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Mutual Fund Independent Directors: A Model for Corporate America?

by Richard M. Phillips¹

INTRODUCTION

Prior to the Enron-WorldCom debacles, corporate governance was largely the province of state corporate law rather than federal securities regulation, and boards of directors of publicly held companies had wide latitude in fulfilling their corporate governance role. The Enron-WorldCom revelations, however, have shown a serious lack of effective oversight of corporate accounting and financial reporting as well as management conflicts by boards of directors and audit committees of publicly held companies. In response, Congress, the Securities and Exchange Commission (“SEC”), and self-regulatory organizations such as the New York Stock Exchange (“NYSE”) and Nasdaq have either enacted or proposed significant corporate governance reforms.

A common theme of the post-Enron-WorldCom reforms is a substantial enhancement of the independence and responsibilities of boards of directors of publicly held companies. The

reforms would, among other things, (a) require an independent director majority on such boards, (b) strengthen the standards for measuring their independence, and (c) vest in the independent directors specific responsibilities for more direct oversight over compliance with the federal securities laws and financial disclosure requirements as well as management compensation and other conflicts of interest.

The new rules proposed by the NYSE and Nasdaq, although not identical in every detail, specify heightened independence standards for outside directors. The proposed rules also require, among other things, that boards of directors of listed companies have a majority of directors who satisfy the new independence standards, that the independent directors approve executive compensation, and that boards of directors adopt codes of ethics for all directors and employees.²

Moreover, as required by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”),³ the SEC has directed the national securities exchanges and Nasdaq to adopt rules specifying, among other things, that audit committees of publicly held companies be composed exclusively of independent directors and be directly responsible for selecting the company’s independent auditors as well as overseeing the adequacy of the company’s internal accounting controls and the accuracy of

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² See SEC Release No. 34-47672 (April 11, 2003); SEC Release No. 34-47516 (March 17, 2003).

³ Section 301 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 78j-1 (2002).

its financial reporting.⁴ In addition, the SEC's newly adopted attorney conduct rule—mandated by Sarbanes-Oxley—encourages publicly held companies to establish a “Qualified Legal Compliance Committee,” composed exclusively of independent directors with responsibility for handling reports of a company's attorneys regarding “material violations” of federal securities laws and breaches of fiduciary duty, including the determination whether the company has appropriately responded to those reports.⁵

To a significant extent, these regulatory responses to Enron-WorldCom emulate the corporate governance model fashioned by Congress and the SEC for investment companies registered under the Investment Company Act of 1940 (the “1940 Act”). Indeed, reliance upon independent directors is a primary component of investment company regulation under the 1940 Act. Under that regulatory regime, the investment company industry has not experienced the Enron-WorldCom-type abuses that have captured the attention of Congress and the media since the burst of the Internet bubble. Nevertheless, the mutual fund industry and the independent directors of mutual funds have not escaped criticism during the post-Enron scapegoating process.

Historically, many of the criticisms of independent directors of mutual funds have centered on their alleged ineffectiveness in managing the relationship between the funds and their external investment managers in the interests of fund shareholders. In particular, the critics charge that the independent directors routinely renew the fund's advisory contracts year after year irrespective of performance, and they tolerate excessive management fees as well as use of the fund's brokerage and other assets

[The] regulatory responses to Enron-WorldCom emulate the corporate governance model fashioned by Congress and the SEC for investment companies registered under the Investment Company Act of 1940.

for the benefit of the advisers rather than the shareholders. In short, the critics question the effectiveness of mutual fund directors as overseers of the conflicts of interest arising from the funds' relationships with their investment advisers and other affiliated service providers.⁶

The criticisms are too numerous and too important to ignore. Their importance goes beyond the mutual fund industry. To the extent that the criticisms of mutual fund independent directors have validity, they cast doubt on the efficacy of the corporate governance reforms engendered by the Enron-WorldCom debacles. Indeed, if true, they suggest that the legislative and regulatory efforts to restore investor confidence by reliance on independent directors will provide little more than illusory protections for public investors generally. Accordingly, a fair evaluation of these criticisms is critically important to the restoration of confidence in our nation's securities markets.

INDEPENDENT DIRECTORS UNDER THE 1940 ACT

An evaluation of the criticisms directed at independent directors of mutual funds should begin with an understanding of the 1940 Act qualification standards for independent directors. It also should consider the increasingly important roles they have been required to play in the oversight of investment company operations and compliance with the regulatory requirements contained in the 1940 Act and other federal securities laws.

⁴ “Standards Relating to Listed Company Audit Committees,” SEC Release No. 33-8220 (April 9, 2003).

⁵ 17 C.F.R. §205 (2003); see SEC Release No. 33-8185 (January 29, 2003). The rule provides that, in the absence of a Qualified Legal Compliance Committee, each individual attorney employed or retained to provide legal services to the company, except “supervised attorneys” as defined in the rule, would have an individual duty to determine if a company has made an “appropriate response” to his or her report of a material violation or breach of fiduciary duty.

⁶ See Letter from Warren Buffett, Chairman of the Board, to the Shareholders of Berkshire Hathaway, Inc., dated February 21, 2003 (“Buffett Letter”); “Mutual Funds at the Millennium: Fund Directors and Fund Myths,” Remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, to the ‘40 Act Institute of PLI, New York (May 15, 2000) available at http://www.vanguard.com/bogle_site/may152000.html; Scott Cooley, “Revisiting Fund Costs: Up or Down” (Feb. 1999) available at <http://news.morningstar.com/doc/article/0,1,543,00.html>; see also John P. Freeman & Stewart L. Brown, “Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,” 26 *J. of Corporate Law* 609 (Spring 2001); *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearings Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Commerce*, 108 Cong. 1st Sess. (2003) (“Baker Hearings”) (testimony of John Bogle, Founder, The Vanguard Group; John Montgomery, Founder and President, Bridgeway Funds; and Gary Gensler, co-author of “The Great Mutual Fund Trap,” and former Undersecretary for Domestic Finance, Department of the Treasury; Deborah Solomon and Aaron Lucchetti, “House Panel Grills Mutual Funds -- Rep. Oxley, Other Critics Attack Fees Charged by Fund Managers As Bear Market Bruises Investors,” *Wall St. J.*, Mar. 13, 2003, at C1.

Since its enactment, the 1940 Act has required that at least 40% of the members of substantially all investment company boards of directors be unaffiliated with the investment adviser.⁷ If, as is most often the case, the adviser is affiliated with the fund's principal underwriter, a majority of the board must be independent of both the investment adviser and principal underwriter.⁸ Moreover, the 1940 Act, as originally enacted, contained broad standards for classifying the directors as independent, and these standards were substantially tightened in 1970 by the addition of an "interested person" concept by amendments to the 1940 Act ("1970 Amendments").⁹

More recently, the SEC in January 2001 amended ten exemptive rules under the 1940 Act to require, as a condition to reliance on those exemptions, that investment company boards be composed of a majority of independent directors, that new independent directors be selected by the other independent directors, and that any legal counsel to the independent directors also must be independent.¹⁰ Since, as a practical matter, substantially all investment companies rely on one or more of these exemptions, the SEC's exemptive rules have established an industry regulatory standard for the independence of directors.

It is significant to note that the mutual fund industry has strongly supported enhancement of the standards for, and the role of, independent directors. Indeed, the best practices recommendations of an advisory committee formed by the Investment Company Institute ("ICI") recommended as a best practice a two-thirds super-majority of independent directors for investment company boards, as well as other measures intended to enhance the effectiveness of independent directors for invest-

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ment companies. These measures included such matters as the appointment of a lead independent director, meetings of independent directors separate from management and representation by experienced independent counsel.¹¹ A significant portion of the mutual fund industry has followed all or most of these recommendations.

The SEC and its staff over the years have placed increasing reliance upon fund directors to police conflicts of interests and compliance with the federal securities laws. The 1940 Act gives boards of directors, and particularly independent directors, explicit duties with respect to the approval of investment advisory and underwriting contracts and the selection of the fund's independent public auditors.¹² SEC rules under the 1940 Act, moreover, have greatly expanded the responsibilities of independent directors to oversee a host of other types of transactions involving potential conflicts of interest between the fund and its investment adviser or the adviser's affiliates.

⁷ Section 10(a) of the 1940 Act.

⁸ Section 10(b) of the 1940 Act.

⁹ Investment Company Act Amendments of 1970, Sec. 5(a), 84 Stat. 1416. The definition of "interested person" contained in Section 2(a)(19) of the 1940 Act essentially disqualifies a person from serving as an independent director of a fund if such person: (1) is an "affiliated person" of the fund, other than solely by reason of his or her directorship or ownership of fund shares; (2) has, at any time during the prior two years, served as legal counsel to the fund; or (3) is affiliated with a person who has, at any time during the prior six months, engaged in any portfolio transactions, as principal or as agent for, or distributed shares of, any fund or account advised by the fund's investment adviser. The term "affiliated person" is broadly defined to include any officer, employee or 5% shareholder of the fund, its investment adviser or principal underwriter or any person controlling, controlled by or under common control with such fund, investment adviser or principal underwriter. See Section 2(a)(3) of the 1940 Act. In addition, the SEC has the authority to issue an order to declare a person an "interested person" of a fund if it finds that such person has or had, at any time during the prior two years, a "material business or professional relationship" with certain specified persons and entities, including some fund affiliates. See Section 2(a)(19)(A)(vii) of the 1940 Act. Legislation also is pending in Congress to enhance the SEC's rulemaking authority under Section 2(a)(19). The Mutual Funds Integrity and Fee Transparency Act of 2003, H.R. 2420, 108th Cong., 1st Sess. (2003) ("Baker Bill"), available at <http://financialservices.house.gov/media/pdf/hr2420.pdf>.

¹⁰ See "Role of Independent Directors of Investment Companies," 1940 Act Release No. 24816 (January 2, 2001). Even prior to this SEC action, the Commission required as a condition to reliance on Rule 12b-1 under the 1940 Act, which permits mutual funds to adopt a plan for the use of fund assets to finance the distribution of shares, that the plan be approved by a majority of the independent directors who are selected or nominated by the other independent directors. See 1940 Act Rule 12b-1, 17 C.F.R. §270.12b-1.

¹¹ See "Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness," Investment Company Institute (June 24, 1999), available at <http://www.ici.org>. The Baker Bill, *supra* note 9, would codify the super-majority recommendation.

¹² Sections 15 and 32(a) of the 1940 Act.

Boards of directors, including a majority of the independent directors, are required to approve procedures for transactions, and to oversee compliance with these procedures, under which a fund may purchase securities from or through an affiliate,¹³ participate in a joint insurance policy,¹⁴ purchase a fidelity bond,¹⁵ merge with an affiliated fund,¹⁶ use fund assets to finance distribution,¹⁷ contract with affiliates of the investment adviser for transfer agent or similar services,¹⁸ or participate with affiliates in combined letters of credit and similar transactions.¹⁹ The board approval process for these types of business arrangements typically includes a determination that the terms of the arrangement are fair and reasonable and in the best interest of each participating fund.

The conflict and compliance oversight responsibilities of independent directors occupy a major part of their role under the 1940 Act.

In addition to their role in policing conflicts of interest, mutual fund boards of directors must oversee and monitor compliance with federal securities laws by the fund and its service providers. These compliance responsibilities include: the pricing of fund shares, including determining the fair value of portfolio securities for which market quotations are not readily available;²⁰ approving the amortized cost or penny rounding method for pricing money market fund shares;²¹ determining the eligibility of unrated securities held by money market funds;²² overseeing compliance with certain 1940 Act prohibitions or limitations on investments;²³ and approving personal securities trading policies

(codes of ethics) for personnel employed by the investment company and its investment adviser and principal underwriter.²⁴ SEC rules dealing with these matters generally require that mutual fund boards of directors adopt detailed policies and procedures for the protection of the investment company and oversee the implementation of these policies and procedures.

Additional compliance responsibilities are imposed on independent directors by conditions contained in SEC exemptive orders and SEC staff no-action letters issued to particular mutual funds. For example, SEC orders exempting funds from the 1940 Act prohibitions on transactions between a fund and its affiliated persons often are premised on the explicit condition that the fund board undertake extensive oversight responsibilities with respect to the affiliated transactions.²⁵ Thus, independent directors have the important responsibility to approve procedures reasonably designed to ensure that transactions with affiliated persons are conducted on a basis that is fair to the fund, and to periodically review the transactions on the basis of information furnished by the adviser documenting its belief that the transactions are in the best interest of the funds and their shareholders.²⁶

¹³ See 1940 Act Rules 10f-3, 17a-7 and 17e-1.

¹⁴ 1940 Act Rule 17d-1(d)(7).

¹⁵ 1940 Act Rule 17g-1.

¹⁶ 1940 Act Rule 17a-8.

¹⁷ 1940 Act Rule 12b-1.

¹⁸ 1940 Act Release No. 8245 (Feb. 25, 1974).

¹⁹ See *T. Rowe Price Assocs., Inc.*, SEC No-Action Letter (pub. avail. July 31, 1995); *Alliance Capital Management L.P.*, SEC No-Action Letter (pub. avail. April 25, 1997).

²⁰ See Section 2(a)(41) of 1940 Act.

²¹ 1940 Act Rule 2a-7.

²² *Ibid.*

²³ See Section 12(d) of the 1940 Act and SEC rules thereunder.

²⁴ 1940 Act Rule 17j-1.

²⁵ See, e.g., *In the Matter of American Century Companies, Inc., et al.*, 1940 Act Release No. 25449 (March 1, 2002).

²⁶ *Ibid.*

The conflict and compliance oversight responsibilities of independent directors occupy a major part of their role under the 1940 Act. Nevertheless, the critics of mutual fund directors tend either to ignore these responsibilities or dismiss them as merely “perfunctory.” They tend to regard mutual fund directors as having only two important responsibilities: the selection of the investment manager and negotiating with that manager for the lowest fee.²⁷

Such a view of the broad conflict and compliance oversight responsibilities of independent directors of mutual funds represents a misunderstanding of their role. The Supreme Court has long recognized the importance of independent directors to effective corporate governance by characterizing them as “independent watchdogs” for the funds and their shareholders.²⁸ Independent director oversight of conflicts of interest and compliance with regulatory requirements has provided significant protections for shareholders. Unlike the seemingly large number of publicly held corporations and professional participants in the securities industry that have been involved in serious financial fraud and other abuses in recent years, regulated investment companies have not experienced such abuses to a significant extent.²⁹

The relative absence of the Enron-type abuses in the mutual fund industry is attributable in large part to the regulatory controls imposed by the 1940 Act, and independent director oversight is a significant part of those controls. As the Director of the SEC’s Division of Investment Management recently stated, “[w]e believe that one of the principal reasons the mutual fund industry has avoided the scandals that have plagued other segments of the securities industry is the presence of independent directors.”³⁰ Accordingly, the responsibilities of independent directors to oversee compliance with regulatory requirements and various conflicts of interest are hardly “perfunctory.” To the contrary, “independent directors are an investor’s front-line defense against conflicts of interests and other potential abuses.”³¹

SELECTION OF THE INVESTMENT ADVISER

More importantly, predominant emphasis on the role of the independent

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directors in selecting the investment manager for their mutual funds is inconsistent with the expectations of shareholders as well as the independent directors’ own understanding of their role. Investors generally make several basic choices in connection with their purchase of mutual fund shares. First, they choose whether to invest directly or with the assistance of a professional intermediary. Second, they choose, often with the assistance of a financial intermediary, a particular

investment objective and a strategy to achieve that objective. Third, and most important, since there usually are many funds with comparable

²⁷ See Buffett Letter, *supra* note 6, at 17.

²⁸ *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

²⁹ During fiscal year 2002, the SEC initiated 163 enforcement actions against non-fund issuers for false or misleading financial statements or reports, 119 actions against non-fund issuers for securities offering violations, 82 actions against broker-dealers, 48 actions against non-fund investment advisers, and only two actions involving registered investment companies and/or their investment advisers. See SEC 2002 Annual Report, available at <http://www.sec.gov/pdf/annrep02/ar02full.pdf>.

³⁰ See Memorandum from Paul F. Roye, Director of the SEC’s Division of Investment Management, to Chairman William H. Donaldson, regarding correspondence from Chairman Richard H. Baker, House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises, dated June 9, 2003 (“SEC Response to Chairman Baker’s Letter”), available at <http://financialservices.house.gov>.

³¹ “Understanding the Securities Products of Insurance Companies,” Keynote Address of Paul F. Roye, Director of the SEC’s Division of Investment Management, before the Practising Law Institute (January 9, 2001), available at <http://www.sec.gov/news/speech/spch455.htm>.

investment objectives and investment strategies, they choose the particular fund which, in their individual judgment, has the best possible manager to implement their chosen investment strategy and shareholder services suitable to their needs at an acceptable cost. In many cases, this decision also is made with the assistance of a financial intermediary.

Accordingly, when investors become shareholders of a fund, they have made a deliberate decision to select an investment manager whom they deem is best qualified to invest their money for them. Indeed, investors select a particular fund from a group of funds with comparable investment objectives and strategies to obtain the investment skills of the fund's manager and not to obtain the skills of the independent directors to select a suitable investment adviser for them.³² Accordingly, under normal circumstances, that selection of the adviser has been, and should be, left to the individual investor and not to the independent directors. For the independent directors, as a matter of routine, to override investor selection of their investment manager would undermine the fundamental principle of competition in the mutual fund marketplace—investor sovereignty in choosing investment advisers.

Nevertheless, independent directors of mutual funds, like directors of public companies, have a critically important role in ensuring that the expectations of the shareholders are satisfied over the long term, and, if they are not, in taking appropriate action. Mutual funds, like publicly held companies generally, are characterized by the classic “separation of ownership from control.” That separation has provided the fundamental conceptual premise for the role of the board of directors under both federal securities law and modern corporate law.³³ Directors resolve

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the problem that arises from the separation of ownership and control by providing continuing oversight over the management on behalf of the shareholders who do not have sufficient time, economic incentive or expertise to do it themselves.

Independent director oversight also is important because mutual fund shareholder relationships are different from most other types of investment management relationships. Unlike the typical relationship between an investment adviser and a separate account client, for example, the relationship between a fund's adviser and the fund's shareholders is impersonal, involving no direct interaction with the fund's adviser. Directors, on the other hand, are able to interact with the fund's adviser on behalf of the fund shareholders, and their interaction serves as a substitute for shareholder interaction with the fund adviser. Moreover, it may be more difficult for a mutual fund shareholder than a separate account client to change investment advisers (by redeeming out of one fund and investing in another) because of sales loads, redemption fees and/or capital gains taxes. For these reasons, the ability to redeem, while important, always has been regarded as an incomplete protection for mutual fund shareholders.

Accordingly, independent directors have the important responsibility of ensuring that the fund's adviser continues to perform according to the expectations of the fund shareholders as formed by the fund's prospectus and other disclosures to the shareholders. The directors do not, and should not, however, exercise their prerogative of overruling the choice of an investment adviser by the fund's shareholders, except in unusual

³² Even in the case of a multi-manager fund, investors select a particular fund in order to obtain the skills of its investment manager to select sub-advisers for portions of the fund's portfolio. They also do not rely upon the skills of the directors for this purpose.

³³ See Adolf A. Berle and Gardner C. Means, *The Modern Corporation and Private Property* (rev. ed. 1991).

circumstances. As one of the draftsmen of the 1940 Act, Alfred Jaretzki, Jr., noted in 1964:

[T]he board of directors does not act in a vacuum ... [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances.³⁴

Similarly, independent directors themselves do not presume that they are charged with the responsibility of selecting a new investment manager for their fund if they can find a “better” adviser. Indeed, absent a distressed situation or other unusual circumstances, they do not accept a position on the board of directors of a fund whose management they do not respect with the idea of making drastic changes. To the contrary, they generally accept the responsibilities of their office only if they believe that over the long term they will be satisfied with the competence and integrity of the management whom they will oversee.

The independent directors do, of course, have important oversight responsibilities for the performance of the investment adviser, and if

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the performance is unsatisfactory, to seek effective changes in the management of the fund’s portfolio. The infrequency with which independent directors initiate a change in the investment adviser, however, is not a measure of their effectiveness. As the SEC staff recently pointed out:

The infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that ... independent directors have not been forceful enough in representing shareholder interests. Fund directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds. ... [They] may reasonably conclude that it would be in the best interests of the fund and its shareholders to require the investment adviser to take appropriate steps to improve its performance, such as by hiring a new portfolio manager for the fund, move to a team approach of portfolio management, increase the adviser’s investment research capability, insist on retention of a sub-adviser, merge or liquidate the fund, close a fund to new investors, or adjust the fee structure, such as including a performance fee component to the advisory fee, without seeking to terminate the investment advisory contract.³⁵

Accordingly, most directors believe that it is only after efforts to obtain improvements within the existing management organization have failed that they generally are justified in selecting a new investment adviser. This is hardly surprising. In the mutual fund industry, a change of investment advisers usually involves a wholesale change in the entire management organization. Such changes are not common for public companies either. While boards of directors of publicly held companies may replace a CEO and one or two other top members of management, they do not, except in extraordinary circumstances, seek to replace the entire management organization.

The SEC long ago recognized the disruptive impact of an independent director-initiated change of investment adviser. In its extensive study of investment companies in the mid-1960s, *Public Policy Implications of Investment Company Growth*, the SEC pointed out that such a step would involve “[t]he possibility of disrupting the fund’s operations, the prospect of a bitter and expensive proxy contest and the risk and uncertainty of replacing an entire fund management organization with a new and untested one.”³⁶

³⁴ Alfred Jaretzki, Jr., “Duties and Responsibilities of Directors of Mutual Funds,” 29 *Law and Contemporary Problems* 777, 786 (1964).

³⁵ SEC Response to Chairman Baker’s Letter, *supra* note 30, at 100.

³⁶ *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337 (1966) (“Public Policy Implications”) at 131.

The SEC's recognition of the difficulties encountered by independent directors who, in the absence of demonstrable and serious fraud or mismanagement, seek to initiate a change in investment advisers has proven to be correct. In two relatively recent instances where the independent directors of two mutual funds sought to remove the investment adviser against its opposition, after substantial redemptions, the remaining shareholders rejected the decisions of the independent directors and voted to stay with the adviser that they had chosen through their decision to invest in the fund.³⁷

For example, when the independent directors of the Navellier Series Fund replaced its adviser because of disagreements over the adviser's proposal to merge the fund out of existence, the adviser responded with both litigation and a proxy battle over shareholder approval of the new adviser. After massive redemptions the remaining shareholders rejected the management contract with the new adviser and approved a contract with the old adviser to manage the fund. Similarly, the investment adviser to the Yachtman Fund, after litigation and a proxy solicitation to select new independent directors, successfully defeated an attempt of the independent directors to remove the president of the adviser as president of the fund.³⁸

Critics further assert that the independent directors of mutual funds routinely approve a new investment adviser whenever proposed by the incumbent adviser in connection with a sale or merger of the advisory organization. This criticism ignores the fact that, in many such cases, while a sale of control of an advisory organization represents a change of control over the fund management organization, it does not involve any change in the portfolio manager or other investment and administrative personnel who have been responsible for the fund's performance. Under these circumstances, it is hardly surprising that fund directors generally choose to remain with the existing investment adviser in lieu of contracting with a new and untested advisory organization. Moreover, such criticism does not take into account the unpublicized instances

where independent directors, prior to any change of control transaction, define for the adviser the acceptable alternatives and do not hesitate to veto an unacceptable proposal.

INDEPENDENT DIRECTORS AND MANAGEMENT FEES

Negotiating the Advisory Fee

The critics also mischaracterize the duty of mutual fund directors in reviewing advisory fees for purposes of deciding whether to renew the advisory contract with the incumbent adviser. While directors, particularly independent directors, have an important responsibility with respect to mutual fund advisory fees, nothing in the 1940 Act, the court decisions thereunder or basic concepts of fiduciary duty impose on the directors a continuing duty to negotiate the lowest possible fee. To the contrary, the fiduciary duty of the independent directors is and should be to approve reasonable fees. As former SEC Chairman Levitt observed, fund directors do not have a duty to negotiate the lowest possible fee but only to approve fees that fall within a "reasonable band."³⁹

Mutual fund directors approach the contract renewal process with the knowledge that fund shareholders have had extensive disclosure concerning the fees and other costs incurred in connection with their investment.⁴⁰ Clearly, the

³⁷ See Charles Gasparino, "Fund Shareholders Fail to Approve Manager's Ouster," *Wall St. J.*, June 17, 1997, at C20; "Navellier Vote Curbs Powers of Trustees," *Wall St. J.*, June 18, 1997, at C1.

³⁸ Charles Gasparino, "Mutual Fund Holders to Vote in Dispute," *Wall St. J.*, Nov. 24, 1998, at C23. "Yachtman Still Reeling a Year after Fight for Funds," *Ignites* (Mar. 8, 2000), available at <http://www.ignites.com>. For a more extensive description of the Navellier and Yachtman cases, see David Sturms, "Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?" *Villanova Journal of Law and Investment Management* (1999).

³⁹ Remarks by SEC Chairman Arthur Levitt before the Investment Company Institute (May 15, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch212.txt>.

⁴⁰ Under SEC rules every fund prospectus must include a user friendly fee table, which shows transactional fees (e.g., sales charges) and fees paid by the fund. The fee table provides a uniform tabular presentation of all fees and expenses associated with the fund investment. It must be located at the beginning of the prospectus and accompanied by a numerical example that illustrates the total dollar amounts that an investor could expect to pay on a \$10,000 investment if he or she received a 5% annual return and remained invested in the fund for various periods of time. The fee table must be placed in the plain English risk-return summary because of the SEC's belief in the importance of fees and expenses to an investor's decision to invest in a fund. The SEC also requires that mutual fund performance figures be computed and disclosed net of fees (Item 3 of Form N-1A). Most recently, the SEC has proposed that expense information also be included in the semi-annual report to shareholders required by the 1940 Act. See 1940 Act Release No. 25970 (December 18, 2002).

directors have no reason to believe that investors have purchased fund shares in the belief that the fees are unreasonable but in reliance on the efforts of the independent directors to reduce those fees and other costs.

Congress determined, however, that additional controls over investment management contracts in the mutual fund industry were needed, notwithstanding disclosure to fund shareholders. For this reason, Congress made clear in the legislative history of the 1970 Amendments that neither disclosure to shareholders nor approval of the existing fee structure by prior boards relieves the directors of the duty to satisfy themselves on an annual basis that the investment adviser satisfied its fiduciary duty to have a reasonable fee.⁴¹ A determination of reasonableness generally focuses on an evaluation of changed circumstances, particularly, changes in management performance, fund growth or other changes in the factors affecting the economics of the management function. Directors cannot ignore such circumstances; each year they have a responsibility to approve an advisory fee that reflects a sharing of the economies of scale realized from fund growth or from other changed circumstances. This is the mandate of Section 36(b), which was added to the 1940 Act by the 1970 Amendments.

The Impact of Section 36(b)

Section 36(b) provides that mutual fund managers have a fiduciary duty with respect to the compensation received by them in connection with their services to the fund. It allows any fund shareholder or the SEC to bring an action in federal district court to recover any “excessive” fees from the recipient of such fees. The legislative history makes clear that

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Congress enacted Section 36(b) because of evidence, in instances too numerous to ignore, that mutual fund advisers had not adapted their fee rates to changed circumstances.⁴² Advisory fee rates had continued in the 1950s and early 1960s to cluster around a traditional rate of .50% of fund assets, notwithstanding economies of scale obtainable from the relatively substantial growth of fund assets during that period.⁴³

Congress added Section 36(b) to the 1940 Act and otherwise emphasized the duty of independent directors with respect to management compensation to make clear that independent directors must evaluate advisory fee rates and other management compensation in light of the changing economics of fund management that may accompany substantial growth. When appropriate, it is the duty of the directors to seek a revised fee structure that reflects a sharing of the economies of scale obtainable from such growth with the shareholders.⁴⁴

Accordingly, the 1970 Amendments to the 1940 Act sought to emphasize the duty of the fund directors to ensure that advisory fees remain reasonable in light of changes in fund size, the nature and quality of the services provided and other factors affecting the economics of fund management and the value of the management services provided. Prevailing fee rates become unreasonable when circumstances have substantially changed without commensurate change in the fund’s fee

⁴¹ S. Rep. No. 91-184, at 4910 (1970) (“Senate Report”); H.R. Report No. 91-1382, at 38 (1970) (“House Report”).

⁴² See, e.g., Senate Report, *supra* note 41, at 4902; Public Policy Implications, *supra* note 36, at 94–102 (citing Wharton School of Finance & Commerce, A Study of Mutual Funds, H.R. Rep. 2274, 87th Cong., 2d Sess. (1962) (“Wharton School Report”).

⁴³ Public Policy Implications, *supra* note 36, at 96, citing Wharton School Report, *supra* note 42, at 28.

⁴⁴ See Public Policy Implications, *supra* note 36, at 130–31; Senate Report, *supra* note 41, at 4048–50.

structure, notwithstanding that at the point of purchase shareholders may have accepted the fees as reasonable and that in prior years the directors also viewed the fees as reasonable.

Section 36(b) has engendered a fair amount of litigation. In a 1983 case involving a Merrill Lynch money market fund, the U.S. Court of Appeals for the Second Circuit articulated the seminal standard for determining whether compensation is excessive and in breach of a fiduciary duty under Section 36(b) as follows:

[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all the surrounding circumstances. ...

To be guilty of a violation of §36(b), therefore, the adviser-manager must charge 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. To make this determination, all pertinent facts must be weighed.⁴⁵

By this standard, the court recognized that Section 36(b) was not intended to introduce public utility concepts of rate regulation to the mutual fund industry. As the Senate Report on the bill which became the 1970 Amendments stated:

"Nothing in the bill is intended to ... suggest that a 'cost-plus' type of contract would be required. It is not intended to introduce a general concept of rate regulation as applied to public utilities."⁴⁶

Accordingly, courts have tended to focus on the process engaged in by fund directors. The courts have carefully evaluated the nature and extent of the information provided to the directors, the expertise that the directors bring to the analysis of the information, and the care and conscientiousness with which they perform that analysis.⁴⁷ Representation by independent counsel is also an important factor.⁴⁸ If the courts are satisfied that the independent directors have engaged in a process designed to produce an informed evaluation of all applicable factors, they generally have not sought to second-guess a board's determination as to the fairness of an advisory fee. In this area, as in others,

the courts have hesitated to intrude on the business judgment of independent directors who are in a position to exercise their informed business judgment in good faith. The 1970 Amendments enhanced the abilities of directors to undertake the necessary analysis by amending Section 15(c) of the 1940 Act to explicitly require that directors meet in person to review the contract annually and to request from the adviser the information reasonably needed in connection with that review. Section 15(c) also requires the adviser to comply with such requests for information.

By providing an enforcement mechanism for excessive compensation, Section 36(b) has brought a new rigor to the board's Section 15(c) review of

Under the impetus of Section 36(b) and the judicial decisions thereunder, the annual fee review of most fund boards has evolved into an extensive deliberation.

management fees and other compensation paid to investment advisers of investment companies and their affiliates. Under the impetus of Section 36(b) and the judicial decisions thereunder, the annual fee review of most fund boards has evolved into an extensive deliberation which considers

the factors relevant to the fairness of the fees in light of the adviser's overall management performance, as well as the costs to shareholders and the benefits to the

⁴⁵ See *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928–29 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983) (citations omitted).

⁴⁶ Senate Report, *supra* note 41, at 4902.

⁴⁷ See, e.g., *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 412 (2d Cir. 1989); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F.Supp. 962, 980–83 (S.D.N.Y. 1987), *aff'd per curiam*, 835 F.2d 45 (2d Cir. 1987); *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 930 (2d Cir. 1982); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1241–48 (S.D.N.Y. 1990). As noted above, SEC rules, in effect, require that any counsel to the independent directors must itself be independent. "Role of Independent Directors of Investment Companies," *supra* note 10.

⁴⁸ *Krinsk*, 875 F.2d 404; *Schuyt*, 663 F. Supp. 962; *Gartenberg*, 694 F.2d 923; *Kalish* 742 F. Supp. 1222.

adviser and its affiliates.⁴⁹ There is compelling evidence that this process has had some impact. Most of the larger funds have adopted fee schedules that, through breakpoints at higher asset levels or otherwise, reflect a sharing of the economies of scale obtainable from fund growth. Thus, a 2000 SEC Staff study of mutual fund fees and expenses found that operating expense ratios decreased as fund assets and fund family assets increased.⁵⁰ Other studies conducted by the General Accounting Office and Lipper Analytic Services reached similar conclusions.⁵¹

The decline in fund expense ratios shown by the various studies is especially significant in view of the substantial cost pressures created by the increased complexity of the mutual fund portfolio management, shareholder servicing and distribution functions since publication of the Wharton School Report and Public Policy Implications—the reports that led to the 1970 Amendments. Cost of the investment

management function, for example, reflects the development of more complex and costly management disciplines such as investments in international securities, high yield bonds and distressed securities and emerging markets, in order to maintain liquidity and diversification. Each of these disciplines requires specialized and highly compensated staff (such as sub-portfolio managers, traders, research, credit, and bankruptcy analysts). Moreover, over the past twenty years, there have also been dramatic increases in the number of equity securities (both domestic and foreign) that funds consider and in the number of new investment techniques used by funds. These include structured notes, options, currency hedging, futures and other derivatives, private money market transactions and complex quantitative techniques. These also require more and highly specialized staff as well as larger investments in information technology.

Compensation levels of investment personnel also have increased over the years, in part because of competition for talent with hedge funds and other alternative investment vehicles, which generally charge higher fees than mutual funds.⁵² That competitive pressure became particularly intense in the rising equity markets of the 1990s as compensation of the of investment personnel often doubled and tripled over a relatively short time span.⁵³

⁴⁹ See *Gartenberg*, 694 F.2d 923; *Schuyt*, 663 F.Supp. at 974–83; *Krinsk*, 875 F.2d at 409; *Kalish*, 742 F.Supp. at 1228. The factors, as set forth in these Section 36(b) decisions, include: (i) the nature, extent and quality of the services provided by the adviser; (ii) the investment performance of the fund; (iii) the costs of the services provided and the resulting profits realized by the adviser and its affiliates from its relationship with the fund, including the extent to which the adviser has realized economies of scale as the fund grows; (iv) other sources of revenue to the investment adviser and its affiliates from their relationship to the fund and intangible or “fall-out” benefits that accrue to the adviser and its affiliates; (v) the control of the operating expenses of the fund; (vi) the manner in which the portfolio transactions of the fund are conducted, including any use of soft dollars; (vii) a comparative analysis of expense ratios of, and advisory fees paid by, similar funds; and (viii) the entrepreneurial risk and financial exposure assumed in organizing and managing the fund.

⁵⁰ SEC Division of Investment Management: Report on Mutual Fund Fees and Expenses (Dec. 2000) (“SEC Fee Study”) at 28, 31, available at <http://www.sec.gov/news/studies/feestudy.htm>. The Study found that, all other things being equal, a \$10 million fund had an operating ratio that was 22 basis points lower than a similar \$1 million fund, while a \$1 billion fund had a 66 basis-point lower expense ratio than a similar \$1 million fund. Similarly, the Study found a 68 basis-point decline in expense ratios if total assets of a fund family rose from \$1 million to \$10 million, and a 75 basis-point decline if family assets rose from \$1 million to \$10 billion. Operating expense ratios exclude Rule 12b-1 distribution fees since, as the Study pointed out, such fees are a substitute for the front-end sales load which are not part of fund expenses. *Ibid* at 26.

⁵¹ GAO, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition (June 7, 2000) (“GAO Report”) at 48–49, available at <http://www.gao.gov>; The Third White Paper: Are Mutual Fund Fees Reasonable? Lipper Analytic Services (Sept. 1998) (“Lipper Report”) at 12; John D. Rea and Brian K. Reid, “Trends in the Ownership Cost of Equity Mutual Funds,” *Investment Company Institute Perspective*, Vol. 4, No. 3, Nov. 1998; “Total Shareholder Cost of Mutual Funds: An Update,” *Investment Company Institute Fundamentals*, Vol. 2, No. 4, Sept. 2002, available at <http://www.ici.org>; see also GAO, Mutual Funds: Information on Trends in Fees and Their Related Disclosure (March 12, 2003), available at <http://www.gao.gov>. The SEC, GAO and Lipper studies used, in part, a longitudinal approach in that they tracked operating expense ratios for larger funds over time. They generally found a decline in such expense ratios as the funds grew in size. In contrast, critics of fund management fees often look at fees and expenses on a fund-by-fund basis or neglect to account for 12b-1 distribution fees that substitute for front-end loads. They use data that are not asset-weighted and appear to be significantly affected by the introduction during the 1990s of a plethora of relatively small new funds that characteristically have high expense ratios, which include 12b-1 distribution fees. See, e.g., “Mutual Funds at the Millennium: Fund Directors and Fund Myths,” remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, to the ‘40 Act Institute of PLI, New York (May 15, 2000), available at http://www.vanguard.com/bogle_site/may152000.html.

⁵² One study shows that in 1997, the typical hedge fund fee amounted to 1–2% of net assets in addition to a performance fee amounting to 20% of gains above a specified threshold or hurdle rate. Fees for individual securities wrap accounts typically varied between 150 and 300 basis points, and for mutual fund wrap accounts, the average fee was 125 basis points in addition to the fees and other costs of the underlying funds. In contrast, an SEC Report found that in 1997, the weighted average expense ratio of no-load mutual funds was 72 basis points, and the weighted average total ownership cost of load mutual funds was 150 basis points (assuming a 10-year holding period). Lipper Report, *supra* note 51, at 5.

⁵³ See, e.g., Richard Blake, “How High Can Costs Go?” *Institutional Investor*, May 1, 2001, at 56.

The cost of the shareholder servicing function in the mutual fund industry also has experienced inflation. In response to investor demands, mutual fund management organizations have provided an increasing array of expensive shareholder services such as exchange privileges, 24-hour telephone access, extensive internet websites, checking accounts, direct deposits, directed dividends, automatic account builders, hearing-impaired services, retirement plan advice, and cost basis and other tax information. As a result, information technology expenses at many fund complexes have greatly exceeded the rate of fund asset growth. These trends mean that advisers have had to invest some of the savings from economies of scale attributable to fund growth in building a more extensive and complex information technology infrastructure to satisfy investor demands for increased shareholder services.⁵⁴ Investors, of course, are the beneficiaries of these expenditures.

Unlike the investment management functions, the economies of scale in acquiring and servicing fund shareholders cannot be measured by asset growth of the funds themselves. Instead, to the extent such economies exist, they are related to the size of the shareholder accounts. Moreover, mutual fund managers typically provide transfer agency and other shareholder services or, in the case of smaller fund complexes, oversee external providers of these services, at little or no profit. They are willing to absorb the costs and the entrepreneurial risk of increased capital investment in the hope that they will earn a sufficient return from the fees charged for the management function. Accordingly, an evaluation of management fees in the mutual fund industry also must allow for a level of profitability necessary to compensate the management company for the costs and risk of the shareholder servicing aspect of the mutual fund business.⁵⁵

Changes in the cost of portfolio management and shareholder servicing are important factors for directors to consider in reviewing advisory contracts. These costs have undeniably increased in recent years with the growing complexity of portfolio management and shareholder servicing. Notwithstanding these inflationary pressures, mutual fund advisory fees have declined over the years, particularly in the case of the larger and older funds and fund complexes. Accordingly, there is good reason to believe that independent directors on the whole have operated as

an effective restraint on fund expenses and that shareholders have benefited from the economies of scale obtainable from fund growth.

CONCLUSION

The duty of independent directors with respect to advisory fees, however significant, must be placed in the context of their overall responsibilities as “watchdogs for the shareholders.” In this capacity, they have the responsibility to guard against abuses, particularly abuses that emanate from conflicts of interest and noncompliance with the shareholder protections of the 1940 Act. By this standard, even the severest critics of the independent fund directors must concede that mutual fund directors have performed well. The mutual fund industry simply has not experienced the abuses that have arisen in other sectors of the financial community.

Mutual funds have emerged from the bull markets of the 1990s with far fewer problems of fraud and abuse than those afflicting other types of public companies. Such relative absence of abuse reflects the fact that mutual funds are the most heavily regulated segment of the financial community and that the independent director mechanism is an important component of that regulation. This record alone demonstrates that the post-Enron reform efforts to enhance the independence and responsibility of outside directors have a high potential to effectively serve the interests of public shareholders. Contrary to the implications of the attacks on mutual fund independent directors, Sarbanes-Oxley and other corporate governance reform efforts will provide a substantial, and not an illusory, measure of protection to investors in publicly held companies generally.

⁵⁴ GAO Report, *supra* note 51, at 37.

⁵⁵ Moreover, any evaluation of the question whether mutual fund managers are fairly sharing with fund shareholders the economies of scale attributable to fund growth must take into account the cost and the entrepreneurial risk associated with growth of the fund through successful distribution of its shares. While the Commission has indicated that it is improper to take into account the cost of distributing fund shares in calculating the profitability of mutual fund management fees, it also has recognized that management fee profits may be used to finance such costs as long as the profits are derived from reasonable management fees. Rule 12b-1 proposing release, 1940 Act Release No. 10862 (Sept. 7, 1979); Rule 12b-1 adopting release, 1940 Act Release No. 11414 (Oct. 28, 1980). As one observer has noted: “This conception of ‘profits,’ however, is strictly a legal invention. Distribution expenses are taken out of an adviser’s profits only for compliance purposes; in any meaningful economic sense, and to the fund advisers that pay them, distribution expenses are part of the cost of doing business.” Mercer Bullard, “Second-Guessing 12b-1 Plans,” *Fund Democracy Insights*, Sept. 2001, at 5, available at <http://www.funddemocracy.com/september2001.htm> (subscription required).