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# SEC ROUNDTABLE ON THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS

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**Enhancing the Effectiveness**
**of Independent Directors**
**to Perform Their Duties Under**
**the Investment Company Act of 1940**

**The Debate**

**The System Is Broken—**
**Fix it or Scrap it**

**vs.**

**The System Works—**
**Don't Fix What Isn't Broken**

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# SEC ROUNDTABLE ON THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS

## *I. Introduction*

The New York Times recently asked: "What's a mutual fund director to do? . . . [W]hen independent directors have stood up to fund managers, they've gotten their ears boxed. And when . . . the directors have let fund managers go their own way, they've gotten their ears boxed again."1

For example, the directors of the Navellier, Fundamental and Yacktman funds, who sought to fulfill their fiduciary duties by taking issue with their funds' advisers, were targets of heated proxy battles and/or costly litigation. On the other hand, the SEC brought charges against the independent directors of the Parnassus fund for failing to challenge the adviser's valuation of portfolio securities; shareholders have brought suit against independent directors for being "house boards" indebted to, and controlled and dominated by, the adviser; and Morningstar has questioned the independence of directors by pointing out that the more independent directors are paid, the higher a fund's expenses.

This crossfire of criticism caused the New York Times to exclaim that "rarely, if ever, . . . have fund directors been under fire on so many fronts at once."[2] It is appropriate, therefore, to reexamine the role of independent directors under the Investment Company Act of 1940 (the "Act"). Are they, as some have complained, an ineffectual archaism that cannot provide meaningful oversight or, as others have claimed, the cornerstone of the Act? Let the debate begin.

## *II. The System Is Broken*

### *A. Theory vs. Reality*

In theory, a fund is owned by its shareholders who hire independent directors to run it. The directors, in turn, select various service providers, including an investment adviser, to manage the fund. In reality, a fund is usually created, sponsored, and operated by the adviser. It is the adviser's services, in a pooled investment product, not the directors, that investors buy.

Given such a chasm between theory and reality, is it any wonder that independent directors have been accused of being ineffectual? As one commentator has stated:

> Recent discussions of problems in the mutual fund industry . . . contain numerous statements of opinion that, in many cases, [independent] directors of mutual funds have not performed an effective role in safeguarding the interests of mutual fund shareholders . . . . [Independent] directors normally lack the power to exercise meaningful restraints on the investment adviser or principal underwriter . . . . In his typically vivid way, a leading critic of the mutual fund industry has argued that since "the men who need to be watched pick the watchdogs," no one can expect the [independent] directors to oppose the adviser . . . in areas where the adviser's . . . economic interests are heavily at stake.[3]

What's amazing to this commentator is that the above passage is not from a recent publication, but from a 1967 law review article. In the words of Yogi Berra, "It's dèjá vu all over again."

[1]Edward Wyatt, When Empty Suits Fill the Board Room, N.Y. Times, June 7, 1998.

[2]Id.

[3]Robert H. Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. PA. L. Rev. 1058 (1967) (hereinafter "Mundheim").

This theory-versus-reality debate most obviously manifests itself in the practical inability of independent directors to terminate an investment adviser, let alone negotiate its fees. As the Commission itself has stated:

> It has been the Commission's experience in the administration of the Act that in general the [independent] directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry. In most instances the adviser serves as, or is closely affiliated with, the fund's principal underwriter which maintains a distributing organization for the fund's shares. The organization that has developed over a period of years to manage the fund's portfolio and to furnish it with some, and in certain cases virtually all, of the nonadvisory services necessary to its operation belongs to the adviser and not to the fund. Indeed, in some cases all of the fund's records are maintained by the fund's adviser. Although the [independent] directors under State law have an unqualified right of access to these records, the adviser, as a practical matter, is in a position to seriously hamper any employment of that right which might interfere with or threaten the adviser's operation of or control over the fund.
>
> Thus, negotiations between the [independent] directors and fund advisers over advisory fees would lack an essential element of arm's-length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services. In view of the fund's dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser's reputation, few [independent] directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry.
>
> Moreover, even if some of the [independent] directors were so inclined, they might not have the power to obtain another investment adviser for the fund. In some cases, the [independent] directors are only a minority; in many others they constitute only a bare majority of the board of directors and would need the support of all the [independent] directors for this drastic step. Even with such support it is unlikely that the action of the [independent] directors would be uncontested, since the interest of the existing advisory organization in continuing its relationship to the fund might induce the adviser to devote considerable resources to a proxy contest to retain control of that relationship.
>
> The possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest, and the risk and uncertainty involved in replacing the entire fund management organization with a new and untested one, make termination of the existing advisory relationship a wholly unrealistic alternative in negotiations over advisory fees. Without such an alternative, advisory fees negotiated between advisers and the [independent] directors lack the essential element of arm's-length transactions and provide inadequate assurance that the fees bear a reasonable relationship to the price at which similar services could be obtained in a genuinely competitive market.[4]

This insightful commentary from the Commission, back in 1966, certainly foreshadowed the events of today, as independent directors have faced off with advisers, and lost, in Navellier, Fundamental and Yacktman. Some in the industry have cited these cases as mere anomalies—unique cases with unique facts. Others have said that they are the head of an ugly monster that constantly looms over investment company board rooms. Under either interpretation, these cases point out what many have long recognized—that the independent directors' legal ability to terminate an advisory agreement or negotiate fees may be a legal fiction. For example, the Internal Revenue Service, in its guide for field agents in the examination of investment adviser income tax returns, realized the reality: "It is the investment adviser's strong expectation of earning fees indefinitely by managing a mutual fund's portfolio that motivates an adviser to create a mutual fund. It is widely accepted within the industry that investment management contracts continue indefinitely, notwithstanding the 40 Act requirement that the contract be approved at least annually by its board of directors or trustees, including a majority of the [independent directors]."[5]

Knowing that they have the legal equivalent of a nuclear bomb (i.e., the ability to terminate an advisory contract), but the practical inability to use it, has caused some independent directors to believe they have been thrust into a Twilight-Zone type poker game, where they've been dealt a royal flush, but look down and realize that they don't have any chips.

[4]U.S. Securities and Exchange Commission, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, at 131 (2d Sess. 1966) (hereinafter "PPI").

[5]Department of the Treasury, Internal Revenue Service, Examination Guide: Determination of Costs to Set Up Management Contracts for Mutual Funds, Document 10246 (1-98), Catalog Number 25372N.

### *B. Examples*

Recently, independent directors have become embroiled in a number of controversies, Commission enforcement actions, and private lawsuits. For example, the Parnassus decision last year marked the first time when independent directors were sanctioned by the Commission for aiding and abetting violations of the Act. Other independent directors have found themselves defending their actions in private lawsuits, ranging from a series of suits questioning directors' independence, to one suit alleging improper risk disclosure. Finally, the press has joined the band wagon, criticizing independent directors at almost every turn. Following is just a sampling of the recent trials and tribulations associated with serving as an independent director.

#### *1. The Adviser vs. the Independent Directors*

##### *a. Navellier*

A dispute arose between Navellier Management, Inc. ("Navellier") and the independent directors[6] of the Navellier Series Fund in connection with a proposed merger of the Aggressive Small Cap Equity Portfolio of the Navellier Series Fund, a low-load series fund, into The Navellier Performance Funds, a separate no-load series fund.[7] The independent directors requested certain information from Navellier as part of their consideration of this merger proposal, which Navellier refused to provide on the basis that such information was not relevant to the merger proposal. The independent directors refused to approve the merger proposal.

While this dispute was going on, Navellier's advisory contract with the Navellier Series Fund came up for renewal by the board. The independent directors voted against renewing Navellier's contract and to hire Massachusetts Financial Services ("MFS") as the fund's new investment adviser. The independent directors also voted to remove Louis Navellier, president of Navellier, as a director of the fund. A shareholder derivative suit was then filed in federal court by Mr. Navellier and others against the independent directors and their counsel, seeking to enjoin the independent directors from removing Mr. Navellier as a director of the fund.

A proxy contest ensued between the fund and Navellier. The plaintiffs in the derivative suit brought a series of motions for injunctive relief, unsuccessfully attempting to prevent the shareholders meeting. When the shareholders meeting was held, the requisite shareholder vote to approve the fund's advisory contract with MFS was not received. Navellier eventually was reinstated as investment adviser to the fund, and the independent directors resigned. The plaintiffs in the original derivative suit then amended their complaint to, among other things, add MFS as a defendant and add several new causes of action against the independent directors, including breach of fiduciary duty under Section 36(a) of the Act and, under Delaware law, corporate waste and interference with prospective economic relations.[8] The court found that Congress intended shareholders to have an implied private right of action under Section 36(a) of the Act, and allowed this claim to go forward against the independent directors.[9] The court also refused to grant a motion to dismiss on the basis that the independent directors' actions were protected by the business judgment rule.[10]

##### *b. Fundamental*

The dissension between Fundamental Portfolio Advisors, Inc. ("Fundamental") and the independent directors of its New York Municipal Bond Fund stemmed in large part from a Commission enforcement action brought against Fundamental for fraudulently marketing the fund as a safe investment and failing to properly disclose the risks of the fund's substantial investments in "inverse floaters." The fund's past investment performance also had been erratic, and at that time it was the only tax-exempt mutual fund that had lost money over the previous five years. In connection therewith, the board voted to seek a replacement adviser.

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[6]The Navellier Series Fund is a Delaware business trust, and, as such, has trustees, not directors. Nevertheless, for purposes of this discussion and this outline in general, the term "directors" is used.

[7]The proposed merger would have terminated the independent directors' positions.

[8]McLachlan, et al., v. Simon, et al., 1998 U.S. Dist. LEXIS 12012 (N.D. Cal. 1998).

[9]The court also allowed the claims of corporate waste and interference with prospective economic relations to go forward against the independent directors. All the claims against MFS and the independent directors, counsel were dismissed.

[10]The business judgment rule is a presumption that in making a business decision the independent directors of a company acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company.

Fundamental's president suggested Tocqueville Asset Management ("Tocqueville") as a potential replacement, and the board approved an interim advisory agreement with Tocqueville, subject to shareholder approval. The board later discovered that a portfolio manager at Tocqueville had been routing trades through an affiliated brokerage firm, which caused a disagreement among the fund's four independent directors regarding the selection of Tocqueville as a replacement investment adviser. The two independent directors who opposed hiring Tocqueville resigned. The board, including the two remaining independent directors, filed a proxy statement seeking shareholder approval of the advisory contract with Tocqueville. In response, Fundamental filed a proxy statement asking shareholders not to approve Tocqueville and to replace the fund's two remaining independent directors.

After a lengthy proxy battle, shareholders approved Tocqueville as the fund's new investment adviser. But that was not the end of the saga. A secondary dispute subsequently arose between the fund's new board and Tocqueville over restricting market timers from moving in and out of the fund. Late last year, this dispute came to a head when the board fired Tocqueville and approved an interim advisory agreement with Cornerstone Equity Advisors, Inc. ("Cornerstone"). As of the end of January, no shareholders meeting to approve the Cornerstone agreement had yet been held.[11]

### *c. The Yacktman Funds*

The Yacktman situation is yet another that involved a dispute between the investment adviser and the fund's independent directors.[12] In this instance, the independent directors had questioned the adviser with respect to an apparent deviation in investment technique, the appropriate use of derivatives, violations by certain adviser employees of the fund's Code of Ethics, the management of the fund's portfolios by individuals other than those named in the prospectus, and the depth and experience of investment management personnel employed by the adviser. In addition, the independent directors expressed substantial concern that the fund's investment performance had been very disappointing.

In response, the adviser sent a letter to the independent directors demanding that they resign or a proxy statement would be filed seeking their replacement and threatening personal financial consequences if they contested the adviser. The independent directors refused to resign. The president of the adviser (who was also the president of the fund) then called a special meeting of shareholders to remove the independent directors and replace them with a slate of directors chosen by the adviser. The adviser also filed a preliminary proxy statement with the Commission.

The board revoked the call of the meeting and removed the president from office. The independent directors sent a letter to the Commission seeking intervention to stop the solicitation of proxies by the adviser.[13] In this letter, the independent directors stated that they had attempted to fulfill their responsibilities as "watchdogs for the shareholders" by expressing their concerns. The independent directors expressed the view that the adviser's actions constituted an attempt to control the fund's independent directors. In addition, the independent directors stated that they believed the adviser's actions constituted a breach of the adviser's fiduciary duty to the fund in violation of Section 36(a) of the Act, and that, if allowed to stand, the adviser's actions would have a chilling effect upon independent directors of investment companies throughout the industry.

The adviser then sued the fund and the independent directors in Maryland state court seeking to force the shareholders meeting to be held and, based upon Section 17(d) of the Act, to prohibit the fund from spending its own assets to solicit proxies for its own meeting. The state court judge, among other things, issued a temporary restraining order ("TRO") prohibiting the fund from spending its own assets to counter the adviser's proxy solicitation. The Commission staff then issued a letter that called into question the judge's ruling, saying that such a ruling could severely

[11] On October 8, 1998, the fund and Cornerstone filed an application for an order that would permit the implementation, without shareholder approval, of a new investment advisory agreement between the fund and Cornerstone until the agreement could be approved or disapproved by shareholders for a period of 120 days after such order is issued. Investment Company Act Release Nos. 23527, 812-11346 (Nov. 6, 1998). The fund filed a preliminary proxy statement on December 11, 1998 soliciting shareholder votes to approve or disapprove the Cornerstone agreement and to consider ratification of the payment of advisory fees by the fund to Cornerstone from November 30, 1998 through the date of the meeting. In response, Fundamental filed a preliminary proxy statement on January 22, 1999 seeking to cause a shareholders meeting to be held and soliciting proxies to vote on, among other things, the Cornerstone agreement. According to Fundamental's proxy materials, the board has not yet set a record date for the meeting.

[12] Vedder, Price, Kaufman & Kammholz served as counsel to the fund during portions of this dispute.

[13] *See* letter dated September 25, 1998 from Jon D. Carlson, Thomas R. Hanson, Stanislaw Maliszewski and Stephen E. Upton to Arthur Levitt, Chairman, Securities and Exchange Commission.

undermine the ability of independent directors to perform their duties under the Act.[14] The funds immediately removed the case to federal court, and the federal district court judge vacated this portion of the TRO; thus, allowing the fund to finance its own counter solicitation.

At the shareholders meeting, Yacktman obtained enough votes to remove the independent directors.[15] This vote, however, did not reflect the fact that the holders of approximately 64% of the fund's shares had "voted with their feet" by redeeming their investments in the fund.[16]

### 2. *The Commission vs. the Independent Directors*

#### a. *Parnassus*

The independent directors of the Parnussus Fund found themselves in a battle with the Commission regarding the pricing of the fund's shares. The fund owned a position in a thinly-traded stock of a California maker of supermarket refrigeration systems. The company filed for bankruptcy protection and subsequently was delisted from NASDAQ. After it was delisted, the fund continued to value the stock at $0.34 per share, although it traded down to $0.03 per share in the "pink sheets." The Commission brought an enforcement action against Parnassus Investments for overstating the fund's net asset value and against the independent directors for aiding and abetting this violation. The Commission claimed that the independent directors "ignored or failed to give adequate consideration" to relevant factors necessary to make pricing decisions. In late 1998, the Commission issued a cease and desist order against the independent directors and ordered them each to pay $5,000 in civil penalties.[17]

#### b. *Community Bankers*

The Community Bankers Mutual Fund consisted of a single series, the U.S. Government Money Market Fund. The fund was a money market fund that valued its assets using the amortized cost method. As a result of having a substantial percentage (about 27.5%) of its assets invested in certain structured notes that declined in value during mid-1994 because of rising interest rates, the fund failed to maintain a $1.00 net asset value per share.[18] The structured notes became illiquid when many of the market makers considerably lowered their bids for the notes or discontinued making a market in them altogether. As a result, the market value of the structured notes and the fund's portfolio decreased significantly.

After this decline in value, the board amended the fund's pricing procedures to allow the use of fair value pricing as well as market quotations. Use of fair value shadow pricing permitted the board to conclude that the amortized cost method continued to fairly reflect the fund's market-based net asset value per share.[19] After fair value pricing had been in use for a substantial length of time without any recovery in the market quotations for the structured notes, the board was informed by the fund's subadviser that the market value of the notes would not likely revert to par until they reached final maturity, which was years away. Nevertheless, the board continued to use fair value pricing. The Commission claimed that prior to that time, and certainly afterwards, the independent directors should have known that the continued use of the fund's fair value shadow pricing methodology was inappropriate.

The Commission instituted an enforcement action against, among others, the three independent directors of the fund. The independent directors were charged with willfully violating Sections 17(a)(2) and 17(a)(3) of the Act, willfully aiding and abetting and causing a violation of Rule 22c-2 under Section 22(c) of the Act, and willfully violating Section 36(b) of the Act. In January of this year, the Commission issued a cease and desist order against the independent directors and ordered them each to pay $5,000 in civil penalties.[20]

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[14] *See* letter dated October 16, 1998 from Jacob H. Stillman, Associate General Counsel, Securities and Exchange Commission and Douglas J. Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission to Richard Teigen, et al., questioning whether the acts alleged by the plaintiff adviser constitute a violation of Section 17(d) of the Act and Rule 17d-1 thereunder.

[15] Yacktman's proposal to remove the independent directors was favored by the holders of 21,394,079 shares of the funds, 51.2% of the shares eligible to vote. The vote required for the removal of directors was a majority of the of the shares eligible to vote.

[16] *See* The Yacktman Funds, Inc., press release dated December 3, 1998. The Funds' shares decreased from 81 million shares ($1.14 billion in assets) on January 1, 1998, to 29 million shares ($0.4 billion in assets) on November 24, 1998, the date of the shareholders meeting.

[17] In the Matter of Parnassus Investments, et al., Initial Decisions Release No. 131 (Sept. 3, 1998).

[18] After the fund was liquidated, the total loss to shareholders was approximately $2.5 million, before the recovery of additional funds in the settlement of a private lawsuit brought by some of the investors in the fund.

[19] Shadow pricing using market quotations would have caused the board to conclude that the amortized cost method no longer fairly reflected the fund's market-based net asset value per share, which would have required the board to mark the securities to market pursuant to Rule 22c-1 under the Act.

[20] Investment Company Act Release No. 23639 (Jan. 11, 1999).

### 3. *The Shareholders vs. the Independent Directors: Strougo et al. Litigation*

A series of shareholder lawsuits have questioned the independence of directors who sit on multiple boards within the same fund complex. Such suits have been brought against independent directors serving on funds managed by Scudder Kemper, BEA, T. Rowe Price, Blackrock, Prudential and Fidelity. This wave of suits began early in 1997 when Robert Strougo, a shareholder of Scudder's Brazil Fund, sued, among others, the four independent directors of the fund in connection with a rights offering.[21] Three of the four independent directors served on the boards of other funds managed by Scudder. Several of Strougo's claims were allowed to go forward against the three independent directors who served on multiple boards, including breach of fiduciary duty claims under Section 36(a) of the Act and under Maryland law and a control person liability claim under Section 48 of the Act. Due to the significant policy issues involved in the case, the Investment Company Institute was granted the right to participate *amicus curiae*. The proceedings were then stayed for a period of time to allow a special litigation committee of the board to determine whether continued prosecution of the suit was in the best interests of the fund and its shareholders. Based upon the special litigation committee's extensive investigation and conclusion that continuation of the suit was not in the best interests of the fund and its shareholders, the suit was ultimately dismissed, but only after a lengthy and expensive court battle.[22]

In the BEA, T. Rowe Price, Blackrock, Prudential and Fidelity suits, plaintiffs claimed that certain funds' investment advisory contracts should be deemed invalid on the basis that the independent directors who approved such contracts sit on multiple boards within the same fund complex and, therefore, are beholden to the adviser. Charging that such directors are not truly independent, the suits allege that the investment advisers received fees pursuant to a "sweetheart contract," entitling shareholders to recover those fees on behalf of the fund on the grounds of breach of fiduciary duty by the directors. The T. Rowe Price and Blackrock suits were recently dismissed. Each of the other suits remains pending.

### 4. *The Press vs. the Independent Directors*

Independent directors also have come under attack by the press, which has portrayed independent directors as mere props—individuals willing to "rubber stamp" any proposal by the adviser, including an increase in advisory fees and/or the imposition of 12b-1 fees.[23] In addition to the numerous articles criticizing independent directors, several industry leaders, such as Morningstar, Lipper Analytical Services and the Investment Company Institute, have conducted various studies regarding shareholder expenses.

The Morningstar Study, in particular, was critical of the role of independent directors in approving advisory contracts and found a correlation between the level of director fees and shareholder expenses.[24] The Morningstar Study looked at director compensation and shareholder expenses at the 82 largest fund families. The Morningstar Study revealed a "disturbing pattern" at these fund families, and found a "link" between director fees and shareholder expenses.[25] This, according to the Study, "raises serious questions about the role independent [directors] play in protecting shareholders." Although admitting that, in dollar terms, the differences in director salaries between high-cost and low-cost fund families have little effect on shareholders, the Morningstar Study argued that it revealed a "potentially chilling conflict of interest" on the part of independent directors. This study has been widely cited by the press.[26]

In 1997, Lipper Analytical Services conducted a study of mutual fund fees and concluded that such fees were reasonable.[27] While new funds, on balance, are charging higher fees, the composition of those funds has changed, according to the Lipper Study. The Lipper Study cited a proliferation of new international bond and stock funds, which are inherently more expensive to run, as the reason for increased mutual fund costs.

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[21] Strougo v. Scudder, Stevens & Clark, Inc., 96 Civ. 2136 (S.D.N.Y. May 6, 1997).

[22] On May 12, 1998, the Governor of Maryland signed into law legislation that reaffirms for purposes of Maryland corporate law that the Investment Company Act of 1940 governs the determination of whether a director of an investment company is an "interested person."

[23] *See*, *e.g.*, Steve Bailey and Steve Syre, Mutual Fund Firms Work to Protect Director System; Seek to Make Challenges By Shareholders More Difficult, Boston Globe, Dec. 4, 1998; Mary Beth Grover & Jason Zweig, Squeak, Squeak, Forbes, May 22, 1995; *but see* Thomas D. Lauricella, Lipper Says Fund Fees Reasonable, Critics Unswayed, The Daily Record (Baltimore, MD), Sept. 26, 1997.

[24] Michael Mulvihill, A Question of Trust, Morningstar Commentary (Aug. 30, 1996) (hereinafter the "Morningstar Study").

[25] For example, the Morningstar Study concluded that fund families that pay their directors $100,000 per year or more charge an average of 15 basis points more for domestic equity funds, not including 12b-1 fees, than do families that pay their directors less than $25,000 per year. The Morningstar Study, *supra* note 24.

[26] *See*, *e.g.*, Carole Gould, Are Well-Paid Trustees Putting Shareholders First?, N.Y. Times, Oct. 13, 1996; Russ Wiles, Study Raises Questions About the Vigilance of the Family Watchdog, LA Times, Oct. 6, 1996.

[27] Lipper Analytical Services, Inc., The Third White Paper: Are Mutual Fund Fees Reasonable? September 1998 (hereinafter the "Lipper Study").

The Lipper Study also argued that the higher fees on new funds reflects the higher cost of doing business in today's mutual fund environment, with its emphasis on marketing and increased customer service.

The Investment Company Institute conducted a similar study in 1998 that examined the trends in the ownership cost of equity mutual funds.[28] The ICI Study examined the level and trend in mutual fund fees and expenses using "total shareholder cost," which was calculated to measure the cost that an investor would expect to incur in purchasing and holding mutual fund shares.[29] The ICI Study, which based its conclusions upon the sales-weighted average of shareholder cost ratios for individual equity funds, determined that the total shareholder cost for equity funds decreased by more than one-third between 1980 and 1997.[30] The ICI Study attributed this decrease to lower distribution costs (sales loads and 12b-1 fees) and increased investment in lower-cost equity funds, and found economies of scale to exist among individual equity funds.

Notwithstanding this debate on the levels and reasonableness of fees, the popular perception in the media is that independent directors have a "duty" to keep fees as low as possible and that they have failed in fulfilling that role. Indeed, in a recent article discussing this roundtable, the Wall Street Journal claimed that: "While ostensibly there to defend fund holders' interests, including keeping fund expenses as low as possible, [independent directors] rarely do kick up a fuss, and expenses charged to investors have kept rising industry-wide despite vast new economies of scale."[31]

Perhaps the most scathing criticism of independent directors, however, comes from an industry insider, John C. Bogle, Chairman of the Vanguard Group,[32] who claimed:

> Mutual fund directors generally seem to operate under a distinctly different mission statement, which might read something like this: "The mission of the Board is to serve as a watchdog over the management company that controls and operates every aspect of the Fund's affairs and to approve contracts with the company that provide fees sufficient to ensure its growth and profitability. The Board may consider the economic value of the returns achieved for the Fund's shareholders relative to its peers and to unmanaged market indexes, but may accept a level of long-term value that fails to meet either standard."
>
> Consider the contrast: The corporate mission statement simply expresses the way things work in America today. Managers who fail to create shareholder value lose their jobs or their corporations.
>
> The fund mission statement, however, shows a limited commitment to the principal of putting shareholders first. It suggests that while a fund's directors may serve the economic interests of the shareholders, they will also serve the economic interests of the fund's management company. As a result, whether fund shareholders are well served or ill served, managers, without significant exception, lose neither their jobs nor their contracts. The balance of interests tilts toward the management company . . . .
>
> It is impossible to imagine that either the letter or the spirit of the law, as stated in the Investment Company Act of 1940, is being observed: "The national public interest of investors are adversely affected . . . when investment companies are organized, operated, and managed . . . in the interest of . . . investment advisers . . . rather than in the interest of [shareholders] . . . or when investment companies . . . are not subjected to adequate independent scrutiny."

Compare, however, the comments from a publication of the Investment Company Institute,[33] the leading trade organization for the investment company industry, which cites the many benefits of the independent director governance structure and the high standards by which independent directors act:

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[28]John D. Rea & Brian K. Reid, Trends in the Ownership Cost of Equity Mutual Funds, Investment Company Institute Perspective, Nov. 1998 (hereinafter the "ICI Study").

[29]The fees and expenses comprising total shareholder cost include fund operating expenses, 12b-1 fees, and sales loads, similar to the fees and expense information required by the Commission in mutual fund prospectuses.

[30]The ICI Study also found a decrease in total shareholder cost based upon the simple average, asset-weighted average, and median of the operating expense ratios for such funds. The ICI Study, *supra* note 28.

[31]Charles Gasparino & Pui-Wing Tam, Mutual Fund Boards: No comfort? SEC to Host a Round Table Hoping to Prod Fund Directors Into Doing More for Investors, Wall St. J., February 3, 1999.

[32]John C. Bogle, Bloomberg Personal, December 1997.

> Investors receive many other benefits by investing in mutual funds, including strong legal protections and full disclosure. In addition, shareholders gain an extra layer of protection because each mutual fund has a board of directors looking out for shareholders' interests . . . .
>
> Independent directors are often prominent individuals with diverse backgrounds in business, government or academia, often with distinguished careers and experience. Such individuals are well-suited for the position because they can be expected to exercise independent business judgment on behalf of the fund and its shareholders, with integrity and diligence . . . .
>
> Because mutual fund directors are, in essence looking out for shareholders' money, the law holds directors to a very high standard of behavior in carrying out their responsibilities. They must act with the same degree of care and skill that a reasonably prudent person would use in the same situation or in connection with his or her own money . . . .
>
> Each director bears a tremendous responsibility to represent the best interests of shareholders. This responsibility constitutes both a crucial and unique role for mutual fund directors in the protection of consumers.
>
> In a 1992 report, the SEC concluded: "The oversight function performed by investment company boards of directors, especially the 'watchdog' function performed by the independent directors, has served investors well, at minimal cost."

### *C. Scrap the Current System — The Unitary Investment Fund ("UIF") Approach*

Some argue that the tension between theory and reality makes the status quo corporate governance system for investment companies wholly unworkable. Many point to the lack of action by independent directors in holding down fees or replacing poor performing advisers as prima facie evidence that the current system does not work. They compare investment company independent directors to ERISA trustees. While their fiduciary duties are arguably similar,[34] advisers in the ERISA context are routinely terminated and replaced and fees are aggressively negotiated. Moreover, as one commentator noted, "[T]he efficacy of the directors in actually discovering mistakes or bad practices is exaggerated. In fact, it is invariably the auditor, SEC inspection or confession or disclosure by the manager that uncovers these situations--not the investigative work of the directors."[35]

There are at least a couple of explanations for the suggested inability of independent directors to bargain at arm's-length with the adviser: one, that independent directors are, as some have alleged, controlled and dominated by the adviser or, two, that independent directors recognize that investors buy the adviser, not the directors, fully cognizant of the adviser's investment capabilities, track record and the fees charged, and that the directors should not substitute their judgment for that of the investors so long as the adviser continues to provide the product chosen by the investors, the fees are not excessive and the adviser is not in violation of the law.

### *1. The Original UIF Proposal*

Disenchantment with the present investment company governance structure has led some to endorse radically simplified governance arrangements such as the unitary investment fund ("UIF"). Originally proposed in 1980,[36] the UIF is an alternative form of open-end management investment company whose structure is predicated on the belief that an investment company is a proprietary product, more suited to a contractual arrangement than to corporate democracy. Its advocates claim that the UIF's simplified governance and fee arrangements would be more flexible for the adviser and more comprehensible to investors.

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(cont'd)
[33]Investment Company Institute, Understanding the Role of Mutual Fund Directors, ICI Investor Awareness Series, Feb. 1999.

[34]The Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C.A. Section 1104 (1998). Section 1104 of ERISA provides that: "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims . . ." *See also* Address by SEC Commissioner Friedman, ALI-ABA Conference on Investment Company Regulation 5 (Dec. 12, 1980) ("How Much Can We Expect From Independent Directors?") ("We are deluding ourselves if we think that the independence of directors will produce the same result as a negotiation between the trustees of a profit-sharing fund and a prospective money manager.")

[35]Werner Renberg, Sixth Men or Fifth Wheels: Do Fund Directors Earn their Paychecks, Barron's, August 12, 1991 (quoting Stephen K. West, Esq.).

[36]Stephen K. West, Address at the General Meeting of the Investment Company Institute (May 1, 1980).

As proposed in 1980, the UIF would have the following key features:

(1) The UIF would be an optional form of investment company, similar in form to a trust, with a corporate trustee (the sponsor/manager), a trust indenture (which would spell out fundamental investment policies and the management fee), and investors holding interests in the trust.

(2) A single management fee would cover all expenses, except for extraordinary expenses and shareholder account services. The fee would be subject to a statutory maximum, which the Commission could increase by rulemaking. No limit would be placed on the percentage of the fee that could be used for distribution expenses.

(3) The UIF would have no board of directors or shareholder voting, nor would Section 36(b) of the Act apply.

(4) During an initial period (perhaps five years) the indenture could not be amended without an exemptive order from the Commission. Thereafter, the sponsor could amend the indenture at any time upon adequate notice to investors. Shareholders objecting to a change could redeem.

(5) The UIF either would be no-load or would refund the sales charge upon redemption in most situations.

(6) All prohibitions under Section 17 of the Act concerning transactions with affiliates would apply. Because there would be no board of directors to prevent the sponsor's brokerage affiliate from charging excessive commissions to a UIF, agency transactions with affiliates, for example, currently allowed under Section 17(e) of the Act would be prohibited.

(7) The UIF could not engage in activities that rely on rules or exemptive orders conditioned on director oversight unless mechanical rules or individual exemptive orders were substituted for such oversight.

Since the time of the original proposal, a number of variations have been suggested. For example, some advocates of the UIF take the position that even UIF shareholders should have voting rights. These commentators believe that a UIF sponsor should be able to recover distribution costs through front-end and contingent deferred sales charges, as well as through the asset-based fee paid by the UIF. Since a UIF would have no board of directors to review proposed fee increases and investment policy changes on behalf of shareholders, these commentators would require the sponsor to obtain shareholder approval of any such changes. Others, citing investor protection concerns, have recommended that any UIF structure retain independent directors to exercise oversight over the affairs of the company. Finally, although the original proposal included a statutory maximum fee that the Commission could increase through rulemaking, most pro-UIF commentators would not retain this provision. Some UIF proponents, however, would continue to require that fee increases be subject to shareholder approval.[37]

### *2. Modified UIF Proposal*

Since 1980, a modified version of the original UIF proposal has evolved. The modified UIF proposal, in effect, has three main provisions: (1) it eliminates the board of directors; (2) it retains Section 36(b)-type liability; and (3) it prohibits Section 17-type transactions with affiliates.[38] The rest of the terms and provisions would be contractual in nature, operating, in effect, similarly to Section 3(c)(1) or 3(c)(7) entities (or so-called "hedge funds"), but in a more regulated environment.

Supporters of the UIF model argue that not only is it more intellectually honest, it also provides greater flexibility to the adviser in developing and operating the product. Investors make decisions based on the anticipated performance of the product. The thrust of the UIF model is to provide the investor with full information concerning the product to enable the investor to make rational investment decisions between competing products. At the same time, the UIF model recognizes the inherent conflict between shareholders and advisers, retaining some fundamental Section 17-type provisions of the Act (similar to those imposed on adviser/client relationships directly by the Investment Advisers Act of 1940).

[37] U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation (1992) (hereinafter the "1992 SEC Report").

[38] Under the modified UIF approach, Rule 17e-1, Rule 17a-7 and other similar types of transactions would be permitted, subject to the substantive requirements of such rules.

Underlying the UIF model is a greater faith in the market than that embodied in the current corporate governance model. The current model was developed in the late 1930s on the heels of the Great Depression when faith in the market was at an all-time low. And for good reason — especially considering the abuses in the industry at that time. The current corporate governance structure was designed to address the problems of an industry in its infancy. However, argue UIF supporters, the investment company industry has matured, and the existing corporate governance structure is archaic. Investors have many more choices of advisers, have greater access to information about investment companies and are generally more sophisticated.

Aside from arguing that the current corporate governance system works, as discussed below, critics of the UIF approach have a number of specific criticisms. First, they argue that the UIF proposal offers no practical alternatives for board oversight in areas that do not involve fees.[39] Some proponents of the UIF approach have argued that, in most cases, matters involving directors could be detailed in the trust indenture (*e.g.*, a money market fund's Rule 2a-7 procedures establishing the guidelines an investment manager must follow could be spelled out in the indenture agreement without board review). Critics, however, argue that no UIF proponent has provided any analysis of how various rules that look to directors could be implemented and modified to operate without directors. One alternative to the board that is cited by UIF supporters would substitute a trustee or custodian, similar to a "depositary" used in Europe.[40] The trustee or custodian would oversee all fund operations. However, critics argue that such an approach is unlikely to create any cost savings, since such a trustee or custodian would presumably insist on the same level of compensation as a board. In addition, there is no reason why a trustee or custodian would be significantly better than independent directors. Another alternative would be to substitute greater oversight and examination by the Commission. However, critics believe such a suggestion to be unrealistic, given budgetary constraints.

Second, critics fear that unchecked market competition under the UIF approach creates incentives for an adviser to cut corners on basic services to a fund to meet competitive pressures. Even in the absence of competitive pressures, an adviser may nevertheless be tempted to cut corners on basic services to bolster its own profitability. Without a third party to oversee the level of services to a fund, critics argue that investors would be left to their own devices, without the necessary expertise, information and ability to assess the quality of these services.

### *D. Modify the Current System*

The majority of commentators, while occasionally expressing some frustration with the current system of investment company governance, believe that independent directors can and do provide an important level of investor protection. Thus, they have proposed that the current system should have various structural amendments, rather than be scrapped. In particular, they advocate reforms to enhance the effectiveness of independent directors. Such reforms are intended to maintain the basic overall corporate governance structure under the belief that investment company governance works best with independent directors acting in their traditional role as "watchdogs" for shareholders.[41] They seek also to enhance the independence of independent directors and to provide them with additional tools to fulfill their role.

#### *1. 1992 SEC Study — the "no-brainers"*

In the 1992 SEC Report, the Commission staff, after examining the current governance requirements of the Act as they relate to the role of directors and the various criticisms of those requirements, concluded that the corporate regulatory structure embodied in the Act is fundamentally sound. Nevertheless, the Report acknowledged that the current system could be improved; and it recommended, among other things, structural changes to enhance the independence of fund boards. First, the Report recommended that Section 10(a) of the Act be amended to require that more than fifty percent (50%) of directors of investment company boards be independent. Second, the Report recommended that Section 10(a) of the Act be further amended to require, as is now the case for mutual funds that have Rule 12b-1 plans, that independent directors be self-nominating. Finally, the Report recommended that the independent directors be given independent authority to terminate advisory contracts (unlike current law which only allows the full board or the shareholders to take such action).

[39]For example, the independent directors select the fund's independent public accountants, oversee securities transactions involving affiliates to the extent such transactions are permitted by various rules, determine annually whether participation in joint liability insurance policies is in the best interests of the fund, and review and approve fidelity bonds.

[40]*See* European Council Directive of 20th December, 1985, on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, Council Directive 85/611, 1985 O.J. (L375) 3.

[41]Burks v. Lasker, 441 U.S. 471 (1979).

These three recommendations from the 1992 SEC Report have been almost universally seconded by the investment company industry, and should be considered "no-brainers." Nevertheless, to date, they have not been implemented.

### 2. *Additional Regulatory/Legislative Options*

Some commentators have argued that the structural reforms recommended in the 1992 SEC Report do not go far enough. Rather, they argue that, if the current corporate governance structure is to be retained, broader reforms are necessary to ensure that independent directors have the tools to fulfill their role. Following is a summary of some of the ideas that have been proposed.

#### *a. Do not allow an investment adviser (or affiliate) to seek to remove or replace independent directors without a Commission Order.*

In order to further bolster the independence of independent directors, some have suggested that the Act should prohibit an adviser (or an affiliate) from seeking to remove or replace independent directors. The notion is that if independent directors are charged with watching over the adviser, the system is fundamentally flawed if the adviser can have them removed when the oversight "cuts too close to home." To deal with the exception to every rule (*e.g.*, a board consisting of "drunken sailors"), the proposal could permit an adviser to seek to remove or replace independent directors upon a showing to the Commission of good cause. Presumably, the Commission would grant such an order if the adviser could show that the independent directors were in breach of their fiduciary duties to the investment company.[42] This proposal would insulate independent directors from the threat of removal from office through economic or other coercion if, in fulfilling their duties, they disagreed with the adviser.

#### *b. Allow the board to replace the adviser without requiring shareholder approval.*

It has also been proposed that the Act be amended to permit an investment company board of directors (or even the independent directors alone) to replace the adviser without requiring shareholder approval. Currently, a board can terminate an adviser and hire a new adviser on an interim basis; but ultimately the new adviser must be approved by shareholders.[43] As evidenced by the Navellier, Fundamental and Yacktman cases, the practical ability of a board to replace an adviser is limited, which, of course, gives the board little negotiating strength and makes it unlikely that a successor adviser would be willing to step in on an interim basis. If the directors had the authority to permanently hire a new adviser without shareholder approval, the board would be able to fire an adviser and replace it without the unpleasant prospect of leaving the fund without an adviser or without the threat of facing a well-financed proxy battle against the adviser for control of the fund. In addition, other advisers may be more willing to compete for management of a fund's assets if they do not face the high barrier to entry imposed by the costs of such a proxy battle or resulting litigation. At the very least, this proposal could add credibility to a board's threat to "shop" the fund's advisory contracts when negotiating advisory contracts with an adviser and thereby strengthen the board's negotiating position.

While this proposal may sound revolutionary and counter to shareholders' rights, it has been argued that the Commission already has effectively eliminated the shareholder approval requirement for a new adviser in all but extreme circumstances. In 1992, the Commission approved an amendment to NYSE Rule 452 to allow "street shares" to be voted in favor of an *initial* investment advisory agreement as a "routine" item.[44] With the recent investment management industry consolidation, application of this Rule has been expanded to approve entirely new advisory agreements with new advisers. In effect, in most circumstances, the shareholder approval process has already been replaced by a lock-step "street" vote.

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[42] It is questionable whether this exception is necessary since the Commission, presumably upon a showing of cause, could initiate removal of the directors under Section 36(a) of the Act.

[43] Rule 15a-4 under the Act. Rule 15a-4 provides:

> Notwithstanding Section 15(a) of the Act, a person may act as investment adviser for an investment company pursuant to a written contract which has not been approved by a majority of the outstanding voting securities of such company during the 120-day period after the termination of an investment advisory contract by an event (other than an assignment by an investment adviser in connection with which such investment adviser, or a controlling person thereof, directly or indirectly receives money or other benefit) described in paragraph (3) or (4) of Section 15(a) of the Act or by the failure to renew such contract; *provided* that:
>
> (a) Such contract has been approved by the investment company's board of directors, including a majority of the directors who are not interested persons thereof; and
>
> (b) The compensation to be received under that contract does not exceed the compensation which would have been received under the most recent investment advisory contract that had been approved by the vote of a majority of the outstanding voting securities of the investment company.

[44] Exchange Act Release No. 30697 (May 13, 1992) (approving a NYSE interpretation of Rule 452 "to allow a member organization to give a proxy on the initial approval of an investment advisory contract if the beneficial holder does not exercise his right to vote").

Moreover, this lost shareholder voting right may be a small trade-off compared to the benefit of greatly strengthening the board of directors. Indeed, a 1962 study of the investment company industry by the Wharton School of Finance and Commerce (the “Wharton Report”) concluded that the Act’s shareholder voting provisions appeared to be of “limited value” in governing the relationships between investment companies and their investment advisers, and that “the very concept of shareholder control through the exercise of voting rights may be contrary to the realities of the mutual fund business.” The Report attributed ineffectiveness of shareholder voting to “the wide diffusion of ownership . . . [coupled with] the redemption feature of mutual fund shares which facilitates exit from the fund as the normal outlet for dissatisfaction with management performance.”[45]

Under this proposal, the directors would have the unfettered ability to change advisers. Shareholders who approve of any new adviser would obviously stay with the fund, while those who did not approve could “vote with their feet” and redeem. Opponents argue that this proposal is unfair to shareholders because shareholders may not be able to vote with their feet due to disincentives to redemption (including front-end and contingent deferred sales charges, redemption fees and adverse tax consequences).[46] Moreover, they claim that it is contrary to the basic notions of shareholder democracy and may promote independent director usurpation of the original investment choice of the shareholders (i.e., to buy that particular adviser’s product). Proponents counter that this proposal simply removes the requirement of securing shareholder approval of a new adviser and is no more onerous for shareholders than the current system, which already permits the board to terminate the existing adviser and thrust the shareholder into a “stay or leave” decision.

### *c. Rescind 1980 SEC Release as it relates to the advancement of expenses for independent directors.*

Recently, the Commission staff confirmed that it would be consistent with Section 17(h)[47] of the Act for independent counsel selected to render an opinion on the advancement of legal fees to independent directors to afford those directors a rebuttable presumption that they did not engage in “disabling conduct.”[48] This has caused some commentators to push for the rescission of a 1980 Commission release[49] that still imposes a number of unnecessary procedural hurdles on independent directors seeking advancement of legal fees, particularly in actions brought against the independent directors by the adviser.[50]

Most investment companies, consistent with state law, have charter or by-law provisions that provide for indemnification and advancement of expenses for directors and officers. Ordinarily, under state law, a director could obtain advancement of expenses by representing that he did not engage in disabling conduct and undertaking to pay back any advancement of expenses if it is determined later that he engaged in disabling conduct. The 1980 Release, however, also requires one of the following additional conditions to procuring an advancement of expenses: (1) the director shall provide a security for his undertaking; (2) the fund shall be insured against losses arising by reason of any lawful advances; or (3) a majority of a quorum of the disinterested, non-party directors of the fund, or an independent legal counsel in a written opinion, shall determine, based on a review of readily available facts (as opposed to a full trial-type inquiry), that there is reason to believe that the director has not engaged in disabling conduct.

The additional requirements imposed by the 1980 Release on advancement of expenses were intended to establish a reasonable procedure for determining, prior to an advance, that indemnification is likely to be available. Given that requests for advances can be made both by the

[45]Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 87-2274, at 1 (2d Sess. 1962).

[46]It has also been argued that an adviser has a proprietary right to manage a fund that it created, and that neither independent directors nor shareholders should be permitted to “move the contract.” *See also* Mundheim, *supra* note 3, “The [independent] directors’ major task . . . consists of evaluating the quality of the investment advice received by the fund. This review often seems to be made on the assumption that the existing investment adviser . . . has a vested right to remain the investment adviser of the fund — that the investment adviser has a property right in having the investment advisory agreement renewed.”

[47]Section 17(h) of the Act prohibits contractual provisions that protect a director or officer of an investment company from liability by reason of wilful misfeasance, bad faith, gross negligence or reckless disregard of duties as a director or officer (“disabling conduct”).

[48]The Yacktman Funds, Inc., SEC No-Action Letter (pub. avail. Dec. 18, 1998).

[49]Investment Company Act Release No. 11330 (Sept. 4, 1980) (hereinafter the “1980 Release”).

[50]Many investment companies maintain joint liability insurance policies with the adviser, and its affiliates, as co-insureds. Most of those policies, however, exclude coverage for disputes between or among insureds, subject to certain exceptions (such as a derivative claim brought without the assistance or participation of any insured or a claim where, in the opinion of independent counsel, failure to bring such claim would result in liability to such insured). Independent directors may, therefore, wish to consider, in determining whether to participate in a joint liability insurance policy, whether there is any possibility of a dispute with the adviser under which they or the fund would likely desire liability insurance coverage, and, if so, whether the proposed policy would provide such coverage or whether they should maintain separate insurance policies or make other appropriate arrangements.

independent directors and those who are affiliated with the adviser, the 1980 Release provides reasonable safeguards against inappropriate overreaching, particularly by the adviser or its affiliates.[51] In *Yacktman*, however, counsel argued that when independent directors, acting in their capacity as directors, make determinations that they believe are in the best interest of the fund and its shareholders, such independent directors should, in essence, be given the benefit of the doubt and allowed to use fund assets to defend themselves unless and until it is shown that they have engaged in disabling conduct. Now that the Commission staff has allowed such a presumption, it may be questioned whether any of the so-called safeguards articulated in the 1980 Release are necessary for independent directors. Rather than protecting the fund, they may simply serve to make it more difficult for independent directors to obtain lawful and appropriate advances of expenses, particularly when faced with a "strike suit," or with predatory action from an adviser. Moreover, if independent directors are not reasonably assured that they can defend themselves from attack, they may be less willing to confront an adviser or "ask the hard questions."

### *d. Require independent directors to have counsel separate from counsel for the adviser.*

In the 1992 SEC Report, the Commission staff considered and rejected requiring investment companies to provide independent directors with their own staff or counsel. The Report argued that, while independent counsel would be beneficial to independent directors and in some circumstances may be necessary for a board to properly perform its responsibilities under the Act, independent directors are, in many situations, capable of functioning without such assistance. The Report concluded that the costs of requiring counsel for the independent directors was not justified in all cases.

Notwithstanding the absence of any explicit duty to do so, as a practical matter, the legal complexities applicable to investment companies and their independent directors routinely result in the retention of legal counsel. Moreover, the courts and the Commission have made it clear that access to expert legal advice is a key factor in determining whether directors have satisfied their fiduciary duties under the Act. For example, courts[52] and the Commission[53] have cited access to legal counsel as a factor in deciding whether directors have satisfied their fiduciary duties under Sections 15 and 36 of the Act when adopting or renewing advisory contracts, and under Rule 12b-1 of the Act when adopting or renewing distribution plans.

Accordingly, a number of commentators have argued that the Act should codify the industry "best practice" and require that independent directors have "separate" counsel. There is some confusion, however, as to exactly what this notion means. There are a number of structures that provide for counsel to the independent directors that is separate from counsel to the adviser. Let's start then, with a review of the three most common models of investment company legal representation. In the first model, the independent directors, the investment company and the adviser each retain their own separate counsel. This is the ultimate degree of separateness. In the second model, one counsel represents the investment company and the adviser, while the independent directors retain their own separate counsel. This model is premised on the notion that the fund and the adviser are essentially synonymous and, therefore, one counsel represents those parties while another counsel represents the independent directors. In the third model, one counsel represents the investment company and the independent directors and another counsel represents the adviser. This model is premised on the belief that the fund and the independent directors are essentially synonymous, and that any conflict is with the adviser, which retains its own counsel.

Although any of the three models can, depending upon the circumstances, achieve the goal of giving the independent directors adequate and appropriate counsel, the type of structure employed can affect the access to information and the influence that the independent directors have over fund matters. This writer believes the third model to be the most efficient and logically consistent with the goals of the Act.[54] As a publication of the American Bar Association notes:

[51]*See* Steadman Security Corp. v. Steadman Associated Fund, 1982-83 Fed. Sec. L. Rep (CCH) ¶99,009 (D.D.C. Dec. 2, 1982).

[52]*See* Fogel v. Chestnut, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976); Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977); Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981) aff'd 694 F.2d 923 (2d Cir. 1982).

[53]*See* Investment Company Act Release No. 11414 (Oct. 28, 1980) (adopting Rule 12b-1 and listing as a factor for a board in approving or renewing a distribution plan the "need for independent counsel").

[54]In comparing an investment company board to that of an operating company, one commentator noted that an operating company does not customarily retain separate counsel for its independent directors unless an actual conflict has arisen. Ernest V. Klein & David C. Phelan, Responsibilities of Independent Directors of Investment Companies, A Practical Guide (1996). (Ernest V. Klein and David C. Phelan are senior partners at the law firm of Hale and Dorr.)

> Whether to retain separate counsel for the independent directors is dependent on a number of factors. Counsel with no material relationship with the investment adviser or its affiliates frequently acts both as fund counsel and counsel for the independent directors. In other cases, the relationship of fund counsel to management warrants having the directors retain separate counsel. The size and complexity of a fund group may also warrant retaining separate counsel who can focus on the needs of the independent directors. In lieu of regular, separate counsel, the board might consider independent counsel on an *ad hoc* basis with respect to specific matters. The decision to retain separate counsel may be a question of economics as smaller fund groups may not have the asset base to afford regular separate representation. There is no "bright line" test, but generally it is important that the independent directors have ready access to counsel who views the board and the fund, not the adviser, as the client. (emphasis added).[55]

Accordingly, commentators (often lawyers) have opined that, by providing independent directors with separate counsel (or their own staff), independent directors will be better able and more willing to be "the vigorous advocates of shareholder interests which Congress intended."[56]

Others have argued that rather than requiring a specific structure, a majority of the independent directors should determine what structure best serves the interests of fund shareholders in a particular fund organization, and determine who should be selected. This would place the selection of counsel to the fund and, if determined appropriate, separate counsel for the independent directors, on a par with the selection of independent public accountants for the fund, which must be approved by a majority of the independent directors.[57]

## *III. The System Works*

Supporters of the current system argue that the inherent conflicts presented by externally managed investment companies make it uniquely appropriate that independent directors take an active role in their governance. Shareholders need the protections of independent directors and neither the Commission nor the market is capable of replacing the board. Indeed, the investment company industry, under the current regulatory system, has not experienced the recent abuses and mismanagement seen in other financial institutions.

### *A. The "Nuclear Threat" is a great deterrent*

Commentators argue that independent directors do serve as a meaningful counterweight to the entrepreneurial spirit of advisers.[58] Indeed, the hoops the adviser must jump through in order to get board approval or to meet a board's oversight responsibilities is, in itself, a valuable exercise. The extensive and ongoing process of preparing information for independent directors forces the adviser to address and resolve certain issues that otherwise would not be raised. The process also increases the chance that problems will be identified at an earlier stage, when they can be more easily solved.[59]

In addition, if advisers make mistakes, whether or not such mistakes violate the law, independent directors are able to exert pressure on advisers to act in the shareholders' best interests, including full disclosure of the problem and reimbursement of the fund to make shareholders whole.[60] Absent pressure from independent directors, the adviser may attempt to hide such mistakes from shareholders, the general public and regulators. In fact, absent third party oversight, competitive pressures give advisers every incentive to hide such mistakes from the market.

Finally, the mere threat of not approving an advisory contract or removing an adviser may very well deter advisers from some of the most egregious conduct. Even though rarely used, the "nuclear deterrent" could be the psychological key to avoiding conflict. In essence, the supporters

[55] Fund Director's Guidebook, 52 Bus. Law. (1996).

[56] *See* April 15, 1983 letter to Mr. George A. Fitzsimmons, Secretary, Securities and Exchange Commission from Stanley M. Grossman and Bruce G. Stumpf, Pomerantz Levy Haudek Block & Grossman (SEC File No. S7-955) and September 17, 1990 letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Francis X. Cain (SEC File No. S7-11-90).

[57] *See* Section 32(a) of the Act, which requires that an investment company's selection of accountant be approved by a majority of the independent directors.

[58] Richard M. Philips, Deregulation Under the Investment Company Act – A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Board of Directors, 37 Bus. Law. 903 (1982).

[59] 1992 SEC Report, *supra* note 37.

[60] 1992 SEC Report, *supra* note 37.

of the current system argue that the mere presence of independent directors imposes a certain discipline on advisers that cannot be adequately provided by the market or by regulators.[61]

### *B. Independent directors do say "no"*

Supporters of the current system note that independent directors do say "no";[62] it is just that the media do not trumpet this fact or simply do not know the inner workings of the investment company board room. Moreover, they point to the recent clashes between independent directors and funds as examples of why the system works, not why it doesn't. They cite Navellier, Fundamental and Yacktman as success stories. In those cases, directors stood up to the adviser and alerted shareholders of potential problems with the adviser. Although they were ultimately unsuccessful in removing and then replacing the adviser, bringing the issues to the attention of the market enabled shareholders to "vote with their feet." Without the independent directors' oversight, many of those issues would not have been aired in public.

In addition to the recent, high-profile examples, proponents argue that such cases are the exception primarily because the system works. Again, the threat of independent directors blowing the whistle deters advisers from the most egregious violations. For proof, proponents of the system cite case law under Section 36(b) where defendants are found by courts to have performed well in their oversight of advisory fees and rule 12b-1 plans.

### *C. Independent directors provide a check against conflicts of interest*

Structurally, supporters of the current system argue that only third party monitors such as independent directors can adequately check the inherent conflict associated with the external management of investment companies. The Commission does not have the resources to fill the gap, and sole reliance upon the market is insufficient. First, there are significant costs to "voting with your feet" in the form of commissions, redemption fees and taxes that may make redemption unattractive. Second, by the time shareholders learn about problems with a fund, irreparable harm may already been done.

### *D. The costs are de minimis*

Lastly, supporters of the current system argue that it should be retained, even if there are only marginal benefits, because the costs are de minimis. In a survey performed by Lipper Analytical Services, Inc.,[63] it was estimated that the industry-wide, dollar weighted average cost to shareholders of independent directors is 0.005%, or one-half of one basis point.

## *IV. Conclusion*

Winston Churchill once said, "Democracy is the worst form of government except all those other forms that have been tried from time to time." In the case of independent directors and their role under the Act, the current system may not be perfect, but neither are the various alternative structures.

Independent directors may be confused, and caught in the cross fire, because the various marksmen are also confused. The press would have you believe that it is the duty of independent directors to keep fund expenses as low as possible, and that they have failed miserably. The Commission jawbones for the same action, yet its enforcement actions target valuation problems or other technical deficiencies; indeed, the Commission has never sanctioned independent directors for failure to maintain low expenses or even for failure to terminate poorly performing advisers.[64] Moreover, independent directors are reluctant to drop the nuclear bomb over fees or performance. Might that be because they shouldn't? When Section 15 was enacted in 1940, Congress and the Commission were not concerned with the magnitude of advisory fees. David Schenker, after discussing certain state laws that limited management and operating expenses to a percentage of assets, testified that:

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[61]Investment Company Act Release No. 12888 (December 10, 1982).

[62]*See* Stephanie A. Djinis & Amy L. Goodman, Director Independence Challenged by Strougo Case, 4 Inv. Law. 9 (1997) ("If our experience is any barometer, independent directors take their duties and responsibilities quite seriously—in many cases rejecting or countering the fund sponsor's proposals.")

[63]*See* letter from Lipper Analytical Services, Inc. to Jonathan G. Katz, Secretary, SEC, dated October 9, 1990 (SEC File No. S7-11-90).

[64]*See* Jean W. Gleason, Fulbright & Jaworski, 1994 Mutual Funds and Investment Management Conference, SEC Agenda, Mutual Fund Governance: Independent Directors — Their Role and Incentives and Tools for Fulfilling It (1994) ("In fact, the SEC has rarely brought proceedings against independent directors, presumably because of concern that to do so might threaten the delicate balance between the duties of the independent director and the practicalities of their position . . .")

There is not a single provision in section 15 which even remotely assumes to fix what [advisers] should be paid in compensation . . . . We feel that is a question for the stockholders to decide. If they want to pay a man a million dollars to manage the fund and if they know they are paying him a million dollars and if they have the right to approve the payment of a million dollars, the bill says that is perfectly all right.[65]

In the 1960s, the Commission began to examine the level of advisory fees.[66] The Commission concluded that the unique nature of the mutual fund industry made arm's-length bargaining impossible, that the marketplace consequently could not be relied upon to curb excessive fees, and that existing law did not adequately protect investors with respect to such fees. The Commission thereafter recommended that the Act be amended to include a "reasonableness" standard for fees. This standard, however, was never adopted. In 1970, Congress enacted Section 36(b), which imposes a fiduciary duty on *advisers* with respect to the amount of compensation received.

Despite the criticisms and confusion, the corporate governance structure, including the requirement of independent directors, has served the investment company industry fairly well for nearly 60 years. Perhaps, in some instances, independent directors are too cozy with management. Perhaps the respect of advisers for their fiduciary duty, rather than independent director oversight, has caused the investment company industry to be remarkably scandal-free. Perhaps that respect for duty, coupled with competitive pressures, will better address rising fee and poor performance issues than would increase independent director responsibilities or powers. Perhaps it is time to try some form of a UIF. Perhaps it is time to reconcile the independent investment company director construct with the reality that an investment company is an adviser-created, branded and operated product. Perhaps it is time to amend the Act to give independent directors more power and authority to perform their duties under the Act. All these issues merit considerable more debate.

Whether structural changes are ultimately adopted, what we have now purports to depend upon effective independent directors. A crucial element of an effective independent director structure is a strong regulator, dedicated to the success of that structure in the interest of shareholders. Advisers, directors and shareholders must know that the Commission will be vigilant in its support of directors who do take action in an appropriate case. Suppose, for example, that the president of an adviser, who was also the president of a fund, allegedly used his powers and influence as fund president to secretly and then overtly pursue the interests of the adviser. Suppose he allegedly did the following:

First, without the knowledge of the independent directors, he used the fund's lawyers to draft a proxy statement to remove the independent directors;

Second, he hired a proxy solicitation firm for the adviser, and then, without the knowledge of the independent directors, used his office of the president of the fund to appoint that same firm as the fund's agent to receive fund shareholder voting lists;

Third, using his office of the president of the fund, without the knowledge of the independent directors, he called a special meeting of shareholders of the fund so that the adviser could seek proxies to remove the fund's independent directors; and

Fourth, he sent a letter to each of the independent directors announcing his actions, requesting their resignations and threatening them with personal financial ruin if they contested his actions or used fund assets to mount a counter-solicitation.

Suppose, after regaining their composure, the independent directors immediately sent to the Commission an impassioned plea that could be summarized in four letters — H.E.L.P.!

One might think that, if there were ever a time for the Commission to act decisively and publicly in support of independent directors, surely this would be such a case.[67] But suppose the Commission chose to basically sit on the sidelines, referring to the matter as a state law corporate governance dispute.

[65]Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong. 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel).

[66]*See* PPI, *supra* note 4 and Wharton Report, *supra* note 45.

[67]Section 36(a) of the Act provides that:

(cont'd)

An industry insider once described an “ideal” independent director as “management’s best friend; the type of friend that will take the keys away when you’ve had too much to drink.” If the Commission expects independent directors to be the “first line of defense,” then it must support those directors who do take the keys away, or it must share responsibility for allowing drunk drivers to stay on the roads.

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(cont’d)
The Commission is authorized to bring an action in the proper district court of the United States . . . alleging that [any mutual Fund officer, director, investment adviser or principal underwriter] has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty . . . and that the court may enjoin such person from acting in any or all such capacities . . . and award . . . injunctive or other relief against such person . . .