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Enhancing the Effectiveness of Independent Directors:
Is the System Broken, Creaking or Working?

David A. Sturms

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 three mutual funds who sought to fulfill their fiduciary duties by taking issue with their funds' investment advisers were targets of heated proxy battles and/or costly litigation. On the other hand, the Securities and Exchange Commission ("Commission") brought charges against the independent directors of another mutual fund for failing to challenge the investment 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 investment adviser; and a recent study has questioned the independence of directors by pointing out that the more independent directors are paid, the higher a mutual fund’s expenses.²

This crossfire of criticism caused the New York Times to exclaim that "rarely, if ever, . . . have fund directors been


² See Michael Mulvihill, A Question of Trust, Morningstar Mutual Funds, Aug. 30, 1996 (hereinafter MORNINGSTAR STUDY). For a discussion of the MORNINGSTAR STUDY examining the relationship between the compensation of independent directors and mutual fund expenses, see the text accompanying note 31, infra.
under fire on so many fronts at once." It is appropriate, therefore, to reexamine the role of independent directors under the Investment Company Act of 1940 (the "Investment Company Act"). Are they, as some have complained, an ineffectual archaism that cannot provide meaningful oversight or, as others have claimed, the cornerstone of the Investment Company Act? Let the debate begin.

I. THE SYSTEM IS BROKEN

A. THEORY VERSUS REALITY

In theory, a mutual 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 mutual fund is usually created, sponsored and operated by the adviser. It is the investment adviser's services, 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 ....

What's amazing to this author 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 déjà vu all over again."

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3 See Wyatt, supra note 1.  
The distance between theory and reality most obviously manifests itself in the practical inability of independent directors to terminate an investment adviser, let alone negotiate its fees. As the Commission noted in 1966:

It has been the Commission's experience in the administration of the [Investment Company] 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. . . . 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.5

The Commission's commentary certainly foreshadowed events of today, as independent directors have faced off with investment advisers, and lost. 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.6 Knowing that they have the legal equivalent of a nuclear bomb (that is, the


6 For example, the Internal Revenue Service, in its guide for field agents in the examination of investment adviser income tax returns, recognized 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 [Investment Company] Act requirement that the contract be approved at least annually by its board of
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 poker game, where they have been dealt a royal flush, but look down and realize that they do not have any chips.

**B. ATTACKS ON INDEPENDENT DIRECTORS**

1. *The Investment Adviser versus the Independent Directors: Navellier, Fundamental and Yacktman*

*Navellier.* A dispute arose between Navellier Management, Inc. ("Navellier") and the independent directors\(^7\) 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 mutual fund, into the Navellier Performance Funds, a separate no-load series fund.\(^8\) 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 proceeding, 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 voted to hire Massachusetts Financial Services ("MFS") as the mutual 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

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\(^7\)The Navellier Series Fund is a Delaware business trust, and, as such, has trustees, not directors. Nevertheless, for purposes of this discussion and this article in general, the term directors is used.

\(^8\)The proposed merger would have terminated the independent directors’ positions.
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 mutual fund.

A proxy contest ensued between the mutual 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 mutual fund’s advisory contract with MFS was not received. Navellier eventually was reinstated as investment adviser to the fund. 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 Investment Company Act and, under Delaware law, corporate waste and interference with prospective economic relations. 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. 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.

**Fundamental.** The dissension between Fundamental Portfolio Advisors, Inc. ("Fundamental") and the independent directors of its New York Municipal Bond Fund

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10 Id. at 736-37. 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. Id. at 740-44.

11 Id. at 738. "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’." Id. at 737 (quoting Aronson v. Lewis, 437 A.2d 805, 812 (Del. Supp. 1984)).
stemmed in large part from a Commission enforcement action brought against Fundamental for fraudulently marketing the mutual fund as a safe investment and failing to properly disclose the risks of the fund's substantial investments in inverse floaters.\textsuperscript{12} The mutual 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. The board voted to seek a replacement investment adviser.

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 mutual 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 mutual fund's two remaining independent directors.

After a lengthy proxy battle, shareholders approved Tocqueville as the mutual fund's new investment adviser. That was not, however, the end of the saga. A secondary dispute subsequently arose between the mutual fund's new board and Tocqueville over restricting market timers from moving in and out of the fund. Late in 1998, this dispute came to a head when the board fired Tocqueville and approved an interim investment advisory agreement with Cornerstone Equity Advisors, Inc. ("Cornerstone").

\textsuperscript{12} An inverse floater or inverse floating rate note is "a variable rate security whose coupon rate increases as a benchmark interest rate declines." \textit{Campbell R. Harvey's Hypertextual Finance Glossary} (visited June 30, 1999) <http://www.duke.edu/~charvey/Classes/wpg/bfglosi.htm>.
a special meeting on March 12, 1999 shareholders approved an investment advisory agreement with Cornerstone. The fund is now known as the Cornerstone New York Muni Fund.\textsuperscript{13}

\textbf{Yacktman.} The Yacktman situation is yet another that involved a dispute between the investment adviser and the mutual fund's independent directors.\textsuperscript{14} 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 investment advisory employees of the mutual 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 investment adviser. In addition, the independent directors expressed substantial concern that the mutual fund's investment performance had been very disappointing.

In response, the investment adviser sent a letter to the independent directors stating that, if the independent directors did not resign, a proxy statement would be filed seeking their replacement. The letter threatened personal financial consequences for the independent directors if

\textsuperscript{13} On October 8, 1998, the mutual fund and Cornerstone filed an application for an order permitting 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. Fundamental Funds, Inc., et al, Investment Company Act Release No. 23,527, 63 Fed. Reg. 63,515 (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 a prospectus supplement for the mutual fund dated March 16, 1999, the agreement was approved by shareholders on March 12, 1999.

\textsuperscript{14} Vedder, Price, Kaufman & Kammholz served as counsel to the fund during portions of this dispute.
they contested the proxy. The independent directors refused to resign. The president of the investment adviser (who was also the president of the mutual 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 investment 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 investment adviser. 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 investment adviser's actions constituted a breach of the adviser's fiduciary duty to the fund in violation of section 36(a) of the Investment Company Act, and that, if allowed to stand, the investment adviser's actions would have a chilling effect upon independent directors of investment companies throughout the industry.

The investment adviser then sued the mutual 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 Investment Company 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 mutual fund from spending its own assets

\footnotesize{15 Letter from Jon D. Carlson, Thomas R. Hanson, Stanislaw Maliszewski and Stephen E. Upton, Independent Directors, The Yacktman Funds to Arthur Levitt, Chairman, U.S. Sec. and Exch. Comm'n (Sep. 25, 1998) (on file with author).}

\footnotesize{16 15 U.S.C. § 80a-35(a) (1998).}

\footnotesize{17 15 U.S.C. § 80a-17(d) (1998).}
to counter the investment adviser's proxy solicitation. The Commission staff issued a letter that called into question the judge's ruling, saying that such a ruling could severely undermine the ability of independent directors to perform their duties under the Investment Company Act. The fund immediately removed the case to federal court, and the federal district court judge vacated this portion of the TRO; thus, allowing the mutual fund to finance its own counter-solicitation.

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

2. **The Commission versus the Independent Directors: Parnassus and Community Bankers**

*Parnassus.* The independent directors of the Parnassus Fund found themselves in a battle with the Commission regarding the pricing of the mutual 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

18 Letter from Jacob H. Stillman, Associate General Counsel, U.S. Sec. and Exch. Comm'n, and Douglas J. Scheidt, Associate Director and Chief Counsel, Div. of Inv. Management, U.S. Sec. and Exch. Commission, to Richard Teigen, et al. (Oct. 16, 1998) (on file with author) (questioning whether the acts alleged by the plaintiff adviser constitute a violation of section 17(d) of the Investment Company Act and rule 17d-1 thereunder, 17 C.F.R. § 270.17d-1(1998)).

19 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 shares eligible to vote.

20 See Yacktman Funds press release, Yacktman Wins Vote, Loses Shareholders (Dec. 3, 1998) (on file with author). 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. *Id.*
delisted, the mutual 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 for making 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.

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 money market fund failed to maintain a $1.00 net asset value per share. 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. 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 money market fund's pricing procedures to allow the use

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21 The "pink sheets" are a printed quotation medium published by the National Quotation Bureau, Inc. See Revision of Rule 504 of Regulation D, Securities Act Release No. 7541, 63 Fed. Reg. 29,168 (May 21, 1998). Securities offered through this medium are "characterized by thin capitalization, low share prices, and little or no analyst coverage" (i.e., "microcap" companies). Id.


23 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.
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. 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 money market fund’s fair value shadow pricing methodology was inappropriate.

The Commission instituted an enforcement action against, among others, the three independent directors of the money market fund. The independent directors were charged with willfully violating section 17(a)(2) and 17(a)(3) of the Investment Company 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 1999, the Commission issued a cease and desist order against the independent directors and ordered them each to pay $5,000 in civil penalties.

24 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 Investment Company Act. 17 C.F.R. § 270.22c-1(a) (1998).
26 John E. Backlund, 68 SEC Dkt. 2663 (Jan. 11, 1999).
3. Shareholders versus the Independent Directors: 
   Strougo, et al.

A series of shareholder lawsuits has questioned the independence of directors who sit on multiple boards within the same fund complex. Suits have been brought against independent directors serving on boards of mutual funds and closed-end 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 closed-end fund in connection with a rights offering.27 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 Investment Company Act and under Maryland law and a control person liability claim under Section 48 of the Investment Company Act.28 Due to the significant policy issues involved in the case, the Investment Company Institute (“ICI”) 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 closed-end 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.29

29 On May 12, 1998, the Governor of Maryland signed into law legislation that affirms for purposes of Maryland corporation law that the Investment Company Act of 1940 governs the determination of whether a director of an investment company is an interested person.
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 investment 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. In several of the suits the original complaints were dismissed. However, amended complaints have been filed.

4. The Press and John Bogle versus 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 investment adviser, including an increase in advisory fees or the imposition of fees pursuant to plans adopted under Investment Company Act rule 12b-1 (hereinafter "12b-1 fees" and "12b-1 plans"). To support the criticism some articles have cited a study by Morningstar examining the relationship between the


31 MORNINGSTAR STUDY, supra note 2.
level of directors’ fees and shareholder expenses. (Other, more favorable, studies of shareholder expenses by Lipper Analytical Services and the ICI have also received coverage). Finally, comments by John C. Bogle, Chairman of the Vanguard Group, have added fuel to the fire.

The MORNINGSTAR STUDY, in particular, is critical of the role of independent directors in approving investment advisory contracts and finds a correlation between the level of directors’ fees and shareholder expenses. The MORNINGSTAR STUDY looked at director compensation and shareholder expenses at the 82 largest fund families. According to the MORNINGSTAR STUDY, it reveals a "disturbing pattern" at these fund families, and finds a "link" between directors' fees and shareholder expenses. This "raises serious questions about the role independent [directors] play in protecting shareholders." Although admitting that, in dollar terms, the difference in director compensation between high-cost and low-cost fund


35 See, e.g., Russ Wiles, Are Expenses Justified, or Just Plain Excessive, LA Times, Nov. 9, 1997, at D3 (reporting on the key points of the Lipper Study); Bill Barnhart, The Fee Fracas: A Bit of Light With the Heat, Chicago Tribune, Oct. 12, 1997, at 3 (providing statistics and comments from the Lipper Study); Werner Renberg, Cost of Owning Money Market and Bond Funds Drops Greatly, Star-Tribune (Minneapolis - St. Paul), Mar. 21, 1999, at 2D (highlighting the various components of the ICI Study).


37 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. See MORNINGSTAR STUDY, supra note 2.
families has little effect on shareholders, the Morningstar Study argues that it reveals a "potentially chilling conflict of interest" on the part of independent directors.

In contrast in 1997, Lipper Analytical Services conducted a study of mutual fund fees and concluded that such fees are reasonable.\(^{38}\) While new funds, on balance, are charging higher fees, the composition of those funds has changed, according to the Lipper Study. The Lipper Study cites a proliferation of new international bond and stock mutual funds, which are inherently more expensive to run, as the reason for increased costs. The Lipper Study also argues that the higher fees on new mutual funds reflects the higher cost of doing business in today's mutual fund environment, with its emphasis on marketing and increased customer service.

Similarly, the ICI conducted a study in 1998 that examined trends in the ownership cost of equity mutual funds.\(^{39}\) The ICI Study examines the level and trend in mutual fund fees and expenses using "total shareholder cost" (calculated to measure the cost that an investor would expect to incur in purchasing and holding mutual fund shares).\(^{40}\) The ICI Study, which bases its conclusions upon the sales-weighted average of shareholder cost ratios for individual equity funds, determines that the total shareholder cost for equity funds decreased by more than one-third between 1980 and 1997.\(^{41}\) The ICI Study attributes this decrease to lower distribution costs (sales loads and 12b-1 fees) and increased investment in lower-cost equity funds, and finds economies of scale to exist among individual equity funds.

\(^{38}\) Lipper Study, supra note 33.

\(^{39}\) ICI Study, supra note 34.

\(^{40}\) Id. 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. Id.

\(^{41}\) Id. 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 34.
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 the Commission's then upcoming Roundtable on the Role of Independent Investment Company Directors, 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." 42

Perhaps the most scathing criticism of independent directors, however, comes from an industry insider, John C. Bogle, Chairman of the Vanguard Group, 43 who has stated that:

Mutual fund directors generally seem to operate under a... 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."... 

[Such a mission statement] 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...


43 See Bogle, supra note 36.
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. . . . 44

C. PROPOSALS TO REPLACE THE INDEPENDENT DIRECTORS

1. The UIF Approach

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 1980,45 the UIF is an alternative form of open-end management

44 Compare, however, the comments from an ICI publication that cites the many benefits of the independent director governance structure and the high standards by which independent directors act:
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.”


45 Stephen K. West, Address at the General Meeting of the Investment Company Institute (May 1, 1980).
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 investment adviser and more comprehensible to investors.

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 Investment Company Act apply.46

(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 Investment Company 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 Investment Company 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.

2. Proposed Variations of the UIF Approach

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. Moreover, 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.

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One modified version of the original UIF proposal that has evolved since 1980 has the following 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. 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.

3. Projected Advantages of the UIF Approach

Supporters of the UIF approach argue that not only is it more intellectually honest than the corporate governance model under the Investment Company Act, it also provides greater flexibility to investment advisers in developing and operating products. Investors make decisions based on the anticipated performance of a product. The thrust of the UIF approach is to provide an investor with full information concerning a product, enabling the investor to make rational investment decisions between competing products. At the same time, the UIF model recognizes the inherent conflict between shareholders and investment advisers, retaining some fundamental section 17-type transactions that should be retained under the Investment Company Act (hereinafter 1992 Commission Report).

50 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. See 17 C.F.R. § 270.17e-1 and 270.17a-7 (1998).

51 Section 3(c)(1) of the Investment Company Act excludes from the definition of an investment company, as defined under section 3(a)(1) of the Act, "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities". 15 U.S.C. §§ 80a-3(a)(1) and 80a-3(c)(1) (1998).

Section 3(c)(7) of the Investment Company Act excludes from the definition of an investment company, as defined under section 3(a)(1) of the Act, "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at the time propose to make a public offering of such securities". 15 U.S.C. §§ 80a-3(a)(1) and 80a-3(c)(7) (1998).
provisions of the Investment Company Act (similar to those imposed on adviser/client relationships directly by the Investment Advisers Act of 1940). 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 1930's during the Great Depression when faith in the market was at an all time low. 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 investment advisers, have greater access to information about investment companies and are generally more sophisticated.

4. Criticisms of the UIF Approach

Aside from arguing that the current corporate governance system works, 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. Some proponents of the UIF approach have argued that, in most cases, matters involving directors could be detailed in the trust indenture (for example, a money market fund's amortized cost 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

52 For example, the independent directors select the fund's independent public accountants, determine annually whether participation in joint liability insurance policies is in the best interests of the fund, and review and approve fidelity bonds. See, e.g., 15 U.S.C. § 80a-31 and 17 C.F.R. § 270.17g-1(d)(1998).
"depositary" used in Europe. 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 would create incentives for an investment adviser to cut corners on basic services to a mutual fund to meet competitive pressures. Even in the absence of competitive pressures, an adviser might 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 mutual 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.

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II. THE SYSTEM CREAKS

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. 54 In addition, they seek to enhance the independence of independent directors and to provide them with additional tools to fulfill their role.

A. THE 1992 COMMISSION REPORT

In "Protecting Investors: A Half Century of Investment Company Regulation", 55 a 1992 report by the Commission staff examining, among other things, the current governance requirements of the Investment Company Act as they relate to the role of directors and the various criticisms of those requirements, the staff concluded that the corporate regulatory structure embodied in the Investment Company Act is fundamentally sound. Nevertheless, the 1992 Commission 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 Investment

54 See, e.g., Burks v. Lasker, 441 U.S. 471, 484-85 (1979). In Burks, the Court held that "the structure and purpose of the [Investment] Company Act indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state, the primary responsibility for looking after the interests of the funds' shareholders". Id.
55 See note 49, supra.
Company 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 Investment Company Act be further amended to require, as is now the case for mutual funds that have adopted 12b-1 plans, that independent directors be self-nominating. Finally, the Report recommended that the independent directors be given independent authority to terminate investment advisory contracts (unlike current law which only allows the full board or the shareholders to take such action).

Two of these three recommendations from the 1992 Commission Report — having a majority of independent directors and requiring that independent directors be self-nominating — were recently identified by Commission Chairman Arthur Levitt as two of the four “concrete measures which will form the cornerstone of a major Commission initiative to improve mutual fund governance.” All three have been almost universally seconded by the investment company industry, and should be considered “no-brainers”.

Chairman Levitt’s third concrete proposal — requiring independent directors to have counsel separate from counsel for the investment adviser — was considered by the Commission staff when preparing the 1992 Commission Report and rejected. The Report argued that, while independent counsel would be beneficial to independent directors and in some circumstances might be necessary for a board to properly perform its responsibilities under the Investment Company 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.

Despite the conclusion of the 1992 Commission Report, 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 Investment Company Act. For example, courts and the Commission 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 Investment Company Act when adopting or renewing advisory contracts, and when adopting or renewing 12b-1 plans. Accordingly, legal observers have argued, as the Chairman suggested, that the Act should codify the industry "best practice" and require that independent directors have separate counsel.

58 See Tannenbaum v. Zeller, 552 F.2d 402, 428 (2d Cir. 1977) (holding that although independent directors received the advice of interested legal counsel, such advice was accurate and therefore does not "vitize the reasonableness of the [independent director's] judgment". But see Fogel v. Chestnut, 533 F.2d 731, 749-50 (2d Cir. 1975) (finding that if disinterested legal counsel had been provided to independent directors in the performance of their duties disposition of case would be different); Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F. Supp. 1038, 1064 (S.D.N.Y. 1981) aff'd 694 F.2d 923 (2d Cir. 1982) (concluding that approval of advisory contact by trustees of the fund will be weighted heavily in deciding whether compensation paid to adviser was reasonable since trustees were represented by independent counsel in the discussions concerning the contract).


61 See, e.g., letter from Stanley M. Grossman and Bruce G. Stumpf, Pomerantz Levy Haudek Block & Grossman to Mr. George A. Fitzsimmons, Secretary, U.S. Sec. and Exch. Comm'n. (Apr. 15, 1983) (on file with author); See also letter from Francis X. Cain to Jonathan G.
There are a number of structures that provide for counsel to the independent directors separate from counsel to the investment adviser. In one model, the independent directors, the investment company and the investment adviser each retain their own separate counsel. This is the ultimate degree of separateness. In a second model, one counsel represents the investment company and the investment adviser, while the independent directors retain their own separate counsel. This model is premised on the notion that the mutual fund and the adviser are essentially synonymous and, therefore, one counsel represents those parties while another counsel represents the independent directors. In a third model, one counsel represents the investment company and the independent directors and another counsel represents the investment adviser. This model is premised on the belief that the mutual 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 author believes the third model to be the most efficient and logically consistent with the goals of the Investment Company Act. 62 I have yet to see an instance where the interests of the independent directors and the fund shareholders were not aligned, yet I have seen many

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62 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. See Section 32(a)(1) of the Investment Company Act, which requires that an investment company's selection of accountant be approved by a majority of the independent directors. 15 U.S.C. § 80a-31(a)(1) (1998).
instances in which counsel representing only the independent directors has less access to information, which, dilutes or even blocks the information flow to the independent directors. As the *Fund Director's Guidebook* of the American Bar Association notes:

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)*

B. ADDITIONAL REGULATORY/LEGISLATIVE OPTIONS

Some commentators have argued that the structural reforms discussed in the 1992 Commission 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.

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Chairman Levitt's fourth concrete measure would require providing mutual fund shareholders with "more specific information on which to judge the independence of their funds' directors." The Chairman stated that he would like to see shareholders get more information about directors. I know that there are directors who may technically be considered to be independent, but who have had business or other relationships with management. Shareholders should know that. Shareholders should also know whether the directors' interests are in line with their own interests. They should know whether and how much the directors have invested in the funds they oversee.\(^6^4\)

To further bolster the independence of independent directors, perhaps the Investment Company Act should prohibit an investment adviser (or an affiliate of the investment adviser) from seeking to remove or replace independent directors. The notion is that if independent directors are charged with watching over the investment 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 (for example, a board consisting of "drunken sailors"), the Act could permit an investment 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.\(^6^5\) This 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 investment adviser.

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\(^{64}\) Levitt Speech, supra note 57.

\(^{65}\) 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 Investment Company Act. See 15 U.S.C. § 80a-35(a)(1) (1998).
It has also been proposed by a former independent director of the Yacktman Funds that the Investment Company Act be amended to permit an investment company board of directors (or even the independent directors alone) to replace the investment 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 investment adviser must be approved by shareholders. 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 investment adviser would be willing to step in on an interim basis. If the directors had the authority to permanently hire a new investment adviser without shareholder approval, the board would be able to fire an adviser and replace it without either the unpleasant prospect of leaving the mutual fund without an adviser or the threat of facing a well-financed proxy battle against the adviser for control of the mutual fund. In


67 Investment Company Act Rule 15a-4. 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.

addition, other investment advisers might be more willing to compete for management of a fund’s assets if they did 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 mutual fund’s investment advisory contract when negotiating with the adviser and thereby strengthen the board’s negotiating position.68

A final proposal to strengthen independent directors is a proposal to rescind a 1980 Commission release69 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 investment adviser.70 Most investment

68 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. 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. Exchange Act Release No. 30,697, 51 S.E.C. Docket 688 (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).


70 Many investment companies maintain joint liability insurance policies with the investment adviser, and its affiliates, as coinsureds. Most of those policies, however, traditionally excluded 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). ICI Mutual has recently revised its Directors and Officers/Errors and Omissions policy to ensure that fund independent directors may recover for defense costs, settlements and judgments in bona fide “insured vs. insured” claims otherwise covered under its policy. Independent directors may wish to consider, in determining whether to participate in a joint liability insurance policy, whether there is any possibility of a dispute with the investment adviser.
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 be met before receiving 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. Recently, however, the Commission staff confirmed that it would be consistent with Section 17(h) of the Investment Company Act for independent counsel to render an opinion on the advancement of legal fees to independent directors to afford those directors a

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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.


Section 2-418(f)(1) of the Maryland General Corporate Law provides that “[r]easonable expenses incurred by a director who is a party to a proceeding may be paid or reimbursed by the corporation in advance of the final disposition of the proceeding. . . .” Md. Code Ann., Corps. & Ass'ns § 2-418 (f)(1).

72 See 15 U.S.C. 80a-17(h) (1998). Investment Company Act Section 17(h) prohibits contractual provisions that protect a director or officer of an investment company from liability by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of duties as a director or officer (“disabling conduct”). Id.
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 independent directors and those who are affiliated with the investment adviser, the 1980 Release provides reasonable safeguards against inappropriate overreaching, particularly by the adviser or its affiliates. In its request for no-action, 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 mutual 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 conditions articulated in the 1980 Release are necessary for independent directors. Rather than protecting the mutual 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 investment 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.

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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 protection provided by 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 DETERRENT

Commentators argue that independent directors do serve as a meaningful counterweight to the entrepreneurial spirit of investment advisers.\textsuperscript{75} 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 investment 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.\textsuperscript{76}

In addition, if investment 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 mutual fund to make shareholders whole.\textsuperscript{77} Absent pressure from independent directors, the investment adviser may attempt to hide such mistakes from shareholders, the

\textsuperscript{75} See, e.g., Richard M. Phillips, Deregulation Under the Investment Company Act - A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 Bus. Law. 903, 910 (1982) (noting that "over the years independent directors of mutual funds have become increasingly sophisticated and sensitive to their responsibility to oversee the relationship between the investment adviser and the fund").

\textsuperscript{76} 1992 SEC Report, supra note 49.

\textsuperscript{77} Id.
general public and regulators. In fact, absent third party oversight, competitive pressures give investment advisers every incentive to hide such mistakes from the market.

Finally, the mere threat of not approving an investment advisory contract or removing an adviser may very well deter advisers from egregious conduct. Even though rarely used, the "nuclear deterrent" could be the psychological key to avoiding conflict. In essence, the supporters 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.78

B. INDEPENDENT DIRECTORS Do Say "No"

Supporters of the current system note that independent directors do say "no";79 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 mutual funds as examples of why the system works, not why it is broken. They cite Navellier, Fundamental and Yacktman as success stories. In those cases, directors stood up to the investment adviser and alerted shareholders to potential problems with the adviser. Although in two of those cases the independent directors 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

79 See Stephanie A. Djinis & Amy L. Goodman, Director Independence Challenged by Strougo Case, 4 Investment Lawyer 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.")
independent directors blowing the whistle deters investment advisers from the most egregious violations. For proof, proponents of the system cite case law under Investment Company Act section 36(b) where defendant directors have been found by courts to have performed well in their oversight of advisory fees and of 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 already may have been done.

### D. THE COST OF INDEPENDENT DIRECTORS IS DE MINIMUS

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. 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 Investment Company

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81 See letter from Lipper Analytical Services, Inc. to Jonathan G. Katz, Secretary, U. S. Sec. and Exch. Comm’n (Oct. 9, 1990) (on file with author).
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 investment advisers. Moreover, independent directors are reluctant to drop the nuclear bomb over fees or performance. Might that be because they shouldn't? When Investment Company Act 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:

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.

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82 See Jean W. Gleason, Mutual Fund Governance: Independent Directors — Their Role and Incentives and Tools for Fulfilling It 1994 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE. ("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.

83 Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong. 252 (1940) [statement of David Schenker, Chief Counsel).
In the 1960s, the Commission began to examine the level of investment advisory fees. 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 Investment Company Act be amended to include a "reasonableness" standard for fees. This standard, however, was never adopted. In 1970, Congress enacted Investment Company Act section 36(b), which imposes a fiduciary duty on investment 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 investment 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 increased 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 investment adviser-created, branded and operated product. Perhaps it is time to amend the Investment Company Act to give independent directors more power and authority to perform their duties under the Act. All these issues merit 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,

84 See PPI, supra note 5; see also A Study of Mutual Funds - Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, H.R. REP. NO. 87-2274, at 37 (1962).
dedicated to the success of that structure in the interest of shareholders. Investment 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 investment adviser, who was also the president of a mutual 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 things.

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

Second, he hired a proxy solicitation firm for the investment adviser, and then, without the knowledge of the independent directors, used his office of the president of the mutual 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 mutual fund, without the knowledge of the independent directors, he called a special meeting of shareholders of the fund so that the investment adviser could seek proxies to remove the fund's independent directors.

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 mutual 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. 85

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85 Section 36(a) of the Act provides that:

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
But suppose the Commission chose to basically sit on the sidelines, referring to the matter as a state law corporate governance dispute.\footnote{To give Chairman Levitt almost the last word, if only in a footnote, the Chairman responded to such criticism of the Commission in his recent speech on independent investment company directors as follows. Some at the [Commission Roundtable on the Role of Independent Investment Company Directors] made the point that the Commission, in allocating key governance responsibilities to independent directors, needs to be actively involved and pursue charges of illegal conduct by fund managers whenever they occur. I couldn’t agree more.

Let me assure you that we have always taken allegations of wrongdoing very seriously. You should know that even if our findings can’t be publicly revealed, we look into every allegation by an independent director that the securities laws have been violated. And if we find a violation, we take aggressive action to support them and the interests of investors.

Some said that the Commission didn’t do enough to support independent directors during recent conflicts with management at certain funds; that we took a neutral stance as we always do in highly charged proxy battles. Some had gotten the impression that the Commission didn’t care or wasn’t willing to take action. I think it’s fair to say that we at the Commission do listen, and we will continue to look for opportunities to support independent directors where appropriate. See Levitt Speech, supra note 57.}

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.

\footnote{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. ... 15 U.S.C. § 35(a) (1998).}