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## FUND GOVERNANCE: A SUCCESSFUL, EVOLVING MODEL

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THE Investment Company Act of 1940 (“ICA”), one of the last pieces of legislation to come out of the New Deal, should be recognized as one of the most important. In the seventy-five years since President Franklin Roosevelt signed the ICA into law, investment companies (“funds”)<sup>1</sup> have grown enormously under its framework, giving rise to a form of financial intermediation that stands today as one of the most important developments in U.S. and global financial markets in the second half of the 20th century.

At the end of 1940, assets under management in U.S. registered open-end funds were about \$450 million, in about 300,000 shareholder accounts.<sup>2</sup> By the end of 2015, assets under management in these funds had reached nearly \$16 trillion,<sup>3</sup> in more than 250 million shareholder accounts.<sup>4</sup> Today, U.S. registered open-end funds are the predominant savings vehicle for more than 90 million investors in an estimated 53.6 million (or 43% of) U.S. households.<sup>5</sup> Viewed collectively, U.S. registered funds—which generally include mutual funds, closed-end funds, and most exchange-traded funds (“ETFs”)—rank among the most important aggregators and allocators of capital in global financial markets, and among the largest participants in the U.S. stock and bond markets.

A wide range of factors have had a hand in this remarkable growth—including the ICA’s robust investor protections; pass-through tax treatment

<sup>1</sup> For purposes of this article, “funds” include, except where otherwise specified, open-end funds, exchange-traded funds, closed-end funds, and unit investment trusts registered with the U.S. Securities & Exchange Commission (“SEC”).

<sup>2</sup> U.S. SEC. & EXCH. COMM’N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 2 (1966) [hereinafter PUBLIC POLICY REPORT]; see generally INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY (54th ed. 2014), available at [https://www.ici.org/pdf/2014\\_factbook.pdf](https://www.ici.org/pdf/2014_factbook.pdf).

<sup>3</sup> See INV. CO. INST., 2016 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 172 (56th ed. 2016) [hereinafter 2016 FACT BOOK], available at [https://www.ici.org/pubs/fact\\_books](https://www.ici.org/pubs/fact_books) (forthcoming).

<sup>4</sup> See Memorandum from the Inv. Co. Inst. on Supplementary Data for the Quarter Ending December 31, 2015 to Members 32 (March 2016) (on file with the Investment Company Institute).

<sup>5</sup> See 2016 FACT BOOK, *supra* note 3, at 112; see also Kimberly Burham et al., *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2015*, ICI RES. PERSP., Nov. 2015, at 1, available at <http://www.ici.org/pdf/per21-05.pdf>.

established in the Revenue Act of 1936; diversification of risk and professional investment management; and effective administration of the ICA by the SEC.

Other major influences include intense competition in the fund marketplace, which has fueled innovation in types of funds, fund structures, and shareholder services; the rise of defined contribution plans and the role of funds as attractive vehicles for long-term retirement saving; demographic trends, particularly the post–World War II baby boom and longer life expectancies; and the generally strong performance of U.S. and global financial markets.

One especially important factor, sometimes overlooked, is the unique system of fund governance outlined in the ICA. Since the ICA was passed, funds have enjoyed a statutory form of governance in which the role of independent directors was important from the outset and has since evolved significantly. Reaching back before the ICA, fund governance has evolved in three distinct phases.

- **The first phase.** After the 1929 market crash and ensuing Great Depression revealed a litany of abuses in the fund industry, the government and the industry worked together to develop a new statutory regime for funds and fund governance—one that ultimately would be enshrined in the ICA. The ICA would institute a strict regulatory framework on funds—including a number of provisions for fund directors—and precipitated tremendous growth across the industry.

- **A second phase.** Following two decades of strong industry growth, regulators and lawmakers began to conduct studies focusing on the implications of funds as a rising new form of financial intermediation, and particularly on the economics of fund investing. The studies led to an array of congressional amendments to the ICA, several of them directed at the roles and responsibilities of fund directors. Amendments relating to the regulation of management fees set the stage for court rulings that would reinforce the value of directors' oversight role in protecting shareholder interests.

- **A third phase.** By the mid-1990s, continued growth had put funds and fund investing at the center of a “seismic shift in American finance.”<sup>6</sup> The tectonics influencing this third phase are still felt today. They include higher public expectations of funds, their advisers, and their boards, as stewards of so great a portion of U.S. household wealth; the reverberations of controversy and scandal, especially the market-timing and late-trading abuses

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<sup>6</sup> *The Seismic Shift in American Finance*, THE ECONOMIST, Oct. 21, 1995, at 117.

that emerged in 2003; and a renewed focus, from both the industry and regulators, on ways to further improve fund governance.

This article examines these three phases in greater detail, and concludes with a look at what might lie ahead for fund governance.

### I. THE FIRST PHASE OF FUND GOVERNANCE: COMPREHENSIVE FUND REGULATION AND ITS AFTERMATH

Investment funds played a major role in the financial innovation of the Roaring Twenties.<sup>7</sup> After the formative early part of the decade, funds experienced tremendous growth, largely due to the accompanying stock market boom. Nearly 600 funds formed between 1927 and 1929, doubling the industry total.<sup>8</sup> At the peak of their 1920s expansion, funds “were literally being formed at the rate of almost one each business day”—with 265 forming in 1929 alone.<sup>9</sup>

But the growth was a facade—masking “various deficiencies, inequitable structures, and patterns of improper practices.”<sup>10</sup> The industry lacked professional fund advisers, and so people from a wide variety of backgrounds—industrialists, commercial bankers, economists, lawyers, accountants, and more—began to sponsor funds.<sup>11</sup> Advisers had no obligation to make a “substantial personal investment” in their funds.<sup>12</sup> Coupled with a lack of regulation, this all but ensured improper transactions between funds and their affiliated persons, including advisers’ domination of the funds and use of fund assets to promote their own interests at the expense of shareholders’ interests.<sup>13</sup>

With the fund business seemingly thriving, Congress and the investing public appeared little concerned with its inner workings. The press and some regulatory entities, however, were paying attention.<sup>14</sup> “No investment trust can be successful except under the most careful management and with the

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<sup>7</sup> See U.S. SEC. & EXCH. COMM’N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES: FIXED AND SEMIFIXED INVESTMENT TRUSTS, H.R. DOC. NO. 76-279, at 2–4 (1940) [hereinafter SEC 1940 STUDY]. Sales of closed-end, rather than open-end, funds accounted for most of the growth prior to the end of 1929. *Id.* at 4.

<sup>8</sup> *Id.* at 3.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 2.

<sup>11</sup> *Id.* at 3.

<sup>12</sup> *Id.*

<sup>13</sup> See, e.g., Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH U. L.Q. 303, 307 (1941).

<sup>14</sup> See SEC 1940 STUDY, *supra* note 7, at 39–40.

assurance of expert reports on all its holdings,” a 1920 Federal Reserve Bulletin noted.<sup>15</sup> Two years later, a book highlighting the potential conflict of interest between fund advisers and investors cautioned: “Another weakness militating against proper insurance of small investors who buy securities of investment companies lies in the fact that these companies are private undertakings usually operated by those who manage them, and who look first to their own private profit.”<sup>16</sup>

The market crash of 1929 devastated the industry, validating the earlier concerns. “Owing to the immense stake of the public in the affairs of investment trusts,” the *Harvard Law Review* wrote the year after the crash, “danger of mismanagement has become a matter of widespread concern, and evidences of abuse have given rise to demands for, and some attempts at, legislative correction.”<sup>17</sup> Added *Fortune* magazine several years later: “[M]anagements had rigged [investment trusts] for the rankest sort of speculative activity at a time when the whole scale of values was about to hit the skids.”<sup>18</sup>

In response, Congress directed the SEC to study the fund industry as part of its authority under the Public Utility Holding Company Act of 1935.<sup>19</sup> The ambitious 4000-page effort, delivered to Congress over thirty-four months, explored the formation, growth, and operation of investment trusts, focusing largely on conflicts of interest, self-dealing, and incestuous corporate and personal relationships. The study found that advisers’ unfettered control of fund operations fed their many ugly abuses: using fund assets to finance personal business ventures, engaging in larceny and embezzlement, using funds as captive markets for unsalable securities underwritten by an affiliate of the sponsor, rewriting investment policies without shareholder approval, charging exorbitant sales loads, and much more.<sup>20</sup> At the core of these abuses, fund directors were appointed by the adviser and thus loyal to the adviser’s interests (and even their own)—while leaving shareholders’ interests unprotected.

Directors also were involved in a number of dubious practices revealed in the study: directors of the investment adviser, distributor, and underwriter (in debt offerings) were also directors of the funds; directors of the funds were

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<sup>15</sup> *Id.* at 40.

<sup>16</sup> *Id.* (quoting ARCHIBALD H. STOCKDER, BUSINESS OWNERSHIP ORGANIZATION 302 (1922)).

<sup>17</sup> Legislation, *Statutory Regulation of Investment Trusts*, 44 HARV. L. REV. 117, 117 (1930).

<sup>18</sup> SEC 1940 STUDY, *supra* note 7, at 45 (quoting FORTUNE, Sept. 1935, at 53).

<sup>19</sup> *Id.* at 48.

<sup>20</sup> See S. REP. NO. 76-1775, at 6–8 (1940); see also Jaretzki, *supra* note 13, at 307.

also directors and senior executives of portfolio companies; funds made loans to their directors and to portfolio companies with whom their directors were affiliated; and directors retained all voting rights over the outstanding shares so that shareholders could not vote on any important matter involving the fund.<sup>21</sup>

The study induced a deep motivation for reform on all sides, and on March 14, 1940, the SEC submitted to Congress a bill designed to fix the problems it revealed. The bill would become the ICA, one of the longest, most complex federal securities statutes. Adopted at a most unlikely time, as the United States was preparing to enter World War II, it was born out of a remarkable government-industry collaboration, and passed both the Senate and the House of Representatives unanimously. The final Act—though it did not turn out as strong as the SEC urged at first<sup>22</sup>—embodied “give and take on both sides,” reflecting not merely “the real desire of both sides to cooperate, but more particularly . . . the sympathetic understanding on each side of the opposing point of view.”<sup>23</sup>

#### A. The ICA’s Provisions for Fund Board Composition

In support of the ICA’s goal of protecting investors, stakeholders debated the best way to address potential conflicts of interest, including those involving fund directors. Board composition was a key focus of the debate. The harshest critics of the industry

insisted that investment companies must be segregated from any investment banker, security dealer, broker, or similar person, and from any person acting as its investment adviser

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<sup>21</sup> See generally S. Rep. No. 76-1775, *supra* note 20.

<sup>22</sup> A note in an issue of the *Yale Law Journal* observed:

While it was never seriously proposed to outlaw investment companies entirely, the original bill for federal regulation, submitted by the SEC to Congress last March, surpassed even the Holding Company Act in grants of discretionary power to the Commission. Whether it would have been politically possible to pass the bill in its original form is questionable. At any rate, the present Act is a drastic modification, rewritten entirely by the Commission and the industry, and passed by Congress without debate as a tribute to the cooperative spirit which fathered it. Where the original draft left the Commission with power by rule and regulation to implement the broad policies of the bill, the present Act generally sets certain maxima of regulation, leaving in the Commission a discretionary power only to exempt and minimize.

Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677, 682 (1969) (quoting Note, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 442–43 (1941)).

<sup>23</sup> Jaretzki, *supra* note 13, at 303–04.

or distributor of its securities—that is to say, that all such persons should be excluded from acting as officers or directors of investment companies.<sup>24</sup>

The critics worried that funds were operating not in the interests of their shareholders, but in the interests of their officers or directors.<sup>25</sup>

Early drafts did not go quite that far, but they did require that a majority of a fund's directors have no relationship with the fund's adviser and principal underwriter. Industry representatives argued in response that, if funds were required to have a majority of their directors be independent, they would “be forced to elect outside directors . . . from among those individuals who have no business affiliations, connections, or property of their own; and the boards will be filled with artists, architects, musicians, doctors, and the like.”<sup>26</sup> The provision would, industry representatives contended, “make it extremely difficult to secure and retain the services of directors who are by training and situation competent to aid, advise, and administer the affairs of investment companies,”<sup>27</sup> thus “defeat[ing] the very purpose for which [the] funds were organized”—to provide investors with expert financial management.<sup>28</sup>

The industry also worried that requiring a majority of a fund's board of directors to be independent would lead to a problematic division of responsibility and decision-making power within the fund. One fund adviser hypothesized that “the divided responsibility might result in compromises with which neither [the adviser] nor the independent directors would be satisfied,” or that the division could cause “constant changes of direction [that] would be harmful.”<sup>29</sup>

The industry views prevailed, and the final legislation required that only forty percent of directors be independent.<sup>30</sup> When the SEC revised its recommendation to forty percent, David Schenker, the SEC's chief counsel at the time, testified:

[T]he argument was made that it is difficult for a person or firm to undertake the management of an investment

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<sup>24</sup> *Id.* at 317.

<sup>25</sup> *Id.*

<sup>26</sup> *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. on Sec. & Exch. of the S. Comm. on Banking and Currency*, 76th Cong. 477 (1940) (statement of Paul Cabot, founder of State Street Investment Corporation).

<sup>27</sup> *Id.* at 476.

<sup>28</sup> *Id.* at 702 (statement of James N. White, General Partner, Scudder, Stevens & Clark).

<sup>29</sup> *Id.* at 703 (statement of James N. White, General Partner, Scudder, Stevens & Clark).

<sup>30</sup> See H.R. 10065, § 10, 76<sup>th</sup> Cong. 3d. Sess. 20 (1940) (enacting final legislation); see also S. 4108, § 10, 76<sup>th</sup> Cong. 3d. Sess. 44 (1940) (introducing requirement that 40% of directors be independent).

company, give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying the management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice.

Now, that made sense to us. If the stockholders want A's management, than [sic] A should have the right to impose his investment advice on that company. However, we felt that there should be some check on the management and that is why the provision for 40 percent independents was inserted.<sup>31</sup>

This notion of an independent "check" on management was critical for addressing the potential for conflicts of interest and self-dealing at the inception of the modern fund industry, and it remains so today. As Schenker noted, this requirement was "one of the most salutary provisions in this bill."<sup>32</sup> And as the U.S. Supreme Court would observe years later, the underlying intent of the ICA's governance provisions was to "place the unaffiliated directors in the role of 'independent watchdogs,' . . . who would 'furnish an independent check upon the management' of investment companies."<sup>33</sup>

## B. Dealing with Conflicts of Interest

The ICA addressed the potential for conflicts of interest through other provisions as well. In addition to the requirement that at least forty percent of the directors not be affiliated with the adviser or principal underwriter, the ICA also required that boards "have a majority of its directors independent of brokers as a group, principal underwriters of its securities as a group, and investment bankers as a group."<sup>34</sup> The ICA supplemented the board-composition requirements with specific prohibitions against certain transactions with affiliated persons and requirements pertaining to the

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<sup>31</sup> *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 76th Cong. 109–10 (1940) [hereinafter *Hearings on H.R. 10065*] (statement of David Schenker, Chief Counsel, U.S. Sec. & Exch. Comm'n).

<sup>32</sup> *Id.* at 109.

<sup>33</sup> *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (1977)); *Hearings on H.R. 10065*, *supra* note 31, at 109.

<sup>34</sup> Jaretzki, *supra* note 13, at 319.



investment advisory and distribution contracts.<sup>35</sup> These provisions, the SEC determined, would be sufficient to protect shareholders from the abuses that were identified when a fund was affiliated with an investment banker, security dealer, broker, or similar person.<sup>36</sup> It is also worth noting that by this time, many of the problems involving conflicts of interest in the 1920s and the early 1930s had already disappeared.<sup>37</sup>

But while the ICA focused on the role of a fund board,<sup>38</sup> it did not address general board responsibilities. This absence suggests that Congress, assuming that funds would continue to be organized under state law as corporations or trusts, had decided to defer to the states to define how directors should govern.<sup>39</sup> In this respect, fund directors have the same responsibilities under state law as do operating company directors.<sup>40</sup>

The governance structure outlined in the ICA, especially its emphasis on independent director oversight, was well ahead of its time—and led to the early adoption of governance practices that only much more recently became prevalent in operating company boardrooms.

## II. A SECOND PHASE OF FUND GOVERNANCE: EXPLOSIVE GROWTH, THE 1970 AMENDMENTS, AND THE ECONOMICS OF FUND INVESTING

Recognizing that funds likely would continue to grow, Congress included a provision directing the SEC, “at such times as it deems that any substantial further increase in [the] size of investment companies creates any problem involving the protection of investors,” to study the effects of fund size and

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<sup>35</sup> *Id.* at 319–23 (summarizing Section 10, entitled “Affiliations of Directors,” Section 15, entitled “Investment Advisory and Underwriting Contractions,” and Section 17, entitled “Transactions of Certain Affiliated Persons and Underwriters,” of the ICA).

<sup>36</sup> *Id.* at 320.

<sup>37</sup> *See id.* at 319.

<sup>38</sup> The Act also required that a majority of the board’s independent directors (along with a majority of the board) approve the advisory contract, 15 U.S.C. § 80a-15(c) (2012), and the underwriting agreement, 15 U.S.C. § 80a-15(b) (2012). Further, the board was tasked with selecting and approving the fund’s outside accountant, 15 U.S.C. § 80a-31(a) (2012), and principal accounting officer, 15 U.S.C. § 80a-31(b) (2012), and with determining, in good faith, the fair value of portfolio securities for which market quotations are not readily available. 15 U.S.C. § 80a-2(a)(41)(B) (2012).

<sup>39</sup> State law imposes fiduciary responsibilities on directors, which are generally characterized as the duties of loyalty and care. The duty of loyalty requires directors to act in good faith and in the best interests of the fund, rather than in their private interests. The duty of care requires directors to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as directors.

<sup>40</sup> *See Lutz v. Boas*, 171 A.2d 381, 395 (Del. Ch. 1961).

report its findings and recommendations to Congress.<sup>41</sup> In just seventeen years, the number of U.S. registered open-end funds more than doubled, from sixty-eight at the end of 1940 to 143 at the end of 1957. The assets under management of these funds also grew substantially during this period, from about \$450 million to \$8.7 billion,<sup>42</sup> as did the number of shareholder accounts, from fewer than 300,000 to more than 3 million.<sup>43</sup> The industry and its regulatory framework had become ripe for further study.

Responding to the growth, in 1958 the SEC commissioned the Wharton School of Finance and Commerce to prepare a report on the effects of the growth on the industry.<sup>44</sup> In 1963, the SEC published *The Report of the Special Study of Securities Markets*, written by a quasi-independent group within the agency.<sup>45</sup> The findings of these two reports paved the way for the Commission's own report in 1966, *Public Policy Implications of Investment Company Growth*, which included legislative recommendations.<sup>46</sup>

These reports posited the view that funds were not competing with one another on the basis of their fees: as assets grew, fees did not reflect economies of scale—reductions in fund expenses per dollar of assets that are realized as a fund grows larger—and were higher than those for other types of advisory accounts. In addition, some contended that directors, in their review of fund fees, were not effective in looking out for shareholder interests.<sup>47</sup>

The reports formed the basis for important amendments to the ICA adopted by Congress in 1970. Three of the amendments—relating to director independence, approval of the advisory agreement, and regulation of management fees—would prove important in the further evolution of fund governance.

## A. Director Independence

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<sup>41</sup> 15 U.S.C. § 80a-14(b) (2012); *see also* WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, at 1 (1962) [hereinafter WHARTON REPORT] (explaining the scope of the study beyond the size of individual funds to include the fund industry generally and fund advisers).

<sup>42</sup> *See* INV. CO. INST., STATISTICAL WORKBOOK 1 (1986) [hereinafter ICI STATISTICAL WORKBOOK] (on file with the Investment Company Institute).

<sup>43</sup> *Id.*

<sup>44</sup> WHARTON REPORT, *supra* note 41, at III.

<sup>45</sup> *See generally* U.S. SEC. & EXCH. COMM'N, REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 88-95, p. 1–5 (1963).

<sup>46</sup> PUBLIC POLICY REPORT, *supra* note 2, at 2.

<sup>47</sup> *See* William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 184 (1971) (citing WHARTON REPORT, *supra* note 41, and PUBLIC POLICY REPORT, *supra* note 2).

Leading up to the 1970 Amendments, congressional hearings challenged independent directors' effectiveness as watchdogs over management. Independent directors are "generally uninformed on many matters which are basic to the efficient management of a mutual fund," one senator remarked.<sup>48</sup> "The testimony in our litigations shows the unaffiliated directors passive to the point of somnolence," a lawyer recounted, "while the advisory fees mounted year after year to figures of shocking magnitude."<sup>49</sup>

These hearings lent credence to the Wharton Report's suggestion that independent directors "may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser,"<sup>50</sup> and bolstered the Public Policy Report's finding that negotiations between a fund's unaffiliated directors and its adviser lacked "arm's length bargaining."<sup>51</sup>

Accordingly, congressional committee reports in both the House and the Senate concluded that the "unaffiliated" requirement for independent directors was not sufficient to provide the independent check on management that the ICA intended.<sup>52</sup> The existing requirement, for example, permitted independent directors to have economic or familial relationships with management.<sup>53</sup> Heeding this concern, Congress added the term "interested person" to the ICA to narrow the scope of directors who could be independent. Instead of just being unaffiliated, an independent director now had to be "disinterested"—that is, not an immediate family member of an affiliated person of the fund's adviser and having no beneficial interest in securities issued by the adviser or principal underwriter.<sup>54</sup>

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<sup>48</sup> *Investment Company Amendments Act of 1969: Hearings Before the Comm. on Banking and Currency on S. 34 and S. 296*, 91st Cong. 109–12 (1969) [hereinafter *Hearings on S. 34 and S. 296*] (excerpt of Senator Proxmire questioning Robert Augenblick, President of the Investment Company Institute, regarding the role of independent directors).

<sup>49</sup> *Id.* at 179 (remarks by Abraham L. Pomerantz of the New York Bar).

<sup>50</sup> PUBLIC POLICY REPORT, *supra* note 2, at 130.

<sup>51</sup> *Id.* at 131.

<sup>52</sup> Gerard H. Manges, *The Investment Company Amendments Act of 1970 – An Analysis and Appraisal After Two Years*, 14 B.C. INDUS. & COM. L. REV. 387, 388, 389 (1973) (citing INV. CO. INST., 1971 MUTUAL FUND FACT BOOK 3, 7 (1971)).

<sup>53</sup> Before Congress adopted the amendments, a director could be classified as "independent" and still own up to 4.99% of the adviser's or underwriter's stock, have substantial business or professional relationships with the adviser or underwriter, or be closely related by blood or marriage to the fund's adviser. *Id.* at 398.

<sup>54</sup> 15 U.S.C. § 80a-2(a)(19) (2012). Moreover, a "disinterested" director excludes anyone who served as legal counsel to the fund, the adviser, or the principal underwriter within the previous two years and anyone affiliated with a broker-dealer that has, within the

## B. Approval of the Advisory Agreement

Congress also felt that independent directors needed a stronger handle on the advisory agreements they approve on behalf of the fund. Amended Section 15(c) accordingly required a fund's directors to "request and evaluate," and the adviser to provide, "such information as may reasonably be necessary to evaluate the terms of any contract," so that the directors can make an informed decision on whether to approve it. The amendments further provided that, to "assure informed voting on matters [that] require action" from fund boards, directors must be present at a meeting at which their votes are taken.<sup>55</sup>

## C. Regulation of Management Fees

The original language in Section 36 of the ICA empowered the SEC to sue for injunctive relief in cases of "gross misconduct or gross abuse of trust" relating to adviser compensation. Yet the Commission was reluctant to sue advisers for excessive management fees, for fear of "stigmatiz[ing] advisers with charges of 'gross abuse of trust' solely because they had adhered to the traditional pattern of fee rates in the industry."<sup>56</sup> The Commission also might have been reluctant to sue because it deemed the ICA's only sanction for such an offense—an injunction against acting in an advisory capacity—too harsh.<sup>57</sup> In addition, without effective SEC enforcement of Section 36, shareholders' attempts to challenge management fees under state common law principles had to meet a "corporate waste" standard, under which only "unconscionable" or "shocking" fees are considered excessive.<sup>58</sup> To no one's surprise, these challenges saw little success.<sup>59</sup>

In the more than three years leading up to the 1970 Amendments, industry leaders and Congress fiercely debated how best to amend the restrictive "gross misconduct or abuse of trust" language. In 1967, lawmakers introduced bills incorporating an SEC-proposed "reasonableness" standard

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previous six months, executed portfolio transactions for, engaged in any principal transactions with, or distributed shares for the fund. *Id.*

<sup>55</sup> H.R. REP. NO. 91-1382, at 26 (1970).

<sup>56</sup> William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. REV. 1059, 1073 (1982) (quoting PUBLIC POLICY REPORT, *supra* note 2, at 143).

<sup>57</sup> Manges, *supra* note 52, at 394.

<sup>58</sup> Rogers & Benedict, *supra* note 56, at 1076, 1088.

<sup>59</sup> *Id.* at 1088–89.

for evaluating adviser compensation, including five factors for fund directors to consider:

- the nature and extent of the services provided;
- the quality of the services provided;
- the extent to which the adviser's compensation takes into account economies of scale;
- benefits other than compensation received in any fashion by the adviser; and
- any other relevant circumstances.<sup>60</sup>

The industry strongly opposed this approach, arguing that if the courts were to determine whether a management fee was reasonable, the ICA would become a ratemaking statute, and courts would be forced to substitute their own business judgment for that of the directors.<sup>61</sup> The final amendments, after much back and forth, shifted the standard from “reasonableness” to one of “fiduciary duty” imposed on an investment adviser (or an affiliate). The SEC contended that the change was “primarily procedural” and “not substantive,” because its intent was to shift the focus of any litigation from the directors to the adviser. The industry, however, found the change to be both procedural and substantive.

A second important change to Section 36 provided for a private right of action against an adviser for a breach of fiduciary duty in connection with the receipt of compensation. Under the amended section, plaintiffs can recover only “actual damages”—damages not exceeding compensation received by the defendants, and not for any compensation received more than one year before the action was filed. The burden of proof lies with the plaintiff, who must prove that the adviser breached its fiduciary duty—in sharp contrast with the general common law understanding, which typically requires the fiduciary to justify its conduct to prevail on the merits of a case.<sup>62</sup> Further, while the amended Section 36(b) imposes on investment advisers a fiduciary duty with respect to receipt of compensation, it fails to clarify or elaborate on the meaning of “fiduciary duty”—leaving interpretation of the term up to the courts. Congress limited this broad grant of judicial discretion, however, by requiring that courts defer to the business judgment of independent directors where “appropriate under all the circumstances.”<sup>63</sup>

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<sup>60</sup> *Id.* at 1109.

<sup>61</sup> *Hearings on S. 34 and S. 296, supra* note 48, at 100 (statement of the Investment Company Institute).

<sup>62</sup> *See* Nutt, *supra* note 47, at 196.

<sup>63</sup> 15 U.S.C. § 80a-35(b)(2) (2012).

#### D. Litigation Surrounding Management Fees

The new governance standards under the 1970 Amendments set the stage for lawsuits alleging that advisers were charging excessive fees. The rulings in these cases demonstrated substantial deference to the judgment of independent directors.

Perhaps the most important ruling came more than a decade after the amendments were passed. On December 3, 1982, the Second Circuit Court of Appeals dismissed charges against a Merrill Lynch fund in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, where the plaintiffs alleged that the management fees charged by Merrill Lynch to one of its funds were so excessive that receiving those fees constituted a breach of fiduciary duty under the ICA.<sup>64</sup>

Had the court sided with the plaintiffs, Merrill Lynch could have been required to return management fees of almost \$40 million. But the court held that a breach of fiduciary duty exists only when an adviser charges “a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”<sup>65</sup> The court also made important findings regarding the role of a fund board, affirming that independent directors are important advocates for fund shareholders, and that their efforts can influence management fees.

The ruling had an immeasurable impact on fund boards everywhere. According to the *Gartenberg* court, “the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager’s service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether . . . the adviser-manager [is] guilty of a breach of fiduciary duty . . . .”<sup>66</sup> In reiterating a Supreme Court characterization of independent directors as “watchdogs” for fund

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<sup>64</sup> *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 925 (2d Cir. 1982).

<sup>65</sup> *Id.* at 928. The *Gartenberg* opinion also articulated factors, based on the legislative history of the 1970 Amendments, for judicial review of board approval of fund advisory agreements. The *Gartenberg* factors also formed the basis for new disclosure requirements that the SEC adopted in 2004, requiring funds to disclose the material factors and the conclusions with respect to those factors that formed the basis for the board’s approval of advisory contracts. See Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 33-8433, Exchange Act Release No. 34-49909, Investment Company Act Release No. IC-26486, at n.31 (June 23, 2004) (codified at 17 C.F.R. pts. 239, 240, 374).

<sup>66</sup> *Gartenberg*, 694 F.2d at 930.

shareholders, the court went on to praise the fund board's review of "extensive relevant information."<sup>67</sup>

The court's confidence in the diligence and business judgment of fund directors—and its recognition that decisions reached in good faith by a board deserve judicial deference—became the lens through which judges would come to evaluate later cases involving allegations of excessive fees. This, in turn, led to more rigorous board oversight. Advisers generally supported the added scrutiny from boards, recognizing that an informed, thorough, and conscientious board, led by its independent directors, was not only likely to be a good steward for fund shareholders but also the best defense against an assault on management fees.

The premise of ineffective director oversight led, in part, to the 1970 Amendments, yet those amendments set the stage for judicial and regulatory pronouncements that emphasized and relied on the actions of independent directors considerably more. Far from being sidelined or having private litigants or the courts supersede their judgment, directors gained leverage, credibility, and prominence.

Court recognition of the value of directors has continued in a number of cases alleging excessive management fees<sup>68</sup>—most notably in March 2010, when the Supreme Court ruled in *Jones v. Harris* that the *Gartenberg* standard remains the appropriate measure for evaluating the merits of excessive-fee cases.<sup>69</sup> Citing its own precedent, the Court reasoned that "[u]nder the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the 'cornerstone of the . . . effort to control conflicts of interest within mutual funds.'"<sup>70</sup> The Court also stressed that

[W]here a board's process for negotiating and reviewing investment adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently.<sup>71</sup>

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<sup>67</sup> *Id.* at 933 (citing *Burks v. Lasker*, 441 U.S. 471, 484–85 (1979)).

<sup>68</sup> *See, e.g.*, *Krinsk v. Fund Asset Mgmt.*, 875 F.2d 404, 412 (2d Cir. 1989); *Kalish v. Franklin Advisors, Inc.*, 742 F. Supp. 1222, 1241 (S.D.N.Y. 1990); *Schuyt v. Rowe Price Prime Reserve Fund*, 663 F. Supp. 962, 977 (S.D.N.Y. 1987); *Pfeiffer v. Bjurman, Barry & Assocs.*, No. 03 Civ.9741DLC, 2004 WL 1903075, at \*4 (S.D.N.Y. Aug. 26, 2004).

<sup>69</sup> *Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 353 (2010).

<sup>70</sup> *Id.* at 348.

<sup>71</sup> *Id.* at 351.

The Court also emphasized that “[Section] 36(b) does not call for judicial second-guessing of informed board decisions.”<sup>72</sup>

Surprisingly, however, the Supreme Court’s decision in *Jones* did not quell the enthusiasm of the plaintiffs’ bar for filing “excessive fee” cases. Currently, there are nineteen cases pending—a veritable epidemic.<sup>73</sup> In part, this appears to be the result of lower courts’ failing to heed *Jones* at the earliest stages of litigation and refusing to grant defendants summary judgment. This has been troublesome for several reasons. First, it ignores the Supreme Court’s own observation in *Jones* that trials should be rare.<sup>74</sup> Second, courts have focused myopically on the *Gartenberg* “factors” in their early stage analysis of Section 36(b) cases, and have held actions to be plausible when the factors are invoked to hint at high fees. But after *Jones*, the issue is not whether any factor points to “excessiveness.” It is whether any factor (or other circumstance) points to *fees beyond the bargaining range*. The courts’ shorthand use of “excessiveness” has blurred the *Jones* test of whether fees “could *not* have been the product of arm’s-length bargaining.”<sup>75</sup> Finally, these lower courts appear to forget that *Jones* itself got to the Supreme Court after a grant of summary judgment to the investment adviser. And on remand from the Supreme Court, the Seventh Circuit *upheld* the grant of summary judgment by faithfully applying *Jones*.<sup>76</sup> The consequence of all three of these points is that plaintiffs appear to be unconcerned about early-stage dismissals and, therefore, have every incentive to sue and prolong litigation. While this reality creates a certain degree of economic uncertainty for the industry, it is particularly difficult for independent directors, whose business judgment and oversight come under assault each time an excessive fee claim is filed.

## E. The Economics of Fund Investing

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<sup>72</sup> *Id.* at 352.

<sup>73</sup> See ICI MUTUAL, CLAIMS TRENDS: A REVIEW OF CLAIMS ACTIVITY IN THE MUTUAL FUND INDUSTRY 2–3 (2016). Since the *Jones* decision, twenty-four Section 36(b) lawsuits, involving twenty-one fund groups, have been filed. *Id.* at 3.

<sup>74</sup> The Court said a plaintiff can get to trial *only* by showing great disparities in fees between separate clients that cannot be explained by different services “in addition to” other evidence that the challenged fee is outside the bargaining range. See *Jones v. Harris Assoc. L.P.*, 559 U.S. 335, 350 n.8 (emphasis supplied). Courts have simply not invoked that language—which clearly signaled skepticism about advancing cases to trial—on motions to dismiss or for summary judgment.

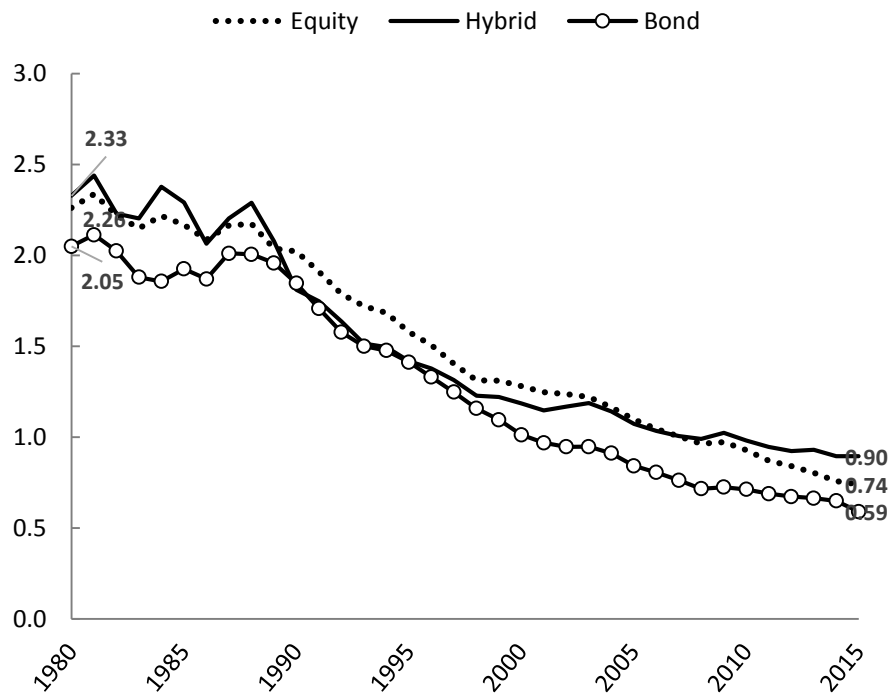
<sup>75</sup> *Jones*, 559 U.S. at 346 (emphasis supplied).

<sup>76</sup> *Jones v. Harris Assoc. L.P.*, 611 F. App’x 359 (7th Cir. 2015).



As noted above, the 1970 Amendments to the ICA reflected concerns about the cost of fund investing and the need for greater competition among funds based on cost. Evidence suggests that the statutory reforms were highly successful. In the years since, as the fund industry has grown and fund governance has evolved under the influence of this new framework, fund fees and expenses have fallen substantially. As the figure shows, the average total cost of investing in equity funds fell from 2.26% in 1980 to 0.74% in 2015; the average total cost of investing in hybrid funds fell from 2.33% in 1980 to 0.90% in 2015; and the average total cost of investing in bond funds fell from 2.05% in 1980 to 0.59% in 2015.

**Total Shareholder Costs Have Declined Substantially Since 1980**  
Percentage, 1980–2015



*Note: Total shareholder cost is measured as the dollar value of fees, expenses, and sales loads incurred during a given year by buyers of a fund in that year, expressed as a percentage of the amount invested in the fund. For a no-load fund, the expense ratio is the sole component of cost, since no sales load is incurred. For a load fund, the sales load must be included along with the expense ratio. Since the sales load is a one-*

*time payment, it cannot be directly added to the recurrent, annual expense ratio. Rather, it must be converted to the equivalent of annual payments spread over the period the investor holds the fund. The annualized or “annuitized” sales load, expressed as a percent of fund sales, can then be added to the expense ratio to calculate the total cost of investing for load fund purchasers.*

*Sources: Investment Company Institute, Lipper, Strategic Insight Simfund, and Federal Reserve Board.*

No doubt, numerous factors have contributed to these sharp declines. Competition, especially, has led fund advisers to reduce fund expenses to attract investors, who have shown a degree of sensitivity to the cost of investing in funds. The rise of low-cost index funds has also contributed significantly to this trend.

Certainly, however, board oversight has been another important factor. Independent directors engage in a rigorous annual review of advisory contracts. They review hundreds, even thousands, of pages of information about the adviser’s services and probe the appropriateness of the fee (emphasizing the *Gartenberg* factors). Many advisory contracts include breakpoints—often negotiated by directors with the fund adviser—which provide for the advisory fees to decline at selected levels of fund assets. These arrangements implement economies of scale, with the benefits passed to shareholders.

In addition to approving the adviser’s fees, directors approve fees paid by the fund to other service providers, such as the fund’s distributor and transfer agent. Directors evaluate whether the fees are reasonable in light of the services to be provided and oversee the ongoing performance of the providers.<sup>77</sup>

### III. A THIRD PHASE OF FUND GOVERNANCE: CONTROVERSY, SCANDAL, AND REFORM—AND THEIR LASTING EFFECTS

Years of tremendous growth following the 1970 Amendments cemented fund investing in the financial landscape—and sharpened the congressional and regulatory focus on the fund industry and its governance system, particularly the role of independent directors. By the mid-1990s, U.S. registered open-end fund assets under management had reached \$2.8

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<sup>77</sup> See generally INV. CO. INST., INDEP. DIRS. COUNCIL, BOARD OVERSIGHT OF CERTAIN SERVICE PROVIDERS (June 2007), available at <https://www.idc.org/pdf/21229.pdf>.

trillion,<sup>78</sup> more than sixty times the amount when the 1970 Amendments were passed.<sup>79</sup> Meanwhile, under successive chairs, the SEC was devoting more attention to the role of independent directors.<sup>80</sup>

Against this backdrop of growth and regulatory scrutiny, a third phase of fund governance unfolded. Over the next ten years, the industry grappled with controversy surrounding proxy battles, major scandals involving market timing and late trading, and a series of substantive reforms in response—each leaving an indelible imprint on the fund governance landscape.

### A. The Yacktman Proxy Battle

In the late 1990s, in at least three circumstances, disputes arose between independent directors and advisers that led to proxy battles and shareholder redemptions. The Yacktman proxy battle illustrated the complex dynamics of fund governance when a fund's independent directors and its adviser come to loggerheads.<sup>81</sup> For more than two years, the Yacktman directors had

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<sup>78</sup> 2016 FACT BOOK, *supra* note 3, at 172.

<sup>79</sup> See ICI STATISTICAL WORKBOOK, *supra* note 42, at 76.

<sup>80</sup> SEC Chairman Richard C. Breeden requested Commission staff to conduct a broad study of the regulatory system under the ICA, and the resulting report included a chapter with recommendations for enhancing fund governance. The chapter recommended, among other things, “legislation that would increase the minimum proportion of independent directors on investment company boards from 40 percent to more than 50 percent,” that “independent director vacancies be filled by persons chosen by remaining independent directors,” and that “independent directors be given the express authority to terminate advisory contracts.” U.S. SEC. & EXCH. COMM’N, DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 253–54 (1992) [hereinafter 1992 REPORT]. Breeden’s successor, Arthur Levitt, emphasized the importance of independent directors in several speeches. See *e.g.*, Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm’n, Remarks at the Mutual Fund Directors Education Council Conference (Feb. 17, 2000), available at <http://www.sec.gov/news/speech/spch346.htm> (calling directors “crucial” and “investors’ first line of defense against abuses”); Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm’n, Remarks at the General Membership Meeting of the Investment Company Institute (May 15, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch212.txt> (advising that directors “may be called upon to take significant action in their companies at some point”); Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm’n, Remarks at the General Membership Meeting of the Investment Company Institute: The SEC and the Mutual Fund Industry: An Enlightened Partnership” (May 19, 1995), available at <http://www.sec.gov/news/speech/speecharchive/1995/spch042.txt> (urging directors to be “tireless in the pursuit of shareholder interests”).

<sup>81</sup> Similar disputes took place between independent directors and the funds’ advisers at the Navellier Funds and Fundamental Funds. The Navellier directors had decided against renewing an advisory contract with the adviser after a dispute over a proposed fund merger. Navellier refused to provide the independent directors with information in

discussed with the adviser their concern that the funds' public disclosures did not align with how the funds were actually being managed. During this period, the number of independent directors came to constitute a majority of the board, a development that the adviser did not welcome.

On September 15, 1998, the adviser wrote an extraordinary letter to the independent directors.<sup>82</sup> If the directors did not resign promptly, the letter warned, they could expect a proxy solicitation asking shareholders to replace them en masse. The letter also threatened personal financial ruin and a lawsuit, stressing that the insurance policy, jointly held between the adviser and the funds, would not cover claims between the adviser and the directors.<sup>83</sup> After extensive deliberations, the directors concluded that their fiduciary duties to fund shareholders precluded any thought of resigning.

The adviser filed its preliminary proxy statement on September 18.<sup>84</sup> The directors retained counsel—and on October 20, filed their own proxy statement.<sup>85</sup> The directors' statement was not to oust the adviser, but to alert shareholders of their concerns and to defend themselves against the adviser's

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connection with the proposal, which led the independent directors to refuse to approve the merger, vote against renewing Navellier's advisory contract, and hire a new adviser. A shareholder vote of the new adviser was not successful, however, and Navellier remained the adviser, while the directors resigned. *Navellier v. Sletten*, 262 F.3d 923, 933 (9th Cir. 2001). During the proxy battle, shareholders withdrew seventy-five percent of the funds' assets. NAVELLIER & ASSOCS., NAVELLIER PERFORMANCE FUNDS ANNUAL REPORT, December 31, 1998 (Form N-30D), 20 and 33 (Mar. 3, 1999). The Fundamental directors had recommended that a new adviser replace Fundamental after an SEC enforcement action had been brought against the firm. The board filed a proxy statement seeking shareholder approval of the new adviser, while Fundamental filed its own proxy statement asking shareholders to reject the new adviser and to replace the independent directors. Although shareholders voted for the new adviser, many also voted with their feet—and left the funds. See David A. Sturms, *Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working*, 1 VILL. J. L. & INV. MGMT. 106–11 n.19 (1999); Edward Wyatt, *Empty Suits in the Board Room; Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung*, N.Y. TIMES (June 7, 1998), <http://www.nytimes.com/1998/06/07/business/empty-suits-board-room-under-fire-mutual-fund-directors-seem-increasingly.html?pagewanted=all>.

<sup>82</sup> See The Yacktman Funds, Inc., Information Required in Proxy Statement, Schedule 14A Information (Form DEFA14A) (Sept. 29, 1998) (includes September 25, 1998, letter from Yacktman independent directors to SEC Chairman Arthur Levitt, attaching September 15, 1998, letter from Yacktman to the independent directors).

<sup>83</sup> The September 15 letter from Yacktman to the independent directors asserted: "We are prepared to immediately pursue all legal remedies at our disposal. You should be aware that any resulting litigation would not be covered by the Funds' D&O insurance." *Id.*

<sup>84</sup> The Yacktman Funds, Inc., Preliminary Proxy Materials, Schedule 14A (Form PREN14A) (Sept. 18, 1998).

<sup>85</sup> The Yacktman Funds, Inc., Information Required in Proxy Statement, Schedule 14A Information (Form DEFA14A) (Oct. 20, 1998).

allegations. The intense five-week battle ended on November 24, when 51.2% of Yacktman shareholders voted in favor of the adviser, thus ousting the independent directors.<sup>86</sup> During those five weeks, however, the funds lost two-thirds of their assets—shareholders had decisively voted with their feet.<sup>87</sup>

The proxy battles highlighted two facts. First, when an adviser and a board do not collaborate, everyone loses. There is every incentive on all sides—business, personal, professional, and fiduciary—to ensure that the fund boardroom remains a respectful, professional forum to discuss matters that could affect fund shareholders. Second, independent directors are not well positioned to withstand a determined challenge from a fund adviser. The adversarial model of oversight that some had commended to independent directors could be unavailing insofar as it assumed shareholder support for independent directors' actions.

## B. Governance Reforms from the SEC and Congress

In the wake of the proxy battles, the SEC organized a Roundtable on the Role of Independent Investment Company Directors in February 1999, to “discuss the increasingly important role that independent directors play in protecting fund investors, and precisely how their effectiveness may be enhanced.”<sup>88</sup> The roundtable focused on three questions: First, are independent directors really effective? Second, can they really act as a check on management? Third, are they serving shareholders' interests above all else? The roundtable aimed to highlight “ideas and approaches that can lead to enhancing effectiveness of independent directors in advocating and protecting the interests of fund shareholders.”<sup>89</sup>

The SEC and the industry shared a desire to enhance fund governance. Shortly after the roundtable, the Investment Company Institute (“ICI”) created an Advisory Group on Best Practices for Fund Directors, made up of

<sup>86</sup> See Sturms, *supra* note 81, at 103, 111.

<sup>87</sup> *Id.*

<sup>88</sup> U.S. SEC. & EXCH. COMM'N, THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS (1999), *available at* <http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm> and <http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm> (providing transcripts from roundtable of independent directors, investor advocates, executives of mutual fund advisers, academicians, corporate governance experts, and legal counsel).

<sup>89</sup> *Id.*

fund executives and independent directors.<sup>90</sup> The Advisory Group aimed to “identify the best practices used by fund boards to enhance the independence and effectiveness of investment company directors, and to recommend those practices that should be considered for adoption by all fund boards.”<sup>91</sup> In June 1999, the Advisory Group published *Enhancing a Culture of Independence and Effectiveness*, a report outlining fifteen best practices for independent directors.<sup>92</sup> The recent proxy battles helped shape the Advisory Group’s recommendations, which were designed to enhance directors’ independence and effectiveness. The Advisory Group recommended, among other things, that:

- “at least two-thirds of the directors of all investment companies be independent directors;”
- “independent directors be selected and nominated by the incumbent independent directors;”
- “independent directors have qualified investment company counsel who is independent from the investment adviser and the fund’s other service providers;”
- “independent directors meet separately from management in connection with their consideration of the fund’s advisory and underwriting contracts and otherwise as they deem appropriate;”
- “fund boards obtain directors’ and officers’ errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors;” and
- “independent directors designate one or more ‘lead’ independent directors.”<sup>93</sup>

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<sup>90</sup> *Investment Company Institute Appoints Industry Group to Consider Best Practices for Fund Directors*, INV. CO. INST. (Mar. 22, 1999), [https://www.ici.org/pressroom/news/ci.news\\_99\\_best\\_practices\\_group.print](https://www.ici.org/pressroom/news/ci.news_99_best_practices_group.print).

<sup>91</sup> INV. CO. INST., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS: ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS i–ii (1999) [hereinafter ADVISORY GROUP REPORT].

<sup>92</sup> *Id.* ICI’s Board of Governors unanimously adopted a resolution recommending that all ICI management investment company members take such actions as may be appropriate to implement the practices recommended in the report. See INV. CO. INST., RESOLUTION OF THE BOARD OF GOVERNORS OF THE INVESTMENT COMPANY INSTITUTE (1999), *available at* [https://www.ici.org/policy/governance/directors/99\\_SEC\\_FUND\\_GOV\\_BEST\\_STMT](https://www.ici.org/policy/governance/directors/99_SEC_FUND_GOV_BEST_STMT).

<sup>93</sup> ADVISORY GROUP REPORT, *supra* note 91, at iii–vi. In 2003, ICI published an additional two best practices, bringing its published total to seventeen recommended best practices. See INV. CO. INST., RESOLUTION OF THE BOARD OF GOVERNORS OF THE INVESTMENT COMPANY INSTITUTE (2003), *available at*

Building on its roundtable and ICI's Advisory Group Report, the SEC adopted a sweeping set of regulatory reforms on January 2, 2001, "designed to reaffirm the important role that independent directors play in protecting fund investors, strengthen their hand in dealing with fund management, [and] reinforce their independence . . . ."<sup>94</sup> The new governance standards required that:

- fund boards have a majority of independent directors. According to the SEC, this would permit "independent directors to control the fund's 'corporate machinery,' i.e., to elect officers of the fund, call meetings, solicit proxies, and take other actions without the consent of the adviser."<sup>95</sup>
- incumbent independent directors select and nominate new independent directors. In framing this requirement, Chairman Levitt asked: "If the primary role of independent directors is to protect . . . shareholder interest[s] and act as a check on management, wouldn't self-nominating independent directors be more effective . . . ?"<sup>96</sup>
- any legal counsel for the fund's independent directors be an "independent legal counsel." It is "critical," said the SEC, for independent directors to be "represented by persons who are free of significant conflicts of interest that might affect their legal advice."<sup>97</sup>
- any insurance policy shared by the adviser and its funds not exclude coverage for litigation between the adviser and the funds' independent directors.

The governance standards were written as conditions to a fund's ability to rely on any one of ten exemptive rules under the ICA—rules that most funds rely on to operate.<sup>98</sup> The ICA itself was not amended, so the reforms—not requiring congressional action—took effect almost immediately.<sup>99</sup>

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[http://www.ici.org/policy/governance/corporate/03\\_fund\\_gov\\_best\\_stmt](http://www.ici.org/policy/governance/corporate/03_fund_gov_best_stmt)  
(recommending two new governance standards).

<sup>94</sup> Role of Independent Directors of Investment Companies, Securities Act Release No. 33-7932, Exchange Act Release No. 34-43786, Investment Company Act Release No. IC-24816, Fed. Sec. L. Rep. (CCH) ¶ 86,411 (Jan. 2, 2001) [hereinafter 2001 Release] (codified at 17 C.F.R. pts. 239, 240, 270, 274).

<sup>95</sup> *Id.*

<sup>96</sup> Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, Address at the Mutual Funds and Investment Management Conference: Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds (Mar. 22, 1999), <http://www.sec.gov/news/speech/speecharchive/1999/spch259.htm>.

<sup>97</sup> 2001 Release, *supra* note 94.

<sup>98</sup> The exemptive rules are: 17 C.F.R. § 270.10f-3 (2009) (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); 17 C.F.R. § 270.12b-1 (2013) (permitting use of fund assets to pay distribution expenses); 17 C.F.R. § 270.15a-4(b)(2) (2006) (permitting fund boards to

Meanwhile, U.S. public operating companies were seeing controversy and reform of their own. In response to several high-profile corporate and accounting scandals, including at Enron and WorldCom, Congress enacted the Sarbanes-Oxley Act of 2002, ushering in (directly or by instigating changes to listing standards) major governance reforms for public operating companies. Many of these reforms, which resulted in governance practices that funds already had been following for years, included the following changes:

- boards must be composed of a majority of independent directors;<sup>100</sup>
- stricter requirements associated with qualifying as an “independent” director (not only are current officers and employees of a company precluded from serving as independent directors of that company, but an independent director cannot have been an employee or officer during the past three years nor can the director have a close relative who is employed by the company);<sup>101</sup>
- key board committees, like the audit committee, can consist of only independent directors;<sup>102</sup> and
- boards must have regular executive sessions of independent directors.<sup>103</sup>

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approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); 17 C.F.R. § 270.17a-7 (2006) (permitting securities transactions between a fund and another client of the fund’s adviser); 17 C.F.R. § 270.17a-8 (2006) (permitting mergers between certain affiliated funds); 17 C.F.R.17d-1(d)(7) (2013) (permitting funds and their affiliates to purchase joint liability insurance policies); 17 C.F.R. § 270.17e-1 (2006) (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); 17 C.F.R. § 270.17g-1(j) (2006) (permitting funds to maintain joint insured bonds); 17 C.F.R. § 270.18f-3 (2014) (permitting funds to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors).

<sup>99</sup> The SEC staff had previously recommended a legislative change to increase the minimum proportion of independent directors from forty percent to more than fifty percent, *see* 1992 REPORT, *supra* note 80, at 253, but the 2001 reforms implemented this change by making the standard a condition of the exemptive rules. The SEC staff also had recommended in the 1992 Report that independent director vacancies be filled by persons chosen by the remaining independent directors. 1992 REPORT, *supra* note 80, at 253–54.

<sup>100</sup> *See* N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.01 (2009) (Independent Directors).

<sup>101</sup> N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.02 (2012) (Audit Committee).

<sup>102</sup> *See* N.Y. STOCK EXCH. LISTED CO. MANUAL § 303A.04(a) (2013) (Nominating/Corporate Governance Committee); § 303A.05(a) (Compensation Committee); § 303A.06 (Audit Committee); § 303A.07(b) (Audit Committee Additional Requirements).

<sup>103</sup> *See* N.Y. STOCK EXCHANGE LISTED CO. MANUAL § 303A.03 (2009) (Executive Sessions).



### C. Market-Timing and Late-Trading Scandals

Barely a year after Congress enacted the Sarbanes-Oxley Act, the exposure of improper practices in various funds and intermediaries triggered public concerns and a regulatory response unlike anything the fund industry had seen since the 1930s. On September 3, 2003, New York Attorney General Eliot Spitzer announced that the state had settled a claim against Canary Capital Partners and related entities for allegedly using market-timing and late-trading strategies to improperly trade fund shares. Spitzer alleged that Canary obtained special trading opportunities from some fund families, enabling it to time the market and trade fund shares after trading had closed for the day.<sup>104</sup> He opined that a fund group that permits market timing, which is illegal only if in contravention to its public disclosures and internal policies, is “like a casino saying that it prohibits loaded dice, but then allowing favored gamblers to use [them].”<sup>105</sup> He went on to accuse fund groups of enabling favored clients to buy fund shares *after* the market closed (at 4 p.m. Eastern Standard Time) at a net asset value determined *when* the market closed. This, he alleged, allowed the favored clients to trade having knowledge of post-closing events that were not reflected in the fund’s closing price. Canary, which did not admit or deny wrongdoing in the settlement, agreed to pay \$40 million in fines and restitution.

The day after Spitzer announced the settlement, the SEC launched its own investigation—and then-SEC Chair William Donaldson wrote ICI urging its members to “promptly seek assurances from their selling broker-dealers and other intermediaries that they are following all relevant rules and regulations, as well as internal policies and procedures, regarding the handling of mutual fund orders on a timely basis.”<sup>106</sup> Chairman Donaldson also led the SEC in exploring regulatory actions to prevent late trading and curb

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<sup>104</sup> Complaint at 6–7, *New York v. Canary Capital Partners, LLC*, 2003 WL 25691660 (N.Y. Sup. Ct. Sept. 3, 2003) (No. 2003-402830).

<sup>105</sup> Press Release, Office of the N.Y. State Attorney Gen., *State Investigation Reveals Mutual Fund Fraud* (Sept. 3, 2003) (on file with author).

<sup>106</sup> See Letter from William Donaldson, Chairman, U.S. Sec. & Exch. Comm’n, to Matthew Fink, President, Inv. Co. Inst. (Sept. 4, 2003), *available at* <http://www.ici.org/pdf/16505.pdf>.

market-timing abuses.<sup>107</sup> The SEC's investigation led to enforcement actions against fund advisers<sup>108</sup> and several regulatory initiatives.<sup>109</sup>

Congress also took action to address the trading abuses. Early in November 2003, the Senate Committee on Banking, Housing, and Urban Affairs, the House Committee on Financial Services, and the Senate Committee on Governmental Affairs began holding a series of hearings to re-examine mutual fund management and governance—and, more specifically, to prevent the abuses from recurring, and to better protect fund shareholders. Congress focused not only on general industry reform but also on fund governance, as Spitzer urged in congressional testimony.

During the hearings, Spitzer testified that fund directors had failed to protect shareholder interests by permitting market timing and late trading, and urged Congress to adopt reforms requiring “truly independent” boards and an independent chairman.<sup>110</sup> By the time the hearings had concluded in late November, two perceptions had hardened: first, that the SEC should have been aware of the problems; and second, that independent directors might have caught the abuses earlier had they been more alert.

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<sup>107</sup> Press Release, U.S. Sec. & Exch. Comm'n, SEC Chairman Donaldson Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds (Oct. 9, 2003), available at <http://www.sec.gov/news/press/2003-136.htm>.

<sup>108</sup> See e.g., Pilgrim Baxter & Assocs., Ltd., Securities Act Release No. 26470, 2004 WL 1379874 (June 21, 2004); Mass. Fin. Servs. Co. et al., Securities Act Release No. 26347, 2004 WL 226714 (Feb. 5, 2004); Alliance Capital Mgmt., L.P., Securities Act Release No. 26312, 2003 WL 22988724 (Dec. 18, 2003).

<sup>109</sup> See e.g., Mutual Fund Redemption Fees, Securities Act Release No. 26782, Investment Company Act Release No. IC-26782 (Mar. 11, 2005) (codified at 17 C.F.R. pt. 270) (requiring fund directors to determine whether redemption fees are necessary and appropriate for the funds they oversee and funds to enter into contracts with intermediaries concerning shareholder identity and transaction information); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 33-8408, Investment Company Act Release No. 26418 (Apr. 16, 2004) (codified at 17 C.F.R. pt. 239, 274) (requiring open-end funds to disclose in their prospectuses both the risks to shareholders of frequent purchases and redemptions of fund shares and the fund's policies and procedures with respect to such frequent purchases and redemptions).

<sup>110</sup> See *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 108th Cong. 143 (2003) (testimony of Eliot Spitzer, Att'y Gen. of New York); *Mutual Funds: Who's Looking Out for Investors?: Hearing Before the H. Comm. on Fin. Servs.*, 108th Cong. 15–17 (2003) (testimony of Eliot Spitzer, Att'y Gen. of New York); *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the S. Subcomm. on Fin. Mgmt., the Budget, & Int'l Sec. of the S. Comm. on Governmental Affairs*, 108th Cong. 17–19 (2003) (testimony of Eliot Spitzer, Att'y Gen. of New York).

#### D. The SEC's Fund Compliance Program Rule

To address these perceptions, the SEC adopted a compliance program rule for funds at the end of 2003 “designed to foster, among other things, improved compliance by clarifying the compliance obligations of fund management and to strengthen the hand of fund boards and compliance personnel when dealing with them.”<sup>111</sup> Rule 38a-1 of the ICA established several key focus areas for compliance personnel and required that boards oversee the adoption of funds’ formal compliance programs.<sup>112</sup> Proving even more important was a requirement that funds have a chief compliance officer, or CCO.

The CCO has “overall compliance responsibility for the fund [and must] answer directly to the board.”<sup>113</sup> The board must approve the appointment, compensation, and removal of the CCO and meet with the CCO in executive session at least once a year.<sup>114</sup> According to the SEC, “compliance failures have occurred when a fund service provider has denied information to the fund’s board, or has been less than forthright, because the service provider viewed full disclosure as detrimental to its own interests.”<sup>115</sup> The CCO was to

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<sup>111</sup> Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. IA-2204, Investment Company Act Release No. IC-26299 (Dec. 17, 2003) (codified at 17 C.F.R. pts. 270, 275) [hereinafter Compliance Rule Release]. At the same time, the SEC adopted a compliance program rule for investment advisers. *See id.*

<sup>112</sup> In *The Rise of Mutual Funds: An Insider's View*, former ICI President and CEO Matthew Fink notes that the Investment Company Institute submitted its own compliance proposal to the Commission about a decade earlier, after SEC Chair Arthur Levitt had renewed the issue of self-regulation for mutual funds. *See* MATTHEW P. FINK, *THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW* 192–93 (2008); *see also* Letter from Matthew P. Fink, President, Inv. Co. Inst., to Arthur Levitt, Chair, U.S. Sec. & Exch. Comm’n (Nov. 23, 1994) (on file with the Investment Company Institute) (proposing a rule that would have required funds to establish internal compliance systems that meet certain minimum requirements). The proposal called for “requiring each fund to have compliance standards and procedures and a senior compliance officer reporting to the fund’s independent directors and board.” *Id.* The SEC did not act on the proposal and only adopted compliance requirements for mutual funds after the market-timing and late-trading abuses were revealed. Fink went on to write that he has “often wondered whether adoption of these requirements in the mid-1990s, as urged by the Institute, might have prevented the fund trading abuses.” *Id.*

<sup>113</sup> Compliance Rule Release, *supra* note 111.

<sup>114</sup> 17 C.F.R. § 270.38a-1(a)(4)(i)–(ii) (2016).

<sup>115</sup> Compliance Rule Release, *supra* note 111.

be the “eyes and ears” of the board<sup>116</sup>—to assure that boards were no longer kept in the dark—and “the newest tool available to fund directors is a ‘hammer’” that directors were “strongly encouraged” to use.<sup>117</sup>

The boards of the funds implicated in the market-timing and late-trading scandals certainly did not cause, and reasonably had no awareness of, such abuses. Still, many people, including some members of Congress, concluded that the independent directors of the funds had failed their respective shareholders.<sup>118</sup> The SEC did not join the chorus explicitly, but admonitions from high-ranking SEC officials following the adoption of the fund compliance rule added credence to the notion that directors had not been sufficiently independent or proactive. In late 2004, for example, the head of the SEC’s Division of Enforcement warned the industry:

You can . . . expect to see, over the next year, a continued focus on whether independent directors have lived up to their role as guardians of the interests of the shareholders they serve. . . . [W]e have been looking very closely at fund directors. Were directors aware, or should they have been aware, of the abusive practices [perpetrated by some]? If there were red flags, did the directors follow up? Did they

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<sup>116</sup> Paul F. Roye, Director, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Speech at the Fourth Annual Policy Conference: Critical Issues for Investment Company Directors (Jan. 8, 2004).

<sup>117</sup> *Id.*

<sup>118</sup> During a Senate hearing, Congressman Richard H. Baker expressed his lack of confidence in independent directors’ commitment to protecting investors rather than their funds’ advisers. “Investors need to be assured that the fund’s board chairman is looking out for *them*,” he said, “and not themselves or the management company.” *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int’l Sec. of the S. Comm. on Governmental Affairs*, 108th Cong. 8 (2003) (statement of Rep. Richard H. Baker, Chairman, Capital Mkts. Subcomm. of the H. Fin. Servs. Comm.). Barbara Roper, Director of Investment Protection, Consumer Federation of America, expressed a similar view in testimony before the Senate Committee on Banking, Housing, and Urban Affairs. She stated that

The mutual fund scandals helped to shine new light on the failure of all too many mutual fund boards to provide effective oversight of fund managers on behalf of fund shareholders. . . . Given the primary role of the board in policing conflicts of interest and negotiating the management contract, we believe it is essential that funds be chaired and dominated by individuals whose loyalty is exclusively to shareholders.

*Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. 11 (2004) (statement of Barbara Roper, Director of Investor Protection, Consumer Federation of America).

question practices that could harm fund investors or did they passively acquiesce to those practices?<sup>119</sup>

The SEC did not bring enforcement action against any independent fund director in connection with the scandals. Yet, its public statements left a distinct impression—one keenly felt by independent directors themselves—that boards could have and should have done more to prevent the abuses that led to them.

### E. The SEC's 2004 Governance Reforms

In 2004, the SEC adopted new governance standards to supplement its 2001 reforms. In doing so, the SEC explained that

To be truly effective, a fund board must be an independent force in fund affairs rather than a passive affiliate of management. Its independent directors must bring to the boardroom “a high degree of rigor and skeptical objectivity to the evaluation of management and its plans and proposals,” particularly when evaluating conflicts of interest. They must commit their time and energy, and devote themselves to the principles set forth in the Investment Company Act and state corporate and trust law under which the fund is organized.<sup>120</sup>

To further ensure that independent directors acted with necessary rigor, the SEC's newest governance initiatives required that:

- at least seventy-five percent of the directors of a fund be independent;<sup>121</sup>
- the chairman of the board be independent;
- the board perform an annual self-assessment;
- the independent directors meet in executive sessions at least once a quarter; and

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<sup>119</sup> Stephen M. Cutler, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks at the 2004 ICI Securities Law Developments Conference: Minding Your Ps: Preventing Another Crisis in the Mutual Fund Industry (Dec. 6, 2004).

<sup>120</sup> Investment Company Governance, Investment Company Act Release No. IC-26520, 83, SEC Docket 1384 (July 27, 2004) (codified at 17 C.F.R. pt. 270) (quoting Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 798 (2001)).

<sup>121</sup> With its proposal to require that seventy-five percent of a fund board's membership be independent, the SEC expanded on its position that fund boards should retain a simple majority membership, which it advanced when the ICA was being drafted and as a regulatory requirement much later.

- the independent directors be explicitly authorized to hire their own staff.<sup>122</sup>

While many boards already had adopted some of these practices, many also opposed making the first two practices mandatory, on the grounds that fund boards should have the discretion to determine their composition and operations. Arguing that the SEC had promulgated the rule without a rigorous review of the costs associated and any available alternatives, the U.S. Chamber of Commerce challenged the two requirements—and in April 2006, the U.S. Court of Appeals for the District of Columbia vacated them.<sup>123</sup>

#### F. Reverberations of the Governance Reforms in Today's Boardroom

The cumulative impact of the SEC's 2001 and 2004 fund governance reforms—as well as the governance reforms established in the Sarbanes-Oxley Act—has been quite significant. They have promoted the independence, objectivity, and professionalism of the board as a mechanism for oversight of fund operations. They also have helped ensure sustained, ongoing attention to questions of “good governance” by fund boards themselves. This is evident in the growth of voluntary practices.

Today, for example:

- eighty-three percent of fund complexes have boards made up of at least seventy-five percent independent directors;
- nearly two-thirds of fund complexes have an independent board chair;
- more than nine in ten fund complexes have independent legal counsel; and
- more than eight in ten fund complexes are overseen by a unitary board.<sup>124</sup>

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<sup>122</sup> *Id.* Like the 2001 governance reforms, the 2004 governance standards were made conditions to reliance on the ten exemptive rules.

<sup>123</sup> *See* Chamber of Commerce v. Sec. & Exch. Comm'n, 443 F.3d 890, 904–05 (D.C. Cir. 2006) (finding fault with the SEC's “bare request for information on costs” and its reliance on extra-record material critical to its cost estimates without affording opportunity for public comment); *see also* Investment Company Governance, Investment Company Act Release No. 27395 (June 13, 2006) (codified at 17 C.F.R. pt. 270) (seeking additional public comment on governance reforms, particularly their costs); Investment Company Governance, Investment Company Act Release No. 27600 (Dec. 15, 2006) (codified at 17 C.F.R. pt. 270) (seeking additional public comment on two papers prepared by the Office of Economic Analysis on the topic of seventy five percent independent director composition and independent chair requirements).

<sup>124</sup> INDEP. DIRS. COUNCIL & INV. CO. INST., OVERVIEW OF FUND GOVERNANCE PRACTICES, 1994–2014, at 1, 5, available at [https://www.ici.org/pdf/pub\\_15\\_fund\\_governance.pdf](https://www.ici.org/pdf/pub_15_fund_governance.pdf).

But the evolution of fund governance has not quelled all the effects of the scandals. Intense regulatory scrutiny continues to shape the governance landscape. In 2009, the SEC's Division of Enforcement announced a national Asset Management Unit, focused in part on funds and advisers.<sup>125</sup> Robert Khuzami, the division's director at the time, said that he "expected [the initiative] to result in examinations and investigations of investment advisers and [funds'] boards of directors concerning duties under the Investment Company Act."<sup>126</sup> With the help of the Asset Management Unit, the SEC has since settled several cases involving independent directors.<sup>127</sup>

The substance and number of those cases show that the independent director community faces higher expectations, lower tolerance thresholds, and narrower scope for business judgment from regulators than ever before. Until recently, the SEC had typically brought enforcement action against boards only in cases where the directors were alleged to be complicit in

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<sup>125</sup> See Robert Khuzami, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), available at <https://www.sec.gov/news/speech/2009/spch080509rk.htm>.

<sup>126</sup> See *Investigating and Prosecuting Financial Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. 54 (2010) (statement of Robert S. Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm.).

<sup>127</sup> For example, in December 2012, the SEC accused the independent directors of Morgan Keegan Funds (by then defunct) of "abdicating" their responsibilities to appropriately value certain subprime assets held by the funds. Curiously, the case involved the same set of facts from two years before, in a settlement with the funds' adviser in which the SEC alleged that the adviser had defrauded the board by failing "to disclose to the Funds' boards that [the adviser was] not complying with stated valuation procedures." The settlement with the directors did not allege that the valuations caused a material misstatement of the funds' net asset value. No monetary or other sanctions were imposed on the directors. See Morgan Keegan Asset Mgmt., Inc., Exchange Act Release No. 64720 (June 22, 2011) (administrative proceeding in which the SEC accepted an offer of settlement from Morgan Keegan Asset Management, Inc.); see also Alderman, Investment Company Act Release No. 30557 (June 13, 2013) (administrative proceeding in which the SEC accepted an offer of settlement from the independent directors). Several months later, the SEC accused the directors of Northern Lights Funds of causing the funds to make untrue or misleading public disclosures regarding its review and approval of advisory agreements. The case alleged that board meeting minutes, which formed the basis of the disclosures, were incorrect, and that since the directors approved the minutes, they had caused the incorrect disclosures. See N. Lights Compliance Servs., LLC, Investment Company Act Release No. 30502 (May 2, 2013) (administrative proceeding in which the SEC accepted an offer of settlement from the independent trustees, among others). The Asset Management Unit's focus on management fees also produced enforcement actions for failures in the Section 15(c) process: one action that charged the trustees as well as the adviser and fund administrator, see Commonwealth Capital Mgmt., LLC, Investment Company Act Release No. 31678 (June 17, 2015), and another that charged the adviser and chief compliance officer. See Kornitzer Capital Mgmt., Inc., Investment Company Act Release No. 31560 (Apr. 21, 2015).

fraud.<sup>128</sup> But now, it is using a rule initially heralded as a “tool” for directors—the fund compliance program rule—as a hammer against them,<sup>129</sup> precisely what the industry had cautioned against.<sup>130</sup> And because almost any problem can have roots in compliance failures, for those who wonder where director liability may exist, it is worrisome that the answer could be “anywhere.”

#### IV. LOOKING AHEAD

In each successive phase of fund governance, as outlined above, funds and fund investing have grown and become more central to the financial system and the economy. Increased regulatory and public scrutiny was sure to follow—and so it did. With the growth showing no signs of abating, today’s intense regulatory focus should come as no surprise.

What is surprising—and quite troubling—is the growing number of regulatory bodies vying to join the ranks of the industry’s primary regulators, including the SEC. How these new entrants involve themselves in the industry—and how the SEC reacts to them—could shape fund governance for decades to come.

The U.S. Financial Stability Oversight Council (“FSOC”)—established in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010—has been tasked with determining whether non-bank financial firms could pose outsized risks to the financial system, and thus should be designated as systemically important financial institutions (“SIFIs”). Designated firms would fall subject to “enhanced prudential supervision” from the Federal Reserve Board. If FSOC designates any funds or their advisers—a real

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<sup>128</sup> See Jean Eaglesham & Kirsten Grind, *Former Morgan Keegan Directors to Settle with SEC*, WALL ST. J. (Mar. 28, 2013), <http://www.wsj.com/articles/SB10001424127887323501004578388820199059716>.

<sup>129</sup> In both the Morgan Keegan and Northern Lights settlements, the directors were charged with allegedly causing the funds’ violation of Rule 38a-1 under the ICA. See Morgan Keegan Asset Mgmt., Inc., Exchange Act Release No. 64720 (June 22, 2011); N. Lights Compliance Servs., LLC, Investment Company Act Release No. 30502 (May 2, 2013).

<sup>130</sup> In its comments on the compliance program rule proposal, ICI expressed concern that any violation of law by a fund or its service providers could be deemed either a de facto violation of the compliance rule or a failure to supervise, and recommended the inclusion of a safe harbor expressly providing that no person be liable under the rule solely because of a violation of the securities laws. See Letter from Craig S. Tyle, General Counsel, Inv. Co. Inst., to Jonathan G. Katz, Secretary, Sec. & Exch. Comm’n (Apr. 17, 2003) (on file with the Investment Company Institute) (regarding compliance programs of investment companies). ICI had recommended such a safe harbor in its 1994 proposal for internal compliance systems as well. See *id.*



possibility, given its recent focus on asset management—the consequences for funds and the fund boardroom could be significant.<sup>131</sup>

Even short of designation, the financial stability concerns that are a legacy of the 2008 financial crisis predictably will affect fund governance. In a speech at the end of 2014, SEC Chair Mary Jo White noted that “one of the most fundamental post-crisis changes for all of the financial regulators, including the Commission, has been an emphasis on addressing risks that could have a systemic impact on the securities markets or the financial system as a whole.”<sup>132</sup> She went on to outline a comprehensive agenda for asset management, with a focus on mitigating systemic risk. As the SEC has begun to unveil the details of its agenda, through specific proposals, it is clear that these changes likely will have significant implications for the fund boardroom and the industry at large.

The first initiative to come out of the SEC’s agenda for asset management—a new set of disclosure and reporting changes for funds and advisers<sup>133</sup>—is designed to “improve the staff’s ability to carry out regulatory functions, including risk monitoring and analysis of the industry,” according to the release accompanying the proposal.<sup>134</sup> The second initiative—a comprehensive rule proposal intended to promote more uniform liquidity risk management frameworks and more detailed liquidity-related disclosures—aims to create “a regulatory framework that would reduce the risk that a fund will be unable to meet its redemption obligations and minimize dilution of

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<sup>131</sup> FSOC’s designation of General Electric Capital Corporation shows what might be in store for fund boards. Just as it proposed for GE Capital’s board, the Fed could seek to influence fund board composition. In addition to the “interested” and “independent” directors who already serve on fund boards, the Fed could hand-pick its own. Whether the loyalties of the directors chosen by the Fed would accrue to investors is questionable at best. More likely, these directors would be accountable to the Fed’s regulatory priorities. The Fed could also require fund boards to form risk-management committees outside the adviser’s pre-existing risk-management structure, to review the adviser’s risk-management environment, to analyze and approve risk-management policies, and to review the process for assessing capital adequacy and capital plans submitted to the Fed each year. See Paul Schott Stevens, *How SIFI Designation Could Undermine Fund Governance: Parsing the Fed’s Proposal for GE Capital*, INV. CO. INST. (June 16, 2015), [https://www.ici.org/viewpoints/view\\_15\\_sifi\\_fund\\_governance](https://www.ici.org/viewpoints/view_15_sifi_fund_governance).

<sup>132</sup> Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, Remarks at the *New York Times DealBook* Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370543677722>.

<sup>133</sup> See Investment Company Reporting Modernization, Investment Company Act Rel. No. 31610 (to be codified at 17 C.F.R. pts. 200, 210, 230, 232, 239, 240, 249, 270, 274), available at <http://www.sec.gov/rules/proposed/2015/33-9776.pdf>.

<sup>134</sup> *Id.*

shareholder interests by promoting stronger and more effective liquidity risk management across open-end funds.”<sup>135</sup> With its third initiative, the SEC has proposed a rule that, while characterized as “an updated and more comprehensive approach to the regulation of funds’ use of derivatives,”<sup>136</sup> effectively would severely limit funds’ ability to use derivatives.<sup>137</sup>

The SEC’s recent proposals evidence its willingness to break new ground in its regulation of risk in the fund industry. Particularly with its last two proposals, it has ventured into the realm of “prudential” regulation that is characteristic of bank regulation.<sup>138</sup> Further, the SEC seems all too willing to rely on independent directors to approve and oversee a number of complicated functions more closely associated with (and likely better undertaken by) professionals steeped in fund operations than individuals tasked with fund governance. And while Chair White has recently acknowledged that an independent director’s role is that of “oversight” and not “management,”<sup>139</sup> a discrepancy seems to persist between how the SEC, on the one hand, and independent directors, on the other, interpret that oversight role.<sup>140</sup>

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<sup>135</sup> See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31835 (to be codified at 17 C.F.R. pts. 210, 270, 274), *available at* <https://www.sec.gov/rules/proposed/2015/33-9922.pdf>.

<sup>136</sup> See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 31933 (to be codified at 17 C.F.R. pts. 270, 274), *available at* <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.

<sup>137</sup> See Letter from David W. Blass, General Counsel, Inv. Co. Inst., to Brent J. Fields, Secretary, U.S. Sec. & Exch. Comm’n, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies, File No. S7-24-15 (Mar. 28, 2016), *available at* [https://www.ici.org/pdf/16\\_ici\\_sec\\_derivatives\\_ltr.pdf](https://www.ici.org/pdf/16_ici_sec_derivatives_ltr.pdf).

<sup>138</sup> See, e.g., Letter from Paul Schott Stevens, President and CEO, Inv. Co. Inst., to Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, regarding Summary of ICI and IDC Comments on the SEC’s Liquidity Risk Management Proposal (Jan. 13, 2016), *available at* [https://www.ici.org/pdf/16\\_ici\\_sec\\_lrm\\_overview\\_comment.pdf](https://www.ici.org/pdf/16_ici_sec_lrm_overview_comment.pdf) (observing that certain highly prescriptive requirements under the liquidity risk management proposal “bear a striking resemblance to the asset-limiting or capital-classification schemes that banking regulators historically have imposed”).

<sup>139</sup> See Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016), *available at* <https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html>.

<sup>140</sup> See Letter from Amy B.R. Lancellotta, Managing Director, Indep. Dirs. Council, to Brent J. Fields, Secretary, U.S. Sec. & Exch. Comm’n, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies, File No. S7-24-15 (Mar. 28, 2016), *available at* [https://www.idc.org/pdf/16\\_idc\\_sec\\_derivatives\\_ltr.pdf](https://www.idc.org/pdf/16_idc_sec_derivatives_ltr.pdf) (encouraging the SEC to revise

On the other side of the ledger, recurring calls for streamlining or rethinking independent director responsibilities have not yet resulted in any regulatory changes. Although SEC staff had previously examined directors' regulatory responsibilities in an effort to enhance board effectiveness,<sup>141</sup> market events and other pressures have since directed priorities elsewhere.<sup>142</sup> All the more important, then, for boards to continue attracting independent directors with resolve and conviction about their critical role in the economy. The more challenging the responsibilities, the regulatory scrutiny, and the potential liabilities, the higher the demand for—and the harder to find and keep—independent directors who can dedicate the time and attention required of that role.

Throughout the fund industry's impressive expansion, fund directors have been an anchor, overseeing fund operations to serve as a check on fund management and protect the interests of shareholders. Indeed, fund governance practices generally have been ahead of their time—and certainly ahead of practices prevalent in operating company boardrooms.

But for all their successes over the years, directors have never been everywhere—nor can they be. We must be realistic about what we should expect from directors, and not lose sight of the limits of even the strongest fund governance. The appropriate role of fund directors—and the role where they have proven most effective for seventy-five years—is to provide meaningful oversight of a fund, not to become involved in or assume responsibility for, directly or indirectly, day-to-day management. A truism perhaps, but nonetheless true—and something policymakers must bear in mind when considering new regulatory requirements that could affect fund boards.

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its derivatives proposal so that boards are not drawn “too closely into a management function” that is inconsistent with their oversight role).

<sup>141</sup> SEC Division of Investment Management Director Andrew J. Donohue launched a “Director Outreach Initiative” in 2007 to consider what the SEC can and should do “to aid fund directors in the performance of their duties.” Andrew J. Donohue, Director, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Keynote Address at the Investment Company Directors Conference (Nov. 28, 2007). IDC sent the SEC staff a letter with recommendations for enhancing fund director effectiveness. *See* Letter from Robert W. Uek, Chair, Governing Council, Indep. Dirs. Council, to Andrew J. Donohue, Director, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n (Feb. 26, 2008), *available at* <https://www.idc.org/pdf/22275.pdf>.

<sup>142</sup> Nevertheless, the responsibilities of fund boards and the complexity of their agendas have continued to increase. It is appropriate and timely for the SEC to take a comprehensive look at fund board responsibilities and consider modifications that would enhance fund board effectiveness and thereby benefit fund shareholders.