

**The Role of Independent Directors
In Mutual Fund Governance**

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Introduction.

Investment companies, commonly known as mutual funds, continue to grow in size and importance.¹ As of the end of 1999, mutual funds managed a total of \$6.844 trillion in assets, and were owned by an estimated 44.4 million American households.² Investment companies of various kinds account for an increasing share of U.S. financial assets.³ Offering diversification of assets and professional expertise, funds have encroached on the traditional territory of intermediaries such as depository institutions. Mutual fund complexes offer high levels of service, including check-writing, credit cards, and other financial products traditionally available only through banks. Moreover, mutual funds have flourished as they have grown. By some measures, 1999's performance was stellar. Boosted by a rapidly expanding economy and towering valuations in some sectors of the economy, mutual funds posted a record number of one-hundred percent returns.⁴ If overall performance remains mixed, star funds have gathered public attention and rapid inflows of capital.⁵

Despite the growth of the industry, however, commentators and the Securities & Exchange Commission (the "SEC") have raised persistent concerns about the quality of

¹ This paper focuses on open-ended investment companies. Closed-end investment companies, in contrast to open-end companies, do not offer redeemable securities. Instead, shares in closed-end funds are listed directly on an exchange and may be traded by investors. *See* Investment Company Act of 1940 §5(a), 15 U.S.C. § 80a-5(a) (1998).

² Assets from Investment Company Institute, *Trends in Mutual Fund Investing*, December 1999, <http://www.icic.org/facts_figures/trends_1299.html>; accessed 1/31/00. Household holdings from Investment Company Institute, *Mutual Fund Factbook, 1999 Edition*, at 41 <http://www.ici.org/aboutfunds/factbook99_toc.html>; accessed 3/08/00.

³ *See* Robert Pozen, editorial assistance by Sandra D. Crane, *THE MUTUAL FUND BUSINESS* (1998), p. 5 (mutual funds accounted for 29.54% of the assets of major U.S. financial institutions at the end of 1996).

⁴ *See* Jeffrey M. Laderman and Marcia Vickers, *Our Annual Guide to Mutual Funds*, *BUS. WEEK*, Jan. 24, 2000, at 75 (noting that 157 equity funds had 100% gains, eighteen funds had two-hundred percent gains, and two funds had three-hundred percent gains).

⁵ Mutual fund capital flows are reaching unprecedented heights as investors seek to take part in the current boom market—in February 2000, investors put \$54 billion in equity mutual funds, compared to the 1999

mutual fund governance. The Investment Company Act of 1940 created a particular structure for fund governance that relies, in large part, on each fund's independent directors to guard against the conflicts of interest inherent in the fund's interactions with its investment adviser. Over the past decade, a growing chorus of voices has asserted that these independent directors, stereotyped as country club acquaintances of investment adviser management, are not doing their jobs. A rash of lawsuits has focused attention on the realities of how independent directors are selected and compensated. The financial press has railed against independent directors as well-compensated "rubber-stamps" for proposals that serve the profit motives of the investment adviser. Finally, the SEC itself, having concluded in a 1992 study that the governance system was essentially sound, has recently revisited the issue to propose new rules aimed at strengthening the role of independent directors in protecting fund investors. Despite the scrutiny paid to the subject in recent years, however, defenders of the industry insist that the system works, and their views have listeners inside the SEC.⁶

This paper will examine the controversy surrounding independent directors with an eye to determining both the debate's likely resolution and the advisability of various changes in the legal framework. Part I outlines the legal system created by the 1940 Act and examines the complaints that have spurred calls for reform. Part II presents and discusses defenses of the role of independent directors in the system as a whole. Part III

monthly average of \$15.6 billion. *See* Kimberly Blanton, *Americans' Ardor for Stock Unshaken by Market Volatility*, BOSTON GLOBE April 8, 2000 at C1.

⁶ The problems with mutual funds have arguably not gone unnoticed by consumers. Although the precise reasons why are unclear, the speed of capital inflows into the fund industry in 1999 slowed some 30% since 1997. However, capital flows have since increased, perhaps indicating that capital flows have dropped off or increased based largely on reasons extraneous to funds themselves. *See* Jeffrey M. Laderman and Amy Barrett, *Mutual Funds: What's Wrong*, BUS. WEEK, Jan. 24, 2000, at 66. 69.

analyzes recent SEC and Investment Company Institute (ICI) proposals for reforming the system.⁷ Finally, in Part IV, I propose conclusions.

Part I: The System and its Critics.

A. The Business Model: Birth of a Fund.

Before discussing the regulatory structure in which independent directors play so large a role, it is important to outline the mutual fund business model.⁸ A mutual fund is an investment pool organized in the form of a corporation or trust to facilitate collective investments managed by a professional investment manager. Although funds are separate legal entities, they are not generally organized by entrepreneurial investment managers, although costs of entry are relatively low. Inside management—in which the fund itself hires employees to manage its funds and provide shareholder services—is rare. Instead, funds are created by a sponsor—an investment adviser firm that seeks to serve as outside manager of the fund’s assets in exchange for a fee.

The impetus for a fund’s creation thus comes from its future business partner, which may be a specialized investment management firm, a bank, or a securities firm. From the sponsor’s perspective, a new fund may be a rich source of profit. The management fee, calculated as a percentage of assets under management, is the basic source of compensation for management; however, revenues from affiliated brokers and other service providers also enrich the sponsor at the complex level. When analysis of

⁷ The ICI is a trade organization for mutual funds.

⁸ See generally Thomas M.J. Kerwin and Victoria Schonfeld, *Organization of a Mutual Fund*, 49 Bus. Law. 107 (1993).

investor demand and the competitive offerings of rival sponsors indicates that a new fund will afford a desirable level of profit, the sponsors will begin a new fund.⁹

Regardless of the precise legal form in which the fund is organized—many funds are organized under Massachusetts or Maryland law, and take the form of corporations or Massachusetts business trusts—the fund itself is a legal shell. It will have no employees; all investor services will be provided by its contractual partners. As initial shareholder, the sponsor selects the fund’s board of directors, including both independent directors (those unaffiliated with the sponsor) and “inside” directors (those employed and paid by the sponsor itself, or by its affiliates). The sponsor, operating through its managers on both sides of the bargaining table, will execute a management contract with its new fund. It will then assign a manager to pick the stocks, bonds, and other investments that make up the fund’s portfolio. In addition, the fund will execute contracts with other service providers, including transfer agents, brokers, and custodians. In the typical case, many or all of these parties will be owned by the sponsor or its parent company. Once in place, the fund will be part of a family of funds who share the same sponsor and affiliated brokers and other service providers—a “complex” or family of funds.

After organizing the fund and filing documents with the SEC to establish its existence and investment objectives, the sponsor, directly or indirectly, will seek to market its new financial product to the public. Advertising will rely in part on the brand name of the sponsor and the track record of the new fund’s manager, but will focus most prominently on the type of investments that the fund manager intends to make—equity or debt investments, domestic or overseas, tax-free or taxable. As sales begin, the

⁹ See generally Ajay Khorana and Henri Servaes, *The Determination of Mutual Fund Starts*, 12 REV. FIN. STUDIES 1043 (Winter 1999) (noting that advisers start funds based on factors such as achievement of fee

ownership structure of the fund changes—shareholders buy into the fund and thus replace the sponsor as its owners. Nonetheless, the sponsor will maintain access to and control over the fund’s assets. Sponsor employees will continue to serve on the fund’s board of directors along with the fund’s own independent directors, whose loyalty must now run to the public as shareholders. The sponsor will remain the fund’s largest contract partner and, in most cases, provide it with most of the services that it requires to invest, comply with the law, and provide ancillary services to its shareholders. Although investors maintain some degree of control over the funds they place in a fund, the risk and return that their funds face is largely in the hands of the fund’s sponsor/adviser.

B. The SEC and the 1940 Act.

The crucial difficulty in mutual fund regulation is that the key statute involved does not reflect the business model under which modern funds operate today. Investment companies, like most financial intermediaries in the U.S., are closely regulated by legal rules intended to limit risk, ensure investor protection, and prevent the systemic effects arising from a firm’s collapse. The existing system for regulating mutual funds emerged in the aftermath of a rash of scandals in the 1930’s.¹⁰ The funds of that decade served their unscrupulous promoters as a vehicle for fail-safe profit. Organizers typically bought shares in their funds at low cost and saddled the fund with high levels of debt before selling to the public at an inflated price with extravagant claims about future performance. Investors learned little of their funds either before or after investing, and commonly held interests that proved to be worth nothing by the time the fund’s

breakpoints for existing funds and the actions of competing fund families).

complicated capital structure came to light. Though pitched for their particular investment strategies, funds often did not adhere to their targets. Managers would often shift strategies dramatically within a short span of time, leaving investors with more exposure to risk than they had anticipated. Finally, it was a rare fund that adhered closely to any legitimate strategy at all: fraud and theft of investor assets were commonplace. The mutual funds of the 1930's were pools of cash that quickly emptied out, leaving investors outraged.

Anger over these practices led, beginning with Congressional investigations and studies, to a revamping of the laws governing the industry.¹¹ The resulting system has multiple legal sources. Investment companies are uniquely regulated under the comprehensive scheme of the Investment Company Act of 1940 (the 1940 Act), whose provisions largely define the duties discussed in this paper. In addition, three other statutes apply to the operations of the mutual fund complex. First, the Investment Advisers Act of 1940 applies to the activities of each fund's investment adviser. Second, the Securities Act of 1933 and Securities Exchange Act of 1934 apply in full.

Taken as a whole, the regulatory system thus created promises six methods of protecting fund investors. First, the system finds its roots in the disclosure philosophy of the 1933 and 1934 Acts, which require individual funds to comply with extensive disclosure requirements on an ongoing basis and impose penalties for misrepresentation or material nondisclosure. Disclosure aims at creating an efficient, information-rich market for mutual fund shares. In theory, it ensures that shareholders (considered in the

¹⁰ See generally HOWELL E. JACKSON AND EDWARD L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS (1998), p.812-821.

¹¹ See generally TAMAR FRANKEL, INVESTMENT MANAGEMENT REGULATION at 19-32 (1998) (describing the abuses revealed in Congressional studies).

aggregate as “the market”) are aware of the risks they undertake when purchasing shares and prevents fund managers from surreptitiously straying from their announced investment strategies. Investors in any fund will have available a stream of information regarding their investment. Not all information will actually be sent to the shareholders; in some cases, information will instead be included in a Statement of Additional Information (SAI) to be filed with the SEC and available to investors upon their request. Moreover, if the fund complex so chooses, the fund may be marketed simply by a profile prospectus, a simple document which, again, may be supplemented by further information at the investor’s request.¹² The disclosure system strives to balance investor protection with the concern that too much information may confuse investors and thus undermine the purpose of disclosure.

The 1940 Act also imposes various portfolio rules designed to limit risk. Most crucially, the fund’s shares must be sold at a fixed price—on the basis of the fund’s net asset value (NAV), on a going-forward basis.¹³ The fixed price rule responds to the abusive pricing of 1930’s fund shares by forcing all parties to purchase at the same price. Another major investor protection is the availability of redemption. Dissatisfied investors in an open-ended fund have the option of redeeming their shares at NAV and moving their capital elsewhere.¹⁴ Other portfolio rules seek to limit risky investments or unstable capital structures prevalent during the 1930’s. Diversified funds must meet tests as to how large a piece of their holdings consists of the securities of a few firms.¹⁵ With limited exceptions, leverage is prohibited; funds are to issue only equity, though recent

¹² See Bevis Longstreth, *The Profile: Designer Disclosure for Mutual Funds*, 64 BROOK. L. REV. 1019 (1998).

¹³ Investment Company Act of 1940 §22(d), 15 U.S.C. § 80a-22(d) (1998)

¹⁴ Investment Company Act of 1940 §22.

practice has permitted different equity interests within a single fund.¹⁶ Finally, the Act imposes a number of rules limiting transactions between mutual funds and their affiliates (defined as 5% shareholders in the fund or its manager).¹⁷

Third, in certain circumstances, the 1940 Act imposes direct duties on investment advisers. Section 36-b, for instance, establishes a fiduciary duty with respect to the advisory fee, and creates liability where that duty is breached. Fiduciary rules contrast sharply with portfolio shaping rules. The latter provide certainty and are easily administered; they constitute the clear lines that no fund may cross. In contrast, fiduciary duties and liability rules are standard-like and are uncertain in application. This flexibility allows regulators and courts to prevent behavior that may hurt investors, but is difficult to police with a clear rule.¹⁸

Fourth, the Act provides for a role for two regulatory monitors. The NASD (National Association of Securities Dealers) reviews mutual fund advertisements to prevent misstatements or exaggerations of performance. More importantly, the SEC has inspection and investigation powers over all U.S. investment companies. The SEC's Division of Investment Management works closely with fund complexes and with industry groups, including the ICI, to monitor fund practices. The SEC reviews investment company disclosure materials required by the 1933 Act. In addition, the agency has the power to act decisively against breaches of fiduciary duty. The Division of Enforcement brings complaints against sponsors and directors whose actions violate the Act.

¹⁵ Investment Company Act of 1940 §5(b).

¹⁶ Investment Company Act of 1940 §18(f).

¹⁷ Investment Company Act of 1940 §17.

Fifth, the 1940 Act provides the shareholders of mutual funds with certain voting rights that may be used to prevent abuses and protect their interests. Shareholders, for instance, must approve of any basic change in their fund's investment strategy; likewise, they hold the power to elect directors and, under certain circumstances, to approve of major fund contracts.¹⁹

C. The Independent Director.

Finally, the 1940 Act creates a major role for independent directors. The Act requires that at least 40% of a fund board's members be "disinterested."²⁰ Directors are considered interested for a variety of reasons—including, for instance, if they are affiliated with the firm's adviser or principal underwriter or with any broker/dealer.²¹ Although arguably under-inclusive, the list of interested persons is a clear one. In certain circumstances, the bar for board composition is raised. Funds that utilize 12b-1 plans (by which fund assets may be used to market the fund to new investors) must have a disinterested majority.²² Where a mutual fund is sold to a new adviser, Rule 15-f requires that, for the three years following the sale, disinterested directors compose

¹⁸ See Howell Jackson, *Strategies for Regulating Risk in Financial Intermediaries: General Approaches and Their Application to Regulation of Investment Companies*, in THE FINANCIAL SERVICES REVOLUTION 543-545 (Clifford Kirsch ed., 1997).

¹⁹ See Pozen, *supra* note 3, at 112-113.

²⁰ Investment Company Act of 1940 §10 (a), 15 U.S.C.80a-10(a) (1998).

²¹ Investment Company Act of 1940 §2 (a)(19).

²² 17 C.F.R. §270.12b-1. *See also* Investment Company Act of 1940 §10(b)(2) (requiring that a fund whose principal underwriter is an affiliate of its investment adviser must have a majority of directors that are disinterested with respect to that underwriter).

seventy-five percent of the fund's board.²³ In addition, as a matter of practice, most mutual funds have more disinterested directors than the required 40%.²⁴

In 1940, Congress realized that the daily operation of mutual funds was wrought with the potential for conflicts of interest. In other corporations, independent directors serve to monitor self-dealing or other, presumably *infrequent* lapses of loyalty by inside management. In a mutual fund, however, inside management also represents the fund's largest contract partner. In the ordinary course of operations, insider managers will be motivated by the interests of the sponsor/adviser.²⁵ They will structure business for the fund to succeed—because the advisory fee is based on assets under management, stellar performance helps both shareholders and the sponsor. But they will also seek to insure that the fund grows by selling additional shares (even where such growth has no obvious benefits to existing shareholders) and provides a rich source of fee income. This conflict appears most sharply when the advisory fee is negotiated. Imagine a car manufacturer whose board is dominated by officials from the union that provides its workers. When the firm's union contract is negotiated, the presence of independent directors is absolutely necessary to prevent exorbitant wages.²⁶

²³ 17 C.F.R. §270.15-f.

²⁴ See DIV OF INV. MANAGEMENT, U.S. SEC. AND EXCH. COMM'N, PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION. (1992), p. 268.

²⁵ See *Moses v. Burgin*, 445 F.2d at 376 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971) (“[in mutual funds,] conflict of interests is not the exception but the order of the day.”) It is also important to note that, unlike corporation management, mutual fund management does not face a viable threat of outside takeover; as a result, an alternative device for monitoring management performance—independent directors—becomes necessary.

²⁶ Presumably, in each case the manager will be constrained by the desire to keep the business viable, since only a viable business can continue to provide income to management. Nonetheless, in many cases, fund sponsors may have it within their power to raise fees without losing income. First, if shareholders are not fee-sensitive, a rise in fees must be dramatic before it will cause capital outflows. Second, in many cases, the fund may be able to attract disgruntled shareholders into another, lower-fee fund within the complex, thus maintaining their business without lowering the first fund's fees.

Disinterested directors thus play a vital part in fund governance. In the late Justice Brennan’s phrase, they are “watchdogs” looking out for the interests of their investors.²⁷ Directors’ major duties include considering and voting on the major changes in a fund’s life-cycle, either along with “interested” directors or, when the Act requires separate ratification by independents, alone. Disinterested directors approve of major contracts, including both the all-important management contract with the fund’s adviser and other contracts with service providers who may or may not be affiliated with the adviser. Directors also play a major role in consideration of the sale of a fund. Because these duties consist chiefly of policing overreaching by the fund’s adviser, they may loosely be labeled “conflict of interest duties.”

The regulatory system established by the 1940 Act may be described as director-centered because, at the crucial moments in the fund’s life-cycle, the Act makes independent director approval of a transaction or practice a necessary condition to its legality. In a number of areas, director approval is the key to fund practices that would otherwise be forbidden by the 1940 Act.²⁸ Along with these critical duties, however, directors also are required to consider a plethora of other issues related to the fund’s operation. The tables on the following pages provide an overview of director duties.²⁹

D. Summary: the Regulatory System

The sum of the 1940 Act’s regulatory devices appears formidable. Parts of the system have worked well. Portfolio rules, fiduciary duties, and disclosure requirements

²⁷ See *Burks v. Lasker*, 441 U.S. 471, 485-485 (1979).

²⁸ See the Exemptive Duties table, *hereinafter*.

have prevented many of the abuses characteristic of the period preceding the 1940 Act.

Nonetheless, the true difficulty with mutual funds today is not blatant fraud, insider preferences, or overt risk-seeking in violation of stated investment objectives; instead, it is the conflict of interest inherent in the decision to contract with an outside adviser. Fund investors may, in a very real sense, be unprotected against conflicts of interest.

Director Duties: An Overview.³⁰
General Statutory Duties:

Duty	Statutory Section	Independent Vote?
Approve material contracts.	15(a)-(c).	Yes.
Approve of fund's independent accountants.	32-a.	Yes.
Approve fund's plan for distribution.	Rule 12b-1.	Yes.
Approve interim advisory contract without shareholder approval.	15a-4.	No.
Approve of multiple classes of voting stock.	18f-3.	No.
Approve fidelity bond and joint insurance policies.	Rules 17g-1 and 17d-1(d)(7).	Yes/No.
Approve foreign sub-custodial arrangements.	17f-5.	No.
Ensure adherence to investment objectives.	13.	No.
Determine time for calculating net asset values.	Rule 22c-1.	No.
Value securities.	2(a)(41)(b).	No.
Judge creditworthiness of brokers in repurchase agreements.	12d, 12d-3.	No.
Approve depository arrangements.	Rule 17f-4.	No.
Approve, and monitor compliance with, fund's code of ethics.	17(j); Rule 17(j)(1).	No.
Approve of mergers between funds in same complex.	Rule 17a-8.	No.
Monitor trades with affiliated funds.	17; Rule 17a-7.	Yes.
Approve liquidity determinations.	22-e. ³¹	No.

²⁹ I omit specific duties that may exist in particular classes of funds (money market funds, funds with overseas investments, bank-sponsored funds, or insurance product vehicles) or in closed-end funds. For an overview of these specific duties, see _____, *Fund Director's Handbook*, 52 BUS. LAW. 229, 267-272.

³⁰ This list is not exhaustive with respect to non-statutory duties. It is derived from a convenient list in Paul A. Haaga, Jr. and Michelle Y. Yang, *Spotlight on Mutual Fund Corporate Governance*, 1112 PRAC. LAW INSTIT CORP. 35 (1999) and from DIV OF INV. MANAGEMENT, *supra* note 24, at 256-260.

³¹ This duty is not explicit on the text of the rule, but has been made clear by SEC rules. See FRANKEL, *supra* note 11, at 300-301.

Extraordinary Statutory Duties³²

Duty	Statutory Source	Independent Vote?
Approve of sale of fund, where necessary.	15(f)	No.
Select and nominate independent directors during three years after sale of fund.	Rule 15(f)	Yes.

“Exemptive” Duties³³

Duty	Rule	Independent Vote?
Approve of fund’s purchasing securities in a primary offering underwritten by affiliated broker-dealer.	10b-3.	No.
Approve of use of fund assets for distribution costs.	12b-1.	Yes.
Approve interim advisory contract without shareholder vote.	15a-4.	Yes.
Approve of securities transactions with affiliates.	17a-7.	Yes.
Approve of mergers between affiliated funds.	17a-8.	Yes.
Approve of joint insurance policies.	17d-1(d)(7).	Yes.
Approve payment of commission to affiliated broker.	17e-1.	Yes.
Approve of joint insurance bonds.	17g-1(j).	Yes.
Approve of issuance of multiple classes of stock.	18f-3(d).	Yes.
Approve of repurchases of shares by closed-end funds.	23c-3.	No. ³⁴

General Duties:

Duty
Elect officers.
Call shareholder meetings.
Serve on committees, including audit committee.
Monitor fund’s investment performance.
Monitor firm’s personal trading policies.
Monitor allocation of complex-level opportunities (e.g., IPO subscription rights).

³² These duties apply in a change of control and thus, until the recent trend toward consolidation, did not often apply.

³³ This table overlaps with the first. Each of these duties involves a situation in which the germane section of the 1940 Act would prohibit a particular action as posing a conflict of interest, but the relevant rule allows it, in part of the condition of board oversight or approval. The category is that developed by the SEC in its latest proposals, *hereinafter*.

³⁴ Use of this rule in some circumstances already requires that the fund have a majority of self-selecting, disinterested directors. *See* 17 C.F.R. §270.23c-3(b)(8).

General Duties, Continued
Duty:
Monitor fund use of derivatives.
Monitor soft-money practices.
Determine policies for voting fund shares.
Monitor fund's disclosure and general investor communications.
Monitor regulatory compliance and overall business operations.
Declare dividends.

Part II: Four Criticisms of the System.

Criticisms of the director-based system boil down to four assertions. First, directors are not “independent,” but captive to the interests of their funds’ advisers. Second, independent directors must pass judgment on a variety of legally complex, controversial practices—their jobs, if taken seriously, are extremely difficult. Third, directors are largely powerless. Fourth, directors lack financial incentives to do their jobs effectively. This section examines each of these assertions in turn.

A. The Capture Hypothesis.

First, critics assert that the system by which shareholder “watchdogs” are selected and compensated ensures that their interests will inevitably be closely intertwined with those of the sponsor complex. In a word, directors will be “captured” by their fund complex. The Act’s key solution to conflicts of interest, third-party monitoring, duplicates the conflict inherent in the use of outside management. Because independent directors are initially nominated and voted upon by the fund sponsor, they may feel

indebted, on a personal level, to their “sponsors.” To put it simply, “the men who need to be watched pick the watchdogs to watch them.”³⁵

The selection process raises several questions. First, are independent directors qualified? Critics argue that independent directors are at times unsophisticated in matters of finance and investment. They have been stereotyped as old friends of high-ranking members of the investment adviser complex, invariably hailing from the same social class, economic background, and network of connections as those that hire them. Some fund boards include directors whose appointment can only be attributed to their fame in other, unrelated endeavors such as sports or acting.³⁶

Second, are directors capable of overcoming psychological and personal pressures to acquiesce to their funds’ adviser? Service as a director, particularly on multiple boards, ensures that directors will develop close relationships with adviser management through repeated interactions. Independent directors are likely to feel as if they are part of the sponsor “team,” and may feel subtle pressures to conform to the sponsor’s interests. The mutual fund adviser may not legally force a director to resign. However, because the sponsor complex is responsible for each director’s initial election and, indirectly, for his or her compensation, directors are likely to hesitate before opposing the sponsor directly. Insiders have related anecdotes in which perennially defiant independent directors have been asked to step down.³⁷ These factors, combined with the

³⁵Nutt, *A Study of Mutual Fund Independent Directors*, 120 U.Pa.L. Rev. 179, 223 (1971) (citing Abraham L. Pomerantz, remarks at University of Pennsylvania Law School Conference on Mutual Funds, 115 U.Pa.L.Rev. 662, 739 (1967)).

³⁶ See _____, *The Dog That Rarely Bites*, FORBES, Oct. 2, 1989, at 210.

³⁷ See David Sturms, *Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working*, 1 VILL. J. L. & INV. MGMT. 103, 109-110 (1999) (describing Yachtman dispute, in which independent directors were asked to resign by adviser).

conservative nature of the corporate board as an institution, make it unlikely that directors will argue vigorously for the shareholders whom they represent.

Representatives in many contexts are at risk of being co-opted by the system within which they function. In the usual case, however, a representative's contacts with her constituents provides some basic protection against the possibility that their interests will be ignored. In contrast, mutual fund directors have little if any contact with the shareholders whose interests they are to advocate. Mutual fund shareholders are largely passive and often uninformed about their investments. Few fund companies appear to have given thought to how investors might communicate more directly with their directors. More importantly, mutual funds, unlike corporations, are not required to law to hold annual meetings where, at least in theory, shareholders may voice complaints. Finally, unlike other elected representatives, fund directors need not concern themselves with re-election. Shareholder participation in director elections is minimal, and a director with the fund adviser's support is thus almost assured of another term. In a very real sense, then, directors are representatives without constituents.

Finally, directors earn substantial compensation that may tie them tightly to the fund sponsor. While compensation for each particular fund may be limited, by serving on multiple boards, directors may earn well in excess of \$200,000 annually. The directors of Fidelity's flagship Magellan fund, for instance, earned complex-level compensation ranging from \$213,000 to \$269,000 for the fiscal year 1999.³⁸ Other complexes pay even

³⁸ Fidelity Magellan Fund, *Notice of Special Meeting of Shareholders*, February 22, 2000, p. 12.

higher salaries.³⁹ The prospect of losing these considerable salaries, critics posit, cannot help but motivate directors to support inside management's policies.

These psychological and financial pressures have two possible effects. First, director loyalty to fund advisers, critics suggest, has a direct effect on the vigilance with which directors perform their responsibilities. Simply put, at some point, directors are no longer truly "disinterested." Yet a more powerful effect may be the illusion of safety that the system creates. Directors are presented to shareholders in fund communications as independent watchdogs for their interests. In reality, argues Vanguard's John Bogle, the mutual fund business has largely focused on the profits of the adviser to the detriment of shareholder interests.⁴⁰ Shareholders who trust their directors will not expend the time and expense needed to monitor their investments. As a result, "captured" directors may serve as a shield to the industry and inadvertently discourage shareholders from taking efforts to become more aware of their funds' performance and practices.⁴¹

B. Controversial Practices.

Problems created by director capture might be minimized were the director's task a routine one. Yet an examination of several of the duties listed on the charts in Part I reveals that this is not the case. Although their responsibilities do include matters that seem merely technical, directors are also called on to judge a number of practices that are controversial and difficult to resolve in the interest of fund shareholders.

³⁹ At the time of the Strougo suit, for instance, some directors for the Brazil fund were receiving as much as \$400,000 annually. See Pui-Wing Tam, *Fund Firms Push for Laws Allowing "Double Duty" Boards*, WALL. ST. J., February 19, 1999.

⁴⁰ See Guy Halverson, *Still the Star of the Game? The Romance Between Investors and Mutual Funds May Be Fading*, CHRIST. SCI. MONITOR, MAY 17, 1999.

⁴¹ See, e.g., Charles Jaffe, *Don't Depend on Directors for Protection*, CHIC. TRIB., February 28, 1999 (suggesting that shareholders "be their own watchdogs").

Directors, for instance, are the first and most important judges of whether a fund's use of soft dollars is appropriate. Soft dollars exist when a fund selects a broker that charges relatively high commissions to execute its portfolio transactions in part because that broker will provide the adviser with research reports on certain securities, industries, or countries. Because their interest is in maximizing returns, shareholders would prefer to use the lowest-cost broker who provides good execution. From their perspective, research is precisely what the advisory fee covers; thus providing extra compensation to brokers for additional research is a way of forcing shareholders to pay twice for the same service. More importantly, in many cases, soft dollars pay for research that benefits only certain funds within a firm complex (a broker report on Southeast Asian utilities, for instance, would scarcely help a state bond fund). It is unclear why funds that do not benefit should be forced to bear the costs of increased commissions. Advisers, in countering this argument, point to the fact that additional research helps management to pick stocks more effectively. In addition, they note that higher-cost brokers often provide better execution, which benefits all shareholders.

The Act and the SEC have punted on the question; existing legal authorities place the burden of judgment on the shoulders of the independent directors. Under Section 28(e)(1) of the 1934 Act, soft dollar payments are permitted so long as a determination that any commission paid is reasonable compensation for the research and trading rendered.⁴² Case law has stressed the importance of disclosure to independent directors, though disclosure to shareholders, too, must occur.⁴³ Yet a perplexing difficulty emerges—how can a director who represents the shareholders of each of a family's funds

⁴² Investment Company Act of 1940 §28 (e), 15 U.S.C. § 80a-28(e) (1998).

⁴³ See, e.g., *Tannenbaum v. Zeller*, 552 F.2d 402 (2nd. Cir. 1972), *cert. denied*, 434 U.S. 934 (1977).

protest a practice that will help some at the expense of others? Is it feasible, for that matter, for independent directors at a particular fund to reject a practice that is common in the industry and has not been prohibited by the SEC?

Similarly, directors must pass judgment on the use of 12b-1 plans, by which mutual fund assets are utilized directly for marketing of the fund's shares to new investors. Sales of fund shares increase overall fund size, thus improving the fees earned by the investment adviser. It is unclear, however, that growth in total assets assists existing investors—if anything, funds beyond a certain size may lose flexibility and thus produce lower returns. Nonetheless, the SEC has granted funds the ability to spend their assets for growth.⁴⁴ In addition to creating a number of procedural requirements, 12b-1 focuses on the role of independent directors in determining whether a plan will be in the firm's best interests—independent directors must approve a plan for it to be adopted.

A director's decision to approve a 12b-1 plan appears, on its face, to be a capitulation unless existing shareholders will benefit. Yet it is difficult, critics assert, for directors to say no to proposed 12b-1 fees. Marketing increases the fund's profile and that of the adviser. It may yield intangible benefits by creating awareness of the adviser and its financial products. Finally, advisers commonly argue that fees support brokers whose services are crucial to fund success. But more fundamentally, 12b-1 fees carry the imprimatur of the SEC's acquiescence in their use. In evaluating the wisdom of a proposed plan, directors are likely to consider the fact that an adviser who is denied these fees may be less able to attract top investment managers, and shareholders may thus suffer. A 12b-1 plan, at its root, involves placing the interests of the adviser over those of

⁴⁴ 17 C.F.R. 270.12b-1.

the existing shareholder—but for a director overseeing multiple funds for a single adviser, reasoning that fees may benefit the complex as a whole is natural.⁴⁵

Multiplicity.

The difficulty of properly representing shareholder interests is increased by the fact that directors often serve not on one fund board, but on multiple boards within a sponsor complex.⁴⁶ The location of individual funds within a complex creates the potential for conflicts of interest beyond those contemplated by the 1940 Act. In 1940, Congress envisioned the difficulty inherent in negotiating fees with a sponsor where that sponsor controls the fund’s board of directors. It did not envision, however, the possibility that a fund adviser, responsible for dozens of funds, would rationally have incentives to favor one fund at the expense of another. The adviser’s desires—to maximize fund size, to increase the fund family’s reputation by ensuring that some funds perform well, etc.—may run counter to the interests of individual funds.⁴⁷

The duty of the independent directors is to represent the interests of particular funds. Serving multiple funds within the same complex may force directors to trade off

⁴⁵ 12b-1 fees may also help new shareholders. By creating new information (advertising or broker recommendations) about funds in particular categories, 12b-1 plans may lower search costs for investors seeking to place capital in a fund in a particular category. See Erik R. Sirri and Peter Tufano, *Costly Search and Mutual Fund Flows*, J. FIN 1589, 1605-1608 (October 1998). Arguably, then, shareholders who will move from fund to fund over the course of their investing lifetimes have an interest in the information that 12b-1 plans compensate advisers for generating. It is unclear, though, that directors should give weight to this sort of interest in protecting their constituents: current shareholders.

⁴⁶ In a common structure, each complex might have several different boards to oversee funds divided by their type: equity, bond, foreign, etc.

⁴⁷ At a minimum, the nature of fee arrangements means that the adviser must inevitably shift resources from fund to fund to maximize its return. For instance, the adviser may seek to open new funds in a category where existing funds have passed breakpoints on their fee schedules. The opening of these new funds could theoretically harm existing funds that compete for asset flows. A new fund’s opening, particularly if combined with aggressive adviser marketing, for instance, may prevent existing funds in the same category from reaching higher breakpoints that would lower fees further. See Khorana and Servaes, *supra* note 9, at 1066.

one fund's interests against those of another.⁴⁸ In a recent case, for instance, the SEC took action against a firm that allocated profitable IPO opportunities to a new fund for some time in order to boost performance without disclosing that the fund's performance was largely dependent on these allocations.⁴⁹ IPO investment opportunities arise as a form of legal kickback given by the offering's underwriter (a securities firm) as a reward for the high volume of orders that a fund complex places with its broker/dealer unit. An opportunity "earned" through the portfolio transactions of a particularly large fund may be allocated to a new fund that generates little volume where the adviser seeks to promote the smaller fund aggressively.⁵⁰

The fund industry has not dealt in a systematic way with the issue of allocation, so it is unlikely that directors considering such an issue will have the option of resorting to an existing practice, such as spreading IPO opportunities among their funds according to the funds' relative trading volumes or other relevant characteristics. Directors may thus find it difficult to determine how they may best protect the interests of each of the funds that they represent.

While the frequency with which allocation issues arise is uncertain, 12b-1 fees and soft dollars are an ubiquitous part of the fund landscape. Each of these practices involves at least the appearance that directors acquiesce as fund advisers favor their own interests, directly or indirectly, over those of particular funds. Each arises, at least in part,

⁴⁸ A more basic criticism is that the mechanics of overseeing multiple funds insure that directors will do a bad job of overseeing each. Can directors, for instance, really evaluate the best interests of a particular fund's shareholders when they consider isues regarding dozens of funds during a single meeting?

⁴⁹ See *In Matter of Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Investment Advisers Act of 1940 Release No. 1819 and Investment Company Act of 1940 Release No. 23996 (Sept. 8, 1999).

⁵⁰ Similar issues could arise with regard to allocation of prized managers or other resources to particular funds. This is not to say that directors should press for their funds to gain the complex's best managers; some decisions may best be left to inside management as a matter of business practice, since there is no

from the fact that funds operate within fund complexes, and the adviser of a complex may have incentives to play the interests of one fund off against those of another to maximize its own overall profits. Directors may feel that they have good practical reasons not to fight these practices.⁵¹ Refusal to acquiesce on borderline calls may limit the director's power to fight for later, more important shareholder interests. Given the pervasiveness of practices enriching the adviser at the expense of a particular fund, it simply may be impossible to fight for shareholders on every issue without quickly exhausting credibility and adviser goodwill. The task that directors face is thus a profoundly difficult one.

C. Directors lack credible powers.

Even the best-intentioned directors may lack the power to create change within a fund complex. Directors' powers come in two varieties. On the one hand, directors have the ability to negotiate, demand, or otherwise argue for shareholders' interests. Because the adviser holds greater bargaining power, there is little reason to believe that this power is a meaningful one. Directors, as a practical matter, are aware that their attempts to reign in adviser "greed" have consequences. If directors are too zealous in pressing for low fees, for instance, funds will not be created. The company represented is itself a product of the directors' willingness to allow some profitable fees to be charged.

An analogy is CEO compensation in industrial firms. CEOs demand market compensation; if they do not receive it, they may leave their current firms. Likewise, advisers must expect profitable fees or they will not continue the entrepreneurial work of

clear entitlement by any given fund to a particular manager. However, where a fund's claim seems particularly strong, as in the IPO allocation issue, directors should protect their funds' entitlement.

⁵¹ Conflicts of interest are an ubiquitous and inevitable part of fund management; as a result, independent directors may be forced to pick their battles. In the corporate context, in contrast, a blatant conflict of

creating and running funds (or, more realistically, they will seek to oust directors who press too strongly). But a key difference persists. Although replacement of a CEO is difficult, a thriving market for executive talent, supplemented by third-party intermediaries such as “headhunter” firms, gives firms the chance to replace management. In contrast, there is virtually no market for new advisers. Although it is clearly possible to replace an adviser, engagement of a new firm may have high transaction costs, and is unlikely as a result of factors discussed below. Advisers may thus have even more leverage vis-à-vis independent directors than do corporate CEOs do with respect to their compensation committees.⁵²

Where negotiation fails, directors have a “nuclear deterrent”—the apocalyptic power to reject the fund’s contract with its investment adviser and seek a new firm to advise it. The threat of such a dramatic move may give independent directors some degree of leverage. Yet the power has seldom been used, and it is unclear that it should be. Independent directors who terminate an advisory contract do not necessarily act in the best interests of their silent constituents. Rational investors, for instance, might prefer that fund directors avoid rejection of the advisory contract, since redemption likely provides a lower-cost method of exit for the dissatisfied shareholder. Conversely, investors often look for a particular manager or a particular style of investment when choosing mutual funds.⁵³ Fund insiders point out, quite accurately, that the average investor is likely to care about performance, not fees. Faced with a choice of losing a

interest may be rare, and independent directors may be willing to spend part of their relational capital to deal with those conflicts when they arise.

⁵² Engagement of a new firm must take place through individual negotiation, generally in the context of a lawsuit challenging the old firm’s dismissal. The rarity of such an occurrence decreases the likelihood that a replacement can be found without high transaction costs.

⁵³ See _____, *Forum on Mutual Fund Governance Issues*, MUTUAL FUND MARKET NEWS, Feb. 22, 1999.

talented manager over a few basis points, few shareholders would likely be willing to switch fund advisers.⁵⁴ Yet the difficulty lies in the fact that there is often no way for directors to force a reduction in fees short of switching advisers. As a result, it is unclear that the nuclear deterrent actually works. Thus, in a 1966 study of the fund industry, the SEC concluded that “negotiations between...unaffiliated directors and fund advisers...lack an essential element of arm’s length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same service.”⁵⁵

Perhaps more importantly, even where directors seek to act, concerns with liability confine their discretion and diminish incentives to monitor aggressively. Recent mutual fund disputes bear out the point that when directors oppose inside management, they face pressure to resign, proxy fights, and allegations of fiduciary breach. The Navellier dispute is illustrative.⁵⁶ In 1997, the board of directors of Navellier Aggressive Small Cap Equity Fund fired the fund’s money manager, Louis Navellier (the fund’s eponymous founder). The board hired a new company, Massachusetts Financial Services, to manage the fund. In the proxy fight that ensued, Navellier was able to force the fund to rehire him and, ultimately, to pressure the independent directors to resign. More crucially, Navellier and several fund shareholders filed a lawsuit alleging fiduciary breach against the directors. The fund’s directors thus faced the possibility of liability for

⁵⁴ Nutt, *supra* note 35, at 223 (“most independent directors assume that fund shareholders have purchased a package of investment management services based on the strength of a particular adviser’s reputation”).

⁵⁵ THE PUBLIC POLICY IMPLICATIONS OF MUTUAL FUND GROWTH, H.R. No. 2337, 89th Cong., 2d Sess. 131 (1966).

⁵⁶ See Sturms, *supra* note 37, at 106-107.

their exercise of the sole power in their arsenal as shareholder fiduciaries.⁵⁷ While two of the directors won at a jury trial in U.S. district court, a third settled before trial.⁵⁸

Two further problems exacerbate the fear of proxy contests and litigation. First, until recently, difficulties arose for funds seeking to insure their directors against liability claims as part of the fund's errors and omissions liability policy. Available policies commonly excluded claims by co-insureds, thus leaving directors unprotected if sued in a derivative action by the firm.⁵⁹ Second, before a recent SEC Interpretive Release, some lawyers were concerned that advancing legal fees to a director could be interpreted as illegal "joint activity" for purposes of section 15-d of the 1940 Act.⁶⁰ The upshot was that directors could be uninsured and unable to have their legal fees advanced by their funds. Directors faced the possibility that zealous advocacy of shareholder interests could put their personal assets at risk—if not for judgments, then for legal fees pending resolution of all claims against them. This threat could lessen the willingness of qualified individuals to serve as directors and weaken the intensity of director commitment to investors.

As a result of these developments, critics have claimed that directors appear to be damned if they do, damned if they don't. Quite naturally, no consensus exists as to precisely what level of activism is desirable. While most agree that passive approval of sponsor proposals is not enough, directors who seek to do battle with the sponsor complex on a frequent basis may be ineffective as shareholder representatives.

⁵⁷ See Catherine Hickey, *Navellier Presses on Amid Lawsuits and Small-Cap Woes*, MORNINGSTAR MUTUAL FUNDS, March 3, 1999.

⁵⁸ See Pui-Wing Tam, *U.S. Jury Decision is Boost for Independent Directors*, WALL ST. J., July 27, 1999.

⁵⁹ This problem has been solved by a combination of ICI action and a proposed SEC rule. See text at 55-56, *hereinafter*.

⁶⁰ See text at pp. 55-56, *hereinafter*.

Nonetheless, a properly-arranged governance system would not punish directors who take actions that are truly in the interest of the shareholders.⁶¹

D. Directors lack proper incentives.

Finally, directors lack strong incentives to act in their shareholders' interests. Academics writing on corporate governance outside the investment company context have identified two theoretical reasons for independent board members to perform their jobs well.⁶² First, independent directors are "disciplined" by the market for talent and responsibility.⁶³ An independent director who performs her duties negligently or thoughtlessly will lose her reputation as a good director. She will suffer a loss of personal prestige and lose further opportunities for income as an independent director for other firms.

It is unclear how strong this motivation is for mutual fund directors. Because an independent director who serves a large fund complex may earn a significant living, fears over loss of employment may be minimized. If a director can remain in the fund complex's good graces, he need not concern himself with further employment. Concerns over reputation are more difficult to dismiss. Directors may indeed do their jobs carefully in part because they fear losing reputations for carefulness and competence. However, if mutual fund culture as a whole affirms a passive role for directors, even a "rubber-stamp" director may not suffer a significant loss of reputation.

⁶¹ Here, as above, a difficulty arises: shareholders may simply never want to switch advisers, preferring high fees or other "unfair" treatment to loss of the stock-picking talents of a manager whom they perceive to be talented. Presumably a director serving the interests of rational shareholders as he best perceives them, however, may be justified in some cases in rejecting the advisory contract and shopping the fund.

⁶² See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

An alternative explanation for why independent directors do their jobs focuses on the personal character of persons selected to serve as independent directors.⁶⁴ Fund directors, one might argue, are generally conscientious, reputable individuals who take their jobs seriously. Simply put, the sort of people who become directors—often experienced businessmen or academics—will avoid laziness or malfeasance regardless of whether their income will be affected. This “soft” factor, while it represents one possible incentive to director performance, is difficult to quantify. Surely, many of the individuals who serve on fund boards do a good job simply because that is what they ought to do. But good character may not be enough to ensure good results.

A third incentive structure exists when directors themselves hold fund shares. In this most basic of ways, fund complexes have failed: independent directors have historically not been shareholders in the funds that they monitor. This gap contributes strongly to the perception that directors represent the interests of the sponsor, not those of the shareholders. As owners of the funds they monitor, directors would have better understanding of shareholder interests and better incentives to pursue those interests. Yet, as of 1997, only one major fund complex had provided for director compensation in shares of its funds.⁶⁵ While other fund families have subsequently advocated or required share ownership, shareholding by directors is by no means universal.⁶⁶ As a result of this key flaw, director incentives are a legitimate source of concern.

⁶³ *Id.* at 294; see also Ronald L. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 872-876 (1991) (concluding that no convincing explanation of why independent directors have good incentives be effective monitors exists).

⁶⁴ Gilson and Kraakman, *supra*, at 874-875.

⁶⁵ Mike Garrity, *Most Fund Directors Not Required to Buy Their Own Shares*, MUTUAL FUND MARKET NEWS, Sep. 15, 1997.

Part II: Defenses of the System

Although critics of the mutual fund industry make an eloquent case, few would argue that the director system has failed entirely. A strong defense of the system may be forged out of three propositions. First, today's governance problems may be less profound than critics have alleged. Second, the only realistic alternative "regulator" of fund conduct is the market, and evidence of market imperfections exists. Third, directors, at their best, fill several roles that no other player in the industry can. As a result, any change in the system should strengthen, not overthrow, the grounding of the 1940 Act in director oversight.

A. The System Works.

There is no evidence that any severe governance problem in the mutual fund industry in fact exists. The industry is unique among providers of US financial services in that, despite a history of over six decades, it has never faced a major scandal. Industry representatives point out that directors are on the whole extremely conscientious. Although statistical evidence is scarce, published cases and insider accounts point to instances in which directors have challenged management or forced advisers to make concessions in the interests of shareholder welfare.⁶⁷ Of course, some directors do abuse shareholder trust. Two recent cases saw independent directors compromising shareholder interests not for the adviser, but for their own gain—in one case, by failing to prevent

⁶⁶ See *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24082 at 8-9 (October 14, 1999).

⁶⁷ See, e.g., *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222 at 1248 (S.D.N.Y. 1990) (finding that "independent directors performed their responsibilities in a conscientious and careful manner").

improper valuation of securities; in another, for personally accepting profitable IPO allocations without disclosing their receipt.⁶⁸

Nonetheless, these cases may reflect only isolated problems in the culture of directors at some funds. Governance problems may exist chiefly in relatively small or new fund complexes without a strong culture that encourages good governance. The largest fund families in the industry are closely watched by the SEC. They enjoy frequent contact with SEC policy makers and industry representatives at the ICI and, in turn, often serve as industry leaders on issues such as reducing fees or raising awareness of fiduciary duties. Independent directors may function better in these large complexes, where the adviser's management is fully aware of the independent directors' role and works to engender a culture of respect toward that role.⁶⁹ By extension, a program for increasing director education and good governance culture at the complex level could obviate any existing problems.

⁶⁸ See *In Matter of Monetta Financial Services, Inc.*, Investment Advisers Act of 1940 Release No. 1702 (February 26, 1998) and *In the Matter of Parnassus Investments*, Investment Advisers Act of 1940 Release No. 1634 and Investment Company Act of 1940 Release No. 22685 (May 28, 1997).

⁶⁹ See comments of Richard Philips in Transcript, *Conference on the Role of Independent Investment Company Directors* at 76-77 (February 23 and 24, 1999) (www.sec.gov/offices/invmgmt/roundtab.htm, accessed 10/25/99).

Evidence on this question is mixed. Recent proceedings against mutual fund advisers have involved complexes of various size and sophistication. It is the case, however, that the top complexes—Vanguard, Fidelity, Janus, Putnam—have seldom been implicated in wrongdoing. It is possible that, as highly visible players in the mutual fund market, large firms simply cannot afford to damage themselves by engaging in poor governance practices. Compared with newly-created “start-up” advisers, these firms have invested much greater resources in cultivating a positive public image that scandals or allegations of wrongdoing could damage. In addition, well-established firms have experience with regulatory compliance and are better able to recruit outstanding candidates to serve as disinterested directors. Finally, the management of the top firms, whose position often involves close personal contact with SEC policy-makers, are more likely to have personal relationships with SEC personnel and be susceptible to “jawboning” on the part of the agency’s officials.

1. Directors as Failures?

More specifically, examination of several recent controversies reveals that reports of directors' failures have been greatly exaggerated.

a. Fees.

Criticism of directors has often focused on their failure to lower fund fees significantly. The advisory contract that defines the relationship between a fund and its adviser is the linchpin of the mutual fund business. Its most important provision is the advisory fee that the fund pays for investment “advice”—for the adviser to assign a manager to the fund, provide access to its research capacities and technology, and otherwise arrange for core services. The 1940 Act creates a fiduciary duty on the part of both the adviser and the fund’s directors with regard to the advisory fee.⁷⁰ In addition, it provides that independent directors must approve the advisory fee separately from the board as a whole.⁷¹ Section 36-b creates a cause of action against the adviser for unreasonable fees.

Taking up their mandate to determine what fees are “reasonable,” courts in the influential Second Circuit have established a test (the “Gartenberg” test) consisting of six factors: (1) the nature and quality of services provided to fund shareholders; (2) the profitability of the fund to the adviser-manager; (3) fall-out benefits; (4) economies of scale; (5) comparative fee structures; and (6) the independence and conscientiousness of the trustees (directors).⁷² The test is intended to address the question “whether the fee

⁷⁰ Investment Company Act of 1940 §36(b), 15 U.S.C. § 80a-36(b) (1998). *See generally* Ben L. Hernandez, *The Duties of Mutual Fund Trustees with Respect to the Investment Advisory Fee*, 41 BOST. BAR. J. 12 (1997).

⁷¹ Investment Company Act of 1940 §15(c).

⁷² *See Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 409 (2d. Cir. 1989), *cert. denied*, 443 U.S. 919 (1989).

schedule represents a charge within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances.”⁷³

On its face, the Gartenberg test seems sensible. It provides a legal basis for inquiry into key issues such as whether the adviser is in essence earning economic rents. The test, however, is at heart a balancing inquiry, and courts have tended to weigh the balance in favor of finding fees reasonable. In particular, courts appear to have given great consideration to the sixth factor: the disclosure made to directors and their care in considering the proposed fee.⁷⁴ This focus on the process by which fees arise, rather than their result, may reflect a proper judicial decision to defer to the knowledge of internal management and the disciplining force of the market. However, it does not create a credible threat of liability for excessive fees. In practice, fees simply will not be thrown out by the courts.⁷⁵

Precisely how fees have changed over time, and how they are poised to shift over the coming years, is a complex and uncertain inquiry that can only be discussed in summary fashion here.⁷⁶ Many observers have argued that fee reductions have not matched the rapid growth of fund assets. The growth of the fund industry over the last two decades has been staggering. If economies of scale truly exist, rapid increases in assets under management should have yielded proportional (or close to proportional) decreases in fees.⁷⁷ Moreover, the persistence of the occasional fee that seems

⁷³ *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d. Cir. 1982).

⁷⁴ *See Schuyt v. Rowe Price Prime Reserve Fund*, 663 F.Supp. 962, 908-988 (S.D.N.Y.1987).

⁷⁵ *See* Samuel S. Kim, Note, Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard, 98 COLUM. L. REV. 474, 477 (1994) ([as of 1994] “no courts have held any adviser’s fee to be excessive”).

⁷⁶ *See generally* Kevin L. Hicks, *Mutual Fund Fees* (Apr. 10, 1998) (unpublished Harvard Law School student paper at www.cyber.harvard.edu/rfi; accessed 10/22/99).

⁷⁷ *See* Robert Barker, *High Fund Fees Have Got to Go: Vast Economies of Scale Benefit Fund Companies, Not Investors*, BUS. WEEK, August 16, 1999 (noting that according to Morningstar numbers, “[since

indefensible raises serious questions.⁷⁸ Fund companies note that fees drop only as economies of scale emerge in individual funds, so only large funds should show fee decreases. Moreover, some evidence supports the conclusion that fees are not unreasonable. Advisory contracts, for instance, commonly use a staggered fee structure with multiple breakpoints. A fund, for instance, may charge a 50 basis point management fee until the fund reaches \$500,000,000 in assets, 40 basis points until the fund reaches \$750,000,000, etc. The ubiquitous nature of this pro-shareholder structure indicates that at least some of the benefits of economies of scale that exist in mutual fund management are being passed along to shareholders.

The battle over precisely where fees stand was joined in 1998 as a study by the ICI concluded that shareholder costs had dropped dramatically. The ICI's study found that average total investor costs had plummeted in the period 1980-1997—dropping from 2.25 percent to 1.49 percent.⁷⁹ Commentators immediately pointed out that the ICI study included a number of methodological errors. Perhaps most critically, the study itself noted that much of the purported cost change resulted from shareholders shifting from funds with front-end loads to no-load funds. By amalgamating the two fees in its study, the ICI ignored the possibility that, although there has been a decline in shareholder willingness to pay loads, expenses other than loads have not changed significantly. In addition, the ICI study used asset-weighted basis to measure fee changes; as a result, the cost reductions at large complexes may have masked fee stagnation in the industry as a whole.

1984...the average cost of actively run U.S. stock funds fell less than 10%, even as their assets multiplies 32 times”).

⁷⁸ See Michael A. Murvihill, *A Question of Trust*, MORNINGSTAR MUTUAL FUNDS, August 30, 1996 (citing examples such as a single-state municipal bond fund from Florida, a state without income tax).

A follow-up study by Morningstar Mutual Funds involving separate analysis of load and no-load families found that, although the effect of declining ownership of load funds has lowered overall costs, expense ratios have actually risen.⁸⁰ Moreover, fee declines are concentrated. Scott Cooley, the study's author, noted that if the ICI had excluded the ratios of three leading complexes with low costs—Fidelity, Vanguard, and American Funds—average fees would show little if any drop. Supposed decreases in fees, then, may ring hollow for many fund investors.⁸¹

The ICI, apparently standing by its methodology, has responded with new studies. In their most recent analysis, the ICI's economists found in a 1999 study that total shareholder cost for all equity funds dropped a further 5.6 percent in 1998, leaving an average cost of 137 basis points.⁸² This drop means that total cost has dropped forty percent since 1980. However, a recent study by Matthew Sevick and Peter Tufano of the Harvard Business School adds teeth to the argument that the presence and actions of independent directors has failed to lower fees.⁸³ Sevick and Tufano conclude that at least some evidence exists for the proposition that independent directors who are paid relatively higher compensation approve higher fees than those who are less well compensated.⁸⁴ The study warns that little may be concluded from this correlation. Board structure is not exogenously determined; instead, fund sponsors select their own

⁷⁹ John D. Rea & Brian K. Read, Investment Company Institute Perspective, *Trends in the Ownership Cost of Equity Mutual Funds* (Nov. 1998), at 2.

⁸⁰ Murvihill, *supra* note 78.

⁸¹ Scott Cooley, *Revisiting Fund Costs: Up or Down*, MORNINGSTAR MUTUAL FUNDS, February 19, 1999.

⁸² John D. Rea, Brian K. Reed, and Travis Lee, Investment Company Institute Perspective, *Mutual Fund Costs, 1980-1998* (Sep. 1999).

⁸³ Matthew Sevick and Peter Tufano, *Board Structure and Fee-Setting in the U.S Mutual Fund Industry*, 46 J. FIN. ECON. 321 (1997).

⁸⁴ *Id.* at 353. Similar conclusions are reached by Murvihill, *supra* note 78 (noting that, on some statistical analyses, directors at high-cost fund families earn above-average fees).

boards. It is thus possible that fund sponsors who wish to charge higher fees select boards who will approve those fees, or that certain fund families charge high fees and are correspondingly able to recruit and pay for the best available directors. Nonetheless, this evidence bolsters the arguments of fund critics.⁸⁵

Despite critics' assertions, however, fund defenders have a strong case that the fund question is simply indeterminate. Evidence on how vigorously directors press for fee reductions is anecdotal at best. Press accounts tend to assume that directors do press for lowered fees, but that advisers lower fees only modestly in response.⁸⁶ Although shareholders have brought a number of cases since the Gartenberg decision, courts have not found fees to be unreasonable. While critics note that this result flows from the deferential nature of the test, fund defenders suggest that it indicates that fees are, quite simply, not unreasonable. Regardless, court review of fees has almost certainly improved the *process* by which fees are suggested and approved. In sum, fund critics' strongest claim of director failure turns out, on closer examination, to look like a wash.

b. The Strougo Claims.

Critiques of the director system crystallized dramatically in 1997 with the filing of a lawsuit that has illustrated both growing concern over the role of independent directors and the power of the fund industry to squelch its critics. In Strougo v. Scudder, Stevens & Clark, Inc., plaintiffs asserted that directors serving on multiple boards within the Scudder Kemper complex became "interested" by virtue of their close financial

⁸⁵ It is crucial to note that the study only examines fee setting. Directors may do better at other tasks for which they are responsible.

⁸⁶ See, e.g., Pui-Wing Tam, *Has Your Independent Director Done Anything for You Lately*, WALL. ST. J., February 19, 1999.

relationship with the sponsor.⁸⁷ The specific issue in the case—the plaintiff’s right to bring a derivative suit challenging a potentially dilutive rights offering in the closed-end Brazil fund—was less important than the case’s implied assertion: that the fund’s directors were made “interested” by the fact of their service on the board of multiple funds within the complex.⁸⁸

The Strougo claim, an instant cause célèbre, focused press and regulatory attention on the possibility that directors were “captured” by adviser-complexes. The plaintiff’s argument, if successful, might have rewritten the entire industry. The specific legal issue was minor enough that even an adverse decision might have had little effect. Had the court found that service on multiple boards was enough to cause independent directors to be considered “interested,” however, fund complexes might have been forced to redesign the structure of their boards to avoid similar determinations in other areas of the law.

Strougo’s threat, however, was short-lived. Fund advocates raised an outcry at Justice Sweet’s initial willingness to consider directors “interested” for purposes of Maryland law. In further consideration of the case, however, the court dismissed the plaintiff’s claims. Shortly thereafter, through a concentrated lobbying effort, the fund industry was able to influence the Maryland legislature to pass legislation eliminating the possibility that directors serving on multiple boards might be considered “interested” under Maryland law.⁸⁹ Similar legislation passed in December of 1999 in

⁸⁷ 964 F.Supp. 783 (S.D.N.Y. 1997).

⁸⁸ Judge Robert Sweet rejected this argument under federal law, but initially refused summary judgment as to whether, under Maryland corporate law, directors might indeed be “interested,” and the plaintiffs thus excused from the technical requirement of demand before filing suit.

⁸⁹ James J. Hanks, Jr., *Straightening Out Strougo: the Maryland Legislative Response to Strougo v. Scudder, Stevens & Clark*, 1 VILL. J. INV. MGMT. 21 (1999).

Massachusetts.⁹⁰ Although Strougo paved the way for a number of similar suits against other fund complexes, each was subsequently dismissed.⁹¹ Finally, as the uproar grew, even Arthur Levitt, chairman of the SEC, expressed guarded agreement with industry efforts to overturn Strougo.⁹²

To industry insiders, Strougo was misguided. While the idea of forcing directors to serve only a single fund has an intuitive attractiveness, it appears on further consideration to be flawed. First, single-service rules are almost certainly not worth the prohibitive cost they would impose on the largest of fund complexes. Second, there is evidence that serving on multiple boards may lead to better overall monitoring, at least with regard to fund fees. In their already-cited 1997 study of fee-setting, Sevick and Tufano found that fees were lower where directors served on multiple boards within the same complex.⁹³ More particularly, sitting on multiple boards was positively correlated with lower fees paid to third-party service providers, suggesting that directors may gain greater bargaining power when they bring the interests of the entire complex to bear on a negotiation.⁹⁴

Finally, it is intuitive that directors who monitor more funds gain experience and perspective that can make them effective. A director who is aware of the workings of the entire complex, or of at least a subset of the complex's funds (e.g. all equity funds), may be in a better position to protect the shareholders of all funds.⁹⁵ In sum, cost-benefit

⁹⁰ Pui-Wing Tam, *Fund Firms Push for Laws Allowing "Double Duty" Boards*, WALL. ST. J., February 19, 1999.

⁹¹ See Sturms, *supra* note 37, at 114-115.

⁹² Mike Garrity, *Case Questions Levitt's Views*, MUTUAL FUND MARKET NEWS, November 10, 1997.

⁹³ Sevick and Tufano, *supra* note 83, at 348-349.

⁹⁴ *Id* at 348.

⁹⁵ These arguments may be strengthened by the discussion of allocation issues in Part I. Under current law, intra-complex conflicts are largely ignored. (As a matter of business practice, directors in some complexes may pay close attention to them.) The presence of complex-level directors might, as responses to these

analysis, empirical evidence, and commonsense indicate that multiple directorships are a necessary and beneficial part of the system. If the Strougo suit is dead, then, its demise may have been a collective good. Like the concern over fees, Strougo, to fund defenders,

B. Why Directors are Necessary: The Market Fails.

The markets influence mutual funds as they do any other business.⁹⁶ The mutual fund market is a competitive one. Fund families compete across a wide variety of terms, including fees, performance, services, and expertise in particular sectors of the economy.⁹⁷ The industry is characterized by low entry barriers and a proliferation of competing funds. In addition, funds face competition from other financial intermediaries.⁹⁸ Supporting these assertions, evidence from Lipper Analytical Services suggests that fund families do not earn supra-competitive profits.⁹⁹

The forces of competition and information should, theoretically, have the effect of preventing fund complexes from engaging in behavior that harms investors. Funds that charge excessive fees will not survive; they will attract limited new investment, face dwindling assets under management, and ultimately be forced to consolidate or close. Indeed, statistics indicate that investors increasingly seek low-fee funds.¹⁰⁰ Likewise,

allocative issues are clarified, play an important role. It is possible to imagine situations in which service on multiple fund boards might give a director the perspective necessary to defend the interests of each.

⁹⁶ See Investment Company Institute, *Mutual Fund Factbook, 1999 Edition*, at 41 http://www.ici.org/aboutfunds/factbook99_toc.html; accessed 3/08/00 (20 percent of mutual funds are held by fiduciaries and financial or business organizations).

⁹⁷ See Erik Sirri and Peter Tufano, "Competition and Change in the Mutual Fund Industry," in FINANCIAL SERVICES: PERSPECTIVES AND CHALLENGES 181 (1993).

⁹⁸ Competition takes multiple forms. Banks offer mutual funds directly. Insurance companies offer sophisticated annuities. The emergence of low-cost Internet brokers, in particular, has led some to question whether mutual funds may lose market share as investors are increasingly able to pursue individual stock purchases with strong information resources and at low cost.

⁹⁹ Lipper Analytical Services, Inc. *The Third White Paper: Are Mutual Fund Fees Reasonable*, at 6-7 (Sept. 1997). For analysis, see Hicks, *supra* note 76, at 34-37.

¹⁰⁰ See Hicks, *supra* note 76, at 29-31.

funds that engage in wrongdoing will be closely monitored, both by large investors and by third-party monitors.

Mutual fund market discipline comes through the mechanism of capital flows, not pricing. Because the 1940 Act creates fixed-pricing for mutual fund shares, new information regarding the fund's management, fees, and other pertinent data, even if known in the market, cannot be reflected by changes in price. Open-ended investment company shares are not traded on the market, and are not sold or bought except at their NAV in sales and repurchases by the fund. As a result, investors aware of new information cannot cause that information to be reflected in the price of the fund's shares through the ordinary process of market transactions.

However, the market still has a role to play. If redemption is readily available and investors redeem whenever it is in their interests, then even an ineffective board of directors will, in theory, not lead to under-protection of shareholder interests, at least with regard to terms that the market understands. Shareholder capital flows send clear signals that affect fund adviser behavior. Capital flight will decrease the assets of funds that perform badly or are plagued with high fees. Greater inflows will raise successful funds' assets and thus boost sponsor profits. These movements will have a disciplining effect on profit-seeking managers.

So long as competition for prices and other terms exists, market forces should largely alleviate our concerns that shareholder interests may be ignored. Nonetheless, a two key difficulties exist with the assumption that competition is a panacea.

First, shareholders may not be free to redeem at will. Redemption carries its own costs. Although front-end sales loads are now uncommon, contingent deferred loads

penalize investors who withdraw from a fund after only a short period. Sale of shares may also trigger capital gains taxes.¹⁰¹

More importantly, it is far from clear that shareholders monitor their funds closely enough to exercise their rights to redemption intelligently. In a study on mutual fund capital flows, Erik Sirri and Peter Tufano found asymmetries in shareholder reactions to performance and other factors.¹⁰² Their results indicate that investors are swift to move into high performers, but show little inclination to leave funds that have lagged in performance or raised fees.¹⁰³ These results may indicate that, as a practical matter, fund advisors need not compete vigorously, for instance, with regard to funds that are closed to new investors. Once invested in a fund, investors are less than perfectly sensitive to changes in the performance or other characteristics of their holdings.

Other evidence of market imperfections may be drawn from studies regarding investor understanding of mutual fund fees. One study indicated that less than twenty percent of mutual fund shareholders could estimate the fees charged by the largest mutual fund that they held.¹⁰⁴ One out of five of those surveyed believed that higher fees lead to higher returns.¹⁰⁵ Further evidence of investor ignorance is provided by the fact that some investors purchase index funds with a load where no-load funds are also available.¹⁰⁶ Evidence indicating that segments of the market are efficient does exist;

¹⁰¹ Each of these problems is diminished where the investor holds a fund as part of a tax-free retirement account; however, retirement accounts may be the least-monitored of mutual fund holdings.

¹⁰² Erik R. Sirri and Peter Tufano, *Costly Search and Mutual Fund Flows*, J. FIN 1589-1622 (October 1998).

¹⁰³ See *id* at 1599-1600.

¹⁰⁴ See Gordon J. Alexander, Jonathan D. Jones and Peter J. Nigro, *Mutual Fund Shareholders: Characteristics, Investor Knowledge and Sources of Information*, Office of the Comptroller of the Currency, E&PA Working Paper 97-13, at 11-12, 35 (December 1997).

¹⁰⁵ See *id* at 13, 35.

¹⁰⁶ Given the equivalence of index funds with the same target index, buying a load fund is irrational. See Daisy Maxey, *Some Index Funds are Charging a Load*, WALL ST. J., May 5, 1997.

clearly, though, not all investors are cognizant of even the most central issues pertaining to their fund ownership.¹⁰⁷

The debate on how well a semi-efficient, segmented market comprehends fees is in no sense resolved. Nonetheless, to the extent that market failures and structural burdens (fixed pricing) exist with regard to fees, there is theoretical justification for third-party monitoring. Directors should, in theory, have a key function in the system, despite complaints as to precisely how that role has been played.

Moving beyond fees, we find that little or no evidence on precisely what shareholders understand or follow exists. Nonetheless, to the extent that market monitoring of fees is imperfect, we may posit that comprehension of more complex and controversial issues may be even more limited. The market is unlikely to detect fraud or internal wrongdoing, for instance, and may not be able to comprehend various practices that may harm shareholders in subtle ways.

It is here, defenders suggest, that directors can have a clear role. The fund director's role is logically greatest with regard to terms that market players are unable to detect or process intelligently. In these areas, directors have important roles to play, and there is little evidence that they have failed to perform effectively.

C. The Director's Roles.

1. Three Functions.

In moving toward consideration of possible changes to our system of fund governance, it is important to re-examine what directors do. Ron Gilson has analyzed the

¹⁰⁷ Hicks, *supra* note 76, at 34-35.

duties of independent directors as falling into three categories: fiduciary (corporate), regulatory, and contractual.¹⁰⁸

First, directors have responsibilities with regard to corporate governance as representatives of the shareholders' interests. Directors have basic state-law fiduciary duties that include prevention of abuses such as embezzlement, corruption, or insider preferences, regardless of where these problems arise. With regard to these duties, fund directors are no different from corporate directors elsewhere in business. Even in an internally managed mutual fund, some individual must guard against early-stage wrongdoing by portfolio managers and other personnel. Given the SEC's limited resources, it is unclear who, if not directors, is capable of performing this task.

Second, directors engage in contractual governance. As the sole disinterested representatives of the legally separate entity that is a mutual fund, directors must monitor the contracts that exist between the fund and its adviser, underwriter, and other service providers. Contractual governance focuses specifically on the investment adviser and its affiliates, and includes monitoring the fairness of all arrangements between the fund and its sponsor. Critics' arguments have focused on this level of duty.

Finally, directors are asked to play a major part in regulatory governance. Directors are to monitor compliance and ensure that funds do not violate the 1940 Act. As a result, directors are not merely to act in the interests of shareholders or the company, but in the interest of strong enforcement of the provisions of the 1940 Act. Oddly enough, it is unclear that critics have actually alleged that directors fail qua legal regulators.

¹⁰⁸ See Ron Gilson, Comments in Transcript, *Conference on the Role of Independent Investment Company Directors* at 56-58 (February 23 and 24, 1999) (www.sec.gov/offices/invmgmt/roundtab.htm, accessed

At a certain level, these roles merge. The 1940 Act aims at protecting investors and places the ultimate legality of many practices in fund directors' hands. When a director rejects an adviser's attempt to introduce a particular contractual provision, then, he may do so because the provision both violates the 1940 Act and harms the interests of shareholders. Nonetheless, the elucidation of these separable duties points to several ideas.

First, directors may simply be much better at some tasks than others.¹⁰⁹ Studies have examined both the levels of mutual fund fees, in general, and the correlation of those fees with the presence and numbers of independent directors.¹¹⁰ No equivalent studies exist to test whether directors have detected and squelched fraud or blatant wrongdoing, or whether they have handled ethics questions or personal trading policies well. Some observers assert that, contrary to the criticisms of some among the financial press, directors in fact exhibit a high level of responsibility and sophistication. Many directors pay close attention to regulatory compliance, allocation issues, and other matters that, realistically, shareholders could neither anticipate nor monitor.¹¹¹ Little research has been done on any of the different roles that directors carry out in practice. Until we better understand, for instance, the nature of director involvement in issues of

10/25/99).

¹⁰⁹ See generally Victor Brudney, *The Independent Director: Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597 (1982) (arguing the independent directors in the corporate context may be successful at preventing self-dealing, but will fail at technical decision-making and at injecting social responsibility into firm decision-making).

¹¹⁰ See, e.g., Sevick and Tufano, *supra* note 83.

¹¹¹ This paragraph is based in part on conversations with several professionals who have worked closely with independent directors in various contexts. A number of the participants in the SEC's recent conference on these questions expressed similar sentiments. See Transcript, *Conference on the Role of Independent Investment Company Directors* at 56-58 (February 23 and 24, 1999) (www.sec.gov/offices/invmgmt/roundtab.htm, accessed 10/25/99) (*passim*).

deal allocation within the fund complex, it is premature to conclude that directors do not protect shareholders effectively in some instances.

Second, even if the system is reformed, it is unclear that the institution of the director should disappear. At a minimum, any corporate-based structure will require directors of some form to engage in corporate (fiduciary) governance. Our corporate governance mechanisms assume that independent directors are needed to detect and prevent certain acts that the market cannot detect. The same reasoning must apply to fund governance, as well. Likewise, the independent director's role in regulatory governance has gone undiscussed, perhaps in part due to the conflation between contractual and regulatory governance. Perhaps directors have been remiss in their judging of practices where director discretion *is itself* the core of the relevant legal test (as, for instance, in the Exemptive Rules charted in Part I).¹¹² Where the 1940 Act or its rules simply forbid an action, in contrast, directors may, on average, do a much better job of ensuring firm compliance and protecting shareholder interests. In sum, once directors are hired to do corporate governance, it makes sense to require them to play a part in the regulatory scheme. What may not make sense is to rest too much on their discretion.

Put differently, it is unlikely that the capture hypothesis in its strongest form—the presence of “crony” directors may actually harm shareholders—is true. Unnecessary focus on independent directors may occlude the fundamental difficulty involved in basing regulation on the oversight of individuals with skewed incentives. However, independent directors should continue to be used, and it is likely that forcing inside management to disclose and justify their proposals to these directors has an overall

positive effect on governance. Given the low cost of the director system and the lack of good alternatives, the three contributions discussed below may be enough to justify the system as it stands.

2. Three Contributions.

a). The Director as Listener.

The mere fact that disclosure of particular fees and practices must be made to fund directors will have an ameliorative effect on how business is done. Put simply, it is human nature to self-monitor when one must explain one's actions to a third-party. Because they must disclose and justify their business practices to independent directors, fund insiders are likely to eliminate those practices that are most egregiously self-interested. Thus Matthew P. Fink, President of the ICI, has noted that “Since 1940, [the mutual fund industry]—having grown from \$400 million to five and a half trillion—has not had a major self-dealing scandal...and my guess is it's the independent directors who have prevented that from happening. They're the watchdogs who look at conflicts and probably a lot of conflicts never arise because the manager wouldn't dare put a transaction up in front of the directors when a majority of them are independent.”¹¹³

Although largely intuitive, this idea has a strong pedigree. Indeed, the entire disclosure-based regime of the 1933 and 1934 Acts is, at some level, based on the assumption that disclosure is inherently beneficial—an idea which more or less sidesteps arguments regarding what information is truly helpful or whether that information spurs

¹¹² As noted in Part I, reasons for director acquiescence in practices that some would see as against shareholder interests (e.g., 12b-1 fees) may include the commonplaceness of the practice involved and the SEC's tacit acceptance of its existence.

directors to action.¹¹⁴ In the classic phrase of Justice Brandeis, “sunlight is said to be the best of disinfectants, electric light the most efficient policeman.”¹¹⁵ Disclosure cleans up business, we may posit, whether or not anyone closely monitors what is said.

b). The Director as Beacon.

Directors as listeners, then, may play an important role. May directors do the same with their decisions? The answer, though still far from clear, may depend on whether particular decisions involve technical operative detail or entail conflicts of interest. To use the language of fiduciary duty, all directors have a duty of care as well as one of loyalty. The role of independent directors is likely to have a strong beneficial effect on the process by which decisions are made in those instances where disclosure to the directors is required. However, independent directors often do not possess the technical knowledge to serve as primary decision-makers on operational questions.

As monitors of the duty of loyalty, in contrast, independent directors have a clear and important role. With regard to egregious breaches of loyalty, such as embezzlement, directors may be good monitors. More importantly, in many cases, they are the only possible monitors. Self-dealing problems are likely to exist within an organization for some time before they may be detected by outside observers. To the extent that directors are in position to discover violations early, their presence should lower losses from fraud and self-dealing.

¹¹³ Matthew P. Fink, Statement at New York Media Briefing, Feb. 16, 1999, <http://www.ici.org/issues/fink_directors_audio.html>; accessed 1/25/00.

¹¹⁴ See the justifications for the disclosure regime collected at LARRY D. SODERQUIST AND THERESA A. GABALDON, SECURITIES REGULATION 113-125 (1999).

¹¹⁵ LOUIS BRANDEIS, OTHER PEOPLE'S MONEY 92 (1914).

With regard to conflicts of loyalty inherent in the system—practices like the use of 12b-1 plans, for instance—directors theoretically also have the power to add value. Allegations of limited efficacy ring strongly. Nonetheless, directors may play a positive role without actually voting down practices that they oppose. If shareholders and third-party fund monitors are aware of the role played by independent directors, directors may be able to protect investors by acting as a warning beacon. By “noisy” disagreement with fund advisers, directors can provide early signals about fund under-performance, rising fees, or other problems. Rather than using their “nuclear power,” directors could thus serve observant investors simply by voicing disagreement.

Recent struggles at several mutual fund complexes may provide an example of this function. In battles between independent directors and fund management at Fundamental Portfolio Advisers and the Yacktman Funds, directors’ willingness to bring problems with the funds into the public eye clearly sent a signal to investors, who subsequently abandoned each fund in large numbers.¹¹⁶ The same result emerged from the proxy battles at Navellier, discussed above.¹¹⁷ By a combination of protesting management decisions, notifying the SEC, terminating the advisory contract and ultimately resigning, directors were able to add information to the market, thus preventing the interests of investors in their funds from being harmed.

c). The Director as Stopgap.

Finally, even if directors are less than perfect monitors, they surely provide some protection and oversight, and they do so at a remarkably low cost. A Lipper Analytical

¹¹⁶ See Sturms, *supra* note 37, at 136.

¹¹⁷ *Id* at 106-107.

Services, Inc. study in 1997 indicated that the dollar-weighted average cost of independent directors is roughly one-half of one basis point.¹¹⁸ Thus the director-focused system recommends itself as an example of low-cost regulation.

The current system of director oversight may be the only feasible way that funds may be overseen within the U.S. regulatory climate. Actual abolition of the system would leave regulation to the SEC, the courts, or the markets. The SEC's resources are limited; budgetary and staff constraints would not allow it to take on additional responsibilities for review and oversight of funds. Nor does increasing reliance on the courts look promising.¹¹⁹ In a world less focused on independent directors, 36-b actions over fees, for instance, would remain a viable piece of the regulatory puzzle—yet, without independent directors in place, courts might be forced to step more directly into the breach to “set” fees. This ex-post, litigation-based approach would be inefficient, costly, and uncertain. It would prevent beneficial levels of financial intermediation through mutual funds.

The only feasible method of regulation, in such a setting, is low-cost self-regulation or third-party monitoring. Thus, though one observer has suggested abolishing much of the “corporate paraphernalia” of the mutual fund, including shareholder voting, he stopped short of advocating the abolition of the independent director system.¹²⁰ Given the low cost of the system, only an improvement that clearly offers better governance should convince us to scrap the directors' role.

¹¹⁸ See *id.* (citing private letter from Lipper Analytical Services, Inc. to Jonathan G. Katz, Secretary, U.S. Sec. And Exch. Comm'n (Oct. 9, 1997)).

¹¹⁹ See Richard M. Philips, *A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 912-913 (1982).

¹²⁰ *Id.* at 910-913.

This argument, in the end, appears to have won over the SEC. The Division of Investment Management's 1992 study concluded that the system of investor protection through monitoring by independent directors is a fundamentally sound one.¹²¹ More recently, the SEC's current proposals for reform reflect a continued feeling that the system is essentially a promising one.

D. Summary.

In sum, then, it is unclear that a real problem with the regulatory system exists. Directors may not be the best agents to achieve fee decreases; however, they may fill several other roles. First, although little clear evidence exists on the subject, independent directors may be the lowest-cost monitors of fraud and blatant wrongdoing that the market may be unable to ascertain. Directors may also add value in dealing with other issues that shareholders cannot monitor for themselves. Third, directors may improve fund governance by acting as listeners and "beacons" with regard to any fund practice or issue. Finally, directors may, quite simply, be the only answer to the conflicts inherent in fund structure.

The arguments presented above delineate a place for directors within the regulatory system. In the main, though, they do not respond directly to many of critics' allegations. Beyond asserting that directors do their jobs, the industry has few cogent responses to allegations of capture, complexity, powerlessness, and poor incentives.¹²²

¹²¹ DIV OF INV. MANAGEMENT, *supra* note 24.

¹²² Note, however, that the fact that directors may act as "beacons" by indicating problems to the market may alleviate concerns about their powerlessness. A director may warn investors, in theory, without actually rejecting the advisory contract. In reality, however, the two moves are likely to be linked.

Nonetheless, to the extent that the role described above is persuasive, any reforms to the system should focus on improving, not discarding, the regulatory structure that exists today.

Part III: Proposed Solutions.

Independent directors are central to the regulation of U.S. mutual funds; as a result, to propose alterations to their role is to cut at the roots of how funds are managed and regulated. Over the past decades, commentators have suggested reforms ranging from abolition of the corporate model of fund governance to direct SEC regulation of management fees.¹²³ Many of the solutions in the literature, however, begin with the premise that radical change is necessary. As a practical matter, such change will not occur in today's regulatory climate. On the one hand, established expectations regarding the role of the SEC preclude any radical move toward greater direct regulation. Conversely, the human capital invested in decades of 1940 Act practice and experience by fund professionals, the courts, and the SEC makes radical deregulation unlikely.

Directors will continue to have a strong role in part because they are an inexpensive means of regulation in an era of limited regulatory resources. Proposed reforms should accordingly be judged by how well they deal with the four criticisms discussed in Part I without significantly expanding the cost of the system. An examination of the reforms that have emerged from the past year's debates reveals that, on the whole, they fare well under this analysis.

A. The ICI proposals.

Recent ICI action shows a clear trend toward incremental improvements based on the existing system of director-centered oversight. On June 24, 1999, the ICI approved a set of best practices that it suggests for adoption, with possible changes, by the overwhelming majority of fund complexes that make up its membership.¹²⁴ The proposals include recommendations that:

- ◆ 2/3 of each fund’s directors be independent;
- ◆ Directors own shares of the funds they oversee;
- ◆ Independent directors, rather than the adviser, nominate and select independent directors (after selection at the fund’s inception by the adviser);
- ◆ Independent directors give basic disclosure on their business and other relationships on an annual basis,
- ◆ Independent directors have a lead director and, where called for, meetings separate from those of the full board;
- ◆ A single board serve each fund complex or, at least, a group of like funds within a complex;
- ◆ Independent directors have legal counsel separate from that of the investment adviser; and
- ◆ former officers or directors of a fund’s investment adviser or certain of its affiliates not be considered “independent” directors.

¹²³ For a survey of various proposals, see Sturms, *supra* note 37.

¹²⁴ Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 6, 1999). (www.ici.org, accessed 9/15/99).

The proposals are sensible and eminently conservative. In particular, focus on specific governance-related issues such as the use of a “lead director” reflects a laudable engagement with the nuts-and-bolts of how to craft a board that will maximize the voice and efficacy of independents. A few suggestions, if imposed as mandatory rules, would generate controversy—the proposal regarding independent counsel, in particular, has raised dispute as a part of the SEC’s proposed reforms.

At heart, though the ICI proposals are backwards-looking and largely toothless. Indeed, the report itself acknowledges that many or most of the reforms suggested are already in place among the large, well-established firm complexes that dominate fund market share.¹²⁵ This fact, combined with the proposals’ advisory nature, suggests that the best practices may be most effective in ensuring that awareness of good practices is widespread throughout the industry. They are unlikely to induce significant change among those funds that face high costs in adopting them. The ICI’s proposals may have an important though gradual effect in increasing the sensitivity that funds show toward issues of governance. However, they fail directly to address the four criticisms stated in Part I.

B. SEC proposals.

The SEC’s proposed rules, in contrast to the ICI’s suggested practices, contain both conservative and controversial elements. The proposals, published on October 14, 1999, were accompanied by a new Interpretive Release designed to resolve confusion

¹²⁵ See Robert Barker, *supra* note 75 (author’s survey of top ten fund families, with nine responding, reveals that major families are already in compliance with well over half of the best practices).

regarding certain existing issues.¹²⁶ In combination, the two releases create a series of legal reforms founded in the idea that the role of independent directors should grow, not diminish. Both the proposed rules and the Interpretive Release assume that directors are, in the main, capable of and interested in protecting shareholders.¹²⁷ The SEC has sought to bolster director power, rather than to examine directly the capture hypothesis or similar criticisms.

1. The Interpretive Release.

The Interpretive Release consists of several clarifications in SEC positions regarding existing interpretations of the 1940 Act and its accompanying rules.¹²⁸

The Release's interpretations are addressed largely at improving director incentives, the fourth criticism addressed in Part I. The Release first provides that 17d-1, a ban on affiliated party transactions, will generally not apply to transactions in which directors authorize the use of fund assets in a way that may incidentally benefit themselves.¹²⁹

Such uses of fund assets involve matters crucial to director vigilance, including payments to independent counsel and payments for proxy expenses.

Second, the release states that Rule 17h-1, a ban on provisions indemnifying directors from liability for "disabling conduct" in their capacity as directors, will no

¹²⁶ See *Interpretive Matters Concerning Independent Directors of Investment Companies*, Investment Company Act Release No. IC-24083 (October 14, 1999).

¹²⁷ For an example of language that reads oddly in light of critics' accusations, see *id.* at 7-8 ("independent directors are presumed by the nature of their qualifications to be free of many of the kind of conflicts that may color their judgment and affect their actions as directors").

¹²⁸ *Interpretive Matters Concerning Independent Directors of Investment Companies*, *supra.* One of the clarifications is largely irrelevant. The release provides guidance on when directors may be found "interested" under Section 2(a)(19) of the Act due to material business or professional relationships. Avoiding the result in *Strougo*, the release nonetheless expands the realm of "interested" persons by clarifying that material positions with or material transactions with the investment adviser or its related entities within the past two years may cause a director to be considered "interested." *Id.* at 6.

¹²⁹ *Id.* at 6.

longer be read to prevent funds from advancing legal expenses to directors who may be personally liable in a suit for their actions as directors.¹³⁰ Under previous interpretations, an advance of funds could occur only after assurances of repayment were made and the fund's independent directors (or independent legal counsel) had arrived at a reasonable belief that the director involved had not engaged in "disabling conduct."¹³¹ While the release does not eliminate this rule, it provides that directors may be presumed not to have engaged in "disabling conduct." Although advances of funds remain procedurally involved, directors should thus find it easier to defend themselves against allegations of wrongdoing.

Third, the release reverses earlier interpretations of Rule 22-g, which prohibits open-end funds from issuing shares to persons providing the funds with services.¹³² The SEC notes that the rule, designed to prevent windfalls to fund insiders who are issued a fixed number of shares whose value may appreciate before receipt, has prevented many fund complexes from compensating in fund shares. Although some complexes do encourage their directors to purchase shares with the funds provided them as compensation, direct share compensation is simpler and may avoid tax consequences. The staff's interpretation allows for direct share compensation, so long as the amount received is a fixed dollar amount rather than a fixed number of shares.¹³³

Finally, the release provides guidance as to the role of the SEC in disputes between independent directors and fund management.¹³⁴ In response to complaints that

¹³⁰ *Id.* at 7.

¹³¹ "Disabling conduct" includes willful misfeasance, bad faith, gross negligence or reckless disregard of his or her duties as a director. *Id.* at 7.

¹³² *Id.* at 8-9.

¹³³ *Id.*

¹³⁴ *Interpretive Matters Concerning Independent Directors of Investment Companies*, *supra* note 122, at 9-10.

the SEC has failed to act in the face of complaints from independent directors at several funds, the release sets forth an essentially neutral role for the SEC in disputes between fund management and independent directors.

The changes created by the release are, on the whole, laudable. After their promulgation, director incentives should improve. Greater share ownership will align directors' interests more properly. Increased director ability to defend against proxy attacks and lawsuits should lessen concerns that directors may act too cautiously. One might argue, however, that the SEC's role in fund disputes should be elucidated in a more complete fashion. So long as directors' duties include monitoring of legal compliance under the 1940 Act, the SEC should be willing to listen carefully to director requests for investigation or assistance. The elucidation of a formal procedure for considering director complaints might send a clearer signal that the SEC will respect director initiative and encourage active monitoring. This act would blend with the overall theme of the Release, which tweaks the existing legal structure in ways that should marginally improve director incentives without forcing funds to incur significant new costs. The Release thus effects low-cost regulatory change targeted at a particular weakness in the system.

2. Proposed Rules.

The SEC's proposed rules may be split into three groups. The first, a catch-all set of rule changes, addresses a number of minor issues. The rules, for instance, further address the definition of "interested" persons and also provide for record-keeping by

funds so that the SEC may easily examine the basis of fund determinations that particular individuals are disinterested.¹³⁵

Two specific proposals deserve further comment. First, the Release proposes to amend Section 17d-1(d)(17), a provision dealing with errors and omissions liabilities policies commonly obtained by funds to cover director litigation expenses.¹³⁶ Previous policies have carried a “co-insured” exclusion for claims in which the parties to the policy (for instance, the fund and its directors) sue one another. Observers have noted that, as a result of this interpretation, independent directors that face the possibility of uninsured financial loss may act less aggressively in the interests of shareholders. The proposed rule would make the Rule applicable only to policies without a co-insured exemption.¹³⁷ In a related change, ICI Mutual, the insurer associated with the Investment Company Institute, has now removed co-insured exemptions from its policies as a result of SEC comments on the issue.¹³⁸ These actions, closely related to the Interpretive Release’s guidance on legal fee advances, should contribute to directors’ willingness, where appropriate, to pursue actions that may raise the specter of lawsuits. Like the Release, this rule will improve director incentives at low cost.

Second, the SEC would add Rule 32a-4(b), providing that funds which have an audit committee composed entirely of independent directors will not be required to submit the fund’s choice of independent auditors to its shareholders for approval under Section 32-a(2) of the Act.¹³⁹ This change reflects a practical realization that

¹³⁵ *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24082 at 10-14, 22 (October 14, 1999).

¹³⁶ *Id.* at 10.

¹³⁷ *Id.*

¹³⁸ Investment Company Institute, *ICI Mutual Strengthens Insurance Coverage for Independent Directors* (April 1, 1999).(<http://www.ici.org/issues/icim_dtrs_cov.html> accessed 12/22/99).

¹³⁹ *Role of Independent Directors*, *supra* at 10-11.

shareholders simply are not interested in their funds' independent accountants. The rule pushes firms to create audit committees by offering the carrot of reduced shareholder solicitation costs.¹⁴⁰ More importantly, the rule in effect pushes fund corporate governance to incorporate the insights culled from years of discussions on corporate governance. The dynamics of the boardroom have often been ignored in mutual fund debates, perhaps because it is difficult to quantify how institutional factors (how meetings are organized and run, who speaks for the independent directors, how often meetings take place, etc.) actually impact directors' performance. Yet literature on how to make corporate boards work does exist.¹⁴¹ Application of lessons from U.S. industrial firms has the potential to free up fund directors better to perform their jobs.

In one sense, this series of proposals, along with the changes created by the Interpretive Release, exemplify the best of the SEC's rulemaking efforts. While likely to improve director incentives and marginally improve fund governance, they impose few costs on either funds or the SEC itself.

Promoting Independence

The second, more focused series of proposals aims at increasing the independence of disinterested directors. The SEC would require that funds interested in benefiting from the provisions of a long list of 1940 Act rules have a majority of independent directors (or, alternatively, a 2/3 majority), that those directors be nominated and elected by their

¹⁴⁰ In moving toward fully independent audit committees, the proposals echo the recent efforts of the Blue Ribbon Committee with regard to corporate audit committees. See Jordan Eth and Christopher A. Patz, *New Protections and New Risks for Outside Directors*, 1136 PLI/Corp 175, 183-185 (1999) (describing committee recommendations).

¹⁴¹ See, e.g., Martin Lipton and Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 67-76 (1992) (recommending, among other measures, board sizes capped at 8-9 directors,

fellow independent directors, and that any legal counsel for the independent directors be independent.¹⁴² The SEC has made it clear that it does not intend to mandate these measures for all funds; however, the rules would affect most funds.¹⁴³

The proposed measures hinge on fund utilization of one of ten “Exemptive Rules” that “(i) exempt funds or their affiliated persons from provisions of the Act, and (ii) have as a condition the approval or oversight of independent directors.”¹⁴⁴ The proposal recognizes that the Exemptive Rules, by making disclosure to and approval by the board of directors the major prerequisite to an action’s legality, may provide a wide measure of discretion to fund managers. If the SEC is, in effect, to yield its ability to declare fund practices illegal, then the directors who replace it as monitors of fund practice must be independent enough to provide real oversight.

On their face, the rules respond to the capture hypothesis. Self-selection and independent majorities should free directors, to some degree, from the power of the complex. Yet the Release dodges important arguments regarding the manner in which directors are initially selected and compensated. The fact remains that independents, regardless of their numbers or the method of their re-election, are initially picked by fund advisers.¹⁴⁵ Likewise, director service on multiple fund boards may continue to link their

increased meeting frequency and duration, use of a lead director, and increased meeting with large shareholders).

¹⁴² “Independence” in this case means that counsel should not represent both the investment adviser and the independent directors as clients.

¹⁴³ *Role of Independent Directors*, *supra* note 135, at 5.

¹⁴⁴ *Id.* at 4. These rules are summarized in the “Exemptive Rules” table in Part I.

¹⁴⁵ The selection problem is a difficult one. If we are concerned that independent directors are incompetent, or that fund advisers pick individuals who they anticipate will acquiesce to their suggestions, this problem must be dealt with when new funds are formed. Concerns over competence could be dealt with by mandating certain qualifications with regard to financial sophistication or experience, as suggested by Ron Gilson and Reinier Kraakman. *See* Gilson and Kraakman, *supra* note 63 (recommending financial qualifications for independent directors).

A pool of qualified directors might be developed through a central group such as the ICI, with each firm required to select some portion of its directors from that pool. More radically, if strong emphasis

interests with those of fund advisers, both financially and in more subtle ways. The rules, rather than attempting to strike at the root difficulties of directorship in the complex system, seem to contemplate the creation of a countervailing power: a strong culture of independence.

It is possible that, as their numbers increase, independents will become more assertive of shareholder interests.¹⁴⁶ Nonetheless, the thrust of the rules runs into empirical difficulties. Research by Matthew Sevick and Peter Tufano indicates that, while increasing independents' presence is a positive step, adding directors may not help shareholders, at least on the narrow issue of fee-setting.¹⁴⁷ In three of four specifications tested in their study, large boards (with more independent directors) tended to charge high advisory fees.¹⁴⁸ This finding perhaps suggests that smaller boards are better able, perhaps as a matter of group dynamics, to monitor and negotiate fees. Boards with a high percentage of independent directors tended to charge lower fees.¹⁴⁹

Thus, while increasing the percentage of directors who are independent is a beneficial move, large boards may actually be poorer monitors of insider management. It is unlikely the fund advisers will reduce their own board participation in order to comply

is to be put on regulatory compliance and reporting, the SEC might pick one or more of the directors to serve on each fund board, thus ensuring that at least one director will have a clear allegiance to regulatory compliance. Needless to say, the latter move would represent a greater intrusion of than the U.S. regulatory culture is apt to accept; it is perhaps for this reason unwise. More importantly, it is unclear that either a pool of qualified directors or SEC appointments would change the contours of how mutual funds are governed. Observers have noted that the world of individuals familiar with mutual fund law and practice is a limited one. A free flow of attorneys occurs among law firms representing mutual funds, the SEC, and funds complexes themselves. While the pool of potential directors is larger than that of 1940 Act lawyers, it is unclear that the ICI would select a pool of individuals significantly different than those that fund complexes would arrive at on their own. It is therefore uncertain whether a change in how directors are selected would make a significant difference.

¹⁴⁶ The simple fact that directors are a minority of some boards, of course, constrains their bargaining power; however, most boards have independent majorities, so it is unclear that any real shift in composition will be forced by the rules.

¹⁴⁷ Sevick and Tufano, *supra* note 83, at 348.

¹⁴⁸ *Id.*

with the rule. The increase in board size that could accompany passage should be counterbalanced by other measures to improve board governance—measures like the appointment of a lead director or provision for separate meetings of independent directors.¹⁵⁰ Further research may provide a closer map to precisely why large boards perform poorly and how they might be improved.

Independent Counsel.

The SEC proposals also require that directors, if they have legal counsel, have independent counsel separate from that of the fund adviser. The proposal may have several aims. First, it is clear that counsel currently play a major role in educating and guiding directors. Directors routinely rely on memos prepared by fund counsel on issues such as Gartenberg duties and analysis of 12b-1 plans. As fund governance has moved toward standard-like, multiple-factor tests, advice from counsel has become increasingly necessary.¹⁵¹ Fund advisers might argue that the technical nature of most of fund counsel's tasks means that use of common counsel for the fund adviser and the independent directors does not raise difficulties. In practice, however, conflicts may easily arise.¹⁵² A lawyer representing both a fund's adviser and that fund's independent directors clearly can have no major role, for instance, in fee negotiations.

In addition, the presence of independent counsel may have strong intangible effects. One criticism of independent directors has been that they failed to show the tenacity and partisanship characteristic of lawyers, whose loyalty to their clients at all

¹⁴⁹ In both cases, differences were more noticeable between complexes than within a particular complex. *Id.*

¹⁵⁰ For an early set of practical proposals in the corporate arena, *see* Lipton and Lorsch, *supra* note 141.

¹⁵¹ In a backhanded way, the proposal that directors use independent counsel thus addresses the complaint that directors must evaluate increasingly controversial practices.

odds shames their own tepid performance.¹⁵³ Injection of lawyers who may be more willing to stand up for shareholder interests may benefit shareholders if those lawyers are not indebted to or influenced by fund adviser. Ultimately, of course, independent counsel, like their director clients, are paid from adviser coffers. Nonetheless, lawyers, particularly those who perceive their role to be, in effect, that of counsel for shareholders, may be more willing to challenge fund advisers.

Finally, a snowball effect may emerge. As a larger network of independent directors emerges and makes use of its own counsel, greater separation from adviser interests may emerge. Cynics may note that the proposals will constitute a full employment act for mutual fund counsel. In point of fact, the realm of mutual fund lawyers as it exist today is a cozy one, and firms hoping to cultivate fund business may shy away from strong advocacy of shareholder interests as director representatives. A strong requirement of independent fund counsel might encourage new law firms or lawyers to invest the human capital necessary to deal with 1940 Act issues. While the rules would increase work for lawyers, they might also introduce new players into the system, and with them, perhaps, more vigilance. In practice, it is unclear that having more lawyers working in the fund industry will, by itself, improve anything. Nonetheless, because the requirement should improve the chance that directors receive strong, loyal advice, it is a good one.

¹⁵² See generally Philip H. Newman, *Ethical Considerations of Counsel in Advising Registered Investment Companies and Investment Advisers*, 87 ALI-ABA 271 (1999).

¹⁵³ See, e.g., Kris Hunter, *The Independent Director's Duty is Debated*, MORNINGSTAR MUTUAL FUNDS, February 24, 1999 (noting that independent directors lack the willingness to "stick [their] necks[s] out for the client," in part due to lack of contact with shareholders).

Each of this first round of proposals would raise costs enormously, as many funds have been swift to point out in comment letters to the SEC.¹⁵⁴ An industry analyst has estimated that a requirement of (2/3) independent super-majorities, if combined with other practices proposed by the ICI, could cause as many as seven-hundred to eight-hundred new directors to enter the industry over the next five years.¹⁵⁵ The SEC's proposal demurs on the issue of how much changes would cost, and industry insiders have not come forward with a credible estimate. Nonetheless, to the extent that board compositions do change, that change may come with a significant price that will be passed along to investors.

Disclosure Initiatives.

Finally, the Proposed Rules include a number of suggested changes to the disclosure requirements imposed on all mutual funds. Current disclosure rules already provide shareholders with certain information about directors in two separate places: proxy statements for director elections and the statement of additional information ("SAI") available upon shareholder request as a part of fund registration statements. In the SAI, funds must provide information on directors' names, ages, positions with the fund, principal occupations over a five-year period, and compensation, both from the fund and from the fund complex as a whole.¹⁵⁶ Proxy statements also require disclosure of directors' positions in the fund and its affiliates, as well as transactions with and interests in those entities. However, proxy statements are not required of all funds,

¹⁵⁴ See, e.g., Letter from Robert A. Robertson for Independent Directors of Morgan Stanley Dean Witter Family of Funds, to Mr. Jonathan G. Katz, Secretary, U.S. Sec. and Exch. Comm'n. (January 21, 2000), at 5-6.

because, as noted above, funds are not always required to hold annual meetings as a matter of state law.¹⁵⁷ Moreover, even when disclosure is provided, critics have argued that the required information fails to shed light on the real issues: directors' loyalties and incentives.

Responding to complaints that the disclosure regime has gaps, the SEC's release proposes to provide shareholders with a great deal of new information on their directors. The proposals discuss several types of disclosure.¹⁵⁸ First, funds would be required to increase the basic information they provide on all directors. In addition to current requirements, the rules add disclosure of the number of portfolios overseen within the fund complex, other directorships outside the fund complex, and, for interested directors, a description of the events, relationships, or other factors disqualifying the director from being considered "disinterested."¹⁵⁹ This information would be presented in a tabular format and included in three documents: proxy statements relating to director elections, the SAI, and the fund's annual report.¹⁶⁰ In keeping with recent attempts to simplify the prospectus in light of investor demand for clarity and ease of use, the SEC does not propose to include information on directors in the prospectus.

Second, funds would be required to include in the SAI and all election-related proxy statements a chart indicating the aggregate dollar amount of securities in funds of the fund complex held by each director. This disclosure is intended to allow those who

¹⁵⁵ Mike Garrity and Lori Pizzani, *Directors' Proposals Could Increase Turnover*, MUTUAL FUND MARKET NEWS, July 12, 1999.

¹⁵⁶ *Role of Independent Directors*, *supra* note 135, at 13.

¹⁵⁷ *Id.*

¹⁵⁸ The release also proposes to require that funds make greater disclosure of matters pertaining to fund governance. Most important among these changes is the requirement that the SAI include a discussion of the factors used by a fund's independent directors in renewing an existing investment advisory contract.¹⁵⁸ The current rules require only proxy disclosure of these factors. *Id.* at 20-21.

¹⁵⁹ *Id.* at 14.

read the chart to ascertain whether directors' incentives are aligned with those of fund investors.¹⁶¹ However, the proposed chart would not include director holdings of individual funds within the complex. The rule essentially ignores the danger that a director of multiple funds may be tempted or forced to favor one fund at the expense of another. Apparently, the SEC felt that, since ownership of each fund that a director supervised is neither required nor feasible, disclosure of particular holdings might create shareholder concerns where none should exist. A wiser move would have been to require disclosure of individual holdings, but allow funds to include a standard, brief discussion of the issue along with the chart. A paragraph explaining why directors may have good incentives to monitor despite their lack of holdings could obviate any concerns that shareholders will misunderstand the information presented. This problem notwithstanding, the first two proposals seem sensible.

Transactions with Affiliates.

Finally, funds would be required to significant disclosure of “positions, transactions, and interests” that may raise questions as to whether particular directors have conflicts of interest due to their business dealings with fund advisers or other associated parties. Current rules already require information about a number of director conflicts. The proposed disclosure, to be included in the SAI and in proxy statements,

¹⁶⁰ *Id.*

¹⁶¹ Fund complexes have called attention to the violation of privacy inherent, in particular, in forcing disclosure of securities holdings. Many directors, like other Americans, have large chunks of their retirement savings in mutual funds, and the proposed rules could force disclosure of these amounts. The comment letters' solutions—disclosure of the range of directors' holdings in the complex—between 0 – \$50,000, \$50,000 to \$100,000, etc.—seem sensible. It should be noted that this issue is separate from that of showing holdings in particular funds. Particular holdings might be demonstrated without triggering further privacy concerns by use of (admittedly more precise, smaller) ranges.

would expand on those rules in several ways. First, the disclosure requirements would apply not only to all directors, but to their immediate family members, as broadly defined by the proxy rules.¹⁶² Second, the rules expand the list of persons to be considered related to the fund adviser to include fund administrators, funds with the same investment adviser, administrator, or principal underwriter, and officers of the fund adviser or principal underwriter, among others. Third, the rules overstep the boundaries by which “interested” directors are defined in Section 2(a)(19), forcing disclosure of facts that would not cause a director to be considered “interested.” The Release contemplates the possibility of exempting transactions and interests below a certain size from disclosure; nonetheless, the sweep of the proposals is broad. Finally, the rules also force disclosure of cross-directorships, where an officer of the fund or an affiliated party has served in the last two fiscal years as officer or director of a company of which a fund director is an officer.¹⁶³ With this requirement, the SEC appears to be aiming at revealing the layer of social and business networks that some say undermines directors’ willingness to challenge their funds’ investment advisers.

Funds have expressed legitimate concerns over the breadth of the proposed disclosure of conflicts of interest. The upshot of the proposals appears draconian. Any position over the past five years or material transaction over the past two fiscal years with a laundry list of related entities must be disclosed. All securities or other direct or indirect material interests in the fund’s investment adviser, administrator, or principal underwriter would also be disclosed. In each case, the rules are likely to require

¹⁶² *Role of Independent Directors*, *supra* note 135, at 17 (“Immediate family” includes spouse, parent, child, sibling, mother – or father- in-law, son- or daughter- in-law, or sister- or brother- in-law, including step or adoptive relationships”).

¹⁶³ *Id.* at 20.

disclosure of interests that are almost certain not to have an effect on the ability of a director to govern funds well in the interests of his or her investors. The SEC should thus tailor its proposals to reach a more reasonable result.

C. Too little or too much?

To some observers, the rules seem intrusive, costly, and ineffective. Funds have insisted that the SEC's estimations of the cost of the new disclosure requirements—totaling nearly seven million dollars—is overly optimistic.¹⁶⁴ Because a key positive feature of the director system is its low cost, disclosure requirements that exorbitantly raise costs should be viewed skeptically. In addition, it might be argued that expanded disclosure is a waste of time. By placing these new pieces of information in a supplementary documents (the SAI) and a document that is not uniformly required (the proxy statement), the SEC has insured that shareholders will not read them. Further, if anything, investors want less (but better presented) information, not more.

In contrast to funds' complaints, some might argue that the proposed changes do too little to mend the ailing director system. In line with its moves toward simplification and consumer choice in fund disclosure, for instance, the SEC chose not to require that funds disclose information about directors in the prospectus. Don Phillips, president of Morningstar, Inc., has argued that placing information about a fund's independent directors in its prospectus (even a profile prospectus) would have beneficial effects. Phillips contends that, while the 1940 Act conceives of investors as shareholders, the SEC has largely acceded to the view that they are primarily consumers of investment management. Introducing information on the independent directors, Phillips concludes,

would send a clearer signal to investors that by investing in a mutual fund, they are buying a corporate share, and with it the rights and powers of owners. Increased information on directors might lead to greater contact between shareholders and directors, thus adding to directors' incentives and ability to perform their duties as shareholder advocates.¹⁶⁵

Still, there are reasons to believe that the rules could have beneficial effects. Use of disclosure can theoretically buttress the weaknesses of the director system in several ways. First, if shareholders pay attention to the new disclosure (or make use of third-party information providers who do so), their increased awareness of who their directors are and what they do may lead to closer monitoring. While there is little research on the issue, it seems likely that shareholders are able to understand basic information on who directors are and whether they own shares in the funds that they monitor.¹⁶⁶ With added information, shareholders might pay closer attention to electing their representatives, be more likely to contact independents, or more readily select or shift funds based on factors such as directors' independence and incentives. Each of these assertions, of course, faces clear empirical difficulties. It is unclear that shareholders are interested in the new information that the rules will provide them. Nor is it certain that, even with greater information, rational shareholders will find it worthwhile to pay close attention to their directors. It is difficult, for instance, to believe that any but the most egregious of semi-interested transactions by a "disinterested"

¹⁶⁴ *Role of Independent Directors*, *supra* note 135, at 26-28. See also Robertson, *supra* note 154.

¹⁶⁵ See Don Phillips, *Slamming the SEC*, MORNINGSTAR MUTUAL FUNDS, June 13, 1997.

Morningstar writers, who rank among the strongest critics of the fund industry, have focused on the fact that directors have little contact with their shareholders. Note that these observers share this paper's view that the independent director system should be strengthened, not dismantled.

¹⁶⁶ Separate presentation of information on independent directors, also required by the rules, should help those investors who wish to research their directors on their own. *Role of Independent Directors*, *supra*.

director would attract investor attention. Investors who scarcely understand fees are also unlikely to shop for funds based on whether their independent directors hold fund shares. Some changes may thus be made more effectively, and more cheaply, by direct rule-making.

It is possible, though, that merely forcing disclosure of interested transactions, shareholding, and other information will help force fund complexes to promote a culture of director independence. Even if investors ignore the new information available to them, the rules will enable fund experts in the financial press and at investor information providers such Morningstar or Lipper to monitor directors more easily. Complexes may improve governance practices because they overestimate their shareholders' savvy and concern, or may fear the publicity that might be stirred up by journalists reviewing the required disclosure. Disclosure of shareholdings may increase pressure to accept compensation in fund shares. Ultimately, then, the function of disclosure may not, realistically be to cultivate a new, more informed investor capable of keeping close watch over his or her investments. Instead, disclosure may cause changes directly at the complex level, as the airing of questionable practices leads to a reduction in those practices.

D. Summary.

Finally, the SEC reforms—disclosure initiatives and independence-building measures alike—largely stay clear of deciding particular issues. The SEC will not, by means of these rules, directly force independent majorities or the use of independent counsel. Nor will it outlaw any particular fund practice that has been the target of critics'

accusations. If the rules pass, more funds will be forced into arrangements that could increase independence and bolster disinterested directors' bargaining power. More information on directors will be available to investors as well as to analysts and third-party mutual fund monitors. Nonetheless, the substance of what directors do, and how they fit into the structure of the fund family, will remain unchanged. The SEC's reforms aim at allowing directors and the markets to govern funds more effectively, not at restructuring the industry.

Part IV: Conclusion.

As mutual funds play an increasing role in the financial services industry, questions as to the effectiveness of the US regulatory scheme will assume a new importance. Frustration at the alleged ineffectiveness of disinterested directors is common at times in the financial press, and would surely increase in a major market downturn.

Nonetheless, a fair reading of the existing possibilities for reform suggests that few radical changes should be pursued. The SEC's reliance on independent directors to police their funds is unlikely to decline, for there is no feasible substitute for the third-party monitoring function that directors, at their best, are capable of performing. The SEC's limited budget and the limitations of market discipline demand that some third party oversee the potential conflicts of interest inherent in the fund structure. More importantly, there is reason to believe that, in areas that are not easily susceptible to outside study, directors do protect their shareholders in ways that outside regulators or the market fail to do.

However, the question remains: if all is well, why do complaints continue to arise? Certain problems—the tight links between directors and the advisers who initially select them—are likely ineradicable within the current regulatory context. Likewise, other problems that have consumed the energies of many within the industry—the Strougo argument over service on multiple boards, for instance—may be red herrings, unworthy of the time and effort that has been expended upon them. Lacking full evidence that the system, low cost as it is, is flawed, it is difficult to suggest radical reform. The SEC’s proposals, seen in this light, appear on the whole to be a fair balancing of benefit and cost. Incremental, low-cost changes such as those contained in the Interpretive Release will free directors to monitor more aggressively. Holding shares in the funds that a director runs should be mandatory. The proposed disclosure initiatives and power-boosting moves are more costly and more uncertain in their effect, but, when combined, could force fund culture to become more accountable.

Nonetheless, the proposed changes are not the only route to better governance. Returning to the four criticisms of Part II, we find that the new rules address capture, powerlessness, and poor incentives, but ignore the problem of (legal) complexity. The SEC should re-evaluate the legal framework within which directors act. Many of the practices that draw critics’ fire have been implicitly allowed by the SEC. If 12b-1 fees truly are a violation of shareholder interests, the SEC should cease permitting them—or move toward a simplified, single fee system that makes the issue moot and allows the market to grasp fees more easily. It is unfair to expect independent directors to reject practices when the SEC itself has punted on the issue. Once practices that the SEC has

refused to outlaw are removed from the list of director concessions to fund advisers, few complaints may remain.

Second, the SEC should address the issue of the director's role in monitoring multiple funds. Funds are right to argue that Strougo was misguided; abolishing multiple directorships would be a mistake. However, the existence of complex-level directorships does raise problems that should be addressed. The potential tradeoffs among funds that may well be a part of daily complex business exist in part because no one has turned a critical eye to their legal underpinnings. Should IPO opportunities or other benefits, for instance, be allocated by reference to the volume of each fund's trading (and thus implicitly to what it has "earned" from broker-dealers sponsoring the offering)? A set of clearer rules and principles should be developed to guide directors who sit on multiple boards.

Finally, despite the costs involved, the SEC should take clearer steps to indicate to directors that their voices will be heard. Director complaints as to violations of the 1940 Act, while not to be investigated without exception, should be treated as something more than internal management disputes. These changes would go far toward ensuring that the director system will continue to have a place within this growing industry, for the benefit of all involved.