committee in the Senate. *Senate Group Approves Bill to Curb Bureaus*, WASH. POST, May 9, 1940, at 3. But by May 30 the bill was dead. Its opponents successfully deferred a vote on the Senate floor, using the distraction of the war as the sole rationale. *Administration Blocks Action on Agency Curb*, WASH. POST, May 31, 1940, at 2; *What Congress Will Do This Session*, BUS. WK., June 29, 1940, at 7.

Indeed, the war's effect was so pronounced that only a sustained lobbying effort by the mutual fund industry was able to save the ICA. When the Senate hearings reconvened to consider the new draft, the two industry lawyers who had negotiated the revisions, Alfred Jaretzki and Warren Motley, anxiously requested its passage.⁹² When the House held hearings two weeks later, Bunker, speaking for closed-end funds, and Merrill Griswold of MIT, speaking for open-end funds, confidently summarized an industry-wide effort to seek comment on the bill by saying that the industry's support was unanimous.⁹³ Fifteen witnesses appeared for the industry and nine letters were submitted; all urged passage of the bill and made no criticism of any of its provisions.⁹⁴

Several Congressmen indicated a belief that the war had diminished the bill's chances, and expressed surprise at the industry willingness to support the bill in spite of this reality. Probably at the behest of the Boston-based open-end fund industry, Sen. Henry Cabot Lodge of Massachusetts acknowledged on the floor of the Senate that "it is somewhat unusual, perhaps, to seek to pass a bill of this length at a time like this," while the country was preparing for war, but argued that the bill warranted Congress' attention "in view of the very special circumstances [i.e., the industry's unanimous support], and in view of the fact that so much good can flow from the bill."⁹⁵ In the second round of committee hearings in the Senate, Sen. Sheridan Downey of California, was stunned by the SEC's ability to achieve such complete agreement with the industry. "That is a most amazing thing in this chaotic world right now," Sen. Downey observed, presumably referring to the sudden war in Europe and the strength it could have given to the industry to oppose regulation.⁹⁶ "How was this miracle brought about?"

⁹² Senate Hearings, at 1109. Motley expressed similar hope. Senate Hearings, 1109-1110.

⁹³ House Hearings, at 72 (Bunker); *Id.*, at 81 (Griswold)

⁹⁴ *Id.*, at 75.

⁹⁵ 86 CONG. REC. 8843 (1940).

⁹⁶ Senate Hearings, at 1130.

Schenker, an attorney for the SEC and the ICA's principal drafter, replied, "I think I might fairly say that a great deal of it is attributable to the cooperative spirit of the industry."

The industry's support was ultimately enough to propel the bill to swift passage. The bill passed committee and floor votes unanimously in both houses of Congress.⁹⁷

Some readers might argue in spite of the effect of the war and the industry's vociferous support for the bill that the industry capitulated merely because it believed regulation would be inevitable and the industry sought the ICA simply to stave off something worse. This seems unlikely. Many industry sources disputed this claim both before and after the bill's passage.⁹⁸ And one has to wonder just what the industry would have had to fear by putting off the ICA. Political momentum was moving against stricter regulation, not in favor of it. The SEC's study of the mutual fund industry had just been published, and its salience and political significance would only decline with time. The New Deal was over and the public's mood was becoming more conservative. And at the very moment when the industry decided to support the bill most vigorously, it became apparent that war in Europe would consume Congress', the Administration's and the public's attention for years to come.

III. The need for substantive regulation

It appears, therefore, that the mutual fund industry had its own purposes for desiring many of the provisions that go beyond fraud-prevention and disclosure in mutual fund regulation. The question is why. Historical evidence does not thrust upon us a single and obviously correct answer. I now outline one possible answer, however, and then develop it by demonstrating its consistency with evidence regarding the growth of industry support for regulation in the 1930s.

⁹⁷ 86 CONG. REC. 9819 (1940) (House) 36 CONG. REC. 8843 (Senate).

⁹⁸ See, e.g., Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303 (1941).

A. Collective brand-building

In the late 1930s, mutual funds, like the sellers of all mass-market products or services, sought to cultivate reputations to maximize their appeal. They sought to build demand for the kinds of investing strategies that mutual funds were well-suited to undertake. And they sought to demonstrate the consistency of their strategies with the investing public's tastes. Neither open- nor closed-end funds wanted to be associated with holding companies, or with high leverage and risk. Leverage and risk had become extremely unpopular as a result of the closed-end funds' spectacular collapse in 1929.⁹⁹

Many funds were not content, however, to manage their reputations on their own. They wanted to build an industry-wide reputation because they believed that the mass-market investors they targeted could not easily perceive differences among investment funds. Investors' experience with particular funds may have influenced their perceptions of the entire industry, and individual mutual funds may have had difficulty establishing individual reputations apart from the industry's reputation as a whole. In other words, mutual funds may have come to depend on a collective, industry-wide brand or reputation.

This was a problem because, as described above,¹⁰⁰ the mutual fund industry was still struggling for a significant share of the market for saving and investing in the 1930s. There was a real risk that investors might simply choose to invest in securities directly, or not to invest at all, rather than to invest in mutual funds or closed-end funds.

Like many collectively owned assets, the industry-wide brand may have been subject to free-rider problems. Individual funds internalized only a portion of the costs and benefits that their actions had for the reputation of the industry as a whole. And some funds may simply have

⁹⁹ See, e.g., FORTUNE, September 1935, at 53; THE LITERARY DIGEST, Oct. 26, 1929, p. 62; COMMERCIAL AND FINANCIAL CHRONICLE, DEC. 7, 1929, at 3529; *Are American Investment Trusts Sound?*, BARRON'S, Feb. 24, 1930, at 11; John T. Flynn, *Investment Trusts Gone Wrong*, THE NEW REPUBLIC, APRIL 2, 1930.

¹⁰⁰ *Supra* Section I.B.

desired to cultivate reputations and pursue strategies that were not consistent with the reputation the bulk of the industry was seeking to build.

This branding impulse is different from the bonding-related impulse that arguably underlies ordinary securities regulation.¹⁰¹ Securities regulation of ordinary operating companies has often been rationalized as a way of helping individual companies to commit to carrying out their promises. Mandatory disclosure is said to enable investors to know what a company has promised to do and assures them that the company will actually do it. The mutual fund industry, in contrast, wanted not so much to assure investors that mutual funds would operate *as they promised*, but to assure investors that mutual funds would operate *in a particular way*.

The goal, in other words, may have been to standardize funds so that investors would not have to spend time and effort reading through prospectuses to figure out what individual funds had promised to do; they could rely instead on regulation to guarantee a certain approach. It is also important to note that unlike the bonding impulse that underlay ordinary securities regulation, the motivation for limiting freedom of contract for mutual funds resided in the need to solve a collective problem, not an individual one.

It is plausible to think that open-end funds, in particular, could have pushed down dissents within the industry during the lobbying process, because in 1940 the open-end fund industry was highly concentrated. The five largest funds, which included the three large Boston funds that sought the Revenue Act of 1936, had more than 50% of the industry's total assets, and the remaining 50% was widely dispersed.¹⁰²

¹⁰¹ For an overview of the rationales for mandatory disclosure in ordinary companies, see ROBERTA ROMANO, *THE ADVANTAGES OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* (2002); Christian Leuz & Peter Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research* (March 2008), available at <http://ssrn.com/abstract=1105398>

¹⁰² *Supra* notes 44-45 and accompanying text; SEC Study, Part 2 at 56 tbl.6.

It is also plausible to think that mutual funds may have perceived a threat to the industry's reputation from funds that operated inconsistently with industry standards. The open-end fund industry was growing rapidly, beyond its historically narrow confines in Boston, and the closed-end fund industry was still struggling in the late 1930s to restore popular confidence after the excesses of 1929.

B. The growth of industry support for substantive regulation

In the early 1930s the growth of support for regulation reaching beyond fraud and disclosure was evident primarily in the reports of the Investment Companies Committee of the Investment Bankers Association of America (IBAA), which served as the closed-end funds' main trade organization since most closed-end funds were organized and managed by investment banks.¹⁰³ In a manner consistent with the collective branding problem described above, the Committee saw the public as being incapable of understanding the ways in which the industry had changed, the ways in which it differed from holding companies and the ways individual funds differed from one another. The Committee and its members therefore demonstrated a growing conviction through the 1930s that industry-wide action would be necessary to manage the public's perception.

In 1930, the discount to NAV in closed-end funds was still new and there was still hope that it could be gotten rid of quickly. The report of the IBAA Investment Companies Committee expressed confidence that individual funds could eliminate their discounts by simply following sound disclosure practices and the NYSE's listing rules for closed-end funds.¹⁰⁴ Compliance with the NYSE standards was expected to be "a most important factor in restoring to public favor

¹⁰³ SEC Study Part 2 at 201-206.

¹⁰⁴ For an explanation of these rules, see *infra* Subection II.B.1.

many deserving investment companies whose shares are now selling below their liquidating value.”¹⁰⁵

By 1931, however, it had become apparent that the discount was not a fleeting phenomenon. Hope remained that it could be eliminated, but its causes and solutions had been recast. The Committee began to see the discount as a product not of individual funds’ bad behavior, but of public perception of the industry as a whole. The Committee report’s opening paragraphs said

It is desirable that the Investment Bankers Association of America continue to make every effort to bring about a clearer understanding on the part of the investing public of the securities in which its members are interested. The Investment Companies Committee can perform an important service in giving the investing public a full knowledge of the operations of investment trusts, their possibilities and their limitations. If the public is taught to know exactly the sort of thing with which it is dealing when it purchases a certain type of investment trust security, to recognize the advantages and disadvantages of the various types, the danger of faulty management and practices, and the necessity of certain definitely announced policies, it will know more nearly what to expect from its investments and will be better qualified to choose between the good and the poor companies.¹⁰⁶

The way to eliminate the discount was not for individual funds to make information available about themselves; it was to improve the public’s ability to use the information already available and to draw clearer distinctions among funds. No individual fund could transform the investing public or the entire industry’s reputation on its own; industry-level action was required.

In 1932, the Committee had clearly ceased to believe that individual funds could eliminate the discount on their own by complying with the NYSE standards. Therefore, all funds—including the many funds not listed on the NYSE—were encouraged to comply with the standards voluntarily. Great emphasis was placed on industry-wide compliance.¹⁰⁷

In the mid-1930s, the Committee fixated on a slightly different problem, which also called for collective action: the public’s inability to distinguish mutual funds from similar vehicles. The

¹⁰⁵ *Id.* at 55.

¹⁰⁶ Proceedings of the Twentieth Annual Convention of the Investment Bankers Association of America, 19 (1931) [hereinafter 1931 IBAA Proceedings].

¹⁰⁷ 1932 IBAA Proceedings, 103-105. For a brief discussion of these standards, see *infra* notes 119-120 and accompanying text.

chief problem was the “holding company.” The 1932 committee report called for “a clearer understanding of the fundamental distinction between true investment companies and the great host of holding, finance, and control corporations.”¹⁰⁸ The 1933, 1934 and 1935 reports also expressed frustration with the public’s inability to distinguish mutual funds from similar entities including holding companies.¹⁰⁹ The committee further blamed the “lack of an adequate description upon which the investor can readily discriminate between the various types of such companies” for “much of the confusion, loss and subsequent unpopularity of the companies and their sponsoring banking firms.”¹¹⁰

The closed-end fund industry’s belief that the public was incapable of discerning fraudulent and inappropriately risky funds and differentiating mutual funds and holding companies was evident in the many manuals for novice investors published by authors connected to the closed-end fund industry in the late 1920s and early 1930s.¹¹¹ Just a few weeks prior to the crash of 1929, for example, Paul Cravath, a prominent Wall Street lawyer,¹¹² wrote in the introduction to a popular and authoritative manual on mutual funds that

It is important that [investment trusts] should not be confused with numerous other meritorious enterprises... These enterprises vary in range from those organized to finance or manage associated or subsidiary industrial or public utility undertakings, to certain companies recently organized to take over blocks of securities already assembled.... Hovering under the shadow of these meritorious but widely divergent enterprises there are doubtless others masquerading as investment trusts to attract the capital

¹⁰⁸ *Id.* at 104.

¹⁰⁹ 1933 IBAA Proceedings, 152-153; 1934 IBAA Proceedings, 93; 1935 IBAA Proceedings, 227.

¹¹⁰ 1933 IBAA at 152.

¹¹¹ *See, e.g.*, WALTER N. DURST, ANALYSIS AND HANDBOOK OF INVESTMENT TRUSTS, 5-6 (1932); THEODORE J. GRAYSON, INVESTMENT TRUSTS, THEIR ORIGIN, DEVELOPMENT AND OPERATION, 1 (1928); 1 KEANE’S MANUAL OF INVESTMENT TRUSTS, 550, 552-553 (1928); LELAND REX ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT, 14-15 (2d ed. 1929); MARSHALL H. WILLIAMS, INVESTMENT TRUSTS IN AMERICA, 1 (1928); *see also* Alfred Jaretzki, Jr. The Investment Company Act of 1940, 26 WASH. U. L.Q. 303, 311 (1941); Albert Ottinger, Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law (1927), *reprinted in* 1 KEANE’S MANUAL OF INVESTMENT TRUSTS, 131 (1928).

¹¹² *See generally* ROBERT T. SWAINE, 2 THE CRAVATH FIRM AND ITS PREDECESSORS (1948)

of the unwary investor for the purpose of aiding the speculations of the unscrupulous or the promotions of the visionary.¹¹³

In Cravath's view, choosing the right closed-end fund was not easy. One source of error was the "other meritorious enterprises," such as holding companies, that appeared deceptively similar to closed-end funds. Another was the unscrupulous trust operators "hovering under the shadow" of meritorious enterprises.

The open-end fund industry was so small and kept such a low profile through the mid-1930s that there is relatively little record of any of its leaders voicing opinions about the condition of the industry as a whole. Paul Cabot of State Street Investment Trust, however, garnered public acclaim as a critic of the mutual fund industry and an advocate of the view that funds' individual reputations were tied to the reputation of the industry as a whole. In 1928, Cabot published an article in the *Atlantic Monthly* attacking many practices then common among closed-end funds and prophesying that the entire industry would be affected if misconduct persisted.¹¹⁴ "I strongly believe," Cabot wrote, "that unless we avoid these and other errors and false principles we shall inevitably go through a...period of disaster and disgrace. If such a period should come, the well-run trusts will suffer with the bad."¹¹⁵ After the crash, Cabot saw his prophecy vindicated, noting that "many now doubt that there are any 'good investment trusts.'"¹¹⁶ In 1930, he attributed the challenges of gaining public acceptance for mutual funds to "the corrupt and unsound practices which have permeated the investment trust field."¹¹⁷

¹¹³ *Id.*

¹¹⁴ Paul C. Cabot, *The Investment Trust*, *ATLANTIC MONTHLY*, 401-408 (March 1929). The SEC submitted the article for the record during hearings on the ICA before the Senate Committee on Banking and Finance. Senate Hearings, 470-475. It must be mentioned that Cabot was initially hostile to the Investment Company Act in the first round of Senate hearings, although he ultimately supported it after the bill had been revised.

¹¹⁵ Cabot, *supra* note 114, at 408.

¹¹⁶ State Street Investment Trust, Annual Report, at 7 (Dec. 31, 1929).

¹¹⁷ State Street Investment Trust, Annual Report, at 8 (Dec. 31, 1930). Cabot expressed similar sentiments again in 1931. State Street Investment Trust, Annual Report (Dec. 31, 1931).

The notion that federal regulation was the solution to the industry's problems was slow in coming, but it gained steam in the late 1930s, perhaps partly as a result of the bad press and new information generated by the SEC investigation. As noted above, Arthur Bunker attributed his own conversion from supporting purely disclosure-based regulation to supporting more extensive operational regulation to the new information and publicity generated by the SEC investigation.¹¹⁸

C. The inadequacy of alternative solutions

Alternatives to federal law were incapable in the late 1930s of achieving the kind of substantive regulation the industry needed to manage its collective image. The chief problem with most of these alternatives was that they were inapplicable to large segments of the industry. Additionally, some of these mechanisms were incapable of reaching beyond disclosure.

The NYSE began listing mutual funds in 1929¹¹⁹ and specified accounting standards and a few mild disclosure requirements in 1931 in response to pressure by the IBAA.¹²⁰ The problem with the NYSE and other exchanges, however, was that few funds actually listed on them. Open-end funds had little reason to list, since their shares were bought and sold only in transactions with the funds themselves or with brokers who sold the funds' shares.¹²¹ And many closed-end funds never listed, trading only over the counter. At the end of 1936, only 54 closed-end companies had even one issue listed on a national securities exchange, while 59 had none.¹²²

Industry organizations showed similarly little promise. The open-end funds never had anything approximating an industry organization prior to 1940. The closest thing the closed-end funds had to an industry organization was the IBAA, which promulgated a set of best practices in

¹¹⁸ Senate Hearings, at 326.

¹¹⁹ SEC Study Part 3, at 43, 779-799; ROBINSON, *supra* note 111, at 582.

¹²⁰ SEC Study Part 3, at 787.

¹²¹ Five open-end funds had securities listed on exchanges in 1936, apparently to take advantage of state blue sky law exemptions for listed securities. *Id.*, at 280-281.

¹²² *Id.*, at 280.

1928 and in the early 1930s encouraged compliance with accounting, disclosure and ethical standards. These standards, however, were vague, and the IBAA Investment Companies Committee had little way to enforce them.

The 1933 and 1934 Acts were also inadequate. Few closed-end funds were required to register under the 1933 Act, because closed-end funds had stopped selling securities after 1930.¹²³ Additionally, the '33 and '34 Acts were only disclosure and anti-fraud statutes and offered uncertain authority for administrative creation of the extensive substantive regulatory regime the industry eventually came to desire.

State regulation showed only limited promise. In almost all states prior to 1939, there was no special regulation for mutual funds.¹²⁴ Prior to 1929, the National Association of Securities Administrators (the NASA) had promulgated a standard registration form for mutual funds, but it had no standard set of substantive regulations.¹²⁵ New York almost became an exception in 1928,¹²⁶ but personal and political squabbles among the New York Attorney General, the Speaker of the Assembly and the Senate majority leader killed a bill that would have regulated mutual funds.¹²⁷

¹²³ See, e.g., A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisers, and for Other Purposes: Hearing On H.R. 10065 Before A Subcomm. Of the H. Comm. On Interstate and Foreign Commerce, 76th Cong. 59 (1940) [hereinafter House Hearings]; Senate Hearings, at 135.

¹²⁴ Grow, *supra* note 12, at 182; ROBINSON, *supra* note 111, at 525-528.

¹²⁵ ROBINSON, *supra* note 111 at 525-528.

¹²⁶ For the draft of the bill and the investigative report that produced it, see Albert Ottinger, Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law (1927), *reprinted in* KEANE'S INVESTMENT TRUST MANUAL, *supra* note[.]. The industry's attitude toward the bill appears to have been mixed. The bill's advocates claimed industry support. *Investment Trusts Face Early Action*, N.Y. TIMES, Jan. 3, 1928, at 32; *Investing Trusts Approve New Bill*, N.Y. TIMES, Feb. 9, 1928, at 39; *Investment Trust Regulation Bills*, WALL ST. J., Feb. 17, 1928, at 8; *Bank Bills Favored at Albany Hearings*, N.Y. TIMES, Feb. 29, 1928, at 36. But the IBAA officially took no position and some news reports suggested that elements in the industry worked behind the scenes to defeat the bill. *Investment Trust Bills*, N.Y. TIMES, Feb. 18, 1928, at 23; *Investment Trusts Cause Albany Clash*, N.Y. TIMES, Feb. 25, 1928, at 25.

¹²⁷ *Major Legislation Doomed at Albany*, N.Y. TIMES, Mar. 5, 1928, at 14; *Investment Bills Doomed to Defeat*, N.Y. TIMES, Mar. 18, 1928, at 27; *Legislature Ends with a Slaughter of Smith's Bills*, N.Y. TIMES, Mar. 23, 1928, at 1.

Significant state regulation was not to come until 1939 when the Ohio Division of Securities led a number of states that year in adopting a statute called Regulation Q-3.¹²⁸ The NASAA adopted a variant of Regulation Q-3 as its model mutual fund statute in 1939¹²⁹ and the open-end funds gladly supported it.¹³⁰ But Q-3 applied only to new issues, and closed-end funds had ceased issuing new shares by 1930 because of the discount. And Q-3 applied only to the subset of open-end funds that registered new issues in states that adopted Q-3. Moreover, state regulators' enforcement capacity was severely limited by resource constraints.

D. Other explanations

Two general explanations for the industry's support for regulation other than the branding dynamic that I have identified also warrant mention. One was the closed-end fund industry's desire to obtain favorable tax treatment. It had become clear by 1940 that the only way the closed-end fund industry could gain the Administration's and the SEC's support for favorable tax treatment was for these funds to submit to some comprehensive system of regulation. This no doubt partly explains the closed-end funds' willingness to be flexible and to support the ICA's passage in 1940.

The closed-end funds' desire for favorable tax treatment does not, however, explain why open-end funds supported the ICA. Indeed, the possibility that the ICA might enable closed-end funds eventually to obtain favorable tax treatment would have been a reason for open-end funds to *oppose* the ICA. Nor does the tax issue explain why closed-end funds did not attempt to squeeze more concessions out of the SEC. If the closed-end funds had desired regulation purely for the purpose of getting favorable tax treatment, and not did not desire regulation for its own

¹²⁸ Proceedings of the Annual Meetings of the National Association of Securities Commissioners 1938, at 13 [hereinafter NASC Proceedings]; 1939 NASC Proceedings, at 187.

¹²⁹ 1939 NASC Proceedings, at 187, 275.

¹³⁰ The President of Fidelity Fund, for example, submitted a copy of Q-3 to the Senate during hearings on the ICA and expressly endorsed Q-3. Senate Hearings, at 548. MIT proudly announced its compliance with Q-3 very soon after Ohio and other states adopted it. Massachusetts Investors Trust, Annual Report, at 4-5 (Dec. 30, 1939).

sake, they most likely would have tried to weaken the regulation as much as possible. Delaying the ICA for the purpose of weakening it would not necessarily have delayed favorable tax treatment, because the distractions generated by the war prevented closed-end funds from getting favorable tax treatment until 1942—two years after the passage of the ICA.

A second explanation is the retail price maintenance provision in Section 22(d) that prevented brokers from discounting sales fees on open-end fund shares.¹³¹ The open-end funds were clearly responsible for this provision, and they inserted it after the initial round of hearings in the bill on the Senate, when the bill was being redrafted in negotiations between the industry and the SEC.¹³² The provision may have been useful in helping open-end funds to recruit brokers to sell their securities. It is unlikely, however, that this provision alone explains the open-end fund industry's support for the myriad other aspects of the ICA. Additionally, the testimony of open-end fund industry representatives before the Senate indicated that the open-end funds were clearly on board with the key aspects of regulation even before § 22(d) was added.

IV. The origins of particular provisions

The key provisions of mutual fund tax law and regulation that separate modern mutual funds from modern hedge funds were influenced heavily by the mutual fund industry.

A. Control over portfolio companies

I make a few claims with respect to restrictions on mutual funds' control over the operating companies whose securities mutual funds hold in their investment portfolios: (1) Both open- and closed-end mutual funds in the 1930s and early 1940s had very little interest in influencing portfolio companies. And what little interest they had was completely accommodated by the ICA and tax law. (2) Mutual funds' passivity towards their portfolio companies grew largely out of the funds' emphasis on sales. (3) Neither the SEC nor the mutual fund industry considered the

¹³¹ ICA § 22(d).

¹³² Grow, *supra* note 12; *infra* Table 1.

control restrictions to be very important, but the industry was accommodating toward the restrictions and had a substantial hand in drafting them. (4) The industry’s willingness to accommodate the restrictions can be explained partly by a combination of the collective branding dynamic and a desire to gain competitive advantage over holding companies. (5) There is little evidence that the administration used these restrictions as symbols for populist political purposes or that operating companies sought these restrictions to defend themselves against activist mutual funds.

The ICA contains several indirect limits on mutual funds’ influence over portfolio companies.¹³³ The primary restriction on control over operating portfolio companies that concerns me is what I have called the portfolio “depth” limitation. The Revenue Act of 1936, which applied only to open-end funds, prohibited an open-end fund from getting favorable tax treatment if it held more than 10% of the outstanding securities of any one issuer. The ICA then prohibited both open- and closed-end funds from advertising themselves as “diversified” unless they complied with a similar 10% depth limit. This limit, however, applied only to 75% of a fund’s portfolio and only to voting securities. The Revenue Act of 1942 replaced the Revenue Act of 1936 and conditioned favorable tax treatment for both closed- and open-end funds on compliance with a similar 10% voting security limit. This limit applied only to 50% of a fund’s portfolio. Compliance with the limit in the ICA is effectively optional—the only consequence of a fund’s failure to comply is that the fund may not advertise itself as “diversified.”¹³⁴ The most meaningful limit, therefore, is the limit in the Revenue Act of 1942.

¹³³ For an overview of these indirect restrictions, see Gilson & Kraakman, *supra* note 10, at 997-1003.

¹³⁴ Morningstar keeps data on funds’ ICA diversified status and it appears based on this data that today a significant minority of funds of all investment objectives are not diversified for ICA purposes.

1. Minimal control over portfolio companies in the 1930s

a. Closed-end funds

Closed-end funds exercised some influence over portfolio companies, but this influence was minimal and was fully accommodated by the mutual fund regulatory and tax regime.¹³⁵ Table 1 lists the 22 largest closed-end funds by total assets for which portfolio data is available in Moody's Banks, Insurance, Real Estate and Investment Trusts Manual for 1940.¹³⁶ The data in the table reflect balance sheets at the end of 1939 and list total assets calculated using both market and book valuations of portfolio securities. I collected by hand each of these funds' portfolios of common stocks as listed in the Moody's manual for 1940 and matched them to the Center for Research in Securities Prices' (CRSP) database of New York Stock-exchange-listed stocks for December 1939. The Moody's manual lists the number of shares each fund held of each portfolio issuer, the book and market values of each fund's portfolios and the values of each fund's non-portfolio assets. The CRSP data include the share price of each NYSE-listed security at the end of December 1939 and the total number of shares outstanding.

The 22 funds had a total of 1,501 common stocks in their portfolios. Matches to NYSE-listed securities in the CRSP database could be obtained for 1,179, or 79% of these portfolio stocks. The matched stocks account for 90% of the value of securities listed in the portfolios of these 22 funds and 58% of the total assets of these funds as calculated using market values for securities portfolios.

These data indicate that the restrictions in the Revenue Act of 1942 that ultimately applied to closed-end funds were permissive enough that they would have had almost no discernible effect

¹³⁵ Contemporaneous with the writing of this paper, Armour and Cheffins collected news reports of proxy fights dating to the first half of the 20th century. Their data support the findings here. They show that although proxy fights were not unheard of during the first half of the 20th century, it was extremely rare for these proxy fights to be initiated by pooled investment vehicles. Armour & Cheffins, *supra* note 12, at 255.

¹³⁶ 1940 MOODY'S MANUAL OF INVESTMENTS: BANKS, INSURANCE REAL ESTATE, INVESTMENT TRUSTS.

on closed-end funds' investments in NYSE-listed companies in 1940. The average percentage of an issuer's outstanding securities held in the 1,179 matched portfolio positions was just 0.6%. The median percentage was less than 0.2%.

Table 2 lists all positions in which the selected mutual funds held more than 5% of an operating company issuer's securities. Investments in other mutual funds are omitted. The table shows that the 22 mutual funds held among them only 18 positions that comprised more than 5% of a portfolio issuer's securities and only 5 positions that comprised more than 10%.

The Revenue Act of 1942 would not have directly restricted any of the positions in Table 2. Recall that the Revenue Act of 1942 restricted positions in excess of 10% of an issuer's securities only if these positions, together with positions that comprised more than 5% of a fund's total assets, made up more than half of a fund's portfolio.

Table 3 lists the total assets of each fund that violated the 5% breadth or 10% depth restrictions and shows that because the Revenue Act of 1942 applied the restrictions only to 50% of funds' portfolios, only one fund, Petroleum Corp., would have been affected by these restrictions based on its holdings of NYSE-listed securities. The only portfolio fragmentation restriction that would have had any significant bite was the separate prohibition in the Revenue Act of 1942 on investing more than 25% of a mutual fund's assets in the securities of one issuer or two or more issuers which the fund controls.¹³⁷

The ICA's definition of "diversified," with which compliance was required only for funds that wish to call themselves "diversified," did not have any more effect on these portfolio positions than the Revenue Act of 1942 did. Table 3 shows that only two funds (Pennsylvania Industries and Petroleum Corp.) would have violated the ICA's provision, which applies the breadth and depth restrictions to 75% of funds' portfolios.

¹³⁷ I did not attempt to code for this "two or more controlled issuers" problem. I treat a fund as having violated the 25% breadth limit only if it had more than 25% of its assets invested in the securities of one issuer.

Anecdotal evidence supports the claim that closed-end funds had no serious interest in influencing operating companies. Nearly all of the many manuals published in the late 1920s and early 1930s for novice mutual fund investors distinguished mutual funds from holding companies based primarily on mutual funds' passivity towards their portfolio companies.¹³⁸

Although closed-end funds operating close to the core of the industry were unaffected by the fragmentation requirements, the requirements may have had some impact on a small number of companies operating on the margins of the mutual fund industry. The SEC study listed a total of 56 closed-end companies that held at least 10% or more of the outstanding voting securities of at least one issuer at the end of 1935.¹³⁹ These 56 companies held such stakes in 187 portfolio companies.

At first glance, these numbers would appear to provide solid evidence that many closed-end companies were affected by the 10% depth restriction in the 1942 Revenue Act. Indeed, this is precisely how Roe interprets these numbers, and he draws the additional inference that open-end companies were affected by the restrictions as well.¹⁴⁰

A careful reading, however, tells a more complicated story. The SEC divided the 56 companies in the list into two categories: thirty-four "investment companies proper" and twenty-two "investment holding companies." By the definition in the SEC's study, none of the 34 "investment companies proper" would have violated restrictions on control over portfolio companies in the Revenue Act of 1942, although some of the 22 "investment holding companies" might have.¹⁴¹ There was ambiguity about where some of these "investment holding companies"

¹³⁸ See, e.g., WALTER N. DURST, ANALYSIS AND HANDBOOK OF INVESTMENT TRUSTS, 5-6 (1932); THEODORE J. GRAYSON, INVESTMENT TRUSTS, THEIR ORIGIN, DEVELOPMENT AND OPERATION, 1 (1928); 1 KEANE'S MANUAL OF INVESTMENT TRUSTS, 550, 552-553 (1928); ROBINSON, *supra* note 111, at 14-15 (2d ed. 1929); MARSHALL H. WILLIAMS, INVESTMENT TRUSTS IN AMERICA, 1 (1928).

¹³⁹ SEC Study Part 4, at 7 tbl.1.

¹⁴⁰ Roe at 1473 n.13 and accompanying text. Roe says the list included 65 investment companies. *Id.* This is incorrect.

¹⁴¹ SEC Study Part 4, at 3.

fell on the holding company-mutual fund divide,¹⁴² but it appears that most of them would have been well outside the boundary of any plausible definition of an “investment company.” We cannot say precisely how these companies operated, because the SEC study does not present detailed data, but the available data in the study suggests that the great majority of the investment holding companies had portfolios that were extraordinarily concentrated—so concentrated that they would not have counted as investment companies under any plausible definition of an investment company, including the one that was eventually adopted in the Investment Company Act.¹⁴³ Unlike closed-end funds, which were generally promoted by salespeople and investment banks with separate corporate existences from the funds and which actively traded stocks, it appears that the investment holding companies employed their managers directly and had no interest in active trading or in seeking out activism opportunities in portfolio companies. They were essentially conglomerates.

Perhaps the best indication of just how clear the distinction between investment holding companies and closed-end funds had become is the simple fact that no representative from any of the investment holding companies listed in the SEC’s study appeared at any Congressional hearing on any bill related to mutual fund regulation or taxation. This is because mutual funds were a clearly distinct industry by 1940 and the investment holding companies faced neither the

¹⁴² Of these 22 investment holding companies, Moody’s recognized 18 as still being in existence in its 1940 investment manuals series. Fourteen of these were listed as investment trusts in the Moody’s manual and the other four were listed as railroad, finance or industrial companies. Five of the funds listed as investment companies were large enough to make it into my list of the 25 largest closed-end investment companies, although two were excluded—one because 99% of its portfolio was invested in a minority share of E.I. Du Pont De Nemours & Co. and the other because the Moody’s manual did not list its portfolio. The three that appear in my list—Niagara Share Corp., Petroleum Corp. of America and Utility and Industrial Corp.—show only a moderate interest in control. Only Petroleum Corp. of America would have violated the Revenue Act of 1942 based on its investments in NYSE-listed companies.

¹⁴³ In an earlier portion of its study, the SEC used a slightly more expansive definition of “investment holding company” than it used in the later portion described above and came up with 37 investment holding companies. See SEC Study Part 2, at 8-9, 92. There is more data available on these 37 companies than on the companies included in the narrower definition of investment holding company, although the SEC did not break out data by individual funds. At the end of 1935, 14 of these 37 companies held only five or fewer issues, and a single issue accounted for more than half of the total value of the portfolios of 21 of these companies. *Id.* at 92. All but 18 of these companies had fewer than \$20 million in assets.

opportunity nor the threat of being covered by the mutual fund tax and regulatory regime. Although the public may have been confused, there was little uncertainty on the part of the SEC and informed industry observers about what a mutual fund was. If we think of mutual funds and holding companies as inhabiting different points on a continuum of diversification and control over portfolio companies, the continuum would have had a barbell distribution, with mutual funds clustered at one extreme, holding companies clustered at the other, and very few businesses in between.

b. Open-end funds

The case is even clearer with respect to open-end funds. It is not an exaggeration to say that everyone simply knew in the 1930s that these funds had no interest in controlling portfolio companies. This was why open-end funds were excluded entirely from the portion of the SEC study that examined control over portfolio companies.¹⁴⁴

At the end of 1935, just prior to when the 1936 Act applied a 10% depth restriction to open-end funds' entire portfolios, no open-end company held 10% or more of the voting securities of any portfolio company.¹⁴⁵ MIT, the largest open-end fund at the time, had only one position in 1935 that comprised more than 3% of the issuer's outstanding securities, and that position was only 3.3%.¹⁴⁶

The portfolio restrictions in the 1936 Act and the looser restrictions that came later gave open-end funds considerably more freedom than they wanted or needed. Merrill Griswold of MIT wrote a letter to the SEC in 1940 explaining that if the three large Boston open-end companies' portfolios were combined into a single portfolio, they would own more than four percent of the outstanding securities of only three companies, and the largest of these three

¹⁴⁴ SEC Study, Part 4.

¹⁴⁵ *Id.*, at 2, 5-6.

¹⁴⁶ Massachusetts Investors Trust, Annual Report (Dec. 31, 1935). MIT held 3.3% of Chrysler's common stock.

combined positions would have been only seven percent.¹⁴⁷ Indeed, Griswold *expressly invited* the SEC to impose mandatory restrictions in the ICA on the percentage of an issuer's securities a mutual fund could hold.¹⁴⁸ Griswold even offered the SEC advice on how to craft portfolio composition requirements most effectively to discourage control.¹⁴⁹ The SEC tellingly declined this invitation.

On rare occasions prior to 1942, open-end funds led proxy fights over high-level corporate governance issues.¹⁵⁰ But this kind of activism did not reflect ownership of large control stakes, and it would not have violated any provision in the modern versions of the Revenue Acts of 1936 or 1942 or the ICA. Indeed, the type and frequency of open-end funds' activism prior to the advent of regulation appears to be roughly similar to the type and frequency of open-end fund activism in the modern era.

2. Emphasis on sales

The primary explanation for early mutual funds' passivity towards their portfolio companies centers on the skills of the people who promoted these funds. As explained above,¹⁵¹ the great majority of closed-end funds were established during the popular investing boom of the late 1920s and underwritten by the investment banking or brokerage houses that actually managed the funds. The sponsors of these funds maintained a separate corporate existence and a separate set of owners from the funds. Closed-end funds were thus essentially invented by brokers and underwriters as a way of making use of these professionals' expertise in sales, rather than by

¹⁴⁷ Letter from Merrill Griswold to R.W. Goldschmidt (Feb. 13, 1940), at 3-4 (on file with author and with MFS Investment Management).

¹⁴⁸ Griswold suggested the restrictions could substitute for restrictions on investment company size, which he opposed (and which the final draft of the ICA eliminated). *Id.*, at 3-4.

¹⁴⁹ Griswold advised the SEC that restrictions on individual companies would be ineffective at preventing control and observed, "[I]n the case of two or more investment companies under the same management, there should be some limitation to prevent control by said several investment companies jointly." *Id.* at 3.

¹⁵⁰ For example, MIT and an affiliated fund led a proxy fight as a shareholder of Curtiss-Wright Corp. to prevent a merger between Curtiss-Wright and Atlas Corp. *Two Trusts Oppose Curtiss-Wright's Merger With Atlas*, WALL ST. J., April 16, 1940, at 2; *see also* Massachusetts Investors Trust, Annual Report, 4 (December 31, 1941).

¹⁵¹ *Supra* note 24 and accompanying text.

business leaders with expertise in operations management.¹⁵² As explained above, the business models of early mutual funds were built accordingly, with nearly all profits coming directly or indirectly from the sale of new shares, rather than from profits on existing funds.¹⁵³

Because they had already invested in sales outfits and had developed expertise in sales, mutual fund sponsors may have found that they could generate revenue more cheaply by devoting their limited resources to sales than by devoting those resources to the construction of complicated portfolio positions involving control over operating companies and the sustained monitoring necessary to generate value from them. Once a minimally thoughtful portfolio had been constructed, the marginal returns to additional marketing and sales may very well have been higher for mutual fund promoters than the marginal returns to more thoughtful portfolio construction.

It is also possible, of course, that mutual funds' desire to distinguish themselves from holding companies was driven partly by popular tastes. Holding companies were highly unpopular in the 1930s, and mutual funds would have wanted to avoid being associated with holding companies both because such an association might have attracted unwanted political attention and because it might have reduced demand.

Whatever the explanation for mutual funds' passivity, mutual fund marketing in the 1930s had clearly developed to rationalize and promote this kind of passive investing. Marketing heavily emphasized diversification and expertise, and both of these concepts became synonymous with passivity. Theodore Grayson, a professor at the Wharton School, for example, described investment companies this way:

An investment trust...is...a piece of financial machinery capable of many variations as to type, with many features giving it similarity to other well-recognized investment devices, as, for instance, the 'holding company,' but with two distinguishing characteristics which are

¹⁵² SEC Study Part 2, at 57-58.

¹⁵³ *Supra* notes 40-43 and accompanying text.

peculiarly its own and which should exist in every type of true investment trust. These features are diversification of the securities held by the trust, with consequent spreading of the risk involved...and expert management of the trust's securities by the managers of the trust.¹⁵⁴

Expertise evolved to mean passive portfolio management. Expertise was cast in scientific terms, and said to be best practiced in the careful evaluation of stocks, rather than in entanglements in portfolio companies' actual operations.¹⁵⁵

Diversification also evolved to mean passivity and not merely investment in a wide array of stocks. In an influential manual on investment trusts, Leland Rex Robinson, an investment trust consultant, explained that a holding company differed from a mutual fund because "no matter how widely the securities in its general investment portfolio may be diversified, the holding or financing company is intimately concerned with the success or failure of a comparatively few companies in which it has acquired substantial interests."¹⁵⁶

3. Motivations for seeking legal restrictions on control

The mutual fund industry's lack of interest in controlling portfolio companies meant that the restrictions on control rights were mostly a sideshow. Neither the industry nor the administration ever cared a great deal about them. Nevertheless, the industry and administration both exerted some effort in shaping the restrictions and a clear understanding of their motivations for doing so provides some support to my branding hypothesis.

The industry's primary goal in influencing the portfolio restrictions was very likely to make sure that the most influential mutual funds were unaffected by the restrictions. But the industry may have had other goals as well. Mutual funds may have perceived some anti-competitive benefit to keeping the handful of companies that may have sat on the border between mutual

¹⁵⁴ GRAYSON, *supra* note 154, at 1; *see also* State Street Investment Corporation, Annual Report, at 8 (1928).

¹⁵⁵ PARKER CORPORATION, PROFITS THROUGH SCIENTIFIC INVESTING (date uncertain); Massachusetts Investors Trust, Annual Report, 4 (December 31, 1941).

¹⁵⁶ *Id.*

funds and holding companies out of the mutual fund regulatory and tax regime. The primary benefit to keeping holding companies out of the investment management regulatory regime was most likely that holding companies would not have favorable tax treatment on the same terms as regulated mutual funds.

Another benefit of putting these companies outside the boundary of the mutual fund industry may relate to the collective branding problem described above. Recall that closed-end fund leaders expressed concern in the meetings of the IBAA Investment Companies Committee in the early and mid-1930s about investors' inability to distinguish mutual funds and holding companies.¹⁵⁷ Forcibly distinguishing holding companies and mutual funds through tax law may have helped to dispel the public's confusion.

4. Evidence of industry involvement

Regardless of what explanation we accept for mutual funds' influence on the portfolio breadth and depth limits, it is quite clear that the mutual fund industry's influence was strong. (The industry's influence on the depth and breadth restrictions in the Revenue Acts of 1936 and 1942 is described above in Part IV.) Mutual fund industry leaders either drafted or heavily influenced the language in both the Revenue Acts of 1936 and 1940 that restricted mutual funds from owning more than 10% of the outstanding voting securities of individual issuers.

Additionally, the definition of a "diversified investment company" in the ICA reflects exactly the suggestions Arthur Bunker made for it in his definitive statement of the industry's requests.¹⁵⁸ This is especially telling given that Bunker chose to keep the diversification standard even as he requested and obtained the deletion of two other classifications ("securities trading company" and "securities finance company") that appeared next to the "diversified"

¹⁵⁷ *Supra* Section II.A.

¹⁵⁸ Senate Hearings, at 1054. *Cf.* S. 3580, 76th Cong., § 5(b)(1) (1940) and Investment Company Act § 5(b)(1).

classification in the original draft of the bill.¹⁵⁹ Moreover, MIT expressly invited the SEC to draw the breadth and depth restrictions more tightly than the final draft of the ICA did, and to make it mandatory rather than merely optional.¹⁶⁰

5. Limits of populist influence

Mark Roe has influentially argued that the portfolio depth restrictions reflect the influence of populist political forces and that the administration used these restrictions as symbols of its populist politics.¹⁶¹ There may be some room for populism in the story of how the control restrictions originated, but populism's role seems to have been different in important ways from the one ascribed to it by Roe. Evidence indicates very strongly that the administration's purposes in seeking the control restrictions were mainly technical and bureaucratic and that the administration never imbued the control restrictions with symbolic political meaning. The industry, too, had only weak convictions about the control restrictions. To the extent that populism influenced the control restrictions, it did so only through the efforts of the mutual fund industry itself, which may have used the control restrictions to deepen the public's awareness that the mutual fund industry was already avoiding control restrictions and operating in a manner distinct from holding companies.

It is clear that the administration understood by 1940 that mutual funds and holding companies had become distinct as a result of market forces, and that the administration had no desire to affect directly the way the mutual fund industry then did business. This is evident in the fact that the portfolio depth restrictions were only ever attached to tax statutes. The ICA—the main regulatory statute—conspicuously omitted any mandatory portfolio depth restrictions, even though it was passed at a time when tax law placed no restrictions on closed-end funds' ability to

¹⁵⁹ Senate Hearings, at 1054. *Cf.* S. 3580, 76th Cong., § 5(b)(2), (3) (1940) and Investment Company Act § 5(b).

¹⁶⁰ Griswold suggested the restrictions could substitute for restrictions on investment company size, which he opposed (and which the final draft of the ICA eliminated). *Id.*, at 3-4.

¹⁶¹ Roe, *supra* note 5.

take control stakes. Additionally, the portion of the SEC study devoted to mutual funds' control over portfolio companies was not published until June 1941—about a year after the ICA had been passed. Further, no part of the statement of policy in either draft of the ICA mentioned mutual funds' control over portfolio companies.¹⁶²

There is also no evidence that the portfolio depth restrictions had any significant degree of public visibility or that politicians used the restrictions as a “symbol” in public discourse.¹⁶³ As Part IV indicated, the provisions in the Revenue Act of 1936 that originated the depth restrictions were initiated by open-end funds and were passed so stealthily that neither David Schenker, the SEC's chief mutual fund official, nor the closed-end fund industry—let alone the voting public—even knew the restrictions had been proposed.¹⁶⁴ There were no contemporary news reports or public comments by any administration official about the mutual fund tax provisions in the Revenue Acts of 1936 while the provisions were being debated.¹⁶⁵ The depth restrictions in the ICA and the Revenue Act of 1942 similarly attracted no press attention and only dry bits of legislative testimony from administration officials explaining their mechanical operation and wording.

Additionally, the populist political movement had waned by the time mutual fund regulation became publicly visible in 1940. In the late 1930s, the country had settled into a conservative mood.¹⁶⁶ By 1937 the New Deal had ended and the President's popularity and political clout had

¹⁶² The SEC's original draft of the ICA said that investors were adversely affected “when investment companies...attain such great size as to preclude efficient investment management and to have excessive influence in the national economy.” Senate Hearings, at 2 § 2(8). But this passage referred to size, not to control over portfolio companies, and it was deleted from the final draft of the bill, along with the restrictions on investment company size.

¹⁶³ *Id.*

¹⁶⁴ See *supra* note 74 and accompanying text.

¹⁶⁵ Kent made his comments in an executive session of the Senate Finance Committee that was closed to the public.

¹⁶⁶ See generally ALAN BRINKLEY, *THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR* (1995); DORIS KEARNS GOODWIN, *NO ORDINARY TIME: FRANKLIN AND ELEANOR ROOSEVELT: THE HOME FRONT IN WORLD WAR II* (1994), WILLIAM E. LEUCHTENBURG, *FRANKLIN D. ROOSEVELT AND THE NEW DEAL, 1932–1940* (1963); Phil Nicholas, Jr., *The Agency That Kept Going: The Late New Deal SEC and Shareholder Democracy*, 16 J. POL'Y HIST. 212 (2004).

greatly diminished. The war had taken over much of Congress' and the public's attention by the middle of 1940, when the ICA was passed, and the war continued its hold on the public's attention through 1942, when the Revenue Act of 1942 was passed.

This is why Roe's argument for populist influence relies almost entirely on conjecture about how populist forces in the *early* 1930s *might* have influenced mutual fund regulation, rather than on evidence that they *did* influence regulation in the *late* 1930s and early 1940s. Roe writes about Roosevelt's fear of Huey Long and Father Coughlin, for example, and he suggests that William O. Douglas was "a key player" in the ICA.¹⁶⁷ But Long was assassinated in 1935 and Douglas was appointed to the Supreme Court in early 1939, before the ICA was drafted and before the Revenue Act of 1942 and its portfolio depth restrictions became an issue. And in any event, Douglas remained very quiet on the issue of mutual funds' influence over operating companies throughout his tenure at the SEC.¹⁶⁸

It is true that the administration had its own purposes for seeking the portfolio depth restrictions, but these purposes appear to have had more to do with preventing simple abuses than with some ideological program. The only published statement by any administration official about the portfolio depth restrictions in any of the legislative history of the Revenue Acts of 1936 and 1942 is a bit of testimony by Arthur Kent, acting Chief Counsel of the Bureau of Internal Revenue, when he introduced the first draft of the mutual fund provisions in the Revenue Act of 1936. Kent said,

¹⁶⁷ Roe, *supra* note 5, at 1484-1487.

¹⁶⁸ Douglas appears to have made no significant public statement of any importance on the topic of mutual funds, and he passed up many opportunities to do so. When he testified before Congress about the taxation of public utility holding companies in 1938, for example, closed-end funds were simultaneously lobbying for favorable tax treatment and claiming the SEC's support. Douglas, however, mentioned nothing about the closed-end funds. Revenue Act of 1938: Hearing Before Sen. Committee on Finance, 75th Cong. 71-87 (1938) (Statement of William O. Douglas). And Roe makes much of Douglas' famous "Bond Club" speech, in which Douglas told a group of investment bankers that their power over industry would be curtailed. Roe, *supra* note 5, at 1471. But in the speech, Douglas mentioned mutual funds only to say that conflicted transactions between funds and their sponsors should be prohibited. Douglas said nothing about mutual funds' control over industry. William O. Douglas, Democracy in Industry and Finance, Address to the Bond Club of New York (Mar. 24, 1937).

[The bill] does contain the safeguard that the trust or the corporation cannot be made the personal instrument of any one individual, because if an attempt to do that is made, it would be excluded by this 10-percent provision.

....

There is another safeguard that the amendment contains, and that is to prevent an investment trust or investment corporation being set up to obtain the control of some corporation and to manipulate its affairs.¹⁶⁹

The second paragraph can be read to suggest a fear about the accumulation of power on Wall Street, but the first paragraph suggests a purely technical concern that the mutual fund tax provision might become an abusive tax shelter for individuals or operating companies. The concern in the second paragraph seems unlikely to have played an important role, given the total absence of any other evidence in debates about mutual fund regulation and tax policy that would indicate a desire on the part of the administration to limit investment companies' ability to control their portfolio companies.

The legitimacy of the technical concern expressed in the first paragraph is evident in Canada's recent experience with mutual fund taxation.¹⁷⁰ Until 2007 a number of ordinary operating companies in Canada took advantage of a tax provision that was designed for mutual funds and was similar to the U.S. provision, except that it lacked a portfolio depth restriction. A large number of Canadian operating companies put their operating businesses into fully owned subsidiaries of newly created trusts that qualified as mutual funds. The operating businesses then paid dividends in the form of interest on subordinated debt to the trusts and then deducted that interest from their taxable income. The trusts distributed the "interest" to investors as dividends and thereby avoided corporate tax, in the same way that American mutual funds can avoid tax by

¹⁶⁹ *An Act to Provide Revenue, Equalize Taxation and for Other Purposes: Hearings Before the S. Comm. on Finance*, pt. 11, 74th Cong. 11 (1938).

¹⁷⁰ See Anita I. Anand & Edward Iacobucci, *An Empirical Analysis of the Governance Choices of Income Trusts* (2008), available at <http://ssrn.com/abstract=1126426>; Benjamin Alarie and Edward M. Iacobucci, *Tax Policy, Capital Structure and Income Trusts*, 45 CAN. BUS. L.J. 1 (2007).

paying out income to investors. In the end, the operating companies used this device to reduce their tax liabilities significantly.

Of course, it is possible to imagine alternative ways of addressing this problem that would be less invasive than the portfolio depth restrictions. But mutual funds in the mid-1930s and early 1940s had so little interest in controlling operating companies that it probably was just not worth anyone's time to try to devise some subtler method of solving the technical problem.

If there was an ideological motive for the portfolio depth restrictions, it would have concerned mutual funds only indirectly: perhaps the administration wanted to prevent the holding companies from distorting themselves to take advantage of the mutual fund tax provision and thereby avoiding the intercorporate dividend tax that the Roosevelt administration had designed in 1935 for the purpose of breaking up holding companies. There is no direct evidence that this was the administration's intent, but we could easily imagine why the Administration would have acted for this reason and this would indeed suggest an indirect role for populism in the story about the control restrictions' origins.

Additionally, populism might also have affected the shape of the mutual fund industry indirectly. Populist fear of holding companies and a taste among the public for mutual funds that exercised no control over portfolio companies might have strengthened mutual funds' inherent tendency to avoid such control activities.

It is important, however, to keep these indirect forms of populist influence in perspective. The restrictions did not "create" the mutual fund industry, as Roe has argued.¹⁷¹ The boundaries between mutual funds and holding companies grew spontaneously in the era before regulation as a response to market forces. This is why the portfolio depth restrictions were never the subject of

¹⁷¹ See Roe, *supra* note 5, at 1484 ("[P]oliticians were operating at the symbolic level. They were *creating* a mutual fund industry. Through regulation and taxation, politicians created a framework for mutual funds based on their concept of what a legitimate mutual fund ought to be. *Thereafter*, mutual funds had to grow up within that framework.") (emphasis in original).

any serious controversy and it is also why no holding companies ever showed up at the hearings on the ICA to protest or try to prevent their inclusion in the mutual fund regulatory regime; the mutual fund industry's boundaries had already been defined by circumstance before they were defined by law. And although the market forces that drove the distinctions between mutual funds and holding companies may have included the public's distaste for holding companies, they also included mutual funds' entrepreneurial origins among salespeople, who very likely could not and would not have satisfied any public demand for investment entities that controlled portfolio companies even if such demand had existed.

Perhaps the most provocative part of Roe's thesis is the suggestion that operating company managers somehow played a role in the development of the control restrictions because they desired (or at least did not oppose) the insulation that the restrictions may have offered from potential takeovers and control efforts by mutual funds.¹⁷² To be clear, Roe does not claim that operating company managers affirmatively sought these restrictions, only that they failed to lobby against the restrictions.¹⁷³ Roe's argumentative strategy here is wise, because there is simply no direct evidence—no legislative testimony, no news reports, no commentary in private letters or archives—that operating company managers cared at all about the portfolio depth restrictions.

Rather than interpreting operating company managers' silence regarding the control restrictions as evidence that they liked or supported the restrictions, I would interpret it as evidence that they simply did not care about the restrictions; the restrictions were just plain irrelevant. This seems like a more plausible interpretation because holding companies were just as silent as managers of operating companies were, and because mutual funds had never had any ambitions to control operating companies. Moreover, the control restrictions that Congress

¹⁷² *Id.* at 1470.

¹⁷³ *Id.*

ultimately adopted were permissive enough to allow a good deal of activism by mutual funds. Rather than using operating company managers' silence to draw the inference Roe has drawn, therefore, we could just as easily use it to draw the opposite inference: operating company managers' failure to seek even stronger control restrictions could suggest that these managers actually welcomed investment and control by mutual funds.

B. Leverage and capital structure

The mutual fund industry may also have sought or at least accepted restrictions on capital structure and leverage as part of an industry-wide brand-building project. The SEC originally proposed to prohibit all forms of borrowing by both open- and closed-end funds.¹⁷⁴ The industry's definitive statement of requests for changes to the bill asked for a provision allowing both open- and closed-end funds to borrow from banks with the requirement that the funds had to have 300% asset coverage at the time the loans were incurred.¹⁷⁵ The industry accepted, however, the complete prohibition on issuance of senior securities by open-end funds and asked for relatively conservative limits on senior securities issuance by closed-end funds.¹⁷⁶

In the end, the ICA as enacted followed the industry's proposal exactly.¹⁷⁷ Closed-end funds were allowed to issue debentures and preferred stock with minimum asset coverage of 300% and 200%, respectively, and open-end funds were prohibited from issuing senior securities.¹⁷⁸

Perhaps the most intriguing aspect of the leverage restrictions is the complete ban on senior securities issuance by open-end funds. It seems entirely plausible that open-end funds could have at least gotten the SEC to accept reasonable limits on senior securities, rather than a complete

¹⁷⁴ S. 3580 76th Cong. § 18(a) (1940); Senate Hearings, at 1025.

¹⁷⁵ Senate Hearings, at 1056.

¹⁷⁶ Senate Hearings, at 1056.

¹⁷⁷ ICA § 18(f).

¹⁷⁸ ICA § 18(a).

ban, given the open-end funds' political power and the SEC's evident willingness to accept reasonable limits for borrowing by closed-end funds.

The ban on senior securities may have appealed to open-end funds, however, because up through 1940, the great majority of open-end funds issued only common stock. In the 1920s, the simplicity of these funds' capital structures was the primary and often the only difference that these funds emphasized between themselves and closed-end funds.¹⁷⁹ In time, redemption would become the defining feature of open-end funds, but even up through the late 1930s, capital structure simplicity remained an important part of the open-end sales pitch.¹⁸⁰ This heavy emphasis on capital structure simplicity was probably a reaction to the complexity of closed-end capital structures in the late 1920s. Incorporated Investors, for example, published ads emphasizing that open-end funds did *not* have bond holders, preferred stock holders, or management shares, and their "entire assets" belonged "wholly and entirely to the holders of the common stock."¹⁸¹

A few funds, however, had begun to chip away at the uniformity of simple capital structures by 1940. Of the approximately 80 funds in existence in 1940, at least five, including two funds with assets in excess of \$20 million, issued senior securities.¹⁸² This was a late 1930s phenomenon. Of the two large funds with senior securities in 1940, only one had senior securities in 1936, and that one had been very small in 1936.¹⁸³

¹⁷⁹ Grow, *supra* note 12, at 25, 184; *see also, e.g.*, PARKER CORPORATION, PROFITS THROUGH SCIENTIFIC INVESTING (date uncertain) (describing the differences between Incorporated Investors and other investment trusts and emphasizing only the simplicity of Incorporated Investors' capital structure without mentioning redemption rights.)

¹⁸⁰ SEC Study Part 2, at 241.

¹⁸¹ Grow, *supra* note 12, at 187.

¹⁸² Senate Hearings, at 459-61.

¹⁸³ Quarterly Income Shares, Inc. had no senior securities in 1936, but did in 1940. Affiliated Fund, Inc. had senior securities in both years, but had less than \$1.5 million in assets in 1936. 1936 MOODY'S MANUAL OF INVESTMENTS: BANKS, INSURANCE COMPANIES, INVESTMENT TRUSTS, REAL ESTATE, FINANCE AND CREDIT COMPANIES, 977-978, 1855-56 (1936); 1940 MOODY'S MANUAL OF INVESTMENTS: BANKS, INSURANCE COMPANIES, INVESTMENT TRUSTS, REAL ESTATE, FINANCE AND CREDIT COMPANIES 640-641, 1518-1519 (1940)

The borrowing regime created by the ICA may have helped open-end funds to maintain the integrity of the reputation they had created for simple capital structures against this possible threat. The permission for bank borrowing gave the open-end funds significant room for leverage, but the restriction on senior securities prevented any open-end funds from marketing complicated debt securities to the public and thereby creating confusion among the public about the kinds of securities open-end funds offered. Much of the appeal of a share of open-end fund common stock was that a potential buyer did not have to spend time and effort making sure that he or she was indeed getting a share of common stock instead of some more exotic security. The ICA standardized this simplicity.

C. Redemption

The restrictions on redemption rights were clearly drafted by open-end funds. Section 22(e) of the ICA requires any fund that redeems its shares to do so within seven days of the time a share is tendered for redemption, except in a limited set of emergency circumstances or by order of the SEC. The SEC's first draft of the ICA merely authorized the Commission to issue rules preventing the suspension of redemption, specifying nothing about the circumstances or time limitations. Bunker requested the seven-day limit and the restriction to certain emergency situations, along with the authorization for exemption by SEC order.¹⁸⁴

It is easily possible to imagine less frequent redemptions. Modern hedge funds often allow redemptions with substantial delays ranging from a few weeks to a quarter, and they often place significant restrictions on the exercise of redemption rights.¹⁸⁵

Starting in the late 1920s and continuing through 1940, however, redemptions in the great majority of open-end funds were processed daily or within a few days.¹⁸⁶ As redemption rights

¹⁸⁴ Senate Hearings, at 1057.

¹⁸⁵ The section on redemption privileges in the SEC investment trust study mentioned nothing about the timing of redemptions, presumably because it was widely known and understood that most open-end funds redeemed on a daily or near-daily basis. SEC Study Part 2, at 241-244.

became increasingly central to open-end fund marketing, the frequency of redemptions and funds' commitments not to prevent or curtail them gained prominence. For example, while the ICA was being redrafted, Incorporated Investors sent its shareholders a letter insisting, "Nothing can compromise the shareholder's fundamental claim on a pro-rata share of the assets of Incorporated Investors, or of any other 'open-end' investment trust."¹⁸⁷ Redemption was said to be the most important protection investors had.

The redemption regime may therefore have been a product of the collective branding impulse described above. The prospect of a few open-end funds offering complicated redemption schemes may have caused the large funds at the core of the open-end fund industry to fear that their reputation for simple and reliable redemption would be harmed. It does not appear that many open-end funds had begun offering more complicated redemption schemes by 1940, but the possibility that some funds might offer such schemes was certainly imaginable.

D. Income distribution requirement to avoid corporate income tax

The requirement that mutual funds distribute their income each year to avoid corporate income tax may have been both a historical accident and the product of rent-seeking. As Part III indicated, the initial suggestion for the distribution requirement came from the open-end funds that lobbied for the Revenue Act of 1936. There were, however, alternatives other than distribution for giving open-end funds pass-through tax treatment. One would have been to treat mutual funds as partnerships, requiring them to pass through gains and losses on a notional basis but not requiring actual distribution of income to shareholders. Another would have been to abolish some portion of corporate-level tax for mutual funds. There were significant administrative and practical obstacles to each of these other alternatives, but political circumstances may have done as much to kill them as practical obstacles did.

¹⁸⁶ Grow, *supra* note 12, at 389.

¹⁸⁷ Letter to the Shareholders of Incorporated Investors, May 20, 1940.

Recall that the open-end funds first proposed the distribution system after the Roosevelt Administration's and the House's proposal to apply the same system to all corporations had collapsed in the Senate. When the Administration's proposal collapsed, the open-end funds probably saw the distribution system as the most politically feasible of the various options for getting pass-through tax treatment because the Administration and the House had already accepted the idea. Only the Senate would have to be convinced. In his memo proposing the distribution system to the Senate Finance Committee, Paul Cabot said the system would involve merely "reverting...to the theory of the House bill for investment corporations" and observed that he was "maintaining the original principles as laid down by the President in his message to Congress."¹⁸⁸

Additionally, the open-end funds may have perceived in the distribution requirement a source of competitive advantage over closed-end funds. There is no direct evidence for this hypothesis, but its intuitive appeal is strong. Recall that closed-end funds could no longer sell new securities in 1936 because of the discount to net asset value at which they traded. An annual income distribution requirement would therefore have slowly bled away these funds' assets, since they could not be recovered through the issuance of new shares. Distributions received by investors in these funds would have to be reinvested elsewhere—perhaps in open-end funds.

At the time Cabot first proposed the distribution requirement, it was still uncertain whether the Revenue Act of 1936 would allow favorable tax treatment for closed-end funds (it ultimately restricted favorable tax treatment to open-end funds). Cabot may therefore have chosen the distribution requirement from among the various alternatives for pass-through tax treatment as a way of hedging his bets—if he could not completely limit closed-end funds' ability to get tax relief, he could at least make it unattractive to them.

¹⁸⁸ Senate Hearings, at 1081.

The closed-end funds clearly understood that the distribution requirement would harm them. In 1940, one speaker at the IBAA conference said that extending the distribution requirement to closed-end funds “would in effect result in [their] gradual liquidation.”¹⁸⁹ Closed-end funds sought to soften a minimum distribution requirement with respect to capital gains in the Revenue Act of 1942 for precisely this reason.¹⁹⁰

The closed-end funds’ inability to end the distribution requirement in 1942 may be attributable, at least in part, to the open-end funds’ support for this requirement and desire to use it to harm closed-end funds. The intuitive appeal of this theory is strong, since closed-end funds were able to revise other elements of the Revenue Act of 1942 on which their interests were more closely aligned with those of open-end funds, such as the portfolio depth restrictions.

To be clear, the discount and forced income distribution have not killed the closed-end fund industry. The closed-end fund industry is small in comparison to the open-end fund industry,¹⁹¹ but a few closed-end funds nevertheless survive because many funds that originated in the late 1920s have managed to stay afloat by occasionally issuing new shares and because a few funds have been able to sell IPOs in the years since.¹⁹²

¹⁸⁹ IBAA Proceedings 1940, at 193.

¹⁹⁰ *Revenue Revision 1938, Hearings Before the H. Comm. on Ways & Means, 75th Cong.* 842-843 (1938). IBAA Proceedings 1940, at 192. In the original draft of the bill, in order to deduct *any* capital gains, a fund had to distribute *almost all* of its capital gains. There was no option to distribute and take a deduction on some portion of gains and to retain the remainder and pay tax on it. The closed-end funds succeeded in obtaining this option with respect to capital gains in the final version of the bill, but they did not ask for and did not receive this option with respect to ordinary income. 26 U.S.C. § 852(a)(1). In practice, modern closed- and open-end funds almost always distribute all of their income of both capital and ordinary types each year to avoid paying taxes. BNA Tax Management Portfolio, *Taxation of Regulated Investment Companies*, No. 740-2nd, at VII.B.

¹⁹¹ At the end of 2008 there were 646 closed-end funds collectively holding \$188 billion in assets, in contrast to more than 8,000 open-end funds holding \$9.6 trillion. INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 9 fig. 1.1, 54 fig. 4.4 (2009).

¹⁹² See Kathleen Weiss, *The Post-Offering Price Performance of Closed-End Funds*, 18 FIN. MANAGEMENT 57 (1989); INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 53 fig. 4.3 (2009).

V. Conclusion: implications for modern policy

The standardization and branding dynamic that underlay many aspects of mutual fund regulation has relevance to modern readers for several reasons. One is that the dynamic has ambiguous consequences for investors and poses a kind of optimization problem.

Standardization benefits investors who prefer funds that operate consistently with mandatory standards. By eliminating funds that do not suit these investors' preferences, standardizing regulation reduces the time and effort that these investors must spend to sift appealing funds from unappealing funds. This benefit is distinct from the benefit that comes from bonding. Standardization benefits investors not by assuring them that funds will operate *as they promise*, but by assuring them that funds will operate *in particular ways* and that reading through prospectuses to figure out how funds have promised to operate is unnecessary.

However, the branding dynamic harms investors who prefer funds that do not conform to regulation. Branding-related regulation reaches beyond conduct such as fraud that no investor would prefer and prohibits conduct that many investors rationally might prefer, such as high leverage and infrequent share redemptions. Investors who rationally prefer prohibited investing styles cannot invest in mutual funds that suit their preferences.

Balancing the costs and benefits of branding-related regulation thus involves a kind of optimization problem: reductions in search costs must be balanced against the cost of preventing many investors from obtaining what they desire. It is unclear whether the balance was struck optimally in the late 1930s and early 1940s, and since much has changed since then, it is surely worth considering whether the balance remains optimal in the present.

The branding and standardization dynamic is also interesting because it may be possible to achieve some of the benefits of branding and standardization with fewer of the costs than under current regulation. Perhaps the generally applicable restrictions on borrowing, redemption and

other matters could be loosened and tighter restrictions could be devised that apply only to funds that opt into various special regulatory regimes.¹⁹³ Money market fund rules are an example of one such regime, since they apply only to funds that opt into the rules by marketing themselves as “money market funds” or by maintaining constant share prices. Setting the boundaries and number of other optional categories would involve an optimization problem of its own. Too many categories would create the very complexity that standardization seeks to avoid.

Consider as an example of this optimization problem the restrictions on redemption rights in the ICA. Daily redemption rights benefit investors by giving them exceptional liquidity. But the need to meet frequent redemptions forces funds to maintain large cash reserves that could otherwise be invested and to sell their portfolio securities earlier than they otherwise might, generating premature capital gains tax liabilities. This is why most hedge funds redeem only once per month or quarter. Perhaps the benefits of standardization could be achieved at lower cost by devising different regulatory classes with different redemption regimes. Similar considerations apply, for example, to restrictions on leverage.

A clear understanding of the branding dynamic’s historical role is also useful because a version of this dynamic may continue to affect regulatory politics in the present. Money market fund regulation, for example, was largely written in the 1970s by the mutual fund industry. This regulation is enormously important: money market funds today hold almost four trillion dollars in assets and are widely thought of as a “shadow banking industry.”¹⁹⁴

Regulation forces money market funds into highly conservative investments. But this regulation is probably less about “protecting” investors from risky investments than it is about magnifying the value of branding and standardization in a narrow context. Investors are not

¹⁹³ SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION, 283 (1992) available at <http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf>

¹⁹⁴ INVESTMENT COMPANY INSTITUTE, *supra* note 1, at 146 tbl.37.

“protected” from risk by the money market fund rules, because investors remain free to invest in penny stocks, lottery tickets and other risky assets if they so desire. And although money market funds are highly conservative, there are many types of short-term bond funds that are just as conservative or even more conservative than money market funds but nevertheless do not opt into the money market fund regulatory regime.

Rather than serving an investor protection function, the money market fund rules serve primarily a branding function: they relieve investors of the burden of reading prospectuses. The rules standardize money market funds and assure investors that all money market funds operate in essentially the same ways, making the process of choosing a money market fund much easier. This is why the mutual fund industry has strongly supported these rules over the years.

The branding dynamic that originally underlay investment management regulation suggests that the mutual fund industry will alternately fight and advance reforms of the money market fund rules in ways that reflect the industry’s priorities for defining its brand. Money market funds’ most unique element is the pricing of their shares: they maintain a constant price of \$1 per share, even when their actual NAVs deviate from \$1 per share. It is widely understood that constant pricing destabilizes money market funds and makes them vulnerable to runs, because if a fund’s NAV declines to less than \$1 and the fund’s ability to continue redeeming at \$1 is in doubt, shareholders have an incentive to get out quickly, before the fund starts redeeming at less than \$1.¹⁹⁵ The constant pricing feature is an important element of money market funds’ branding, however, because it creates the illusion that these funds offer fixed claims similar to bank accounts, even though they technically offer only equity shares.

¹⁹⁵ For an explanation and a proposal for reform, see Jeffrey N. Gordon, Letter to the SEC on Money Market Fund Reform (Columbia Law School Center for Law and Economic Studies Working Paper No. 352, 2009), available at <http://ssrn.com/abstract=1473275>.

In response to several money market funds' inability to maintain their constant pricing during the recent financial crisis, the SEC adopted rule changes that forced money market funds into even more conservative investments.¹⁹⁶ Prior to the rule changes, the SEC had also called for comments on eliminating the constant pricing system and there was a great deal of public discussion about eliminating the constant pricing system.¹⁹⁷ Since the constant share pricing is an important element of these funds' branding, the industry fought vigorously to maintain it. The industry generally supported, however, the SEC's efforts to require more conservative investing strategies.¹⁹⁸ The enforcement of conservative investing strategies is more appealing to the industry because it helps to prevent damage to money market funds' collective reputation for conservatism, which is another important element of their branding. We can expect a similar dynamic in the current fight about target-date funds, for which the SEC has recently proposed a special set of rules to help standardize the marketing of these funds.¹⁹⁹

This paper also has something to say about mutual fund tax policy. The value and necessity of the annual income distribution system have often been criticized.²⁰⁰ The only question is whether some less destructive alternative is workable in practice, given mutual funds' enormous size and number of shareholders. My contribution here is to observe that the annual income distribution came into being long before mutual funds attained their present size and widely dispersed ownership and to show that the annual distribution requirement had its origins largely in a historical accident and rent-seeking.

¹⁹⁶ Money Market Fund Reform Final Rule, 75 Fed. Reg. 10,060 (Mar. 4, 2010) (to be codified at 17 C.F.R. pts. 270, 274). For a thoughtful assessment of the new rules, see William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WISC. L. REV. 1155 (2010).

¹⁹⁷ Money Market Fund Reform, 74 Fed. Reg. 32,688 (July 8, 2009), available at <http://www.sec.gov/rules/proposed/2009/ic-28807fr.pdf>.

¹⁹⁸ See, e.g., Comment Letter from Goldman Sachs & Co. Re: Money Market Fund Reform (File Number S-7-11-09), available at <http://www.sec.gov/comments/s7-11-09/s71109-118.pdf>.

¹⁹⁹ Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Release No. IC-29301, 75 Fed. Reg. 35920 (proposed June 23, 2010)

²⁰⁰ See, e.g., Coates, *supra* note 9.

Appendix Tables

Table 1. Largest Closed-End Investment Companies in Moody's Investment Trusts Manual, 1940

Fund Name	Total Assets with Portfolio Securities Valued at Cost (Millions of Dollars)	Total Assets with Portfolio Securities Valued at Market	Total Portfolio Securities Valued at Market
Atlas Corporation	74.47	63.08	51.22
Lehman Corporation	67.47	68.62	64.88
Niagara Share Corp. of Maryland	59.06	30.06	28.53
Empire Power Corp.	51.38	36.92	22.91
Adams Express Co.	44.27	29.13	25.00
Tri-Continental	43.79	38.56	30.53
United States & International Securities Corp.	43.70	29.96	29.56
Blue Ridge Corp.	37.50	36.29	34.96
United Gas & Electric Corp.	37.20	24.31	21.64
Selected Industries	35.64	33.85	30.95
United States & Foreign Securities Corp.	33.81	36.31	35.07
Chicago Corp.	31.39	31.98	25.63
Petroleum Corp.	31.29	22.18	21.21
General American Investors	26.48	30.32	28.48
American General Corp.	25.77	23.96	
General Shareholdings Corp.	21.33	16.43	14.70
American International Corp.	20.20	18.73	15.69
Amoskeag Co.	15.76	12.55	11.33
American European Securities Co.	13.86	11.16	10.91
Consolidated Investment Trust	13.54	14.41	13.01
Utility and Industrial Corp.	12.77	2.34	2.27
Pennsylvania Industries	12.35	5.22	5.14

**Table 2: Large Closed-End Fund Stakes in Portfolio Issuers in Excess of 5% of
Portfolio Issuers' Outstanding Common Stock at Year-End 1939**

Fund Name	Portfolio Company Name	Percentage of Issuer's Outstanding Stock Held by Fund	Value of Holding as a Percentage of Fund's Total Assets	Dollar Value of Holding
Pennsylvania Industries	Pittsburgh Steel Co.	35.1%	25.0%	\$ 1,306,557
Chicago Corp.	Dixie Vortex Co.	15.7%	1.2%	\$ 373,956
Pennsylvania Industries	Sharon Steel Corp.	14.0%	13.2%	\$ 687,500
Atlas Corporation	Radio Keith Orpheum Corp.	12.0%	0.6%	\$ 388,015
Niagara Share Corp. of Maryland	Insuranshares Certificates Inc.	12.0%	1.5%	\$ 440,625
Adams Express Co.	Atlantic Gulf & West Indies SS	9.0%	0.9%	\$ 270,000
Lehman Corporation	Simms Pete Co.	8.8%	0.2%	\$ 108,181
Petroleum Corp.	Consolidated Oil Corp.	8.7%	40.5%	\$ 8,976,375
General American Investors	Allied Stores Corp.	8.1%	3.2%	\$ 962,500
Atlas Corporation	Greyhound Corp.	8.0%	5.3%	\$ 3,350,000
American International Corp.	Texas & Pac. Railway Co.	6.6%	1.7%	\$ 316,050
Chicago Corp.	Pacific American Fisheries Inc.	6.4%	0.3%	\$ 102,500
Selected Industries	Kansas City Southern Railway Co.	6.1%	0.4%	\$ 128,800
Chicago Corp.	American Ship Building Co.	6.0%	0.8%	\$ 268,304
Adams Express Co.	International Mining Corp.	5.7%	0.7%	\$ 216,000
United States & International Securities Corp.	St. Louis San Francisco Railway Co.	5.7%	0.0%	\$ 9,250
Adams Express Co.	Underwood Elliot Fisher Co.	5.5%	3.2%	\$ 942,788
United States & International Securities Corp.	Seaboard Air Line RR Co.	5.0%	0.2%	\$ 48,750

Sources: Center for Research In Securities Prices, 1940 Moody's Manual on Banks, Insurance, Real Estate, Investment Trusts

Table 3. Large Closed-End Fund Investments in NYSE-Listed Securities That Would Have Violated Revenue Act of 1942 Portfolio Fragmentation Requirements at Year-End 1939

Fund Name	Percent of Total Assets in Violation of 5% Breadth or 10% Depth Limits	Number of Positions in Violation of 5% Breadth Limit	Number of Positions in Violation of 10% Depth Limit	Violation of 25% Breadth Limit	Violation of Revenue Act of 1942 Based on Holdings in NYSE-Listed Operating Companies
Petroleum Corp.	0.648	4	0	Y	Y
Blue Ridge Corp.	0.493	3	0	N	N
Pennsylvania Industries	0.491	4	2	Y	Y
Selected Shares Corp.	0.472	6	0	N	N
American International Corp.	0.394	2	0	Y	Y
Selected Industries	0.271	4	0	N	N
American European Securities Co.	0.252	4	0	N	N
General Shareholdings Corp.	0.234	2	0	N	N
Atlas Corporation	0.059	1	1	N	N
United States & International Securities Corp.	0.055	1	0	N	N
Niagara Share Corp. of Maryland	0.015	0	1	N	N
Chicago Corp.	0.012	0	1	N	N
Utility and Industrial Corp.	0.000	0	0	N	N
United States & Foreign Securities Corp.	0.000	0	0	N	N
United Gas & Electric Corp.	0.000	0	0	N	N
Tri-Continental	0.000	0	0	N	N
Lehman Corporation	0.000	0	0	N	N
General American Investors	0.000	0	0	N	N
Empire Power Corp.	0.000	0	0	N	N
Consolidated Investment Trust	0.000	0	0	N	N
Amoskeag Co.	0.000	0	0	N	N
American General Corp.	0.000	0	0	N	N
Adams Express Co.	0.000	0	0	N	N

Sources: Center for Research in Securities Prices, 1940 Moody's Manual on Banks, Insurance, Real Estate, Investment Trusts