

2002

The Heartland Funds' Receivership and Its Implications for Independent Mutual Fund Directors

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Recommended Citation

51 *Emory Law Journal* 153–240 (2002)

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**THE HEARTLAND FUNDS' RECEIVERSHIP AND ITS
IMPLICATIONS FOR INDEPENDENT MUTUAL
FUND DIRECTORS**

*Jeffrey J. Haas**
*Steven R. Howard***

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* * *

INTRODUCTION

In the financial arena, the year 2000 will be remembered best as the year the technology stock market bubble burst at the seams. Mutual fund investors, many of whom had counted their chickens before they were hatched, watched in distress as the value of their tech fund investments plummeted. So, too, did investors in three of the mutual funds of Heartland Group Inc. ("Heartland"). But unlike the tech funds' sharp decline, the decline of these Heartland funds occurred in a single day. Moreover, these funds were not laced with technology and other speculative stocks; rather, they were bond funds—funds normally associated with safe, prudent investing.¹

On October 13, 2000—Friday the 13th no less—Heartland's High-Yield Municipal Bond Fund, Short Duration High-Yield Municipal Bond Fund, and Taxable Short Duration Municipal Bond Fund (collectively, the "Funds") experienced one-day price drops of seventy percent, forty-four percent, and six percent, respectively.² These drops did not result from the erosive effect of market forces on the value of the Funds' portfolios of bonds. Rather, they occurred because Heartland had stumbled severely by delaying determinations about the fair value of many of the illiquid bonds it held in the portfolios of the

¹ See John Waggoner, *If Fund Directors Doze, Investors Can Lose Out*, USA TODAY, June 20, 2001, at 1B (stating, with respect to Heartland's losses, that "[t]hose are horrific losses for a stock mutual fund, much less a normally stodgy bond fund").

² See Karen Damato, *Deals & Deal Makers: SEC Gets Court Order Freezing Assets of 3 Heartland Funds amid Investigation*, WALL ST. J., Mar. 23, 2001, at C15; Paul Gores, *Heartland Bond Funds Plummet; One Falls Over 70% After Pricing Method Change*, MILWAUKEE J. SENTINEL, Oct. 17, 2000, at 1D; Russ Wiles, *Heartland Mutual Funds Plummet; Disaster Points to Run on Assets*, ARIZ. REPUBLIC, Oct. 19, 2000, at D1.

Funds.³ Correcting its own missteps resulted in the severe one-day price drops.⁴

Importantly, as an investment company registered under the Investment Company Act of 1940 ("ICA"),⁵ Heartland was required to engage in fair value pricing with respect to the bonds it held for which market quotations were not "readily available."⁶ But instead of ascertaining the fair value of its illiquid bonds, Heartland engaged in "hopeful bond pricing,"⁷ i.e., pricing bonds at what it "hoped" it could receive for them rather than what it actually could obtain for them.⁸ Ultimately, Heartland's valuation of those bonds,

³ See 15 U.S.C. § 80a-2(a)(41)(A) (1994); 17 C.F.R. § 270.2a-4(a)(1) (2000) (both defining "value" with respect to assets of registered investment companies for which market quotations are not readily available as fair value as determined in good faith by the board of directors). For the SEC's guidance on fair value pricing of portfolio securities, see Investment Company Institute, SEC No-Action Letter, 2001 SEC No-Act. Lexis 543 (Apr. 30, 2001), and Investment Company Institute, SEC No-Action Letter, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,658, at 76,383 (Dec. 8, 1999).

⁴ Heartland was not the only fund family experiencing problems with its high-yield municipal bond funds at that time. Strong Capital Management Inc.'s Strong High-Yield Municipal Bond Fund also encountered problems stemming from deteriorating credit quality of the bonds in its portfolio. In some cases, this deterioration led to defaults and heavy investor redemptions. See Karen Damato, *Strong Capital Fund Suffers Muni Blues*, WALL ST. J., July 3, 2001, at C19.

⁵ 15 U.S.C. § 80a (1994 & Supp. V 1999).

⁶ 15 U.S.C. § 80a-2(a)(41)(A) (1994); 17 C.F.R. § 270.2a-4(a)(1) (2000).

⁷ Jacob Fine, *Knocks to Heartland Funds Spur Discussion of Pricing Methods*, THE BOND BUYER, Mar. 19, 2001, at 7 (quoting Douglas Watson, Managing Director of Moody's public finance group). Expanding on this point, Karen Damato of *The Wall Street Journal* wrote:

The Heartland meltdown called attention to the fact that most high-yield munis trade infrequently, making the bonds sitting in portfolios difficult to value. Fund companies typically rely on outside pricing services to calculate the value of such bonds. Those pricing services, in turn, rely heavily on institutional investors, including fund managers, to pass along material information about the financial condition of the borrowers and the status of projects such as nursing homes and hospitals that are financed by high-yield munis.

Ms. Bourboulas [fund manager for Strong Capital Management Inc.'s Strong High-Yield Municipal Bond Fund] said Strong . . . has always been diligent about passing along such information, even when it is likely to lead a pricing service to reduce its calculated value for a bond in Strong High-Yield Muni's portfolio. Some other investors "like to be more optimistic," she said, and not report the first indication of possible problems at an issuer. In some instances, she said, when Strong has passed along such information, pricing officials have said "they have not gotten the same information from the other firms that hold the same positions."

Damato, *supra* note 4. For general survey results on how market participants, including mutual funds, engage in fair value pricing, see CAPITAL MARKET RISK ADVISORS, NAV/FAIR VALUE PRACTICES SURVEY OVERVIEW (May 1998), available at <http://www.cmra.com/html/nav.html> (last visited Aug. 2, 2001).

⁸ Because each Fund's management fee was based on net assets under management, the overvaluation of the bonds resulted in higher management fees. It is unclear whether this side effect was intended.

which had gradually built up like a house of cards, collapsed under the weight of economic reality.

Heartland shareholders who remained invested in the Funds through the long, gray Winter that followed the October swoon were soon confronted with the ultimate indignity. On March 21, 2001, at the request of the Securities and Exchange Commission (“SEC” or “Commission”) and with the consent of Heartland itself, Judge Joan Lefkow of the U.S. District Court for the Northern District of Illinois entered an order of permanent injunction against Heartland and appointed a receiver to oversee the Funds.⁹ Judge Lefkow empowered the receiver to take control of the Funds’ assets, manage the Funds, suspend fund redemptions and, if appropriate, liquidate the Funds.¹⁰ Remaining shareholders, therefore, were locked into the Funds until the receiver, Chicago attorney Phillip Stern of Freeman, Freeman & Salzman, decided otherwise.

The receivership remedy is, indeed, severe.¹¹ The reasons for this are twofold. First, it displaces fund management entirely. This includes both the shareholder-elected board of directors and the officers appointed by the board. Second, the appointment of a receiver eliminates, either temporarily or permanently, shareholder suffrage. While the receivership remedy is the ultimate “no confidence” vote in the directors and officers, a court casts that vote at the SEC’s behest rather than shareholders. Likewise, the court at the SEC’s suggestion selects the receiver who will supplant those directors and officers. In the case of Heartland, that receiver had no previous experience with the Funds themselves, unlike the Funds’ directors and officers.

The district court’s appointment of a receiver in the *Heartland* case comes at a time when mutual fund governance is at an important crossroad. For the past eight years, the SEC and its former Chairman, Arthur Levitt, have been vigorously calling for independent fund directors¹² to assume greater responsi-

⁹ See SEC v. Heartland Group, Inc., Order of Permanent Injunction and Other Equitable Relief Against Heartland Group, Inc., Case No. 01C 1984 (N.D. Ill. Mar. 21, 2001) (“Heartland General Order”).

¹⁰ See *id.* at § III; SEC v. Heartland Group, Inc., SEC Lit. Rel. No. 16,938, 74 S.E.C. Docket 1344, 2001 SEC Lexis 513 (Mar. 22, 2001) (“Heartland Release”).

¹¹ See SEC v. Advance Growth Capital Corp., 470 F.2d 40, 54 (7th Cir. 1972) (“Equitable receiverships are drastic remedies which often fall short of their intended objectives.”); Connolly v. Gishwiller, 162 F.2d 428, 435 (7th Cir. 1947) (noting that “the power to appoint a receiver is a drastic, harsh and dangerous one and should be exercised with care and caution”); Tanzer v. Huffines, 287 F. Supp. 273, 274 (D.C. Del. 1968), *aff’d*, 408 F.2d 42 (3d Cir. 1969) (stating that the remedy “is a harsh one, one to which a Court should not resort in any but the most extreme circumstances”).

¹² We refer to directors who are not “interested persons” of a fund as “independent directors.” See 15 U.S.C. § 80a-2(a)(19) (1994) (defining “interested person”).

bility for the safeguarding of mutual fund shareholders and their investments.¹³ Congress, of course, had originally imbedded within the ICA itself the policy of having independent directors serve on a fund's board¹⁴ as watchdogs to guard against unscrupulous behavior by, among others, fund advisors.¹⁵ It was former Chairman Levitt, however, who decided it was high time for these watchdogs to have their teeth sharpened and put to use,¹⁶ especially given the SEC's "growing reliance on independent directors to protect fund investors."¹⁷

¹³ See, e.g., The SEC and the Mutual Fund Industry: An Enlightened Partnership, Remarks by SEC Chairman Arthur Levitt, Investment Company Institute, Wash., D.C., May 19, 1995; Mutual Fund Directors as Investor Advocates, Remarks by SEC Chairman Arthur Levitt, The Second Annual Symposium for Mutual Fund Trustees and Directors, Washington, D.C., Apr. 11, 1995; SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 264-66 (1992). See also TAMAR FRANKEL & CLIFFORD E. KIRSH, INVESTMENT MANAGEMENT REGULATION 236 (1998) (arguing that the importance of independent directors has increased during the past twenty-five years, as they have been vested with increasing responsibilities to supervise the activities of the investment advisor and the insiders in managing the investment company).

¹⁴ See 15 U.S.C. § 80a-10(a) (1994) (stating that "[n]o registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are 'interested persons' of such registered investment company"); 15 U.S.C. § 80a-2(a)(19) (1994) (defining "interested person").

¹⁵ See 15 U.S.C. § 80a-1(b)(2) (1994) (declaring that the national public interest and the interest of investors are adversely affected "when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisors . . . , in the interest of underwriters, brokers or dealers, . . . rather than in the interest of all classes of such companies' security holders"). See also *United States v. Brashier*, 548 F.2d 1315, 1320-21 (9th Cir. 1976) ("[A] fundamental purpose [of the ICA] . . . is to prevent self-dealing on the part of those managing and controlling investment companies and to protect shareholders in the funds from dishonest and self-dealing advisors."); *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3, 30 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970) ("[L]egislative history shows that the purpose of the Investment Company Act was to prevent abuse which may grow out of the unregulated power of management to use large pools of cash."); Remarks of Paul Roye, Dir. of the SEC's Division of Investment Management, Delivered to the Investment Company Institute's Workshop for New Fund Dirs., available at <http://www.sec.gov/news/speech/spch475.js.htm> ("Roye Remarks") (labeling independent directors the "principal guardians of public trust in the mutual fund industry").

¹⁶ See SECURITIES AND EXCHANGE COMMISSION, ROUNDTABLE ON THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS—PART I (Feb. 23, 1999), available at <http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm> ("SEC ROUNDTABLE—PART I") (noting that Levitt "has been a tireless advocate of enhancing independent director effectiveness"); SECURITIES AND EXCHANGE COMMISSION, ROUNDTABLE ON THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS—PART II (Feb. 24, 1999), available at <http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm> ("SEC ROUNDTABLE—PART II") (where Levitt commented, "I would like to see restless, passionate directors. Directors who cared so much about the well being of investors that they ask the tough questions that many times corporate management find difficulty with." He later added: "I will make a personal commitment to everyone here to look very, very carefully in terms of what the Commission can do to empower those of you in the trenches.").

¹⁷ SEC Rel. No. IC-24816, 74 S.E.C. Docket 102, 2001 SEC Lexis 15, at *9 (Jan. 2, 2001). This SEC Release, together with SEC Release No. IC-24816A, 2001 SEC Lexis 404 (Feb. 27, 2001), which makes certain corrections to it, is hereinafter collectively referred to as the "Independent Director Adopting Release."

At a time when effective and proactive independent fund director oversight is viewed as essential by both regulators and the mutual fund industry,¹⁸ the SEC's actions in the *Heartland* matter raise a number of important issues: Given the new movement towards more effective independent fund directors, when, if ever, should the SEC seek the receivership remedy and end corporate democracy for a fund's shareholders? In other words, when should the SEC armed with a court order push aside the congressionally mandated watchdogs? What can a receiver do that one or more motivated and competent independent fund directors represented by independent legal counsel cannot? Can the SEC achieve what a receivership achieves by employing a less drastic remedy coupled with meaningful independent director oversight?

This Article addresses these and other important issues. Part I briefly discusses the authority of the SEC to seek the receivership remedy in the mutual fund context. It then looks specifically at the factors to which the SEC has cited in seeking court-imposed mutual fund receiverships since the passage of the ICA in 1940. Part II examines the genesis of the independent mutual fund director, the distinction between relational independence, and operational independence, and the SEC's push for more effective independent directors. Part III discusses the inherent tension between that push and SEC-initiated receiverships. It then articulates a standard for when the SEC should work together with capable independent directors in resolving a mutual fund's crisis rather than seek the receivership remedy. That standard is designed to benefit shareholders by supporting the movement towards more effective independent directors while capturing the advantages and minimizing the disadvantages of the receivership remedy.

I. THE SEC'S AUTHORITY TO SEEK THE RECEIVERSHIP REMEDY

What drove the SEC to the "fairly extreme step"¹⁹ of seeking the appointment of a receiver in the *Heartland* case? According to its complaint, the SEC's biggest concern was that *Heartland* was depriving the Funds'

¹⁸ See, e.g., *id.* at *15 ("Most commentators supported [the SEC's] goal of enhancing the independence and effectiveness of funds . . ."); Role of Independent Directors of Investment Companies, 64 Fed. Reg. 59,826, 59,828 (Nov. 3, 1999) ("Proposing Release") ("We endorse the sentiments of the Roundtable participants who favor enhancing the effectiveness and independence of fund boards of directors."); Investment Company Institute ("ICI") Memorandum No. 12997, Jan. 9, 2001 (on file with authors) (indicating the ICI's support for most of the fund governance rule changes set forth in SEC Rel. No. IC-24816 (Jan. 2, 2001)).

¹⁹ Damato, *supra* note 2 (quoting Daniel Gregus, Assistant Regional Dir. of the SEC).

shareholders of statutorily required fundamental financial information. Without this information, existing shareholders could not decide to remain invested or redeem their shares in the Funds.²⁰ Prospective investors, of course, also could not make an informed investment decision with respect to the Funds.

Leading to this informational deprivation was Heartland's failure to send an annual report for the Funds to the Funds' shareholders on March 1, 2001, and to file that report with the SEC by March 10, 2001.²¹ Heartland's failure stemmed from the ICA's requirement that an annual report include audited financial statements certified with an unqualified auditor's opinion.²² Heartland's auditors, PricewaterhouseCoopers, refused to provide these statements. While PricewaterhouseCoopers had commenced an audit, it promised to disclaim any opinion as to the value of the securities held by the Funds during fiscal year 2000.²³ As Tim Warren, Associate Director of the SEC's Midwest Office, stated: "[The auditors] could not audit the financial statements because of questions regarding the value of the securities in the fund. So shareholders could be redeeming [their shares] . . . at incorrect values."²⁴

A. *Equitable Relief and the SEC*

As discussed below,²⁵ the SEC has sought to place a fund in receivership or the equivalent²⁶ at least twenty-eight times since the passage of the ICA. The courts have overwhelmingly granted the SEC's request for this equitable relief.

²⁰ See Heartland Release, *supra* note 10; Kathleen Gallagher, *Inventory of Troubled Heartland Funds Filed; Report Says Many of Their Bonds Are Illiquid*, MILWAUKEE J. SENTINEL, May 29, 2001, at 01D (quoting Paul F. Roye, Dir. of the SEC's Div. of Investment Mgmt., to the same effect).

²¹ See Heartland Release, *supra* note 10; see also 15 U.S.C. §§ 78m(a), 80a-29(a), (b)(2) & (e) (1994 & Supp. V 1999); 17 C.F.R. § 270.30b2-1 & e-1 (2001) (setting forth filing and distribution requirements with respect to annual reports). In late February 2001, Heartland represented to the SEC staff that its auditors would not be able to complete in a timely manner its financial statements. On March 1, 2001, Heartland transmitted to its shareholders and filed with the SEC an annual report for all the funds in its series other than the Funds. On March 14, 2001, Heartland informed the SEC staff that its auditors would begin an audit of the Funds, but that the auditors intended to disclaim any opinion as to the value of the securities held by the Funds during fiscal year 2000. See *SEC v. Heartland Group, Inc., Plaintiff Securities and Exchange Commission's Complaint for Permanent Injunction and Other Equitable Relief*, Case No. 01C 1984 (N.D. Ill. Mar. 21, 2001) ("Heartland Complaint").

²² See 15 U.S.C. §§ 78m(a), 80a-29(a) (1994).

²³ See Heartland Complaint, *supra* note 21, at Averments 15-18.

²⁴ See *Court Takes over Three Heartland Funds—Troubled Muni-Bond Funds Put into Receivership at Request of SEC*, INVESTOR'S BUS. DAILY, Apr. 2, 2001, at B1; Heartland Complaint, *supra* note 21, at Averments 19-20.

²⁵ See *infra* Part I.B.

²⁶ See *infra* note 47.

One could easily conclude, therefore, that the SEC's authority to request, and the court's authority to grant, the receivership remedy were indisputable. Reaching this conclusion, however, is more involved than it appears.

In the *Heartland* matter, the SEC pointed to Section 42 of the ICA²⁷ as giving it the authority to seek a receiver for the Funds and the other equitable relief it obtained.²⁸ Only subsection (d) of Section 42 discusses equitable relief.²⁹ It states, in relevant part:

Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of [the ICA], or of any rule, regulation, or order [under the ICA], [the Commission] may . . . bring an action in the proper district court of the United States . . . to enjoin such acts or practices and to enforce compliance Upon a showing that such person has engaged or is about to engage in any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. *In any proceeding under this subsection to enforce compliance with section 7*, the court as a court of equity may, to the extent it deems necessary or appropriate, take . . . possession of the investment company . . . involved and the books, records and assets thereof, wherever located; *and the court shall have jurisdiction to appoint a trustee, who with the approval of the court shall have power to dispose of any or all of such assets, subject to such terms and conditions as the court may prescribe.*³⁰

A strict reading of Section 42(d) yields two points. First, the SEC is specifically authorized to seek an injunction, either temporary or permanent, against any person that has engaged or is about to engage in any act or practice constituting a violation of any provision of the ICA or any rule, regulation, or order thereunder. Thus, the SEC had the statutory authority to seek, and receive, permanent injunctive relief against *Heartland* to enjoin *Heartland* from

²⁷ 15 U.S.C. § 80a-41 (1994).

²⁸ See *Heartland* Complaint, *supra* note 21, at Averment 4. See also *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, Agreed Application for (1) Issuance of Preliminary Injunction and (2) Order Appointing Special Master and Brief in Support, C.A. No. 3-00CV1482-D (N.D. Tex. July 10, 2000) ("Rupay-Barrington Agreed Application") (where SEC cites to Section 42(d) of ICA in support of its request for special master for Rupay-Barrington Funds, Inc.).

²⁹ See *SEC v. Midland Basic, Inc.*, 283 F. Supp. 609, 619 (D. S.D. 1968). This case refers to "Section 42(e)," which was redesignated as Section 42(d) in 1987. S.E.C. Authorization Act of 1987, title VI, sec. 623, 101 Stat. 1249, 1262 (1987).

³⁰ 15 U.S.C. § 80a-41(d) (1994) (emphasis added).

further violations of the ICA. Indeed, this was the SEC's first prayer for relief in its complaint against Heartland.³¹

Second, the SEC lacked explicit statutory authority to seek the appointment of a receiver for the Funds. Section 42(d) only allows for the appointment of a "trustee" to dispose of any or all of the assets of a given fund in the context of an action to enforce Section 7 of the ICA. That section prohibits any entity that fits within the definition of "investment company" and is not registered as an investment company under the ICA or otherwise exempt from registration under the ICA from, among other things, selling and redeeming its own securities.³² The *Heartland* matter, however, did not implicate Section 7, as the Funds were fully registered under the ICA.³³ The SEC also sought and obtained an order freezing the Funds' assets, a remedy designed to preserve the status quo while the receiver sorts out the Funds' affairs.³⁴ This action also was not explicitly countenanced by Section 42(d).

Despite its lack of explicit statutory authority, the SEC sought and received a court order appointing a receiver for the Funds.³⁵ What then was the legal basis for this? The basis is the inherent equitable power of the federal courts, a power they wield with wide discretion.³⁶ Courts believe this power can and should be used to better effectuate the purposes and improve the enforcement of the federal securities laws,³⁷ including the ICA.³⁸

³¹ See Heartland Complaint, *supra* note 21, Prayer for Relief No. 1. The district court granted this prayer for relief. See Heartland General Order, *supra* note 9, at Sec. I.

³² 15 U.S.C. § 80a-7(a) (1994).

³³ Cf. SEC v. Midland Basic, Inc., 283 F. Supp. 609, 619 (D.S.D. 1968) (where unregistered investment company ultimately registered by the time of court proceeding in which SEC requested appointment of receiver, court stated "[t]he only statutory provision authorizing [the appointment of a receiver] is Section 42(e) [redesignated (d)] of the Investment Company Act of 1940, which is not applicable here").

³⁴ See Heartland Complaint, *supra* note 21, Prayer for Relief No. 2. The district court granted this prayer for relief. See Heartland General Order, *supra* note 9, at Sec. II.

³⁵ See Heartland General Order, *supra* note 9, at Sec. III; see also SEC v. Heartland Group, Inc., Order Appointing a Receiver, Case No. 01C 1984 (N.D. Ill. Mar. 21, 2001) ("Heartland Receiver Order") (detailing the specific responsibilities, duties, and privileges of the Funds' receiver).

³⁶ See, e.g., SEC v. United Fin. Group, Inc., 474 F.2d 354, 358-59 (9th Cir. 1973); SEC v. Wong, 254 F. Supp. 66, 69 (D.P.R. 1966). See also SEC v. John Adams Trust Corp., 697 F. Supp. 573, 577 (D. Mass. 1968) (where, in case involving investment advisor receivership and injunctive relief, court noted that "[t]he federal courts are vested with wide discretion when an injunction is sought to prevent future violations of the statutory securities laws").

³⁷ See SEC v. Materia, 745 F.2d 197, 200-01 (2d Cir. 1984) (confirming authority of district courts to appoint receivers in SEC actions); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980) ("The federal courts have inherent equitable authority to issue a variety of 'ancillary relief' measures in actions brought by the SEC to enforce the federal securities laws."); SEC v. Koenig, 469 F.2d 198 (2d Cir. 1972) (upholding appointment of a receiver to supervise corporate defendant's securities transactions); Bryan v. Bartlett, 435 F.2d 28 (8th

This power to appoint a receiver for an investment company, having been embraced by the federal courts for decades, has become unassailable.³⁹ Indeed, in one of the earliest lines of cases involving an SEC receivership request under the ICA, the First Circuit Court of Appeals, in commenting on the district court's appointment of a receiver for the Aldred Investment Trust, stated:

By placing our [receivership] decision on the ground of general equity jurisdiction, we eliminate the argument hinged on statutory construction of the Investment Company Act of 1940. Nor do we think that it was intended that the district court be deprived of this aspect of its general equity jurisdiction by failing to refer specifically to it in the statute. Consequently, power did reside in the district

Cir. 1970) (federal equity receivership arising from violation of federal securities laws and to preserve assets for benefit of investor-creditors of corporation). *See also* *Whitman v. Fuqua*, 549 F. Supp. 315 (W.D. Pa. 1982) (in private action to enforce the Investment Company Act of 1940 ("ICA"), court appointed federal magistrate to oversee company's operations to ensure maintenance of status quo); *Chicago Title & Trust Co. v. Mack*, 180 N.E. 412, 413 (Ill. 1932) ("The appointment of a receiver is a branch of equity jurisdiction not dependent upon any statute, and rests largely in the discretion of the appointing court."). *See generally* James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

³⁸ *See* *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 54 (7th Cir. 1972) (commenting on equitable receiverships, court noted "[t]he purpose of injunctive relief is . . . to deter future violations, thus insuring general compliance with the broad remedial design of the legislation"); *SEC v. S & P Nat'l Corp.*, 360 F.2d 741 (2d Cir. 1966) (upholding appointment of receiver in view of prior violations of the ICA, false reports, and absence of corporate management); *SEC v. Keller Corp.*, 323 F.2d 397 (7th Cir. 1963) (prima facie showing of fraud and mismanagement, absent insolvency, is enough to call into play equitable powers of court); *Tanzer v. Huffines*, 287 F. Supp. 273 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969) (motion for appointment of receiver pendente lite for investment company would be granted for purpose of safeguarding investments of shareholders in view of management's apparent disregard of its fiduciary responsibilities); *SEC v. Midland Basic, Inc.*, 283 F. Supp. 609, 619 (D.S.D. 1968) (holding federal district court has inherent equitable power to appoint a receiver upon a prima facie showing of fraud and mismanagement, even when Section 42(e) (redesignated (d)) of the ICA is inapplicable); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 714 (D. Del. 1943) (stating that appointment of receiver to carry out court's order "is a normal process of a court of equity").

³⁹ *See* George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 869 (1983) (stating that "[t]he most persuasive argument for ancillary relief in federal securities law is that the Supreme Court and many lower courts have approved such relief and that almost no judicial precedent has questioned it"). In proceedings under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), the courts have cited to Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a) (1994 & Supp. V 1999), and Section 27 of the Exchange Act, 15 U.S.C. § 78aa (1994), as giving them the authority to appoint receivers. *See, e.g.*, *SEC v. First Fin. Group of Texas*, 645 F.2d 429, 438 (5th Cir. 1981) ("The appointment of a receiver is a well-established equitable remedy available to the SEC in its civil enforcement proceedings for injunctive relief."); *Los Angeles Trust Deed & Mtg. Exch. v. SEC*, 285 F.2d 162, 182 (9th Cir. 1960) ("We conclude . . . as the Supreme Court has stated with respect to other regulatory statutes, that the Congress must be taken to have acted cognizant of the historic power of equity to provide complete relief in the light of statutory purposes. As the Supreme Court long ago recognized, there is inherent in the court of equity a jurisdiction to give effect to the policy of the legislature."). Interestingly, Section 44 of the ICA is an analog to those sections of the Securities Act and Exchange Act, yet the SEC does not reference it.

court to appoint a receiver to reorganize or liquidate the Aldred Trust.⁴⁰

Private litigants, however, traditionally must satisfy three strict equitable conditions before a court will appoint a receiver. First, the plaintiff has to assert an existing legal claim to the assets held by the defendant. Second, a serious danger must exist that the defendant will dissipate those assets. Finally, no lesser remedy adequate to protect the plaintiff's claim must exist.⁴¹

If the SEC were a private litigant, therefore, a court would require it to proffer evidence that the three equitable conditions were met. The SEC, of course, never has a claim to the assets of the defendant investment company, and thus never satisfies the first of the three traditional conditions for the appointment of a receiver. Any argument that it could make about "stepping into the shoes of investors" is undermined by the fact that fund investors in their own right have, in the past, petitioned for, and received, court orders appointing receivers for investment companies.⁴²

Nevertheless, the SEC has adeptly sidestepped these private litigant equitable requirements by arguing successfully that in many instances an injunction against violations of the federal securities laws cannot by itself ensure compliance.⁴³ Because the courts have held that "the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief,"⁴⁴ the same should hold true in the case of ancillary relief. That relief, such as the appointment of a receiver and the freezing of fund assets, is needed to carry out the primary injunctive relief

⁴⁰ *Baily v. Proctor*, 160 F.2d 78, 82 (1st Cir. 1947). *See also* *SEC v. Wong*, 254 F. Supp. 66, 69 (D.P.R. 1966) (In an action involving the ICA, court noted that "[defendant's] second contention, that the [SEC] is restricted to the remedies expressly provided by statute, does not take into consideration the historical purpose of Equity to provide the relief which is necessary and proper under the circumstances of the case before the Court.").

⁴¹ *See Dent*, *supra* note 39, at 871-73.

⁴² *See, e.g., Tanzer*, 408 F.2d 42; *Baily*, 160 F.2d 78; *Connolly v. Gishwiller*, 162 F.2d 428 (7th Cir. 1947).

⁴³ *See, e.g., First Fin. Group of Texas*, 645 F.2d at 438 (stating that appointment of receiver "is a well-established equitable remedy available to the SEC in its civil enforcement proceedings for injunctive relief"); *SEC v. Keller Corp.*, 323 F.2d 397, 403 (7th Cir. 1963) (where defendants had committed fraud in raising capital for unregistered fund, appointment of receiver becomes necessary to implement injunctive relief); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 714 (D. Del. 1943) (in a case where the court granted permanent injunction to enforce Section 22(e) of ICA, appointment of a receiver is proper where directors and fund advisor had resigned and, thus, there was no one to whom the injunction could effectively run).

⁴⁴ *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975) (quoting *Hecht Co. v. Bowles*, 321 U.S. 321, 331 (1944)).

granted.⁴⁵ All that is required is for the SEC to make a proper showing that the defendants are engaged or about to engage in violative conduct.⁴⁶

B. What Triggers the SEC's Request for a Receiver in the Mutual Fund Context?

Our research revealed that the SEC has sought a court order appointing a receiver or the equivalent⁴⁷ for an investment company at least twenty-eight times since the passage of the ICA in 1940.⁴⁸ These cases are summarized in

⁴⁵ See *SEC v. Fla. Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, at 94,737, 1978 WL 1131 (M.D. Fla. 1978) (“This Court has authority to grant other equitable relief in conjunction with an injunctive action brought by the Commission, and to do equity and to mold each decree to the necessities of the particular case.” (quotation and citation omitted)); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 714 (D. Del. 1943) (“As is frequently stated, a receivership is an ancillary remedy to carry out the primary relief granted in a cause.”). See also *Chicago Title & Trust Co. v. Mack*, 180 N.E. 412, 413 (Ill. 1932) (appointment of receiver “had its origin in the English Court of Chancery at an early date, and it was incidental to and in aid of the jurisdiction of equity to enable it to accomplish, as far as practicable, complete justice among the parties before it”).

⁴⁶ See *SEC v. Caterinicchia*, 613 F.2d 102, 105 n.3 (5th Cir. 1980).

⁴⁷ As a matter of terminology, in all but four of these cases the court appointed a “receiver,” “trustee,” or “trustee-receiver.” With respect to those four other cases, the court in one appointed a “special master” who had the typical powers of a receiver. See *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000). In the second case, the court appointed a “special officer” whose function was to direct the liquidation and dissolution of the fund in question. See *SEC v. Treasury First, Inc.*, SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991). In the third case, the court appointed a “special master” whose powers “[did] not extend to the plenary powers of a full receiver.” *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, at 95,978, 1979 WL 1238, *7 (D.D.C. 1979). That special master, however, was given more powers than the powers awarded to an actual “receiver” in another case. Compare *id.* at *7 (where court authorized special master to conduct new election of directors and supervise shareholders’ and new boards’ consideration of management contract), with *SEC v. Boca Raton Capital Corp.*, SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994) (where court order only authorized receiver to conduct new election of directors). The court in the last case appointed a “special auditor” and a “special counsel” who, together, had the typical powers of a receiver. See *SEC v. Am. Inst. of Counselors*, SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975).

⁴⁸ One of those cases involved a derivative action brought by a shareholder in which the SEC filed an amicus curiae brief requesting that the district court’s order for a receiver pendente lite be affirmed. See *Tanzer v. Huffines*, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.).

During our research, we also came across five other cases which we have not included within the twenty-eight cases discussed. The first case involved a shareholder suit against Cyprus Corporation, a closed-end investment company. The court appointed a federal magistrate to oversee the company’s operations to ensure maintenance of the status quo. We have not included it because the SEC was not a party to the action, either directly or indirectly. See *Whitman v. Fuqua*, 549 F. Supp. 315 (W.D. Pa. 1982). The second case involved a suit brought by the SEC against a group of foreign companies, including Capital Growth Fund, S.A., a closed-end fund incorporated in Costa Rica. Because the SEC sought and received injunctive relief and the appointment of a receiver solely based on alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, we have not included it given our focus on the ICA. See *SEC v. Capital Growth Co., S.A. (Costa Rica)*, 391 F. Supp. 593 (S.D.N.Y. 1974). The third case involved a suit brought by a

Annex A. The SEC was successful in twenty-six of those cases,⁴⁹ unsuccessful in only one case,⁵⁰ and withdrew its request in the remaining case.⁵¹

We believe three things have contributed to the SEC's remarkable .928 batting average in seeking the receivership remedy. First, as most practitioners with any experience with the SEC recognize, the SEC chooses its cases very carefully. Not only does it like cases that it can win hands down, but it also likes test cases that will send an industry-wide message. Second, when seeking the receivership remedy, the SEC proffers multiple factors in support of its petition. The SEC has, on average, cited to approximately four factors per case from the nineteen different factors to which it has cited for support.⁵² Finally, in at least one-third of the cases, the fund in question consented to, did not oppose, or initiated the appointment of a receiver.⁵³ It is certainly easier to win in court when the other side does not put up a fight.

disgruntled shareholder against the Blair Fund and its advisor, Blair & Co., which was in bankruptcy. We have not included it because the SEC was not a party to the action, either directly or indirectly. *See* Lowey v. Vanderbilt, [1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,907, at 90,383, 1970 U.S. Dist. Lexis 9007 (S.D.N.Y. 1970). The fourth case involved the Townsend Growth Fund, Inc. We have not included it because the court appointed a trustee for the fund only after the fund had voluntarily filed for bankruptcy under Chapter X of the Bankruptcy Act of 1898. *See In re Townsend Growth Fund, Inc.*, 245 F. Supp. 484 (S.D.N.Y. 1965). The final case involved the Calumet Bond & Investment Company. We did not include it because the SEC was not a party to the action, either directly or indirectly. Moreover, the actions of the defendant all occurred prior to the passage of the ICA and thus were not governed by it. *See Connolly v. Gishwiller*, 162 F.2d 428 (7th Cir. 1947).

⁴⁹ In one case included in the "successful" tally, the SEC sought a receiver with plenary powers for a troubled fund. However, upon consideration the court appointed a "special master" with only some of the powers of a receiver. *See SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, at 95,978, 1979 WL 1238, at *4 (D.D.C. 1979).

⁵⁰ *See SEC v. Advance Growth Capital Corp.*, 470 F.2d 40 (7th Cir. 1972).

⁵¹ In a case involving the Steadman Funds, a group comprised of five registered investment companies, the SEC originally sought a receiver for the funds in addition to injunctive relief. *See SEC v. Steadman*, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989). The U.S. District Court for the District of Columbia granted injunctive relief, but stayed its order while the D.C. Circuit Court of Appeals reviewed it. Because the district court's opinion does not mention the appointment of a receiver, it is unclear whether the SEC withdrew its receivership request during settlement negotiations that are mentioned in that opinion. In any event, the receivership issue was effectively mooted when the court stayed its own order. The court of appeals ultimately reversed the lower court, ending any possibility that the court would appoint a receiver. *See SEC v. Steadman*, 798 F. Supp. 733, 735 (D.D.C. 1991) (discussing settlement negotiations), *vacated in part, aff'd in part*, 967 F.2d 636 (D.C. Cir. 1992); e-mail from Peter J. Nickles of Covington & Burling, counsel to Steadman, to Prof. Jeffrey J. Haas, dated Aug. 24, 2001 (on file with Prof. Haas).

⁵² The highest number of factors cited was nine, while the lowest number was only one. *Compare* SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (citing nine factors in a case involving Continental Growth Fund, Inc.), *with* SEC v. Boca Raton Capital Corp., SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994) (citing one factor).

⁵³ *See* Heartland Release, *supra* note 10; SEC v. Rupaya-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); SEC v. Boca Raton Capital Corp.,

The SEC has never publicly set forth the standard it employs when deciding whether to seek the receivership remedy. This Article sets out, therefore, to piece together that standard based on the factors to which the SEC cited when it sought that remedy. In examining each receivership case, this Article looks only at those factors to which the SEC originally cited in support of its receivership request, rather than any additional factors that came to light in later proceedings involving the fund in question and/or any individual defendants. All told, the SEC has cited to nineteen different factors, typically in combination, in the twenty-eight receivership cases examined. Not surprisingly, the SEC cited to certain factors frequently and to others less frequently.

1. *Recurring Factors*

For a factor to be considered recurring, we decided the SEC had to cite to it in at least six, or just over twenty percent, of the twenty-eight receivership cases. Employing this standard, these factors, and the number of cases in which the SEC cited to them, are as follows:

- a. Fraud (17);
- b. Incorrect or Problematic Net Asset Value (“NAV”) (11);
- c. Breach of Fiduciary Duty (10);
- d. Prohibited Affiliate Transactions (9);
- e. Reporting Violations (9);
- f. Suspension of Share Redemption (6); and
- g. Improper Book or Record Keeping (6).

Each of these recurring factors is considered below.

SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,123, 50 S.E.C. Docket 672, 1991 SEC Lexis 2639 (Dec. 18, 1991); SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); SEC v. Am. Inst. Counselors, Inc., SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975); SEC v. All Am. Fund, Inc., SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); SEC v. Financial Fund, Inc., SEC Lit. Rel. No. 6383, 4 S.E.C. Docket 413, 1974 SEC Lexis 3173 (June 4, 1974); *In re Shamrock Fund*, SEC Rel. No. IC-7044, 1972 SEC Lexis 1224 (Mar. 7, 1972); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Funds, Inc.).

a. Fraud

Cited in seventeen of the twenty-eight receivership cases (sixty-one percent) were examples of fraudulent conduct.⁵⁴ The SEC, however, did not limit itself to highlighting fraudulent activities proscribed by Section 34(b) of the ICA.⁵⁵ It also cited to violations of the anti-fraud provisions of the Securities Act, Exchange Act, and Investment Advisors Act of 1940⁵⁶ ("IAA"). For example, in support of its request for a receiver and other ancillary relief in a case involving the Rupay-Barrington Funds, Inc.,⁵⁷ the SEC alleged that the fund, its investment advisor, and an upstream affiliate violated Section 17(a) of the Securities Act,⁵⁸ Section 10(b) of the Exchange Act and Rule 10b-5 thereunder,⁵⁹ Sections 206(1) and (2) of the IAA,⁶⁰ and Section 34(b) of the ICA.⁶¹

Specific examples of fraud mentioned in the seventeen cases include the following:

⁵⁴ See SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); Tanzer v. Huffines, 287 F. Supp. 273 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.); SEC v. Midland Basic, Inc., 283 F. Supp. 609 (D.S.D. 1968); SEC v. S & P Nat'l Corp., 265 F. Supp. 993 (S.D.N.Y. 1966); SEC v. Rupay-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); SEC v. Centurion Growth Fund, Inc., SEC Lit. Rel. No. 14,052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); SEC v. Brenna, SEC Lit. Rel. No. 13,099, 50 S.E.C. Docket 383, 1991 SEC Lexis 2637 (Nov. 19, 1991) (involving four funds managed by Strategic Mgmt., Inc.); SEC v. Treasury First, Inc., SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991); SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corp.); SEC v. Fla. Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); SEC v. Am. Inst. Counselors, Inc., SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975); SEC v. All Am. Fund, Inc., SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); SEC Lit. Rel. No. 3308, 1965 SEC Lexis 65 (Sept. 1, 1965) (involving Puerto Rico Capital Corp.). See also SEC v. First Fin. Group of Texas, 645 F.2d 429, 438 (5th Cir. 1981) (in case involving the Securities Act, court noted that appointment of receiver "is particularly necessary in instances in which the corporate defendant, through its management, has defrauded members of the investing public" because "it is likely that, in the absence of the appointment . . . to maintain the status quo, the corporate assets will be subject to diversion and waste").

⁵⁵ 15 U.S.C. § 80a-34(b) (1994).

⁵⁶ 15 U.S.C. § 80b (1994 & Supp. V 1999).

⁵⁷ See SEC v. Rupay-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000).

⁵⁸ 15 U.S.C. § 77q(a) (1994).

⁵⁹ 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (2001).

⁶⁰ 15 U.S.C. § 80b-6(1), (2) (1994).

⁶¹ 15 U.S.C. § 80a-34(b) (1994).

- Misrepresentation that a large receivable issued by a fund advisor and held by the fund in question was being paid off when it was not;⁶²
- Selling fund shares at prices not based on the calculated NAV of those shares;⁶³
- Selling unregistered gold-related securities “in near total disregard for, and in violation of the entire panoply of federal securities laws”;⁶⁴
- Filing false and misleading proxy materials;⁶⁵
- Filing false and misleading annual reports;⁶⁶ and
- Inducing prospective investors to purchase fund shares based on misleading or false information.⁶⁷

b. Net Asset Value Problems

Cited in eleven of the twenty-eight receivership cases (thirty-nine percent) were events relating to a fund’s calculation of its NAV.⁶⁸ The funds in

⁶² See SEC v. Rupy-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000).

⁶³ See SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989).

⁶⁴ SEC v. Am. Inst. Counselors, Inc., SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975).

⁶⁵ See SEC v. Brenna, SEC Lit. Rel. No. 13,099, 50 S.E.C. Docket 383, 1991 SEC Lexis 2637 (Nov. 19, 1991) (involving four funds managed by Strategic Mgmt., Inc.); SEC v. Fundpack, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238, *4 (D.D.C. 1979); SEC v. Zenith Am. Mgmt. Serv., Ltd., SEC Lit. Rel. No. 6650, 5 S.E.C. Docket 798, 1974 SEC Lexis 2080 (Dec. 24, 1974); SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); SEC Lit. Rel. No. 3308, 1965 SEC Lexis 65 (Sept. 1, 1965) (involving Puerto Rico Capital Corp.).

⁶⁶ See SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); Tanzer v. Huffines, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.); SEC v. S & P Nat’l Corp., 265 F. Supp. 993 (S.D.N.Y. 1966); SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978).

⁶⁷ See SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); SEC v. Centurion Growth Fund, Inc., SEC Lit. Rel. No. 14,052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corp.); SEC v. Fundpack, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238, *4 (D.D.C. 1979).

⁶⁸ See SEC v. Rupy-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); *In re* Centurion Growth Fund, Inc., SEC Rel. No. IC-20204, 56 S.E.C. Docket 1129, 1994 SEC Lexis 1065 (Apr. 7, 1994); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by

question either miscalculated their NAVs,⁶⁹ could not calculate them due to insufficient information,⁷⁰ or otherwise failed to calculate them.⁷¹ Sometimes the miscalculation was tied to an allegation of fraud in that the fund was selling its securities at intentionally miscalculated NAVs.⁷² NAV calculation problems also played a role in the *Heartland* matter, although not specifically cited by the SEC. Indeed, a close reading of the SEC's pleadings indicate that the SEC was clearly concerned about whether the Funds were properly valued.⁷³

A particularly egregious NAV case involved Fundamatic Investors, Inc.,⁷⁴ a fund that could not shoot straight. The SEC alleged that two causes lay behind

Steadman Security Corp.); SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); SEC v. All Am. Fund, Inc., SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.); *In re* Shamrock Fund, SEC Rel. No. IC-7044, 1972 SEC Lexis 1224 (Mar. 7, 1972); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.). See also *In re* Technical Fund Inv. Plans, SEC Rel. No. IC-7393, 1972 SEC Lexis 1388 (Sept. 27, 1972) (although not mentioned in SEC's complaint, receiver suspended share redemption due to inaccurate NAV).

⁶⁹ See *In re* Centurion Growth Fund, Inc., SEC Rel. No. IC-20204, 56 S.E.C. Docket 1129, 1994 SEC Lexis 1065 (Apr. 7, 1994); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corp.); SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); SEC v. All Am. Fund, Inc., SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.). See also *In re* Technical Fund Inv. Plans, SEC Rel. No. IC-7393, 1972 SEC Lexis 1388 (Sept. 27, 1972) (although not mentioned in SEC's complaint, receiver suspended share redemption due to inaccurate NAV).

⁷⁰ See *In re* Shamrock Fund, SEC Rel. No. IC-7044, 1972 Lexis 1224 (Mar. 7, 1992) (insufficient information to calculate fund's NAV properly because independent directors' frequent requests for portfolio information were "systematically denied"). Cf. SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corporation. Upon learning of SEC's investigation of funds based on NAV and other problems, funds' trustees resolved to liquidate the funds, but individual defendants failed to comply with resolutions and take steps to liquidate).

⁷¹ See SEC v. Rupaya-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.).

⁷² See SEC v. All Am. Fund, Inc., SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975).

⁷³ See *Heartland* Complaint, *supra* note 21, Background ¶¶ 19-20 ("Heartland Group's auditors' refusal to opine on the valuation of the securities held by the Funds raises serious concerns about the value of the Funds and the securities held by the Funds Meanwhile, shareholders have redeemed, and continue to redeem, shares in the Funds."); *supra* text accompanying notes 21-24.

⁷⁴ SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972).

the fund's miscalculation of its NAV. First, the fund had not kept current the books and records necessary to compute NAV. Second, the fund had no functioning board of directors to value its portfolio securities for which market prices were not readily available.⁷⁵ To make matters worse, the fund redeemed shares at NAVs computed as of the wrong day.⁷⁶

c. Breach of Fiduciary Duty

Cited in ten of the twenty-eight receivership cases (thirty-six percent) were breaches of fiduciary duty.⁷⁷ In most cases, the SEC cited to a violation of Section 36(a) of the ICA,⁷⁸ which proscribes personal misconduct by, among others, a fund's directors, officers, or investment advisors. Given that Section 36(a) is a "duty of loyalty" styled provision, it was not surprising to find references to self-dealing, gross misconduct, and gross abuse of trust in the cases.⁷⁹

⁷⁵ It later came out that the fund did have directors, but that they played no active or material role in the management of the fund. See *In re Richard O. Bertoli*, SEC Admin. Proc. File No. 3-4618, 1979 SEC Lexis 2450 (June 18, 1979). Instead, one individual defendant "alone directed the Fund's day-to-day operations." *Id.* at *8.

⁷⁶ See SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972).

⁷⁷ See *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40 (7th Cir. 1972); *Tanzer v. Huffines*, 287 F. Supp. 273 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.); *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 20, 1963) (involving Continental Growth Fund, Inc.); *SEC v. Aldred Inv. Trust*, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945); *SEC v. Rupaya-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); *SEC v. Treasury First, Inc.*, SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991); *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238 (D.D.C. 1979); SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Funds, Inc.). See also *United States v. Brashier*, 548 F.2d 1315 (9th Cir. 1976) (although not mentioned in SEC's complaint, fund's officers and investment advisor engaged in self-dealing by causing the fund to purchase certain securities in return for kickbacks); *SEC v. Brenna*, SEC Lit. Rel. No. 13,116, 50 S.E.C. Docket 605, 1991 SEC Lexis 2786 (Dec. 10, 1991) (involving four funds managed by Strategic Mgmt., Inc.) (although not part of SEC's prayer for relief, the court's temporary restraining order also prohibited individual defendants from further violations of Section 36(a) of ICA); *In re Richard O. Bertoli*, SEC Admin. Proc. File No. 3-4618, 1979 SEC Lexis 2450, at *22-24 (June 18, 1979) (in a case involving Fundamatic Investors, Inc., fund officers found to have engaged in self-dealing transactions although such was not alleged in SEC's original complaint).

⁷⁸ 15 U.S.C. § 80a-36(a) (1994).

⁷⁹ See, e.g., *Aldred Inv. Trust*, 58 F. Supp. 724; SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 20, 1963) (involving Continental Growth Fund, Inc.). Two unique cases involving breach of fiduciary duty are *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970), and *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, at 95,981, 1979 WL 1238, at *6 (D.D.C. 1979). In *Fifth Ave.*, the U.S. District Court for the Southern District of New York pointed to certain individual defendants' self-dealing that occurred *prior* to the time the company in question had inadvertently

Worthy of discussion on this point is *SEC v. Advance Growth Capital Corporation*,⁸⁰ the only case in which a court denied the SEC's request for a receiver. The SEC sought a permanent injunction against the defendant corporation and two individual defendants, as well as a receiver for the corporation. The SEC alleged that the defendants had engaged in prohibited affiliate transactions and had filed annual reports with the SEC that omitted discussion of those transactions. It further alleged that the two individual defendants had engaged in a gross abuse of trust within the meaning of Section 36 of the ICA.

The U.S. District Court for the Northern District of Illinois, in an unpublished opinion referred to in the appellate opinion, refused to appoint a receiver. It reasoned that although the two individual defendants had engaged in acts that could be criticized, they had benefitted shareholders immensely by turning the corporation's financial affairs around. In discussing whether a receiver should be appointed, the district court stated:

It would be more than a disservice to [the corporation], its stockholders and creditors, it would be a disaster to them for this court to appoint a Receiver . . . after [the two defendants] had rescued [the corporation] from bankruptcy in 1964, and saved it from dissolution in 1965 and 1966, and have since that time restored most of the capital that was dissipated in the 1962 binge of the officers and directors.⁸¹

The Seventh Circuit Court of Appeals, "weighing all the equities,"⁸² agreed with the district court on this point.⁸³ It noted that "it is probable that removal

become an investment company as supporting, in part, the appointment of a receiver *after* the time the company had become an inadvertent investment company. See *Fifth Ave.*, 289 F. Supp. at 3.

In *Fundpack*, the U.S. District Court for the District of Columbia noted in the context of a breach of fiduciary duties allegation under Section 36(a) of the ICA, 15 U.S.C. § 80a-36(a) (1994), Fundpack's board of directors' pattern of routinely renewing its advisory contract with its fund advisor without assessing the merits of doing so. See *Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,981. The court used this partially to support granting the SEC's request for a receiver. Oddly, the court's reference to a director's breach of his or her "duty of care" is not what Congress intended when it included the words "breach of fiduciary duty involving personal misconduct" in Section 36(a). Indeed, that section embodies duty of loyalty, rather than negligence, concepts.

⁸⁰ 470 F.2d 40 (7th Cir. 1972).

⁸¹ *Id.* at 54.

⁸² *Id.*

⁸³ The Seventh Circuit disagreed with the district court on the issue of whether the district court should issue a permanent injunction against the individual defendants with respect to the affiliated transactions in which they had engaged in violation of Section 17(a) and (d) of the ICA, 15 U.S.C. § 80a-17(a) & (d) (1994 & Supp. V 1999). The district court had refused to grant an injunction based on its finding that the individual

of the defendants and the appointment of a receiver would be more detrimental than beneficial to the investment company and its shareholders, and, as Section 36(a) expressly recognizes, the ultimate benefit of these parties is the primary objective of the Act.”⁸⁴ It did add, however, that “[w]hether the [individual] defendants are barred under provisions of § 9(a)(2) . . . from serving in their present capacity or any other capacity with [the corporation] absent exemption under § 9(c) . . . is an administrative matter within the provisions of the Commission as to which we express no opinion”⁸⁵

d. Prohibited Affiliate Transactions

Cited in nine of the twenty-eight receivership cases (thirty-two percent) were improper transactions between funds and their affiliates.⁸⁶ These transactions are generally prohibited by Section 17 of the ICA.⁸⁷ That section prohibits any “affiliated person”⁸⁸ of an investment company from acting as a principal in (a) selling securities to, or buying securities from, an investment company or (b) lending money to, or borrowing money from, an investment company, in either case, without an exemption granted by the SEC.⁸⁹

defendants had not engaged in intentional misconduct and that, in any event, the corporation had not been harmed. *Advance Growth Capital Corp.*, 470 F.2d at 44. The Seventh Circuit, convinced that these defendants’ conduct was neither inadvertent nor harmless, disagreed: “These were not mere ‘technical’ violations of regulatory legislation, but continual and extensive violations of provisions which lie at the very heart of a remedial statute. They provide the opportunity for personal gain by those with fiduciary obligations—the specific target of the Investment Company Act’s prohibitions.” *Id.* at 53-54.

⁸⁴ *Id.* at 54.

⁸⁵ *Id.* at 55 (citations omitted). Under Section 9(a)(2) of the ICA, 15 U.S.C. § 80a-9(a)(2) (1994), it is illegal for any person who has been permanently or temporarily enjoined from acting as, among other things, an underwriter, broker, dealer, or investment advisor to serve as a director or officer of an investment company absent an exemption granted by the SEC pursuant to Section 9(c) of the ICA, 15 U.S.C. § 80a-9(c) (1994).

⁸⁶ See *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40 (7th Cir. 1972); *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff’d*, 435 F.2d 510 (2d Cir. 1970); *SEC v. Rupy-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Am. Inst. Counselors, Inc.*, SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975); *SEC Lit. Rel. No. 5408*, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); *SEC Lit. Rel. No. 3308*, 1965 SEC Lexis 65 (Sept. 1, 1965) (involving Puerto Rico Capital Corp.); *SEC Lit. Rel. No. 2699*, 1963 SEC Lexis 1020 (July 20, 1963) (involving Continental Growth Fund, Inc.).

⁸⁷ 15 U.S.C. § 80a-17 (1994 & Supp. V 1999). One case also cited to Section 21(b) of the ICA, 15 U.S.C. § 80a-21(b) (1994), which prohibits any registered management company from lending money to a controlling entity. See *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978).

⁸⁸ 15 U.S.C. § 80a-2(a)(3) (1994).

⁸⁹ 15 U.S.C. § 80a-17(a), (b) (1994 & Supp. V 1999). Because the main concern is with the investment advisor taking advantage of the fund it advises, one case, not surprisingly, also cited to a violation of Section

e. Reporting Violations

Cited in nine of the twenty-eight receivership cases (thirty-two percent) were reporting violations.⁹⁰ All nine cases, including *Heartland*, cited a failure on the fund's part to file certain required reports, such as a semiannual or annual report, with the SEC in violation of Section 30 of the ICA and certain rules promulgated thereunder.⁹¹ In addition, all but one of the nine cases⁹² pointed to a fund's failure to deliver certain required reports to the fund's shareholders in violation of that same ICA section and Rule 30d-1 promulgated thereunder.⁹³

f. Suspension of Share Redemption

Cited in six of the twenty-eight receivership cases (twenty-one percent) were illegal suspensions by open-end investment companies of their shareholders' redemption rights under the ICA.⁹⁴ As a general matter, the law requires open-end funds to redeem their shares within seven days of tender by fund shareholders; the six funds in question failed to do so in violation of Section 22(e) of the ICA.⁹⁵

Two cases highlight the importance of this factor. *SEC v. Fiscal Fund, Inc.*,⁹⁶ represented the first case in which the SEC requested, and a district

37 of the ICA, 15 U.S.C. § 80a-37 (1994). See SEC Lit. Rel. No. 3308, 1965 SEC Lexis 65 (Sept. 1, 1965) (involving Puerto Rico Capital Corp.). That section makes it a crime for any person to embezzle any money or securities held by a fund.

⁹⁰ See *Tanzer v. Huffines*, 287 F. Supp. 273 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712 (D. Del. 1943); *Heartland Release*, *supra* note 10; *SEC v. Centurion Growth Fund, Inc.*, SEC Lit. Rel. No. 14,052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Municipal Lease Sec. Fund, Inc.*, SEC Lit. Rel. No. 12,331, 45 S.E.C. (Docket) 256, 1989 WL 992928 (Dec. 26, 1989); *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); *SEC v. Financial Fund, Inc.*, SEC Lit. Rel. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.).

⁹¹ 15 U.S.C. § 80a-30 (1994 & Supp. V 1999); 17 C.F.R. § 270.30a-1, b1-1 & b2-1 (2000).

⁹² That one case was *Tanzer*, 287 F. Supp. 273 (involving B.S.F. Co.).

⁹³ 15 U.S.C. § 80a-30 (1994 & Supp. V 1999); 17 C.F.R. § 270.30d-1 (2000).

⁹⁴ See *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712 (D. Del. 1943); *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Financial Fund, Inc.*, SEC Lit. Rel. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.).

⁹⁵ 15 U.S.C. § 80a-22(e) (1994).

⁹⁶ 48 F. Supp. 712 (D. Del. 1943).

court granted, a receiver to liquidate a solvent investment company.⁹⁷ In addition to pointing to the fund's failure to redeem shares, the SEC highlighted the fund's complete lack of management and failure to file required reports. In weighing these three factors, the U.S. District Court for the District of Delaware stated that the fund's "most crucial violation of the Act has been Sec[ti]on 22(e)."⁹⁸ Later, it added that "the violation of which gives the Commission the greatest concern is Sec[ti]on 22(e)."⁹⁹

*In re Shamrock Fund*¹⁰⁰ also highlighted the seriousness of a Section 22(e) violation. Here, the independent fund directors had made frequent requests to the investment advisor for information relating to the fund's portfolio. That advisor, however, "systematically denied"¹⁰¹ those requests. Through the directors, the fund asserted that there was not enough information to value the fund's assets properly. An emergency, therefore, existed under Section 22(e), and the fund petitioned the SEC for an order to suspend shareholder redemption privileges pursuant to Section 22(e)(3). Rather than grant the requested order, the SEC convinced the U.S. District Court for the Central District of California to issue a temporary restraining order enjoining the fund from failing to redeem its shares in violation of Section 22(e) and from selling its redeemable shares in violation of Section 22(d).¹⁰² Moreover, the district court, at the SEC's request, appointed a receiver pendente lite to take charge of the assets and records of the fund for safekeeping.

g. Improper Book or Record Keeping

Cited in six of the twenty-eight receivership cases (twenty-one percent) were instances of improper book or record keeping.¹⁰³ The SEC claimed that

⁹⁷ See SEC Rel. No. IC-434, 1943 WL 30294 (Jan. 19, 1943).

⁹⁸ *Fiscal Fund*, 48 F. Supp. at 713.

⁹⁹ *Id.* at 714.

¹⁰⁰ SEC Rel. No. IC-7044, 1972 Lexis 1224 (Mar. 7, 1992).

¹⁰¹ *Id.*

¹⁰² 15 U.S.C. § 80a-22(d) (1994).

¹⁰³ See *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Municipal Lease Sec. Fund, Inc.*, SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); *SEC v. American Inst. Counselors, Inc.*, SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.). See also SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.) (complaint charged defendant custodial bank with failure to maintain records which accurately set forth the fund's assets).

must have a majority of independent directors on its board. Boca, however, only had one independent director on its five-member board. *Based on this factor alone*, the U.S. District Court for the Southern District of Florida, at the SEC's request and with Boca's consent, appointed a receiver for the company. The receiver, which was only appointed for sixty days or until further order of the court, was charged with arranging for shareholders to elect the proper number of independent directors and to prepare proxy materials to facilitate that goal.

Cited in five of the twenty-eight receivership cases (eighteen percent) was a fund's deviation from its stated investment policies.¹¹⁰ These deviations violate Section 13(a) of the ICA.¹¹¹ That section prohibits registered investment companies from, among other things, unilaterally deviating from fundamental investment policies that can only be changed through a majority vote of their shareholders. In addition, one fund also made loans in contravention of its prospectus, and thus violated Section 21(a) of the ICA¹¹² in addition to Section 13(a).¹¹³

Another factor that the SEC cited in five cases (eighteen percent) was the failure of fund shareholders to approve a fund's management contract properly;¹¹⁴ shareholders' failure to do so violates Section 15(a) of the ICA.¹¹⁵ Specifically, that section makes it unlawful for any person to serve as an investment advisor to a registered investment company except pursuant to a

¹¹⁰ See *SEC v. Aldred Inv. Trust*, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Treasury First, Inc.*, SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991); *SEC v. Financial Fund, Inc.*, SEC Lit. Rel. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.).

¹¹¹ 15 U.S.C. § 80a-13(a) (1994).

¹¹² 15 U.S.C. § 80a-21(a) (1994).

¹¹³ See *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991).

¹¹⁴ See *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238 (D.D.C. 1979); *SEC v. Florida Bank Fund, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); *SEC v. Steadman*, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corp.); SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972) (involving Technical Fund, Inc.); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.). See also *In re Carob Securities, Inc.*, SEC Admin. Proc. File Nos. 3-4890 & 8-20294, 1974 SEC Lexis 2774 (Aug. 30, 1976) (involving Financial Trends Mutual Fund) (although not in SEC's original complaint, later proceedings noted that management contract had not been approved by required majority shareholder vote).

¹¹⁵ 15 U.S.C. § 80a-15(a) (1994).

the funds in question had violated Section 31(a) of the ICA and Rule 31a-1 promulgated thereunder.¹⁰⁴ That section and rule both discuss the legally mandated maintenance and retention of specific information and documents.

2. *Less Frequently Cited Factors*

In addition to the recurring factors discussed above, the SEC less frequently cited to several other factors when seeking the receivership remedy. The top five of these factors, and the number of cases in which the SEC cited them, are listed below followed by a brief discussion:

- Insufficient Number of Independent Directors (5);
- Deviation from Investment Policies (5);
- Management Contract Improperly Approved (5);
- Failure To Register as an Investment Company (4);
- Abandonment by Board of Directors (4); and
- No Fidelity Insurance Bond (3).

Cited in five of the twenty-eight receivership cases (eighteen percent) was a fund's failure to have a legally sufficient number of independent directors on its board of directors.¹⁰⁵ Failure to have a properly constituted board violates Section 10(a) of the ICA.¹⁰⁶ That section requires a board of directors be comprised of individuals of whom at least forty percent are independent of the fund's management, underwriter, and administrator.¹⁰⁷

The importance of this factor is highlighted in *SEC v. Boca Raton Capital Corp.*¹⁰⁸ Boca, a business development company governed by the ICA, lacked the requisite number of independent directors required to operate that company legally. Under Section 56(a) of the ICA,¹⁰⁹ a business development company

¹⁰⁴ 15 U.S.C. § 80a-31(a) (1994); 17 C.F.R. § 270.31a-1 (2000).

¹⁰⁵ See *SEC v. Boca Raton Capital Corp.*, SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994); *SEC v. Centurion Growth Fund, Inc.*, SEC Lit. Rel. No. 14,052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Zenith Am. Mgmt. Services, Ltd.*, SEC Lit. Rel. 6650, 1974 SEC Lexis 2080 (Dec. 24, 1974) (involving the All American Fund, Inc.); *SEC v. Financial Fund, Inc.*, SEC Lit. Rel. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974).

¹⁰⁶ 15 U.S.C. § 80a-10(a) (1994).

¹⁰⁷ Although individuals affiliated with a fund's administrator are not technically included in Section 10(a), we believe that the spirit of that section would preclude those individuals from serving as independent directors of that fund. Indeed, many fund advisors provide the same administrative services that outside administrators provide. No one would argue that the individuals within the fund advisor providing those services could serve as independent directors of a fund under Section 10(a).

¹⁰⁸ SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994).

¹⁰⁹ 15 U.S.C. § 80a-55(a) (1994).

written contract approved by the holders of a majority of the fund's outstanding voting securities.

Cited in four of the twenty-eight receivership cases (fourteen percent) was a fund's failure to register as an investment company under the ICA.¹¹⁶ These funds fell within the definition of "investment company" under Section 3(a)(1) of the ICA.¹¹⁷ Because they had neither registered as an investment company pursuant to Section 8 of the ICA,¹¹⁸ nor qualified for an exemption from registration under Section 6,¹¹⁹ they violated Section 7(a)'s¹²⁰ prohibition on unregistered investment company transactions. Importantly, all four district courts involved in these cases pointed to the specific language of Section 42(d) of the ICA¹²¹ quoted above¹²² for their statutory authority to grant orders appointing receivers.

In four extreme cases (fourteen percent), the SEC cited as a factor a board's total abandonment of its fund.¹²³ In these cases, the SEC obviously had no choice but to seek a receiver. As the Second Circuit Court of Appeals stated in *SEC v. S & P National Corp.*,¹²⁴ "the primary purpose of the appointment [of a receiver] was promptly to install a responsible officer of the court who could bring the companies into compliance with the law, ascertain the true state of

¹¹⁶ See *SEC v. Keller Corp.*, 323 F.2d 397 (7th Cir. 1963); *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970); *SEC v. S & P Nat'l Corp.*, 265 F. Supp. 993 (S.D.N.Y. 1966); *SEC v. Am. Inst. Counselors, Inc.*, SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975). See also *SEC v. Midland Basic, Inc.*, 283 F. Supp. 609 (D.S.D. 1968) (while SEC alleged in its complaint that, among other things, company had failed to register under the ICA, company registered immediately prior to court proceedings in order to placate SEC).

¹¹⁷ 15 U.S.C. § 80a-3(a)(1) (1994 & Supp. V 1999).

¹¹⁸ 15 U.S.C. § 80a-8 (1994).

¹¹⁹ 15 U.S.C. § 80a-6 (1994 & Supp. V 1999).

¹²⁰ 15 U.S.C. § 80a-7(a) (1994).

¹²¹ 15 U.S.C. § 80a-41(d) (1994).

¹²² See *supra* text accompanying note 30.

¹²³ See *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978) (board had not met in two years and five months); *SEC v. S & P Nat'l Corp.*, 265 F. Supp. 993 (S.D.N.Y. 1966); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712 (D. Del. 1943); SEC Lit. Rel. 5595, 1972 SEC Lexis 1862 (Oct. 31, 1972) (involving Fundamatic Investors, Inc.). With respect to the Fiscal Fund, the SEC labeled it an "orphan" investment company. SEC Rel. No. IC-505, 1943 WL 30350 (Jun. 4, 1943). See also *In re Centurion Growth Fund, Inc.*, SEC Rel. No. IC-20204, 56 S.E.C. Docket 1129, 1994 SEC Lexis 1065 (Apr. 7, 1994) (although fund had not totally abandoned, SEC noted that "the Fund's board . . . has had only one member and appears to be unable . . . to take any corporate actions involving corporate governance or oversight of the management of the Fund").

¹²⁴ 360 F.2d 741 (2d Cir. 1966).

affairs . . . and report thereon to the court and public shareholders and preserve corporate assets.”¹²⁵

In three cases (eleven percent), the SEC cited a fund’s failure to maintain a fidelity insurance bond.¹²⁶ A fund’s failure in this regard violates Section 17(g) of the ICA and Rule 17g-1 promulgated thereunder.¹²⁷ Under that section and rule, funds must maintain a fidelity insurance bond covering the fund against acts of larceny and embezzlement committed by the fund’s officers and employees.

Finally, the SEC cited the following factors twice (seven percent) or only once (3.5 percent) in the twenty-eight receivership cases:

- Directors Serving Without Proper Shareholder Approval (2);¹²⁸
- Directors or Officers Serving While Legally Prohibited from Doing So (2);¹²⁹
- Improper Return of Capital (2);¹³⁰
- Failure To Follow Custodial Procedures (2);¹³¹

¹²⁵ *Id.* at 750-51 (quotation marks omitted).

¹²⁶ *See* SEC v. Fundpack, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238 (D.D.C. 1979); SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.).

¹²⁷ 15 U.S.C. § 80a-17(g) (1994); 17 C.F.R. § 270.17g-1 (2000).

¹²⁸ *See* SEC v. Fiscal Fund, Inc., 48 F. Supp. 712 (D. Del. 1943); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mut. Fund, Inc.). Under Section 16(a) of the ICA, it is unlawful for directors to serve on the board without proper shareholder approval, subject to certain exceptions. *See* 15 U.S.C. § 80a-16(a) (1994).

¹²⁹ *See* SEC v. Midland Basic, Inc., 283 F. Supp. 609 (D.S.D. 1968); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mut. Fund, Inc.). Under Section 9(a) of the ICA, it is unlawful for directors to serve on a fund’s board if they had previously engaged in, among other things, acts of personal misconduct specified in that section. *See* 15 U.S.C. § 80a-9(a) (1994 & Supp. V 1999).

¹³⁰ *See* SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991). Under Section 19(a) of the ICA and Rule 19a-1 promulgated thereunder, registered investment companies are prohibited from returning capital to shareholders unless any such return is accompanied by a written statement adequately disclosing the source of the money being returned. *See* 15 U.S.C. § 80a-19(a) (1994); 17 C.F.R. § 270.19a-1 (2000).

¹³¹ *See* SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); SEC v. Steadman, SEC Lit. Rel. No. 12167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989) (involving five funds managed by Steadman Security Corp.). *See also* SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.) (complaint charged defendant custodial bank with failure to maintain records which accurately set forth the fund’s assets). Under Section 17(f) of the ICA and Rule 17f-2 thereunder, securities of registered management investment companies may be maintained in the custody of the companies specified in that section and rule. *See* 15 U.S.C. § 80a-17(f) (1994 & Supp. V 1999); 17 C.F.R. § 270.17f-2 (2000).

- Sales Without a Legally Valid Prospectus (1);¹³² and
- Accountants Serving Without Proper Shareholder Approval (1).¹³³

C. Interpreting the SEC's Approach in Mutual Fund Receivership Cases

As noted above, the SEC typically points to multiple factors when seeking the receivership remedy in the context of a mutual fund.¹³⁴ Because the SEC has never articulated a standard, however, the question arises as to whether there is a method to the SEC's approach. By looking at the twenty-eight receivership cases and the factors the SEC cited, three major themes stand out.

First, instances of misconduct on the part of the fund's investment advisors, directors, and/or officers greatly increase the chances that the SEC will seek the receivership remedy. Under the rubric of misconduct are the factors of fraud, breach of fiduciary duty, and prohibited affiliate transactions¹³⁵—instances of conduct where the fund's investment advisors, directors, or officers put their own interests ahead of those of the fund's current or prospective shareholders. Twenty-two of the twenty-eight receivership cases, or seventy-nine percent, involved one or more factors involving misconduct. Fraudulent activities, whether violative of the Securities Act, the Exchange Act, the ICA, and/or the IAA, were most prevalent, as they appeared in seventeen of the twenty-two cases. Breaches of fiduciary duty occurred in ten of the twenty-two cases, while prohibited affiliate transactions occurred in nine.

Putting statistics aside, the point here is simple. Individuals who engage in serious misconduct to the detriment of shareholders' interests should not be in

¹³² See *SEC v. Rupaya-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000) (highlighting fund's use of prospectus not meeting the requirements of Section 10 of the Securities Act, 15 U.S.C. § 77k (1994), in violation of section 5(b) of the Securities Act, 15 U.S.C. § 77e(b) (1994).

¹³³ See SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.) (SEC complaint alleged that fund's directors and officers caused the fund to file financial statements certified by accountants who had not received proper shareholder approval in violation of Section 32(a) of the ICA, 15 U.S.C. § 80a-32(a) (1994).

¹³⁴ See *supra* text accompanying note 52. It is worth noting that courts also have imposed the receivership remedy in the context of private equity funds. See *Lincoln Nat'l Life Ins. Co. v. Silver*, 114 F.3d 1191 (7th Cir. 1997) (court appointed a receiver to compel payment of outstanding capital call as well as dissolve private equity partnership due to mismanagement, fraud, and self-dealing by control person). See also *United States v. Colorado Invesco, Inc.*, 902 F. Supp 1339 (D. Colo. 1995) (court appointed Small Business Administration to be a receiver for a small business investment company that received financing from that administration).

¹³⁵ For a discussion of these factors, see *supra* Parts I.B.1.a, c, d.

charge of mutual funds. This, of course, is part of the securities laws' broader theme that these individuals should not be involved in the securities industry, period.¹³⁶ In the fund context, the SEC typically seeks to enjoin individuals or entities engaged in misconduct. Because the efficacy of an injunction, however, depends heavily on having someone responsible and dependable in charge of the fund, a court will grant ancillary relief in the form of a receiver at the SEC's request when no one responsible is left.¹³⁷ Indeed, as the Seventh Circuit Court of Appeals has made abundantly clear:

It is hardly conceivable that the trial court should have permitted those who were enjoined from fraudulent misconduct to continue in control [of Keller Corp.'s] affairs for the benefit of those shown to have been defrauded. In such cases the appointment of a trustee-receiver becomes a necessary implementation of injunctive relief.¹³⁸

Given the retail nature of mutual funds, the second theme running through many of the receivership cases should come as no surprise. That theme is the seriousness with which the SEC views the redeemable share mechanism of an open-end investment company. "Mechanism," in our minds, is a two-fold concept, covering both share pricing and share liquidity. Pricing revolves around a fund's NAV and the information used in deriving it and disclosing it. Thus, fifteen of the twenty-eight receivership cases involved funds that: (a) improperly calculated their NAVs, could not calculate their NAVs, or would not calculate them at all, and/or (b) failed to disclose publicly accurate NAV supporting information.¹³⁹ In terms of share liquidity, six of those fifteen cases also involved funds that unlawfully suspended redeemable share redemption privileges.¹⁴⁰

¹³⁶ See, e.g., 15 U.S.C. § 77u(e) (1994) (permitting a court to bar individuals who violated the antifraud provisions of the Securities Act from serving as officers or directors of public companies); 15 U.S.C. § 78ee (1994) (permitting a court to bar individuals who violated the antifraud provisions of the Exchange Act from serving as officers or directors of public companies); 15 U.S.C. § 80a-9(a)(1) (1994) (prohibiting individuals convicted of any felony or misdemeanor involving a purchase or sale of any security within the past ten years from serving as a fund officer or director); 15 U.S.C. § 80b-3(e)(2) (1994) (allowing SEC to suspend or revoke the registration of any investment advisor convicted of any felony or misdemeanor involving the purchase or sale of any security within ten years preceding the filing of any application for registration).

¹³⁷ See *supra* text accompanying notes 43-46.

¹³⁸ *SEC v. Keller Corp.*, 323 F.2d 397, 403 (7th Cir. 1963). See also *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3, 42 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970) (discussing need for responsible person to take over management of investment company); *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 714 (D. Del. 1943) (same).

¹³⁹ These fifteen cases are the combination of the cases listed under the "NAV Problems" and "Reporting Violations" factors. See *supra* Parts I.B.1.b, e.

¹⁴⁰ These six cases fall under the "Suspension of Share Redemption" factor. See *supra* Part I.B.1.f.

What is surprising, however, is what happens when cases involving the redeemable share mechanism are aggregated with cases involving misconduct. When this is done, twenty-seven of the twenty-eight receivership cases, or ninety-six percent, are covered. This certainly underscores the importance of these two themes to the SEC over the sixty-two years since Congress passed the ICA.¹⁴¹

The final theme involves four of the factors to which the SEC cited less frequently. That theme is that the SEC may seek a receiver for any fund that has a problematic board of directors. This theme encompasses the less frequently cited factors of an insufficient number of independent directors, fund abandonment, directors serving without proper shareholder approval, and directors serving when prohibited by law from doing so.¹⁴² Eleven of the twenty-eight receivership cases, or thirty-nine percent, involved one or more of these four factors. Importantly, one of those eleven cases is the only case that does not also involve either of the two prior themes. Recall that in *SEC v. Boca Raton Capital Corp.*,¹⁴³ the SEC sought a receiver *solely* based on the company's failure to have a legally sufficient number of independent directors.¹⁴⁴

What the analysis above does not answer is how the SEC should respond in a situation where errant business entrepreneurs who, while running a fund, intentionally or unintentionally run afoul of various ICA provisions in a way that does not harm shareholders.¹⁴⁵ Should the SEC seek the receivership remedy under those circumstances? Should the SEC allow the fund to operate under the heightened scrutiny of its independent directors? We believe the appropriate response would depend on whether the fund has capable

¹⁴¹ In weighing in on the importance of different factors in the SEC's case against the Steadman Funds, a mutual fund family comprised of five registered investment companies, the Court of Appeals for the District of Columbia Circuit stated:

The charges in this case fall into three distinct categories. Both parties agree that the claims of willful or reckless securities fraud were at the core of the SEC's case. The negligent fraud charges and the alleged pricing and disclosure violations were next in order of seriousness. Least serious were the technical violations of the advisory agreement and account maintenance rules, and the reporting violations the appellants did not appeal.

SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992).

¹⁴² For a discussion of these four factors, see *supra* Part I.B.2.

¹⁴³ SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2245, 1994 SEC Lexis 3244 (Oct. 11, 1994).

¹⁴⁴ See *supra* text accompanying notes 108-09.

¹⁴⁵ Similar circumstances arose in *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40 (7th Cir. 1972); see *supra* text accompanying notes 80-85.

independent directors who can step in to resolve the crisis.

II. THE RISE OF THE TRULY EFFECTIVE INDEPENDENT MUTUAL FUND DIRECTOR

The passage of the ICA followed an extensive four-year review by the SEC to determine whether the Securities Act and the Exchange Act were sufficient to prevent abuses in the mutual fund industry.¹⁴⁶ In determining that they were not, Congress passed, and President Roosevelt signed into law, the ICA in August 1940. Senator Robert F. Wagner, of New York, commented on the need for the ICA:

The underlying purpose of the legislation is not merely to insure [that] investors receive full and fair disclosure of the nature and activities of investment trusts and investment companies in which they are interested, but to eliminate and prevent those deficiencies and abuses in these organizations which have contributed to the tremendous losses sustained by their securities holders.¹⁴⁷

Section 10(a) of the ICA is one of the cornerstones of investor protection. That section requires at least forty percent of the members of each fund's board of directors to be independent.¹⁴⁸ The oddity of that section, however, has been, and continues to be, that while funds are required to have independent directors on their boards, the ICA never explicitly states why this is, or what the general obligations of those directors are. One must look elsewhere for an explanation.

Legislative history reveals that the independent directors are responsible for preventing abuses by fund advisors by supplying an independent check on their actions. These directors are supposed to stand up for fund shareholders in situations where a fund advisor could exploit the conflicts of interest that are

¹⁴⁶ See 86 Cong. Rec. 8842-43 (daily ed. July 21, 1940) (statement of Sen. Robert F. Wagner).

¹⁴⁷ 86 Cong. Rec. 2844-47 (Mar. 14, 1940) (statement of Sen. Robert F. Wagner on S. 3580).

¹⁴⁸ See 15 U.S.C. § 80a-10(a) (1994). *But see* Independent Director Adopting Release, *supra* note 17, at *16-19 (effectively changing the forty percent requirement to a majority on July 1, 2002). Despite Section 10(a)'s requirement of at least forty percent independent directors, it is clear that a large number of fund families have a higher percentage than forty percent. In addition to those families that naturally believe that a higher percentage is warranted, the ICA mandates a higher percentage in two circumstances. First, Rule 12b-1(c)(1) requires registered open-end investment companies to have a majority of independent directors if those companies want to implement and continue 12b-1 distribution plans. See 17 C.F.R. § 270.12b-1(c)(1) (2000). Second, in the context of a fund advisor merger, where an advisory contract is assigned to the surviving advisor, Section 15(f)(1)(A) requires that independent directors constitute at least seventy-five percent of the board for three years after the merger. See 15 U.S.C. § 80a-15(f)(1)(A) (1994 & Supp. V 1999).

inherent in the fund advisor-investment company relationship.¹⁴⁹ They are, indeed, supposed to be “watchdogs,” as the late Supreme Court Justice William Brennan famously labeled them.¹⁵⁰

A. *The Relational View of “Independence”*

The ICA’s notion of directorial “independence” is the key element in protecting fund shareholders. The ICA clearly views “independence” in a relational context.¹⁵¹ That is, a director is automatically “independent” if he or she does not have a relational nexus with the investment advisor, underwriter, or administrator¹⁵² that the ICA deems too close. Originally, that nexus was fairly narrow, as only “persons who are investment advisors of, affiliated persons of an investment advisor of, or officers or employees of, [a registered investment company]” were disqualified from being independent directors.¹⁵³ Immediately, however, skirmishes erupted over the proper scope of that nexus. For example, as early as 1941, the SEC expanded the nexus so that attorneys on general retainer with an investment company were deemed “employees” of that company and thus would not qualify as independent directors.¹⁵⁴

Congress itself significantly altered the scope of the relational nexus in 1970 in response to several private and governmental reports.¹⁵⁵ One of those

¹⁴⁹ See SEC ROUNDTABLE—PART II, *supra* note 16, at 79 (where Gerald McDonough, an independent director for Fidelity Funds, stated, “The general structure of the mutual fund industry . . . demands that independent trustees effectively represent the shareholders’ interests in order to ensure that conflicts of interest are resolved in favor of the shareholders each and every time they arise.”); Interpretive Matters Concerning Independent Directors of Investment Companies, SEC Rel. No. IC-24083, 70 S.E.C. Docket 2017, 2018, 1999 SEC Lexis 2196, at *5 (“Interpretive Release”) (noting that “[a]n investment advisor’s interest in maximizing its own profits for the benefit of its owners may conflict with its paramount duty to act solely in the best interests of the fund and its shareholders”).

¹⁵⁰ *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting District Judge Frederick van Pelt Bryan in *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), and *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC)).

¹⁵¹ See Interpretive Release, *supra* note 149, at *2-3 (noting that “Section 2(a)(19) of the [ICA] authorizes the Commission to issue an order finding that a person is an ‘interested person’ due to a material business or professional relationship with a fund or certain persons or entities”); SEC Rel. No. IC-214, 1941 WL 37720 (Sept. 15, 1941) (“The purpose of Section 10(a) . . . can hardly be accomplished if a person so closely related to the management is permitted to be included in the minority portion of the board which is designed to check independently on management activities.”).

¹⁵² For a discussion of why we believe a fund’s administrator would fall within the ambit of Section 10(a), see *supra* note 107.

¹⁵³ Investment Company Act of 1940, § 10(a), ch. 686, 54 Stat. 789 (Aug. 22, 1940).

¹⁵⁴ See SEC Rel. No. IC-214, 1941 WL 37720 (Sept. 15, 1941).

¹⁵⁵ See S. Rep. No. 91-184 (1970), 1969 WL 4981, reprinted in 1970 U.S.C.C.A.N. 4897.

reports, The Wharton Study,¹⁵⁶ questioned the “extent to which reliance can be placed on the independent directors to safeguard adequately the rights of shareholders in negotiations between the [fund] and the investment advisor.”¹⁵⁷ Likewise, the SEC’s 1966 PPI Report¹⁵⁸ concluded that while many of the pre-1940 abuses in the fund industry had been eliminated, investment advisory fees appeared higher than necessary. It pointed to ineffective independent directors as one potential culprit.¹⁵⁹ Congress reacted by amending the ICA in 1970 to include the term “interested person” in Section 10(a) and defining it in new Section 2(a)(19).¹⁶⁰ Use of this newly added term had the effect of widening the relational nexus, thus allowing fewer individuals to qualify as “independent.”

Despite this fine-tuning, critics of the current system of independent mutual fund directors have been merciless about its shortcomings. Many argue that fund directors are overpaid, underworked, and ineffectual “lapdogs” instead of “watchdogs.”¹⁶¹ John C. Bogle, founder of the Vanguard Group and now a vocal and often controversial figure in the mutual fund industry, stated that they “are, to a very major extent, sort of a bad joke.”¹⁶² Critics point to these

¹⁵⁶ WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 8 (1962).

¹⁵⁷ *Id.*

¹⁵⁸ SECURITIES AND EXCHANGE COMMISSION, REP. ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 33 (1966).

¹⁵⁹ See Interpretive Release, *supra* note 149, at *10-11 (noting that the SEC’s study agreed with the Wharton study “that the then current standard for director independence was inadequate”).

¹⁶⁰ See Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970). Congress also added Section 36(b) to the ICA, 15 U.S.C. § 80a-36(b) (1994), in response to the concern that the structure of the mutual fund industry prevented arm’s-length bargaining between the mutual fund and its investment advisor concerning the amount of the investment advisor’s fee. That section imposes a fiduciary duty upon a mutual fund’s investment advisor with respect to fees and other payments received from the mutual fund. It specifically provides that fund shareholders or the SEC can sue advisors over excessive management compensation. The legislative history of that section, however, also indicates that Congress intended a significant role to be played by independent directors in this regard. The Senate Report states, “[Section 36(b)] is designed to strengthen the ability of the unaffiliated directors to deal with [compensation] matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation.” S. REP. NO. 91-184, *reprinted in* 1970 U.S.C.C.A.N. 4903.

¹⁶¹ See, e.g., Paul H. Dykstra & Paulita Pike-Bokhari, *The Yacktman Battle: Manager Bites Watchdogs*, INVESTMENT LAW., Nov./Dec. 1998, at 1; Charles A. Jaffe, *Don’t Count on Directors To Guard Your Interests*, KAN. CITY STAR, Mar. 9, 1999, at D19; Tom Lauricella, *This Is News? Fund Fees Are Too High*, Study Says, WALL ST. J., Aug. 27, 2001, at C1; Geoffry Smith, *Why Fees Are So High*, BUS. WEEK, Nov. 30, 1998, at 126; Waggoner, *supra* note 1; Russ Wiles, *Study Raises Questions About the Vigilance of the Family Watchdog*, L.A. TIMES, Oct. 6, 1996, at D5; Jason Zweig, *How Funds Can Do Better*, MONEY, Feb. 1998, at 42.

¹⁶² Smith, *supra* note 161, at 126.

directors' failure to keep down management fees, terminate management contracts with poorly performing advisors, and effectively challenge fund advisors in an attempt to prevent disasters like *Heartland*.¹⁶³ In fact, the chairman of the board of one of the largest mutual fund families in the United States recently stated that "sixty percent to seventy percent of boards of directors don't do a good job. . . . I'm always shocked when I go to industry meetings and hear what directors don't do."¹⁶⁴

Over the years, many in Congress also have been highly skeptical about the efficacy of independent directors, particularly on the issue of holding down management fees. For example, in debating a 1968 bill that would increase the percentage of independent directors to a majority, Senator William Proxmire argued, "[D]o you expect these directors, handpicked by management, to fight management on fees? Can management's own nominees even be expected to ask embarrassing questions about the fees of those who nominated them?"¹⁶⁵ Senator Clifford Case added, "[E]ven independent directors realize why they are selected by sponsoring companies. They are independent, yes, but they know very well that if they are not reasonable, they are not going to be reappointed at the end of their term. It is perfectly natural that they should be chosen because they are friends, with a trust of the individual already in business."¹⁶⁶ Senator John Sparkman was, perhaps, the most blunt: "I am not exaggerating when I say that mutual fund management contracts are almost always renewed by these unaffiliated directors as a matter of routine."¹⁶⁷

The reason these criticisms of the efficacy of independent directors sting is simple. The relational independent director ("RID") standard precariously rests on a fundamental assumption that does not always hold true. That

¹⁶³ See Lauricella, *supra* note 161; Waggoner, *supra* note 1. See also Wyatt, *supra* note 161 (noting that Morningstar Inc. had questioned the independence of independent directors after finding that among the eighty-two largest fund families, the more that directors were paid, the more that shareholders paid in total fund expenses).

¹⁶⁴ See Waggoner, *supra* note 1 (quoting John A. Hill, Chairman of the Board of the Putnam Group of funds).

¹⁶⁵ 114 Cong. Rec. S23,532 (daily ed. July 26, 1968) (statement of Sen. Proxmire). But see SEC ROUNDTABLE—PART I, *supra* note 16, at 25 (comments of Robert Pozen, Pres. and CEO of Fidelity Mgmt. & Research, to the contrary).

¹⁶⁶ 114 Cong. Rec. S23,538 (daily ed. July 26, 1968) (statement of Sen. Chase).

¹⁶⁷ 114 Cong. Rec. S23,541 (daily ed. July 26, 1968) (statement of Sen. Sparkman). In the recent case *Navellier v. Sletten*, 2001 U.S. App. Lexis 19167 (9th Cir. 2001), a fund's investment advisor accused the fund's independent trustees of wrongfully terminating the investment management contract between that advisor and the fund. In support of its claim, the advisor audaciously argued that "'a Board that was acting with *proper motives*' would have renewed [the advisor's] contract." *Id.* at *24 (emphasis added; citation omitted).

assumption is that every director who stands the legislatively mandated relational distance apart from the fund advisor will, ipso facto, look out for the interests of fund shareholders.¹⁶⁸ No doubt this is a safe assumption for a great many independent directors. However, that assumption, no matter how well-intentioned, could break down for other directors. Even the SEC has recognized that “no law can guarantee that an independent director will be vigilant in protecting fund shareholders. Fund shareholders therefore must depend on the character, ability, and diligence of persons who serve as fund directors to protect their interests.”¹⁶⁹

The RID standard is problematic for five major reasons. First, over time, the distance between the independent directors and the fund advisor narrows considerably.¹⁷⁰ While technically still falling outside the relational nexus—and thus statutorily remaining “independent,” most independent directors quickly develop cordial relationships with senior executives of the investment advisor. To expect otherwise is unrealistic.

Friendship, however, throws a wrench into the RID standard because it has the ability to divide loyalties. To expect independent directors to rock the boat in which their new friends are resting comfortably is, in many ways, wishful thinking.¹⁷¹ In the fee context, for example, should we expect independent

¹⁶⁸ On this point, Leslie Ogg commented:

So while you talk about independence as a concept, and you talk about independence as a legal requirement, clearly being an interested person or a non-interested person is just a starting point. The legal definition is not what we're talking about here. What we're trying to do is to create a structure that creates operative independence.

SEC ROUNDTABLE—PART II, *supra* note 16, at 66. Aulana Peters, a partner at Gibson, Dunn & Crutcher and a former SEC Commissioner, provided these thoughts on this point:

I don't think that we can legislate independence. Independence, really, you either will have an independent spirit and mind and point of view or you don't, and it doesn't matter how much you're paid or whether your investment bank does business with the mutual fund. The trick is to have this nominating committee and the advisor be able to recognize it when they see it. I think that they will hire it when they see it as well.

Id. at 87.

¹⁶⁹ Proposing Release, *supra* note 18, at 59,831-32.

¹⁷⁰ *Cf.* SEC ROUNDTABLE—PART II, *supra* note 16, at 64 (SEC Commissioner Laura Unger asking: “Does there come a point in time when you have served a number of years [on a fund's board that] you are no longer independent, because you've become so intertwined with the management of the company?”).

¹⁷¹ One can glean anecdotal evidence of this point by reviewing the situation involving ASM Index 30 Fund and its founder, Steven Adler. Shareholders accused Adler of routing at least \$2.7 million intended for the fund into his capital-starved advisory firm, Vector Index Advisors, Inc. The fund's board of directors, which was populated with friends of Adler, was finally forced to fire Adler and his firm. Karen Damato of *The Wall Street Journal* reported on the directors' sentiments:

directors to be true bargaining agents on behalf of fund shareholders?¹⁷² The irony of all this is that while most independent directors are on a chummy first name basis with the executives of their fund's investment advisor, it is unlikely that few can list the names of their fund's three largest shareholders.

Second, it is only natural not to bite the hand that feeds you. Independent directors receive considerable remuneration for what they do. How this remuneration consciously or unconsciously affects different independent directors will depend, of course, on each director's personal financial situation and moral fiber.¹⁷³ While certainly not true for many independent directors, the *Strougo* line of cases¹⁷⁴ did, in fact, make a valid point with respect to others: the possibility exists that some independent directors will become "house directors" because of the substantial compensation they receive from a fund advisor.¹⁷⁵ Under the ICA, however, compensation is irrelevant because

"We literally took [Adler's] dream away from him," says Dan Calabria, a 25-year acquaintance of Mr. Adler's and a member of the ASM fund's board, "but we didn't have any choice."

.....
Jerome Feltenstein, a 65-year-old marketing consultant who was probably Mr. Adler's closest friend on the board, says he wanted to give Mr. Adler "a swift kick in the you-know-where" for putting the directors in such a horrible position. But at the same time, he says, "I really just wanted to call him and say, 'Hey, whatever happens, we are friends.'"

Karen Damato, *Mutual-Fund Manager, Under Fire, Loses His Dream*, WALL ST. J., June 9, 1999, at C1.

¹⁷² In this regard, Professor Ken Scott of Stanford Law School has stated:

[Independent directors are] not interested persons of the advisor. That's what the statute really simply says. Are [independent directors] supposed to be there as a line of defense against management overreaching or management failure, a safeguard against the extremes, or are [they] supposed to be there as bargaining representatives on behalf of the shareholders? And, of course, those are the polar positions; you can be somewhere along the continuum. If the SEC believes that it wants the bargaining representative point of view, then I think it should give serious consideration as to how it might support that.

SEC ROUNDTABLE—PART I, *supra* note 16, at 16. Professor John Freeman, of the University of South Carolina, has added that few boards ever challenge a fund's management on how much is paid to the fund's investment manager. See Lauricella, *supra* note 161.

¹⁷³ Cf. Interpretive Release, *supra* note 149, at *21-22 (where, in giving interpretive advice as to when a director could be considered "interested" because of a material business or professional relationship he or she had with certain specified persons and entities, including some fund affiliates ("Specified Entities"), the SEC noted that the "key factors in evaluating whether a director's position with a Specified Entity would tend to impair his or her independence include the level of the director's responsibility in the position and the *level of compensation or other benefits* that the director receives or received from the position" (emphasis added)).

¹⁷⁴ See *Strougo v. BEA Assoc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,457, 1999 U.S. Dist. Lexis 3021 (S.D.N.Y. 1999); *Strougo v. Bassini*, 1 F. Supp. 2d 268 (S.D.N.Y. 1998); *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997).

¹⁷⁵ On this point, Professor Ron Gilson, Professor of Law at both Columbia and Stanford Law Schools and an independent director for the Benham American Century Funds, stated: "The issue of independence with

of the relational standard it employs. Either you are too close to the advisor, underwriter, or administrator (and thus not independent) or far enough away from them (and thus independent).

A third reason the RID standard is not fail-safe is due to directorial incompetence. There are, to be sure, a great many smart, talented, and conscientious individuals serving as independent directors. Nevertheless, the fund business is highly complex, and the law governing it even more so.¹⁷⁶ The learning curve is, indeed, very steep for the uninitiated or casually acquainted. Many independent directors, particularly neophytes, simply are not up to the task of protecting shareholders by digging into a fund advisor's actions because they do not understand the reasons for, and ramifications of, those actions. These directors may be good persons—and stand the requisite relational distance away from the fund advisor to qualify as “independent”—but they simply lack the knowledge base needed to be effective watchdogs.¹⁷⁷

A fourth reason to question the efficacy of the RID standard relates to how investment companies are formed. Traditionally, an aspiring or existing investment advisor will provide the seed capital needed to start a new mutual

respect to remuneration is present There is an amount of money that can pose a problem.” SEC ROUNDTABLE—PART II, *supra* note 16, at 50. *But see* Wyatt, *supra* note 161 (quoting Barry Barbash, former director of the SEC’s Division of Investment Management, as saying: “[The SEC’s] view is that the amount of money a director is making does not make him independent or not independent. But shareholders should be told how much directors are being paid.”).

¹⁷⁶ *Cf.* SEC ROUNDTABLE—PART II, *supra* note 16, at 80 (where Gerald McDonough, an independent director of Fidelity Funds, stated: “The role of independent trustees will take on greater significance in the future and will require that those persons filling the positions be intellectually capable of dealing with complex financial matters and arcane laws and regulations in an environment where fiduciary responsibility continues to be obligatory.” He later added, “Even a financially trained person coming on [a] board has a learning curve to go up.”); *id.* at 65 (where Leslie Ogg commented: “[B]eing an independent director in this industry is a profession. It’s not a casual occupation. It’s not a retirement annuity. It’s a business that really requires a lot of attention.”).

¹⁷⁷ On this point, Paul Haaga, the Executive Vice President and Director of Capital Research and Management, stated: “Directors are smart, conscientious people They know how to ask the right questions, *if we just educate them about the business and then give them appropriate information.*” SEC ROUNDTABLE—PART I, *supra* note 16, at 33 (emphasis added). Jessica Bibliowicz, President and Chief Operating Officer at John A. Levin & Company and an independent director of Eaton Vance Mutual Funds, commented as follows with respect to her selection as an independent director: “I was formerly president of a mutual fund company [W]hen I sat down with the nominating committee, I said: . . . [W]hy are you picking me? Are you sure you mean this?” One of the directors pointed out, “You know which questions to ask and you know how to ask them.” *Id.* at 36. Willie Davis, President of All Pro Broadcasting and an independent director of the Strong Funds, stated in response to a question as to his biggest challenge as an independent director: “I think to remain very current and knowledgeable about what is going on to the extent . . . it relates to the shareholders, and at the same time allow yourself to understand management and the business process at the same time.” SEC ROUNDTABLE—PART II, *supra* note 16, at 56.

fund. For all intents and purposes, *that fund is its baby*.¹⁷⁸ The advisor forms it so that the advisor can then provide it with investment management services while in return reaping the management fee and related benefits. An extremely strong proprietary relationship exists between a fund and its advisor, and to expect independent directors to sever that relationship over, among other reasons, poor investment performance or high fees is unrealistic. This is particularly true given that, in most cases, it is the fund advisor that selects all the independent directors of a brand new fund.¹⁷⁹

The final reason for the potential breakdown of the RID standard is one that has finally garnered the attention it deserves. Until recently, most errors and omissions (“E&O”) insurance policies did not cover litigation between the independent directors and the fund advisor.¹⁸⁰ To obtain “insured versus insured” coverage, a director must have known to ask for it and be willing to have the fund incur the cost of the additional premium. Moreover, that director must have directed his or her request through the fund advisor, a delicate matter to say the least. Without proper E&O insurance, independent directors are unlikely to lock horns with the fund advisor in any significant way.¹⁸¹

¹⁷⁸ On this point, Dick Phillips, a partner at Kirkpatrick and Lockhart, has commented:

The investment adviser tends to look at the mutual fund that it has created and promoted and financed as its product. It tends to look at the investors, his market, as customers. And he is told by we lawyers that there's a regulatory pattern and a state law pattern that says, no, it's not his product. It's a separate entity. Whether it's organized as a corporation, a trust, or even a separate account, just notations and a set of books, it's separate from your business, Mr. investment adviser.

SEC ROUNDTABLE—PART II, *supra* note 16, at 67. See also *id.* at 72 (John Haire, an independent director of the Morgan Stanley Dean Witter Funds, stating: “[I]t is perfectly clear that the origin of every mutual fund which exists came from the advisory company itself It does not spring from the independent directors, it doesn't spring from the brow of Zeus. It comes out of the advisory company.”); Independent Director Adopting Release, *supra* note 17, at *7 n.3 (“As a result of their extensive involvement, and the general absence of shareholder activism, investment advisors typically dominate the funds they advise.”).

¹⁷⁹ A better way of selecting independent directors for a new fund—something we would suggest as a “best practice”—is to have the fund advisor select only one independent director. That director would then select the other independent directors. The SEC has recognized the importance of having independent directors select other independent directors: “[W]hen independent directors are self-selecting and self-nominating, they are less likely to feel beholden to the advisor. Thus, they may be more willing to challenge the advisor's recommendations when the advisor's interests conflict with those of the shareholders.” Proposing Release, *supra* note 18, at 59,832.

¹⁸⁰ See Interpretive Release, *supra* note 149, at n.56; Proposing Release, *supra* note 18, at 59,836. See also Dykstra & Pike-Bokhari, *supra* note 161, at 9-10 (describing dilemma that Yacktman independent directors faced upon learning that their D&O insurance policy did not cover disputes between them and the fund's advisor).

¹⁸¹ See Interpretive Release, *supra* note 149, at *39 (“The risk of personal liability could . . . deter some independent directors from making controversial decisions that may benefit the fund and discourage qualified individuals from serving as independent directors.”).

In sum, the RID standard has the potential to muzzle the ferocity of the watchdogs. That standard provides independent directors with a few carrots, but no stick, with which to protect fund shareholders. Making matters worse, in the two recent cases involving the Yacktman Fund and the Navellier Series Fund, independent directors went to the mat for their shareholders but then suffered the fate of Socrates.¹⁸² By confronting very popular fund advisors, those directors were either ousted by fund shareholders after a bitter proxy battle, in the case of the Yacktman Fund,¹⁸³ or ultimately resigned only to be sued by the fund advisor, in the case of the Navellier Series Fund.¹⁸⁴ Prior to the recent changes adopted by the SEC in January 2001,¹⁸⁵ therefore, the best we could have hoped for is for independent directors to defend shareholders up to the point where it mildly irritated fund advisors, but no further.¹⁸⁶

B. The Need for "Operational Independence"

In an ideal world, whenever a fund advisor threatens to take action that would exploit in its favor the conflicts of interest that exist between it and its fund, independent directors should not only speak up but take action to prevent it. These directors would indeed police the situation as warranted.¹⁸⁷ In all other situations, however, these directors should cooperatively engage the fund's advisor. After all, watchdogs are only needed when the interests of shareholders are threatened or potentially threatened, and those situations by and large are the exception rather than the norm in the fund industry.¹⁸⁸

We believe a new era of independent directors is upon us. This new era was ushered in by former SEC Chairman Arthur Levitt, a man who was

¹⁸² See generally Wyatt, *supra* note 161 (describing the difficult position in which independent directors find themselves when taking action contrary to the investment advisor).

¹⁸³ For a detailed description of the Yacktman battle from the independent directors' perspective, see Dykstra & Pike-Bokhari, *supra* note 161, at 1.

¹⁸⁴ After a three and one-half year legal battle, the trustees prevailed. See *Navellier v. Sletten*, 2001 U.S. App. Lexis 19167 (9th Cir. 2001).

¹⁸⁵ See Independent Director Adopting Release, *supra* note 17.

¹⁸⁶ As the attorneys for the Yacktman independent directors have underscored, "real-life perils [await] independent directors who dare to confront hostile investment advisors apparently determined to entrench themselves at all costs." Dykstra & Pike-Bokhari, *supra* note 161, at 8.

¹⁸⁷ Cf. Interpretive Release, *supra* note 149, at *7 (stating that "[i]ndependent directors play a critical role in policing the potential conflicts of interest between a fund and its investment advisor").

¹⁸⁸ Cf. SEC ROUNDTABLE—PART II, *supra* note 16, at 54 (Willie Davis, President of All Pro Broadcasting and an independent director of the Strong Funds, stating: "I don't believe that good independent corporate government has to be confrontational. It might become confrontational. But it doesn't necessarily need to be.").

determined to make independent directors more effective.¹⁸⁹ Recent changes that the SEC has implemented have laid the groundwork to eliminate or lessen some of the problems associated with the relational independence standard. Over time, independent directors increasingly will become operationally independent,¹⁹⁰ whereby they will act as agents of targeted opposition when circumstances warrant it.¹⁹¹ And, in the mutual fund industry, "opposition" is a four-lettered word.¹⁹²

The SEC recently adopted changes substantially affecting the system of independent mutual fund directors.¹⁹³ Those changes "strengthen [the independent directors'] hand in dealing with fund management."¹⁹⁴ First and foremost, on or after July 1, 2002, independent directors must make up at least

¹⁸⁹ See *supra* note 16.

¹⁹⁰ Leslie Ogg first used the similar term "operative independence" at the SEC's Roundtable on the Role of Independent Investment Company Directors, and we have coopted it for our own purposes. See SEC ROUNDTABLE—PART II, *supra* note 16, at 66.

¹⁹¹ See *id.* at 80 (Gerald McDonough, an independent director of Fidelity Funds, stating: "The adversarial role, not confrontational, but adversarial, role of independent trustees and fund advisors is a healthy and desirable one.").

¹⁹² Cf. SEC ROUNDTABLE—PART I, *supra* note 16, at 41 (Faith Colish, a securities attorney and independent director of Neuberger Berman Funds, stating that, with respect to the relationship between the independent directors and the fund advisor, she "certainly hope[s] it doesn't become, it shouldn't be" adversarial); Remarks of Terry K. Glenn, Chairman of the Investment Company Institute, at the Investment Company Institute's General Membership Meeting, available at http://www.ici.org/info/glenn_01_report_speeches.html (commenting that independent directors and fund advisors have worked together "much more as partners than as adversaries, very much to the benefit of [the mutual fund] industry and [fund] shareholders").

¹⁹³ See Independent Director Adopting Release, *supra* note 17. Additionally, the SEC issued interpretive guidance designed to enhance the ability of fund directors to own fund shares, thereby further aligning their interests with those of fund shareholders. See Interpretive Release, *supra* note 149, at *51-57.

¹⁹⁴ Independent Director Adopting Release, *supra* note 17, at *5. In order to take advantage of certain exemptive rules which are essential to the functioning of a sophisticated investment company, funds must comply with these changes. See *id.* at *14. Those rules are: Rule 10f-3, 17 C.F.R. § 270.10f-3 (2000) (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1, 17 C.F.R. § 270.12b-1 (2000) (permitting use of fund assets to pay distribution expenses); Rule 15a-4(b)(2), 17 C.F.R. § 270.15a-4(b)(2) (2000) (permitting fund boards to approve interim advisory contracts without shareholder approval where the advisor or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7, 17 C.F.R. § 270.17a-7 (2000) (permitting securities transactions between a fund and another client of the fund's advisor); Rule 17a-8, 17 C.F.R. § 270.17a-8 (2000) (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7), 17 C.F.R. § 270.17d-1(d)(7) (2000) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1, 17 C.F.R. § 270.17e-1 (2000) (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j), 17 C.F.R. § 270.17g-1(j) (2000) (permitting funds to maintain joint insured bonds); Rule 18f-3, 17 C.F.R. § 270.18f-3 (2000) (permitting funds to issue multiple classes of voting stock); and Rule 22c-3, 17 C.F.R. § 270.22c-3 (2000) (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors).

a majority of the members of a fund's board.¹⁹⁵ Despite the fact that several key decisions already must be approved by a majority of the independent directors voting as a separate group,¹⁹⁶ and that most fund boards are comprised of a majority or even higher percentage of independent directors currently,¹⁹⁷ the SEC implemented this change to help boost the comfort level of independent directors making decisions that may run contrary to the interests of the fund advisor.¹⁹⁸ While not entirely counteracting the "us versus them" mentality, it ensures that the number of independent directors included within "us" is greater than the interested directors included within "them."¹⁹⁹ We believe this change will have the greatest impact on small fund families, as most large fund complexes already have boards comprised of a majority of independent directors.²⁰⁰

A second important change requires a fund's existing independent directors to select and nominate prospective independent directors.²⁰¹ This change

¹⁹⁵ See Independent Director Adopting Release, *supra* note 17, at *16-19.

¹⁹⁶ See, e.g., 15 U.S.C. § 80a-15(c) (1994) (requiring investment advisory contract to be approved by majority of independent directors); 15 U.S.C. § 31(a)(1) (requiring independent public accountants to be approved by majority of independent directors); 17 C.F.R. § 270.12b-1 (2000) (requiring Rule 12b-1 plans to be approved by majority of independent directors); 17 C.F.R. § 270.17g-1(e) (requiring the amount of a fund's joint fidelity bond to be approved by majority of independent directors).

¹⁹⁷ Under Section 10(b)(2) of the ICA, 15 U.S.C. § 80a-10(b)(2) (1994), if a fund's principal underwriter is an affiliate of the fund's advisor, then independent directors must comprise a majority of the fund's board. Section 15(f)(1) of the ICA, 15 U.S.C. § 80a-15(f)(1) (1994), by contrast, provides a safe harbor for the sale of an investment advisory business if independent directors constitute at least seventy-five percent of a fund's board of directors for at least three years following the assignment of the investment advisory contract.

¹⁹⁸ Cf. SEC ROUNDTABLE—PART II, *supra* note 16, at 61 (Professor John C. Coffee, Jr. of Columbia University School of Law arguing that a "critical mass" of independent directors is needed "before they become an equal negotiator with the investment advisor").

¹⁹⁹ See *id.* at 79 (Gerald McDonough, an independent director for Fidelity Funds, stating: "There is no valid excuse for independent trustees when constituting a majority of the board, to fail to effectively represent the shareholders. By definition, if they are a majority, they outvote the interested trustees.").

²⁰⁰ See Independent Director Adopting Release, *supra* note 17, at *18 (noting that "most funds already have a majority of independent directors").

²⁰¹ See *id.* at *21-22. Despite this change, the fund's advisor may "suggest independent director candidates if the independent directors invite such suggestions, and the advisor may provide administrative assistance in the selection and nomination process." *Id.* at *22.

Dawn-Marie Driscoll, President of Driscoll Associates and an independent director of several Scudder Kemper mutual funds, alluded to how fund advisors might react to having independent directors nominate additional independent directors: "I'm a great believer in independent directors choosing other independent directors who the advisor does not know. I know that puts chills of fear in some advisors but I think that independence is one of the most important characteristics of an independent director." SEC ROUNDTABLE—PART II, *supra* note 16, at 21. On this point, Professor Ron Gilson argued: "I would view as quite important a nominating committee composed solely of independent directors because . . . it does provide a mechanism by which the independent directors can maintain a quality of the board membership even in those circumstances in which the advisor may prefer a less independent group." *Id.* at 57.

should have an immediate impact on the influence the fund advisor wields in the selection of new independent directors. Those new directors should, at least initially, clearly stand at arms-length from fund advisors. It does not, however, prevent personal relationships from developing over time between new independent directors and executives of the fund advisor. Nor does it solve the problem of fund advisors selecting new independent directors when those advisors establish brand new funds.²⁰²

A third important change is that if the independent directors obtain legal counsel, then that counsel must be independent.²⁰³ Counsel's independence should ensure that its allegiance runs directly to the independent directors. Independent counsel could help watchdog directors in several ways. He or she can immediately enhance the competence of independent directors by helping them understand management proposals, providing a valuable source of unfiltered information, and explaining their obligations under the law. He or she also can help identify potential conflicts of interest, provide the independent directors with the shareholders' perspective on those conflicts, and act as a sounding board during discussions of those conflicts.²⁰⁴ Lastly, independent counsel can intermeditate between the independent directors and the fund advisor when intermediation is necessary.

A fourth important change is that the SEC, at least partially, solved the E&O insurance problem. Now, under newly amended Rule 17d-1(d), if a fund wants to purchase a joint insurance policy for its directors and officers, that policy cannot exclude coverage for litigation between the fund advisor and the independent directors.²⁰⁵ Directors who are less concerned about their personal liability will likely be more effective watchdogs. This change, however, does nothing to resolve the E&O insurance problem for the many funds that have separate insurance policies for the fund advisor and the independent directors, as Rule 17d-1(d) is inapplicable in that situation.²⁰⁶

²⁰² See Proposing Release, *supra* note 18, at 59,827.

²⁰³ See Independent Director Adopting Release, *supra* note 17, at *23-37 (the effective date of this change is July 1, 2002). On this point, Professor John C. Coffee, Jr. of Columbia University School of Law has stated: "[I]ndependent directors can function well as a committee if and probably only if they have the effective assistance of a truly independent legal counsel who does not generally represent the investment advisor and who does not have any other conflict." SEC ROUNDTABLE—PART II, *supra* note 16, at 61. The SEC, however, recently agreed to allow independent counsel to sit as an independent director on a fund's board, thereby opening up an ethical can of worms previously reserved for traditional operating companies. See Ballard Spahr Andrews & Ingersoll, LLP, SEC No-Action Letter, 2002 SEC No-Act. Lexis 330 (Apr. 3, 2002).

²⁰⁴ See Proposing Release, *supra* note 18, at 59,833-34.

²⁰⁵ See Independent Director Adopting Release, *supra* note 17, at *38-40.

²⁰⁶ Independent directors who find themselves in that situation should insist that their policy include

A final change that the SEC implemented relates to the information concerning independent directors that funds provide to shareholders. According to the SEC:

[S]hareholders have a significant interest in knowing who the independent directors are, whether the independent directors' interests are aligned with shareholders' interests, whether the independent directors have any conflicts of interest, and how the directors govern the fund. This information helps a mutual fund shareholder to evaluate whether the independent directors can, in fact, act as an independent, vigorous, and effective force in overseeing fund operations.²⁰⁷

In addition to satisfying other disclosure requirements, funds must disclose: (a) basic information about directors²⁰⁸ to shareholders annually so that shareholders will know the identity and experience of their representatives, (b) share ownership of each director to help shareholders evaluate whether directors' interests are aligned with those of the shareholders, (c) information about directors that may raise conflict of interests concerns, and (d) information on the board's role in governing the fund.²⁰⁹

As a general matter, we applaud this additional disclosure requirement. It does, however, raise a concern about the burdens placed on the shoulders of fund investors. Given the enormous number of mutual fund options available to those investors, is it realistic to expect them to review the backgrounds of directors of funds in which they are interested in investing? Should not investors *rightfully expect* independent directors to be "independent" in the operational sense in the first place? And if particular directors turn out not to act operationally independent, will shareholders of the fund in question have only themselves to blame for not doing their homework better by anticipating

coverage for controversies arising between them and the fund advisor. Moreover, prudence dictates that those directors insist that their separate coverage come from an insurance company other than the one insuring the advisor. Indeed, a failure to do so could result in the insurance company that is separately covering both the advisor and the independent directors siding with the most deep-pocketed of the two clients (i.e., the fund advisor) in any dispute between them to the detriment of the independent directors and the fund's shareholders.

²⁰⁷ See Independent Director Adopting Release, *supra* note 17, at *45-46.

²⁰⁸ That information includes for each director: (1) his or her name, address and age, (2) current positions he or she has held with the fund, (3) his or her term of office and length of time served, (4) his or her principal occupations during the past five years, (5) number of portfolios he or she has overseen within the fund complex, and (6) other directorships he or she has held outside the fund complex. *Id.* at *47.

²⁰⁹ *Id.* at *46-47. These new disclosure obligations became effective on January 31, 2002. See *id.* at *76.

future problems?²¹⁰

Only time will tell whether the changes the SEC has adopted will lead to more effective independent mutual fund directors. We believe they will, although it is far from clear what the degree of added effectiveness will be. The SEC, of course, could have gone further,²¹¹ especially in light of the SEC's view that investors will need to rely increasingly on independent directors to safeguard their interests.²¹² The SEC could have accelerated this process by requiring that fund boards be entirely comprised by independent directors.²¹³ It also could have mandated that the independent directors retain independent legal counsel.²¹⁴ Perhaps most importantly, the SEC could signal that it will stand up for directors that confront fund advisors when facts and

²¹⁰ A useful analogy is the neighborhood beat cop. Is it realistic for members of the community to conduct background checks on their local police officers? Or, rather, is that the job of the police department in hiring new officers? In the case of fund shareholders, they should certainly review the qualifications of director nominees up for election before they cast their votes. It does not seem fair, however, thereafter to charge shareholders interested in "hassle free" investments with the responsibility of protecting themselves through a review of enhanced disclosure documents. Their focus is rightfully on fund performance, and to require otherwise would likely diminish the desirability of fund products in their eyes.

²¹¹ The Investment Company Institute ("ICI") has proposed fifteen "best practices," many of which exceed the SEC's initiatives. For example, the ICI proposed that independent directors constitute a super-majority or at least two-thirds of board membership and that independent directors retain independent legal counsel. See INVESTMENT COMPANY INSTITUTE, REP. OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS: ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS 10-12, 18-20 (June 24, 1999), available at http://www.ici.org/issues/fund_governance.html.

²¹² Paul Roye, the Director of the SEC's Division of Investment Management, has stated that "[a]s we work to keep pace and modernize the regulatory structure to accommodate the increased competitiveness and globalization of the fund industry, we will need to increasingly rely on fund directors to vigorously perform their 'watchdog' duties." Roye Remarks, *supra* note 15.

²¹³ In the context of a bank-sponsored mutual fund, where bank officers are prohibited from serving on the fund's board of directors, Kathleen Dennis, Senior Managing Director of Key Asset Management, Inc., stated:

We have eight trustees at the moment on our Victory Funds. All of them, except one, are independent . . . I think because we do not have a management group on the board our trustees feel much freer to challenge what we want to do to make us justify the recommendations that we're making to explain any changes that we might want to have. And they don't always approve everything. We've been, I would say successful in general in terms of where we want to go, but we certainly don't take anything for granted when we walk into the board meetings.

SEC ROUNDTABLE—PART II, *supra* note 16, at 40.

²¹⁴ On this issue, members of the Section of Business Law of the American Bar Association stated: "The complexities of the [ICA], the nature of the separate responsibilities of independent directors and the inherent conflicts of interest between a mutual fund and its managers effectively require that independent directors seek the advice of counsel in understanding and discharging their special responsibilities." SUBCOMM. ON INVESTMENT COMPANIES AND INVESTMENT ADVISORS, COMM. ON FED. REGULATION OF SECURITIES, SECTION OF BUSINESS LAW OF THE AM. BAR ASS'N, REP. OF THE TASK FORCE ON INDEPENDENT DIR. COUNSEL: COUNSEL TO THE INDEPENDENT DIR. OF REGISTERED INVESTMENT COMPANIES 3 (Sept. 8, 2000).

circumstances warrant it by actually taking appropriate action.²¹⁵

III. TOWARDS AN ARTICULATED RECEIVERSHIP STANDARD

Given the push towards truly effective independent mutual fund directors, the issue arises as to when, if ever, the SEC should displace fund directors in favor of a receiver. As we move forward and crises inevitably arise, should the SEC continue to request court-imposed receivers when capable independent directors are on fund boards? If so, under what circumstances? Or should the SEC tip its hat to the checks and balances Congress originally installed in the

²¹⁵ The SEC's official policy on involving itself in disputes between independent fund directors and fund management is as follows:

The Commission's role, as a general matter, is to interpret, administer and enforce the federal securities laws for the protection of investors. Accordingly, the Commission's role in connection with internal fund disputes generally is to provide guidance regarding the requirements of the federal securities laws, investigate possible violations of these laws, and institute enforcement actions in appropriate circumstances when the Commission believes that these laws have been violated. While there may be instances in which the Commission, in fulfilling this role, may indirectly assist one party in a dispute, the Commission generally will not mediate private disputes, side with one party over another, or seek to effect a particular outcome. Rather, the Commission will assist the parties to understand the requirements of the federal securities laws, evaluate all allegations of violations of those laws, and take appropriate action for the protection of investors.

Interpretive Release, *supra* note 149, at *61.

Many commentators, however, strongly believe that the SEC should be more aggressive in assisting independent directors in fulfilling their obligations under the ICA. *See, e.g.*, SEC ROUNDTABLE—PART II, *supra* note 16, at 15 (comment of Jay Baris, Esq., partner at Kramer, Levin, Naftalis & Frankel, indicating that if the SEC stood up for independent directors by filing amicus briefs, it would greatly benefit them); *id.* at 51-52 (Professor Ron Gilson of Stanford University Law School arguing, "When independent directors believe that there has been a violation of the '40 Act by the advisor, . . . the right answer is, as a matter of policy, an investigation [by the SEC] ought to be initiated." He later added, "[I]f what the point of part of our exercise here is to energize independent directors, to take [their] regulatory responsibilities seriously, . . . then it imposes an obligation on the SEC."); *id.* at 22 (Dr. Joseph Hankin, President of Westchester Community College and independent director of the Stagecoach Funds and the First Choice Funds, commenting, "We need the strong support of the Commission in reinforcing our roles as guardians."); *id.* at 89-90 (David Sturms, a partner at Vedder, Price, Kaufman and Kammholz, arguing, "A crucial element, in my opinion, of having a strong independent director structure is having a strong regulator dedicated to the success of that structure." He later added, "I think the independent directors have been put in the position of being the cop on the street and been asked to do a lot of things. . . . [T]he Commission needs to be prepared to take the type of action that a police force would take in terms of supporting their cops, their people on the street."); *id.* at 92 (Tom Smith, a partner at Brown & Wood, arguing, "I would just endorse . . . that the SEC and the staff be supportive of independent directors when they get into confrontations."); Wyatt, *supra* note 161 (quoting Leslie Ogg as saying: "In the end, as a director you've got very little economic leverage. You've only got your prestige. That's the point where a director has got to be able to say that he has the support of regulators in acting independently.").

For a discussion of the level of support the SEC gave the independent directors of the Yackman Fund during their confrontation with the fund's advisor, see Dykstra & Pike-Bokhari, *supra* note 161, at 11.

ICA and let directors resolve problematic situations? We believe firmly that, while there will be times when the SEC should step in, the SEC should defer to, or utilize, the watchdogs whenever the "Capable Independent Director" Standard articulated in Part III.B below is met.

A. *Receivers Versus Watchdogs*

The appointment of a receiver is a very serious matter. His or her appointment signals the suspension, either temporarily or permanently, of shareholder democracy. Shareholders are no longer entitled to have their elected officials oversee their fund, which is instead now controlled by an officer of the court²¹⁶ with no previous experience with or connections to the fund. During the course of a receivership, shareholders often remain in the dark as to what is happening to their investments.²¹⁷ The appointment of a receiver also ends the system of checks and balances in which Congress believed so strongly. That system established independent directors as the first line of defense against heavy-handed fund advisor tactics.²¹⁸

In resolving the debate over receivers and watchdogs, a fundamental issue needs to be addressed: What, if anything, can a receiver do that a properly motivated and capable independent director cannot? If the answer to this is "not much," then the SEC should reconsider when it should seek the receivership remedy. If, however, the answer is "a lot," then perhaps the SEC should seek the receivership remedy more aggressively than it has in the past. In answering this question, we looked at the advantages and disadvantages of a receiver versus an independent director or directors.

1. *Advantages of a Receiver*

What are the advantages of a receiver? In answering this, we begin with the *Heartland* case. Judge Lefkow granted two orders that impacted Heartland's receivership. In the first order, the Heartland General Order

²¹⁶ See SEC v. S & P Nat'l Corp., 265 F. Supp. 993 (S.D.N.Y.), *aff'd*, 360 F.2d 741, 750-51 (2d Cir. 1966); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 42 (S.D.N.Y. 1968).

²¹⁷ See Karen Damato, *Heartland Investors Are Waiting To Exhale*, WALL ST. J., Aug. 9, 2001, at C1.

²¹⁸ See SEC ROUNDTABLE—PART II, *supra* note 16, at 51 (Professor Ron Gilson of Stanford University Law School labeling independent directors "the first line enforcers of [the ICA]"); The SEC and the Mutual Fund Industry: An Enlightened Partnership, Remarks by SEC Chairman Arthur Levitt, Investment Company Institute, Wash., D.C., May 19, 1995 (former Chairman Levitt calling independent directors "the investors' first line of defense against [management] abuses").

mentioned earlier,²¹⁹ she appointed a receiver “to marshal and manage [the Funds].”²²⁰ She later added that “[t]he receiver is expressly authorized to suspend the redemptions in the Funds and, if appropriate in the *receiver’s discretion*, liquidate the Funds.”²²¹

The second order was the Heartland Receiver Order.²²² It described both the receiver’s obligations and the necessary powers needed to fulfill those obligations. The Heartland Receiver Order begins:

[The SEC] has requested that the Court appoint a Receiver for the benefit of investors to marshal, conserve, protect, hold, sell or otherwise dispose of, all assets of any nature, wherever those assets may be found, of [the Funds] and all assets in the Funds’ custody, possession or control or in which the Funds have a legal or equitable interest (collectively “Receivership Property”); and suspend redemptions, operate and, if appropriate, liquidate the Receivership Property; and with the approval of the Court, if feasible distribute Receivership Property to investors.²²³

Although this language is described as an “SEC request,” the court clearly views this as a statement of the receiver’s obligations. Indeed, just two sentences later, the court states that “[t]he receiver shall have the following powers and duties to fulfill his obligations”²²⁴

By cutting through the verbiage of the Heartland General Order and Heartland Receiver Order, it is clear that Phillip Stern, the Heartland receiver, has three general obligations. First, he is obligated to maintain and preserve the current position of the Funds, not move them forward. Words like “marshal, conserve, protect, hold, sell or otherwise dispose” of Receivership Property are conservative in nature. Although the word “manage” is used in the Heartland General Order and “operate” is contained in the Heartland Receiver Order, when read in light of the language specified in the preceding sentence, we believe “manage” and “operate” mean keeping each Fund’s engine idling as opposed to putting it into gear. Thus, the Heartland receiver’s obligation in this regard is more akin to a trustee’s role as preserver of the trust

²¹⁹ Heartland General Order, *supra* note 9.

²²⁰ *Id.* at 2.

²²¹ *Id.* at 2-3 (emphasis added).

²²² *See supra* note 35.

²²³ Heartland Receiver Order, *supra* note 35, at 1.

²²⁴ *Id.* at 2.

corpus,²²⁵ as opposed to a corporate director's role as business risk-taker.²²⁶

Second, along the same lines, the Heartland receiver is obligated to suspend shareholder redemptions. The purpose of this is obvious. It is designed to preserve the Funds' assets while matters are investigated and sorted out.²²⁷ It also ensures fair treatment among shareholders, as no shareholder can monetize his or her investment before any other shareholder.

Third, the Heartland receiver is obligated to liquidate the Receivership Property if he believes the Funds cannot be salvaged. If he makes a decision to liquidate, the obvious next step is to distribute Receivership Property to creditors and investors. While he must receive court approval to do so, we believe it is highly unlikely that a court would object given the receiver's previous decision to liquidate the Receivership Property.

Which of the receiver's three general obligations can one or more motivated and capable independent directors fulfill? In terms of the first obligation, nothing would prevent a director from preserving fund assets if the director determined that "asset preservation" was, at that time, in the best interests of the fund and its shareholders. While a director's fiduciary responsibilities are designed to promote business risk-taking in the context of a fund's investment objective and strategies, he or she has managerial discretion under extraordinary circumstances so long as he or she acts in the best interests of the fund's shareholders. Moreover, as a general matter, even risk-taking directors are prohibited from wasting corporate assets under basic fiduciary principles.²²⁸

The second general obligation—suspension of shareholder redemption rights—clearly cannot be accomplished unilaterally by one or more independent directors. To do so would violate Section 22(e) of the ICA.²²⁹ Nevertheless, directors are entirely within their rights to petition the SEC for an order calling for such a suspension. Section 22(e)(3) allows the SEC to suspend the right of redemption for a period of time "as the Commission may

²²⁵ See GEORGE GLEASON BOGERT, GEORGE TAYLOR BOGART & AMY MORRIS HESS, *THE LAW OF TRUSTS AND TRUSTEES* § 582 (2d rev. ed. 1980 & Supp. 2000).

²²⁶ See FRANKLIN A. GEVURTZ, *CORPORATION LAW* § 4.1.2, at 279 (2000).

²²⁷ A great portion of Phillip Stern's time has been spent on trying properly to value the bonds contained in the portfolios of the Funds. See Damato, *supra* note 217.

²²⁸ See GEVURTZ, *supra* note 226, § 4.2.4.a., at 345-46.

²²⁹ See 15 U.S.C. § 80a-22(e) (1994).

by order permit for the protection of security holders of the company.”²³⁰ If appropriate circumstances existed, therefore, the SEC could suspend redemption rights at the request of fund directors.²³¹

The third general obligation relates to fund liquidation and distribution of assets to creditors and shareholders. Recall that liquidation is within the discretion of the Heartland receiver. Fund liquidation may sometimes be accomplished solely through independent director action, depending upon the state law governing the fund and the fund’s articles of incorporation or declaration of trust.²³² In those situations in which directors must obtain shareholder approval under state law prior to any liquidation, they can certainly seek that approval when circumstances warrant. Shareholders would likely give their approval if the directors recommended liquidation at a time when the SEC has authorized the suspension of shareholder redemption rights.

In sum, given the right circumstances, we believe independent directors can fulfill the same general obligations that a receiver can. To do so, however, would take the cooperation of the SEC. If investor interests were imperiled, as they were in the *Heartland* matter, we believe that the SEC should and would provide that cooperation.

Judge Lefkow also gave the Heartland receiver seven powers to aid him in fulfilling his three general obligations. Those seven powers read as follows:

- a. Use reasonable efforts to determine the nature, location, and value of all assets and property owned by the Funds, in their possession, custody or subject to their control, or in which the Funds have a legal or equitable interest;
- b. Use reasonable efforts to determine the identity of all shareholders of the Funds;

²³⁰ 15 U.S.C. § 80a-22(e)(3).

²³¹ Although not a frequent occurrence, funds at their own volition have filed a Section 22(e)(3) petition to suspend shareholder redemptions. See, e.g., *In re Steadman Fin. Fund*, SEC Rel. No. IC-16958, 43 S.E.C. Docket 1416, 1989 SEC Lexis 888 (May 16, 1989); *In re Centurion Growth Fund, Inc.*, SEC Rel. No. IC-20204, 56 S.E.C. Docket 1129, 1994 SEC Lexis 1065 (Apr. 7, 1994); *In re OTC-100 Fund, Inc.*, SEC Rel. No. 16866, 43 S.E.C. Docket 763, 1989 SEC Lexis 484 (Mar. 15, 1989); *In re Am. Fed. of Labor and Congress of Indus. Organ. Mortg. Inv. Trust*, SEC Rel. No. IC-11575, 1981 SEC Lexis 2223 (Jan. 21, 1981).

²³² Mutual funds are typically organized as either Delaware or Massachusetts business trusts or as Maryland corporations. Delaware and Massachusetts business trust law does not require shareholder approval to liquidate a fund. See DEL. CODE ANN. tit. 12, § 3808 (2000); *State Street Trust Co. v. Hall*, 41 N.E.2d 30, 34-36 (Mass. 1942) (unless otherwise provided by declaration of trust, trustees manage the trust and shareholders have no right to dissolve trust). Maryland corporate law, by contrast, has a two-thirds shareholder approval requirement. See MD. GEN. CORP. L. § 3-403(d) (1999).

- c. Engage and employ a law firm, and with the approval of the Court, any accounting firms or other necessary individuals or entities the Receiver deems necessary to assist in his duties . . . ;
- d. Take such action as necessary and appropriate to prevent the dissipation or concealment by the Funds or any of their affiliates of any funds or assets constituting Receivership Property and otherwise preserve any such funds and assets;
- e. The Receiver shall have the authority to issue subpoenas to compel testimony of persons or production of records, consistent with the Federal Rules of Civil Procedure and the Local Rules for the United States District Court for the Northern District of Illinois, concerning any subject matter relating to the identification, preservation, collection and/or liquidation of the Receivership Property or otherwise related to the discharge of the Receiver's duties;
- f. Oversee the operations of any and all businesses owned or controlled by the Funds, or otherwise constituting a part of the Receivership Property; and
- g. The Receiver may bring such legal actions based on law or equity in any state, federal, or foreign court as he deems necessary or appropriate in discharging his duties as Receiver or on behalf of investors whose interests he is protecting.²³³

Of the seven powers listed above, each clearly helps in preserving the Funds' assets. Therefore, they help with the receiver's first general obligation. Three of the seven powers (b, c, and e) also help in the context of a liquidation, the receiver's third general obligation. While none of the powers specifically aid in suspending shareholder redemptions, the receiver's second general obligation—none are essential once the receiver suspends the right of redemption.

Do directors have the same panoply of powers at their disposal that Judge Lefkow provided the Heartland receiver? Those powers were viewed as essential by the court in order for the Heartland receiver to achieve his objectives. We believe that, except in one situation, directors also have those

²³³ Heartland Receiver Order, *supra* note 35, at 2-3.

powers.

Directors already exercise the first four powers (a-d) enumerated in the Heartland Receiver Order. Indeed, these powers are fundamental powers that enable directors to play their role as fund watchdogs. Directors are responsible for knowing the nature, location, and value of all assets and property owned by their fund. They also are responsible for ensuring that an accurate shareholder list is maintained. Furthermore, directors already engage and employ law firms accounting firms, or other necessary individuals or entities to serve their shareholders' interests. Finally, directors are required to guard against the dissipation or concealment of fund assets.

The last two powers (f and g) also fall within the directorial ambit. Overseeing operations constituting fund assets is what directors do. Directors also are entitled to bring legal actions in law or equity in any state, federal, or foreign court they deem necessary or appropriate to discharge their duties and protect the interests of their shareholders.²³⁴ Again, these are quintessential watchdog powers.

The only power a director does not have is the fifth power (e). That power allows the Heartland receiver to issue subpoenas to compel testimony concerning the identification, preservation, collection, and/or liquidation of the Funds or otherwise related to his duties. Directors, however, have this power indirectly. To use it, they must file a lawsuit against a person or entity that has wronged the fund or its shareholders and seek to compel testimony during the discovery and trial phases of the litigation. Of course, a court, at the directors' request, issues subpoenas and thus ultimately controls the subpoena process.

Moving away from the *Heartland* matter, the twenty-six other cases in which a receiver was appointed shed additional light on the general obligations and powers of a receiver.²³⁵ For the most part, the three general obligations of

²³⁴ One receivership case not included within the twenty-eight cases analyzed in this Article indicated that it is the SEC's standard practice to open up its files to a receiver. In *Armstrong v. McAlpin*, 625 F.2d 433 (2d Cir. 1980), the SEC sought and received a court-appointed receiver for a fund organized outside the United States solely pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, 15 U.S.C. § 78j(b) (1994) & 17 C.F.R. § 240.10b-5 (2000). On appeal, the Second Circuit Court of Appeals noted: "Shortly after the appointment of [the receiver], the SEC made its investigatory files available to him, in accordance with its practice, we are informed in its brief, of assisting 'the efforts of receivers who have been appointed by the courts in Commission law enforcement actions.'" *Armstrong*, 625 F.2d at 435. If an independent director meets the standard we espouse in Part III.B. and is left in charge of a troubled fund, the SEC should do the same to aid the efforts of that director if in fact this is SEC policy.

²³⁵ Recall that in one of the twenty-eight receivership cases, the SEC's request for a receiver was denied.

the Heartland receiver are reflected in the other receivership cases. Covered completely is the first general obligation to operate the fund and preserve its assets. All twenty-six cases charged the receivers with this obligation, either directly²³⁶ or by implication,²³⁷ although one court took a circuitous route in arriving there.²³⁸

Those cases, however, provided mixed signals on the second general obligation relating to the suspension of share redemptions. One would expect that, at a minimum, the courts in all ten cases in which a fund's NAV was problematic and a receiver was appointed would either suspend fund redemptions outright or empower the receivers to do so. Yet, only two courts

See SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972). In another case, the SEC's request for a receiver was effectively mooted. *See supra* note 51.

²³⁶ *See* SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); Tanzer v. Huffines, 287 F. Supp. 273, 274 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969) (involving B.S.F. Co.); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 42 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970); SEC v. Midland Basic, Inc., 283 F. Supp. 609, 619 (D.S.D. 1968); SEC v. Wong, 42 F.R.D. 599, 600 (D.P.R. 1967) (involving Puerto Rico Capital Corp.); SEC v. Continental Growth Fund, Inc., [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,437 (S.D.N.Y. 1964), 1964 U.S. Dist. LEXIS 8890, at *7; SEC v. Rupay-Barrington Capital Mgmt., Inc., SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); SEC Rel. No. IC-18,688, 51 S.E.C. Docket 638, 1992 WL 102254 (May 1, 1992) (involving Municipal Lease Securities Fund, Inc.); SEC v. Brenna, SEC Lit. Rel. No. 13,116, 50 S.E.C. Docket 605, 1991 SEC Lexis 2786 (Dec. 10, 1991) (involving four funds managed by Strategic Mgmt., Inc.); SEC v. American Inst. Counselors, Inc., SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975); SEC v. All Am. Fund, SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); SEC v. Financial Fund, Inc., SEC Lit. Rel. No. 6383, 4 S.E.C. Docket 413, 1974 SEC Lexis 3173 (June 4, 1974); *In re* Fundamatic Investors, Inc., SEC Rel. No. IC-7692, 1973 SEC Lexis 1894 (Feb. 27, 1973); *In re* Technical Fund Investment Plans, SEC Rel. No. IC-7393, 1972 SEC Lexis 1388 (Sept. 27, 1972); SEC Lit. Rel. No. 5362, 1972 SEC Lexis 1630 (Mar. 21, 1972) (involving Shamrock Fund); SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.). *See also* BOCA RATON CAPITAL CORP., FORM 10-KSB (Apr. 1, 1996), at F-11 (auditors stating that "the appointed receiver, Daniel H. Aronson, was granted full and exclusive power, duty and authority to administer and manage the Company's affairs").

²³⁷ *See* SEC v. S & P Nat'l Corp., 265 F. Supp. 993, 998-99 (S.D.N.Y.), *aff'd*, 360 F.2d 741 (2d Cir. 1966); SEC v. Aldred Inv. Trust, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945); SEC v. Fiscal Fund, Inc., 48 F. Supp. 712, 714-15 (D. Del. 1943); SEC v. Centurion Growth Fund, Inc., SEC Lit. Rel. No. 14,052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,123, 50 S.E.C. Docket 672, 1991 WL 288651, 1991 SEC Lexis 2639 (Dec. 18, 1991); SEC v. Treasury First, Inc., SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991); SEC Lit. Rel. No. 2468, 1962 SEC Lexis 882 (Dec. 28, 1962) (involving Keller Corp.).

²³⁸ In *SEC v. Fundpack, Inc.*, the SEC did seek the appointment of a receiver with traditional powers. SEC Lit. Rel. No. 8698, 1979 SEC Lexis 1927 (Mar. 22, 1979). However, the court instead appointed a "special master" with more limited powers. *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238, at *7. Nevertheless, another court order was issued soon thereafter that, in many ways, superseded the previous order and appointed a "special counsel" rather than a special master with much broader powers. *Fundpack, Inc.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,125, 1979 U.S. Dist. Lexis 9440 (D.D.C. 1979).

did so at the outset.²³⁹ A third court granted a special master the power, in its sole discretion, to suspend redemptions, although if the master did so, he nevertheless could “honor redemption requests where it appears that honoring the request is necessary to avoid undue hardship to any shareholder.”²⁴⁰ In four other cases, the courts did not suspend share redemptions but did issue injunctions freezing the assets of the funds,²⁴¹ thus, effectively preventing shareholders from redeeming. As for the final three cases, the first involved a fund that was not redeeming shares in the first instance,²⁴² so an order suspending redemptions may have been viewed as unnecessary. In the second case,²⁴³ the receiver petitioned the SEC for an order to suspend redemptions pursuant to Section 22(e)(3) of the ICA,²⁴⁴ which the SEC granted.²⁴⁵ The last case is puzzling because, based on the limited information available, the court neither froze assets nor empowered the receiver to suspend redemptions.²⁴⁶

The Heartland receiver’s third general obligation was his duty to consider whether to liquidate the Funds. Most of the other twenty-six receivership cases, by contrast, took a different approach. In four of those cases, the court

²³⁹ See *SEC v. Centurion Growth Fund, Inc.*, SEC Lit. Rel. No. 14052, 56 S.E.C. Docket 1237, 1994 SEC Lexis 1132 (Apr. 14, 1994); *In re Centurion Growth Fund, Inc.*, SEC Rel. No. IC-20204, 56 S.E.C. Docket 1129, 1994 SEC Lexis 1065 (Apr. 7, 1994) (suspending share redemptions outright after the SEC had previously granted the fund’s request to suspend share redemptions in a Section 22(e)(3) proceeding); SEC Lit. Rel. No. 5362, 1972 SEC Lexis 1630 (Mar. 21, 1972) (involving Shamrock Fund) (empowering receiver to suspend share redemptions). In another case not included in the nine cases, a court granted a receiver’s request to suspend redemptions a short time after it appointed the receiver. See *In re Technical Fund Inv. Plans*, SEC Rel. No. IC-7393, 1972 SEC Lexis 1388 (Sept. 27, 1972).

²⁴⁰ *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, Order Appointing Special Master, C.A. No. 3-00CV1482-D (N.D. Tex. July 11, 2000), at 5 (“Rupay Special Master Order”). The special master in that case, AIM Advisors, Inc., did suspend all share redemptions. See *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, Application for an Order Approving Plan of Distribution and Providing for Discharge of Special Master, C.A. No. 3-00CV1482-D (N.D. Tex. Dec. 10, 2000), at 5 (“Rupay Discharge Application”).

²⁴¹ See *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991); *SEC v. Municipal Lease Sec. Fund, Inc.*, SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989); *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); SEC Lit. Rel. No. 2699, 1963 SEC Lexis 1020 (July 30, 1963) (involving Continental Growth Fund, Inc.).

²⁴² See SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972) (involving Financial Trends Mutual Fund, Inc.).

²⁴³ See *In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-8022, 25 S.E.C. Docket 540, 1973 SEC Lexis 556 (Oct. 4, 1973); *In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-7692, 1 S.E.C. Docket 14, 1973 SEC Lexis 1894 (Feb. 27, 1973).

²⁴⁴ 15 U.S.C. § 80a-22(e)(3) (1994).

²⁴⁵ See *In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-7742, 1 S.E.C. Docket 18, 1973 SEC Lexis 1707 (Mar. 28, 1973).

²⁴⁶ See *SEC v. All Am. Fund, Inc.*, SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975).

simply directed the receiver to liquidate the funds.²⁴⁷ The receiver in question had absolutely no discretion. In another case involving four orphaned funds,²⁴⁸ the SEC petitioned for a court order directing that the funds be liquidated if their independent directors ultimately failed to find a new advisor by a certain date. The court, however, refused to grant the order, stating that the SEC could simply renew its liquidation request if the directors failed to find a new advisor. The court in another case simply ordered the receiver to find a merger partner for the fund in question rather than liquidate.²⁴⁹

More in line with *Heartland* on the liquidation point, but providing seemingly more flexibility, were eight of the twenty-six receivership cases.²⁵⁰ These cases basically charged the receiver with the responsibility of coming up with alternatives that would resolve the crises faced by the funds in question. While the specific language varied, phrases such as “pursue alternatives for the constitution, operation, and management of [the fund],”²⁵¹ “prepare . . . recommendations as to what action may be appropriate, including but not limited to . . . [a liquidation],”²⁵² “make a determination as to the final disposition of the [f]und,”²⁵³ “recommend any action,”²⁵⁴ “merge [the fund]

²⁴⁷ See *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712 (D. Del. 1943); *SEC v. Rupay-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000); *SEC v. Treasury First, Inc.*, SEC Lit. Rel. No. 13094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991); *SEC v. Alpine Mut. Fund Trust*, SEC Lit. Rel. No. 13,123, 50 S.E.C. Docket 672, 1991 WL 288651, 1991 SEC Lexis 2639 (Dec. 18, 1991). See also *In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-8143, 3 S.E.C. Docket 271, 1973 SEC Lexis 66 (Dec. 19, 1973) (the court ultimately approving plan of liquidation); *In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-8022, 2 S.E.C. Docket 605, 1973 SEC Lexis 556 (Oct. 4, 1973) (while unclear whether court ordered receiver to liquidate fund, receiver nevertheless submitted a plan of liquidation to the court).

²⁴⁸ See *SEC v. Brenna*, SEC Lit. Rel. No. 13,116, 50 S.E.C. Docket 605, 1991 SEC Lexis 2786 (Dec. 10, 1991) (involving four funds managed by Strategic Mgmt., Inc.); *SEC v. Brenna*, SEC Lit. Rel. No. 13,099, 50 S.E.C. Docket 383, 1991 SEC Lexis 2637 (Nov. 19, 1991).

²⁴⁹ See SEC Rel. No. IC-21000, 60 Fed. Reg. 19,428, 1995 SEC Lexis 894 (Apr. 12, 1995) (involving Centurion Growth Fund, Inc.).

²⁵⁰ See SEC Rel. No. IC-18,688, 51 S.E.C. Docket 638, 1992 WL 102254 (May 1, 1992) (involving Municipal Lease Securities Fund, Inc.); *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131 (M.D. Fla. 1978); *SEC v. All Am. Fund, Inc.*, SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 WL 161610 (Apr. 15, 1975); *SEC v. Financial Fund, Inc.*, SEC Lit. Rel. No. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974); SEC Lit. Rel. No. 5362, 1972 SEC Lexis 1630 (Mar. 21, 1972) (involving Shamrock Fund); *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970); *SEC v. Aldred Inv. Trust*, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945).

²⁵¹ SEC Rel. No. IC-18,688, 51 S.E.C. Docket 638, 1992 WL 102254 (May 1, 1992) (involving Municipal Lease Securities Fund, Inc.).

²⁵² *SEC v. Florida Bank Fund, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131, at *7 (M.D. Fla. 1978).

²⁵³ *SEC v. All Am. Fund, Inc.*, SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 710, 1975 WL 161610 (Apr.

into another . . . or . . . liquidate [it],”²⁵⁵ “clean up the past and . . . prepare for the future,”²⁵⁶ and “either . . . reorganize the capital structure of the Trust or liquidate the Trust”²⁵⁷ are representative.

Leaving aside the three general obligations, it should be noted that five of the twenty-six receivership cases provided one or more objectives or powers not discussed in the *Heartland* matter. In two of those cases, the court essentially tasked the receiver with providing for the orderly selection of a newly constituted board of directors.²⁵⁸ In pursuit of that objective, each receiver was to prepare proxy materials to facilitate a shareholder vote. Oddly enough, the court in one of those two cases also required the receiver, after the election of the new board, to watch the new watchdogs. Indeed, the court ordered the receiver to supervise the “consideration by shareholders and the new Board of Directors of renewing [the existing advisor’s] advisory contract . . . in view of the lapse of [the contract] and the previous Board’s failure to consider the merits of renewing the contract when it became obvious that [the existing advisor had engaged in self-dealing].”²⁵⁹

The court in the third case ordered certain ancillary relief, including the appointment of new independent trustees to the boards and executive committees of two corporate defendants.²⁶⁰ It was unclear, however, whether the court itself appointed these individuals or left it up to the newly appointed special counsel and special auditor to handle the matter. The court in the fourth case ordered the receiver “to act in the capacity of an equity Receiver, as may be appropriate in the circumstances[,]” in addition to providing a laundry list of duties for the receiver. This would imply that the receiver could take action going beyond that laundry list if circumstances warranted.²⁶¹

15, 1975).

²⁵⁴ SEC v. Financial Fund, Inc., SEC Lit. Rel. No. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974).

²⁵⁵ SEC Lit. Rel. No. 5362, 1972 SEC Lexis 1630 (Mar. 21, 1972) (involving Shamrock Fund).

²⁵⁶ SEC v. Fifth Ave. Coach Lines, 283 F. Supp. 3, 42 (S.D.N.Y. 1968).

²⁵⁷ SEC v. Aldred Inv. Trust, 58 F. Supp. 724, 733 (D. Mass.), *aff’d*, 151 F.2d 254 (1st Cir. 1945).

²⁵⁸ See SEC v. Boca Raton Capital Corp., SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994); SEC v. Fundpack, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238, at *7 (D.D.C. 1979).

²⁵⁹ SEC v. Fundpack, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238, at *7 (D.D.C. 1979).

²⁶⁰ See SEC v. Am. Inst. Counselors, Inc., SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975).

²⁶¹ See SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707, 1978 WL 1131, at *7 (M.D. Fla. 1978).

In the last case, *SEC v. Centurion Growth Fund, Inc.*,²⁶² the court gave the receiver the general powers of a receiver as well as those of the board of directors and shareholders. The receiver alone, therefore, could make all necessary decisions subject to court supervision. In this case, the fund in question was floundering because it had no investment advisor, counsel, underwriter, president, secretary, or treasurer. It also had an improperly constituted board of directors.²⁶³ The receiver located a merger partner for the fund. He then argued to the court that it made no sense to put together an expensive disclosure document to secure shareholder approval for the merger because he alone had been given the power to approve the merger by the court. He would be drafting a disclosure document deliverable only to himself.²⁶⁴ The court agreed, noting that “[n]o vote, consent, or other action by [the fund’s] shareholders was required or solicited in connection with the [merger] due to the Court’s jurisdiction and broad powers of equity.”²⁶⁵

Can one or more independent directors accomplish the tasks given to receivers in these additional receivership cases? Certainly, the added flexibility provided by several of these cases is within the ambit of an independent director. He or she continually considers alternatives that would strengthen a fund and benefit fund shareholders. Moreover, requiring a receiver to hold an election for new independent directors, as three of these cases did, is a task that independent directors already handle. Directors oversee elections and the proxy process as part of their current duties.

In sum, we believe that a receiver’s obligations and powers are not meaningfully different than those of independent directors. As discussed above, an independent director can achieve the three general objectives of the Heartland receiver. In doing so, however, that director will sometimes need the help of either the SEC and/or the courts. Other receiver obligations provided by receivership cases other than the *Heartland* case are not unique and can be adequately handled by an independent director without the aid of any court or governmental authority.

²⁶² SEC Lit. Rel. No. 14,063, 56 S.E.C. Docket 1572, 1994 SEC Lexis 1281 (Apr. 28, 1994).

²⁶³ *See id.*

²⁶⁴ Telephone Interview with Daniel H. Aronson, Esq. of Greenberg Traurig LLP (July 24, 2001).

²⁶⁵ SEC Rel. No. IC-21000, 60 Fed. Reg. 19,428, 1995 SEC Lexis 894 (Apr. 12, 1995).

2. *Disadvantages of a Receiver*

When weighing the disadvantages of a receiver against those of an independent director, one must evaluate both tangible and intangible costs. Tangible receiver costs would include cash outlays to pay receiver fees and to reimburse the receiver for his or her out-of-pocket costs and expenses. Intangible receiver costs would include, among others, time delays incurred while the receiver learns about and develops an understanding for the problems at a given fund. Even more intangible, but nevertheless significant, would be any loss of faith in the fund industry at the shareholder or creditor level when a court appoints a receiver.

With respect to tangible costs, empirical data from the receivership cases is far from complete.²⁶⁶ Each case is idiosyncratic, as the fees for any particular receiver depend primarily on what the court asks him or her to do. Some

²⁶⁶ A sampling of tangible receiver costs stemming from cases over the last ten years shows the idiosyncratic nature of these costs. In the case involving Municipal Lease Securities Fund, Inc., the court charged the receiver, Richard Lindrooth, with pursuing alternatives for the constitution, operation, and management of the fund and to submit them to the fund's shareholders. *See* SEC v. Municipal Lease Sec. Fund, Inc., SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989). Ultimately, the receiver submitted a plan of liquidation, and the shareholders approved it. *See* SEC Rel. No. IC-18,688, 51 S.E.C. Docket 638, 1992 WL 102254 (May 1, 1992). The receiver submitted expenses of approximately \$187,718, which were payable by the fund. Of those expenses, \$88,364 was received by the fund's attorneys and auditors. Of the remaining \$99,354, approximately \$54,000 was paid to the receiver himself, \$30,000 went to other personnel that assisted with the liquidation, and the remainder went for administrative costs and expenses. *See id.*

In the litigation involving Treasury First, Inc., the "special officer," Edward Gelfand, was responsible for supervising and directing the liquidation of the fund and its advisor, as well as the deregistration of the fund under the ICA. *See* SEC Rel. No. IC-20436, 57 S.E.C. Docket 794, 59 Fed. Reg. 40,401, 1994 SEC Lexis 2394 (Aug. 2, 1994). The special officer withheld \$150,000 of the fund's assets for payment of expenses incurred in connection with winding up the fund. The special officer estimated his compensation and expenses to be \$35,019, and those of the fund's accountants to be \$60,551. The special officer would distribute any remaining amount to shareholders. *See id.*

A most unusual case involved the Rupay-Barrington Funds, Inc. The court appointed A I M Advisors, Inc. as "special master," and charged it with liquidating the portfolios of three series funds. The special master was clearly entitled to charge a fee for its services, as well as be reimbursed for its out-of-pocket expenses. *See* Rupay Special Master Order, *supra* note 240, at 1-2. Other than seeking reimbursement for certain minor tax payments made on behalf of two of the portfolios, however, the special master charged no fee and did not seek further expense reimbursement. *See* Rupay Discharge Application, *supra* note 240, at 4. When posed with the obvious question of "why," A I M's Assistant General Counsel, Renee Friedli, responded that given what the unfortunate shareholders had been through, A I M did not believe it should add to their burden. Moreover, she added that A I M did not believe it should profit from another advisor's mistakes. *See* Telephone Interview with Renee A. Friedli, Esq., Assistant General Counsel, A I M Advisors, Inc. (Aug. 3, 2001). *Cf.* SEC v. John Adams Trust Corp., 697 F. Supp. 573, 576 (D. Mass. 1988) (where, in a case involving the receivership of an investment advisor, "[n]either the diligent receiver nor his able counsel sought or obtained any monetary compensation for his work").

receivers move their funds toward liquidation immediately. Others expend significant time on a lengthy investigation and then additional time searching for a merger partner or new fund advisor.

We believe the tangible costs of a receiver resolving a fund's crisis and an independent director doing so would, as a general matter, be equivalent. This conclusion stems mostly from the fact that the actions necessary to resolve a fund's crisis would likely be very similar whether a receiver or an independent director undertook them. Ultimately, the fund pays a receiver's bill or an independent director's fee. Whether that bill is based on an hourly rate or is calculated on a "per meeting" basis or otherwise is not, as a practical matter, relevant.

Tangible receiver costs may, however, lean in favor of an independent director and against a receiver in certain instances. A receiver's education is not free of charge. The greater the particular receiver's learning curve is, the greater the tangible costs associated with that receiver will be. In addition, because accountants and lawyers typically do a fair amount of the educating, the fund in question incurs additional advisory expenses. By contrast, an independent director already has significant experience with the fund in question and its accountants, lawyers, and other service providers. The independent director's learning curve, therefore, should be substantially flatter than that of a receiver, thus lowering tangible costs.

In terms of intangible costs, time delays incurred while the receiver learns about and develops an understanding for the problems at a given fund could negatively impact that fund and its shareholders in two ways. First, a long delay could lead to a substantively worse outcome for shareholders.²⁶⁷ Available solutions to a fund's crisis could evaporate if the health of the fund declines as delays mount.

Another significant intangible cost is the negative effect a court's appointment of a receiver has on a fund's shareholders and creditors.²⁶⁸ This

²⁶⁷ In this regard, the less experience a receiver has with the fund industry, in general, and the fund itself, in particular, the greater the chance he or she will make a substantive mistake when analyzing options and making recommendations as to the future direction of the fund.

²⁶⁸ Karen Damato of *The Wall Street Journal* relates the experience of Gregory Patchen, an investor in the Heartland Funds:

[F]ive months ago, the Securities and Exchange Commission stepped into the [Heartland] situation by getting a court order to take away management of the funds from Milwaukee-based Heartland Advisors. But while the SEC intervention was supposed to help Heartland bond-fund investors,

appointment has to tear at the fabric of investor and creditor confidence in the mutual fund industry.²⁶⁹ Suddenly, an outsider is in charge of the fund, rather than the directors the shareholders elected. Shareholder democracy and the congressionally mandated system of checks and balances are either permanently or temporarily suspended. The only real check on the receiver is a judge who may or may not be familiar with the workings of the fund industry. Moreover, the appointment of a receiver runs contrary to the SEC's highly publicized initiative to empower independent directors.

While it is unrealistic to expect that the mutual fund industry can avoid *Heartland*-type crises entirely, the SEC and the industry do have some control over how they handle them. The advantages of replacing an independent director with a receiver do not appear to be significant. Moreover, it is likely that the combined tangible and intangible costs of a receiver exceed, sometimes significantly, those of an independent director. The SEC, therefore, should seek to minimize its use of the receivership remedy as outlined in the next section. By doing so, fund crises will be managed in a way that is least likely to shake investor and creditor confidence in the troubled fund, in particular, and the fund industry, in general.

Mr. Patchen hasn't seen it yet. Instead, the monthly dividend distributions have been barred. Furthermore, fund shareholders haven't gotten any word since March from the SEC or the court-appointed receiver on what their remaining investment might be worth or when they will be able to get their hands on their money. . . . [A]ccording to Mr. Patchen[,] "The lack of communication to shareholders by a public agency about something they seized for our own good is disturbing," he says. Adds Patrick Lemons, another *Heartland* investor: "It has been a long and frustrating wait."

Damato, *supra* note 217, at C1. See generally *SEC v. Spence & Green Chem. Co.*, 612 F.2d 896, 904 (5th Cir. 1980) (in context of an operating company, court noting that "the imposition of a receivership on a corporation is a drastic measure, the detrimental business effects of which should be carefully considered").

²⁶⁹ On the issue of trust, Mickey Roth, CEO of USAA Investment Management Company, opined:

The key thing here I think . . . [is] the great trust that has grown up, that has propelled the mutual fund industry to become the premier financial intermediary for the American people. And I think what the Commission can do, number one, priority is to do things to preserve that trust, to make sure that it continues to impel us toward things that work toward the benefit of the investors

SEC ROUNDTABLE—PART II, *supra* note 16, at 15. Dawn-Marie Driscoll, President of Driscoll Associates and an independent director of several Scudder Kemper mutual funds, added:

In my view, the most important thing that [the mutual fund industry] offers shareholders may surprise you. It's not performance. It's not low fees. It's not professional management. It's not outstanding 21st century service. In my view, the most important thing that this industry offers shareholders is its integrity. . . . Therefore, in my view, . . . the most important responsibility of directors, and particularly independent directors, is to oversee the trust of this industry.

Id. at 19.

B. An Articulated Receivership Standard

1. The "Capable Independent Director" Standard

Three priorities guided the crafting of the receivership standard discussed below. First, the standard should place the interests of shareholders first. Second, the standard should embrace the movement towards truly effective independent mutual fund directors. Finally, the standard should minimize the costs, particularly the intangible costs, associated with the receivership remedy. We recommend that the SEC adopt what we refer to as the "Capable Independent Director" or "CID" Standard. This Standard is simple:

So long as at least one capable independent director is available and willing to lead a fund through a crisis, the SEC should work with that director in resolving the fund's crisis rather than seek the appointment of a third-party receiver. If, however, the SEC determines that the CID Standard is not met during its investigation of the troubled fund, it should seek the receivership remedy.

The CID Standard has four elements. The first element is the existence of at least one independent director. While more than one independent director would be preferable, only one is needed to take charge of a troubled fund. That director, however, must be truly independent, because shareholder protection particularly demands it under the circumstances. Indeed, the likelihood that the director will lock horns with the fund advisor is extremely high in these cases.

In this context, "independent" means more than not being an "interested person" under the ICA.²⁷⁰ The director must have been nominated to the board by a committee of independent directors, rather than by an interested director with the blessings of the fund advisor. In addition, that director's remuneration from the fund must not be material given that director's personal financial circumstances. Finally, if that director is not already represented by independent legal counsel, he or she must retain one.

The second element is the most involved element. It requires that the independent director be "capable," which itself encompasses two concepts. Capable first means having clean hands. A director being considered to lead a troubled fund must be loyal to the fund and its shareholders.²⁷¹ If the

²⁷⁰ See 15 U.S.C. § 80a-2(a)(19) (1994).

²⁷¹ "Loyalty" is a different concept than "interested." A director, for example, may not be an "interested

shareholders of that fund have been subjected to fraudulent activities or other violations of the ICA, that director must not have taken part, or even be suspected of having taken part, in those activities or violations. The SEC should exclude from leadership consideration any independent director who fails this fundamental litmus test.²⁷²

Capable also means being competent. Whether an independent director is competent is an involved inquiry. This is especially true given that the fund in question has experienced serious problems during that director's watch.

In our minds, competency embodies both knowledge and alertness. In terms of knowledge, a director is competent if he or she has the necessary mutual fund industry experience to understand the fund's troubles and determine, in consultation with his or her advisors, what to do about them. Unfortunately, not all independent directors are created equally when it comes to industry experience. While we strongly believe that the vast majority of independent directors understand most of what is going on with their particular funds, it is far less certain whether that same majority can claim truthfully that it understands the intricacies of fair value pricing,²⁷³ Rule 2a-7,²⁷⁴ affiliated transactions,²⁷⁵ Rule 12b-1,²⁷⁶ or other complex topics. In this regard, one of

person" under the ICA, and thus qualify as an independent director. Yet that same director may also engage in fraudulent conduct injurious to shareholders. Thus, the concept of "loyalty," which is embedded within the element of "capable," is a necessary part of the CID Standard.

²⁷² Cf. *SEC v. Keller Corp.*, 323 F.2d 397, 403 (7th Cir. 1963) (noting that "[i]t is hardly conceivable that the trial court should have permitted those who were enjoined from fraudulent misconduct to continue in control [of Keller Corp.'s] affairs for the benefit of those shown to have been defrauded").

²⁷³ See 15 U.S.C. § 80a-2(a)(41)(A) (1994); 17 C.F.R. § 270.2a-4(a)(1) (2000). In discussing the complexity of fair value pricing, Jean Gleason Stromberg, an independent director of the AARP Investment Program for Scudder, commented: "[T]he lawyers and the accountants tell me that I'm the one who needs to understand all the processes and how the pricing works and everything else, I'm finding a little intimidating, because I thought they were the ones who understood that, and that they were the ones who would help me understand it." SEC ROUNDTABLE—PART I, *supra* note 16, at 85. See generally *Should Directors Sit on Valuation Committees?*, FUND DIRECTIONS (Institutional Investor, Inc., New York, N.Y.) Oct. 2001, at 6, available at <http://www.funddirections.com> (discussing the logistical and other impediments to having directors involved in the fair valuation process).

²⁷⁴ 17 C.F.R. § 270.2a-7 (2000).

²⁷⁵ See 15 U.S.C. § 80a-17 (1994 & Supp. V 1999).

²⁷⁶ 17 C.F.R. § 270.12b-1 (2000). With respect to Rule 12b-1, former SEC Chairman Arthur Levitt commented: "[I]ndependent directors have special responsibilities under the Investment Company Act when fund assets are used to pay distribution expenses. . . . Do directors really understand what payments are being made to whom and why?" SEC ROUNDTABLE—PART I, *supra* note 16, at 3. Faith Colish, a securities attorney and independent director of Neuberger Berman Funds, added: "[A]s a securities lawyer sitting on a board, I find that this subject is extremely complicated. I think that my fellow directors who are not securities lawyers are heroic for grappling with them." *Id.* at 50.

the authors previously has made a general proposal that, if implemented, would help ensure that fund boards were made up only of individuals with at least a basic level of industry knowledge.²⁷⁷

Competency also means being alert. One inescapable fact in the vast majority of the receivership cases is that a fund's problems occurred under the independent directors' noses. Needless to say, this does not instill confidence in their abilities as watchdogs. Nevertheless, the SEC needs to examine closely a troubled fund's particular situation. Did the directors spot the problem and bring it to the SEC's attention? If so, we believe they should not be excluded from leadership consideration. Likewise, independent directors who satisfied their fiduciary duty of care, yet failed to discover a problem, should not be excluded from leadership consideration once the problem comes to their attention. In both situations, assuming the other elements of the CID Standard are met, the SEC should give the independent directors the opportunity and appropriate time frame in which to solve the problem or develop alternative courses of actions.

The SEC, of course, must make a determination as to whether a particular independent director is "capable" under the Standard. The SEC is well-equipped to do so. Currently, the SEC investigates individuals in Section 9 proceedings²⁷⁸ to determine whether those individuals should be barred from being directors. An investigation under the CID Standard would involve a substantially similar investigation and analysis.

The third element of the CID Standard focuses on the desire of one or more independent directors to take the leadership reins and solve problems. At least one director must have the time, availability, and willingness to do so. Shareholders deserve nothing less. No doubt in a crisis situation the understandable inclination of many independent directors will be to resign and head for the hills. Others, however, may very well be willing to tackle the problems directly, utilizing their industry knowledge and personal experience or expertise with the fund along the way. The SEC will benefit shareholders by granting those directors the first opportunity to remedy the situation.

The final element of the CID Standard addresses the involvement of the SEC itself. Independent directors have most, but not all, of the powers of a

²⁷⁷ See Steven R. Howard, *A National Association for Independent Directors of Investment Companies: A Supplement to Current SEC Proposals*, 44 N.Y.L. SCH. L. REV. 535 (2001).

²⁷⁸ 15 U.S.C. § 80a-9 (1994 & Supp. V 1999).

receiver. In particular, they cannot freeze assets and suspend fund redemptions unilaterally. The SEC, however, has the ability to suspend fund redemptions upon the request from independent directors. Moreover, the SEC, either alone or together with independent directors, can petition a court to freeze fund assets. The important point here is that the SEC needs to work together with the independent directors if shareholders are to reap the benefits of the CID Standard.²⁷⁹

In situations in which the SEC believes an independent director satisfies the CID Standard, it would be preferable if the SEC places him or her in charge of the fund and foregoes a receivership action. This would minimize the costs associated with a fund in crisis. To the extent there is an insufficient number of directors remaining on the fund's board to govern in accordance with state law and the fund's by-laws, then the remaining director could appoint new additional directors who would serve until the next election of directors. Any director remaining in charge of the fund should ensure that he or she is properly covered by E&O insurance. To the extent the SEC still believes a fund should be placed in receivership, the SEC should propose to the court that it select as receiver an independent director who satisfies the CID Standard.

We believe the benefits of the CID Standard are many. It is more respectful of the congressionally established system of checks and balances. It supports and enhances the SEC's initiative to empower independent directors. It is less harmful to shareholder democracy. It minimizes the negative impact on shareholders' confidence by ensuring that someone they elected remains in charge of the fund to sort out and solve its problems. Finally, it is likely more cost-effective, in that it minimizes the intangible costs and possibly even some of the tangible costs associated with the receivership remedy.

2. *Applying the CID Standard*

The purpose of this section is to ascertain how the CID Standard would work in practice. Accordingly, we viewed it light of the three themes gleaned from examining the factors to which the SEC cited in seeking receivers in the

²⁷⁹ Currently, the SEC appears to approach each potential receivership case as a "one off," delegating the handling of the matter to the appropriate regional office. Whether the SEC adopts the CID Standard or not, we believe a different approach is warranted. In our view, the SEC should designate one or more individuals in its Washington headquarters as receivership experts. These individuals would stay involved with the cases. Over time, therefore, they would develop an invaluable institutional knowledge base about receiverships that could be of great assistance to future receivers.

twenty-eight receivership cases. Recall that those themes involve misconduct, the redeemable share mechanism, and problematic boards of directors.²⁸⁰

The first theme of misconduct covered the recurring factors of fraud, breach of fiduciary duty, and prohibited affiliate transactions.²⁸¹ Twenty-two of the twenty-eight receivership cases, or seventy-nine percent, involved one or more of those factors. Under the CID Standard, if all independent directors of a troubled fund are personally implicated in the misconduct, the SEC should not consider any of them for a leadership role. Rather, it should simply seek a third-party receiver.

If a director is not implicated in the misconduct, however, the SEC should consider him or her for a leadership role. That director, of course, must meet the remaining elements of the CID Standard. Thus, if, among other things, that director failed to intervene in the crisis because he or she was asleep at the switch or did not understand the complexities of what was occurring, the SEC should not consider him or her for a leadership role.

The second theme running through many of the receivership cases was the seriousness with which the SEC views the redeemable share mechanism of an open-end investment company. This theme covered the recurring factors of incorrect or problematic NAVs, reporting violations, and suspension of share redemptions.²⁸² Fifteen of the twenty-eight receivership cases, or fifty-four percent, involved one or more of those three factors. None of those factors, however, implicates the personal conduct of an independent director. Rather, they implicate that director's oversight capability, competence, and knowledge base. The SEC, therefore, should consider for a leadership role any independent director who is demonstrably "capable" under the CID Standard. If no director qualifies, then the SEC should seek the appointment of a third-party receiver.

The final theme we gleaned from the receivership cases was the emphasis the SEC places on having problem-free boards of directors. This theme covered the less frequently cited factors of an insufficient number of independent directors, fund abandonment, directors serving without proper shareholder approval, and directors serving when legally prohibited from doing

²⁸⁰ For a discussion of these themes, see *supra* Part I.C.

²⁸¹ For a discussion of these factors, see *supra* Parts I.B.1.a, c, d.

²⁸² For a discussion of these factors, see *supra* Parts I.B.1.b, e, f.

so.²⁸³ Eleven of the twenty-eight receivership cases, or thirty-nine percent, involved one or more of those four factors. One of those eleven cases is the only case not also involving either of the two prior themes.²⁸⁴

In terms of this final theme, so long as one independent director meets the CID Standard, the SEC should consider that director for a leadership role. The SEC should allow that director to oversee the election of additional independent directors rather than petition a court for a receiver. The SEC obviously should seek a third-party receiver for those funds that have been completely abandoned by their boards or that have boards with no properly-serving independent directors. The SEC needs to show particular sensitivity, however, if a given fund's issue involves whether it has the requisite number of independent directors. Deciding whether a particular director is or is not "interested" has always been a highly factual inquiry. Well-intentioned individuals have been known to get it wrong from time to time. Thus, an independent director who fails to discover that another alleged independent director is really "interested," and, therefore, the board lacks a full complement of independent directors, should not necessarily be excluded from a leadership role.²⁸⁵

Although not included in one of the three themes, one of the factors to which the SEC cited less frequently deserves honorable mention. That factor is the failure by an investment company to register under the ICA.²⁸⁶ Because this factor is the only one for which the SEC has explicit statutory authority to seek a receiver,²⁸⁷ it represents a special case. Accordingly, the SEC would be entirely within its right to seek a receiver for an unregistered investment company. Moreover, this makes sense in that it is highly unlikely that the directors of that company were nominated and elected with an eye towards the ICA's independent director requirement. The probability that any particular

²⁸³ For a discussion of these factors, see *supra* Part I.B.2.

²⁸⁴ See *SEC v. Boca Raton Capital Corp.*, SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994).

²⁸⁵ The SEC has admonished funds on this point: "Funds and directors should be mindful of their responsibilities to maintain the required percentage of independent directors, and should monitor director independence (and other composition issues) accordingly. A fund also could avoid problems . . . by maintaining a greater percentage of independent directors than the simple majority required by the Exemptive Rules." Independent Director Adopting Release, *supra* note 17, at *20 n.29.

²⁸⁶ For a discussion of this factor, see *supra* Part I.B.2.

²⁸⁷ See 15 U.S.C. § 80a-41(d) (1994).

director would naturally qualify as someone other than an "interested person" under the ICA is, therefore, very low.²⁸⁸

In light of the CID Standard, did the SEC do the right thing in pursuing the receivership remedy in the *Heartland* case? The answer to this query ultimately depends on a factual analysis of the independent directors of the Funds and the actions they took and failed to take.²⁸⁹ To date, the SEC has not charged the independent directors of Heartland with misconduct of any kind—something that would automatically exclude them from leadership consideration under the Standard. Thus, the important inquiry is whether any of Heartland's independent directors meets the other elements of the CID Standard. It could very well be the case that those directors are not "capable" under the Standard, something that ongoing shareholder litigation against those directors may seek to prove for other purposes.²⁹⁰ Or, perhaps, none of those directors were available and willing to take on a leadership role. If either is true, then the SEC did the right thing in seeking a receiver. If, however, the elements of the CID Standard are met, we believe the SEC may have made a mistake by excluding those directors from leadership consideration.

CONCLUSION

The purpose of this Article is to harmonize the SEC's desire to seek the receivership remedy in the context of a mutual fund in crisis with its push for truly effective independent mutual fund directors. Harmonization is important because the appointment of a receiver disrupts the congressional mandate that independent directors, rather than a receiver, be the watchdogs looking after the interests of fund shareholders. Moreover, the appointment of a receiver carries with it significant costs, including damage to investor confidence.

To provide guidance to the SEC as to when it should seek the receivership remedy, we carefully analyzed the twenty-eight cases in which the SEC sought that remedy to determine which factors were most important to it. Once we

²⁸⁸ See 15 U.S.C. § 80a-2(a)(19) (1994).

²⁸⁹ As of April 25, 2002, the SEC has not commenced an enforcement action against the independent directors of the Heartland Funds.

²⁹⁰ The losses at the three Funds of Heartland prompted twenty shareholder lawsuits, nineteen of which are being consolidated into a single class action lawsuit in federal court in Milwaukee. See *Heartland Inventory*, *supra* note 20. Additionally, the losses apparently have caused the Funds' investment advisor, Heartland Advisors, to consider putting itself up for sale. See *Lawsuits Could Influence Decision To Sell Heartland*, FUND DIRECTIONS, (Institutional Investing, Inc., New York, N.Y.) Oct. 2001, at 6, available at <http://www.funddirections.com>.

ascertained those factors, we attempted to develop a standard that would put shareholders' interests first, maintain an important leadership role for independent directors, and minimize the costs associated with the receivership remedy.

The standard we developed is the "Capable Independent Director" or "CID" Standard. Under the Standard, so long as at least one capable independent director is available and willing to lead a fund through a crisis, we believe the SEC should work with that director in resolving the fund's crisis rather than seek the appointment of a third-party receiver. The CID Standard, therefore, has four elements. The first element is the existence of at least one truly independent director. The second element requires that the independent director be "capable," which itself includes ethical, experiential, and alertness components. The third element requires that at least one director have the availability and willingness to take control of a troubled fund and resolve its problems. The final element of the CID Standard requires the SEC to work together with the independent director or directors if shareholders are to reap the benefits of the Standard. If the SEC determines that the CID Standard is not met during its investigation of a troubled fund, it then should seek the receivership remedy.

ANNEX A
SUMMARY OF MUTUAL FUND RECEIVERSHIP CASES

1. Heartland Group, Inc. (2001)
2. Rupay-Barrington Funds, Inc. (2000)
3. Boca Raton Capital Corp. (1994)
4. Centurion Growth Fund, Inc. (1994)
5. Alpine Mutual Fund Trust (1991)
6. Strategic Funds (1991)
7. Treasury First, Inc. (1991)
8. Municipal Lease Securities Fund, Inc. (1989)
9. Steadman Funds (1989)
10. The Fundpack, Inc. (1979)
11. Florida Bank Fund, Inc. (1978)
12. All American Fund, Inc. (1975)
13. American Institute Counselors, Inc. (1975)
14. Financial Fund, Inc. (1974)
15. Fundamatic Investors, Inc. (1972)
16. Financial Trends Mutual Fund, Inc. (1972)
17. Technical Fund, Inc. (1972)
18. Shamrock Fund (1972)
19. Advance Growth Capital Corp. (1972)
20. B.S.F. Company (1968)
21. Fifth Ave. Coach Lines, Inc. (1968)
22. Midland Basic, Inc. (1968)
23. S & P Nat'l Corp. (1966)
24. Puerto Rico Capital Corp. (1965)
25. Continental Growth Fund, Inc. (1963)
26. Keller Corp. (1962)
27. Aldred Investment Trust (1945)
28. Fiscal Fund, Inc. (1943)

1. *Heartland Group, Inc.* (2001) — The SEC filed suit against Heartland alleging that Heartland was depriving shareholders in three of its funds of statutorily required fundamental financial information. Without this information, existing shareholders could not decide to remain invested or redeem their shares in the funds. The SEC alleged that Heartland also failed to send an annual report for the funds to shareholders on March 1, 2001 and to file that report with the SEC by March 10, 2001. *See SEC v. Heartland Group, Inc.*, SEC Lit. Rel. No. 16,938, 74 S.E.C. Docket 1344, 2001 SEC Lexis 513 (Mar. 22, 2001). Heartland's failure stemmed from the ICA's requirement that an annual report include audited financial statements certified with an unqualified auditor's opinion. Heartland's auditors, PricewaterhouseCoopers, refused to provide these statements. While PricewaterhouseCoopers had commenced an audit, it promised to disclaim any opinion as to the value of the securities held by the funds during fiscal year 2000. This led to a situation where shareholders could be redeeming shares at incorrect NAVs. *See SEC v. Heartland Group, Inc.*, Plaintiff Securities and Exchange Commission's Complaint for Permanent Injunction and Other Equitable Relief, Case No. 01C 1984 (N.D. Ill. Mar. 21, 2001), at Averments 15-18. With Heartland's consent, the U.S. District Court for the Northern District of Illinois entered an order of permanent injunction against Heartland and appointed a receiver to oversee the funds. The receiver, Phillip Stern, Esq. of Freeman, Freeman & Salzman, was empowered to take control of the funds' assets, manage the funds, suspend fund redemptions, and, if appropriate, liquidate the funds. *See SEC v. Heartland Group, Inc.*, Order of Permanent Injunction and Other Equitable Relief Against Heartland Group, Inc., Case No. 01C 1984 (N.D. Ill. Mar. 21, 2001).
2. *Rupay-Barrington Funds, Inc.* (2000) — The SEC filed suit against the fund (a registered series investment company), its investment advisor, and an upstream affiliate, alleging fraud, mismanagement, and breach of fiduciary duty. The SEC also alleged sales of securities without a valid prospectus, violations of net asset valuation requirements, improper loans to affiliates, and illegal suspension of share redemptions. Specifically, the advisor caused the fund to carry a worthless receivable from the upstream affiliate that owned the advisor. The receivable stemmed from the affiliate's agreement to pay fund expenses that exceeded a certain percentage of the fund's net assets. The receivable artificially inflated the NAV of the fund's portfolios by as much as 600% in one instance. This

led to the series holding the largest portion of the receivable to suspend redemptions. Defendants consented to the order by the U.S. District Court for the Northern District of Texas appointing a special master (A I M Advisors, Inc.) to assume management of the fund, to liquidate the fund, and to make a distribution to the fund's service providers, creditors, and shareholders. The court also issued a preliminary injunction against the defendants enjoining them from violating various provisions of the securities laws. *See SEC v. Rupay-Barrington Capital Mgmt., Inc.*, SEC Lit. Rel. No. 16,623, 72 S.E.C. Docket 2089, 2000 SEC Lexis 1438 (July 10, 2000).

3. *Boca Raton Capital Corp.* (1994) — The SEC filed suit against the corporation (a business development company), its directors, officers, and agents alleging that they violated Section 56 of the ICA. The SEC alleged that five of the six directors of the corporation were “interested persons,” thus violating Section 56's requirement that a majority of directors be independent. With the corporation's consent, the U.S. District Court for the Southern District of Florida preliminarily enjoined the corporation, its directors, officers, and agents from violations of Section 56. The court also appointed a receiver, froze assets, and prohibited the destruction of books and records. The purpose of receivership was, among other things, to ensure an orderly selection of a newly constituted board. The receiver was instructed to arrange for shareholders to elect a proper number of disinterested directors and prepare proxy materials to facilitate the process. The court appointed the receiver, Daniel H. Aronson, Esq., for sixty days or until further order of the court. *See SEC v. Boca Raton Capital Corp.*, SEC Lit. Rel. No. 14,294, 57 S.E.C. Docket 2145, 1994 SEC Lexis 3244 (Oct. 11, 1994).
4. *Centurion Growth Fund, Inc.* (1994) — Prior to the SEC's action, the fund's sole officer requested the SEC suspend fund redemptions in a Section 22(e)(3) proceeding. In granting the request, the SEC noted that “it appears that the Fund's board of directors is unable to take any corporate action and that the Fund may be redeeming its shares at an inaccurate net asset value.” *In re Centurion Growth Fund, Inc.*, SEC Rel. No. IC-20204, 1994 SEC Lexis 1065 (Apr. 7, 1994). The SEC thereafter sought injunctive and other ancillary relief against the fund. The SEC alleged that since 1993 the management of the fund had become increasingly deadlocked and in disarray. It presently did not have an investment advisor, counsel, underwriter, president, secretary, or treasurer.

It also did not have a properly constituted board. The SEC stated that the fund was delinquent in its filings with the SEC and had not fulfilled its disclosure obligations to shareholders under the Securities Act and the ICA, pointing to Section 17(a)(2) and (3) of the Securities Act and Sections 30(b)(2) and 30(d) of the ICA and Rules 30b2-1 and 30d-1 thereunder. The U.S. District Court for the Southern District of Florida granted the SEC's request for injunctive relief, froze the assets of the fund, prohibited the destruction of books and records, suspended the offer, sale, and redemption of the fund's shares, and granted the SEC's request for a receiver. *See* SEC v. Centurion Growth Fund, Inc., SEC Lit. Rel. No. 14,052, 1994 SEC Lexis 1132 (Apr. 14, 1994). On April 22, 1994, the court appointed Daniel H. Aronson, Esq. as the receiver. On June 10, 1994, the court directed the receiver to pursue a merger of the fund with another investment company on terms as advantageous as possible to the fund's shareholders. The court approved the receiver's merger plan with The World Funds, Inc. "No vote, consent, or other action by [the fund's] shareholders was required or solicited in connection with the Plan due to the Court's jurisdiction and broad powers of equity." SEC Rel. No. IC-21000, 60 Fed. Reg. 19428, 1995 SEC Lexis 894 (Apr. 12, 1995). The receiver retained \$65,000 of the fund's assets to pay the fund's final costs, expenses, debts, and liabilities. *See id.*

5. *Alpine Mutual Fund Trust* (1991) — This case involved two series funds investing in municipal obligations: National Municipal Asset Trust ("NMAT") and California Municipal Asset Trust ("CMAT"). With Alpine's consent, the SEC filed suit against the funds seeking an injunction to freeze their assets and the appointment of a receiver. In its complaint, the SEC alleged multiple violations of the ICA by the funds, to wit: (a) failure to compute accurately the NAV of their shares on a daily basis in violation of Section 22(c) and Rule 22c-1(a) and (b) thereunder; (b) failure to make required annual and semiannual reports and filings with their shareholders and the SEC in violation of Sections 30(a) and (d) and Rules 30a-1 and 30d-1 thereunder; (c) failure to redeem their shares within seven days of tender in violation of Section 22(e); (d) failure to conduct shareholder elections of trustees and consequent failure to have requisite number of independent directors in violation of Sections 16(a), 10(a), and 15(f)(1); (e) loans incurred by NMAT in contravention of its prospectus in violation of Sections 13(a)(2) and 21(a); (f) NMAT's sale of certain portfolio assets to affiliated persons in violation of Section 17(a)(2); (g) the funds' return of capital to shareholders without disclosing that capital

was being returned in violation of Section 19(a) and Rule 19a-1 thereunder; and (h) failure of the funds to maintain certain books and records accurately in violation of Sections 31(a) and Rules 31a-1(a), (b)(1), and (b)(8) thereunder. The U.S. District Court for the District of Colorado froze the funds' assets on November 20, 1991 and appointed a receiver, Raymond Friedloeb, Esq., on November 25, 1991. The order appointing the receiver also ordered the liquidation of the two funds. *See* SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,123, 50 S.E.C. Docket 672, 1991 WL 288651, 1991 SEC Lexis 2639 (Dec. 18, 1991); SEC v. Alpine Mut. Fund Trust, SEC Lit. Rel. No. 13,101, 50 S.E.C. Docket 386, 1991 WL 288420 (Nov. 21, 1991).

6. *Strategic Funds* (1991) — The SEC filed a complaint against Strategic Management, Inc. ("SMI"), four funds that SMI managed and certain individual defendants, on November 19, 1991. The SEC alleged that the corporate defendants and also two individual defendants violated Section 17(a) of the Securities Act, Sections 10(b) and 14(a) of the Exchange Act and Rules 10b-5 and 14a-9 thereunder, Sections 206(1) and (2) of the IAA, and Section 20(a) of the ICA. Specifically, the funds had filed proxy materials with the SEC and distributed them to shareholders that detailed a proposed assignment of the funds' advisory contracts by SMI to another advisor, Chesire Hall Advisors, Inc. The assignment was being made in accordance with SMI's settlement of an SEC enforcement proceeding. While the proxy materials disclosed that the new advisor was paying \$300,000 to SMI for the assignment, a secret, undisclosed deal for the new advisor to pay approximately \$1.9 million more to SMI existed. The SEC sought injunctive relief against SMI and the individual defendants and the appointment of a "special master" for the funds. The SEC wanted the special master to manage the funds in the ordinary course of business and to commence an orderly liquidation if, by December 31, 1991, the independent directors of the funds had failed to assign the advisory contracts to a new advisor, subject only to shareholder approval. *See* SEC v. Brenna, SEC Lit. Rel. No. 13,099, 50 S.E.C. Docket 383, 1991 SEC Lexis 2637 (Nov. 19, 1991). The U.S. District Court for the Northern District of Texas, while granting the SEC's request for the special master, rejected the SEC's contingent liquidation plan, stating that the SEC could renew its request for liquidation if the independent directors were unsuccessful in finding a new advisor. *See* SEC v. Brenna, SEC Lit. Rel. No. 13,116, 50 S.E.C. Docket 605, 1991 SEC Lexis 2786 (Dec. 10, 1991). Lexington Management Corp. took over management of the funds on

December 12, 1991. *See* SEC v. Brenna, SEC Lit. Rel. No. 13,125, 50 S.E.C. Docket 673, 1991 SEC Lexis 2878 (Dec. 18, 1991). For a related case, see *infra Treasury First, Inc.*

7. *Treasury First, Inc.* (1991) — The SEC filed a complaint against the fund, its advisor, and an individual defendant (John Hall). The complaint alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1) and (2) of the IAA, and Sections 13(a)(3) and 36(a) of the ICA. Specifically, Hall, through the advisor, misappropriated approximately \$2.1 million of the fund's money by purchasing non-existent commercial paper. Hall planned to use the money to help purchase the management contract for the Strategic Funds. None of these actions were disclosed to the fund's shareholders. The U.S. District Court for the Central District of California froze assets of the fund and its advisor and later appointed a "special officer" to direct the liquidation and dissolution of the fund and its advisor. *See* SEC v. Treasury First, Inc., SEC Lit. Rel. No. 13,094, 50 S.E.C. Docket 381, 1991 SEC Lexis 2632 (Nov. 19, 1991). On November 14, 1991, the court appointed Edward S. Gelfand as the special officer. After distributing assets to shareholders, Gelfand retained \$150,000 for expenses. Expenses were estimated at \$35,019 for the special officer, \$60,551 for the fund's accountants, and the rest as a reserve. *See* SEC Rel. No. IC-20436, 57 S.E.C. Docket 794, 59 Fed. Reg. 40401, 1994 SEC Lexis 2394 (Aug. 2, 1994). For a related case, see *supra Strategic Funds.*
8. *Municipal Lease Securities Fund, Inc.* (1989) — The SEC filed a complaint against the fund, its advisor, its underwriter, and Howard Hutchinson, the president of each of the other corporate defendants. The complaint alleged violations of the antifraud provisions of the Securities Act, Sections 22(c), 34(b), 17(f), 30(a), 30(b), and 30(d) of the ICA, and Rules 22c-1, 31a-1, 17f-2, 30a-1, 30b1-1, and 30d-1 under the ICA. Specifically, the SEC alleged that the fund through, or with assistance of, the other defendants sold and redeemed its shares at prices not based on the calculated NAV of those shares. The complaint also alleged that the defendants falsely stated in disclosure documents that the prices of shares were based on the calculated NAV, and omitted to state that the fund had not calculated the NAV of its shares for at least the last five months. The complaint further alleged that the fund failed to keep current certain required books and records, failed to follow proper custodial procedures, and failed to file certain required reports with the SEC. With the fund's

consent, the U.S. District Court for the Northern District of Illinois enjoined sales, redemptions, and repurchases of fund shares, froze fund assets, and enjoined the destruction of books and records. Also with the fund's consent, the court appointed a receiver for the fund. Among other things, the court directed the receiver to assume management responsibility for the fund, collect and distribute payments as necessary, pursue alternatives for the constitution, operation, and management of the fund, and submit such alternatives to the fund's shareholders. *See SEC v. Municipal Lease Sec. Fund, Inc.*, SEC Lit. Rel. No. 12,331, 45 S.E.C. Docket 256, 1989 WL 992928 (Dec. 26, 1989).

9. *Steadman Funds* (1989) — After an SEC investigation of the Steadman Funds, a mutual fund group comprised of five registered investment companies, the SEC raised with the trustees of the funds issues concerning undisclosed liabilities relating to the funds' failure to register their shares under the state blue sky laws in the various states in which they were offered and sold. The trustees thereafter, on two separate occasions, resolved to liquidate the funds, but Charles W. Steadman, the president and chairman of both the funds and their investment advisor, refused to comply. *See SEC v. Steadman*, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989). The trustees then petitioned the SEC to allow the funds to suspend fund redemptions under Section 22(e)(3), which petition the SEC granted. *See In re Steadman Financial Fund*, SEC Rel. No. IC-16958, 43 S.E.C. Docket 1416, 1989 SEC Lexis 888 (May 16, 1989). The SEC thereafter filed a complaint seeking preliminary and permanent injunctions against the funds, their advisor and Steadman. The SEC also sought the appointment of a receiver for the funds. The SEC alleged that the funds incurred material liabilities by failing to register their securities in the states in which their shares were offered and sold. The funds did not include those liabilities when calculating their current NAVs. The SEC also alleged that the defendants misled fund investors about the implications for those investors stemming from the failure to register fund shares with the various states. The SEC also alleged violations by the advisor and the individual defendant relating to the custody of fund monies, the provision of investment advice without the approval of fund trustees, and the filing of required reports and registration forms. Specifically, the SEC alleged violations of: (a) the antifraud provisions of the Securities Act, Exchange Act, the ICA, and the IAA; (b) Section 17A(d)(1) of the Exchange Act and Rule 17Ad-13 thereunder; (c) Section 15(a) of the ICA; (d) Section 22(c) of the ICA and

Rule 22c-1 thereunder; and (e) Section 204 of the IAA and Rule 204-1(a) thereunder. *See* SEC v. Steadman, SEC Lit. Rel. No. 12,167, 44 S.E.C. Docket 45, 1989 SEC Lexis 1362 (July 17, 1989). Apparently, during settlement talks, the SEC dropped its request for a receiver, but pursued its request for injunctive relief. The U.S. District Court for the District of Columbia granted the SEC's request for injunctive relief, only to have the Court of Appeals for the District of Columbia vacate the injunction. *See* SEC v. Steadman, 798 F. Supp. 733 (D.D.C. 1991), *vacated in part, aff'd in part*, 967 F.2d 636 (D.C. Cir. 1992).

10. *The Fundpack, Inc.* (1979) — The SEC filed a complaint against six corporate defendants (including Fundpack and two other open-end investment companies) and twelve individual defendants seeking a permanent injunction against them. It also sought an order appointing a trustee “to take possession of, administer and dispose of the assets of, the Funds subject to the Court’s supervision.” SEC v. Fundpack, Inc., SEC Lit. Rel. No. 8698, 17 S.E.C. Docket 73, 74, 1979 SEC Lexis 1927 (Mar. 22, 1979). The SEC alleged violations of the antifraud and registration provisions of the Securities Act, the antifraud provisions of the Exchange Act, and the IAA, and the antifraud, reporting, proxy, fiduciary obligation, and investment restriction provisions of the ICA. Specifically, the SEC detailed how Fundpack’s advisor, Fundpack Management, Inc. (“Management”), implemented “switching,” whereby an investor in the funds could transfer his investment into or out of Fundpack or the other funds with a telephone call. Switching resulted in excessive borrowing costs, high transaction costs, and investment losses due to the use of leverage in declining markets. The SEC alleged that the incurrence of switching costs evidenced self-dealing by Management. None of these costs were disclosed in the funds’ registration statements, prospectuses, and proxies. In addition to the nondisclosures, the SEC alleged that Fundpack failed to disclose the lapse of its advisory contract with Management and that all the funds failed to disclose the cancellation of their fidelity bond. Finally, the SEC claimed that Fundpack’s directors breached their fiduciary duty involving misconduct by acquiescing in Management’s conduct and by renewing Management’s contract in disregard of Fundpack and its shareholders. The directors also failed to conduct inquiries and evaluate the switching program and self-dealing transactions by Management. *Id.* The U.S. District Court for the District of Columbia essentially agreed with the SEC, particularly noting that the material omissions in proxy materials resulted in a violation of Section

20(a) of the ICA. The court therefore exercised its equitable power to void the proxies solicited and the election of the new board of directors. The court noted its power to appoint a receiver under Section 42(e) of the ICA, but stopped short of completely granting the SEC's request in this regard. Rather, the court believed it could appoint, and it thereafter did appoint, a "special master" whose powers did not extend to the plenary powers of a full receiver. The court directed the special master to supervise the sending out of new proxy materials, the election of a new board of directors for each fund, and the consideration by the shareholders and new board of each fund of renewing Management's advisory contract with that fund in view of what had transpired. *See SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951, 1979 WL 1238 (D.D.C. Aug. 10, 1979). Notwithstanding the court's initial order, it issued a subsequent order on September 29, 1979 that, in many ways, superseded its previous order. In particular, a "special counsel"—James W. Beasley, Esq.—rather than a special master was appointed. The new order gave the special counsel much broader powers than had been granted to the special master. Moreover, that order placed four specified individuals onto each of the boards until an election of directors could be held. The order further required that when that election was held, each fund recommend those specific individuals to shareholders. Finally, the new order required that each board have not less than eighty percent independent directors for at least a year after the election. *See SEC v. Fundpack, Inc.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,125, 1979 U.S. Dist. Lexis 9440 (D.D.C. 1979).

11. *Florida Bank Fund, Inc.* (1978) — The SEC sought a preliminary injunction against the fund, its investment advisor, and certain individual defendants and the appointment of a receiver for the fund. The SEC alleged that the fund violated: (a) Section 17(g) of the ICA and Rule 17g-1 thereunder for failing to maintain a proper fidelity bond; (b) Section 22(c) of the ICA and Rule 22c-1 thereunder for redeeming shares at an improperly computed NAV; (c) Section 34(b) of the ICA in that its annual report contained untrue statements; (d) Section 30(a) of the ICA and Rule 30a-1 thereunder for failing to file annual reports with the SEC; (e) Section 30(d) of the ICA and Rule 30d-1 thereunder for failing to transmit annual and semiannual reports to shareholders; and (f) Section 31(a) of the ICA and Rule 31a-1 thereunder for failing to maintain records properly. The SEC also claimed that the advisor violated: (i) Section 15(a) of the ICA because it acted as an advisor when its contract was not properly

approved; (ii) Section 17(a)(3) of the ICA because it engaged in improper affiliate transactions; (iii) Section 48(b) of the ICA in that, as manager, the advisor hindered and delayed the fund from filing its annual reports; and (iv) the antifraud provisions of the IAA. *See* SEC v. Florida Bank Fund, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. ¶ 96,707, 1978 U.S. Dist. Lexis 15237 (M.D. Fla. 1978). The U.S. District Court for the Middle District of Florida granted the requested injunctive relief and the request for a receiver, noting that the fund “has no functioning board of directors . . . [and] having no board [the fund] is unable to execute its duties to shareholders and its obligations under the [ICA] and rules promulgated thereunder.” *Id.* at *11. The court appointed Frank N. Fleischer, Esq. of Schiffino & Fleischer as receiver “of all assets and property of, and owned beneficially by, [the fund], and all assets or property which [the fund] has in its custody or control.” *Id.* at *16. He was authorized to take custody of all books and records of the fund, ascertain the true state of affairs of the fund, marshal, collect, and take charge of all such assets, prosecute all claims, and, upon application of the court in accordance with the following sentence, liquidate the estate of the fund and pay all just claims. He was to prepare and file a report with the SEC and the court containing the results of his investigation and recommendations as to what action may be appropriate, including but not limited to liquidation of the fund, subject to court approval. He was also to act “in the capacity of an equity Receiver, as may be appropriate in the circumstances.” *Id.* at *18. The court also effectively froze the fund’s assets by prohibiting the fund advisor, and any affiliated parties from transferring, selling, assigning, etc. any assets of the fund. *Id.*

12. *All American Fund, Inc.* (1975) — The SEC filed a complaint against the fund, its advisor, the advisor’s parent corporation, and three individual defendants who were officers and directors of the parent and directors of the fund. The SEC’s complaint alleged that certain defendants had failed and refused to cause the advisor to pay monies owed by the advisor to the fund. Because the advisor appeared to be unable to pay the amounts owing, the fund’s shares had been improperly and fraudulently valued. The SEC also alleged that the fund had distributed false and misleading proxy material to its shareholders and that more than sixty percent of the fund’s directors were interested persons. The SEC’s complaint sought the appointment of a receiver for the fund. *See* SEC v. Zenith Am. Mgmt. Serv., Ltd., SEC Lit. Rel. No. 6650, 5 S.E.C. Docket 798, 1974 SEC Lexis 2080 (Dec. 24, 1974). The U.S. District Court for the Central District of

California appointed Murray L. Simpson, Esq. as receiver of the fund, and the defendants consented to the appointment. The court ordered the receiver to take charge of the assets of the fund, make a full investigation into possible claims on behalf of the fund, obtain an interim investment advisor, and make a determination as to the final disposition of the fund. *See SEC v. All Am. Fund, Inc.*, SEC Lit. Rel. No. 6836, 6 S.E.C. Docket 709, 1975 SEC Lexis 1824 (Apr. 15, 1975).

13. *American Institute Counselors, Inc.* (1975) — The SEC sought injunctive and other ancillary relief against a constellation of defendant corporations (referred to as the “Progress Group,” of which American Institute Counselors, Inc. (“AIC”) was one) and certain individual defendants. The SEC alleged that the defendants engaged in a fraudulent scheme and course of business by distributing numerous types of unregistered gold-related securities “in near total disregard for, and in violation of virtually the entire panoply of federal securities laws.” *SEC v. Am. Inst. of Counselors*, SEC Lit. Rel. No. 7183, 8 S.E.C. Docket 587, 1975 WL 160733 (Nov. 25, 1975). Specifically, certain defendants acted as investment advisors, investment companies, and broker-dealers without registering with the SEC in violation of the registration provisions of the IAA, ICA, and Exchange Act. Certain defendants also engaged in transactions with affiliates in violation of the IAA and ICA and failed to make and keep certain books and records required of registrants under the IAA, ICA, and Exchange Act. Two defendants, AIC and American Institute of Economic Research (“AIER”), consented to the entry of permanent injunctions enjoining them from violations of the antifraud and registration provisions of the Securities Act, the antifraud and broker-dealer registration requirements of the Exchange Act, the registration requirements of the ICA, and the registration, reporting, and antifraud provisions of the IAA. Additionally, the U.S. District Court for the District of Columbia ordered certain ancillary relief including, among other things: (a) the appointment of new independent trustees to the boards and executive committees of AIC and AIER, and (b) the appointment of a special auditor and a special counsel. The court gave the special auditor and special counsel certain prescribed duties and responsibilities, including ensuring fair and equitable treatment to investors and taking control of, the accounting for, and the preserving of, the funds, securities, and other assets of the investors. The court also ordered certain defendants to comply with the registration requirements of the Exchange Act, IAA, and ICA. *See id.* In granting ancillary relief, the court relied, in part, on Section 42(e) (now

(d)) of the ICA that specifically allows the court to appoint a trustee in connection with violations of Section 7 of the ICA. *See SEC v. Am. Inst. Counselors, Inc.*, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,388, 1975 WL 440, at *20 (D.D.C. Dec. 30, 1975).

14. *Financial Fund, Inc.* (1974) — The SEC filed a complaint against the fund seeking an injunction to prevent further violations of the ICA and the appointment of a receiver to take control of the fund, manage and preserve its assets, render an accounting to the court, and recommend action. The SEC's complaint alleged that, among other things, the fund: (a) had a board comprised of more than sixty percent "interested persons"; (b) deviated from its investment policy without proper authorization; (c) suspended the right of investors to redeem their shares; and (d) failed to make accurate and timely reports to investors or to file those reports with the SEC. *See SEC v. Financial Fund, Inc.*, SEC Lit. Rel. No. 6359, 4 S.E.C. Docket 293, 1974 SEC Lexis 3241 (May 8, 1974). The fund did not contest the SEC's requested relief. The U.S. District Court for the Western District of Washington appointed Lloyd Shorett as receiver on May 24, 1974. *See SEC v. Financial Fund, Inc.*, SEC Lit. Rel. No. 6383, 4 S.E.C. Docket 413, 1974 SEC Lexis 3173 (June 4, 1974). The court issued an order of permanent injunctive relief on July 12, 1974. *See SEC v. Financial Fund, Inc.*, SEC Lit. Rel. No. 6442, 4 S.E.C. Docket 621, 1974 SEC Lexis 2955 (July 19, 1974).
15. *Fundamatic Investors, Inc.* (1972) — The SEC sought preliminary and final injunctive relief against the fund as well as the appointment of a "receiver and trustee." *See SEC Lit. Rel. No. 5595*, 1972 SEC Lexis 1862 (Oct. 31, 1972). The SEC's complaint alleged that the fund: (a) violated Section 22(c) of the ICA and Rule 22c-1 thereunder by (i) not keeping current the books and records necessary to compute an accurate NAV, (ii) failing to have a functioning board of directors to value its portfolio securities, (iii) using the NAV computed as of the wrong day in effecting shareholder redemptions, and (iv) redeeming shares at prices other than those based on current NAV; (b) violated Section 22(e) of the ICA in that it failed to pay redemptions within seven days of receipt of redemption requests; (c) violated Sections 30(a) and (d) of the ICA and Rules 30a-1 and 30d-1 thereunder by failing to file with the SEC and transmit to its shareholders its annual report; and (d) failed to keep current certain books and records in violation of Section 31(a) of the ICA and Rule 31a-1 thereunder. *See id.* The U.S. District Court for the Southern District of

New York appointed Sidney R. Pine, Esq. as receiver and trustee of the fund's books, records, and assets on November 10, 1972. *See* SEC Lit. Rel. No. 5628, 1972 SEC Lexis 1893 (Nov. 13, 1972). The receiver/trustee then sought, and obtained, SEC approval to suspend share redemptions by the fund pursuant to Section 22(e)(3) of the ICA. *See In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-7742, 1 S.E.C. Docket 18, 1973 SEC Lexis 1707 (Mar. 28, 1973). The receiver/trustee ultimately submitted a plan of liquidation to the court, which the court approved on October 5, 1973. *See In re Fundamatic Investors, Inc.*, SEC Rel. No. IC-8143, 3 S.E.C. Docket 271, 1973 SEC Lexis 66 (Dec. 19, 1973).

16. *Financial Trends Mutual Fund, Inc.* (1972) — The SEC sought injunctive relief against the fund, its advisor, and various individual defendants (including Robert A. Schilleman, the president of the fund and the advisor) and the appointment of a receiver for the fund. The SEC alleged the fund's NAV was not being computed daily, the fund was not redeeming its shares, and the fund's books and records were not being maintained and kept current. Also, certain individual defendants were serving as fund directors without having been elected by fund shareholders. Certain defendants were also acting as an officer, director, or investment advisor while subject to a court order enjoining them from engaging in certain transactions involving the purchase and sale of securities. Certain defendants also were engaging in breaches of fiduciary duty involving personal misconduct and converting fund property to their own use. The U.S. District Court for the Central District of California appointed Kevin O. Lewand as receiver pendente lite for the fund on February 25, 1972, which appointment was unopposed by defendants. The court ordered the receiver to take charge of the properties, assets, and records of the fund. *See* SEC Lit. Rel. No. 5341, 1972 SEC Lexis 1609 (Feb. 28, 1972). It was determined later that the management contract between the fund and the advisor had not become effective because that contract had not been properly approved by fund shareholders. *See In re Carob Sec., Inc. and Robert A. Schilleman*, SEC Admin. Proceedings 3-4980 & 8-20294, 1976 SEC Lexis 2774 (Aug. 30, 1976).
17. *Technical Fund, Inc.* (1972) — The SEC filed a complaint against the fund, its president, one of its directors, an alleged undisclosed principal of the underwriter and advisor, and counsel for the fund. The SEC sought injunctive relief against the defendants and the appointment of a receiver for the fund. Its complaint alleged, among other things, that the

defendants violated the ICA by filing false and misleading proxy material with the SEC and by engaging in unlawful transactions between the fund and affiliated persons. The SEC further alleged that the director and president were guilty of gross abuse of trust by engaging in practices constituting a breach of fiduciary duty in respect of the fund and that the management contract had not been approved by a majority of the fund's shareholders. The SEC also accused the defendants of violating the antifraud provisions of the Exchange Act. *See* SEC Lit. Rel. No. 5408, 1972 SEC Lexis 1676 (May 25, 1972). The U.S. District Court for the District of Massachusetts appointed Ronald F. Kehoe as receiver on May 26, 1972. *See* SEC Lit. Rel. No. 5409, 1972 SEC Lexis 1677 (May 26, 1972). Although not part of the SEC's complaint, the receiver discovered after his appointment that the fund was not accurately computing NAV. As a result, the receiver suspended the redemption of the fund's shares. *See In re* Technical Fund Inv. Plans, SEC Rel. No. IC-7393, 1972 SEC Lexis 1388 (Sept. 27, 1972).

18. *Shamrock Fund* (1972) — The fund held significant amounts of restricted securities. Because the independent directors' frequent requests for information concerning the fund's portfolio securities were "systematically denied," they (and through them, the fund) asserted there was not enough information to value the fund's assets properly. *See In re* Shamrock Fund, SEC Rel. No. IC-7044, 1972 SEC Lexis 1224 (Mar. 7, 1972). An emergency thus existed under Section 22(e)(2) and (3) of the ICA, and the fund petitioned the SEC for an order pursuant to Section 22(e)(3) to suspend share redemption privileges. *See id.* Thereafter, on the SEC's motion, the U.S. District Court for the Central District of California entered a temporary restraining order enjoining the fund from failing to redeem its redeemable shares in violation of Section 22(e) and from selling its redeemable shares to the public at prices other than the current offering price in the prospectus in violation of Section 22(d). The court also appointed Harry L. Nelson, Jr. as receiver pendente lite on March 21, 1972. The court empowered him to take charge of the assets and records of the fund for safekeeping. He also was to perform the duties of the board, suspend repurchase and redemption of redeemable shares, and obtain shareholder approval for a new investment advisor, merge the fund into another, or liquidate it. *See* SEC Lit. Rel. 5362, 1972 SEC Lexis 1630 (Mar. 21, 1972). As detailed in many subsequent proceedings, the officers of the fund's advisor had caused the fund to purchase certain securities for

which they or the advisor received kickbacks. *See, e.g., United States v. Brashier*, 548 F.2d 1315 (9th Cir. 1976).

19. *Advance Growth Capital Corporation* (1972) — The SEC sought a permanent injunction against the corporation and its chairman and president. It also sought the appointment of a receiver for the corporation. The SEC alleged that the defendants had engaged in unlawful affiliated transactions and filed annual reports with the SEC that omitted discussion of those transactions. It further alleged that the two individual defendants had engaged in a gross abuse of trust within the meaning of Section 36 of the ICA. The U.S. District Court for the Northern District of Illinois, in an unpublished opinion referred to in the appellate opinion, refused to grant injunctive relief on the basis that the individual defendants had not engaged in intentional misconduct, and that in any event the corporation had not been harmed. The Seventh Circuit Court of Appeals disagreed and issued a permanent injunction against the defendants. The district court had also refused to grant the SEC's request for a receiver, because although the two individual defendants had engaged in acts that could be criticized, they had done much good for the corporation by turning it around financially. In the appellate opinion, the district court is quoted as stating that "[i]t would be more than a disservice to [the corporation], its stockholders and creditors, it would be a disaster to them for this court to appoint a Receiver . . . after [the two defendants] had rescued [the corporation] from bankruptcy in 1964, and saved it from dissolution in 1965 and 1966, and have since that time restored most of the capital that was dissipated in the 1962 binge of the officers and directors." The Seventh Circuit, "[w]eighing all the equities," held that "it is probable that removal of the defendants and appointment of a receiver would be more detrimental than beneficial to the investment company and its shareholders, and, as Section 36(a) expressly recognizes, the ultimate benefit of these parties is the primary objective of the Act." It added, however, that "[w]hether the defendants are barred under the provisions of § 9(a)(2) . . . from serving in their present capacity or any other capacity with [the corporation] absent exemption under § 9(c) . . . is an administrative matter within the provisions of the Commission as to which we express no opinion . . ." *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 54, 55 (7th Cir. 1972).
20. *B.S.F. Company* (1968) — This was a derivative action by a shareholder requesting the appointment of a receiver pendente lite for the company. In

granting the request, the U.S. District Court for the District of Delaware relied on: (1) defendants' gross and deliberate fraud, (2) the company's non-compliance with Section 29 of the ICA by failing to file an annual report with the SEC, (3) omissions in materials defendants submitted to the court, and (4) misleading information in the company's 1967 annual report to stockholders. The court noted that "the interest of the stockholders of B.S.F. Company is not only unrepresented but, in fact, is imperiled by present management's apparent disregard for its fiduciary responsibilities." *Tanzer v. Huffines*, 287 F. Supp. 273, 277 (D. Del. 1968), *aff'd*, 408 F.2d 42 (3d Cir. 1969). Defendants used the company's assets to purchase controlling stakes in operating companies. Defendants used these stakes to have themselves appointed directors and officers of those operating companies, receiving large salaries and other perquisites there-after. 287 F. Supp. at 274. Defendants appealed the case to the Third Circuit Court of Appeals, and the SEC filed an amicus curiae brief requesting the Third Circuit to uphold the district court's appointment of a receiver pendente lite for the company. The Third Circuit held that the district court did not abuse its discretion by appointing a receiver pendente lite. *See* 408 F.2d at 42.

21. *Fifth Ave. Coach Lines, Inc.* (1968) — The SEC sought injunctive relief against the corporation and other individual defendants and the appointment of a receiver for the corporation. It alleged that the corporation was an unregistered investment company and that, prior to the time the corporation needed to register, the individual defendants had engaged in self-dealing and prohibited transactions with affiliates. Therefore, the SEC argued that because these individual defendants were still in control of the corporation, they were likely to engage in violations of the ICA now that the corporation fell within the definition of "investment company" under the ICA. The U.S. District Court for the Southern District of New York held that the SEC was entitled to injunctive relief against the corporation and the individual defendants. Pursuant to Section 42(e) [now (d)] of the ICA, the court appointed a receiver for the corporation because it required "strong independent management to lead the company out of its difficulties, to clean up the past and to prepare for the future. . . . [T]here is no need for liquidation of [the corporation.] The need is for constructive management." *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3, 42 (S.D.N.Y. 1968). The court further stated that it could not take a chance on allowing the one individual defendant (Bolan) to whom the injunction did not run to continue operating the company,

because “[i]t is the court’s best judgment that the situation demands the appointment of a wholly disinterested officer of the court to administer [the corporation], to prosecute its action against Krock [a director and control person], to investigate and ascertain whether there are other actions that can be maintained.” *Id.* The court found that Bolan was too closely tied to the other individual defendants to be allowed to run the corporation. *See id.* The court appointed S. Hazard Gillespie, Esq. as trustee-receiver on August 12, 1968. *See In re Fifth Ave. Coach Lines, Inc.*, SEC Rel. No. IC-5667, 1969 WL 95187 (Apr. 29, 1969).

22. *Midland Basic, Inc.* (1968) — The SEC sought a permanent injunction against the company and certain individual defendants and the appointment of a receiver for the company. The SEC alleged that the individual defendants had engaged in self-dealing and other fraudulent acts in violation of the Securities Act and the Exchange Act, and that the company had failed to register as an investment company under the ICA. (By the time the court proceedings began, however, the company had registered under the ICA in order to placate the SEC.) The U.S. District Court for the District of South Dakota permanently enjoined the individual defendants and disqualified them from serving as officers and directors of the company pursuant to Section 9(a) of the ICA. With respect to the SEC’s request for a receiver, the court noted that the only statutory provision authorizing the appointment of a receiver is Section 42(e) (now (d)) of the ICA. While that section was not implicated in the case at bar because the company had registered prior to the court proceeding, the court nevertheless held that it had inherent equitable power to appoint a trustee-receiver upon a prima facie showing of fraud and mismanagement. Because that showing was made, the court appointed a receiver to take control of all records, claims, and assets of the company for the protection of its stockholders who had been made the subject of defendants’ fraudulent scheme. *See SEC v. Midland Basic, Inc.*, 283 F. Supp. 609 (D.S.D. 1968).
23. *S & P Nat’l Corp.* (1966) — This case involved S & P National Corp., a publicly-traded corporation which in turn controlled two other corporate defendants. The SEC sought injunctive relief against the three corporate defendants and a trustee for all three. The SEC alleged that all three corporate defendants had been unregistered investment companies for many years, yet had been selling and buying securities in violation of Section 7(a) of the ICA. In addition, the SEC alleged that S & P had been

abandoned by its board of directors and filed false annual reports in violation of the Exchange Act. The U.S. District Court for the Southern District of New York enjoined the defendants from selling or acquiring securities or engaging in business in interstate commerce. Pursuant to Section 42(e) (now (d)) of the ICA and the court's inherent equitable powers, it also appointed Leslie Kirsch as trustee for all three corporations. The court noted that the recent appointment of directors and officers by those in control of S & P was done for the purpose of avoiding a trustee, and that such "revival" is not sufficient to defeat the court's statutory or equity power. The court order empowered the trustee to: (a) take possession and maintain books, records, and assets of the corporate defendants, wherever located; (b) ascertain the true state of affairs of the corporate defendants and report thereon to the court and shareholders of S & P; (c) determine what persons are and have been directors, parents, and controlling persons of S & P; and (d) cause the corporate defendants to comply with applicable provisions of the ICA and Exchange Act. *See SEC v. S & P Nat'l Corp.*, 265 F. Supp. 993 (S.D.N.Y.), *aff'd*, 360 F.2d 741 (2d Cir. 1966). The Second Circuit Court of Appeals held that the lower court's appointment of a receiver was not an abuse of discretion where long-continuing violations of the Exchange Act and ICA had been prima facie established, no shareholder meetings had been held for eleven years, two hasty attempts to dissolve the corporations after the SEC filed suit occurred, the corporations conducted no substantial business except for holding securities, and there was an absence of corporate management. The Second Circuit noted that "the primary purpose of the appointment was promptly to install a responsible officer of the court who could bring the companies into compliance with the law, 'ascertain the true state of affairs . . . and report thereon' to the court and public shareholders and preserve the corporate assets." 360 F.2d at 750-51 (citation omitted).

24. *Puerto Rico Capital Corp.* (1965) — The SEC sought injunctive relief against three individual defendants and the fund, which was a nominal defendant but not charged with any violations of the securities laws. The SEC alleged that the individual defendants: (a) caused the fund to invest in companies owned and controlled by two of them in violation of Sections 17(a) and (d) and 37 of the ICA; (b) made false and misleading statements in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 34(b) of the ICA; and (c) solicited proxies and filed reports that were false and misleading in violation of Section 20(a) of the ICA. *See SEC Lit. Rel. No. 3308*, 1965 SEC Lexis 65 (Sept. 1, 1965).

Although the SEC's litigation release does not mention a request for a receiver, subsequent proceedings indicate that the SEC's complaint did, in fact, request relief other than injunctive relief. The U.S. District Court for the District of Puerto Rico appointed Miguel Gonzalez as receiver for the fund on November 10, 1965. *See SEC v. Wong*, 42 F.R.D. 599 (D.P.R. 1967); *SEC v. Wong*, 252 F. Supp. 608, 610-11 (D.P.R. 1966).

25. *Continental Growth Fund, Inc.* (1963) — The SEC filed a complaint against the fund and its officers and directors seeking, among other things, to enjoin the defendants from continuing to act as officers and directors and to appoint a receiver for the fund's assets. The SEC's complaint alleged that: (a) Richard Jacobs, a director and president of the fund, embezzled money from the fund by causing the custodial bank to disburse monies for sham stock purchases by the fund; (b) Jacobs caused the fund to deviate from its stated investment policy; (c) directors and officers permitted the fund to operate for more than a year without a fidelity insurance bond to indemnify the fund against larceny and embezzlement; (d) directors and named officers permitted the fund to operate without necessary books and records; (e) Jacobs and the fund's treasurer permitted the fund to compute improperly the NAV of the fund's shares; (f) the directors and officers caused the fund to file financial statements certified by accountants who had not been approved by fund shareholders; (g) the directors caused the fund to enter into advisory and underwriting agreements without the requisite shareholder and director approvals; (h) the custodial bank (also a defendant) failed to maintain records which accurately set forth the fund's assets; and (i) Jacobs illegally sold securities to the fund as a principal. The U.S. District Court for the Southern District of New York immediately froze the fund's assets pending a hearing on the SEC's application for a preliminary injunction and receiver. *See SEC Lit. Rel. No. 2699*, 1963 SEC Lexis 1020 (July 30, 1963). The court appointed Leon Leighton as receiver on August 9, 1963. *See In re Continental Growth Fund, Inc.*, SEC Rel. No. IC-5564, 1962 SEC Lexis 882 (Dec. 28, 1962). According to the "Order Appointing Receiver of Cont'l Growth Fund, Inc., *SEC v. Continental Growth Fund, Inc.*," No. 63 Civil 2252 (S.D.N.Y. Aug. 9, 1963), the court directed the receiver to "take possession of all the assets and properties belonging or in the possession of the Fund . . . and to operate the business and manage the property of the Fund" *SEC v. Continental Growth Fund, Inc.*, [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,437 (S.D.N.Y. 1964), 1964 U.S. Dist. Lexis 8890, at *7. The related case of *SEC v. Continental Growth*

Fund, Inc., [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,437 (S.D.N.Y. 1964), 1964 U.S. Dist. LEXIS 8890, states that J. Dudley Devine, a fund director, caused in part the fund to experience losses through his gross misconduct. He permitted Richard Jacobs to maintain sole control over the operations of the fund, and thus was inattentive, neglectful, and failed to recognize and perform his fiduciary duties as director in a way which facilitated Jacobs' misconduct and gross abuse of trust. See SEC Lit. Rel. No. 3568, 1966 SEC Lexis 41 (Aug. 19, 1966).

26. *Keller Corp.* (1962) — The SEC sought injunctive relief against the corporation, certain individual defendants, and a securities corporation controlled by those individuals. It also sought a trustee and receiver for the corporation. The SEC alleged that: (a) the corporation was an unregistered investment company in violation of Section 7 of the ICA; (b) certain individual defendants had attempted fraudulently to induce prospective investors to purchase the corporation's stock based on misleading or false information; and (c) the one dividend that was paid by the corporation consisted of a return of capital that was not disclosed properly. The U.S. District Court for the Southern District of Indiana issued a preliminary injunction pursuant to the Securities Act and ICA. It also appointed Edward D. Lewis as "trustee and receiver of all records, claims and assets of The Keller Corporation pursuant to Section 42(e) [now (d)] of the [ICA.]" SEC Lit. Rel. No. 2468, 1962 SEC Lexis 882 (Dec. 28, 1962). The trustee-receiver was necessary because the defendants had committed fraud against shareholders and thus should not be left in charge. See *SEC v. Keller Corp.*, 323 F.2d 397 (7th Cir. 1963).
27. *Aldred Investment Trust* (1945) — The SEC sought injunctive relief against the trust and certain individual defendants and the appointment of a receiver for the trust. The SEC alleged that the individual defendants, as officers or trustees of the trust, engaged in gross misconduct or gross abuse of trust withing the meaning of Section 36 of the ICA. One defendant had obtained voting control over the trust, ousted the existing board, and appointed his relatives, employees, or close personal friends as trustees. The individual defendants then paid themselves salaries higher than those previously paid to the officers and trustees. They also violated the stated investment policy of the trust by pursuing, and acquiring, control of a horse racing track. The SEC alleged that the individual defendants were motivated by self-interest and failed to disclose what they were doing to securityholders. The U.S. District Court for the District of Massachusetts

enjoined all the individual defendants except one who had become a trustee much later on from serving or acting in the capacity of trustee or as an officer of the trust. It also appointed a receiver with the power to either reorganize the capital structure of the trust or liquidate the trust and distribute the assets to the creditors, debentureholders, and shareholders of the trust. *See SEC v. Aldred Inv. Trust*, 58 F. Supp. 724 (D. Mass.), *aff'd*, 151 F.2d 254 (1st Cir. 1945). On appeal, the First Circuit Court of Appeals agreed that the individual defendants had engaged in a gross abuse of trust in violation of Section 36 of the ICA and affirmed the injunction and the receivership. With respect to the receivership, it held that "Section 36 invokes the equity power of the Federal Court and that calls into play its inherent powers where necessary to do justice and grant full relief. The appointment of receivers in the case at bar was an appropriate exercise of the court's inherent equity power." *Aldred Inv. Trust v. SEC*, 151 F.2d 254, 261 (1st Cir. 1945).

28. *Fiscal Fund, Inc.* (1943) — The SEC sought a temporary restraining order against the fund and a temporary receiver for the fund. The SEC alleged that: (a) the fund failed to redeem its shares in violation of Section 22(e) of the ICA; (b) the fund failed to file quarterly reports with the SEC in violation of Section 30(b)(1) of the ICA; (c) the fund failed to send semiannual reports to shareholders in violation of Section 30(d) of the ICA; (d) the board of directors had abandoned the fund as four of the five directors had resigned and the fifth was out of the country serving in the army; and (e) two new directors appointed by the board had not been properly elected by the shareholders in violation of Section 16(a) of the ICA. The U.S. District Court for the District of Delaware enjoined the fund with respect to its Section 22(e) violation, noting that the fund's "most crucial violation of the [ICA] has been Sec[tion] 22(e)." *SEC v. Fiscal Fund, Inc.*, 48 F. Supp. 712, 713 (D. Del. 1943). The court also noted that "the violation of which gives the Commission its greatest concern is Section 22(e)." *Id.* at 714. In addition to enjoining the fund with respect to its violation of Section 22(e), the court appointed a receiver because the fund "has no functioning management" and, given the court's desire to enforce compliance with Section 22(e), "there is no one to whom my injunction can effectively run." *Id.* at 714. (In this regard, the SEC labeled the fund as an "orphan" investment company. *See SEC Rel. No. IC-505*, 1943 WL 30350 (Jun. 4, 1943)). Importantly, the court considered whether the fund, which was solvent, should be revived by appointing a new board of directors or whether it should be liquidated.

The court held that evidence suggested that the paltry management fee was not sufficient to attract a new advisor (as the SEC had tried), and that if the fee were raised in light of the fund's meager income, shareholders would redeem in droves. It therefore ordered the receiver to liquidate the fund, stating "[t]here is a well-established power in the Federal Court sitting as a court of equity to order liquidation of a solvent corporation where there is no other course available to remedy a situation which is inequitable to the stockholders. . . . This power is an obvious corollary of the proposition that once a court of equity has taken jurisdiction it may and should retain jurisdiction to complete justice." 48 F. Supp. at 715. Note that this was the first case in which the SEC requested, and a district court granted, a permanent receiver to liquidate a solvent investment company. It was also the first time the SEC obtained a permanent injunction against a fund for failing to redeem its outstanding shares, furnish semiannual reports to shareholders, or file quarterly reports with the SEC. *See* SEC Rel. No. IC-434, 1943 WL 30294 (Jan. 19, 1943).