

University of Pennsylvania Law Review

FOUNDED 1852

Formerly
American Law Register

VOL. 120

DECEMBER 1971

No. 2

A STUDY OF MUTUAL FUND INDEPENDENT DIRECTORS

WILLIAM J. NUTT †

INTRODUCTION: THE PRESENCE THEORY OF DIRECTOR RE- SPONSIBILITY	181
I. EVOLVING THEORIES OF DIRECTOR RESPONSIBILITY	186
A. <i>The Investment Company Amendments Act of 1970</i> ...	186
1. Pre-Amendments Concept of Adviser Fiduciary Ob- ligation	192
2. The Independent Directors' Duty To Request and Evaluate Information	195
3. The Weight To Be Given Independent Director Approval	196
B. <i>The Moses v. Burgin Concept of Director Responsibility</i>	197
II. SOURCES OF INDEPENDENT DIRECTOR RESPONSIBILITY	202
A. <i>State Law Duties</i>	202
1. The Problem of Preemption	202
2. State Law Duties of Care and Loyalty	205

† B.A. 1967, Grove City College; J.D. 1971, University of Pennsylvania. Member, Pennsylvania Bar.

This Article was prepared while I was a Fellow at the University of Pennsylvania Law School Center for Study of Financial Institutions, and many of the ideas were the subject of a round table discussion at the University of Pennsylvania Law School on November 17, 1971. I am indebted to the Director of the Center, Professor Robert H. Mundheim, for his invaluable counsel and assistance. The Article bears a date of September 1, 1971, and the views expressed are my own. Certain citations have been editorially updated.

- B. *Federal and State Regulatory Statutes Beyond the 1940 Act* 207
 - 1. The Federal Securities Acts and the *BarChris* Decision 207
 - 2. State Blue Sky Regulation 210
- C. *The "Interested Persons" Definition* 211
- D. *Framework of Director Responsibilities* 214
- III. PROFILE OF PRESENT DIRECTOR PRACTICES 215
 - A. *Selection of Independent Directors* 215
 - B. *Orientation to the Role of Independent Director* 219
 - C. *Monthly Meetings, Individual Participation, and Committee Functions* 220
 - D. *Renewal of the Advisory Contract* 222
 - E. *Independent Directors' Contributions to Fund Affairs* .. 223
 - F. *Staff Facilities and Legal Counsel* 225
 - G. *Compensation, Insurance, and Indemnification* 228
- IV. SCOPE OF INDEPENDENT DIRECTOR RESPONSIBILITIES IN SPECIFIC CONTEXTS 230
 - A. *Approval of the Advisory Contract* 231
 - 1. Assuring an Opportunity for Performance 232
 - 2. Evaluating the Reasonableness of the Fee 238
 - a. *Costs Incurred in Managing the Fund* 239
 - b. *The Adviser's Direct and Indirect Income* 241
 - c. *The Rewards for Entrepreneurial Risk* 242
 - d. *The Quality of the Adviser's Services* 246
 - 3. Structuring the Fee 246
 - 4. Summary of Independent Director Responsibilities in Approving the Advisory Contract 248
 - B. *Approval of the Distribution Contract* 251
 - C. *Allocation of Portfolio Brokerage* 254
 - 1. Assuring Best Execution 256
 - 2. Creation of a Broker Affiliate 259
 - D. *Non-Conflict Areas of Independent Director Responsibility* 262
 - 1. Shareholder Accounting Expenses 263
 - 2. The Custodian Function 264
- V. SUMMARY OF INDEPENDENT DIRECTOR RESPONSIBILITIES .. 265

INTRODUCTION: THE PRESENCE THEORY OF DIRECTOR
RESPONSIBILITY

The Investment Company Act of 1940¹ was fashioned largely in response to a report to the Congress on investment trusts and investment companies by the Securities and Exchange Commission (SEC).² That *Investment Trust Study* focused on the danger to those who invest in mutual funds³ and other investment companies posed by the insider securities transactions, inequitable capital structures, and outright dishonesty prevalent in the pre-1940 fund industry.⁴ The *Study* cited specific abuses by the investment advisers of such companies, including domination of the funds and use of fund assets to promote the advisers' interests at the expense of fund shareholders.⁵

The regulatory scheme of the 1940 Act attacked these particular abuses by requiring registration of the fund and its securities,⁶ prescrib-

¹ 15 U.S.C. §§ 80a-1 to -52 (1970) [hereinafter referred to as the 1940 Act].

² SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES (1939-1942) [hereinafter cited as INVESTMENT TRUST STUDY]. The *Study* appears in parts as H.R. Documents beginning with the third session of the seventy-fifth Congress (1938) and ending with the first session of the seventy-seventh Congress (1942).

³ "Mutual fund" here refers to an open-end investment company, as defined by § 5(a) (1) of the 1940 Act, 15 U.S.C. § 80a-5(a) (1) (1970). The fund offers the public securities representing a proportionate share of a constantly changing portfolio. Because the fund must redeem its securities upon demand at their current net asset value, a continuous selling effort is often undertaken both to offset the resulting cash outflow and to promote fund growth. Fund shares are distributed by an underwriter, usually an affiliate of the fund's investment adviser, and retailed by broker-dealers, who usually charge the investor a "sales load" in addition to the net asset value of his shares. For a description of the investment company industry's structure and the regulatory framework within which it operates, see SEC, REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 33-77 (1966) [hereinafter cited as PUBLIC POLICY REPORT].

⁴ INVESTMENT TRUST STUDY, *supra* note 2, pt. 3, at 1914, 1924, 2541, 2640-2720 (SEC Printings, 1940, 1942). The *Study* found the industry replete with instances of insider self-dealing and use of fund assets either as sources of capital for their promoters' private ventures or as dumping grounds for unsaleable blocks of stock taken by investment advisers who were also underwriters. Insiders often purchased fund shares below net asset value and received interest-free loans. Indeed, outright embezzlement of fund assets had also occurred.

⁵ *E.g.*, INVESTMENT TRUST STUDY, *supra* note 2, pt. 3, at 1922, 2640-2720 (SEC Printings, 1940, 1942).

⁶ 15 U.S.C. § 80a-7, -8 (1970). The recent amendments to the 1940 Act remove the exemption from registration under the Investment Advisers Act of 1940 formerly granted to those advisers whose only clients were registered investment companies. Investment Company Amendments Act of 1970, § 24(a), Pub. L. No. 91-547, § 24(a), 84 Stat. 1430; see Investment Advisers Act of 1940, § 203(b), 15 U.S.C. § 80b-3 (1970). In addition, the fund must file with the SEC a registration statement described in form N-8B-1. See 1 CCH MUTUAL FUNDS GUIDE ¶¶ 2013-14, at 1313-14. The fund's shares must be registered under § 5(a) of the Securities Act of 1933, 15 U.S.C. § 77e(a) (1970), as described in form S-5. See 1 CCH MUTUAL FUNDS GUIDE ¶¶ 2021-22, at 1340-61. Finally, the fund or its securities must be registered under the blue sky laws of each state in which its shares are sold.

ing accounting procedures, periodic reporting methods,⁷ and alignment of capital structures,⁸ and limiting transactions between the funds and their affiliates, including their advisers.⁹ The Act further required that all adviser compensation for managing the fund's portfolio be precisely described in a contract initially approved by the shareholders and annually renewed by the board of directors.¹⁰ To bring an element of independent negotiation and decisionmaking to the directors' renewal, as well as to their review of the adviser's handling of fund assets, the 1940 Act required that at least forty percent of the board be neither officers, employees, nor controlling persons of the adviser.¹¹

In addition to specific abuses and the problem of adviser compensation, the *Investment Trust Study* mentioned but gave secondary importance to potential areas of conflict of interest between fund and adviser, such as fund share-selling practices¹² and the adviser's use of fund brokerage.¹³ Reflecting the *Study's* priorities, the 1940 Act did not deal specifically with these areas of potential conflict, but relied upon the presence of the non-affiliated directors to provide both adequate representation of shareholder interests and a sufficient safeguard against

⁷ All registered investment companies must make periodic reports to their shareholders and the SEC, which is authorized to prescribe reporting rules and accounting procedures for the funds. Not only must the funds' records be available for inspection by the SEC, but all relevant financial statements must be certified by independent public accountants approved by the shareholders. 15 U.S.C. §§ 80a-17, -29 to -31 (1970). The basic reporting document filed annually with the SEC is form N-1R, which requires statements of fund policy, reports on trading activities, and financial statements and exhibits. The entire form N-1R is given to the fund's independent directors for their review, although only the first half is public. See 1 CCH MUTUAL FUNDS GUIDE ¶¶ 6201-07, at 4201-38.

⁸ The 1940 Act prohibits open-end investment companies from issuing any debt securities. 15 U.S.C. § 80a-18(f) (1) (1970).

⁹ Absent prior SEC approval, loans or sales of property between a fund and its affiliated persons are prohibited. The Act also limits the activities of affiliated persons acting as brokers for the fund. *Id.* §§ 80a-17, -36.

¹⁰ *Id.* § 80a-15(c).

¹¹ 1940 Act § 10(a), ch. 686, tit. I, 54 Stat. 806, as amended, 15 U.S.C. § 80a-10(a) (1970). In 1970 this provision was replaced. See note 32 *infra* & accompanying text. Section 2(a) (3) of the 1940 Act, 15 U.S.C. § 80a-2(a) (3) (1970), defines an "affiliated person" of either the fund or its adviser as:

(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

¹² See WHARTON SCHOOL OF FINANCE & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 2 (1962) (discussing *Investment Trust Study*, *supra* note 2) [hereinafter cited as WHARTON REPORT].

¹³ *Id.* 525-39.

adviser abuse.¹⁴ Thus, the Investment Company Act placed final responsibility for resolving most of these potential conflicts of interest with those directors who were "not affiliated" with the fund's investment adviser.

The success of the 1940 Act's regulatory pattern became evident as renewed investor confidence and favor swelled mutual fund net assets from \$450 million at the end of 1940¹⁵ to more than \$55 billion in 1971.¹⁶ This remarkable growth, however, drew attention to economies of scale, selling practices, and alternative uses of fund brokerage—incidents of fund management the SEC and others came to regard as the most serious problems in the investment company industry.

In response, the SEC undertook studies directed primarily to areas given secondary importance in the regulatory scheme of the 1940 Act. The first of these studies was prepared for the SEC in 1962 by the University of Pennsylvania's Wharton School.¹⁷ The following year, the Commission itself examined the mutual fund industry as part of its *Special Study of Securities Markets*.¹⁸ The *Wharton Report* and the *Special Study* suggested that higher initial sales charges created undesirable selling pressures that in turn produced fund growth of questionable benefit to existing shareholders.¹⁹ Both of these early studies of

¹⁴ The safeguards Congress adopted were the requirements of § 15 of the Act dealing with the content and approval of the advisory and underwriting contracts, 1940 Act, ch. 686, tit. I, 54 Stat. 812, *as amended*, 15 U.S.C. § 80a-15 (1970).

When the 1940 Act was proposed, many people advocated more drastic approaches such as requiring either that management be internalized or that external advisers furnish their services at cost. The internalized-management approach had recently been adopted by Congress in § 13(d) of the Public Utility Holding Company Act of 1935, ch. 687, tit. I, 49 Stat. 825 (codified at 15 U.S.C. § 79m(d) (1970)), which required that, when a mutual service company furnished services or sold goods to operating members of the system, the cost be fairly allocated among all the companies in the system. This approach, however, was rejected because small investment companies could not afford managerial staffs of their own. Instead, external advisers' service contracts were made subject to approval by the funds' non-affiliated directors. *See Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 76th Cong., 3d Sess., pt. 1, at 251-52 (1940) (Investment Trusts & Investment Companies). *See also* PUBLIC POLICY REPORT, *supra* note 3, at 148.

During the Senate hearings on what was to become the 1940 Act, the Chief Counsel of the SEC's *Investment Trust Study* remarked that "a few elementary safeguards" would suffice to protect fund shareholders in the areas of the advisory fee, sale of fund shares, and use of brokerage. *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 76th Cong., 3d Sess., pt. 1, at 252 (1940).

¹⁵ PUBLIC POLICY REPORT, *supra* note 3, at 2.

¹⁶ The Investment Company Institute, an association representing many of the industry's mutual funds and their advisers, reported that mutual fund assets reached a record high of \$55.9 billion in April 1971. *The Evening Bulletin* (Philadelphia), May 19, 1971, at 37, col. 8.

¹⁷ WHARTON REPORT, *supra* note 12.

¹⁸ SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 89-255 (1963) [hereinafter cited as SEC SPECIAL STUDY].

¹⁹ WHARTON REPORT, *supra* note 12, at 6; SEC SPECIAL STUDY, *supra* note 18, at 121-212; *see id.* 107-10.

the regulated fund industry found that advisers placed fund portfolio business with brokers who sold fund shares or offered research and statistical services.²⁰ The SEC's 1966 report, *Public Policy Implications of Investment Company Growth*,²¹ similarly concluded that such practices benefited advisers but had potentially adverse effects for the funds those advisers managed. Advisers were found to be under pressures to turn over or churn the portfolio based upon commission business rather than upon wise investment policy; to avoid the third market, which might offer a fund better prices because no minimum commissions were charged, but which offered no services in return for portfolio business; and to pay higher than necessary commissions while failing to recapture any portion of them for the funds' benefit.²²

In addition, the *Wharton Report* had found that most mutual fund advisory fees did not reflect the economies of scale inherent in the management of greater assets, and that funds were charged substantially higher fees than other types of advisory accounts.²³

The inability of the regulatory techniques of the 1940 Act to respond to these problems was attributed to two characteristics of the fund industry. Shareholders were believed to be primarily concerned with performance rather than the cost of investment advice and gave little consideration to the advisory fee and other fund expenses when purchasing their shares or ratifying the advisory contract.²⁴ Thus, advisers had no incentive to reduce the cost of their services.²⁵ In addition, the non-affiliated directors had not asserted themselves effectively on behalf of the shareholders, either in negotiating the advisory fee or in reviewing adviser practices.²⁶ Noting the dependence of a fund on its existing adviser, the SEC's *Public Policy Report* attributed the inability of the non-affiliated directors to secure meaningful reductions in advisory fees to the lack of "arm's-length bargaining," and specifically to the directors' inability to terminate negotiations with the fund's adviser and bargain for similar services with others in the industry.²⁷ The Commission also

²⁰ WHARTON REPORT, *supra* note 12, at 32-33, 527, 536-37; SEC SPECIAL STUDY, *supra* note 18, at 218, 233.

²¹ *Supra* note 3.

²² PUBLIC POLICY REPORT, *supra* note 3, at 16-17, 173-75.

²³ WHARTON REPORT, *supra* note 12, at 490-91, 493-94.

²⁴ *Id.* 34-35; see PUBLIC POLICY REPORT, *supra* note 3, at 12, 128-29.

²⁵ The *Wharton Report* concluded that:

[C]ompetition in the mutual fund business has assumed the principal nonprice forms—variety of product, product quality, and sales promotion Management fee rates and the allocation of brokerage business have not as yet elicited important competitive responses for a major part of the industry.

WHARTON REPORT, *supra* note 12, at 35.

²⁶ *Id.* 34; PUBLIC POLICY REPORT, *supra* note 3, at 130-31.

²⁷ PUBLIC POLICY REPORT, *supra* note 3, at 131.

repeated the *Wharton Report's* earlier conclusion that the non-affiliated 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."²⁸

Although the possibility of requiring internalized fund management was discussed in its *Public Policy Report*,²⁹ the Commission's recommendations for legislative changes assumed that the existent pattern, by which funds typically secured their investment advisory and management services from separate, external advisers, would continue. Thus, when Congress undertook a comprehensive revision of the 1940 Act, no radical restructuring of the industry was proposed.³⁰ Instead, the Commission sought to increase the effectiveness of existing controls. Despite its doubts concerning the non-affiliated directors' abilities to protect fund shareholders, the Commission concluded that these directors "can and should play an active role in representing the interests of shareholders . . . where the interests of the professional managers may not coincide with those of the company and its public investors."³¹

This Article will trace the evolution of the 1940 Act's regulatory approach as it has been congressionally and judicially modified in response to the problems articulated in these studies. Exploring the ramifications of those changes, the Article will attempt to clarify and explain the developing role that independent directors are now required to assume in fund management.

Part I considers the new problems raised by both the growth of fund assets and the emergence of the fund complex as the dominant form of organization in the investment company industry. After four years of legislative consideration of alternative methods of dealing with these problems, Congress enacted the Investment Company Amendments Act of 1970.³² The 1970 Amendments and recent case law influence the

²⁸ *Id.* 130 (quoting *WHARTON REPORT*, *supra* note 12, at 34).

²⁹ *Supra* note 3, at 8, 102-11, 148-49.

³⁰ *PUBLIC POLICY REPORT*, *supra* note 3, at 148. Although the SEC found that internalization could produce significant savings in management costs for large mutual funds, it again concluded that this step might inflict increased costs on smaller funds. To require internalization might thus inhibit the promotion of new funds and eliminate smaller existing funds. *Id.* 148-49; *see* note 14 *supra*.

A second reason the SEC was unwilling to propose internalization may have been that the securities of about 20 investment advisers were then publicly held. *PUBLIC POLICY REPORT*, *supra* note 3, at 46.

³¹ *PUBLIC POLICY REPORT*, *supra* note 3, at 148.

³² Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413, *amending*: 1940 Act, ch. 686, tit. I, 54 Stat. 789 (codified at 15 U.S.C. §§ 80a-1 to -52 (1970)), Investment Advisers Act of 1940, ch. 686, tit. II, 54 Stat. 847 (codified at 15 U.S.C. §§ 80b-1 to -21 (1970)); Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a-aa (1970)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-hh (1970)) [hereinafter termed 1970 Amendments].

The 1970 Amendments became law on December 14, 1970, *see* BNA SEC. REG. & L. REP. No. 81, at A-25 (Dec. 16, 1970), but many sections were not to take effect

duties of the independent director especially in those areas of fund management in which the interests of the adviser and the fund are in conflict. Part II focuses on the other federal and state statutes defining director obligations and the operational framework of a fund. Part III presents a profile of present director practices, based upon interviews with independent directors and adviser officials, that helps define reasonable limits on what independent directors can be expected to do. Part IV sets forth the various elements of a sound business decision by independent directors in specific areas such as the advisory fee, the underwriting contract, use of fund brokerage, and shareholder-accounting and custodian expenses. Finally, Part V suggests guidelines for independent directors in evaluating the information presented in these various areas.

I. EVOLVING THEORIES OF DIRECTOR RESPONSIBILITY

A. *The Investment Company Amendments Act of 1970*

Legislative proposals between 1967 and 1970 focused on alternative methods to remedy the shortcomings of the 1940 Act. One approach was an attempt to fashion a standard upon which meaningful judicial supervision of management compensation could be based. A second approach was to revise the definition of the non-affiliated directors in order to increase their independence from the fund's adviser. The procedures for approval of the advisory contract were also defined with greater particularity by specifying the adviser's duty to disclose and the non-affiliated directors' duty to request and evaluate certain information before giving their approval.

Early drafts advocated requiring a "reasonable" advisory fee—a judicially reviewable standard that would ease the burden upon the Commission or a shareholder when either challenged management's compensation. Later bills placed more emphasis upon defining non-affiliated-director and adviser responsibilities in the presentation and approval of the advisory contract. Major spokesmen for the opposing viewpoints were the Securities and Exchange Commission and the Investment Company Institute (ICI). The Commission's first proposals to imple-

until 6, 12, or 18 months after enactment. 1970 Amendments § 30, Pub. L. No. 91-547, § 30, 84 Stat. 1436. For example, the substitution of the phrase "interested persons" for "affiliated persons" made by § 5(d) will take effect on December 14, 1971; the addition, made by § 20, of a new standard of adviser fiduciary obligation to the 1940 Act, ch. 686, tit. I, 54 Stat. 841, *as amended*, 15 U.S.C. § 35 (1970), is to take effect on June 14, 1972. The delays were intended to give funds and their advisers time to recompose their boards and conform their advisory contracts to the new requirements. Cf. HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. No. 1382, 91st Cong., 2d Sess. 199 (1970).

ment the recommendations of its *Public Policy Report*,³³ S. 1659 and H.R. 9510, would have amended section 15 of the 1940 Act to require that all compensation received by management for services to the fund should be "reasonable."³⁴ As guidelines for applying the standard, the bills included a list of five factors to structure the directors' and, if necessary, a court's inquiry.³⁵ The emphasis was thus on a judicial examination of the fee, an approach opening the proposals to charges of judicial ratemaking.³⁶ The bills also amended the definitional sections of the 1940 Act to include the concept of "interested persons."³⁷ To bar those having family or material business relationships with the adviser from serving as non-affiliated directors, the phrase "interested" was substituted for "affiliated" in most places where the latter had appeared in the Act.³⁸ These proposals were attacked by a minority of

³³ See SENATE COMM. ON BANKING & CURRENCY, 90TH CONG., 1ST SESS., INVESTMENT COMPANY AMENDMENTS OF 1967, at v (Comm. Print 1967) (statement of Sen. Sparkman [hereinafter cited as PROPOSED 1967 AMENDMENTS]).

³⁴ S. 1659, 90th Cong., 1st Sess. §8(d) (1967); H.R. 9510, 90th Cong., 1st Sess. §8(d) (1967). For the *Technical Statement of the Securities and Exchange Commission* explaining these proposals, see CCH FED. SEC. L. REP., SPECIAL REP. No. 2, May 8, 1967.

³⁵ The elements of "reasonableness" suggested by the SEC were:

(A) The nature and extent of the services to be provided . . . ;

(B) The quality of the services theretofore rendered to such investment company . . . , or, if no such services have been theretofore rendered, the quality of the services rendered to other investment clients, if any . . . ;

(C) The extent to which the compensation . . . takes into account economies attributable to the growth and size of such investment company . . . giving due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser . . . ;

(D) The value of all [non-compensatory] benefits . . . directly or indirectly received or receivable by the . . . investment adviser by reason of his relationship to such investment company;

(E) Such other factors as are appropriate and material.

S. 1659, 90th Cong., 1st Sess. §8(d) (1967).

³⁶ David Silver, General Counsel of the Investment Company Institute, summarized the industry's objections:

The reasonable test made it clear, notwithstanding Commission's analogy to the reasonable man of tort law, that in the economic area the reasonable test is a word of art used in rate making. What was done was to put rate making back into the courts where it was in the 19th century before the courts proved unable to handle rate making. . . . The administrative agency is saying that the courts are a more appropriate rate-making body under the reasonable proposal.

MUTUAL FUNDS 306-07 (Practising Law Institute 1970).

³⁷ S. 1659, 90th Cong., 1st Sess. §2(3) (1967).

³⁸ *Id.* §§5, 8(c), 18. The SEC's proposals would have substituted the new phrase in most cases in which "affiliated person" appeared in the 1940 Act. See PROPOSED 1967 AMENDMENTS, *supra* note 33, at 29-57. The final version of the 1970 Amendments substituted the new definition in fewer sections, omitting §10(b)(1). Neither version made the substitution in §§10(f) or 17, which prohibit transactions between the fund and affiliated persons of the fund or its adviser. See SENATE COMM. ON BANKING & CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 184, 91st Cong., 1st Sess. 33 (1969) [hereinafter cited as 1969 SENATE REPORT]; PROPOSED 1967 AMENDMENTS, *supra* note 33, at 22.

a House subcommittee. The minority argued that the existence of competitive investments, voting rights, and independent director supervision provided a sufficient check against adviser abuse.³⁹ The minority further argued that management fees were not only reasonable but were declining,⁴⁰ and that in light of these findings the present judicial remedy, shareholder derivative actions in which the plaintiff had the burden of proving "waste of corporate assets,"⁴¹ was a sufficient safeguard of the shareholders' interests.⁴²

In 1968, the Senate Banking Committee reported S. 3724,⁴³ which would have adopted the notion of a reasonable fee but would have deleted specific criteria because the Committee concluded that the elements of reasonableness were too numerous to be made part of the legislation.⁴⁴ The bill would also have amended section 15(d) to require that shareholder suits challenging the reasonableness of advisory fees could only be brought if the Commission refused or failed to bring suit within six months after requested by the shareholder.⁴⁵ The proposals expanded the definition of "interested persons"⁴⁶ and provided that the independent directors' decision with regard to adviser compensation should be given "substantial weight."⁴⁷ Finally, section 36, authorizing the Commission to enjoin an adviser's "gross abuse of trust," was to be amended to permit the Commission to enjoin a "breach of fiduciary duty involving personal misconduct," a standard intended by the Commission to reduce its burden of proof.⁴⁸

³⁹ *Hearings on H.R. 9510 & 9511 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce*, 90th Cong., 1st Sess., ser. 90-21, pt. 1, at 241 (1968) [hereinafter cited as *1967 House Hearings*].

⁴⁰ *Id.*

⁴¹ See note 53 *infra*.

⁴² *1967 House Hearings*, *supra* note 39, at 237-42.

⁴³ 90th Cong., 2d Sess. (1968).

⁴⁴ SENATE COMM. ON BANKING & CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1968, S. REP. NO. 1351, 90th Cong., 2d Sess. 13 (1968) [hereinafter cited as 1968 SENATE REPORT]. This version of the amendments listed only all types of compensation paid, services rendered, and "other relevant and material" circumstances.

⁴⁵ *Id.* 6. This proposal merely increased the industry's opposition to the reasonableness standard. Although designed to allay investment advisers' fears that the new legislation would encourage "strike suits," the change was seen by the industry as a shift of the ratemaking power from the courts to the SEC. *Id.* 48-50.

⁴⁶ S. 3724 expanded the earlier SEC-proposed definition of "interested persons" to include any broker-dealer registered under the Securities Exchange Act of 1934, affiliated persons of any such broker-dealer, and legal counsel of the fund, its adviser or underwriter. *Id.* 31; *cf.* S. 1659, 90th Cong., 1st Sess. §2(3) (1967).

⁴⁷ 1968 SENATE REPORT, *supra* note 44, at 5-6.

⁴⁸ "Breach of fiduciary duty involving personal misconduct" was substituted for the SEC-proposed standard of "breach of fiduciary duty." The "personal misconduct" standard is similar to that used in §5(d) of the Home Owners' Loan Act of 1933, 12 U.S.C. § 1464(d) (4) (1970). The Committee apparently thought a higher standard was necessary to preclude §36(a)'s use as the basis for "unspecified regulatory actions." See 1968 SENATE REPORT, *supra* note 44, at 11.

Echoing much of the industry's position, the Banking Committee minority report on S. 3724 characterized this scheme as "agency rate-making." It suggested that if a fee were challenged, the fund's directors would be coerced by the threat of a Commission suit for an injunction or a shareholder derivative action to negotiate a fee acceptable to the Commission staff.⁴⁹ The Commission's "right of first refusal" would, in their view, make the non-affiliated directors' determination merely a formal step on the director-Commission-court road to "reasonableness." The minority members adopted the industry's view that the *Wharton Report* and the two SEC studies incorrectly assessed the effectiveness of the non-affiliated directors. They suggested that:

There is no real evidence in any report of the Commission or in any of the material submitted to the hearings which provides a basis for this conclusion. The conclusion is, in fact, supported only by another conclusion, that the investment advisory contract is almost invariably renewed as a matter of course. . . . There is every reason to expect that the management contract should be routinely renewed absent, of course, the abuses to which Congress addressed itself in 1939 and 1940, and which Congress sought to end by the adoption of the scheme of oversight by independent directors—apparently with great success.⁵⁰

The minority proposed that sixty percent of the directors be outsiders, that they be expressly charged with the responsibility for shareholder protection, and that they be subject to suit if they approved an excessive fee.⁵¹

The successive drafts leading to the Investment Company Amendments Act of 1970, reflected a compromise between the SEC and the mutual fund industry.⁵² Advisers sought to preserve the doctrine that actions receiving the disinterested approval of the board should not be overturned unless the transaction amounted to "waste" of corporate assets.⁵³ The SEC sponsored proposals making clear that waste of assets was no longer the standard. Over these discussions loomed more than fifty shareholder derivative actions alleging that the advisers' com-

⁴⁹ 1968 SENATE REPORT, *supra* note 44, at 48-52.

⁵⁰ *Id.* 51-52.

⁵¹ *Id.* 52.

⁵² *Hearings on H.R. 11,995, S. 2224, H.R. 13,754, & H.R. 14,737 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 91st Cong., 1st Sess., ser. 91-33, pt. 1, at 138 (1969) [hereinafter cited as 1969 House Hearings].*

⁵³ The waste-of-assets doctrine developed in *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962), made it extremely difficult for shareholders to obtain judicial review of allegedly excessive management fees and is mentioned in the legislative debates as a major cause of the need for amendments. See 1969 House Hearings, *supra* note 52, at 188. See also text accompanying notes 65-67 *infra*.

pensation was excessive.⁵⁴ Although no shareholder had won a judgment at that time,⁵⁵ the cost of settlement⁵⁶ and the potential of large liability⁵⁷ made the negotiators aware of the importance of a mutually acceptable standard for judicial review of the advisory fee.

The reasonableness standard was unacceptable to many in the fund industry.⁵⁸ The industry's spokesmen, however, apparently foresaw that a new standard of adviser obligation was inevitable. Thus, the industry switched from placing the entire emphasis of its proposals on the new definition of interested persons to a search for an acceptable standard of judicial review.⁵⁹ The compromise reached between the industry and the Commission was contained in S. 2224,⁶⁰ which became the 1970 Amendments. The Amendments deleted the reference to a "reasonable fee" in section 15 and substituted not only a different standard but a different approach to judicial review of the advisory fee.⁶¹ Section 36(b) expressly imposed a "fiduciary duty" upon the adviser with respect to its compensation, an approach preserving the

⁵⁴ PUBLIC POLICY REPORT, *supra* note 3, at 132; *see, e.g.*, *Moses v. Burgin*, 316 F. Supp. 31 (D. Mass. 1970), *rev'd*, 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971); *Horenstein v. Waddell & Reed, Inc.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,678 (S.D.N.Y. 1970); *Kurach v. Weissman*, 49 F.R.D. 304 (S.D.N.Y. 1970).

⁵⁵ The first major decision finding for a shareholder under §36 of the 1940 Act was decided by the First Circuit on June 4, 1971. *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971). For a discussion of the impact of the case, see *Wall St. J.*, June 7, 1971, at 1, cols. 4-5 (*Fidelity Funds' Manager is Found Guilty of Interest Conflicts; Wide Impact Seen*).

⁵⁶ *See, e.g.*, *Neuwirth v. Allen*, 338 F.2d 2 (2d Cir. 1964); *Alleghany Corp. v. Kirby*, 333 F.2d 327, *aff'd en banc*, 340 F.2d 311 (2d Cir. 1964), *cert. dismissed as improvidently granted sub nom. Holt v. Alleghany Corp.*, 384 U.S. 28, *rehearing denied*, 384 U.S. 967 (1966); *Glickens v. Bradford*, 35 F.R.D. 144 (S.D.N.Y. 1964); *Saminsky v. Abbott*, 40 Del. Ch. 528, 185 A.2d 765 (Ch. 1961), *settlement approved*, 41 Del. Ch. 320, 194 A.2d 549 (Ch. 1963), *aff'd sub nom. Kleinman v. Saminsky*, 41 Del. Ch. 572, 200 A.2d 572 (Ch.), *cert. denied*, 379 U.S. 900 (1964). *See also Eisenberg & Phillips, Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962).

⁵⁷ *See* PUBLIC POLICY, *supra* note 3, at 138-47.

⁵⁸ *See* Baris, *Mutual Fund Legislation*, 4 REV. SEC. REG. 977 (1971).

⁵⁹ *See Hearings on S. 34 & S. 296 Before the Senate Comm. on Banking & Currency*, 91st Cong., 1st Sess. 92 (1969).

⁶⁰ 91st Cong., 1st Sess. (1969). The Senate version of the 1970 Amendments was passed on May 26, 1969. 115 CONG. REC. 13,700-01 (1969). The House version, passed on September 23, 1970, 116 CONG. REC. H9104 (daily ed. Sept. 23, 1970), differed only in the requirement that the plaintiff prove a breach of fiduciary duty under §36(b) by "clear and convincing evidence," a higher burden of proof than that imposed by the Senate. *Compare* S. 2224, 91st Cong., 1st Sess. §20 (1969), *with* H.R. 17,333, 91st Cong., 2d Sess. §20 (1970). The conference committee agreed upon the Senate's version. H.R. REP. NO. 1631, 91st Cong., 2d Sess. 18 (1970). For a further analysis of the legislative history of the 1970 Amendments, see Rottenberg, *Developing Limits on Compensation of Mutual Fund Advisers*, 7 HARV. J. LEGIS. 309 (1970).

⁶¹ The deletion of the reasonableness standard and substitution of the adviser's fiduciary obligation changed not only the standard of judicial review but the method for testing management's compensation. The test no longer modified the fee in §15 but was made part of the adviser's duties under §36. 1969 SENATE REPORT, *supra* note 38, at 5-6.

traditional pattern in which a court examines the fiduciary's performance of his duties as well as the fee itself.⁶² The 1970 Amendments, however, do not define the scope of this obligation; nor does the legislative history indicate that the Commission and industry spokesmen ever agreed upon a common definition.⁶³ Of equal importance but also unanswered by the Amendments was the effect to be given the independent directors' approval of the advisory fee and review of adviser practices.⁶⁴

The 1970 Amendments also added subsection 15(c), which requires that before the independent directors approve the advisory contract:

It shall be the *duty* of the directors of a registered investment company to request and evaluate, and the *duty* of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.⁶⁵

Although receiving far less attention during the legislative debates,⁶⁶ the impact of the two duties imposed by section 15(c) may be greater than the fiduciary standard of section 36(b). Section 15(c) makes clear that independent director approval of the advisory fee remains a necessary condition of fund management. Unless willing to assume that Congress had no reason for requiring it, courts should give this approval weight in deciding whether fiduciary duties have been performed.

How the courts should approach the independent directors' responsibilities can be answered in part by defining three key phrases or

⁶² *Id.* 6.

⁶³ The SEC apparently did not believe that this compromise would impair the effectiveness of its earlier proposals. In their view, the fiduciary standard was: a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34.

The Commission therefore supports these provisions as a satisfactory and even more effective method than its original proposal to test the reasonableness of mutual fund management fees.

1969 *House Hearings*, *supra* note 52, at 138-39.

The industry, however, placed more emphasis on the change. General Counsel David Silver of the Investment Company Institute suggested that, at least in his view, the fiduciary duty language implied a higher standard:

I think there is a difference. . . .

The fiduciary test at least requires the court to determine, in accordance with the traditional judicial function, *that somebody did something wrong*, not that the court under the reasonable test, is obligated to set a fee. Here the court would be required to try the advisor, not the fee, and find out qualitatively whether people in the negotiation behaved unreasonably.

MUTUAL FUNDS 306-07 (Practising Law Institute 1970) (emphasis added).

⁶⁴ See text accompanying notes 92-97 *infra*.

⁶⁵ 15 U.S.C. § 80a-15(c) (1970) (emphasis added).

⁶⁶ The original SEC proposals would also have required that the adviser provide a specific breakdown of the advisory fee. See H.R. 9510, 90th Cong., 1st Sess. § 8(a) (1967); S. 1659, 90th Cong., 1st Sess. § 8(a) (1967). See also CCH FED. SEC. L. REP., SPECIAL REP. No. 2, May 8, 1967.

groups of phrases of the 1970 Amendments. First, what information must the adviser "furnish" under section 15(c), and how can the adviser fulfill its "fiduciary" obligation under section 36(b)? Second, what information must the independent directors "request and evaluate" under section 15(c)? Finally, what circumstances will lead to favorable consideration by a court of the independent directors' approval of the advisory contract?⁶⁷

1. Pre-Amendments Concept of Adviser Fiduciary Obligation

Several years before amendments to the 1940 Act were proposed, two circuit courts had held that under the Act an investment adviser stood in a fiduciary relationship with the funds it managed.⁶⁸ Both decisions suggest that a "fiduciary" relationship in the mutual fund context implies duties to the fund closely analogous to those of the fund's directors because the adviser is often in a position to influence board decisionmaking and may hold several of the fund's directorships.⁶⁹ In addition, whenever the adviser's interest conflicts with that of the fund, the adviser's duty is that owed by the affiliated directors. Because their loyalty is divided, the affiliated directors are held to a higher standard of loyalty and their decisions subject to closer judicial review than those of the independent directors.⁷⁰ This distinction is sound because the affiliated directors (or the adviser), who may stand to profit from a particular decision in a conflict area, will have to exercise greater care if they are to ensure that conflicting interests do not motivate them but that in fact the fund's interests are controlling.⁷¹

Once the adviser is recognized to have the same obligations as an affiliated director, any contract between fund and adviser is analogous to a contract between corporations with overlapping directorships or between a controlling person and his corporation, because in each of

⁶⁷ Section 36(b)(2) provides that the approval of the advisory contract by the board of directors shall be given "such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2) (1970).

⁶⁸ *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961); *SEC v. Insurance Securities, Inc.*, 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958). See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (citing with approval Professor Loss' reference to "the delicate fiduciary nature of an investment advisory relationship." 2 L. LOSS, *SECURITIES REGULATION* 1412 (2d ed. 1961)).

⁶⁹ See Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966); Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266 (1959); Note, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120 (1967).

⁷⁰ See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Bates v. Dresser*, 251 U.S. 524 (1920); *Lanza v. Drexel & Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. Oct. 9, 1970); Eisenberg & Lehr, *supra* note 69; Folk, *Civil Liabilities Under the Securities Acts: The BarChris Case, Part I—Section 11 of Securities Act of 1933*, 55 VA. L. REV. 1, 37-46 (1969).

⁷¹ Cf. text accompanying notes 73 & 74 *infra*.

these situations some of the same individuals typically sit on both sides of the agreement.⁷² The "interested transactions" statutes of several states provide that these contracts are neither void nor voidable for that reason alone if they are ratified by a majority of the disinterested directors after complete disclosure, and are fundamentally fair.⁷³ Judicial scrutiny, therefore, focuses on the question of the "fairness" of the transaction. In the mutual fund context, fairness encompasses a prohibition against not only direct use of fund assets for the adviser's own interests, but any practice benefiting one of a complex of funds in which the fund's net asset size, fee arrangement, or potential growth gives the adviser a greater self-interest in it than in the others.⁷⁴

The effect of the pre-Amendments fairness standard, however, was blunted by a line of decisions, beginning with *Saxe v. Brady*, holding that ratification by the shareholders or independent directors relieved the adviser of the duty to prove fairness and required the plaintiffs to prove "that no person of ordinary sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given."⁷⁵

Although the 1970 Amendments make explicit the adviser's fiduciary obligation and seek to reimpose a fairness standard, they leave open the effect a court should now give to the independent directors' sound business judgment. This question is really twofold: when would it be to the adviser's advantage to seek board approval, and when does the adviser have a fiduciary obligation to submit a transaction for their approval?⁷⁶ The distinction between these questions is

⁷² See, e.g., *Levien v. Sinclair Oil Corp.*, — Del. Ch. —, —, 261 A.2d 911, 914 (Ch. 1969); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918).

⁷³ E.g., DEL. CODE ANN. tit. 8, §144 (1968), as amended (Supp. 1970); N.Y. BUS. CORP. LAW §713(a) (McKinney 1963); see W. CARY, CASES AND MATERIALS ON CORPORATIONS 552-59, 571 (4th ed. 1969). See also *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960); Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335 (1948).

⁷⁴ For a complete explanation of the factors which may lead an adviser to favor some funds over others, see Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205, 226-33 (1970).

⁷⁵ 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Ch. 1962). This standard has also been applied following the disinterested approval of the non-affiliated directors. For examples of how courts apply the "sound business judgment" doctrine, see *Kurach v. Weissman*, 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970); *Acampora v. Birkland*, 220 F. Supp. 527, 548-49 (D. Colo. 1963); *Meiselman v. Eberstadt*, 39 Del. Ch. 563, 170 A.2d 720 (Ch. 1961).

⁷⁶ The First Circuit recently termed this obligation the fiduciary "duty of disclosure." *Moses v. Burgin*, 445 F.2d 369, 376 (1st Cir. 1971), cert. denied, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971). The adviser's fiduciary duties encompass most of its transactions with the funds it manages. See *Rosenfeld v. Black*, 445 F.2d 1337, 1348 (2d Cir. 1971). Here, the discussion is limited to instances in which the fiduciary standard implies not only that the dealings must be inherently fair, but also that, after complete disclosure, they must have been approved by the independent directors.

crucial to judicial review of director approval. If the adviser has no fiduciary obligation to submit a transaction for board review, it may choose not to do so and forego only the protection director approval might afford. But if the adviser has a fiduciary obligation to submit the practice to the board and does not, or does so but fails to present all relevant information, it will incur liability for whatever losses the fund suffers regardless whether a reasonable board could have decided that the transaction was fair. It is probable that section 36(b) specifically limits the adviser's fiduciary duty to disclose its practices to only those practices affecting the advisory fee because that section employs the fiduciary standard only "with respect to the receipt of compensation."⁷⁷ This conclusion, however, does not imply that the adviser does not have other fiduciary duties beyond disclosing information necessary for the independent directors' approval of the advisory contract. These duties include, among others, a fiduciary's obligation not to sell his office or usurp fund opportunities. In these areas, the fairness standard applies but does not require that the adviser disclose its practices to the directors. If the transaction is inherently fair, the adviser cannot be found to have breached his duty under the statute.

This analysis of the adviser's fiduciary duty to disclose suggests that section 36(b) merely gives statutory eminence to duties that could be found in pre-Amendments case law interpreting the adviser's fiduciary duties and that section 15(c) offers the only really new approach to these questions.⁷⁸

The two duties of section 15(c) are stated disjunctively: the independent directors must request and evaluate what they know to be relevant, and the adviser must furnish or submit for their approval information on certain transactions regardless of their request.⁷⁹ Section 15(c) limits the adviser's fiduciary duty to disclose to information bearing on the contract for investment advice. To conclude that the adviser's fiduciary duty to submit a transaction for board approval encompasses only the advisory fee is, then, consistent with section 36(b). This interpretation is strengthened by the similarity between the negotiation of the advisory fee and the setting of executive salaries

⁷⁷ 15 U.S.C. § 80a-35(b) (1970).

⁷⁸ Although most mutual fund attorneys recognized that the adviser's dominance of the funds implied some fiduciary duties, several industry spokesmen insisted that because the advisory fee was negotiated with the non-affiliated directors at arm's-length these duties did not encompass that fee. University of Pennsylvania Law School, *Conference on Mutual Funds*, 115 U. PA. L. REV. 662, 745 (1967) (remarks of Alfred Jaretzki, Jr.) The present "breach of fiduciary duty" language in § 36(b), which applies specifically to the adviser's compensation, was designed in part to moot this argument.

⁷⁹ See text accompanying notes 65-67 *supra*.

by the officers or directors of a corporation.⁸⁰ In this area, involving the most acute conflict of interest, the adviser cannot choose to forego board approval. Of course, the conclusion that the adviser's fiduciary duty to disclose extends only to the advisory fee does not mean that it would not be prudent to seek the disinterested approval of the board in many other areas. Nor does this conclusion suggest that the adviser does not have other fiduciary duties in which a fairness standard will be imposed.⁸¹ Rather, this interpretation of section 15(c) implies that when a shareholder challenges an advisory fee, compliance with the adviser's fiduciary duty to have made full disclosure to the independent directors before they approved the fee is an essential element of fairness. In all other areas of its dealings with the fund, the adviser can establish the fairness of the transaction by showing that a reasonable board might have approved the arrangement.⁸²

2. The Independent Directors' Duty To Request and Evaluate Information

Just as section 36(b) helps define the adviser's duty to disclose under section 15(c), the other provisions of the 1940 Act requiring specific board action should be reflected in the construction of the independent directors' duty to pass on certain transactions. Admittedly the "request and evaluate" phrase appears in section 15(c) and modifies only their duty to approve the advisory contract.⁸³ The 1940 Act also requires, however, that they approve the distribution contract,⁸⁴ value non-listed securities, and select the fund's accountants.⁸⁵ In addition, the 1940 Act and state law place final responsibility for the expenditure of fund assets on the directors.⁸⁶ Thus, before renewing the advisory contract the independent directors must evaluate the fee not only in the light of the investment advisory services offered by the adviser but with regard to the underwriting contract and fund expenses such as

⁸⁰ The SEC's *Public Policy Report* attributes the adviser's ability to dictate its own compensation to (1) the absence of competitive pressures, (2) the limitations on disclosure, (3) the ineffectiveness of shareholder voting rights, and (4) the obstacles to effective action by the non-affiliated directors. PUBLIC POLICY REPORT, *supra* note 3, at 132; see Note, *Management Compensation: The SEC Mutual Funds Report*, 3 COLUM. J. LAW & SOC. PROB. 66 (1967).

⁸¹ See note 76 *supra*.

⁸² Cf. text accompanying notes 95-97 *infra*.

⁸³ 15 U.S.C. § 80a-15(c) (1970); see text accompanying note 65 *supra*.

⁸⁴ 15 U.S.C. § 80a-15(b) (1970).

⁸⁵ *Id.* § 80a-31(a).

⁸⁶ The legal framework of most funds is defined initially by the various state corporation codes or trust laws under which they are organized. For a comprehensive discussion of the legal context in which funds operate, see Glazer, *supra* note 74, at 208-17. See also Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 780-85 (1964).

brokerage commissions, shareholder accounting, and custodial and other costs not included in the advisory fee. The adviser's obligation to provide this information is derived from section 15(c), not its fiduciary obligation under section 36(b). The effect of an adviser failing to adequately inform the directors is that they cannot effectively approve the advisory contract, and any fees paid thereunder must be returned to the fund.⁸⁷

3. The Weight To Be Given Independent Director Approval

The practical consequences of determining when the adviser has a fiduciary duty to submit a transaction for board approval are twofold. The first question is, who must bear the burden of proof? Because the fairness of a transaction can seldom be proved without information in the hands of the insiders, it is usually held that if a breach of a fiduciary duty is alleged, the defendants have the burden of proof.⁸⁸ If, however, the transaction has been approved by the shareholders, or, one must conclude a fortiori, an informed business judgment of independent directors, the burden of proof may shift to the plaintiff.⁸⁹ Finally, an occasional case has suggested that if the plaintiff does establish a prima facie case the burden of proof reverts to the insiders.⁹⁰ The 1970 Amendments reject these occasional cases and, in effect, reach the former by requiring board approval and then, in section 36(b), stating: "the plaintiff shall have the burden of proving a breach of fiduciary duty."⁹¹

The remaining question is the weight a court should give the independent directors' approval of specific transactions between fund and adviser. Section 36(b) provides that with regard to the advisory fee "approval by the board of directors . . . shall be given such consideration by the court as is deemed appropriate under all the cir-

⁸⁷ An action brought to enforce the adviser's statutory obligation to disclose under § 15(c) would not be subject to the limitations on damages and time for filing the action imposed by § 36(b). The damages, however, might be offset by a *quantum meruit* counterclaim by the adviser for the cost of the services rendered.

⁸⁸ *Pepper v. Litton*, 308 U.S. 295 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); C. ISRAELS, *CORPORATE PRACTICE* 197 (2d ed. 1968).

⁸⁹ *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Ch. 1962); cf. *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963).

⁹⁰ *See, e.g., Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp.*, 73 F. Supp. 721 (D.D.C. 1947), *rev'd*, 173 F.2d 416 (D.C. Cir. 1949).

⁹¹ 15 U.S.C. § 80a-35(b)(1) (1970). A student commentator has suggested that while this section may place the burden of proof ultimately on the plaintiff, the defendant still has a burden to come forward with a justification for his actions once the plaintiff has made a prima facie showing of fraud. Note, *Mutual Fund Advisory Fees and the New Standard of Fiduciary Duty—Interpreting the 1970 Mutual Fund Act*, 56 CORNELL L. REV. 627, 645-47 (1971).

cumstances.”⁹² This phrase may indicate congressional rejection of the *Saxe v. Brady* doctrine that makes shareholder ratification a significant consideration in the fairness analysis. This suggestion, however, does not follow a fortiori from the statutory language,⁹³ which only indicates that independent director approval is no longer conclusive.⁹⁴ In addition, this statutory language may reject an extension of the “waste” doctrine that protects an adviser practice if a court believes a hypothetical board could reasonably have found the transaction fair.⁹⁵ This conclusion is consistent with the earlier analysis suggesting that in the fee area the adviser must present the arrangements for investment advice for board scrutiny and cannot defend his compensation solely on the basis of fairness. In areas beyond the advisory fee, the 1970 Amendments are silent as to the weight to be given board approval, and presumably the waste standard still applies.

This analysis produces a curious result. In the advisory fee context, where the independent-director and adviser duties are most explicit, section 36(b) seems to instruct the courts to disregard the independent directors’ determination when weighing the fairness of the fee. Surely Congress did not imply that the adviser’s disclosures and directors’ evaluation and decision should be entirely meaningless. A better construction is that the court should decide how well the adviser has informed the independent directors so that their approval is a matter of substance.⁹⁶ The 1970 Amendments do not list the information that must be presented to the board but do indicate both that the adviser must play a greater role in securing board approval and that the independent directors’ judgment should be a significant, although no longer controlling, factor in the determination of fairness.⁹⁷

B. *The Moses v. Burgin Concept of Director Responsibility*

Although no court decisions have dealt with the standards imposed by the 1970 Amendments, *Moses v. Burgin*,⁹⁸ the most recent appellate decision construing the former section 36 “gross misconduct or abuse of trust” standard, may indicate how a court will apply fiduciary principles to the adviser and, especially, the affiliated directors of a mutual

⁹² 15 U.S.C. § 80a-35(b) (2) (1970).

⁹³ *But see* Note, *supra* note 91, at 650 (little weight assignable because approval of little value).

⁹⁴ *See* 1969 SENATE REPORT, *supra* note 38, at 15-16.

⁹⁵ *See* Eisenberg & Lehr, *supra* note 69, at 224.

⁹⁶ The legislative history of § 36(b) (2) suggests that courts might weight director approval according to “whether the deliberations of the directors [were] a matter of substance or a mere formality.” 1969 SENATE REPORT, *supra* note 38, at 15.

⁹⁷ *Id.*

⁹⁸ 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971).

fund. The suit, a derivative action on behalf of Fidelity Fund, Inc. (the Fund), named the Fund, Fidelity Management and Research Company (Fidelity), the Fund's investment adviser, Crosby Corporation (Crosby), a wholly-owned subsidiary of Fidelity that acted as underwriter for the Fund, two affiliated directors, and six non-affiliated directors as defendants. Following dismissal of the allegations raised in the district court,⁹⁹ the derivative plaintiff, a fund shareholder, sought judicial review of whether the Fund through its adviser had an opportunity and obligation to recapture a portion of the commissions paid to brokers who executed the fund's purchases and sales of investment securities.¹⁰⁰

As do most advisers, Fidelity not only recommended investments but selected the broker, on a national or regional exchange or on the over-the-counter market, through which each trade would be executed. Before 1971 nearly all exchanges maintained fixed commission schedules,¹⁰¹ and after 1968 most prohibited direct or indirect rebate or discount reducing these minimum fees.¹⁰² Although it was unclear whether the "antirebate rules" prohibited refunds other than cash,¹⁰³ Fidelity directed portfolio brokerage to brokers who would "give up" a portion of their commissions to brokers who sold fund shares¹⁰⁴ and, to a lesser

⁹⁹ *Moses v. Burgin*, 316 F. Supp. 31 (D. Mass. 1970).

¹⁰⁰ In the district court, the plaintiff also alleged violations of §§ 1, 15(a), 36, and 37 of the 1940 Act and breaches of the adviser's common law fiduciary duties. *Id.* at 35.

¹⁰¹ See, e.g., N.Y. STOCK EXCH. CONST. art. XV, §§ 2, 7, in 2 CCH NEW YORK STOCK EXCH. GUIDE ¶¶ 1702, 1707, at 1091-94, 1097 (1971); see Wall St. J., May 3, 1971, at 11, col. 1 (*American Exchange Narrowly Approves Negotiated-Rate Rule*).

¹⁰² See, e.g., N.Y. STOCK EXCH. CONST. art. XV, § 1, in 2 CCH NEW YORK STOCK EXCH. GUIDE ¶ 1701 (1970). For a discussion of the minimum commission fee structures maintained by most exchanges before 1971, see Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U.L. REV. 35 (1970). For a discussion of the rebate and fee-splitting practices prevalent on the regional exchanges, see Welles, *The War Between the Big Board and the Regionals*, INST. INV., Dec. 1970, at 21.

¹⁰³ *Moses v. Burgin*, 445 F.2d 369, 372 (1st Cir. 1971). An exception to the antirebate rules permits a broker to reduce its fee for "statistical and investment advisory services" by the amount of brokerage it receives from the customer. NYSE rule 440A, in 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2440A, at 3781-3 to -5 (1971). The district court in *Moses v. Burgin* limited this exception to "that minuscule portion of the advisory fee which covered publications such as investment letters, loose-leaf and like investment services, and the conventional statistical information stockbrokers give customers in return for their business." 316 F. Supp. 31, 44 (D. Mass. 1970).

This interpretation is clearly at odds with that of New York Stock Exchange Vice President Robert Bishop, who interprets rule 440A as permitting reduction of the advisory fee by the full amount of the brokerage commissions. Plaintiff's Reply Brief After Trial at 23, *Moses v. Burgin*, 316 F. Supp. 31 (D. Mass. 1970). Judge Wyzanski's interpretation is also contrary to the experience of several advisers who credit the profits of broker affiliates on regional exchanges against their fund's advisory fees. See BNA SEC. REG. & L. REP., No. 69, at A-1 to -3 (Sept. 23, 1970) (concluding that rule 440A permits dollar-for-dollar offsetting of brokerage commissions against the advisory fee).

¹⁰⁴ Under this "give-up" practice the fund's adviser directs the executing broker to turn over a portion of his commission to another broker who had no role in the transaction, but who has previously sold shares in the fund or who has provided statistical information. 316 F. Supp. at 37.

extent, those who had provided Fidelity with research and statistical information.

Plaintiff's allegations on appeal were twofold. First, she alleged that despite the antirebate rules recapture of a portion of these commissions was possible either through the creation of a broker affiliate, on a regional exchange, that could execute the Fund's portfolio transactions, or by channeling present give-ups to Crosby, which was already a registered broker-dealer.¹⁰⁵ Either way, the recaptured brokerage could be used to offset fund expenses by allowance of a credit against the advisory fee.¹⁰⁶ Second, she alleged that Fidelity's give-up practices benefited the adviser more than the Fund by stimulating sales that enhanced Crosby's commissions and increased the size of the Fund, which, in turn, increased Fidelity's advisory fee.¹⁰⁷ In sum, she contended that the adviser and the affiliated directors, who owned ninety percent of the adviser's stock, used Fund assets for their own benefit while withholding the potential for recapture from the non-affiliated directors—conduct alleged to amount to a "gross abuse of trust,"¹⁰⁸ as then prohibited by section 36 of the 1940 Act.

The First Circuit's resolution of each of these claims will be discussed in Part IV's analysis of the directors' role in managing fund brokerage, but it is important here to point out how and why Judge Aldrich, speaking for the court, reached these issues. Fidelity's principal contention was that even if recapture were practical, the directors could choose between the benefits of recapture and the adviser's use of brokerage to promote sales; if they chose the latter, they should not be second-guessed by a court.¹⁰⁹ Judge Aldrich responded that "if recovery was freely available to Fund, the directors had no such choice."¹¹⁰ He reasoned that because the Fund's charter required all new sales to be at net asset value to protect existing shareholders, any reduction in asset value caused by rewarding the selling broker with brokerage that could be practically recaptured for the Fund was strictly prohibited. The conclusion that the non-affiliated directors' approval could not have shielded the adviser from liability was simply Judge Aldrich's manner of saying that there was no way that the give-up practices of Fidelity could have been fair to the funds.

Judge Aldrich's opinion, however, did not stop there but discussed at great length the obligation of the adviser and affiliated directors to

¹⁰⁵ 445 F.2d at 372.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 373.

¹⁰⁹ *Id.* at 374.

¹¹⁰ *Id.*

disclose possible recapture techniques to the non-affiliated directors. Setting aside the district court's finding that Fidelity fully informed its directors,¹¹¹ Judge Aldrich concluded that Fidelity was well aware of the potential for recapture but that the information communicated to the non-affiliated directors through Fidelity's reports and those of its law firm failed to properly inform the directors so that they could reach a sound business judgment on the alternative uses of fund brokerage.¹¹²

Why the court undertook this seemingly gratuitous discussion of the non-affiliated directors' role after stating that, if it was practical to recapture, they had no choice but to do so, can be explained by two theories. First, Judge Aldrich drew a clear distinction between the obligations of the affiliated and non-affiliated directors. The purpose of this distinction may have been to protect the non-affiliated directors from liability, a technique often employed when a court fears that too high a standard will place an unreasonable burden on outside directors.¹¹³ After finding that the affiliated directors had breached their fiduciary duties, he concluded:

On the other hand, the unaffiliated directors . . . have not been shown to have had any knowledge of the possibility of NASD recapture. Nor did they have any personal conflicting interest which should have sharpened their attention. Plaintiff has not shown that they violated any duty to discover and explore the issue on their own; recapture was a new problem, and they were entitled to rely on the Management defendants . . . to advise them of its emergence. While the unaffiliated directors are not free of all obligations to consider matters on their own, we see no basis for holding them in this case.¹¹⁴

This ruling does not free the non-affiliated directors from responsibility to investigate problems the adviser has not reported to them, but it

¹¹¹ 316 F. Supp. at 48.

¹¹² 445 F.2d at 378.

¹¹³ In *Lanza v. Drexel & Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. Oct. 9, 1970), an action alleging *inter alia* that the outside directors had breached their fiduciary duties, District Judge Frankel noted:

[An outside director], not involved in the daily business, may think he "knows" things contrary to what he is told by the management upon which he must perforce rely. He may be wrong. His primary loyalties are familiar and stern ones. How and when he must—or may—run off to "warn" or advise outsiders dealing with his corporation could suggest questions of great refinement. At the very least, such actions would violate the decorum of the management hierarchy; at most, it could cost him his seat on the board and a judgment for interfering with a corporate opportunity. *If people of stature and creative potential are still wanted for corporate directorships, we must take care how agonizingly subtle their choices are to be.* See *Barnes v. Andrews*, 298 Fed. 614, 620 (S. D. N. Y. 1924) (L. Hand, J.).

Id. at 90,105 n.18 (emphasis added).

¹¹⁴ 445 F.2d at 384.

limits their obligation to do so to areas in which they have knowledge, potential conflicts, or in which the adviser has brought a matter to their attention without a full explanation.

Second, the discussion in *Moses* of non-affiliated director responsibilities recognizes that although the 1940 Act places final responsibility for fund management in their hands, the adviser, through the affiliated directors, must bring to their attention new problems of conflict of interest in fund operations. This is consistent with the observation above that the SEC and Congress are moving away from the 1940 Act's exclusive reliance upon the non-affiliated directors for shareholder protection and toward assignment of greater responsibility to the adviser. The *Moses* decision, however, carries this analysis a step further by beginning to spell out how a court using fiduciary principles might approach the role of both the non-affiliated directors and the adviser. Judge Aldrich's analysis of the adviser's duty to disclose recapture techniques suggests that an adviser must do more than simply tell the independent directors that a problem exists and stand ready to answer their questions. Fidelity had not entirely ignored the brokerage issue but had discussed some aspects of the problems with its directors, supplied one independent director with SEC reports dealing with brokerage, and instructed its law firm to explore the possibilities of recapture.¹¹⁵ Nonetheless, Judge Aldrich concluded that:

[T]he Management defendants saw a question, . . . they knew it to be in an area where there was a conflict between their personal interests and the direct interests of the Fund treasury, and . . . they did not inform the unaffiliated directors or submit it to their consideration.¹¹⁶

The *Moses* decision does not set forth a standard by which the fund's adviser might have "made [effective] the functioning of the mechanism protecting Fund from their overreaching,"¹¹⁷ but by negative inference suggests how much further the adviser should have gone. If Fidelity's presentation of the problem was insufficient for the director's consideration, Judge Aldrich must have been suggesting that the adviser and, particularly, the affiliated directors must point out and describe each area of potential conflict when seeking the independent directors' approval. To be complete, such a presentation would have to encompass the present practice of the fund and others in the industry, the legal issues raised, and an analysis of the probable benefits and disadvantages of the various alternatives. In addition, the affiliated di-

¹¹⁵ *Id.* at 377-81.

¹¹⁶ *Id.* at 378.

¹¹⁷ *Id.* at 384.

rectors must explain the area to the outsiders and may not rely upon them to raise discerning questions. The affiliated directors must pose the difficult problems raised by a conflict of interest and show how each party to the transaction would benefit. If the adviser were to make such a presentation, the independent director concept could, in Judge Aldrich's view, "function effectively."

II. SOURCES OF INDEPENDENT DIRECTOR RESPONSIBILITY

Although the 1940 Act is the only statute that speaks explicitly of independent director responsibilities, common law doctrines of fiduciary obligation help define the federal standards of adviser and director responsibility. In addition, the Securities Act of 1933 (1933 Act), the Securities Exchange Act of 1934 (1934 Act), the Investment Advisers Act of 1940, and state blue sky laws help develop the regulatory environment in which funds, through their directors and investment advisers, must operate.

A. State Law Duties

1. The Problem of Preemption

Although sections 36(a) and (b) of the 1940 Act specifically limit the defendants and remedies available in SEC or shareholder derivative actions to enforce both adviser and director responsibilities, the substantive standards controlling such actions are unclear. In addition, the legislative history of the 1970 Amendments is silent on whether section 36(a)'s "breach of fiduciary duty involving personal misconduct" and section 36(b)'s "breach of fiduciary duty" standards merely recite state law definitions or instead imply that federal courts should fashion a uniform federal standard. Thus, the problem of preemption arises from the choice among the standards defined by judicially created equitable principles, state statutes, and sections 36(a) and (b) of the 1940 Act. The problem is especially acute where the three standards impose differing levels of responsibility. And, finally, the 1940 Act, unlike the 1933 and 1934 Acts, does not contain a "savings clause" that preserves state law rights and obligations except where specifically altered by federal law.¹¹⁸

Preemption is a problem because shareholder litigants often file simultaneously in federal district and state trial courts¹¹⁹ and because

¹¹⁸ Securities Act of 1933, §16, 15 U.S.C. §77p (1970); Securities Exchange Act of 1934, §28(a), 15 U.S.C. §78bb(a) (1970).

¹¹⁹ This practice has been strongly criticized. *Rosenfeld v. Black*, 445 F.2d 1337, 1341 n.5 (2d Cir. 1971).

dismissal of the federal claims does not compel denial of recovery on state law grounds. Dicta in *DeRenzis v. Levy*¹²⁰ suggest that the 1940 Act's regulatory scheme preempts all other regulation although, of course, that statute cannot anticipate every problem. And the opinion of the district court in *Moses v. Burgin* specifically denies plaintiff's contentions that the standards applied by the court should be derived from a "general federal common law of fiduciary obligation."¹²¹ Under its construction of the charter provision prohibiting sales below net asset value, the First Circuit found it unnecessary to reach either this contention or the contention that plaintiff had a valid claim by pendent jurisdiction because in its view neither argument would have altered the result.

A very recent Second Circuit opinion, however, speaks specifically to the preemption issue. In *Rosenfeld v. Black*¹²² shareholders of the former Lazard Fund (the Fund) sought an accounting of profits realized by Lazard Freres (Lazard), the Fund's investment adviser, when it was replaced in this position by Moody's Advisors and Distributors, Inc. (Moody's A & D), a wholly-owned subsidiary of Moody's Investors Service, Inc., which was in turn a wholly-owned subsidiary of Dun & Bradstreet, Inc. (D & B). Although its prospectus provided for redemptions at net asset value, the Fund, in contrast to most open-end funds, did not continuously offer its shares. Without new sales to offset redemptions, Fund assets diminished to a point at which continuous sales and new investment policies were in Lazard's opinion necessary to meet competition. Because it was not prepared to build a sales network or change its investment philosophies, Lazard negotiated a series of agreements with D & B providing for the merger of the Fund into Moody's Capital Fund and Capital Fund's employment of Moody's A & D as investment adviser and underwriter. In addition, Lazard and D & B entered an agreement on April 5, 1967, providing for the transfer of 75,000 shares of D & B common stock to Lazard over a five year period to commence on the date the new advisory contract between Capital Fund and Moody's A & D was approved by the shareholders.

Although the proxy statement soliciting approval of the merger discussed the April 5 agreement, the shareholders were not asked to ratify the agreement. Plaintiffs alleged that the D & B shares were not delivered as consideration for the merger agreements, covenants not to compete, and consulting arrangements, but as payment for Lazard's

¹²⁰ 297 F. Supp. 998, 1002 (S.D.N.Y. 1969).

¹²¹ 316 F. Supp. 35, 55 (D. Mass. 1970).

¹²² 445 F.2d 1337 (2d Cir. 1971).

assistance in securing the appointment of Moody's A & D as investment adviser and the profits anticipated from the appointment. Although finding no evidence to support this contention, the district court chose instead to rest its summary judgment for the defendants on section 15(a) of the 1940 Act, which requires that an advisory contract automatically terminate if assigned by either party.¹²³ District Judge Mansfield relied upon the Ninth Circuit's statement in *SEC v. Insurance Securities, Inc., (ISI)*¹²⁴ that section 15(a) "gives force and effect to [the] statutory finding and declaration of policy" that there should be no transfer of control without shareholder consent.¹²⁵

The Second Circuit reversed in a decision by Judge Friendly.¹²⁶ The broad implications of this opinion will be discussed in Part IV, but we must here note how the court dealt with the defendant's contention, based upon the *ISI* decision, that section 15 of the 1940 Act constitutes a policy determination by Congress that compliance with the shareholder-approval and termination-on-assignment provisions of this section were to be the exclusive protection for the fund when a change of advisers occurred. Judge Friendly responded that section 15 did not withdraw safeguards already afforded by equity but merely supplemented them and should not be construed as the exclusive antidote for a sale of fiduciary office. He concluded by noting:

We held in *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961), that in requiring annual approval of investment advisory contracts by directors (or, alternatively, by stockholders) Congress meant to prescribe a uniform federal standard of directorial responsibility. . . . There is thus every reason for believing that Congress meant to adopt the established prophylactic rule. Just as it is unimaginable that, with respect to the responsibility of directors of investment companies, Congress would have been content "if a particular state of incorporation should be satisfied with lower standards of fiduciary responsibility for directors than those prevailing generally," see 294 F.2d at 421, it is similarly unthinkable that if a particular state had chosen not to recognize the rule of equity here in question Congress would have sanctioned an investment adviser's profiting from using his influence in se-

¹²³ The district court opinion is found at 319 F. Supp. 891 (S.D.N.Y. 1970). The reasons for Judge Mansfield's conclusions are not entirely clear. He may have concluded that once the shareholders had ratified the new adviser, any taint caused by the former adviser's influence was removed. Alternatively, he may have believed that termination of the contract on assignment left no fiduciary office to be sold or that when the contract terminated, all fiduciary obligations of the adviser similarly terminated.

¹²⁴ 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

¹²⁵ *Id.* at 649.

¹²⁶ 445 F.2d 1337 (2d Cir. 1971).

curing stockholder approval of the appointment of a successor.¹²⁷

This language suggests that the standards for judicial review in cases brought under the 1940 Act are exclusively federal and that a federal common law of director and adviser fiduciary responsibility is developing based upon both state law concepts and principles of equity inherent in either the Act's policies as stated in section 1(b) or the specific responsibilities imposed by sections 15(c), 35(a), and 35(b). Thus, if a state standard is lower than standards implicit in the 1940 Act's statutory scheme, the federal law will apply.

A more difficult problem is posed when a state standard is higher than that imposed by federal law. For example, a plaintiff might be able to prove waste of assets but not "breach of fiduciary duty involving personal misconduct," the federal standard which implies that the defendant must have actually profited by the challenged transaction.¹²⁸ Here, a federal court might dismiss the section 36(a) claim but find for the plaintiff on common law principles. Such a decision would not be inconsistent with federal standards and could be said to help effectuate the remedial purposes of the Act.

A final variation of the preemption problem is posed when a state court adopts federal standards but is asked to disregard the limitations on damages imposed by sections 36(a) and (b). The legislative history of these sections suggests that the amount of damages recoverable, the short period in which actions may be initiated, and the class of persons against whom money damages may be recovered, are all parts of a carefully designed scheme that could be disrupted if a state court were to extend liability beyond the bounds of section 36.¹²⁹

2. State Law Duties of Care and Loyalty

The independent directors' common law duty of care is often stated in terms of the degree of diligence a businessman of ordinary prudence exercises in the management of his own affairs.¹³⁰ The duty of care standard usually leads, however, to only cursory review by the courts; cases in which directors have been found liable for corporate losses

¹²⁷ *Id.* at 1345.

¹²⁸ See note 48 *supra*.

¹²⁹ See, e.g., 1969 SENATE REPORT, *supra* note 38, at 16. For an introductory discussion of the preemption problem, see MUTUAL FUNDS 335-39 (Practising Law Institute 1970).

¹³⁰ See *Simon v. Socony-Vacuum Oil Co.*, 179 Misc. 202, 203, 38 N.Y.S.2d 270, 273 (Sup. Ct. 1942), *aff'd mem.*, 267 App. Div. 890, 47 N.Y.S.2d 589 (1st Dep't 1944). See also cases cited in W. CARY, *supra* note 73, at 513-50. For an example of the statutory version of the duty of care, see PA. STAT. ANN. tit. 15, § 1408 (1967); N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

attributable to a lack of due care are extremely rare.¹³¹ There are several reasons underlying the laxity of this standard. Courts are reluctant to overturn a business judgment of the board and may use the "sound business judgment" test to protect the directors in cases in which a hypothetical board could reasonably have arrived at an identical solution.¹³² Courts have also traditionally favored outside directors. A lenient standard may result from the fear that too strict a standard of care would impose an intolerable burden on directors who are not intimately involved in daily operations.¹³³

When developing a federal standard of independent director obligation, a federal court might require a greater degree of care than usually imposed by state courts because the common law duty of care has always recognized that the character of the enterprise and the responsibilities of directors of different types of corporations must be considered when construing that standard.¹³⁴ In most corporate settings, management and shareholders seek a common goal of profit maximization by selling a product at the lowest cost yet highest price to the public. But the customers of the fund's manager are the fund's own shareholders, and their interests in reducing the costs of the investment management conflict with the adviser's interest in the greatest return for management services. The resolution of conflicts of interest inherent in the fund enterprise is the special responsibility delegated the independent directors by the 1940 Act. Thus, the duty of care increases as the potential conflicts between professional money managers and their clients are recognized. Whether this theory of the duty of care is considered a distinct principle or a part of the duty of loyalty because it is based on conflicts of interest, it is consistent with federal concepts of enforcing director responsibilities.

A more rigorous standard of director responsibility is imposed by the duty of loyalty. This duty prohibits a director from pursuing his own interests or those of a third party over the interests of the shareholders he represents.¹³⁵ When such a breach is alleged, a court will apply the stricter standard of fairness: whether "under all the circumstances the transaction carries the earmarks of an arm's-length

¹³¹ Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). See also Note, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120, 1135-39 (1967).

¹³² See notes 75 & 96 *supra*.

¹³³ See note 113 *supra*.

¹³⁴ See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963); *W. CARY*, *supra* note 73, at 543-48.

¹³⁵ See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

bargain.”¹³⁶ If a director or an adviser receives the benefit of a transaction, and the fund sustains loss or is deprived of profit thereby, the directors could be liable for breach of loyalty.

For example, in a very recent decision in a context similar to that of a mutual fund, *Goodman v. Perpetual Building Association*,¹³⁷ the directors of a building and loan association were also general partners of Fidelity Investment Company, a partnership that managed properties, made short-term loans, and acted as an insurance agent and broker. When customers of Perpetual received their loans, they were informed that they could purchase insurance from Fidelity. Finding that Perpetual could have qualified as an insurance agent and broker and thus written hazard insurance for commissions on properties insuring its loans, the court ruled that the receipt of such commissions by the directors through Fidelity usurped a corporate opportunity. This breach of fiduciary duty made them liable for the association's lost commissions.

In the mutual fund context, the relationship between Perpetual and Fidelity would be analogous to that of a fund and a broker affiliate of its adviser, and the problems would be dealt with under section 17(e) of the 1940 Act.¹³⁸ But unlike the Perpetual-Fidelity relationship, in which there are no disinterested directors to make a judgment solely for the benefit of the Association, in a mutual fund context the independent directors are charged with the responsibility of making the determination whether fund portfolio business may be channeled through the adviser's broker affiliate. The affiliated directors' duty of loyalty, however, requires that they fully explain the alternative uses of fund brokerage and discuss the possibilities of recapture as a precondition to the independent directors' approving such transactions.¹³⁹

B. Federal and State Regulatory Statutes Beyond the 1940 Act

1. The Federal Securities Acts and the *BarChris* Decision

Independent director responsibility not only stems from the 1940 Act¹⁴⁰ but is also influenced by three other federal securities acts and by

¹³⁶ *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); see *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Johnson v. American Gen. Ins. Co.*, 296 F. Supp. 802 (D.D.C. 1969).

¹³⁷ 320 F. Supp. 20 (D.D.C. 1970).

¹³⁸ 15 U.S.C. § 80a-17(e) (1970). Section 17(a) prohibits a fund and an affiliated person of that fund to join in any transaction violating SEC rules. Section 17(b) requires SEC approval before entering any such transaction. Section 17(e), however, permits an affiliated person to perform services for the fund as either underwriter or broker. See text accompanying notes 324-39 *infra*.

¹³⁹ See generally text accompanying notes 112-16 *supra*.

¹⁴⁰ 15 U.S.C. § 80b-3 (1970).

state blue sky laws. Mutual fund advisers must now register under the Investment Advisers Act of 1940. This change, which was brought about by the 1970 Amendments, has particular significance for incentive fee structures and the extension of SEC disciplinary powers over advisers and persons associated with them.¹⁴¹ Additionally, the publicly offered shares of the fund must be registered under the Securities Act of 1933,¹⁴² and the proxy solicitation completed in compliance with the Securities Exchange Act of 1934. The sale of fund shares is regulated under the 1940 Act, the antifraud provisions of the 1934 Act, the rules of the SEC and NASD, and the various state blue sky laws.

The SEC has frequently used the disclosure requirements of section 5 of the 1933 Act, section 14 of the 1934 Act, and section 31 of the 1940 Act as regulatory techniques. For example, in a 1959 SEC disciplinary proceeding, *In re Managed Fund, Inc.*,¹⁴³ the Commission suspended the effectiveness of the fund's registration under the 1933 Act because its prospectus misstated the fund's investment policy, failed to disclose that the actual management of the fund was not performed by the investment adviser as provided in the advisory contract but had been delegated to a person not mentioned in the prospectus, and misrepresented the directors' role in fund affairs. In a more recent disciplinary action, *In re Provident Management Corp.*,¹⁴⁴ the SEC ruled that an investment adviser and its controlling persons had violated the disclosure sections of all three acts by failing to report in the fund's prospectus, proxy materials, or form N-1R that the adviser's broker affiliate was receiving certain "clearance commissions"—fees related to the adviser's ability to channel fund transactions to certain New York Stock Exchange brokers rather than provide any execution services.¹⁴⁵

In addition to SEC disciplinary actions based upon the disclosure requirements, section 11 of the 1933 Act¹⁴⁶ might be used by a shareholder to enforce the responsibilities of the fund's directors or officers.

¹⁴¹ By requiring registration under the Investment Advisers Act, 15 U.S.C. §§ 80b-1 to -20 (1970), the 1970 Amendments authorize the SEC to bar or suspend any individual from associating with an adviser and make failure to supervise employees a basis for disciplinary action. *Id.* § 80b-3; see note 6 *supra*.

¹⁴² *Id.* § 77e-5; see form S-5, CCH MUTUAL FUNDS GUIDE ¶¶ 2021-23A, at 1340-61.

¹⁴³ 39 S.E.C. 313 (1959). A stop order suspending the fund's effectiveness is often an effective means of bringing misstatements in the fund's prospectus to the public's attention. See *Oklahoma-Texas Trust v. SEC*, 100 F.2d 888 (10th Cir. 1939).

¹⁴⁴ SEC Securities Exchange Act Release No. 9028 (Dec. 1, 1970), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,937.

¹⁴⁵ See *In re Imperial Financial Services, Inc.*, SEC Securities Exchange Act Release No. 7684 (Aug. 26, 1965), in [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,287.

¹⁴⁶ 15 U.S.C. § 77k (1970).

The leading case in this context, *Escott v. BarChris Construction Corp.*,¹⁴⁷ suggests that although the independent directors are not held to the same standard of care and diligence as insiders, they do bear a heavy burden in checking the accuracy of the fund's registration statement.¹⁴⁸ Before joining the board, the outside directors of BarChris made general inquiries into the company's financial condition and its officers' reputation. Once on the board, they asked few discerning questions and accepted at face value the inside directors' assurances. Because their initial inquiry was irrelevant to the truth of the registration statement, and their later questioning was so superficial, the court found that the outside directors failed to establish a reasonable inquiry sufficient to make out the due diligence defense of section 11 of the 1933 Act, the statutory standard of care applicable to all signers of the registration statement.

In a comprehensive analysis of the broad implications of the *BarChris* decision, Professor Folk suggests that outsider directors with particular knowledge or skill may bear a greater burden in showing that they have made reasonable inquiries.¹⁴⁹ Thus, "specialist directors," those with particular expertise in areas of the fund's investments or fund operations, may be required to ask more probing questions of the adviser in order to establish their reasonable inquiry.¹⁵⁰ For example, an independent director who is an investment banker may be required to scrutinize with the care employed in his own business the adviser's valuation of non-listed securities. Similarly, a real estate investor may be held to a higher standard of diligence when approving the fund's participation in a real estate investment trust.

In a recent decision also involving the outside directors of the BarChris corporation,¹⁵¹ Judge Frankel suggests that, although independent directors are held to a lower standard of care, if they assume the responsibilities of officers or members of an executive committee their duty of care could increase.¹⁵² Thus, if an independent director assumes a special responsibility, for example, reporting on new companies within a certain industry group or on a particular problem of fund operations such as the development of guidelines for the use of the adviser's brokerage subsidiary, a court could impose the responsibility to do so with the same degree of care as an insider. This result is par-

¹⁴⁷ 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁴⁸ *Id.* at 687-89.

¹⁴⁹ Folk, *supra* note 70, at 33-37.

¹⁵⁰ *Id.* 37, 41.

¹⁵¹ *Lanza v. Drexel & Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826, at 90,089 (S.D.N.Y. 1970).

¹⁵² *Id.* at 90,104 n.17.

ticularly likely to occur if he receives compensation substantially in excess of that received by other independent directors.¹⁵³

2. State Blue Sky Regulation

The blue sky laws and rules adopted by state securities administrators also regulate mutual fund policies and operations. Failure to comply with these provisions can lead to revocation or suspension of a fund's registration to sell securities within the state.¹⁵⁴

In some instances, blue sky laws go far beyond the regulation of fund sales within the state.¹⁵⁵ For example, the Statements of Policy of the Central Securities Administrators Council, an informal coalition of blue sky regulators representing the states of Indiana, Michigan, Minnesota, Missouri, and Wisconsin, include rules governing investments, speculative activities, redemption of shares, minimum assets, brokerage transactions, and expense ratios.¹⁵⁶

Although the independent directors need not be familiar with the intricacies of such rules and can in most instances rely on fund counsel to seek compliance, a particular blue sky regulation may pose a conflict of interest that the affiliated directors should explain to the entire board. Examination of maximum expense ratios offers an illustration of how the independent director should approach his duties in this regard. Conflicts may arise when the adviser allocates the expenses of a new fund. In many states, the aggregate annual expenses of the fund cannot exceed approximately one and a half percent of the first \$30 million of net assets.¹⁵⁷ The adviser must reimburse the fund for any expenses exceeding this limitation. The independent directors of the established funds should not condone an allocation of expenses permitting the adviser to keep the expense ratio of a new fund below this limitation by shifting a portion of the new fund's promotional, special research, legal, or administrative expenses to the established funds unless they are certain the shareholders of these funds will benefit proportionately through either exchange privileges or increased profitability that may enable it to hire more and better personnel and thus do a better job of managing all the funds in the complex.

¹⁵³ The responsibility of a director is usually not measured by the compensation he receives, but if he assumes duties that independent directors typically leave to the fund's adviser and receives added compensation for these responsibilities, a higher standard might be imposed. See Jaretzki, *supra* note 86, at 780.

¹⁵⁴ Statements of Policy Approved by Central Securities Administrators Council, 1 CCH BLUE SKY L. REP. ¶ 4851, at 651 (Aug. 31, 1971).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ Typical maximum expense ratios limit a fund's aggregate annual expenses of every kind, except taxes and brokerage commissions, to 1½% of its first \$30 million net assets and 1% of any additional net assets. *Id.* ¶ 4856, at 654.

C. The "Interested Persons" Definition

A cornerstone of the 1940 Act's concept of director responsibility was section 2(a)(3)'s definition of "affiliated persons."¹⁵⁸ The draftsmen of this section sought to ensure that non-affiliated directors would possess a substantial degree of independence from the fund's investment adviser. Their definition, however, permitted non-affiliated directors to own up to five per cent of the adviser's stock, have frequent business dealings with the adviser—particularly in the brokerage context—and have close family relationships with adviser officials.¹⁵⁹ The SEC saw the relationships fostered by these ties as undermining any arm's-length bargaining by the directors¹⁶⁰ and in its *Public Policy Report* suggested that complete independence be required insofar as a statutory definition could do so.¹⁶¹ Thus, the SEC's earliest proposals to amend the 1940 Act included a definition of "interested persons" precluding not only affiliated persons but those with family or business relations with the adviser from serving as independent directors.¹⁶² The industry acquiesced in this definition—possibly in the hope that strengthening existing controls in this regard would deter Congress from enacting the "reasonable" advisory fee standard. To move Congress away from this standard and back to continued substantial reliance on the non-affiliated directors, the industry supported proposals that left no question about the outside directors' independence. By the time the SEC and industry representatives had agreed upon section 36(b)'s standard of fiduciary obligation,¹⁶³ the industry was not in a position to argue that the interested persons definition was no longer necessary.

Section 2(a)(19) now defines interested persons to include affiliated persons of the fund, its adviser, or underwriter as previously defined in section 2(a)(3); members of the immediate family of persons affiliated with the adviser or underwriter; and those holding beneficial or legal interests as fiduciaries in securities issued by the adviser, underwriter, or their controlling persons. The new definition excludes from independent director status any person affiliated with a broker-dealer registered under the Securities Exchange Act of 1934; legal counsel for the fund or its investment adviser and underwriter (and such legal counsel's partners or employees); and anyone having a "material busi-

¹⁵⁸ See note 11 *supra*.

¹⁵⁹ PUBLIC POLICY REPORT, *supra* note 3, at 332-34.

¹⁶⁰ *Id.* 130-31.

¹⁶¹ *Id.* 334.

¹⁶² H.R. 9510, 90th Cong., 1st Sess. § 2(3) (1967); S. 1659, 90th Cong., 1st Sess. § 2(3) (1967).

¹⁶³ See text accompanying notes 92-97 *supra*.

ness or professional relationship" with the fund, with any other fund within the complex, or with the adviser, underwriter or their executive officers or controlling persons.¹⁶⁴

The intricacies of the "interested persons" definition pose practical as well as legal problems for fund counsel when reviewing the status of present directors or screening potential candidates for the board. The breadth of these rules may in some cases exclude those who meet the statutory goal of independence from the adviser but not its technical definition. For example, an insurance company executive could be excluded by the prohibition against independent directors who are affiliated with a registered broker-dealer if a subsidiary of the insurance company has registered as a broker-dealer so it may sell annuities as well as its life insurance policies even though it does not function as a trading house through which fund business could be channeled. The same prohibition would exclude a partner in a municipal bond house even though fund transactions were not executed through such a broker.

A literal reading of section 2(a)(19) would exclude both candidates, but in neither case is the statutory goal of independence impaired. If the fund does not do business with the type of firm with which a candidate is affiliated, his eligibility should not be challenged by the SEC. Rather the test of "interest" should be whether there exists a relationship that could make the director dependent upon the adviser. Experience under the 1970 Amendments is too limited to predict whether the interested persons definition will in fact make the selection of qualified directors much more difficult. In its only reported opinion, however, the SEC has indicated that it will very strictly construe the interested persons definition.¹⁶⁵ Such a strict construction of the interested persons definition may produce two undesirable consequences. First, the selection of new independent directors may turn more upon legal niceties than experience, knowledge, or business acumen. Second, the pool of qualified candidates may not be sufficient to satisfy the demand for their services.

The new phrase raises several additional problems of construction. First, section 2(a)(19)(B)(vi) provides that no SEC determination pursuant to the "material business relationship" part of the definition shall become effective nor affect the status of any director until at least

¹⁶⁴ 15 U.S.C. § 80a-2(a)(19) (1970).

¹⁶⁵ *Southwestern Investors, Inc.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,172 (May 14, 1971). The SEC, however, avoided a decision on the issue in this ruling. See generally *Investment Company Act Release No. 6336* (Feb. 2, 1971), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,951.

sixty days after its entry.¹⁶⁶ The purpose of this delay is to allow a board of directors time to rearrange its affiliated and independent directorships and, if necessary, renew the advisory contract after the SEC's order. Section 2(a)(9), which defines "control" (an element of the affiliated persons definition), establishes a broad presumption of non-control by the adviser until a contrary determination is made by the Commission.¹⁶⁷ Although the purpose of this presumption is apparently the same as the delay in section 2(a)(19), the SEC has stated that its determinations of control will have retroactive effect.¹⁶⁸ Thus, a shareholder who wished to challenge a board decision might try to avoid the prospective effect of a "material business relationship" determination by first asking the SEC to rule that a particular director was "controlled" by the adviser and use this determination to upset a past decision of the board.¹⁶⁹ This result destroys the statutory purpose of section 2(a)(9)'s presumption of non-control and is contrary to the 1970 Amendment's clear intent to give only prospective effect to any determination disqualifying a director.

Affiliated and independent directors often share common interests and sit on the boards of the same charitable, educational, or industrial corporations. The legislative history of section 2(a)(19) suggests that such contacts do not constitute material business relationships.¹⁷⁰ The Report of the Senate Banking Committee on S. 2224 states that the criterion by which a relationship will be evaluated is whether it "might tend to impair the independence" of the independent director.¹⁷¹ This standard would not be compromised in such cases unless the selection, compensation, or prestige of such a directorship would make the independent director beholden to an affiliated person.

Many independent directors sit "across" a fund complex or on all or nearly all of the funds managed by a single adviser. Here the common practice of individuals occupying similar positions in "any other investment company having the same investment adviser or principal underwriter" could be prohibited by a strict reading of section 2(a)(19)(A).

¹⁶⁶ 15 U.S.C. § 80a-2(a)(19)(B)(vi) (1970); see 1969 SENATE REPORT, *supra* note 38, at 33.

¹⁶⁷ 15 U.S.C. § 80a-2(a)(9) (1970).

¹⁶⁸ Fundamental Investors, Inc., 41 S.E.C. 285 (1962).

¹⁶⁹ The standard of proof necessary to establish control under § 2(a)(9) may be lower if the SEC, rather than a court, makes this determination. For example, in *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963), the court refused to find that the non-affiliated directors were "controlled" despite the fact that their numbers included directors who did a substantial amount of printing business for the fund, acted as its broker on several occasions, sold it insurance, and owned 0.4% of the adviser's outstanding stock. *Id.* at 536-37, 542-43.

¹⁷⁰ See 1969 SENATE REPORT, *supra* note 38, at 33-34.

¹⁷¹ *Id.* 33.

The standard of impairment of independence, however, is not ordinarily violated unless it can be shown that the benefit of sitting across a complex flows to the director rather than to the funds,¹⁷² a determination usually requiring more than a showing that this arrangement multiplies director fees.¹⁷³

An independent director may involuntarily become "interested" if he becomes the executor of an estate holding stock in the adviser or is named beneficiary of a trust holding or acquiring such stock.¹⁷⁴ In addition to defining "material business relationship" with greater precision, the SEC should either exempt de minimis, nonvoluntary acquisitions of adviser stock or make clear that an independent director may seek an exemption under section 6(c), which, if granted, would obviate the necessity for restructuring the board.¹⁷⁵

D. *Framework of Director Responsibilities*

Three conclusions of Parts I and II should be emphasized. First, one practical effect of the 1970 Amendments and the *Moses* decision is a shift from the 1940 Act's nearly exclusive reliance upon independent directors as a check on the adviser's compensation, use of brokerage, and sale of shares, to what the SEC has termed a more "realistic" approach that places the main burden of shareholder protection in these areas on the fund's adviser.¹⁷⁶ One problem with this approach is that it leaves in doubt both the factors that independent directors should consider before reaching a sound business judgment and the weight a court should now give their approval in its own determination of fairness. It is apparent, however, that, at least in the advisory fee context, the independent directors' approval is a necessary condition not only for the contract but for the fulfillment of the adviser's fiduciary duty. Although the independent directors' approval of the fee no longer limits the standard of judicial review to waste of assets, their judgment must be given some weight by the courts. The external management relationship between fund and adviser is only feasible if the independent decisions of the board are given substantial weight by the court. Even if a different course of action would have been more profitable for the fund, without a showing that there was a lack of disclosure to the independent directors or that the arrangement was unfair to the fund, the board's determinations should be upheld.

¹⁷² *Id.*

¹⁷³ The benefit derived from director's fees is not usually large enough to seriously impair independence. See text accompanying note 208 *infra*.

¹⁷⁴ 1969 SENATE REPORT, *supra* note 38, at 34.

¹⁷⁵ See *id.* 32-34 (anticipating such action).

¹⁷⁶ 1969 House Hearings, *supra* note 52, at 138-39.

Second, the *Moses* decision suggests that the adviser's representatives on the board have a special responsibility to raise and explain the difficult questions of conflict of interest between fund and adviser. The affiliated directors' greater responsibility could be characterized either as the common law duty of loyalty or simply as a prerequisite for the effective functioning of the 1940 Act's concept of fund management. At least in the fee area, the adviser's fiduciary duties are synonymous with the affiliated directors' duty to educate the outsiders.

Third, the 1940 Act standards of both director and adviser responsibility are exclusively federal. The developing federal common law of corporate fiduciary obligation includes only those state rules or common law doctrines that are consistent with the Act's regulatory scheme. The procedural aspects and remedies available in actions to enforce these responsibilities are similarly limited to the 1940 Act's scheme.

III. PROFILE OF PRESENT DIRECTOR PRACTICES

Although several recent articles have discussed the role of the independent directors,¹⁷⁷ interviews with fund officials and directors conducted in the preparation of this Article suggest a substantial divergence between legal theory and actual practice.¹⁷⁸ The following discussion of independent director practices will explore the extent of this difference. Part IV will develop guidelines suggesting ways in which the gap between theory and practice can be reduced.

A. Selection of Independent Directors

A chief criticism of independent directors has been that in practice the adviser, rather than the shareholders, selects the board, or "[t]he men who need to be watched pick the watchdogs to watch them."¹⁷⁹

¹⁷⁷ Eisenberg & Lehr, *supra* note 69; Glazer, *supra* note 74; Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058 (1967).

¹⁷⁸ Much of the information on particular independent director practices was gathered through questionnaires sent to approximately 30 investment advisers and the independent directors of the funds they managed. Twenty-four fund complexes agreed to participate in the study by either returning the completed questionnaires or granting interviews with adviser officials and directors.

¹⁷⁹ University of Pennsylvania Law School, *Conference on Mutual Funds*, 115 U. PA. L. REV. 662, 739 (1967) (remarks of Abraham L. Pomerantz). Mr. Pomerantz went on to observe:

But obviously, you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours; and may I say again, as a footnote, that in my litigation I have encountered two situations where a so-called unaffiliated or independent director happened to be the son of the leading stockholder of the adviser.

Now, how funny can you get? And yet with straight countenance under oath the testimony was that the son was going to "call them as he sees them," to coin a phrase, and he was not going to be partial to his father.

Both the *Wharton Report* and the *SEC Public Policy Report* attribute the lack of effective independent director control largely to the existing selection process.¹⁸⁰

The power to place a slate of directors before the shareholders through the proxy mechanism is tantamount to appointment.¹⁸¹ Thus, the issue is not who will elect the directors but who should select the candidates either for annual elections or for interim terms which the board must fill. Like most promoters of a new enterprise, the adviser selects the fund's original directors. Candidates for subsequent elections are in most fund complexes selected by a nominating committee composed of both affiliated and independent directors. Although the screening of possible candidates is jealously guarded by some nominating committees, most rely upon the adviser's representatives to suggest possible candidates whom the committee then interviews and recommends. This is especially true if the president of the adviser is also president of the fund and either a member of or the chairman of the nominating committee. Thus, through either informal suggestions or the veto often given the adviser's representatives on the committee, the selection of independent directors effectively remains in the adviser's hands.

Recently some advisers have attempted to divorce themselves entirely from the selection of new independent directors. Because studies of the industry have been critical of the adviser's hand-picking of new directors, these advisers fear that any connection with the selection process might be interpreted by a court as a circumstance tainting the objectivity of later board decisions. Not only may the adviser avoid a charge of appointing subservient directors by divorcing itself from the selection process, but an important psychological result may carry over into later board deliberations. The extent to which a new director seeks information and opinion from the other independent directors rather than from the adviser's representatives may be directly related to the extent to which he attributes his selection to the former group.

How independent directors should be selected turns upon both the adviser's and the existing independent directors' understanding of a director's role in fund affairs. If, as suggested in Part IV, the independent directors should play an active role in negotiating the advisory contract and reviewing the adviser's practices, they should also assume the entire responsibility for recruiting new independent directors. Several adviser officials suggested that the present independent directors

¹⁸⁰ WHARTON REPORT, *supra* note 12, at 34; PUBLIC POLICY REPORT, *supra* note 3, at 130.

¹⁸¹ See PUBLIC POLICY REPORT, *supra* note 3, at 129.

on their boards might not have the broad contact that the president of the adviser has or the influence to encourage the type of men who would actively participate in fund affairs to join their boards. This criticism, however, assumes that new directors should come from the financial community in which the adviser's contacts are greatest. If the board seeks a broader array of business experience, there is no reason to conclude that the adviser is better equipped than the independent directors to encourage qualified individuals to join the board.

The qualities for which advisers and independent directors said they look in new directors showed a striking similarity. Both assert little interest in candidates with backgrounds in the securities industry or those whose names and reputations might spur sales. Rather, they seek intelligent, congenial men of varied backgrounds who will be diligent in fund affairs. But the list of fund directors found in many prospectuses suggests that, whoever selects the new directors, reputation, prestige, and connection with the financial community are in fact important criteria. Most boards include corporation presidents, bankers, attorneys, former government officials, and university presidents.¹⁸² Interestingly, most have achieved a nearly comparable measure of success in their respective fields and frequently sit together on other boards.¹⁸³ Currently, academics are in vogue, and many boards have at least one economics or law professor as an independent director.¹⁸⁴

The criterion most often mentioned in interviews with fund officials is that a candidate "must know the function of a good director." When asked to define this phrase, both advisers and independent directors said they wanted men who understood the corporate form of decisionmaking,

¹⁸² For example, the independent directors of one income fund include: a life member of the corporation of Massachusetts Institute of Technology; the president of Fiduciary Trust Company of Boston; the owner of Louis J. Hunter Associates, which provides trustee and financial services to corporations and individuals; a partner of a prestigious law firm; and the president of Massachusetts Institute of Technology. The Putnam Income Fund, Inc., Prospectus 4-5 (Feb. 22, 1971).

The independent directors of another income fund include: a partner of a prestigious law firm; a former professor of the Graduate School of Business of Stanford University; a former executive director of the National Association of Securities Dealers, Inc.; a former president of Calaveras Cement Company; and a professor of law at the University of California Hastings College of Law. American Express Investment Fund, Inc., Prospectus 4-5 (Mar. 11, 1971).

¹⁸³ For example, the chairman of the board and president of Broad Street Investing Corporation is a trustee of Vassar College, as is one independent director of the Fund. Broad Street Investing Corp., Annual Report 3 (1971).

¹⁸⁴ For example, Dreyfus Fund recently added four new members to its board: Dr. Alan Greenspan, an economic consultant and adviser to the Nixon administration; Dr. Jonas Salk, developer of the polio vaccine; Mrs. Eugene McCarthy; and Mr. William Moyers, former press secretary to President Johnson. NEWSWEEK, Mar. 22, 1971, at 92 (*Directors: Stein's Salon*). In addition, the board of Union Capital Fund, Inc., includes Professor Robert Mundheim of the University of Pennsylvania Law School. Union Capital Fund, Inc., Prospectus 3 (May 1, 1970). And the boards of directors of the Oppenheimer and Oppenheimer A.I.M. funds include Professor Sidney M. Robbins of the Graduate School of Business, Columbia University. Oppenheimer Fund, Inc., Prospectus 8 (Apr. 24, 1970).

men who served on other boards or as presidents working with their own boards. They seek men who know that "a good director does not interfere with day-to-day management and does not disturb the existing system when he joins a board." Although they seek men who will offer advice, ask discerning questions, and contribute to board affairs, their idea of "appropriate participation" excludes from consideration anyone known to have caused trouble on other boards.

Two reasons were commonly given by independent directors for accepting their board positions. First, each had hoped to gain the chance to apply in the fund context some special expertise developed in his own profession. Second, he had hoped to acquire knowledge about a financial institution that might be useful either personally or in his own business. Of course, the psychological reward of being part of a well-known company and sharing responsibility with men of prominence cannot be discounted.

In several complexes, past presidents or executive officers of the adviser serve as independent directors either after their retirement or after the former adviser has been bought out by the present management company. An SEC order, pursuant to section 2(a)(19)(B)(vi) defining interested persons, may exclude from independent director status former adviser officers for a period of two years after they leave the employ of the adviser. These directors are among the most knowledgeable in fund matters and in some cases have proven among the most vigorous advocates for the interests of the funds.¹⁸⁵ Prior affiliation with the fund's adviser, however, is certainly a circumstance that a court should consider when determining the weight to be given a board decision.¹⁸⁶

A possible source of future independent directors is the increasing number of "professional directors," usually retired executives, who serve on the boards of several industrial, service, or educational corporations. These directors not only bring extensive experience and business acumen to a board but often have more time to devote to fund business than directors still active in their own professions.¹⁸⁷ Although over-

¹⁸⁵ For example, Mr. Harold K. Bradford, the chairman of the board of the Investors Diversified Services' group of funds, was formerly associated with the funds' adviser, but is said now to be an outspoken advocate for the funds.

¹⁸⁶ Section 2(a)(19)(B)(iv), which specifically provides that the SEC has authority to determine who are interested persons of the adviser and hence the fund, is limited to individuals who have had material business relationships with the adviser during the past two years. One might accordingly infer that after this period such individuals should be conclusively presumed to be independent unless entirely unrelated grounds for disqualification exist.

¹⁸⁷ Of course, if the "professional director" receives several fees, and those constitute a substantial portion of his income, his independence may be impaired.

lapping directorships have recently come under renewed attack,¹⁸⁸ the prohibitions found in blue sky laws against fund investments in other corporations served by a director, and the strict enforcement of the personnel-trading policies already in effect in most funds, minimize nearly all objections to professional directors. A different problem arises when an independent director sits not only on boards of more than one fund in a single complex but on the boards of funds in several complexes. Here the most difficult problem is not insider trading by either the director or the fund complexes, but the potentially awkward position in which the director may be placed if competitive pressures for performance between complexes mean that he must approve certain portfolio selections or investment strategies that he has been told are unwise by the adviser of another fund group which he serves. This situation may also deter the adviser from disclosing some new strategy or investment approach if he believes there is any possibility a competitor will learn of it through the independent director.

B. Orientation to the Role of Independent Director

The orientation of a new director is initially shaped by the person who invites him to sit on the board. If the president of the adviser is also president of the fund and takes an active hand in selection, the new director may attribute his appointment to and be aligned with the adviser. This tendency may be even greater where the adviser asks the candidate to sit on all the boards of the complex because the new director may not identify with any particular fund. But, in practice, regardless whether the new director is contacted by the president of the adviser or by a board nominating committee, orientation is almost always left to the adviser. The process is often both informal and superficial. Typically, a new director is introduced to adviser officials and the fund portfolio manager even before meeting the other directors. Indeed, very few directors learn more about the funds they serve before the first directors' meeting than what a shareholder may learn from reading a prospectus or annual report. If new directors are often friends of adviser officials, they are usually friendly to their mode of business. This is hardly surprising because a reasonable man who appreciates the potential liability of directorship will not join a board if he knows that he cannot support the existing fund-adviser relationship,

¹⁸⁸ See, e.g., STAFF OF HOUSE COMM. OF BANKING & CURRENCY, 92D CONG., 1ST SESS., REPORT ON THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS, PART III, PENPHIL: THE MISUSE OF CORPORATE POWER (Comm. Print 1971).

or if he suspects he may be asked to approve practices he would feel were unfair.¹⁸⁹

Advisers who see independent director orientation as another circumstance that may affect the weight a court would give the board's judgment have turned this process over to the independent directors or separate fund counsel.¹⁹⁰ Of course, what is said is far more important than who explains the responsibilities of an independent director. There are, however, several compelling reasons the independent directors and fund counsel should assume this responsibility. First, although most new directors have some knowledge of the fund industry, they nearly always see their independent-director role as identical to the role they or their friends perform as directors of other types of corporations. The new director must be alerted to his unique obligations to represent the shareholders. Second, if a new director is elected to sit on the boards of all of the funds in a complex, he must be familiar with the different funds' investment objectives, fee structures, net asset values, and special research or sales needs. Too often, directors see different investment objectives among funds as eliminating the possibility of conflicts between them. Although fund objectives may vary, for example, in terms of overall volatility of the portfolio, this does not guarantee that the same investment will not be considered appropriate to more than one fund. The stock of one promising company may be available in only a limited supply in the market. Yet it may interest both a fund with an aggressive growth objective and one with a more conservative, balanced objective because, although they invest in stocks ranging over different volatility spectra, those spectra overlap and both could accommodate the particular stock.

C. Monthly Meetings, Individual Participation, and Committee Functions

The 1940 Act's concept of arm's-length bargaining and independent review of the adviser's handling of fund assets is seldom more at odds with reality than in the matter of monthly board meetings. The reasons for the divergence are hardly surprising. Mutual fund directors are highly qualified and successful men; their time is at a premium and devoted primarily to their own enterprise or profession. Fund directorship is at best a secondary occupation to which only a few hours each

¹⁸⁹ Cf. Mundheim, *supra* note 177, at 1058 & n.4.

¹⁹⁰ The orientation of new independent directors might also be undertaken by the Investment Company Institute or some other industry-wide organization whose objectivity or expertise would be less open to criticism.

month can be allocated.¹⁹¹ In addition, the investment company industry is extremely complex. Understanding the fund's place, not only in the complex and the industry but among all the competing equity investments, requires years of experience. Most directors simply cannot take time to learn thoroughly on their own the detailed problems of fund operation. Finally, independent directors derive nearly all the information on which their decisions are based from the adviser, which controls not only the content but the form of presentation and even the selection of the topics discussed.

Most boards meet monthly for approximately one and a half hours, although special committees may meet more frequently.¹⁹² If the same board serves all the funds in the complex, a joint meeting for two to three hours is common. Joint meetings not only conserve time but may give the independent directors an overview of the adviser's allocation of investment opportunities, common expense, and pooled brokerage among the various funds. This practice also permits joint determination of the advisory and underwriting contracts between the individual fund and adviser. Both directors and adviser officials agree that it would probably be unrealistic to ask the independent directors to spend substantially more time either in preparation for or in attendance at board meetings.

The independent directors typically receive an agenda and reports showing portfolio additions and deletions, investment performance, and sales and redemptions of fund shares, a week before each meeting. Comparing agendas for the year indicates that the format of each board meeting is nearly identical. Several directors described the discussion as "predictable": they could, for example, anticipate that at a part of the presentation with which a particular director was knowledgeable, he would interject the same question each month. With almost ritualistic precision, boards move through the minutes of past meetings, portfolio changes, sales reports, the president's report, and special committee presentations to adjournment. One director suggested that meeting monthly for an hour was less productive than former quarterly meetings because the short time span between meetings gave no perspective on the direction in which the fund was going.

When asked if certain issues were discussed, such as whether an advisory fee increase would be necessary if the adviser could no longer

¹⁹¹ Most directors questioned indicated that they spent approximately 2 to 3 hours each month on fund matters. Nearly all of these directors considered this time sufficient to satisfy their obligations to the fund.

¹⁹² In several complexes an investment committee met bi-weekly to review fund portfolio transactions. When special committees were appointed to deal with particular problems, such as selection of a new independent director, they frequently met on the same day as the regular monthly meeting.

use fund brokerage to generate sales or gather research, several independent directors responded that the board meeting was not the appropriate setting for such questioning. If bothered by a particular report, they preferred to question the president of the adviser privately, possibly because they did not want to take up their fellow board members' time or wish to appear not to understand a seemingly well-accepted practice. The extent to which the directors asked discerning questions usually depended upon whether the adviser solicited their participation. If a single independent director or the affiliated directors took the lead in questioning, the rest of the board often followed. When asked what occurred if the adviser's answer was unsatisfactory, most directors said they either dropped the subject until such time as someone else raised it or relied upon the adviser's integrity. The impression from most interviews was that the "first-Monday-of-the-month" meeting was congenial, conducted with dispatch and minimal unpleasantness, often predictable and repetitious, and seldom produced changes in fund operation.

D. Renewal of the Advisory Contract

Most independent directors indicated that the annual meeting called to renew the advisory contract is the longest, most detailed and informative meeting of the year. Usually the agenda for this meeting includes not only the advisory agreements for each fund but also the underwriting contracts and N-1R forms.¹⁹³ Although the substance of the adviser's presentation of this information and the directors' evaluation of it will be discussed in Part IV, it is important here to note the attitude that most independent directors bring to renewal of the advisory contract.

The renewal process is commonly referred to as "negotiation," but the meeting bears few of the earmarks of arm's-length bargaining. Advisory contracts are seldom forged in the heat of an adversary process, nor is it clear that they should be. On the other hand, the advisory agreement is seldom arrived at by independent directors and adviser representatives participating with a community of interest to scribe a new contract. The adviser usually presents a completely drafted contract calling for a certain fee structure. No independent director suggested during this study that either the board or any independent

¹⁹³ Form N-1R, filed annually with the SEC, contains a wealth of information on fund policies and transactions, including, with other information, a list of the top 10 brokers with whom the adviser placed portfolio brokerage, the allocation-of-opportunities formula, the brokers selling fund shares, and all transactions with affiliated persons. See 1 CCH MUTUAL FUNDS GUIDE ¶¶ 6201-15, at 4201-86 (forms with commentary). Although several independent directors indicated that they found this compilation useful, many thought it too detailed for their purpose. In some complexes, form N-1R is the subject of an entire meeting during which the fund counsel or an affiliated director explains each of the answers submitted for the fund.

director acting alone should contact other investment advisory houses to ascertain the price of comparable services. Only a few directors indicated that the adviser was ever asked to submit a lower fee. Contract renewal is not a bid-and-ask proposition.

Independent directors' acquiescence in this pattern of contract renewal is again attributable to the unique structure of the fund industry. Most independent directors believe that fund shareholders have purchased a package of investment management services based upon the strength of a particular adviser's reputation. Most directors feel that it would be difficult for them to justify to these shareholders hiring an adviser untested with regard to their fund simply to get a reduction in a widely accepted fee rate. Although the same independent directors said they might want to look for new advice if they believed the fee excessive or an adviser practice unfair to the funds, they believed such a drastic step a practical impossibility. Most admitted that their funds could secure comparable investment advisory services from other advisers, but asserted that their present adviser offered not only investment advice but all of the management, shareholder accounting, and distribution services necessary to maintain the complex—management services that could not readily be duplicated by others. Thus, most independent directors were reluctant to use the ultimate weapon of terminating the advisory contract. Finally, they insisted that although in theory they could always refuse to renew the contract, as a practical matter this would be impossible. The independent directors would first have to obtain a majority within their own ranks to withhold renewal. More important, any attempt to switch advisers would surely lead to a proxy battle for board control with the existing adviser having a great incentive and some advantages of incumbency.¹⁹⁴

E. Independent Directors' Contributions to Fund Affairs

This description of board meetings and contract renewal certainly does not negate the contributions of the independent directors or mean that they do not serve important functions. First, their very presence inhibits practices which cannot stand even superficial scrutiny. Even the adviser's president knows and accepts the fact that he must report periodically to men accustomed both to top level decisionmaking and to evaluating subordinate's reports. Similarly, a portfolio manager with absolute discretion will seldom act to the limits of this authority if a

¹⁹⁴ Proxy contests involving attempts to select directors who will approve a management contract with a competing adviser are extremely rare. The one recorded contest took place only after existing management relationships had completely broken down and the SEC had taken disciplinary actions, *see* *Managed Funds, Inc.*, 39 S.E.C. 313 (1959), against the adviser for serious violations of 1940 Act.

director is likely to question his recommendation. But the salutary effect of the independent directors' presence typically bars only practices they can readily perceive to be unconscionable.

The independent directors often contribute most in areas in which they have independently developed experience. For this reason, advisers seek directors with varying business, professional, and geographic backgrounds. An adviser does not usually consult an independent director about day-to-day fund management, but may seek his advice when a problem arises in his area of expertise. If, for example, the fund is considering participation in a real estate investment trust, a director who knows the real estate industry in general and the mortgage market in particular may be called upon to advise management. Similarly, an investment banker may be asked to evaluate new financing arrangements, a broker to explain the impact of negotiated rates, or an attorney to criticize the fund's prospectus. Although independent directors feel this advice is their major contribution, it usually only supplements the information upon which management's decisions are based. Advisers must seek more detailed professional advice because large amounts of capital are involved.

A third area of active director participation is membership on special committees. The complexity of the mutual fund industry has led some directors to try to develop intra-board areas of expertise. Thus, many funds have an investment committee to review an "eligible list" of securities in which the portfolio manager may invest,¹⁹⁵ the adviser's investment strategy, and the fund's overall performance. A "special" committee may investigate new selling techniques, redemptions, advertisements, and use of contractual plans. An auditing committee recommends the fund's certified public accountants and reviews accounting procedures and the reporting of "fails."¹⁹⁶ Committees composed entirely of independent directors are an even more recent development, and experience has been limited to four areas. As noted,¹⁹⁷ the selection of new independent directors has been assumed in a few complexes by nominating committees chosen and manned exclusively by the independent directors. In one complex, all the independent

¹⁹⁵ The directors of The Investment Company of America have established an "Advisory Board," composed of experts in several investment areas who meet with the directors to discuss proposed investments. The directors suggest securities for addition to an "eligible list" from which the portfolio manager must choose. Securities proposed by the directors are added to the list unless objections are raised by more than one-third of the Advisory Board within ten days. The Advisory Board may also remove any security from the eligible list if one-third of its membership so agree. The Investment Company of America, Prospectus 2 (Apr. 30, 1970).

¹⁹⁶ The term "fail" refers to a broker-confirmed purchase of stock that subsequently cannot be produced on the delivery date.

¹⁹⁷ See text accompanying notes 180-82 *supra*.

directors serve on an advisory fee committee and negotiate with a team of affiliated directors. A third group of independent directors formed a special committee and hired their own legal counsel when faced with shareholder litigation. Finally, the advent of negotiated commission rates has spurred some boards to select a committee of independent directors to establish policies defining the circumstances in which portfolio transactions may be executed through an affiliated broker. The potential such committees have to develop special competency and also avoid charges of adviser domination may lead to their use in nearly every area of director responsibility. The expertise and added compensation produced by such committee work should not result in their being held to the higher standard of care sometimes applicable to "specialist directors," because they are merely performing in a more orderly and efficient manner the responsibilities which the 1940 Act assumes every independent director will perform.¹⁹⁸ Increased potential liability could deter greater independent director participation, a result contrary to the goal of the 1970 Amendments. Moreover, additional compensation is both reasonable and necessary for directors asked to spend additional time on fund affairs and does not suggest that they have undertaken new or different responsibilities. A more significant problem is whether such committees should depend upon the adviser for information or conduct their own investigations. The latter approach certainly enhances the objectivity of the committee's report but is not feasible unless the independent directors have separate counsel to assume most of these responsibilities.

F. Staff Facilities and Legal Counsel

Only one of the fund complexes interviewed had a permanent staff; it consisted of a president, vice president, secretary-treasurer, and general counsel. Only the funds' president also served as a fund director.¹⁹⁹ Although a full-time staff can better check the accuracy of reports presented by the adviser, most smaller funds cannot afford the additional expense of full-time directors, assistants, secretaries, and office space. Cost is not the only drawback; absent special precautions, the fund's staff could become so identified with the adviser through sharing the same facilities that its objectivity would be impaired. If the board needs greater expertise, a committee of independent directors could select and oversee a special consultant. Even a small complex might be able to afford a management consultant to evaluate the adviser's profit margin on a particular fund, the efficiency of certain

¹⁹⁸ Compare text accompanying notes 149-50 *supra*.

¹⁹⁹ See Investors Mutual, Inc., Prospectus 12-14 (Jan. 13, 1971).

personnel structures, or the fairness of the adviser's allocation of common expenses.

Very few fund complexes have recognized the practical, if not statutory, necessity of separate legal counsel for their funds. Granting the highest integrity to attorneys who simultaneously serve the funds and their adviser and underwriter, it nonetheless seems highly anomalous that since 1941 an attorney retained by the adviser is disqualified from voting as an independent director on any aspect of fund operations, advisory contract negotiation, and the resolution of conflicts of interest, yet continues to counsel the funds' boards on all of these issues.²⁰⁰ No attorney familiar with mutual fund regulation could deny that by representing both sides in these deliberations he has placed himself in a position of conflict of interest;²⁰¹ the fact that this practice has been accepted for years is no answer. Indeed, continuing to serve both fund and adviser may be a disservice to both because a conscientious court would certainly take this into consideration when deciding the weight to be given the directors' business judgment.

This warning is well stated by the court in *Kohn v. American Metal Climax, Inc.*,²⁰² a shareholder derivative action alleging that an amalgamation of Roan Selection Trust, Ltd. (RST), and American Metal Climax Company (AMAX) violated the proxy rules and anti-fraud provisions of the 1934 Act, and that the RST directors had breached their fiduciary duty to their shareholders during the merger negotiations. Ruling for the plaintiffs, District Judge Masterson suggests that a controlling factor in the decision was that both RST and AMAX were represented by the same legal counsel. He found:

[Legal counsel] thus placed itself in a clear position of conflict of interest. Though this position is sought to be justified because the RST directors agreed to allow [the law firm] to continue to represent it notwithstanding the conflict, such an agreement is meaningless in view of AMAX's control of RST Nevertheless, even assuming [the law firm] could continue to represent both, their position is a material fact which should have been disclosed to the shareholders. It would be important for shareholders, in evaluating the advice of RST directors to vote in favor of the amalgamation, to

²⁰⁰ The SEC has ruled that no partner or associate of a law firm on a general retainer from the investment adviser may serve as an independent director. SEC, Opinion of General Counsel, Investment Company Act Release No. IC-214 (Sept. 15, 1941), in 3 CCH FED. SEC. L. REP. ¶¶ 48,032, 48,033; cf. 15 U.S.C. § 80a-2(a)(19)(B)(iv) (1970).

²⁰¹ Cf. ABA CODE OF PROFESSIONAL RESPONSIBILITY, disciplinary rule 5-105(B) (1970).

²⁰² 322 F. Supp. 1331 (E.D. Pa. 1970).

know that through December, 1969 RST was being advised by lawyers who were also advising AMAX.²⁰³

Although Chief Judge Aldrich did not reach this issue in *Moses v. Burgin*,²⁰⁴ he did note that the attorneys who surveyed the possibilities of recapturing fund brokerage commissions through a broker affiliate on a regional stock exchange were either affiliated directors or associates in the law firm which represented management.²⁰⁵ Because their report was never fully communicated to the directors, the court was able to disregard it and avoid weighing either its accuracy or its credibility.²⁰⁶

Both decisions clearly evidence judicial concern that in an area with substantial public interest one party to the agreement lacked effective legal counsel. Admittedly, the *AMAX* case arose in a context different from the relationship between fund and adviser. There, *AMAX* dominated the RST directors in a manner that prevented them from reaching a disinterested business judgment whether RST should have been represented by the same counsel as *AMAX*. In the fund context, the independent directors can, after full disclosure, approve the same counsel for the funds as retained by the adviser. The independent directors of a small fund might decide that the cost of separate counsel could not be justified to their shareholders. This determination however, should only be reached after the directors have assured themselves that they can retain counsel who can structure the relationship so as to maintain his integrity in this situation. Both the independent directors and the adviser must realize the extent of the liability they risk should a court later disregard their decisions made upon information or advice furnished by the adviser's attorney. At least with regard to the advisory fee, the weight a court will give the independent directors' "sound business judgments" may depend upon whether they were advised by counsel who represents only the fund.

The *Moses* decision further suggests that the funds should be represented by counsel at least as independent as the directors themselves. The new definition of "interested persons" emphasizes this requirement by prohibiting an attorney, his partners, and his employees from serving as independent directors if they have represented the adviser or underwriter within the past two years.²⁰⁷ The soundness of

²⁰³ *Id.* at 1362.

²⁰⁴ 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971).

²⁰⁵ *Id.* at 376-80.

²⁰⁶ *See id.* at 381 n.18.

²⁰⁷ Section 2(a)(19)(B) includes within its definition of "interested person": any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter.

15 U.S.C. § 80a-2(a)(19)(B)(iv) (1970).

this prohibition is obvious: an independent director must often be a diplomat, a role that might conflict with that of advocate for the fund.

G. Compensation, Insurance, and Indemnification

Despite potential liability and increased responsibility for fund decisionmaking, independent directors' fees remain nominal. Most independent directors receive between \$1200 and \$1800 per year from each fund.²⁰⁸ It is either a flat fee or a certain minimum plus a sum for each board meeting attended. The independent directors within a single board occasionally receive different fees, especially if some of them assume special responsibilities such as reviewing portfolio decisions or reporting on companies within their geographic area. For independent directors sitting on the boards of all of the funds in a complex, the fee from each fund is allocated either on a net asset basis or divided on a ratio of the fund's net assets to the assets of the entire complex. In nearly every instance, the independent directors are paid by the fund rather than the adviser.²⁰⁹ Unless the combined fees become significant in relation to an independent director's total income, there is little reason to believe that increasing compensation to reflect added responsibilities impairs a director's independence. In addition, there are sound reasons to suspect that director service, like any other, is worth what one pays for it.

Despite the potential liability that their independent directors assume, very few complexes can obtain any form of insurance protection for them.²¹⁰ The director-and-officer-liability or errors-and-omissions coverage frequently offered other types of directors is not readily available to fund directors. Perhaps insurers believe the contours of liability are too unsettled, or directors believe the exclusions are too broad and the premiums too great to justify the expense to the fund.²¹¹ The 1970 Amendments may, however, fix money damages recoverable from independent directors with sufficient particularity that insurers will now

²⁰⁸ The trustees of the few remaining fund groups that are organized as trusts may receive substantially greater compensation. The amount of discretion which a trustee can delegate is not entirely clear. Thus, in order to protect against liability, a fund trustee may be called upon several times a week to approve the portfolio selections recommended by the adviser.

²⁰⁹ If they receive any separate compensation for serving on the fund's board, the affiliated directors are paid by the adviser. See, e.g., Wellington Fund Inc., Prospectus 3 (May 10, 1970).

²¹⁰ Only four of the fund complexes interviewed offered their directors any form of insurance. In each of the four, the adviser was associated in some way with an insurance company that had dealings with Lloyds of London.

²¹¹ For differing views on the public policy implications of director insurance, compare Bishop, *New Cure For An Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92, 107-12 (1966), with Note, *Liability Insurance for Corporate Directors*, 80 HARV. L. REV. 648, 669 (1967).

offer coverage.²¹² In addition, section 36(b) and the *Moses* decision may lead shareholders to name only the adviser and affiliated directors in hope that the court will apply the higher standard of fiduciary obligation.

Assuming a fund may purchase liability insurance for its directors, the allocation of premium expenses poses three problems. First, it might be argued that it is unconscionable for the fund to insure its directors against liability for conduct that redounds to the detriment of fund shareholders.²¹³ But, as a matter of public policy, liability insurance cannot even today protect a director from liability for his intentional or reckless wrongdoing.²¹⁴ No similar policy prohibits a company from insuring its directors for their careless or negligent mistakes. Second, in many instances the fund's adviser must bear some responsibility for their failure either to discover or to prevent an unfair practice. Thus, some portion of the premium should be borne by the adviser. Third, the independent directors should pay part of the expense for their own coverage even though their fee may be increased to reflect part of this expense. For example, one fund complex allocates ten percent of the insurance premium expense to the independent directors; forty percent of the premium is assigned to the fund, and the adviser pays the remaining fifty percent of the expense. Although several different allocation schemes are equally rational, the adviser should in every case bear a substantial part of the premium.

Most fund charters provide for indemnification of the directors. Because state corporation codes expressly permit indemnification,²¹⁵ the public policy arguments that might be raised against insuring directors are minimized. Some states, however, have gone so far as to authorize indemnity insurance even in those circumstances in which indemnification would not be permitted by the same state's statutes.²¹⁶ If a fund were to undertake this type of coverage, such an expenditure could be attacked either as a waste of assets or as a violation of federal policy expressed in the 1940 Act.²¹⁷ Moreover, the SEC might condition

²¹² Section 36(b), 15 U.S.C. § 80a-35(b) (1970), limits the damages recoverable from an independent director to the amount of the director's fees received during the year before the action was instituted (and while it is pending). Section 36(a), *id.* § 80a-35(a), does not limit damages to compensation received, but an insurance company probably could not lawfully reimburse a director for liability based on a breach of fiduciary duty involving personal misconduct. See Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403, 1428 (1963).

²¹³ See Note, *supra* note 211, at 669.

²¹⁴ The SEC has taken the position that indemnity insurance in cases of reckless or willful misfeasance by a director subverts civil liability as a deterrent. See 3 L. LOSS, *SECURITIES REGULATION* 1829-32 (2d ed. 1961).

²¹⁵ See, e.g., DEL. CODE ANN. tit. 8, § 145 (1968).

²¹⁶ See, e.g., *id.* § 145(g).

²¹⁷ See Note, *supra* note 212, at 1428.

acceleration of the fund's prospectus on waiver by the benefited party of such indemnification or on inclusion in the registration statement of a promise to submit the public policy question to a court.²¹⁸

IV. SCOPE OF INDEPENDENT DIRECTOR RESPONSIBILITIES IN SPECIFIC CONTEXTS

When Congress made the policy decision in 1940 that advisers could continue to offer their services through external management companies,²¹⁹ it was assumed that the judgments of the independent directors would be given effect so that every fund decision would not be challenged in the courts. Although the 1970 Amendments make explicit that advisers, as well as directors, owe fiduciary obligations to the fund, they nonetheless continue the concept that the independent directors are the initial guarantee that the adviser is fulfilling its obligations to the fund. Thus, the courts should only overturn board decisions that cannot reasonably be justified and are unfair to the fund. Unless the sound business judgments of the board are insulated to this extent, a heavy burden of policing fund managements will be placed on the courts. One of the reasons the courts are still in the business of reviewing board decisions, not only when board-approved transactions are alleged to be unfair but when another course of action might have been more profitable, is that neither the independent directors nor the shareholders have a common standard with which to determine whether the board's choice was in fact a sound business judgment. Thus, guidelines defining the factors controlling board decisions in specific contexts will give the directors a measure for their own performance, the shareholders a basis for evaluating the board's effectiveness, and the courts a standard for reviewing the fairness of the transactions approved by the board.

Any attempt to fashion such guidelines is limited by the diversity within the investment company industry and the practical realities of fund management. If guidelines are to offer a broad spectrum of directors the standards that they now lack, these procedures must deal with problems common to nearly all complexes. A specific checklist of director duties may be worthwhile on the individual fund level, but such a checklist must be developed by fund counsel who appreciate the particular problems of that complex and can continuously review

²¹⁸ SEC Reg. C, 17 C.F.R. §230.460 (1971) (note (a)). The Commission enforces a promise to litigate by maintaining that the prerequisites for acceleration under §8(a) of the Securities Act of 1933 are not met unless the promise is incorporated in the registration statement. For an appraisal of the impact of denying acceleration, see 1 L. LOSS, *SECURITIES REGULATION* 277 (2d ed. 1961).

²¹⁹ See note 14 *supra*.

this checklist. In addition, the key factors working against effective independent director control are two practical realities: directors often fail to appreciate their unique responsibilities and cannot devote substantial time to fund matters. Thus, guidelines must place upon advisers the responsibility to present reports identifying and exploring problems with sufficient detail and clarity to be understood and acted upon within the few hours each month that independent directors can reasonably be expected to spend on fund business.

A. *Approval of the Advisory Contract*

Section 15(a) of the 1940 Act²²⁰ requires that the advisory contract precisely describe the adviser's compensation, be initially approved by the shareholders, and be annually renewed by the board of directors or a majority of the shareholders. Section 15(c) additionally conditions board action on the approval of a majority of the independent directors.²²¹ Here, the independent directors' duty to "request and evaluate" and the adviser's duty to provide such information as may be reasonably necessary for their decision are identical. The renewal process should be approached in three steps. First, the independent directors must decide whether the quality of the adviser's service on both an individual-fund and a complex-wide basis warrants continuation of the advisory agreement. This determination turns upon a composite evaluation of each fund's investment performance.²²² Performance comparisons should be presented to the directors monthly so that the statistics presented at the annual renewal meeting need only show a composite picture of the year's growth. If the fund's performance has been disappointing, the independent directors should ask the adviser for an explanation. Their inquiry should be specifically directed to an evaluation of the investment management process, the adviser's formula for allocating investment opportunities among the various funds in the complex, the trader's approach to best execution, the allocation of fund portfolio business, and the depth and quality of the adviser's staff. Only after the independent directors have assured themselves that the adviser can offer each fund an equal opportunity for performance should they move to an analysis of the fee. Even assuming, however, the fund's performance has been satisfactory, the directors should review these factors although they need not concentrate upon them.

Second, to evaluate the reasonableness of the fee, the directors must know what services are included within the contract and how the

²²⁰ 15 U.S.C. § 80a-15(a) (1970).

²²¹ *Id.* § 80a-15(c).

²²² This discussion assumes that the adviser's ability to handle shareholder accounts and transfer service is adequate.

adviser has allocated common expenses. If the directors know what each service costs and the cost of similar services to other funds or advisory accounts, they can determine whether their fund is sharing in the economies of scale inherent in the complex form of organization. When determining whether the adviser's profit margin is reasonable, the directors may consider the adviser's entrepreneurial risk and the quality of the investment advice received, usually evaluated in terms of the fund's performance.

Third, the independent directors must structure the adviser's compensation. Usually this is either a flat percentage of net assets or a flat fee plus an incentive for superior performance. Here, the independent directors must decide if incentive arrangements are necessary or appropriate in light of their fund's objectives. They should employ a risk-adjusted formula²²³ to ensure that the fee actually reflects superior investment advice and not just a general increase in market prices.

The following subsections will develop each of these steps. Before the directors begin their evaluation of the contract, however, they should make two initial judgments. If they sit across a complex, they must decide if a particular course of action will affect a single fund or all the funds. In many cases, the independent directors can jointly determine fee rates and structures for all the funds. Joint determination permits more exact comparisons among the funds and perspective on the adviser's total compensation. The independent directors should also determine if the adviser's self-interest in a particular fund or funds is greater than in others.²²⁴ If the fee structure, net asset size, new sales relative to increased performance, and current market conditions indicate that the adviser will gain more from favoring a particular fund, the independent directors should scrutinize with particular care the fairness of the adviser's treatment of the other funds.

1. Assuring an Opportunity for Performance

Most shareholders invest in a particular fund because of its adviser's reputation for performance measured by the fund's objective.²²⁵

²²³ The most complete performance comparisons are published in the monthly periodicals *Fundscape* and *Insight* by Arthur Lipper Services, Inc., of New York City. The criteria for comparisons adjusted for risk are discussed in I. FRIEND, M. BLUME & J. CROCKETT, *MUTUAL FUNDS AND OTHER INSTITUTIONAL INVESTORS: A NEW PERSPECTIVE* 54-55 (1970), and in SEC, *INSTITUTIONAL INVESTOR STUDY REPORT*, H.R. DOC. NO. 64, 92d Cong., 1st Sess., pt. 1, at xiv (1971).

²²⁴ See Glazer, *supra* note 74.

²²⁵ The *Wharton Report* found a positive relationship between a fund's performance and new sales. Both the volume and consistency of fund sales were affected by its performance over several years. *WHARTON REPORT*, *supra* note 12, at 343-44. The relationship between performance and the inflow of new money has increased since that publication. See I. FRIEND, M. BLUME & J. CROCKETT, *supra* note 223, at 13.

The quality of the adviser's service is thus judged in part by the fund's ability to achieve its objective relative to either its past performance, a market index, or the performance of like equity investments.²²⁶ The independent directors should begin to evaluate the adviser's service by comparing each fund's achievement of its objective against a selection of comparable investment companies with like objective and risk. They should then compare the performance of each fund against the other funds in the complex. When presenting comparisons, the adviser should point out the criteria for selection and the method of reporting investment results. This can be simplified by using a recognized tabulation such as that published by Arthur Wiesenberger or Arthur Lipper Services.²²⁷ If similar adjustments for objective and volatility can be made, nonfund advisory assets managed by the fund's adviser or others in the industry can provide meaningful comparisons. For example, a conservative income fund's performance might be compared with a pension or endowment account, or a capital appreciation fund compared with an aggressive hedge fund so long as both entities employ similar investment techniques, such as leveraging or short sales.²²⁸ In most instances, however, a combination of these comparisons will be necessary to reflect performance adequately. The adviser's performance reports should cover the most recent period or portion thereof for which published data is available as well as the preceding three and five year periods.

Performance comparisons, however, do not fully portray the quality of an adviser's service. Adverse performance may not be symptomatic of either the adviser's inattentiveness or its preference for other funds in the group. Nonetheless, the independent directors should be alert for consistently low performance patterns developing over several quarters. They should pay particular attention if one fund in the complex performs poorly but the other funds compare favorably with funds of like objectives. This pattern may indicate either a weakness in the adviser's ability to manage a particular type of fund or receipt of less than a fair share of investment opportunities.

If the independent directors are satisfied with the funds' performances, they can generally assume that the quality of the adviser's service

²²⁶ See Mundheim, *supra* note 177, at 1063-64.

²²⁷ FUNDSCOPE, INSIGHT (Arthur Lipper Services, Inc.); MUTUAL FUND PANORAMA (Arthur Wiesenberger Services, Inc.). *Forbes* also publishes annual performance figures and rates various funds against the Standard & Poor's 500 Stock Average. *Mutual Fund Ratings—1971: 519 Funds Covered*, FORBES, Aug. 15, 1971, at 51-68.

²²⁸ Developing meaningful comparisons is difficult because the services provided non-fund accounts were frequently quite different from those provided the funds. See PUBLIC POLICY REPORT, *supra* note 3, at 90-92.

warrants continuation of the contract. The significant problems arise if one or all of the funds show unsatisfactory performance over several comparison periods. When a pattern of poor performance develops, the independent directors should ask the adviser for an explanation. If the performance comparisons accurately reflect the fund's rate of return adjusted for risk, such factors as size or adverse market conditions should not explain poor performance. For example, a large balanced fund's rate of return may be only half that of a smaller growth fund, but the risk of loss in the large fund is only a fourth as great as in the growth fund. Thus, the large fund has a better risk-adjusted performance. Some advisers insist that a very large fund cannot be expected to perform as well as smaller funds with the same objective because the large fund cannot take meaningful positions in smaller, aggressive companies.²²⁹ But exactly why size should justify poor performance is unclear. The investor certainly receives no consolation from the fact that the larger fund may expose his dollars to less risk when the most reliable measures of performance compensate for this factor in arriving at comparisons.

If the independent directors are not satisfied with the adviser's explanations, they should make further inquiry before deciding to continue the contract. The questions which then arise are: (1) What reports should they request and evaluate? (2) Should the directors attempt to secure further information from sources other than the adviser? (3) Will additional staff help, such as a management consultant, be necessary? (4) At what point should the directors refuse to renew the contract? If the independent directors are not convinced by the adviser's explanation of the fund's poor performance, they should focus particular attention on four reports that they should have received during the year. First, at least annually they should have received a report on the internal operations of the adviser's staff presenting a structural outline of the personnel assigned to each fund, the flow of research information to each portfolio decisionmaker, and the trader's policy for allocating limited quantities of securities requested by several funds.²³⁰ They should begin their review of the investment management process by asking the adviser to explain changes in its operational structure for the past year. If not satisfied that these changes will enhance future performance, the independent directors should ask to speak with the fund's portfolio manager. If the portfolio manager serves a

²²⁹ The SEC in 1966 found no relationship between fund size and performance. *Id.* 263. The most recent study of mutual fund performance also concluded that "there does not seem to be any consistent relationship between size and performance." I. FRIEND, M. BLUME & J. CROCKETT, *supra* note 223, at 60.

²³⁰ Cf. text accompanying notes 237-40 *infra*.

single fund and his compensation is tied to its performance,²³¹ he can be expected to be an effective advocate for the fund.²³² The independent directors' inquiry should be directed not toward his investment philosophy but toward his possible complaints about the ways in which research materials are communicated, authorizations are executed, and pooled brokerage is allocated to secure research for the fund. If one portfolio manager serves several funds or lacks final discretion over fund investments, the independent directors must assume the responsibility for analyzing the investment management process. This burden, however, could be delegated to fund counsel, who need not be experts in adviser operations, but in time will become sufficiently familiar with the process to assure the directors that it is fair to each fund.

The second report the directors should request is an explanation of the fund's investment strategy for the past year and changes anticipated for the coming one. Although the directors should not become involved in the selection of individual investments for the fund's portfolio, they do have a role in defining the fund's investment strategy. Because investment objectives cannot be changed without shareholder approval,²³³ most prospectuses state the fund's objective in terms broad enough to permit nearly any combination of securities whose composite volatility reflects a generally understood level of risk. The independent directors' function in narrowing such broad objectives as placing investments in "industries and companies which have particularly favorable long-term prospects for appreciation in value, based on increased earnings and dividends,"²³⁴ is twofold. First, they should ask the portfolio manager or investment committee how the stated ratios of cash, equity and debt securities, or industry groups fit within the fund's objective.²³⁵ The independent directors do not have sufficient expertise to develop limits on how fund assets should be invested but do have the responsibility to see that the adviser's investment strategy is consistent with the goals of most shareholders. Second, whenever a new portfolio manager is hired for the fund or its investment committee is restructured, the independent directors should

²³¹ See generally Ellis, *To Get Performance You Have to Be Organized For It*, *INST. INV.*, Jan. 1968, at 44, 70.

²³² The portfolio manager, however, is still an employee of the adviser. The degree of his advocacy for a particular fund may depend upon whether the adviser believes better performance will be achieved by promoting a spirit of competitiveness or cooperation among the portfolio managers.

²³³ 15 U.S.C. § 80a-13(a) (1970).

²³⁴ Windsor Fund, Inc., Prospectus 1 (revised ed. May 1, 1970).

²³⁵ The fund's portfolio manager usually attends the monthly directors' meeting and should be asked to explain how each addition to the fund's portfolio fits within its stated objectives. When the contract is reviewed, only the broad objectives need to be considered.

ask for a report on how the new decisionmaker will change existing investment strategy. Frequently a fund's objective reflects the investment philosophy or style of its portfolio manager.²³⁶ Here the directors' role is similarly limited to an evaluation of whether changes in investment strategy are consistent with the fund's objective. They should not attempt to second-guess professional management's selection of the portfolio companies, absent particular expertise in an investment area or knowledge of a recommended company.

One consequence of a fund's participation in a complex is that its orders or authorizations may compete with those of other funds or non-fund accounts in the group. If the adviser's trading department cannot acquire or sell sufficient quantities of the stock to satisfy each order, or by executing a series of trades adversely affects the market price, the fund's performance may suffer. Consistently low performance by one fund while the others perform well may indicate that the adviser's policy for allocating the opportunity to buy or sell a limited quantity of the same security discriminates unfairly against that fund.

In most complexes the adviser has adopted a policy directing the trader's allocation of investment opportunities. This is the third matter the independent directors should request and review.²³⁷ The typical formula allows each fund daily purchases or sales based on the ratio of the fund's authorization to the total authorizations of all funds.²³⁸ This formula, however, may cause a fund to forego lower brokerage commissions because none of its small orders over several days qualify for the discount usually afforded orders over \$500,000.²³⁹ To take advantage of these new, negotiated commissions, the adviser might permit execution of authorizations over \$500,000 on a sequential basis, rotating the opportunity to trade first among the funds. Some advisers have also instructed their traders to "bunch" the orders of two or more funds to take advantage of negotiated commission rates. For example,

²³⁶ See Ellis, *supra* note 231.

²³⁷ Form N-1R, *see* note 6 *supra*, asks that the adviser state this policy, suggesting that the SEC believes an allocation policy necessary.

²³⁸ A typical allocation formula provides:

It sometimes happens that two or more of the funds for which the Adviser acts as investment adviser, such as funds with similar investment objectives, policies and restrictions, simultaneously purchase or sell the same portfolio security. When this occurs, each day's transactions in such security are, insofar as possible, averaged as to price and allocated between such funds in accordance with the total amount of such security being purchased or sold by each of such funds.

The Putnam Income Fund, Inc., Prospectus 3 (Feb. 22, 1971).

²³⁹ At the urging of the SEC, the Board of Governors of the New York Stock Exchange approved on April 1, 1971, an amendment to the Exchange's constitution permitting firms to negotiate commissions on portions of orders in excess of \$500,000. For a complete discussion of the views of the Board of Governors and the SEC, see BNA SEC. REG. & L. REP., No. 96, M-1 to 0-2 (Apr. 7, 1971).

if Fund *A* authorizes the purchase of \$400,000 of IBM stock and Fund *B* simultaneously authorizes \$200,000 of the same stock, the trader will execute a single trade. The first \$500,000 will come within the lower competitive rates and the remaining \$100,000 at minimum commission rates. The funds' custodian will receive and allocate the total authorization.

The independent directors must ensure that the adviser's allocation policy is fair to each fund in the complex and that the stated policy is followed in practice. The independent directors should first check whether the adviser has greater self-interest in a particular fund manifest in the allocation formula. Several advisers insist that the allocation problem is more apparent than real. While admitting that fund objectives often overlap,²⁴⁰ they contend that differences in fund size and the limits portfolio managers place on their authorizations mitigate any potential for unfairness. A large fund cannot take a small position in a security if the impact on performance is to be meaningful, and a small fund cannot take a large position without either substantially affecting its portfolio's composition and volatility or violating the 1940 Act prohibition against investing more than five percent of the fund's assets in any one company's stock.²⁴¹ In addition, advisers contend that orders are often qualified by limits which effectively prevent any competition for the same security. For example, Growth Fund's portfolio manager may authorize the purchase of 5000 shares of *X* Company as quickly as possible, regardless of price. Income Fund may order the same number of *X* Company shares but only if the trade can be executed at 35 or less, with a single day's purchases limited to 1000 shares and the entire order completed within 30 days of the authorization. Moreover, advisers insist that investment research is but a highly technical estimate of performance, and analysts will seldom agree on a "sure bet." Finally, adviser officials argue that they have no greater interest in one fund than in others because their reputations are founded upon the ability of all of their funds to perform well. These arguments are persuasive but do not undercut the necessity for an allocation policy which eliminates any potential for questionable allocation.

The independent directors can only check compliance with the stated allocation formula by detecting a pattern of discrimination.²⁴² By selecting several allocations each month and applying the formula, the independent directors can see if a disproportionate share of the

²⁴⁰ See, e.g., Oppenheimer Fund, Inc., Prospectus 5 (Apr. 24, 1970).

²⁴¹ 15 U.S.C. § 80a-12(d) (1970).

²⁴² The monthly portfolio additions and deletions reports can be cross-checked more easily by the independent directors if all of the funds' transactions in a security are listed together.

more highly recommended investments find their way into the portfolio of a particular fund.

The fourth report the independent directors should request is a list of the brokers through whom fund portfolio business has been channeled. How the adviser's reciprocal business arrangements can affect the fund's performance will be discussed in a following section. It is only important here to note that the allocation of portfolio business may be reflected in the fund's cash flow, size, and availability of outside research, all of which may in turn influence performance.

If none of these reports shows a causal link between poor performance and the adviser's arrangements for investment advice, the independent directors should make two further inquiries. First, they should consider the depth of the adviser's staff assigned to a particular fund. The quality of the adviser's service may well depend upon both the number and the experience of analysts and portfolio managers who manage fund investments. Although the directors are not in a position to pass upon the quality of the second-level staff, they should recognize that as a fund grows additional personnel may be required. In addition, the fund's performance may be closely linked to the ability of a particular individual. The independent directors should know what arrangements the adviser has made to replace such key individuals.

The independent directors cannot evaluate all of these reports at a single meeting even with the help of separate fund counsel. Thus, much of this information should be presented during the year and only a synopsis of monthly reports discussed at the meeting called to renew the contract. In most cases, monthly performance comparisons will permit each independent director to formulate before the meeting an opinion whether the quality of the adviser's service warrants continuation of the contract. If performance is unsatisfactory, and the independent directors can specify the problem with particularity, they can request help from a management consultant. This course of action may cause hostility between the adviser and directors and should only be considered when they have reached the point of refusing to renew the contract unless dramatic changes in adviser practices are forthcoming.

2. Evaluating the Reasonableness of the Fee

After satisfying themselves that the arrangements for providing investment advice offer each fund an equal opportunity for performance, the independent directors should determine whether the fee is reasonable. Reasonableness implies that the fund is participating in the econ-

omies of scale inherent in the complex form of organization.²⁴³ Thus, the key elements of this evaluation are the costs incurred to manage the funds, the advisers' direct and indirect compensation from the entire complex, and a profit reflecting not only the cost but the value of these services.²⁴⁴ If the fee is later challenged as a breach of the adviser's fiduciary duty, the weight a court gives this approval will depend on the objectivity with which information regarding the fee was presented and explained to the independent directors.²⁴⁵

a. Costs Incurred in Managing the Fund

Most advisory contracts offer a package of investment advisory and administrative services representing the major operating expenses of the fund.²⁴⁶ In a few complexes, the fund enters two contracts with the adviser: ²⁴⁷ an advisory contract covering research and investment advisory services, and a management services contract covering the administrative and shareholder accounting functions performed by the adviser.²⁴⁸ The advisory fee paid by a particular fund cannot be readily compared with the fees of similar funds for two reasons. First, the adviser may assume such expenses as fund office space or shareholder recordkeeping, or the fund may pay them directly. Second, the fee is nearly always stated as a percentage of net assets rather than as a compilation of individual charges for the distinct services offered the fund. Because the industry does not volunteer, nor the SEC specifically require, a breakdown of the advisory fee, the independent directors cannot compare, for example, the investment advisory or shareholder accounting fees paid by comparable funds. Such a breakdown would facilitate the directors' evaluation of the adviser's compensation, but until this information becomes publicly available, the independent directors should require a breakdown of the advisory fee as part of their evaluation of its reasonableness.

Most of the expenses assumed by the adviser are incurred jointly for all the funds and accounts in the complex. For example, research

²⁴³ See PUBLIC POLICY REPORT, *supra* note 3, at 94-96; WHEARTON REPORT, *supra* note 12, at 503.

²⁴⁴ Cf. note 35 *supra*.

²⁴⁵ See text accompanying notes 88-97 *supra*.

²⁴⁶ Brokerage commissions are not paid out of the advisory fee but directly out of fund assets. Brokerage is typically considered not an operating expense but a capital expenditure reflected in the fund's overall performance. See PUBLIC POLICY REPORT, *supra* note 3, at 90.

²⁴⁷ For a more complete description of the variety of contractual arrangements, see *id.* 90-94.

²⁴⁸ In addition to an advisory fee, several funds pay an administrative fee based upon a percentage of the fund's average net assets for the year. This fee typically covers non-advisory services such as shareholder accounting and custodian services performed or paid by the adviser. *Id.* 92.

is nearly always performed collectively,²⁴⁹ and the salaries of traders and administrative personnel are paid by the adviser.²⁵⁰ In addition, the adviser can purchase shareholder accounting services²⁵¹ and pay legal and printing fees at savings reflecting volume discounts. In this way the adviser and the funds benefit from the economies of a complex. When expenses are incurred jointly, however, the portion of the expense benefiting a particular fund is not directly ascertainable. And, if the fee is not broken down into readily identifiable costs, the independent directors have no way of knowing whether the adviser is passing on part of the economies of the complex to their fund. In addition, they cannot know if the fund's advisory fee encompasses expenses that should be covered under the underwriting contract, or expenses that the fund should not bear either because they were not contemplated by the advisory contract or because they are properly allocable to other funds in the complex.

The independent directors should request a cost breakdown of each service included in the advisory fee. Most advisers already compile such information for internal audits of each fund's expenses.²⁵² With this information, the independent directors must then determine whether the adviser's allocation of each expense accurately reflects the costs of providing that service to the fund, and whether the expense of operating the complex accurately reflects the combined fees paid by all the funds. Most advisers have developed formulas for allocating the different collective expenses, and not only the formula but the criteria upon which it was devised should be made available to the directors. For example, the formula for investment analysis expenses is usually based upon the relative net asset values of the various funds.²⁵³ This formula may not be appropriate, however, for such expenses as shareholder accounting and prospectus and annual report preparation.²⁵⁴ By weighing each of the formulas, and their application during the past year, the directors can determine whether the fund is paying an appropriate share of the common expenses.

²⁴⁹ *Id.* 47.

²⁵⁰ *Id.* 46.

²⁵¹ Administrative and shareholder accounting services can be purchased from such organizations as Investment Companies Services Corporation or the State Street Bank of Boston. See Glazer, *supra* note 74, at 262 n.273.

²⁵² Early drafts of the 1970 Amendments would have required that the directors be given a breakdown of the advisory fee by expense category. See note 66 *supra*. Most directors do get at least a partial breakdown. MUTUAL FUNDS 312-13 (Practising Law Institute 1970) (remarks of General Counsel David Silver, Investment Company Institute).

²⁵³ For a discussion of the development and implementation of formulas for allocating fund expenses, see Glazer, *supra* note 74, at 265-68.

²⁵⁴ See *id.* 266-67.

The independent directors should also compare the investment advisory expenses charged the non-fund clients of the adviser. If these fees are lower than those charged the fund, the directors should ask for an explanation. Although the services provided pension, endowment, or individual accounts may differ,²⁵⁵ these fees are arrived at through arm's-length bargaining and offer significant comparisons.²⁵⁶

b. The Adviser's Direct and Indirect Income

The adviser's income, for purposes of determining a reasonable management fee, can be accurately estimated by checking two sources. The first, direct income from the funds, is easily ascertainable by combining the various advisory fees. The second, indirect income received either as the profits of the adviser's broker affiliate attributable to fund business or in the form of services for placing fund portfolio brokerage, is more difficult to evaluate. If the adviser has a wholly-owned brokerage subsidiary which acted as soliciting broker in a takeover or received commissions or clearance fees,²⁵⁷ these profits of the broker affiliate should also be taken into account. The adviser may also have received research information or sales promotion from brokers with whom it placed fund trades.²⁵⁸ The directors should attempt to place a value on these services to reflect the money saved by the adviser's not having to purchase them. The question here is not whether in either the broker-affiliate or services context this income could be recaptured for the fund, but simply how much income it represents to the adviser. One approach to valuing this research may be to consider the cost of equivalent research purchased with cash from these brokers or from "research houses"—firms that offer only investment analysis and not market executions.

The independent directors should also ask for the adviser's profit-and-loss record for the preceding year. Some advisers argue that their profit-and-loss statement is not "reasonably necessary to evaluate the

²⁵⁵ See WHARTON REPORT, *supra* note 12, at 490-91.

²⁵⁶ The Wharton Report concluded that:

The principal reason for the difference in rates charged open-end companies and other clients appears to be that with the latter group "a normal procedure in negotiating a fee is to arrive at a fixed fee which is mutually acceptable." In the case of fees charged open-end companies, they are typically fixed by essentially the same persons who receive the fees, although in theory the fees are established by negotiation between independent representatives of separate legal entities, and approved by democratic vote of the shareholders. This suggests that competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds.

Id. 493-94 (footnote deleted).

²⁵⁷ See text accompanying notes 326-34 *infra*.

²⁵⁸ See text accompanying notes 310-17 *infra*.

contract" within the meaning of section 15(c).²⁵⁹ They contend that when they contract for services the profitability to the other party is never disclosed, and that their obligation to the fund is the same regardless of their profit margin. But both arguments are merely an extension of the pre-1970 Amendments position that, at least with regard to fee negotiations, advisers were not fiduciaries.²⁶⁰ Arm's-length bargaining seldom occurs in the fund context, and the competitive forces that shape the adviser's bargaining with others are not present in advisory fee negotiation. Although funds pay an advisory fee that is typically not broken down into individual prices, a high profit by the adviser from managing the entire complex should lead to an examination of whether a single fund is sharing in the economies inherent in this form of organization. A second indicator may be a comparison of the expense ratios of similar funds belonging to other complexes assuming, of course, that like services are included in these ratios.

Determination of a reasonable or fair profit should include three elements: a comparison with other funds' expense ratios, an allowance for assumption of entrepreneurial risk, and, most important, an evaluation of the quality of the adviser's service. Although performance is the primary gauge of effective management, cost is also an important element. By comparing the expense ratios of the fund with those of the funds used to test performance, the independent directors can determine whether they are paying more or less for comparable value received by funds in other complexes. The pitfall of emphasizing expense ratios is that it often develops into a cost-plus philosophy of reasonable return, an approach which rewards the expensive, inefficient adviser.²⁶¹

c. The Rewards for Entrepreneurial Risk

Most advisers contend that a reasonable profit must include a reward for entrepreneurial risk if the industry is to attract the personnel and capital necessary for maintaining the quality of investment advice, continuing the industry's growth, and encouraging new funds to compete through different objectives and investment techniques. This element of profit was recently considered in *Rosenfeld v. Black*.²⁶² As discussed above, the plaintiff argued that the payment in stock receivable by Lazard when its former shareholders approved the advisory contract

²⁵⁹ See also Mundheim, *supra* note 177, at 1067.

²⁶⁰ See University of Pennsylvania Law School, *Conference on Mutual Funds*, 115 U. PA. L. REV. 662, 745 (1967) (remarks of Alfred Jaretzki, Jr.).

²⁶¹ A large profit margin may reflect very efficient management. To reduce the profit margin of an adviser who has consistently kept the fund's expense ratio low would be to penalize efficient, conscientious management.

²⁶² 445 F.2d 1337 (2d Cir. 1971).

with Moody's A & D was not consideration for the series of agreements merging the Lazard Fund into Moody's Capital, but compensation for Lazard's assistance in securing appointment of Moody's A & D as investment adviser and the profits anticipated from this position.²⁶³ The district court found no evidence to support this claim but chose to rest its summary judgment for the defendants on the automatic termination on assignment provision of section 15(a). District Judge Mansfield ruled that:

Where (as here) a majority of the stockholders approve a new advisory contract, as they are empowered to do by 15 U.S.C. § 80a-15(a), the management's conduct in arranging such a substitution does not violate the Act, regardless how it is labelled.²⁶⁴

This decision relied upon the Ninth Circuit's reasoning in *SEC v. Insurance Securities, Inc.*, which held that section 15(a) was directed not at the money received by the former adviser but at a transfer of control without shareholder consent.²⁶⁵

The *Rosenfeld* district court opinion was reversed by the Second Circuit in a decision by Judge Friendly.²⁶⁶ Beginning from the "well-established" principle of equity that a fiduciary cannot sell his office for personal gain, the court reasoned that because the adviser stood in a fiduciary relationship, the receipt of profit derived from influencing the selection of its successor was a violation of this relationship. The court noted that:

A fiduciary endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries. Experience has taught that, no matter how highminded a particular fiduciary may be, the only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain.

. . . If Lazard did not wish to continue as adviser and chose to recommend a successor and assist in the latter's installation, it was obliged to forego personal gain from the change of office, no matter how deeply or rightly it was convinced it had made the best possible choice.²⁶⁷

To Lazard's contention that there could be no sale of fiduciary office because the contract automatically terminated on assignment,

²⁶³ See notes 122-24 *supra* & accompanying text.

²⁶⁴ 319 F. Supp. 891, 897 (S.D.N.Y. 1970).

²⁶⁵ 254 F.2d 642, 649 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

²⁶⁶ 445 F.2d 1337 (2d Cir. 1971).

²⁶⁷ *Id.* at 1342-43 (footnote omitted).

Judge Friendly responded that as organizer of the fund and controller of the proxy machinery, Lazard was in a position to influence the shareholders' appointment of a new adviser. Nonassignability of the contract, he reasoned, simply underscored the fact that payments to an outgoing adviser represent compensation for using its influence to secure shareholder approval of a new adviser that anticipates profit from this relationship. The Ninth Circuit's decision in *SEC v. Insurance Securities, Inc.*, (*ISI*) was distinguished by the court both upon its facts and upon the section of the 1940 Act under which the action was brought. In *ISI* the SEC unsuccessfully challenged the sale of adviser stock by a controlling group of shareholders to a new controlling group at a price twenty-five times its book value. The SEC alleged that, despite shareholder approval, this transaction constituted a "gross abuse of trust" as then provided in section 36 of the Act. This allegation, in Judge Friendly's view, was readily distinguishable from those in *Rosenfeld* because the former section 36 standard was "addressed to highly reprehensible conduct [and] we would not dream of suggesting, much less holding, that Lazard's actions were so culpable."²⁶⁸ Although noting that in the Ninth Circuit's opinion none of the price in excess of book value received by the outgoing controlling group was recoverable under any circumstances by the fund, he concluded:

While we do not find it necessary at this time to determine whether the difference between a transaction such as that here before us and the sale of a controlling block in a corporate adviser at a price reflecting the expectations of profit under a renewed contract with the corporation which the sellers were to aid in procuring, is sufficiently substantial to warrant a different result in this latter case, we should not wish to be understood as accepting these broad views.²⁶⁹

Implicit in this language is the suggestion that a sale of a controlling block of adviser stock, at a price in excess of the value of the adviser's tangible assets plus some amount representing the value of the adviser's expertise absent a contractual relationship with the fund, may make the recipients liable to the fund. This suggestion has very significant implications not only for the founders of investment advisory firms who may be locked to their companies but also for the shareholders of advisers whose stock is publicly traded.²⁷⁰ The most important implication in the advisory fee context, however, may be that the inde-

²⁶⁸ *Id.* at 1346.

²⁶⁹ *Id.* (footnotes omitted).

²⁷⁰ In 1966 the SEC found that the securities of approximately 20 fund advisers were publicly held. PUBLIC POLICY REPORT, *supra* note 3, at 46. The number of publicly held advisers is probably greater today.

pendent directors can no longer approve an advisory fee that includes compensation for entrepreneurial risk.

Earlier in his opinion Judge Friendly had questioned, but had not decided, whether, even assuming the D & B—Lazard stock transfer had been fully disclosed to the shareholders, they or the independent directors could have approved the transaction.²⁷¹ Put more simply, payment to an outgoing adviser is so fundamentally unfair to the fund that it could not be a sound business judgment for the independent directors to approve it. The fund had received no benefit from the D & B—Lazard stock transfer; Moody's A & D would presumably have been even more willing to advise the Capital Fund without paying Lazard for its influence. Indeed, the independent directors of the Fund might have negotiated a lower fee with Moody's A & D because, if it was willing to pay Lazard, it would in all likelihood have been willing to make the same concession to the fund.

The conclusion that the Lazard—D & B agreement was so unfair that it could not be approved by the independent directors does not necessarily mean that they could not approve a renewed advisory contract at the same fee rate after a sale to a new controlling group of the adviser or that the previous advisory fee was excessive. The distinction lies in the fact that if the adviser organization continues to manage the fund, the fund is benefited because it does not have to accept an adviser whose satisfactory management had not been proven by advising the fund. In the *ISI* case, this benefit, a form of "good will," was held to be an asset of the adviser, not the fund.²⁷² If the former chief executive officer of the adviser, its portfolio managers, research analysts, and administrative personnel continue to serve the funds after the transaction, the directors can exercise sound business judgment in approving a fee that is not reduced by the amount in the excess of the tangible asset value plus the value of the adviser's organization absent the contract received by the selling shareholders. Here the contract cannot be characterized as unfair to the funds.

This conclusion also implies that in the usual contract renewal the independent directors can consider entrepreneurial risk although the rationale is somewhat different and the amount in question will be substantially less. The adviser typically sustains a loss when starting a new fund or group of funds and must recoup these losses through its profit margin in later years. Although these losses cannot be considered after they have been recouped, they can be an element of a reasonable profit. Some advisers have created funds through an initial public

²⁷¹ 445 F.2d at 1343.

²⁷² 254 F.2d 642, 650-51 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

offering and almost immediately generated a net asset base sufficient to assure a reasonable profit. If this technique becomes prevalent, the independent directors should not reward an adviser who does not or cannot employ these techniques, and who thus sustains initial losses, by returning these losses in the form of a higher advisory fee.

d. The Quality of the Adviser's Services

The final element of a reasonable advisory fee is an evaluation of the quality of the adviser's service. If performance of the fund has been superior, a greater profit acts as an additional incentive.²⁷³ There is no reason to assume that the best performing fund should not have the highest paid adviser so long as its expense ratio remains comparable to those of similar funds.

The independent directors should not, however, approve an advisory fee including as an element of profit a subsidy for losses sustained in the adviser's selling. Regardless whether the adviser distributes fund shares through broker-dealers or its own retail selling network, the underwriting function is frequently unprofitable. To rescue this part of its operation from red figures, the adviser may seek a corresponding increase in the advisory fee. If the independent directors are presented a package of services that is not broken down into individual charges, this added compensation can easily be disguised. This "bundling practice" may place the cost of the selling effort on existing shareholders in violation of charter provisions requiring all sales at full net asset value.²⁷⁴ The independent directors should request a breakdown of each expense under the advisory contract to prevent this subsidization.

3. Structuring the Fee

Until recently, a majority of the largest funds and nearly all of the smaller funds paid a flat fee, a fixed percentage charged against the net assets under management, regardless of the fund's size or objectives. The *Wharton Report* and the SEC's *Public Policy Report* criticized the customary one-half of one percent fee for failing to reflect the economies of managing greater assets.²⁷⁵ In addition, a flat fee may not provide sufficient incentive to advisers who incur greater cost and

²⁷³ Because performance spurs new sales, which increase the fund's net assets and thereby increase the advisory fee, additional incentives may be unnecessary, even assuming a relationship between the size of the fee and performance. See note 225 *supra*.

²⁷⁴ See notes 98-112 *supra* & accompanying text (discussion of *Moses v. Burgin*).

²⁷⁵ In 1960, 13 of the largest 20 mutual funds charged a flat fee; by 1965 the number had dropped to 3. WHARTON REPORT, *supra* note 12, at 28-29, 480-81; PUBLIC POLICY REPORT, *supra* note 3, at 11, 97-100.

thereby risk more of their capital by managing funds with aggressive objectives.²⁷⁶

Usually the adviser's cost of managing a second \$50 million is less than that of the first.²⁷⁷ A flat fee does not permit a fund to share in these economies because the charge per dollar under management remains the same.²⁷⁸ Thus, some complexes have adopted a scaled-down fee: for example, 0.5 of one percent on the first \$150 million, 0.4 of one percent on the next \$150 million, 0.36 of one percent on assets between \$300 and \$600 million, 0.33½ of one percent on all additional net assets.²⁷⁹ The independent directors must structure the fee for each fund to permit it to share proportionately in these economies. For example, if the first break point is set at \$150 million, a small fund may never realize any benefit from being part of the complex. This problem can be eliminated either by lowering the break point for smaller funds or by charging each fund that portion of the total fee which its net assets represent in the entire complex. For example, if Fund *A* has \$100 million in net assets, Fund *B* \$200 million, and Fund *C* \$300 million, and the total fee is \$12 million, Fund *A* would pay \$2 million, Fund *B* \$4 million, and Fund *C* \$6 million. The "whole complex" approach still charges each dollar under management equally but permits all the funds to share in the savings.

Many funds have recently adopted a performance fee, a proportionate increase or decrease in the advisory fee based on the fund's performance. A typical performance fee arrangement charges the fund:

a basic fee of ⅛ of 1% (annually ½ of 1%) of the Fund's average month-end net asset value for the quarter, subject to a decrease of ⅓ of 1% quarterly (annually ⅛ of 1%) if the Fund's investment performance for the twelve months preceding the end of the quarter is two percentage points or more below that of the Dow-Jones Industrial Stock Average and subject to an increase of ⅓ of 1% quarterly (annually ⅛ of 1%) if the Fund's investment performance for the twelve months preceding the end of the quarter exceeds that of the Dow-Jones Industrial Stock Average by two percentage points or more. Under this formula, the total annual management fee may vary from a minimum of ⅓ of 1% to a maximum of

²⁷⁶ Cf. WHARTON REPORT, *supra* note 12, at 492.

²⁷⁷ The Wharton Report concluded that:

[T]he decline in operating ratios is much more rapid in cases where investment company assets alone are managed. In that type class of advisers the operating ratio declines by some 32.7 percentage points between the \$10 to \$50 million asset size class and the largest size class of assets, those in excess of \$600 million.

Id. 503.

²⁷⁸ *Id.* 30.

²⁷⁹ See, e.g., American Mutual Fund, Inc., Prospectus 3 (Feb. 24, 1971).

$\frac{5}{8}$ of 1% of average net assets depending on the Fund's investment performance.²⁸⁰

The 1970 Amendments to the Investment Advisers Act of 1940 eliminate the one-way street that gave advisers a bonus if they outperformed a specific index but exacted no penalty if performance fell below the index.²⁸¹ But the 1970 Amendments leave much for the independent directors and fund counsel to consider before approving a performance fee structure. First, they should consider whether an additional performance factor is necessary or a built-in incentive—tying adviser compensation to increases in net assets—is sufficient. They should also realize that an incentive fee, unless adequately adjusted for risk, may encourage investments of a more speculative nature. Second, they must select an index offering a fair standard for comparison. For example, the thirty common stocks included in the Dow-Jones average are usually high-grade industrial stocks with composite performance that may be an objective indicator but too conservative an index to be used in judging the performance of an aggressive capital appreciation fund. The independent directors should ask the adviser to prepare a chart comparing the fund's performance against several market indexes. If, for example, the fund would have outperformed a given index in eighteen of the past twenty quarters, the directors might well conclude that the index offers too low a standard. Third, the independent directors should be aware that a performance fee, unless uniformly applied to all of the funds in a complex and properly adjusted for risk, might encourage the adviser to favor one fund over another, thus destroying an important element of the community of interest that should exist among the funds and the adviser.

4. Summary of Independent Director Responsibilities in Approving the Advisory Contract

The independent directors' determination whether to continue the existing arrangements for investment advice should be based upon information received throughout the year. Reports covering the organi-

²⁸⁰ Ivest Fund, Inc., Prospectus 3-4 (Jan. 1, 1971).

²⁸¹ The 1970 Amendments deleted the exemption of investment advisory contracts from the prohibitions of §205 of the Investment Advisers Act of 1940. Congress also amended §205 to prohibit any performance fee arrangement unless it:

provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify.

15 U.S.C. § 80b-5 (1970).

zational structure of the adviser, and its policy for allocating income and expenses and assigning fund portfolio business should be presented by the adviser at monthly meetings. The information given the independent directors before contract renewal should be limited to performance comparisons, service and expense breakdowns, comparisons of expense ratios, and profit-and-loss computations for the adviser. Specifically, the independent directors should receive:

1. A comparison of the fund's performance with that of similar funds during the past year. These statistics can be taken directly from Arthur Wiesenberger's *Panorama* or the Arthur Lipper Services.²⁸² In both instances, funds are categorized by objective, size, and volatility, and the criteria for selection are adequately explained. The fund's performance should also be compared with the Dow-Jones, Standard & Poor's, or New York Stock Exchange index, and with the ability of other funds in the group to compare favorably in their respective categories.

2. A breakdown of the services provided under the contract and the adviser's policy for allocating income and expenses among the funds. The statement of a certified public accountant that these policies conform to acceptable accounting practices for equitable allocation of expenses should accompany this report.

3. A description and tabulation of the advisory fees and the expense ratios of the funds against which the fund's performance has been compared. If similar comparisons are available for pension, endowment, or private counseling accounts, these statistics should also be given to the independent directors. If the fund has a performance fee, a description of the fee structure and rate paid by other funds with similar incentives should be presented. Finally, a graph showing the expense ratio and advisory fee for each fund in the complex may be more meaningful than the statistics alone.

4. A consolidated balance sheet and profit-and-loss statement for the adviser's total operations. If the adviser breaks down its profit by individual fund or advisory account for internal accounting purposes, these figures should also be disclosed.

5. The advisory and management services contracts for all the funds in the complex. In addition, the fee structures and descriptions of services rendered nonfund accounts should be presented.

After the affiliated directors have explained this information, the independent directors should meet separately to consider their approval.

²⁸² MUTUAL FUNDS PANORAMA (Arthur Wiesenberger, pub. 1970); INVESTMENT COMPANIES—1970 (Arthur Lipper, pub. 1970).

Although in most instances the board acts as a whole, here a separate meeting of the independent directors seems appropriate. The 1940 Act requires approval by a majority vote of the independent directors to approve the contract,²⁸³ and the 1970 Amendments further require that the vote be taken in person at a meeting called specifically for this purpose.²⁸⁴ The independent directors may be hesitant to undertake a critical analysis of the proposed contract in the presence of affiliated directors who are closely related to the adviser. But if their decision is to be one of substance, the disclosure of information alone is insufficient. The Act contemplates an evaluation of this information uninfluenced by the adviser. At the board's monthly meetings, the continuing review of fund management can take place with the entire board present, but, when the independent directors meet to go over the proposed contract, only their opinions on behalf of the shareholders should be determinative. Although a separate meeting may not be required by the 1940 Act, how the contract was approved is a circumstance which a court will consider along with its fairness when determining the weight to be given the independent directors' approval.²⁸⁵

If the independent directors conclude that the fund's performance has been satisfactory and that the fee proposed is reasonable in light of the quality of the adviser's service, they have no fiduciary obligation to require a lower advisory fee. As fiduciaries, the directors have no obligation to bargain for the least expensive investment advisory services for the fund.²⁸⁶ But if the fee is not reasonable in light of the fund's performance, the independent directors should bargain for a lower fee either by reducing the percentage charged against net assets, lowering the break points, or asking the adviser to assume more of the fund expenses.

If, however, the independent directors are convinced that the present adviser cannot offer the funds a chance for good performance, they should contact other investment advisory houses and solicit competing offers to manage the fund's portfolio. This dramatic step should not be undertaken without the professional help of, for example, a management consultant firm. Finding another adviser willing to assume not only the investment advisory responsibilities, but also the administrative and sales responsibilities, of a fund that has a tarnished reputation is a task the directors should assume only as a last resort.

²⁸³ 15 U.S.C. § 80a-15 (1970).

²⁸⁴ Cf. 1969 SENATE REPORT, *supra* note 38, at 39.

²⁸⁵ See text accompanying notes 88-97 *supra*.

²⁸⁶ See generally Jaretzki, *supra* note 86, at 786.

B. *Approval of the Distribution Contract*

Section 15(b) of the 1940 Act requires that the independent directors renew the distribution contract with the fund's underwriter, usually an affiliate of the adviser. This approval is typically given almost as an afterthought at the meeting called to renew the advisory contract.²⁸⁷ Most distribution agreements state only that the underwriter will use its "best efforts" to find purchasers, a contractual *carte blanche* to sell as many shares as possible so long as the selling practices are lawful. The independent directors' willingness to give the adviser such complete discretion is traceable to three assumptions. First, most directors believe that continuous sales are necessary to offset redemptions and that new sales cannot be successfully initiated whenever necessary. Second, they believe that a positive cash flow is essential to performance. Finally, they see their duty as extending only to existing shareholders and not prospective purchasers.²⁸⁸ Although each of these assumptions is true to a degree, none is so axiomatic as to relieve the directors from their obligation to review the adviser's arrangements for selling fund shares.

The increase in net assets of most funds is attributable primarily to a level of sales well in excess of redemptions. Indeed, between 1957 and 1965, the reinvestment of dividend income and capital gains by existing shareholders alone offset more than half the outflow caused by redemptions.²⁸⁹ The independent directors should recognize that the adviser benefits directly from sales, because the advisory fee is based on net assets that increase with sales, but the benefit to the fund of new sales is indirect at best. If total assets under management increase, a scaled-down fee may reduce the cost of management charged against each dollar,²⁹⁰ and many portfolio managers believe a positive cash flow improves performance.²⁹¹ The absence of a positive correlation between size and performance separates the adviser's interest from that of the fund.²⁹² If cash flow were in fact so essential to performance, the independent directors should see their fund's performance exceed that of closed-end, dual-purpose, or exchange funds which have no continuous cash flow. Possibly the best comparison is the performance of exchange

²⁸⁷ See Mundheim, *supra* note 177, at 1068-70.

²⁸⁸ *Id.*

²⁸⁹ PUBLIC POLICY REPORT, *supra* note 3, at 204.

²⁹⁰ Fund growth generated by new sales may produce economies of scale not only in investment advisory services but in custodial services, transfer agency services, and administrative services. These economies, however, benefit only the adviser unless the advisory fee scale-downs are accurately related to fund size. See *id.* 252-53.

²⁹¹ See Glazer, *supra* note 74, at 253 n.222.

²⁹² See note 229 *supra*.

funds. They have no continuous cash inflow but must redeem their shares at net asset value, yet they maintain performance records nearly identical to open-end funds with similar objectives.²⁹³

Several advisers argue that even if sales cannot increase performance, a substantial outflow caused by net redemptions may impair their ability to attract new personnel or even keep their key employees, as the best analysts and portfolio managers want to be part of a dynamic, growing organization.²⁹⁴ This argument is persuasive, but the independent directors should remember that a very large fund may lose flexibility and thus be unable to take meaningful positions in smaller companies, and that a rapid influx of cash may have to stand idle until sufficient opportunities for new investment can be found.²⁹⁵ The independent directors should be prepared to restrict or suspend sales if rapid growth threatens either the quality of portfolio investments or the administration of shareholder accounts.²⁹⁶ If the independent directors are convinced that new growth in the fund will not be detrimental to existing shareholders, they may approve a continuous sales effort by the adviser. After this determination, their role is limited to policing the load the adviser charges and its selling practices and observing the volume of redemptions; all three factors may reflect on the fund's reputation and thus its ability to achieve new sales.

The underwriter's selling effort is financed in part by the "sales load," usually 8.5 percent of the total price charged new investors for fund shares.²⁹⁷ Because sales charges apply to dividend and capital gain reinvestments by existing shareholders, the independent directors must decide whether these charges are excessive. To the investor, all

²⁹³ See *Mutual Fund Ratings—1971: 519 Funds Covered*, FORBES, Aug. 15, 1971, at 51.

²⁹⁴ The converse of this argument, that sales increase the adviser's compensation and thus its ability to hire better analysis and portfolio managers, is very questionable. There is no evidence that fund growth is reflected in better performance. See note 229 *supra*. See generally PUBLIC POLICY REPORT, *supra* note 3, at 252, 255; Glazer, *supra* note 74, at 253.

²⁹⁵ See, e.g., Fiske, *Fidelity: The Problems of Success*, INST. INV., Mar. 1969, at 29; Mattlin, *The Problems of Being the Enterprise Fund*, INST. INV., Mar. 1970, at 25.

²⁹⁶ The directors of Rowe Price New Horizons Fund, Inc., voted to terminate sales when the rapid inflow of new cash exceeded the supply of attractive investments.

The New Horizons Fund, in the best interest of its shareholders, suspended sales of new shares to the general public in October, 1967. This action followed a very rapid increase in subscriptions Fund assets escalated from \$26,000,000 in December, 1966, to over \$104,000,000 only nine months later With most of the stocks in the Fund's portfolio and new candidates for investment selling at prices far above our buy limits, it was simply impossible to invest the large flow of new money to advantage; consequently, management restricted sale of new shares.

Undated letter to potential investors from Curran W. Harvey, President, Rowe Price New Horizons Fund, Inc., copy on file Biddle Law Library, Univ. of Pa. Law School.

²⁹⁷ PUBLIC POLICY REPORT, *supra* note 3, at 204.

charges are costs of securing investment management and therefore within the unique responsibility of the independent directors. In addition, the fund's ability to increase sales in cases in which this is desirable may suffer if sales charges are not competitive.

The fund's underwriter usually wholesales shares to broker-dealers who solicit sales from their customers. The selling broker usually retains between six and eight percent of the sales load as a "dealer discount."²⁹⁸ To promote additional sales, advisers have in the past supplemented the dealer discount by placing portfolio business with broker-dealers who sold fund shares.²⁹⁹ Typically, the distributor gave the trader a list of the broker-dealers responsible for most sales so that brokerage business could be channeled through their houses. This practice, commonly called "reciprocal business," meant that a broker often received orders on the basis of his sales record rather than his expertise in executing fund transactions. In addition to the problems of best execution, this practice encouraged the use of a fund asset to promote the adviser's interest in new sales.

The First Circuit's opinion in *Moses v. Burgin* prohibits not only the use of recapturable commissions (so-called soft dollars) to promote sales but the use of fund cash (hard dollars) as well.³⁰⁰ Judge Aldrich found that the fund's charter required sales to be at full net asset value in order to protect the value of existing shareholders' investment from diminution. He reasoned that if a fund receives net asset value for fund shares but rewards the selling broker with freely recapturable commissions, the fund has sold shares in violation of its charter. The phrase "free money" encompasses not only "soft" dollars but any use of fund cash to promote sales.³⁰¹ Thus, the underwriting contract cannot place the expense of preparing selling literature or advertising on the fund.

Several funds employ their own retail salesmen on either a full or a part-time basis.³⁰² Captive sales forces have become more prevalent as insurance companies with sophisticated sales networks have entered the fund industry.³⁰³ Unlike independent directors in funds that sell

²⁹⁸ *Id.* 207-08.

²⁹⁹ For an analysis of reciprocal business practices, see Note, *Conflict of Interest in the Allocation of Mutual Fund Brokerage Business*, 80 YALE L.J. 372 (1970); Glazer, *supra* note 74, at 241-59.

³⁰⁰ See notes 98-112 *supra* & accompanying text.

³⁰¹ *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971).

³⁰² See, e.g., Hamilton Growth Fund, Inc., Prospectus 7 (May 1, 1970).

³⁰³ See, e.g., Foldessy, *Rush to Mutual Funds by Insurance Concerns Approaches Stampede*, Wall St. J., Feb. 25, 1970, at 1, col. 1. Not only are insurance companies creating new mutual funds, but some investment advisers are acquiring insurance companies. See Wall St. J., May 10, 1971, at 40, col. 6 (*Equity Funding Revises Its Proposal to Acquire Bankers National Life*).

through broker-dealers, those in complexes with a captive sales force are able to check selling practices directly. By reviewing sales literature and reports of the adviser's spot checks with new investors, the directors can assure that the fund's reputation remains high.

Finally, at least quarterly the independent directors should consider the fund's redemptions. A pattern of high redemptions in one geographical area may indicate that the selling practices employed by the customer representatives within the independent retailers' networks or by the fund's own salesmen create unrealistic expectations and in turn tarnish the reputation of the fund and harm its ability to generate new sales. The independent directors should also ask the adviser for a synopsis of any letters expressing shareholder dissatisfaction with their investment. These complaints may indicate not only deficiencies in the selling effort but other areas of dissatisfaction with fund management and should prompt the independent directors to ask for an explanation or a change in adviser practices.

Most of the considerations regarding new sales and increased net assets apply with equal force to the creation of a new fund. The problems arising from the adviser's concentration of research and promotional talent on the new fund are obvious. The independent directors should ask the adviser to explain how their shareholders will benefit from the new fund. Unless the existing funds' advisory fees are scaled down as the assets of a whole complex increase, it is difficult to see what benefits, other than any exchange privilege between funds, will flow to existing shareholders.

C. Allocation of Portfolio Brokerage

The investment management contract authorizes the adviser to select the broker and the exchange through which fund portfolio transactions will be executed. Brokerage commissions are paid directly from fund assets rather than through the advisory fee.³⁰⁴ Thus, the adviser has a fiduciary obligation to place portfolio business in a way that will achieve the best result for the fund.³⁰⁵ The phrase "best execution" implies that fund purchases and sales will not only be made at the best available price for the stock but also for the lowest possible commission charge. Although best execution is a convenient shorthand, the term "best realized price" more aptly describes the adviser's obligation because it connotes both the price per share and the non-price consider-

³⁰⁴ See note 246 *supra*.

³⁰⁵ See, e.g., Delaware Management Co., SEC Securities Exchange Act Release No. 8128 (July 19, 1967), in [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,458.

ations that control the trader's decision for each transaction.³⁰⁶ Price means the best available market price for the entire block or, more simply, the highest or lowest average price per share. Non-price considerations, including speed, secrecy, and expertise in placing orders, are also important. If a fund wishes to acquire or dispose of large block rapidly, the broker's ability to execute a series of trades without adversely affecting the market price or to place the entire block with another broker or institutional investor has an important bearing upon the fund's ability to obtain the best realized price.³⁰⁷

The commission for executing the trade also affects the price at which the fund acquires or disposes of a holding. Funds frequently deal in very large blocks.³⁰⁸ The commission on trades in excess of \$500,000 can now be negotiated with individual brokers.³⁰⁹ "Negotiate" in practice encompasses not only the commission but the price per share. Thus, brokers on the New York Stock Exchange are now offering the same services as those provided by the third³¹⁰ and fourth markets.³¹¹ The best realized price in a hypothetical sale could be stated either as 55 for the stock and \$1.20 a share commission or 54½ at \$0.70, usually depending upon whether the commission is a highly visible item as in the fund context or important only as it reflects an ultimate price as in the private pension or hedge fund context.³¹² Whether negotiated rates mean different commissions or simply a different way of stating a standardized fee is questionable.³¹³ If the fund cannot find buyers through a broker, it may sell the entire holding to a "block positioner," a dealer who buys and attempts to immediately resell the stock. Because such a block trader incurs the risk of a price decline before he can liquidate his position, his willingness to purchase depends upon how much below the market price the fund is willing to sell. Instead of charging a brokerage commission, block houses are compensated by this spread in price.³¹⁴ Regardless of how the trade is

³⁰⁶ See *The Negotiated Rate Experience*, INST. INV., June 1971, at 28.

³⁰⁷ Glazer, *supra* note 74, at 242-43.

³⁰⁸ The average fund order involves approximately \$150,000. N.Y. Times, Oct. 26, 1970, at 58, col. 1.

³⁰⁹ SEC Securities Exchange Act Release No. 9148 (Apr. 14, 1971), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶78,029; see note 239 *supra*.

³¹⁰ The "third market" is a specialized segment of the over-the-counter market that deals in the securities of New York Stock Exchange listed companies. PUBLIC POLICY REPORT, *supra* note 3, at 159-61.

³¹¹ The "fourth market" refers to the direct trades, which are not reported on exchanges, between institutional investors. These transactions do not usually involve a brokerage commission. *Id.* 161.

³¹² See *The Negotiated Rate Experience*, INST. INV., June 1971, at 28, 29.

³¹³ See *id.* 29.

³¹⁴ See Note, *supra* note 299, at 376 n.19.

executed, however, best realized price means the best average price per share, including transaction costs, for the entire block.

As part of their obligation to review the expenditure of fund assets, the independent directors should formulate and require compliance with a series of brokerage allocation guidelines.³¹⁵ Because the adviser may receive either investment research services or the sale of fund shares in return for placing fund portfolio business with a broker, the adviser may select brokers on a basis other than their ability to offer the best realized price.³¹⁶ If an adviser selects a broker based upon his willingness to return valuable services, or if the fund incurs any expense unrelated to best execution because it is denied an opportunity to recapture commission dollars, the adviser has dealt unfairly with the fund and breached his fiduciary obligation.

The independent directors' brokerage guidelines should define allocation policies covering the trader's obligation to check various markets and to employ block trading techniques. The directors must also decide, assuming no charter provisions to the contrary, whether to allow brokerage use to spur new sales. A somewhat different but equally difficult problem is encountered when developing a policy for the trader's allocation of portfolio brokerage in return for investment research services.

As a practical matter, the independent directors cannot check the trader's adherence to their guidelines in every trade. Nonetheless, they should spot check several transactions each month and carefully review the brokerage allocation information contained in the fund's form N-1R. Finally, the independent directors must formulate policies in areas of particular conflict of interest, such as trades executed through a broker-affiliate of the adviser that might be executed on a negotiated commission basis. Although direct cash rebates have been abolished,³¹⁷ advisers frequently allocate commissions to brokers who sell fund shares, and, to a lesser degree, to those brokers who provide the adviser with research or statistical information. As noted in the discussion of selling techniques, reciprocal business such as this nearly always benefits the adviser, while providing only indirect and often questionable benefit to the fund.

1. Assuring Best Execution

Market transactions must be handled quickly and decisively by the fund's traders. Except to acquaint themselves with fund operations,

³¹⁵ See *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3279 (U.S. Dec. 14, 1971).

³¹⁶ See Glazer, *supra* note 74, at 242-44; Note, *supra* note 299, at 375-79.

³¹⁷ See note 102 *supra*.

the independent directors have no place in the trading room. Their proper role is limited to developing policy for the adviser to follow in the allocation of fund brokerage and, occasionally, checking to make certain that trades are executed only on the basis of the approved policy.

Few directors have developed a definition of best execution for their funds. Most assume that trading, like investment research, is sufficiently technical that uninformed tampering will do more harm than good. But, following the *Moses v. Burgin* decision and the advent of negotiated rates, several boards have appointed independent director committees to develop precisely this type of trading guideline.³¹⁸

Initially, the independent directors must determine whether any services unrelated to the execution of a particular order may be considered part of best execution. Whether the trader can reward brokers who sell fund shares with reciprocal business has perhaps been rendered moot by the *Moses* decision. If a fund can recapture a portion of its commissions through a broker affiliate, failure to do so is tantamount to using fund assets to stimulate sales at less than net asset value, a practice prohibited by most fund charters. Similarly, when a better price is available through a third or fourth market broker who offers no services, the adviser cannot pass up these houses in favor of brokers who sell fund shares.

A more complex problem exists if a trader assigns brokerage in return for research services. By contracting to perform investment management, the adviser assumes the obligation to maintain a research staff sufficient to meet the fund's needs. If recapturable dollars are used to buy research, the fund is paying expenses that the adviser has agreed to assume. Most advisers believe that this research merely supplements their own work, is not essential for the performance of their obligations under the management contract with their funds, and does not even necessarily reduce their expenses.³¹⁹ However, many advisers apparently would be willing to pay higher commissions, even under negotiated rates, to receive research services, although few advisers would pay hard dollars for this research.³²⁰

If the investment research services that the adviser receives in return for brokerage are merely corroborative, in the sense that the

³¹⁸ See text accompanying notes 197-99 *supra*.

³¹⁹ See, e.g., Windsor Fund, Inc., Prospectus 5 (May 1, 1970).

³²⁰ A recent survey of 127 financial institutions including 23 mutual fund advisers conducted by Institutional Investor Systems, Inc., reported that approximately 60% of those surveyed would be willing, if rates were set competitively, to pay higher commissions to firms providing research than to firms that only execute trades. Only about 40%, however, said they would be willing to pay cash separately for research. Wall St. J., Mar. 8, 1971, at 7, col. 1 (*Negotiated Rates Would Help Big Board Lure Institutional Business, Survey Finds*).

adviser has already completed his research and uses this information simply to supplement his conclusions, and the research has no readily ascertainable market value because no adviser is willing to pay hard dollars for it, the advisory contract cannot be said to have been violated.

But the validity of advisers' claims becomes suspect when they explain the impact of negotiated rates. Several adviser officials agreed that if soft dollars could no longer be used to buy research, they would have to purchase some research with hard dollars. A few advisers admitted that brokerage was being used for more than supplemental research and suggested that the independent directors should be prepared to increase the advisory fee to compensate the adviser for using hard dollars for research.³²¹

Several large brokerage houses have developed particular expertise in assembling and disposing of block orders, but such houses offer no other services. The combination of their expertise and willingness to negotiate a commission should lead the independent directors to require the adviser to make maximum use of these brokers. If Broker *A* offers execution for \$10,000, and Broker *B* offers execution plus research services for \$11,000, the adviser's fiduciary obligation to seek best execution requires that the order be placed with Broker *A*. Here, the services have a readily quantifiable value and are clearly not a transaction cost.

William J. Casey, Chairman of the SEC, recently stated that some fund advisers were not taking advantage of block traders but continuing to seek services in return for assigning fund portfolio business, either by splitting orders or by obtaining secondary offerings.³²² Both techniques result in additional expenses for the fund. To assure best execution, the independent directors should require that the monthly transaction report supply statistics on each trade not only by broker and exchange, but by cost and transaction type (such as fixed or negotiated commission, or secondary offering). If they find that a single brokerage house has been given several orders to buy or sell the same stock in a short period of time and that the total authorization would have exceeded the \$500,000 break point needed for negotiated rates, the independent directors should ask the trader to explain why a single block at negotiated rates was not executed. And if the fund engaged in any secondary

³²¹ Somewhat surprisingly, the independent directors of the funds these advisers managed did not react adversely to this apparent contradiction of a position espoused for so many years. At least one adviser, however, has found that fund shareholders reacted adversely to an increased management fee by refusing to renew the contract at the higher fee. See Wall St. J., Oct. 13, 1971, at 4, col. 1 (*Keystone Fund Meeting Adjourned Without Voting on Fees*).

³²² Wall St. J., June 18, 1971, at 3, col. 1 (*SEC Is Studying Whether Funds Pay Excess Fees*).

offerings during the month the independent directors should ask why. If the fund is selling a large block and uses the secondary technique, it may incur commission expenses on both the buy and sell sides of the transaction with a total cost higher than even the minimum commission rate. In addition, if the trader executes a secondary offering through retailers who sell fund shares rather than a block house, the fund may incur even greater expense through both higher commissions and poorer execution.

The independent directors' monthly review of the adviser's allocation of portfolio business may also reveal a consistent pattern of discrimination against certain types of trades or market. When spot checking particular transactions, the directors should question any absence of solicitation of quotes from the third or fourth markets. Mutual funds can now deal directly with other institutional investors or market makers in over-the-counter transactions listed on several automated markets. Although fewer stocks are traded on these markets than on the major exchanges, commission rates may be reduced or avoided entirely. Such opportunities suggest that the independent directors' trading guidelines should require the trader maximize the use of these markets whenever possible.

2. Creation of a Broker Affiliate

Although adviser affiliation with a broker-dealer may for some transactions complicate the selection of a broker offering best execution, the independent directors must decide whether the opportunity to recapture part of the fund's brokerage through the affiliate offsets any disadvantage arising from the potential loss of best execution.³²³ The SEC has taken the position that the adviser and independent directors of each fund complex can weigh the benefits of an affiliate and choose whether to create a brokerage subsidiary.³²⁴ Judge Aldrich in *Moses v. Burgin* noted that Fidelity Fund's independent directors had exercised business judgment in deciding not to seek membership on a regional exchange. He concluded:

³²³ See note 103 *supra*.

³²⁴ SEC Securities Exchange Act Release No. 8746 (Nov. 10, 1969), in [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶77,761. The SEC states:

We do not believe that management [has a fiduciary obligation to create a broker affiliate on a regional exchange] if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate.

.
[If a broker affiliate is created, however,] there may be circumstances under which such recapture could be required

Id. 83,747.

It is only too clear, as the [district] court found, that the unaffiliated directors had noted the general risks attendant upon a brokerage operation, especially the risk of loss of best execution, and they had long decided against it. The court found, on adequate evidence, that there were sound business reasons for this decision. We agree; the directors had no duty to pursue [affiliation on a regional exchange], and without their doing so, recapture was not freely available.³²⁵

In deciding whether to create a broker affiliate, the independent directors should first determine whether a broker affiliate of either the fund or the adviser will be profitable. The cost of establishing membership on a regional exchange is substantially less than the cost of a seat on the New York Stock Exchange. Most advisers already have the personnel and expertise in their trading departments to staff the subsidiary and could create a broker affiliate without significantly increasing their operating costs. The profitability of affiliates, however, has been reduced both by the abolition of some reciprocal arrangements and by the advent of negotiated rates.³²⁶

If the independent directors determine that a broker affiliate can be profitable, they must decide what portion of that profit to allow the adviser to retain. A substantial part of the profit of existing affiliates is attributable to "clearance commissions," fees received when the trader assigns fund portfolio business to a New York Stock Exchange member who later directs a broker on a regional exchange to give up part of his commission on an unrelated trade to the adviser's affiliate, which also maintains a seat on the regional exchange. The SEC ruled in *Provident Management Corp.*, that the adviser must credit all such "clearance commissions" against the advisory fee.³²⁷ This was based upon section 17(e) of the 1940 Act, which makes it unlawful for any affiliated person of the fund "acting as agent, to accept from any source any compensation . . . for the purchase or sale of any property to or for such registered investment company . . . except in the course of such person's business as [a] broker."³²⁸ Clearance commissions do not fall within the exception for brokerage services because the affiliate performs no brokerage services in connection with the transaction that gave rise to the commission.

Section 17(e) does not prohibit a broker affiliate from receiving commissions on fund portfolio transactions, but neither does it indicate

³²⁵ 445 F.2d 369, 375 (1st Cir. 1971).

³²⁶ Welles, *The War Between the Big Board and the Regionals*, INST. INV., Dec. 1970, at 21.

³²⁷ SEC Securities Exchange Act Release No. 9028 (Dec. 1, 1970), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,937.

³²⁸ 15 U.S.C. § 80a-17(e) (1) (1970).

whether some or all of them must be credited toward the advisory fee. One federal district court opinion, *Kurach v. Weissman*,³²⁹ suggests that the broker affiliate may retain part of its profit from executing fund portfolio business, but this ruling preceded the SEC's opinion in *Provident Management*,³³⁰ and the *Moses v. Burgin* decision.³³¹ If the ability of the fund to select the broker through whom its portfolio transactions will be executed is a valuable asset of the fund, as the First Circuit suggests,³³² then the entire amount of the recaptured commissions should be returned to the fund. Even if a court should interpret section 17(e) to permit the adviser's affiliate to retain part of this profit,³³³ these receipts are nonetheless part of the adviser's indirect income, which the independent directors must consider when determining the reasonableness of the advisory fee.³³⁴ Whether the advisory fee is reduced directly, by crediting the affiliate's profits toward it, or indirectly, by reflecting retained profits as part of the adviser's income, approximately the same result should be achieved.

If part or all of the profits of the adviser's broker affiliate must be returned to the fund, the adviser may attempt to allocate the expenses of its trading department to the affiliate. The typical advisory contract contemplates that the adviser will assume the expenses of the trading department. When these expenses are paid from the profits of the broker affiliate, which would otherwise go toward reducing the fee, the terms of the advisory contract are defeated.

The broker affiliate's cost of operation and the division of its profits are important but not exclusive factors to be weighed by the independent directors. If the adviser retains part of the affiliate's profit, it may be tempted to increase the fund's turnover rate and procure executions at less than the best realized price. The *Institutional Investor Study* found that funds with an investment adviser affiliated with a broker-dealer had a 3.7 percent higher turnover rate than other funds.³³⁵ The potential for poorer executions is also increased because

³²⁹ 49 F.R.D. 304 (S.D.N.Y. 1970).

³³⁰ SEC Securities Exchange Act Release No. 9028 (Dec. 1, 1970), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,937.

³³¹ 445 F.2d 369 (1st Cir. 1971).

³³² See text accompanying notes 300-01 *supra*. See also Butowsky, *Mutual Fund Brokerage*, 3 REV. SEC. REG. 915 (1970).

³³³ The SEC has interpreted the *Moses* decision to require that once commissions are recaptured, they must be credited *in toto* against the advisory fee. Memorandum of the SEC as *Amicus Curiae* in Opposition to the Proposed Settlement in *Gross v. Moses*, Civil No. 2162 (S.D.N.Y., filed Aug. 13, 1971), in BNA SEC. REG. & L. REP., No. 115, at F-1 to -5 (Aug. 18, 1971).

³³⁴ For a different interpretation of § 17(e), see Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U.L. REV. 35, 53-55 (1971).

³³⁵ SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92d Cong., 1st Sess., pt. 1, at 173 (1971).

portfolio transactions that might have been more expertly handled by independent brokers are channeled through the adviser's affiliate. The variety of factors influencing the trader's assignment of a particular transaction make it difficult, if not impossible, for the independent directors to determine whether a trade was appropriately executed through the affiliate. The advent of negotiated rates merely adds another dimension to the conflicts of interest possible when the adviser negotiates a commission with its own subsidiary. The independent directors cannot critically approve trades in excess of \$500,000 with the adviser's broker affiliate unless they adopt specific guidelines that enable them to determine whether the fund has received the best realized price.

The difficulties that may lead the independent directors to decide not to ask the adviser to form a broker affiliate are not limited to conflicts of interest. Establishing a brokerage business may distract the adviser from its primary function of investment research. In addition, future rules of the New York Stock Exchange or the SEC may adversely affect the profitability or even the legality of broker affiliates.³³⁶ Indeed, the recommendations of the *Martin Report* on restructuring the New York exchange suggest that investment advisers should be prohibited from maintaining affiliation with a broker.³³⁷

If the independent directors decide that recapture of brokerage commissions through an affiliate is desirable, they should consider fund ownership of the affiliate. The cost of establishing and maintaining the affiliate could be shared by all the funds in a complex. If the funds owned the affiliate, the adviser's only interest in allocating fund business to this affiliate would be to secure best execution.

D. *Non-Conflict Areas of Independent Director Responsibility*

Although the role of independent directors is usually thought to be resolution of conflicts of interests, these directors also have responsibilities for fund operations in areas where the interests of the adviser and the shareholders coincide. The most important examples of non-conflict responsibilities are the directors' approval of the arrangements for shareholder accounting and custodian services. As with investment management and distribution services, the quality of these services is

³³⁶ The SEC has suggested that the present \$500,000 break point for negotiated commissions is not permanent. SEC Securities Exchange Act Release No. 9148 (Apr. 14, 1971), in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,039.

³³⁷ The *Martin Report* on Securities Markets to the New York Stock Exchange, in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,184, at 80,562 (Aug. 5, 1971); Rustin, *Wall St. Blueprint: Martin Exchange Study is Likely to Recommend a Merger of Markets*, Wall St. J., Apr. 30, 1971, at 1, col. 5.

the primary concern; but the cost and formula for allocating these expenses must also be reviewed.

1. Shareholder Accounting Expenses

The mutual fund shareholder purchases more than professional investment advice. His shares entitle him to a wide variety of services, including automatic reinvestment of dividends and capital gains distributions, systematic withdrawals, retirement plans, and the right to move his investment from one fund to another within the complex without charge as his objectives change.³³⁸ Although performance is the goal of most shareholders, services are an important, if secondary, consideration. Advisers may compete for new investor dollars more through services than expense ratios,³³⁹ and the adviser and shareholders alike benefit from efficient management of these services.

In a small fund, purchases, reinvestments, accumulations, and exchanges can be administered internally. But as the number of shareholder accounts grows, the fund may need an external "transfer agency." The most frequently selected transfer agents are banks with which the fund maintains its cash and custodian accounts,³⁴⁰ although some advisers have found that in-house computerized transfer agencies can do a more reliable job.³⁴¹ The advantages of in-house service include direct control of personnel and procedures, speed and efficiency, and availability of sophisticated equipment for investment research. In fact, computer software systems can aid in such areas as portfolio pricing and analysis of the financial reports of portfolio companies. Data processing equipment is also being used to process shareholder surveys on questions of social concern,³⁴² portfolio selection, and selling practices.

If the independent directors determine that the quality of shareholder accounting services can be substantially increased by creating an in-house data processing subsidiary, a new fund expense may be incurred. Custodian banks may perform shareholder accounting services at a loss, while requiring the fund to maintain substantial cash reserves in non-interest bearing accounts. Thus, creation of a data processing subsidiary may initially increase costs, but will release cash reserves for investment.

³³⁸ See, e.g., Hamilton Growth Fund, Inc., Prospectus 8-10 (May 1, 1970).

³³⁹ See note 25 *supra*. See generally PUBLIC POLICY REPORT, *supra* note 3, at 86.

³⁴⁰ PUBLIC POLICY REPORT, *supra* note 3, at 91.

³⁴¹ Glazer, *supra* note 74, at 262 n.273.

³⁴² Stabler & Newman, *More Money Managers Reconsider Their Role In Shareholder Voting*, Wall St. J., Apr. 28, 1971, at 1, col. 5. Dreyfus Corp., which manages the Dreyfus Leverage Fund, surveyed the Fund's 128,000 shareholders to gather their opinions on such social-action issues as "Project GM" and investments in South Africa. See also Wall St. J., Apr. 22, 1971, at 15, col. 3 (*Social Reform Group Bids Mutual Funds Back Plans*).

The cost of an in-house transfer agency could be allocated among the funds of a complex on either a net asset or a transaction basis, but neither is particularly appropriate. A fund's proportion of the total complex's assets bears little relationship to the cost of providing the fund's shareholders with these services, and a set fee for each fund transaction would be cumbersome and inefficient. A better approach would be to allocate the expense according to the number of shareholder accounts in each fund.

2. The Custodian Function

Although the 1940 Act does not prohibit internalization of the custodian function, the blue sky laws of several states require that the fund's securities be maintained in a bank with certain reserves.³⁴³ Typically, the bank receives securities from the brokers through which the trade has been executed and makes payment from the fund's account. Because advisers agree that services offered by different custodian banks are relatively comparable, the more important question for the independent directors is the fee paid for these services.

The annual custodian fee is not the bank's only compensation. Although the cash account maintained by the fund is constantly changing, the bank has the use of this "rolling" or "cash" float. Although it cannot be used directly by the fund, this float value can be reflected in the custodian's fee. The time required for the fund's trades generates a second float, commonly referred to as "transaction float." The fund debits the purchase price of a security immediately upon execution of its purchase order, but the custodian does not pay out the fund's cash until delivery, which usually occurs five days later. In the past, funds could not invest this float because government securities did not offer short enough terms. Recently, several major finance companies have offered "master notes," which pay six to eight percent annual interest for the overnight or weekend use of cash. The transaction float of one or all of the funds could be invested in these notes by the fund's custodian and the interest used to offset its custodian fee.

The independent directors should also request that the adviser select a custodian who will make combined orders to take advantage of volume discounts and negotiated commission rates. A broker is prohibited from combining orders only if it receives them separately.³⁴⁴ If

³⁴³ The blue sky laws of most states require that portfolio securities be held by a bank with assets of over \$2 million. At least one adviser, however, acts as its own custodian and refrains from selling in such states. See *Fiduciary Growth Associates, Inc.*, Prospectus 12 (Dec. 12, 1971) (one of the mutual funds advised by Donaldson, Lufkin & Jenrette, Inc., for shareholders who are tax exempt entities).

³⁴⁴ See NEW YORK STOCK EXCH. RULES rule 372, in 2 CCH NEW YORK STOCK EXCH. GUIDE ¶ 2372 (1967).

it receives a single order for all the funds and the custodian divides the authorization upon delivery, the prohibition is not violated. And, if the broker cannot deliver the entire purchase, the custodian can simply allocate the delivered stock pro rata by size of authorization and thus avoid unfairness to any of the funds within a complex.

V. SUMMARY OF INDEPENDENT DIRECTOR RESPONSIBILITIES

Before the 1970 Amendments were enacted, it might have been argued that the presence of independent directors occasionally worked against the interests of fund shareholders. Because most courts accepted the business judgments of the directors as conclusive, shareholder litigation was largely ineffective in forcing advisers to adopt self-regulatory techniques. But Congress was apparently unwilling to abandon the concept of independent director responsibility when the time came for a major overhaul of the 1940 Act. Because the more radical change of requiring internalized mutual fund management posed a real threat to the emergence of new funds and even the continued existence of some smaller funds, Congress continued the unique external management arrangements that had come to be the dominant mode of operation in the fund industry. Independent directors were recognized as a practical necessity for these inter-corporate relations—a necessity which merely increased as advisers began to manage whole complexes of funds.

Although the 1970 Amendments continue to place substantial reliance upon the independent directors, that reliance is no longer exclusive and independent directors' decisions are more vulnerable to judicial scrutiny. Section 15(c)'s requirement that the independent directors "request and evaluate" certain information is a mandate to both the directors and the courts to define with more precision the elements of a sound business judgment. Similarly, section 36(b)'s fiduciary standards suggest that, although the directors' judgment should be a substantial factor in a determination of fairness, the weight a court will actually assign to their decision will depend upon, in part, the depth of their inquiry.

The recommendations of Part IV represent an attempt to develop guidelines that focus the independent directors on the most acute problems of conflict of interest, the types of information they should require, and the factors which should control their decision. Two objections might be raised to these recommendations. The first, that directors simply cannot become an effective voice in fund management, assumes that guidelines would become a formalistic checklist devoid of any substantive inquiry. Why such a pessimistic view prevails among many critics of the independent director concept is not entirely clear. The

past studies of the directors' role in safeguarding shareholder interests attribute their ineffectiveness to their identification with the adviser and failure to comprehend their unique responsibilities. The 1970 Amendments' definition of "interested persons" eliminates from independent director status anyone with a material business, professional, or personal relationship with the adviser. In addition, many independent directors are now selected by their predecessors, and may seek advice from other independents rather than advisers' personnel. There is no reason to assume that if the independent directors are aware of a problem area they cannot deal appropriately with it. Section 15(c) requires that the adviser provide the information they request. Moreover, most directors are unquestionably men of intelligence and ability who can survey material quickly and act responsibly within a short period of time. Some critics argue that, even if directors follow guidelines precisely delineating their responsibilities, they lack the bargaining power necessary to change adviser practices. Admittedly, few directors are willing to terminate the advisory contract, but they do have recourse to other less dramatic methods of control. Few advisers will continue a practice if the directors raise well-reasoned objections against it. A director can always take his case to the shareholders, either at the annual meeting by requiring that his position be set forth in the proxy statement, or through public statements. And the adverse publicity attendant on a director's resignation is a sobering and effective deterrent to the assumption by the adviser of an uncompromising position.

A second objection to Part IV's guidelines might be that they place entirely too much responsibility on the independent directors, who have neither the time nor the expertise to implement them. These recommendations do take the independent directors into fields of inquiry seldom approached by fund boards. Nevertheless, the 1970 Amendments and the mood of the courts seem to compel a greater inquiry if a board wants its judgment to be given substantial weight by the courts. Of course, not every suggestion can or should be adopted by the independent directors of every fund group. For example, conflicts of interest arising from the use of fund brokerage may differ depending upon whether the adviser maintains a broker affiliate, or its own retail selling force, as well as upon the ways in which the independent directors oversee a particular situation. If the management of a fund group is internalized, many of the recommendations are either unnecessary or inappropriate. In addition, much of the groundwork for the directors' determination is laid by the adviser. The independent directors' duty of separate inquiry is a very limited one; in almost every area they can rely initially upon the information provided by the adviser.

The directors' obligation to actually negotiate with the adviser is limited to the arrangements for investment advice and particularly the fee. In all other areas, the adviser initially resolves the problem and the independent directors merely review the fairness of the solution proposed by the adviser. If independent directors sit across the complex, their overview allows them to compare efficiently the standardized reports for each fund to ensure that each is receiving its share of investment opportunities and bearing an appropriate portion of common expenses. Finally, separate fund counsel can assume many of the independent research tasks that the directors might wish to undertake. Their obligation is then limited to merely reviewing the basis for counsel's conclusions and approving or rejecting the action recommended.

The responsibilities of the independent directors of many fund groups fall within four areas. To summarize this Article's conclusions and recommendations, the following guidelines are proposed.

1. The independent directors should become familiar with each of the funds and the non-fund accounts managed by their investment adviser. If they know the net asset size and investment objective of each fund, they may be able to detect whether the adviser has a greater interest in some funds than in others. They should also inquire into the correlation between sales of fund shares and better performance, and the importance of those sales both to the individual fund and the entire complex. If some funds have incentive fee arrangements, they should determine whether this added reward for performance is adjusted for risk and whether it promotes or detracts from a community of interest among all the funds and their adviser. Finally, the independent directors should be particularly aware of the possible conflicts arising when the adviser creates a new fund. The expenses of an addition to the complex should not be borne by the established funds. Rather, the independent directors of that fund should permit the adviser's initial losses to be recouped in later years when the fund's net asset size produces a profitable advisory fee. This practice should, of course, be limited to such losses and not continued indefinitely.

2. The major responsibility of all independent directors of externally managed complexes is approving the fund's arrangements for investment advice. This approval can occur in two stages. Throughout the year, the independent directors should receive monthly performance comparisons, portfolio transaction reports, and fund income and expense allocation reports. Monthly preparation and evaluation of these reports has the desirable effect of limiting the amount of material the directors receive at the annual meeting called to renew the advisory

contract. At that meeting their attention can be focused on the three steps for determining an appropriate fee suggested in Part IV. Performance comparisons are the key to an initial evaluation of the quality of the adviser's service. Only if a pattern of consistently low performance emerges should the independent directors undertake a review of the investment management process, the allocation of investment opportunities, and the assignment of fund brokerage. Assuming performance is satisfactory, these areas of potential conflict can be reviewed at a later time.

The second element of the suggested approach is an evaluation of the costs the adviser incurs on behalf of each fund. This evaluation entails a breakdown of the common expenses of managing a complex of funds and an analysis of the adviser's formulas for allocation of expenses. For example, investment research is usually done collectively and the salaries of the analysts and portfolio managers allocated based on the ratio of net assets of each fund to the net assets of the whole complex. The independent directors can only determine if the fund is sharing in the economies of scale inherent in the fund complex form of operation by reviewing these breakdown and allocation practices. These figures cannot be precise, but it must be remembered that they are used only for the internal purpose of checking whether each fund is bearing an appropriate portion of the common expenses and whether these expenses in turn bear a reasonable relation to the total fee. The final step in approving the fee is an evaluation of the reasonableness of the adviser's profit. The quality of the adviser's service as reflected in the fund's performance is the most important factor in this determination. Cost is similarly important, but only insofar as it shows that performance is achieved at an expense ratio comparable to other funds. The independent directors have no obligation to demand the least expensive advisory services. And, certainly, they should not approach the fee as a cost-plus calculation, a method which rewards the inefficient adviser and undermines most shareholders' hierarchy of goals—performance first and reduced expenses second.

3. This pattern of decisionmaking can also be effectively employed by the independent directors when approving the underwriting contract. The keys to their evaluation are whether the fund needs new growth and whether the performance of the fund will be benefited by more sales. The independent directors should realize that a larger fund may sacrifice flexibility in its investment pattern. Absent a positive or negative correlation between fund size and performance, however, the directors may well conclude that there is no reason to forbid new sales.

The distribution contract must of necessity give the adviser broad discretion as to how fund shares will be sold. Once the determination that the fund will continue to grow has been made, the flow of new sales cannot be simply turned on or regulated at a specific level. The directors' responsibility is limited to checking the adviser's selling practices, redemptions, and advertising to assure that the fund's reputation remains unblemished so that it can continue to generate new sales. Of course, if the cash inflow from sales exceeds the availability of new investments, the independent directors should be prepared to suspend additional sales efforts.

4. In their role of reviewing the adviser's assignment of fund portfolio brokerage, the independent directors should focus on assuring best execution and deciding whether the fund or the adviser should create a broker affiliate on a regional exchange. Although the independent directors cannot determine whether the fund received the best realized price on a specific trade, they can and should review monthly transaction reports for patterns of discrimination against certain types of brokers or markets. If, for example, no trades are executed through third market dealers who offer no services beyond actual execution, the independent directors should ask for an explanation. Similarly, if block positions are avoided or if orders are not combined to take advantage of negotiated rates above \$500,000, the directors should be alerted to the possibility that their fund is incurring unnecessary brokerage expenses. They should require a monthly breakdown of all portfolio trades not only by broker and market but by type of trade and commission. They should also determine whether the brokerage that the fund contributes to the pooled brokerage of the entire complex is generating as much outside research as the portfolio manager requires.

The independent directors of funds with an adviser affiliated with a broker-dealer face particularly difficult problems in deciding whether their funds are receiving best execution. If the adviser retains the profits generated by fund commissions, it may be tempted to channel trades that could be handled more expertly elsewhere through its broker-dealer. Of course, some large broker-dealers have the expertise necessary to handle fund transactions adequately although large blocks that qualify for negotiated rates probably should still be handled by the block houses. Finally, if the directors of a fund with an adviser lacking a broker affiliate conclude that one could be profitable, they should consider fund ownership of an affiliate on a regional exchange. The independent directors should consider here not only the cost and profitability of a fund affiliate but its ability to offer best execution and any conflicts of interest these arrangements might add. And they should

remember that if the fund owns the affiliate the adviser's only interest in assigning portfolio business to it will be to achieve the best realized price for its funds.

5. The independent directors and the adviser share the common goal of offering to the investor the most economical accounting and custodian services. Many of these services could be contained in a separate management services contract approved through the same procedures as those suggested for the advisory fee. Expenses paid directly by the fund should be approved only after the directors are certain that the quality of the administrative, custodial, or other services warrants the expenditure. If external transfer agency services do not adequately meet their fund's needs, they might ask the adviser if the complex of funds could collectively support an in-house transfer agency. If the quality and diversity of services suggests that shareholder accounting should be internalized, a data processing subsidiary could be created by either the adviser or the funds.