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When Is a Mutual Fund Director Independent? The Unexplored Role of Professional Relationships Under Section 2(a)(19) of the Investment Company Act

Larry D. Barnett*

ABSTRACT:

[An investment company that must register with the Securities and Exchange Commission ("the Commission") is required by the Investment Company Act ("the Act") to have a specified percentage or number of directors who are not "interested" in the company. To be not interested (i.e., to be independent), a director of an investment company is barred by § 2(a)(19) of the Act from inter alia having had, during the last two completed fiscal years of the company, a material business relationship or a material professional relationship with specified parties. The Commission, in interpreting § 2(a)(19), has not clearly distinguished the two types of relationships and has not focused on professional relationships apart from business relationships. The present article contends that this is contrary to the intent of Congress. Accordingly, the article first identifies both the elements of a business relationship and the elements of a professional relationship. Second, three no-action letters are reviewed, in each of which the Commission staff could have found that a proposed arrangement would have created a professional relationship for an investment company director.]

"Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders."¹

I. INTRODUCTION

A scandal in the public sector is not only grist for the mass media; it is also an opportunity to learn about the nature of society. A scandal

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1. *Burks v. Lasker*, 441 U.S. 471, 485 (1979).

affects societal conditions and probably results from them as well,² and is therefore a subject that should be viewed sociologically.³ Indeed, the word “scandal” refers *inter alia* to events that erode confidence in institutions,⁴ making scandals an inherently sociological topic. The misdeeds of corporations such as Enron and WorldCom that became widely recognized during the first half of 2002⁵ have appropriately been labeled a scandal,⁶ as they caused many Americans to doubt the integrity of their financial organizations: the proportion of adults in the United States who expressed “very little confidence” or “no confidence at all” in the “financial industry” almost doubled from 19% in January 2002 to 35% in July 2002. During the same period, the proportion having “a great deal of confidence” in the financial industry declined from 10% to 5%.⁷

Even though scandalous activities undermine the social order, the corporations whose misconduct came to light in 2002 must be viewed against the background of the total number of entities forming the

2. Ari Adut, *A Theory of Scandal: Victorians, Homosexuality, and the Fall of Oscar Wilde*, 111 AM. J. SOC. 213, 213 (2005).

3. In this regard, it is notable that dictionary definitions of scandal include “[a] publicized incident that . . . offends the moral sensibilities of society.” AMERICAN HERITAGE DICTIONARY 1554 (4th ed. 2000) (emphasis added).

4. E.g., J. Curtis Greene, Note, *New Regulations for Lawyers: The SEC’S Final Rule For Professional Conduct in the Wake of Sarbanes-Oxley: Challenges for Foreign Attorneys*, 14 IND. INT’L & COMP. L. REV. 807, 810-815 (2004).

5. John A. Weinberg, *Accounting for Corporate Behavior*, ECON. Q., Summer 2003, at 1. While the 1980s and 1990s witnessed an increase in identifiable instances of misstatements by companies of their financial results, “the events of 2002 represented unprecedented levels of both the number and the size of companies involved.” *Id.* at 18.

6. The application of the concept of scandal to the misconduct of corporations at this time is illustrated by a reviewer of a book that was published in 2005 on “the Enron scandal” who finds in the book “fresh reasons for outrage.” Wendy Zellner, *Inside Enron’s House of Cards*, BUS. WK., March 21, 2005, at 20 (reviewing KURT EICHENWALD, *CONSPIRACY OF FOOLS: A TRUE STORY* (Broadway 2005)). The outrage generated by a scandal is, of course, inconsistent with social stability.

7. See Hart and Teeter Research Companies, Roper Center Public Opinion Online, Dec. 7-10, 2000, available at LEXIS accession no. 0376547 (Public Opinion Location Library or Public Opinion Online database); Hart and Teeter Research Companies, Roper Center Public Opinion Online, Jan.18-21, 2002, available at LEXIS accession no. 0397267 (Public Opinion Location Library or Public Opinion Online database); Hart and Teeter Research Companies, Roper Center Public Opinion Online, July 19-21, 2002, available at LEXIS accession no. 0411854 (Public Opinion Location Library or Public Opinion Online database). The changes in confidence from January 2002 to July 2002 are especially notable because confidence levels were stable between December 2000 and January 2002.

See also 3 OXFORD ENGLISH DICTIONARY 705 (2d ed. 1989). In the context of the question used in the cited surveys, the word “confidence” is “the mental attitude of trusting in or relying on a person or thing; firm trust, reliance, faith” and is thus synonymous with trust.

economy of the United States. Business entities are numerous,⁸ and only a minuscule percentage of them seem to have engaged in activities harmful to society. However, while just a small fraction of entities in the economic sector produce scandals and damage the confidence of present and potential investors in securities markets, the entities that do so attract considerable attention from both the news media and the institution of law. The public focus on offending entities is instructive. Given the relatively limited number of entities that imperil confidence in the economic sector of society, the focus underscores an important sociological principle: that confidence in others is a critical constituent of the social fabric and normally goes unnoticed.⁹

When scandals are absent, why does the public exhibit little or no interest in the subject of confidence in the institutions of society?¹⁰ Fickleness is unlikely to explain the ephemeral nature of a general, conscious focus on such confidence. Instead, the rarity of public concern with confidence in institutions can be explained by the conditions necessary for the existence of sustained social interaction and groups: confidence (*i.e.*, trust) in others is, and must be, generally presumed by the participants in social relationships, and this expectation must generally be fulfilled, because such confidence is a prerequisite to group life and to the economic prosperity that group life makes possible.¹¹

A social system, in short, cannot operate effectively if the trust of its participants in one or more of the institutions of the system is below some minimum level for a protracted period,¹² and for this reason, a social system cannot tolerate a lengthy, substantial decline in trust.

8. An indicator of the number of businesses that exist in the United States in a particular year is the number of federal income tax returns that businesses file with the Internal Revenue Service. In 2001, corporations and partnerships together filed more than seven million returns. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2004-2005 483 tbl. 716 (124th ed. 2004).

9. See J. David Lewis & Andrew Weigert, *Trust as a Social Reality*, 63 SOC. FORCES 967 (1985) (discussing trust as an aspect of social relationships).

10. As used in this article, the word "institution" refers to a general pattern of interpersonal behavior that is found in a society and that is fundamental to the operation of the society. An institution is thus "an established . . . custom, usage, practice . . . or other element in the political or social life of a people; a regulative principle or convention subservient to the needs of an organized community or the general ends of civilization." 7 OXFORD ENGLISH DICTIONARY 1047 (2nd ed. 1989). Collectively, institutions are the building blocks of a society and form its structure.

11. FRANCIS FUKUYAMA, *TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY* 9, 47 (The Free Press 1995).

12. See *Clancy v. Superior Court*, 705 P.2d 347, 351 (Cal. 1985) (explaining that the institution of law cannot contribute to the functioning of society when public confidence in the institution is lacking).

Indeed, research in sociology suggests that scandals have just a short-term impact on trust in institutions.¹³ The impact on trust is brief because if informal mechanisms fail to restore the trust that has been eroded by scandals, the subsystem of society that produces and enforces law will do so. The core purpose of law is to deal with the types of problems in interpersonal relationships that significantly affect the operation of the social order.¹⁴

Unfortunately, the threshold of trust in institutions required for a society to function in a given manner and with a given degree of effectiveness is unknown, and the exact paths by which this trust influences a social system are as yet undetermined, because rigorous social science research on trust is scarce. The dearth of well-designed studies of trust is a result of the general neglect of the subject by sociologists until the 1990s. This neglect, in turn, explains at least partially the absence of sophisticated studies of the role of trust in securities markets. Nonetheless, available research indicates that, in a society, the level of trust is positively correlated with the size and robustness of the financial sector: an increase in trust benefits the financial sector, and a decrease in trust harms it.¹⁵ Because the financial sector in the United States includes *inter alia* securities markets, the variable of trust presumably has a major bearing on the effectiveness of these markets and, hence, on the well-being of the economy. This proposition is explicitly accepted by Congress.¹⁶

Law in general serves the social system in which it exists: law is formulated to meet the needs and endorse the values of society.¹⁷ The

13. See Pamela Paxton, *Is Social Capital Declining in the United States? A Multiple Indicator Assessment*, 105 AM. J. SOC. 88, 117-119 (1999).

14. See *Heyer v. Flaig*, 449 P.2d 161, 164 (Cal. 1969). "Indeed, the early common law posited 'rights and duties upon the relationship of parties within the socio-economic system rather than upon factors, such as consensual agreement, dependent on the will of individual litigants' and such relationship concepts served as the major framework of the legal structure." *Id.*

15. César Calderón *et al.*, *Development and Efficiency of the Financial Sector and Links with Trust: Cross-Country Evidence*, 51 ECON. DEV. & CULTURAL CHANGE 189 (2002); Paul J. Zak & Stephen Knack, *Trust and Growth*, 111 ECON. J. 295, 307-311 (2001). See Diana C. Mutz, *Social Trust and E-Commerce: Experimental Evidence for the Effects of Social Trust on Individuals' Economic Behavior*, 69 PUB. OPINION Q. 393 (2005) (suggesting that there is a causal role for social trust influencing commerce).

16. "The Nation's capital markets play a critical role in our domestic economy by creating jobs and expanding businesses. . . . The success of the U.S. securities markets is largely the result of a high level of investor confidence in the integrity and efficiency of our markets." SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, S. REP. NO. 104-98, at 8 (1st Sess. 1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687 [hereinafter S. REP. NO. 104-98].

17. LARRY D. BARNETT, *LEGAL CONSTRUCT, SOCIAL CONCEPT* (Aldine De Gruyter 1993). See *United States v. Scophony Corp.*, 333 U.S. 795, 820 (1948) (Frankfurter, J., concurring) (noting that "society, economic pressures, [and] philosophic notions," have influenced the law).

Investment Company Act (“Act”),¹⁸ which was adopted in 1940¹⁹ and is the focus of the present article, is illustrative. Congress, recognizing the potential of investment companies to contribute to economic growth in the United States,²⁰ sought explicitly through the Act to raise the level of confidence that could be placed in investment companies by investors, especially those having relatively small amounts of money to buy securities.²¹ The legislation, in moving to restore and maintain the trust of Americans generally in the financial institution of their society,²² would have concomitantly served to improve the reputation of that institution. It did so in part by creating a set of rules for the behavior of investment companies, including rules for these companies to follow in structuring themselves internally and in part by symbolizing important social values, especially fairness.²³ Thus, just as anti-virus and firewall software works with only occasional notice to protect the integrity of a computer, the Act similarly operates to promote the integrity of the social system. Specifically, the Act eliminates a basis for persistent public doubts regarding whether investment companies in the United States treat their investors fairly.²⁴

The societal function of the Act was illustrated by the scandal that emerged in the latter part of 2003 involving a number of investment companies.²⁵ The negative impact of the scandal on the public image of the mutual fund industry was apparently offset to a large degree by other factors,²⁶ and while these factors cannot be identified with cer-

18. 15 U.S.C. § 80a-1 to -65 (2000 & Supp. II 2002).

19. H.R. 10066, 76th Cong. (3d Sess. 1940) (*codified as amended at* 15 U.S.C. §§ 80a-1 to -65 (2000 & Supp. II 2002)).

20. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 5 (3d Sess. 1940) [hereinafter SENATE REPORT NO. 76-1775].

21. *Id.* at 6, 12. See also *Sec. & Exch. Comm'n v. Alfred Investment Trust*, 58 F. Supp. 724, 732 (D. Mass. 1945), *aff'd*, 151 F.2d 254 (1st Cir. 1945).

22. The Securities Act and Securities Exchange Act had the same underlying purpose as the Investment Company Act. “Congress enacted the 1933 and 1934 Acts to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation.” SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, S. REP. NO. 104-98, at 4 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683.

23. LARRY D. BARNETT, *Social Productivity, Law, and the Regulation of Conflicts of Interests in the Investment Industry*, 3 CARDOZO PUB. L., POL'Y & ETHICS J. 701 (2006).

24. See THURMAN W. ARNOLD, *THE SYMBOLS OF GOVERNMENT* 34-35 (Yale Univ. Press 1935) (discussing that the law serves to comfort society).

25. The activities of the investment companies were first publicized in September 2003. Stan Luxenberg, *Gray Matter*, REGISTERED REP., Sept. 1, 2005, at 27.

26. See Investment Company Institute, *Shareholder Sentiment of the Mutual Fund Industry*, FUNDAMENTALS, Oct. 2004, at 1, 3-4, available at <http://www.ici.org/stats/res/fm-v14n7.pdf> (last visited Feb. 6, 2006).

tainty, the failure of the scandal to have a substantial effect on investors²⁷ is probably attributable in part to a widespread belief in the adequacy of existing legislation applicable to investment companies. An indicator of such a belief is that the Act was not changed legislatively in response to the scandal. The belief is likely to have been supported by a realization that relatively few fund families were implicated in the scandal²⁸ and to have been reinforced by actions taken by the Securities and Exchange Commission. The Commission, as the administrative agency authorized by the Act to regulate investment companies,²⁹ imposed civil sanctions on parties responsible for violations of the Act³⁰ and adopted new rules under the Act.³¹ The sociological function of law need not involve change in statutory provisions but may be manifested in other ways, and in this instance was.³²

By way of summary, in the absence of the Investment Company Act, prolonged and widespread doubts about investment companies would be likely, and these doubts would appreciably reduce the num-

27. Technometrica Institute of Policy & Polling, Roper Center Public Opinion Online, Dec. 1-7, 2003, available at LEXIS accession no. 044175 (Public Opinion Location Library or Public Opinion Online database). In a telephone survey conducted in December 2003 of a sample of adults in the United States, three out of four respondents stated that they had not altered their "mutual fund investment plans" because of "the recent mutual fund scandals"; just one out of eight respondents had shifted into "other types of investments." *Id.*

28. The fund families targeted by the Securities and Exchange Commission are listed in *Fund Families Under Investigation*, MORNINGSTAR FUNDINVESTOR, April 2005, at 17.

29. 15 U.S.C. §§ 80a-37, 80a-41 (2000 & Supp. II 2002).

30. *E.g.*, *In re Janus Capital Mgmt., LLC*, Investment Company Act of 1940 Release No. 26532, available at 2004 SEC LEXIS 1797, at *28 (Aug. 18, 2004); *In re Banc of Am. Capital Mgmt., LLC*, Investment Company Act of 1940 Release No. 26756, available at 2005 SEC LEXIS 291, at *89 (Feb. 9, 2005); *In re Southwest Sec., Inc.*, Investment Company Act of 1940 Release No. 2341, available at 2005 SEC LEXIS 41, at *30-32 (Jan.10, 2005). Sanctions were also imposed on investment advisers under the Investment Advisers Act. *See In re Janus Capital Mgmt., LLC*, Investment Company Act of 1940 Release No. 26532, available at 2004 SEC LEXIS 1797, at *28 (Aug. 18, 2004) (requiring investment company to cease and desist from committing violations of the Advisers Act and Investment Company Act); *In re Banc of Am. Capital Mgmt., LLC*, Investment Company Act of 1940 Release No. 26756, available at 2005 SEC LEXIS 291, at *89 (Feb. 9, 2005) (Commission censured Bank of America under the Advisers Act and required that they cease and desist from violating various securities laws).

31. *See Investment Company Governance*, 69 Fed. Reg. 46378 (Aug. 2, 2004) (codified at 17 C.F.R. pt. 270) and *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, 69 Fed. Reg. 54728 (Sept. 9, 2004) (codified at 17 C.F.R. pt. 270) (adopting amendments under the Investment Company Act of 1940).

32. *See Sec. & Exch. Comm'n, Exemptive Rule Amendments of 2004: The Independent Chair Condition, A Report in Accordance with the Consolidated Appropriations Act, 2005*, at 2005 SEC LEXIS 1031, at *3 (April 2005) (noting that the Commission responded to the scandal, which had involved "a significant betrayal of mutual fund investors' trust" and had "undermined investor confidence in the mutual fund industry," with enforcement actions and rule making).

ber of investors in investment companies. The Act, and the authority of the Securities and Exchange Commission to enforce the Act, furnishes investors with a basis for assuming that investment companies operate in an evenhanded manner.³³ This assumption is a necessary condition for investment companies to be trusted by the public, and it thereby helps to supply the societal foundation that the companies require to be an important vehicle for finance.³⁴

II. THE INVESTMENT COMPANY ACT AND ITS REQUIREMENTS FOR INDEPENDENT DIRECTORS

The Investment Company Act contains numerous provisions, but a central aspect of the Act is its focus on boards of directors. While one form of investment company recognized by the Act (the unit investment trust),³⁵ operates without a board, all open-end management investment companies,³⁶ commonly called mutual funds, are governed by boards.³⁷ Open-end funds, in terms of the assets they manage, are indisputably the dominant form of investment company in the United States.³⁸ As explained more fully below, the board of a mutual fund must have the minimum percentage of independent directors set by the Act, and for mutual funds in certain categories the Commission, through rules, has mandated a minimum percentage of independent directors that is appreciably higher than the percentage fixed by the

33. Congress explicitly recognized in the Investment Company Act that “the national public interest” is harmed when investment companies favor certain of their participants over others and stated that a goal of the Act was to end, or at least minimize, such favoritism. 15 U.S.C. §§ 80a-1(b)(2)- (3) (2000). The Investment Company Act is supplemented by the Investment Advisers Act. 15 U.S.C. §§ 80b-1 to 80b-21 (2000 & Supp. II 2002). The latter Act applies to *inter alia* an investment adviser responsible for the securities portfolio of an investment company. 15 U.S.C. § 80b-2(a)(11) (2000 & Supp. II 2002). Section 206 of the Investment Advisers Act requires an investment adviser to inform its clients, including clients that are investment companies, about any practice or undertaking by the adviser that discriminates unfairly between the clients or that has the potential to do so. *E.g.*, *Monetta Fin. Serv. .Inc. v. Sec. & Exch. Comm’n*, 390 F.3d 952 (7th Cir. 2004) (noting that § 206 of the Advisers Act required investment advisor to disclose IPO allocations to director-clients). Section 206 is codified at 15 U.S.C. § 80b-6 (2000).

34. The Investment Company Act, as a mechanism to reduce the risk to the public posed by investment companies, illustrates a defining feature of the current epoch in history. *See* PETER L. BERNSTEIN, *AGAINST THE GODS 1* (John Wiley & Sons, Inc. 1998). The Act thus embodies an important cultural value.

35. 15 U.S.C. § 80a-4(2) (2000).

36. 15 U.S.C. §§ 80a-4(3), 80a-5 (2000).

37. INVESTMENT COMPANY INSTITUTE, 2005 INVESTMENT COMPANY FACT BOOK 116, 117 (45th ed. 2005), at http://www.ici.org/stats/res/2005_factbook.pdf (last visited Feb. 6, 2006).

38. At the end of 2004, for example, the net assets of open-end funds that were not money market funds exceeded the combined assets of closed-end funds and unit investment trusts by a ratio of more than 21 to 1. *Id.* at 61, 69, 71.

Act. Furthermore, whether a director is independent is determined by detailed criteria explicitly established in the Act. It is notable that the focus of the Act on directors is unique in federal securities legislation: no other federal securities statute extensively regulates the composition of boards of directors. From an international perspective, moreover, an emphasis on investment company directors is not universal in law; other countries do not uniformly require, or even permit, boards of directors for their mutual funds.³⁹

In the United States, independent directors have been required by statute for mutual fund boards in order to protect the investors in the funds.⁴⁰ But what in the nature of mutual funds poses a risk to investors that independent directors can counter? The answer lies in the conflicts of interests that characterize the funds.

... Unlike a typical corporation, a fund generally has no employees of its own. Its officers are usually employed and compensated by the fund's investment adviser, which is a separately owned and operated entity. The fund relies on its investment adviser and other affiliates — who are usually the very companies that sponsored the fund's organization — for basic services, including investment advice, administration, and distribution.

Due to this unique structure, conflicts of interest can arise between a fund and the fund's investment adviser because the interests of the fund do not always parallel the interests of the adviser. An investment adviser'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.⁴¹

The requirements imposed on directors by the Act are designed to secure directors for a fund who have no significant conflicts of interests and who can therefore fulfill their duty of loyalty to the investors in the fund. However, the requirements have been changed by Congress since the Act was adopted in 1940. Originally, the Act mandated that, with certain exceptions, at least 40% of the directors of a registered investment company⁴² must be persons who were *not* (i) invest-

39. Wallace Wen Yeu Wang, *Corporate versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927 (1994).

40. *Burks v. Lasker*, 441 U.S. 471, 484-485 (1979).

41. Interpretive Matters Concerning Independent Directors of Investment Companies, Release No. IC-24083, 64 Fed. Reg. 59,877, 59,877 (Nov. 3, 1999) [hereinafter Release No. IC-24083].

42. An investment vehicle that qualifies as an investment company under § 3 of the Act is barred by § 7 of the Act from engaging in the activities specified by § 7 until it has registered with the Securities and Exchange Commission pursuant to § 8 of the Act. For example, until it has registered with the Commission, the investment company cannot employ an instrumentality of interstate commerce to offer for sale or sell any securities it has issued. 15 U.S.C. §§ 80a-3, 80a-7, 80a-8 (2000 & Supp. II 2002).

ment advisers, or persons affiliated with an investment adviser, to the investment company, or (ii) officers or employees of the investment company.⁴³ A director was “affiliated” with the investment adviser to the investment company if *inter alia* the director (i) directly or indirectly owned, controlled, or could vote at least 5% of the outstanding voting securities issued by the adviser; (ii) directly or indirectly controlled the adviser, was controlled by the adviser, or was controlled by a third person who controlled both the director and the adviser; or (iii) was an officer, director, partner, copartner, employee, or member of an advisory board of the adviser.⁴⁴

In December 1970, Congress extensively amended the Investment Company Act to broaden the criteria that directors must satisfy in order to be deemed independent.⁴⁵ Specifically, the revision of the Act defined an independent director as one who is not “interested” in the investment company, and thus the Act now directs that generally a minimum of 40% of the directors of a registered investment company must be not “interested” in the company.⁴⁶ The Commission, how-

43. Investment Company Act of 1940, ch. 686, § 10(a), 54 Stat. 789, 806 (1940). Directors satisfying these requirements were deemed “independent.” SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 14 (3d Sess. 1940). While the Act has been amended to change substantially the requirements for qualifying as an independent director, as will be discussed in the text *infra*, notes 45-50 and accompanying text, two requirements for boards have remained essentially the same. Ch. 686, §§ 10(b)(1), 10(b)(3), 54 Stat. at 806 (1940); 15 U.S.C. §§ 80a-10(b)(1), 80a-10(b)(3) (2000). First, the Act requires a majority of the directors of a registered investment company not to be a regular broker (or affiliated with a regular broker) for the investment company when a director, officer or employee of the investment company (or a person with which a director, officer or employee is affiliated) is a regular broker for the company. *Id.* at § 80a-10(b)(1). Second, a majority of the directors of a registered investment company must be persons who are not an investment banker (or affiliated with an investment banker) if a director, officer or employee of the investment company is an investment banker or is affiliated with an investment banker. *Id.* at § 80(a)-10(b)(3).

44. Investment Company Act of 1940, 15 U.S.C. § 80a(3) (2005). “Control” is defined in 15 U.S.C. § 80a(9). *Id.* The criteria for affiliation and the definition of control have not changed since the Act was adopted in 1940. 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(9) (2000).

45. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, §§ 2, 5, 84 Stat. 1413, 1414, 1416 (codified as amended 15 U.S.C. § 80(a)). The prerequisites for serving as an independent director were further modified in 1999 by the Gramm-Leach-Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, § 213, 113 Stat. 1338, 1397, 1398 (codified as amended 15 U.S.C. § 80(a)-2(a)(19)(A)).

46. 15 U.S.C. § 80a-10(a) (2000). See *supra* note 43 and accompanying text (identifying statutory exceptions to the 40% minimum). Additional exceptions include the following:

First, under specified conditions, the board of a registered open-end investment company can be comprised of directors all but one of whom are interested in the investment adviser to the company or are officers or employees of the company. 15 U.S.C. § 80a-10(d) (2000). This provision was designed for an investment company that was created by an investment adviser specifically to serve investors who have relatively small sums of money for securities investments and would therefore have been unable to procure individually the services of the adviser. Charter

ever, has utilized its rulemaking authority⁴⁷ to require even higher percentages of non-interested (*i.e.*, independent) directors. Since July 2002, if the investment company is exempted from a provision of the Act by any one of ten Commission rules, a majority of directors must be not interested.⁴⁸ As of January 2006, a minimum of three out of four directors of such an investment company must be not interested⁴⁹ unless the requirement is judicially nullified.⁵⁰

Under what conditions is a person not interested in an investment company of which the person is a director? Section 2(a)(19) of the Investment Company Act imposes a variety of requirements to be not interested (*i.e.*, to be independent). Thus, an independent director of an investment company cannot *inter alia* be affiliated with the company, its investment adviser or its principal underwriter, or be within the "immediate family" of a person who is affiliated.⁵¹ Affiliation, a

Funds, SEC No-Action Letter (July 6, 1993), 1993 SEC No-Act LEXIS 977, at *2; SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 14 (3d Sess. 1940). Second, the Act requires a majority of the directors of a registered investment company to be persons who are neither a principal underwriter for, nor interested in a principal underwriter for, the investment company when a director, officer or employee of the investment company (or a person in which a director, officer or employee is interested) is a principal underwriter for the company. 15 U.S.C. § 80a-10(b)(2) (2000).

47. 15 U.S.C. § 80a-37 (2000).

48. Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24816, 66 Fed. Reg. 3734 (Jan. 16, 2001) (codified at 17 C.F.R. pts. 239, 240, 270, 274).

49. Investment Company Governance, Investment Company Act Release No. IC-26520, 69 Fed. Reg. 46,378 (Aug. 2, 2004) (codified at 17 C.F.R. pt. 270). On a board with three directors, at least two will need to be not interested. *Id.*

50. Chamber of Commerce of United States v. Sec. & Exch. Comm'n, 412 F.3d 133, *rehearing denied*, 2005 U.S. App. LEXIS 19602 (D.C. Cir. 2005); Investment Company Governance, Investment Company Act Release No. IC-26985, 70 Fed. Reg. 39,390 (July 7, 2005) (codified at 17 C.F.R. pt. 270). The Chamber of Commerce has filed a petition with the Court of Appeals seeking a review of the Commission action that resulted in Release No. IC-26985. Opening Brief of Petitioner for Review of Final Rule of the United States Securities and Exchange Commission (No. 05-1240), 2005 WL 2543995.

51. 15 U.S.C. §§ 80a-2(a)(19)(A)(i)-(A)(iii), 80a-2(a)(19)(B)(i)-(B)(ii) (2000). Under the Act, "[a]ffiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof." 15 U.S.C. § 80a-2(a)(3) (2000). However, a director of an investment company is not interested in the company simply by being a director of the company or an owner of securities it has issued. 15 U.S.C. § 80a-2(a)(19)(A) (2000 & Supp. II 2002). The "immediate family" encompasses a

concept that was in the Act in 1940, is thus now merely one of the criteria for whether a director is independent.⁵² In addition, an independent director of an investment company, within the past two completed fiscal years of the company, cannot have personally furnished legal counsel to the company, its investment adviser or its principal underwriter, or have been a partner or employee of a person who has done so.⁵³

A further requirement for independence is concerned with the types of relationships in which a director who is a “natural person” (*i.e.*, a human being) is involved.⁵⁴ This requirement appears in paragraphs (A)(vii) and (B)(vii) of § 2(a)(19).⁵⁵ Of the various requirements in the section, paragraphs (A)(vii) and (B)(vii) have the

spouse, a parent, a spouse of a parent, a child, a spouse of a child, and a sibling. Step and adoptive relationships can place an individual within the immediate family. *Id.* at § 80a-2(a)(19).

52. The importance of distinguishing affiliation from interest is underscored by Twentieth Century Investors, Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,628, at 81,334 (Feb. 19, 1972), *available at* 1972 SEC No-Act. LEXIS 805.

53. 15 U.S.C. §§ 80a-2(a)(19)(A)(iv), 80a-2(a)(19)(B)(iv) (2000). These statutory provisions are considered and explained in G.T. Global Growth Series, SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,215, at 77,084 (Feb. 2, 1996), *available at* 1996 SEC No-Act LEXIS 323. As defined in the Act, a “person” can be either an entity or a human being. 15 U.S.C. § 80a-2(a)(28) (2000).

54. Congress, in drafting the Investment Company Act, evidently intended to allow an artificial person (*i.e.*, an entity), as well as a natural person, to be an investment company director. The Act defines a director as “any director of a corporation or any *person* performing similar functions with respect to any organization, whether incorporated or unincorporated, including any *natural person* who is a member of a board of trustees of a management company created as a common-law trust.” 15 U.S.C. § 80a-2(a)(12) (2000) (*emphasis added*). In its definition, therefore, Congress recognized that a director could be either a “person” or a “natural person.” *Id.* Notably, Congress defined the word “person” to be “a natural person *or a company*” and included corporations and partnerships — *i.e.*, entities — among the referents of the word “company.” 15 U.S.C. §§ 80a-2(a)(8), 80a-2(a)(28) (2000) (*emphasis added*). Since a director can be a “person” and a person can be an entity, Congress seems to have accepted entities as directors of investment companies. *Id.* However, an entity that is a director of an investment company will be represented by a natural person. *Id.* If the representative is interested in the investment company, the Commission could impute that interest to the entity. *See* 15 U.S.C. § 80a-47(a) (2000).

55. 15 U.S.C. §§ 80a-2(a)(19)(A)(vii), 80a-2(a)(19)(B)(vii) (Supp. II 2002). As originally enacted in 1970, the paragraphs were numbered (A)(vi) and (B)(vi), respectively. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 2(a), 84 Stat. 1413, 1414 (1970) (codified as amended in 15 U.S.C. § 80). In legislation adopted in 1999, the paragraphs were redesignated (A)(vii) and (B)(vii), with no alteration in the wording of the paragraphs. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, § 213, 113 Stat. 1338, 1397-1398 (1999) (codified as amended 15 U.S.C. § 80(a)). The redesignation became effective in 2001. *See id.* at § 225, 113 Stat. at 1402.

most uncertain scope. This scope is the focus of the remainder of the present article.⁵⁶

III. PARAGRAPHS (A)(VII) AND (B)(VII) OF § 2(A)(19)

Under paragraphs (A)(vii) and (B)(vii) of § 2(a)(19), a director of an investment company will be interested in the company, and hence cannot be deemed independent, if the Commission concludes that the director had, during the last two completed fiscal years of the investment company, a material business or professional relationship with any of the following parties: (i) the investment company or the principal executive officer of the investment company on whose board the director serves; (ii) an investment adviser to, or a principal underwriter for, the investment company on whose board the director serves; (iii) another investment company, or the principal executive officer of another investment company, that has the same investment adviser or principal underwriter as the company on whose board the director serves; or (iv) the principal executive officer of, or a person in control of, an investment adviser to or a principal underwriter for the investment company on whose board the director serves.⁵⁷

It should be noted that a director will be deemed interested under paragraphs (A)(vii) and (B)(vii) only if the Commission issues an order finding that, during the two-year period designated by the statute, a material business or professional relationship existed between the

56. Other requirements to be an independent director, which are not identified in the text, are in paragraphs (A)(v), (A)(vi), (B)(v), and (B)(vi) of § 80a-2(a)(19). 15 U.S.C. § 80a-2(a)(19) (Supp. II 2002).

57. Under paragraph § 80a-2(a)(19)(A)(vii), interest in an investment company exists on the part of :

any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company.

15 U.S.C. § 80a-2(a)(19)(A)(vii) (Supp. II 2002).

Section 80a-2(a)(19)(A)(iii) provides that a person interested in an investment adviser to or a principal underwriter for an investment company is interested in the investment company. 15 U.S.C. § 80a-2(a)(19)(A)(iii) (2000). Under paragraph (B)(vii), interest in an investment adviser to an investment company, or a principal underwriter for an investment company, exists on the part of:

any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter. 15 U.S.C. § 80a-2(a)(19)(B)(vii) (Supp. II 2002).

director and any one of the specified parties. The order must be preceded by notice to the parties and an opportunity for a hearing.⁵⁸ Moreover, the order alters the status of the director only after, and not before, the order is issued; the director will not be considered interested prior to an order that concludes there was a material business or professional relationship between the director and a specified party. Significantly, paragraphs (A)(vii) and (B)(vii) do not permit the Commission to promulgate a rule dealing with such relationships in general but, instead, require the Commission to review each case individually. This approach was chosen by Congress in order to minimize the consequences to an investment company from an accidental breach of the mandates of the Act regarding directors.⁵⁹ The Act both prescribes the minimum number of independent directors for an investment company that has a board and charges independent directors with performing certain important tasks. For example, the Act provides that the independent directors must scrutinize every proposed contract of the company with an investment adviser and principal underwriter, and must find, by majority vote, that the terms of the contract benefit the shareholders of the company.⁶⁰ In addition, rules promulgated by the Commission to implement the Act impose tasks on just the independent directors (*e.g.* the independent directors of a registered open-end investment company must approve the use of the assets of the company to compensate distributors of securities issued by the company).⁶¹ Actions taken by a board having an insufficient number of independent directors, or by directors who are required to be but who are not independent, may be voided.⁶² The status of a director as independent or interested is therefore critical. However, given the inescapable uncertainty that exists as to when a director is involved in a material business or professional relationship, the Commission is obligated to initiate an inquiry into whether a relationship is business or professional in character and whether such a relationship is material. If the Commission establishes that such a relationship ex-

58. 15 U.S.C. § 80a-39 (2000).

59. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 33, 34 (1st Sess. 1969) [hereinafter SENATE REPORT NO. 91-184]; HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. REP. NO. 91-1382, at 14, 15 (2d Sess. 1970) [hereinafter HOUSE REPORT NO. 91-1382].

60. 15 U.S.C. §§ 80a-15(a), 80a-15(c) (2000); *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961).

61. 17 C.F.R. § 270.12b-1 (2004).

62. *Apple Computer, Inc. v. Exponential Tech., Inc.*, No. 16,315 (Del. Ch. Jan. 21, 1999), 24 DEL. J. CORP. L. 949, 962 (1999) (unreported case).

isted during the statutory period, the director cannot retroactively be treated as having been interested.

Paragraphs (A)(vii) and (B)(vii), when decomposed, present three separate questions. The first question is whether a relationship between a director and a specified party is material. However, this question is not of concern in the present article and will be discussed only briefly. The answer to the question, which presupposes the existence of a business or professional relationship, depends on the threshold at which a relationship becomes material. According to committee reports of both the Senate and the House, a relationship is to be deemed material whenever the relationship "might tend to impair the independence of" the director.⁶³ The choice of the words "might" and "tend" in defining materiality suggests that Congress wanted just a minimal catalyst to create a material relationship: a relationship is material when it *may* entice a director qua director to act in a manner that benefits persons other than the shareholders of the investment company.

While the question of materiality is not a concern of the present article, the two other questions raised by paragraphs (A)(vii) and (B)(vii) are directly pertinent and, indeed, must be answered before materiality is considered. Stated succinctly, the second and third questions raised by paragraphs (A)(vii) and (B)(vii) are: What is a business relationship, and what is a professional relationship? Curiously, the questions have not, to date, been clearly distinguished by the Securities and Exchange Commission. For example, the sole release of the Commission on the types of business or professional relationships that might be deemed material under paragraphs (A)(vii) and (B)(vii) does not explicitly differentiate a "business" relationship from a "professional" relationship, let alone supply a definition of each.⁶⁴ As a matter of statutory construction, however, whether the character of a relationship is business or professional should *precede* the question of whether a relationship is material, because the elements of materiality are likely to differ between a professional relationship and a business relationship (*i.e.*, the factors determining whether a business relationship is material are probably not the factors determining whether a professional relationship is material. Thus, the type of a relationship (business or professional) is logically prior to, and must be ascertained before, the materiality of a relationship.

63. S. REP. NO. 91-184, at 33; H.R. REP. NO. 91-1382, at 14.

64. Interpretive Matters Concerning Independent Directors of Investment Companies, Release No. IC 24083, 64 Fed. Reg. 59,877 (Nov.3, 1999). The release presented the views of the staff, not of the commissioners. *Id.* at 59879.

Paragraphs (A)(vii) and (B)(vii), consequently, require an analysis that is more detailed than has been undertaken to date by the Commission. Paragraphs (A)(vii) and (B)(vii) name both business relationships and professional relationships, and Congress must be presumed to have wanted the paragraphs to cover different types of relationships. Each paragraph identifies not only relationships of a business nature but also relationships of a professional nature, and each paragraph inserts the word “or” between the word “business” and the word “professional.” That Congress used the disjunctive when listing the relationships to be encompassed by the paragraphs suggests a legislative intent to reach two distinct classes of activities.

To decide whether one type of activity or two are encompassed by paragraphs (A)(vii) and (B)(vii), we turn to judicially recognized rules of statutory interpretation.⁶⁵ Although not determinative, rules of statutory interpretation are helpful in ascertaining the referents of a statute.⁶⁶ Thus, rules that are pertinent to the problem at hand will now be considered.

According to the U.S. Supreme Court, “statutes must be interpreted, if possible, to give each word some operative effect,”⁶⁷ and a word can be ignored only if it appears in a statutory provision whose legislative purpose requires that the word be disregarded.⁶⁸ From committee reports on the legislation that placed the concept of interested person in the Investment Company Act⁶⁹ it is clear that Congress developed the concept, and limited the proportion of board positions that can be filled by interested directors,⁷⁰ in order to protect investors. Directors who are not interested in their investment company, being less likely to suffer from conflicts of interests, are ex-

65. 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION §§ 45:01 to 48: 19 (6th ed. 2000).

66. *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001).

67. *Walters v. Metropolitan Educational Enterprises, Inc.*, 519 U.S. 202, 209 (1997); *Cooper Industries, Inc. v. Aviall Servs., Inc.*, 125 S. Ct. 577, 579 (2004). See SINGER, *supra* note 65, at § 46.06 for a general discussion of this rule of statutory interpretation.

68. *Chapman v. Houston Welfare Rights Org.*, 441 U.S. 600, 608 (1978) (words in a federal statute are to be construed “in light of the purposes Congress sought to serve”); *United Steelworkers v. Weber*, 443 U.S. 193, 201 (1979) (“[i]t is a ‘familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers’”)(quoting *Holy Trinity Church v. United States*, 143 U.S. 457, 459 (1892)). See SINGER, *supra* note 65, at § 45.05 for a general discussion of this rule of statutory interpretation.

69. The reports prepared by the committees of Congress that had jurisdiction over bills enacted into law are accepted by the federal judiciary as the most authoritative statements of congressional intent for legislation. *Eldred v. Ashcroft*, 537 U.S. 186, 210 n.16 (2003). See SINGER, *supra* note 65, at § 48.05 for a general discussion of this rule of statutory interpretation.

70. 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(9), 80a-10 (2000).

pected to resist attempts to disadvantage the shareholders of the company for the benefit of the persons managing the company. Thus, the report by the Senate committee on the legislation that added the concept of interested person to the Act employed the caption “*strengthening independent checks on investment company management*” to introduce § 2(a)(19) and discuss paragraphs (A)(vii) and (B)(vii).⁷¹ In a similarly worded section, the report by the House committee employed a neutral caption,⁷² but like the report of the Senate committee, it pointed out that (i) an investment company board must have directors who “supply an independent check on management” and are responsible “for the representation of shareholder interests in investment company affairs;”⁷³ (ii) directors who are merely unaffiliated with the investment company⁷⁴ have not satisfactorily performed this function; and (iii) the concept of interested director had been developed and was being proposed to “remedy the Act’s deficiencies in this regard.”⁷⁵ Congress thus unquestionably sought to restrict the range of conditions under which a person can be an independent (*i.e.*, non-interested) director, and given this purpose, a plausible inference is that, with respect to paragraphs (A)(vii) and (B)(vii), Congress wanted the word “business” and the word “professional” to encompass entirely different types of relationships.

In light of the evident intent of Congress, the meaning of the word “business” and the meaning of the word “professional” must be ascertained. The Investment Company Act, while furnishing definitions for numerous words,⁷⁶ does not define either “business” or “professional,” and for these words, Congress must be assumed to have adopted the meanings that were generally accepted in the United States at the time the words were placed in the Act.⁷⁷ The Supreme

71. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 32 (1st Sess. 1969) (emphasis added).

72. In the report by the House committee, the heading used for the discussion was “Section-by-Section Analysis,” with a subheading “Section 2(a)(3) — Amending Section 2(a) — Adding Definition of New Term ‘Interested Person.’” HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. R. REP. NO. 91-1382, at 13 (2d Sess. 1970)

73. H.R. REP. NO. 91-1382, at 13; S. REP. NO. 91-184, at 32. See also *supra* note 44 and accompanying text.

74. See *supra* note 51 and accompanying text.

75. H. R. REP. NO. 91-1382, at 14, 15; S. REP. NO. 91-184, at 32.

76. See generally 15 U.S.C. § 80a-2(a) (2000 & Supp. II 2002).

77. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 nn. 20, 21 (1976), where the Court uses a dictionary published in 1934 to define words in a statute that was enacted in the same year.

Court has observed that “when a word is not defined by statute we normally construe it in accord with its ordinary or natural meaning.”⁷⁸

Of the two words, “business” is the simpler to define. Dictionaries published contemporaneously with the adoption in 1970 of the interested-person standard include the following definitions of the word “business.” The definitions reproduced are those that appear appropriate in the settings to which paragraphs (A)(vii) and (B)(vii) apply.

“1. The occupation, work, or trade in which a person is engaged. 2. Commercial, industrial, or professional dealings; the buying and selling of commodities or services. . . . 5. Commercial policy or practice. . . . 7. Serious work or endeavor that pertains to one’s job: *went to Tokyo on business.* . . .”⁷⁹

“1. an occupation, profession, or trade: *His business is poultry farming.* 2. *Econ.* the purchase and sale of goods in an attempt to make a profit. 3. *Com.* a person, partnership, or corporation engaged in commerce, manufacturing, or a service; profit-seeking enterprise or concern . . .”⁸⁰

The preceding definitions suggest that the concept of business contains a significant monetary dimension. At the same time, however, the definitions indicate that business can encompass “professional dealings” or “profession.”⁸¹ Nonetheless, not all manifestations of professional activity need to be, or were necessarily intended by Congress to be, subsumed under the category of business. Unfortunately, when interpreting paragraphs (A)(vii) and (B)(vii) of § 2(a)(19), the staff of the Securities and Exchange Commission appears to be comfortable only with the concept of business. For example, without examining professional relationships, the staff has concluded in a number of no-action letters that investment company directors were potentially involved in material business relationships, and hence might be interested persons, as the apparent result of financial considerations.⁸² In other no-action letters,⁸³ the staff did not focus on pro-

78. *Smith v. United States*, 508 U.S. 223, 228 (1993). A general discussion of this rule of statutory interpretation is found in SINGER, *supra* note 65, at § 46.01.

79. AMERICAN HERITAGE DICTIONARY 180 (1969).

80. RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 201 (1970).

81. The *Oxford English Dictionary*, too, defines “business” as including *inter alia* “[a] person’s official or professional duties as a whole; stated occupation, profession, or trade” and “[a] particular occupation; a trade or profession.” 2 OXFORD ENGLISH DICTIONARY 695 (2d ed. 1989).

82. *Bridges Inv. Fund, Inc.*, SEC No-Action Letter, 1971 SEC No-Act. LEXIS 916 (June 10, 1971); *C. I. Convertible Fund, Inc.*, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 2416 (June 2, 1974); *Cal-Western Separate Account A*, SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,444, at 86,173, available at 1976 SEC No-Act. LEXIS 574 (March 8, 1976); *Crown Western Inv., Inc.*, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4171 (Nov. 20, 1972); *Equitable of Iowa Variable Annuity Account A*, SEC No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,744, at 77,061 (Jan. 6, 1980); *MONEY Fund*,

fessional relationships even though such a focus would have been appropriate. To date, then, business relationships have dominated the interpretation of paragraphs (A)(vii) and (B)(vii), and professional relationships have not been considered on their own.

Given the wording of paragraphs (A)(vii) and (B)(vii) and the available evidence of congressional intent for the paragraphs, professional relationships should not be neglected or subsumed within business relationships. The reports of both the Senate committee and the House committee on the legislation that incorporated the interested-person standard into the Investment Company Act declare at one point that "substantial *financial or professional* relationships" will be covered by paragraphs (A)(vii) and (B)(vii).⁸⁴ By substituting the word "financial" for the word "business," the reports reveal a congressional belief that business is characterized by a significant pecuniary element. At the same time, the disjunctive "or" was inserted between the two named relationships. Because Congress did not need to mention professional dealings if it viewed them as being business in nature, Congress evidently sought to distinguish professional relationships from business relationships. Furthermore, in neither the Act nor its legislative history did Congress indicate that professional relationships are to be included within business relationships. This intent could have been inferred from a statement that paragraphs (A)(vii) and (B)(vii) encompass, for example, "business relationships of all types, including those of a professional nature" or "professional and other forms of business relationships." Since no such statement was made by the committees of Congress that were responsible for the legislation, professional relationships were apparently regarded as separate from business relationships. However, if professional relationships and business relationships are discrete phenomena, the former necessarily possesses different attributes than the latter. Indeed, if professional relationships do not possess distinct attributes, they cannot constitute a category of their own. Accordingly, the attributes of professional relationships are considered next.

Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,661, at 81,402 (Jan. 29, 1972); NEA Mutual Fund, SEC No-Action Letter, 1971 SEC No-Act. LEXIS 753 (June 3, 1971). [hereinafter "Business Relationships Letters"].

83. The letters are reviewed in part V. See *infra* notes 111-135 and accompanying text.

84. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 32 (1st Sess. 1969) (emphasis added); HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 91-1382, at 13 (2d Sess. 1970) (emphasis added).

IV. THE NATURE OF PROFESSIONAL RELATIONSHIPS

Congress is most likely to have employed the adjective “professional” to refer to activities that constitute a profession. The use of “professional” in this manner is consistent both with the generally accepted meaning of the word “professional”⁸⁵ and with the purpose of paragraphs (A)(vii) and (B)(vii). That purpose is the avoidance of situations capable of compromising the ability of a director to be an advocate for shareholders.⁸⁶ Both participation in a business and participation in a profession carry the potential to breed, or be accompanied by, a degree of self-interest that disables an individual from acting for the benefit of others.

Since self-interest may lack a pecuniary motive or possess a merely incidental pecuniary motive, professional relationships may not be driven by a personal financial incentive, and such professional relationships can be distinguished from business relationships, which by definition involve a strong financial motive.⁸⁷ Professional relationships may nonetheless lead their participants to pursue self-serving goals, because professional relationships may allow their participants to secure influence for themselves, increase their prestige, and/or satisfy a narcissistic personality need.⁸⁸

85. AMERICAN HERITAGE DICTIONARY 1045 (1969) (“professional” includes “[o]f, related to, engaged in, or suitable for a profession”); RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1148 (1970) (“professional” includes “pertaining or appropriate to a profession”).

86. See *supra* note 73 and accompanying text.

87. The New York Stock Exchange requires that independent directors comprise a majority of the board of each issuer listed on the Exchange and defines independence to be the absence of a “material relationship” with the issuer. While professional relationships are not explicitly named in defining independence, the Exchange mentions *inter alia* “charitable relationships” in illustrating relationships that may be material. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL Standard 303A.00, 303A.01, 303A.02 cmt., at <http://www.nyse.com/listed/1022221393251.html> (last visited Feb. 7, 2005). However, most participants in charitable organizations probably do not have a monetary incentive for becoming involved in the organizations, and given the attributes of a profession (discussed *infra*), their participation is professional rather than business in character.

88. This type of motivation can apparently be involved in a violation of section 10(b) and Rule 10b-5 of the Securities Exchange Act. 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2004). Specifically, securities trading by an insider will be illegal under section 10(b) and Rule 10b-5 if *inter alia* the insider seeks to benefit personally from the securities transaction. See *Dirks v. Sec. & Exch. Comm’n*, 463 U.S. 646, 662-664 (1983). However, “a specific or tangible benefit” is not necessary. See *Sec. & Exch. Comm’n v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998). Thus, the benefit need not be financial. See *Sec. & Exch. Comm’n v. Yun*, 327 F.3d 1263, 1275, 1280-1281 (11th Cir. 2003). Rather, the benefit, if wanted by the insider, can evidently be social or emotional in nature.

But if a profession can generate self-interest, what is a "profession"?⁸⁹ An answer is available in two sources: (i) social science research on occupations that are professions and (ii) documents in the field of law that emanate from studies concerned with the image and role of lawyers. Each will be discussed in turn.

A. *"Profession" as defined by social science research*

Social scientists have devoted considerable effort to identify the characteristics that define an occupation as a profession, and they have also attempted to determine the functions and consequences of professions.⁹⁰ The former task, which is the focus of this part of the article, seems to have been undertaken mainly by sociologists while the latter task seems to have been mainly the province of economists.⁹¹

The attributes of a profession appear not to be universal because the occupations that are labeled "professions" vary between historical eras within the same country and vary between countries at the same point in time.⁹² However, since the middle of the twentieth century, according to social scientists, the following have been recognized as key traits of an occupation in the United States that is a profession:⁹³

- The occupation is based upon a substantial body of knowledge that involves abstract concepts and complex principles and that is possessed by a small segment of the population. Since this knowledge is essential to performing the tasks of the occupation, entry into the occupation necessitates a relatively long period of education.
- The occupation has established and enforces standards for the ethical behavior of its members.
- The occupation regulates the conditions and content of its work. Consequently, members of the occupation control entry into the occupation and possess a high level of individual autonomy in their job duties.
- A strong, enduring level of dedication to the work of the occupation is expected by the members of the occupation.

89. The historical evolution of professions is described by MAGALI SARFATTI LARSON, *THE RISE OF PROFESSIONALISM: A SOCIOLOGICAL ANALYSIS* (University of California Press 1977).

90. See RONALD M. PAVALKO, *SOCIOLOGY OF OCCUPATIONS AND PROFESSIONS 19-33* (FE Peacock Publishers 2d ed. 1988).

91. James W. Begun, *Economic and Sociological Approaches to Professionalism*, 13 *WORK & OCCUPATIONS* 113, 114-116 (1986).

92. ELIOT FREIDSON, *PROFESSIONAL POWERS 35* (The University of Chicago Press 1986).

93. The list is based on PAVALKO, *supra* note 90, at 20-29, and on Steven Kerr *et al.*, *Issues in the Study of "Professionals" in Organizations: The Case of Scientists and Engineers*, 18 *ORGANIZATIONAL BEHAV. & PERFORMANCE* 329, 332 (1977). The items in the list are not ranked in terms of their importance.

- The members of the occupation both identify with the occupation and share common interests and values.
- The ideal of service to clients and the public is central to the motivation for entering the occupation and performing its work.

Special note should be taken of the last trait, for it distinguishes a profession from a business. While a business chiefly seeks financial profit, a profession is mainly concerned with the ideal of service.⁹⁴

B. “*Profession*” as defined by studies in law

The concept of a profession underlies the appreciable attention given in recent decades to a range of problems that are believed to have increased among practicing lawyers.⁹⁵ The concept was even the subject of an opinion by three justices of the U.S. Supreme Court.⁹⁶ For the present article, however, the concept has received its most authoritative and comprehensive treatment within the field of law from two bodies of the American Bar Association that, in the last twenty years, have considered professionalism. Inasmuch as the concept of professionalism derives from the word “professional”⁹⁷ and hence from the concept of “profession,”⁹⁸ the conclusions appearing in the reports of these bodies merit review even though the conclusions cannot be ascribed to the Association itself.⁹⁹ Not surprisingly, the approach of both bodies was shaped by the nature and needs of the practice of law.¹⁰⁰

94. See PAVALKO, *supra* note 90, at 24. The motivation for service has been described as “the polar opposite” of the motivation for monetary return that prevails in business. *Id.* Some businesses may possess not only a strong motivation for profit but also a strong motivation for service. Laura D’Andrea Tyson, *Good Works — With a Business Plan*, *Bus. Wk.*, May 3, 2004, at 32.

95. See Susan Daicoff, *Lawyer, Know Thyself: A Review of Empirical Research on Attorney Attributes Bearing on Professionalism*, 46 *AM. U. L. REV.* 1337, 1344-1348 (1997) (discussing problems of practicing attorneys).

96. *Shapero v. Kentucky Bar Ass’n*, 486 U.S. 466, 488-489 (1988) (O’Connor, J., Rehnquist, C.J., and Scalia, J., dissenting).

97. *AMERICAN HERITAGE DICTIONARY* 1045 (1969) (“professionalism” includes “[p]rofessional status, methods, character, or standards”); *RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE* 1148 (1970) (“professionalism” includes “professional character, spirit, or methods”).

98. See *supra* note 85.

99. Nonetheless, the American Bar Association holds the copyright on, and hence claims ownership of, the report of each body.

100. The A.B.A. Model Code of Professional Responsibility identifies “the professional judgment of a lawyer” as central to the activities comprising the practice of law, and states that “[t]he essence of the professional judgment of the lawyer is his educated ability to relate the general body and philosophy of law to a specific legal problem of a client.” *MODEL CODE OF PROF’L RESPONSIBILITY* EC 3-5 (1981). Notably, this conceptualization of the practice of law is consistent with one or more of the elements of a profession that have been derived from social science studies and that were identified by the two bodies of the American Bar Association.

The first body was an A.B.A. Commission on Professionalism whose report was released in 1986.¹⁰¹ While the Commission found that no agreement existed on the meaning of “professionalism,” a sociologist who served as a member of the body identified a list of key traits delineating a profession that the Commission endorsed as “useful.”¹⁰² Specifically, a profession was described as an occupation the members of which possess certain privileges because (i) the work of the occupation demands both considerable education of an intellectual nature and sophisticated judgment, (ii) clients cannot judge the quality of work done by the practitioners of the occupation and are therefore forced to trust the practitioners, (iii) dedication to the needs of the client and the welfare of the public is assumed to overshadow self-interest on the part of the practitioners, and (iv) the occupation regulates itself to protect clients and the public against incompetence and self-serving behavior by practitioners.¹⁰³

The Professionalism Committee of the Section of Legal Education and Admissions to the Bar is the second body of the American Bar Association whose report will be considered here.¹⁰⁴ The report, which was issued in 1996, enumerates the attributes of “a professional lawyer,” and although the attributes could have been described more clearly, they appear to be consistent with the elements identified above for a profession. Specifically, a professional lawyer was described as possessing six “essential characteristics:” (i) the lawyer has acquired “knowledge,” a word apparently alluding to the concepts and principles of law; (ii) the lawyer has the ability to apply pertinent concepts and principles of law to concrete problems; (iii) the lawyer, in handling a matter, prepares thoroughly; (iv) the lawyer exhibits “practical and prudential wisdom,” a phrase that presumably refers to the exercise of judgment that is effective and appropriate in the situation confronting the lawyer; (v) the lawyer adheres to the rules of eth-

101. ABA Commission on Professionalism, “. . . In the Spirit of Public Service:” A Blueprint for the Rekindling of Lawyer Professionalism (1986), *reprinted in* 112 F.R.D. 243, 261 (1987) [hereinafter Commission on Professionalism]. A commission is created by a resolution of the House of Delegates of the Association and remains in existence for a limited period of time in order to study a particular matter. The resolution of the House of Delegates that establishes a commission specifies the scope, duties, and powers of the commission. Bylaws of the American Bar Ass’n House of Delegates § 31.6, at <http://www.abanet.org/about/home.html> (follow “ABA Organization” hyperlink; then follow “Constitution and Bylaws.”)

102. Commission on Professionalism, *supra* note 101, at 262.

103. *Id.*, *reprinted in* 112 F.R.D. at 261-262.

104. PROFESSIONALISM COMMITTEE, ABA SECTION OF LEGAL EDUCATION & ADMISSIONS TO THE BAR, TEACHING AND LEARNING PROFESSIONALISM 6 (1996) [hereinafter PROFESSIONALISM COMMITTEE]. The Professionalism Committee is a special, not a standing, committee. See American Bar Ass’n, Section of Legal Education and Admissions to the Bar Bylaws art. VIII, at <http://www.abanet.org/legaled/section/sectioninfo.html> (last visited Feb. 6, 2006).

ics governing lawyers; and (vi) the lawyer is dedicated to the welfare of society, including the need of society for justice.¹⁰⁵

C. *Synthesis*

Each of the preceding works has identified attributes of a profession, but since the works differ to some extent in the attributes they list, this part of the article attempts to catalogue the characteristics on which there is a degree of accord. The characteristics on which some agreement exists are the most likely to be applied, and to be the most appropriate to apply, in determining whether a relationship is professional and therefore within the scope of § 2(a)(19) of the Investment Company Act.

The criterion for determining agreement on an attribute will be the explicit or implicit presence of the attribute in at least two of the preceding lists. Using this criterion, the following five attributes appear to be fundamental to the existence of a profession in the United States at the present time:

1. The occupation possesses a large body of abstract concepts and complex principles;¹⁰⁶
2. The tasks of the occupation, to be performed effectively, require sophisticated judgment¹⁰⁷ and substantial autonomy;¹⁰⁸

105. PROFESSIONALISM COMMITTEE, *supra* note 104, at 6-7.

106. This attribute, in turn, is undoubtedly associated with the higher level of cognitive complexity that has been observed for the professions than other occupations. Kim A. Weeden, *Why Do Some Occupations Pay More than Others? Social Closure and Earnings Inequality in the United States*, 108 AM. J. SOC. 55, 92 (2002).

107. The considerable judgment needed in professions may be attributable in part to the relatively high level of uncertainty that characterizes the subject matter of professions. See William C. Baer, *Expertise and Professional Standards*, 13 WORK & OCCUPATIONS 532, 539-542 (1986).

108. The Securities and Exchange Commission implicitly recognized the nature of the judgment and degree of autonomy needed for the practice of law when it required that any attorney for the non-interested directors of specified investment companies be "independent." See Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24816, 66 Fed. Reg. 3734 (Jan. 16, 2001). Specifically, an attorney who personally, or an attorney whose law firm, has represented certain parties with close ties to the investment company (e.g., as investment adviser or principal underwriter) during the last two completed fiscal years of the company can serve as "independent legal counsel" to the non-interested directors only if a majority of such directors reasonably believe that the "professional judgment" of the attorney is not likely to be impaired. 17 C.F.R. § 270.0-1(6) (2004).

Empirical evidence pertinent to the level of autonomy in professions is found in Patrick B. Forsyth & Thomas J. Danisiewicz, *Toward a Theory of Professionalization*, 12 WORK & OCCUPATIONS 59 (1985). The level of judgment that characterizes a profession is evidently tied to the level of autonomy in a profession: Research suggests that occupational autonomy, not occupational position, accounts for complex intellectual functioning and that occupational autonomy and complex intellectual functioning are mutually reinforcing. See Melvin L. Kohn & Carrie Schoenbach, *Class, Stratification, and Psychological Functioning*, in WORK AND PERSONALITY:

3. Training for entry into the occupation is lengthy;¹⁰⁹
4. Service to clients and/or the public, not personal financial aggrandizement, is the principal ideal motivating individuals to join the profession and perform its tasks; and
5. The occupation regulates itself and, as part of doing so, establishes and enforces ethical standards for the behavior of its members.

Using the above as the defining features of a profession, three factual situations that were the subject of "no-action" letters from the staff of the Securities and Exchange Commission will be examined.¹¹⁰ The letters, which are written by the staff, are the main source of law on the Investment Company Act. The three cases to be reviewed offer an opportunity to consider professional relationships apart from business relationships.

V. PROFESSIONAL RELATIONSHIPS IN NO-ACTION LETTERS

Unfortunately, neither the commissioners nor the staff of the Commission appear to have focused on professional relationships per se under paragraphs (A)(vii) and (B)(vii) of § 2(a)(19). Although business relationships have been severed from professional relationships and been the subject of separate treatment in a number of instances,¹¹¹ the reverse apparently has not occurred: professional relationships have only been discussed in conjunction with business relationships.

In three no-action letters, however, the Commission staff has had the opportunity to examine professional relationships on their own. Since the failure to take advantage of the opportunity can be instructive, each of the three letters is discussed below.

A. *S & P Counselors Fund, Inc.*¹¹²

In S&P Counselors Fund, Inc., two directors of a registered investment company planned to collaborate on the revision of a book, and

AN INQUIRY INTO THE IMPACT OF SOCIAL STRATIFICATION 154, 169-170, 172-174 (Melvin L. Kohn et al. eds., 1983).

109. The argument has been advanced that the sole source of training for the professions in a society are the organizations that deliver higher education. Steven Brint, *Eliot Freidson's Contribution to the Sociology of Professions*, 20 WORK & OCCUPATIONS 259, 263 (1993).

110. Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921 (1998) (discussing the nature and importance of no-action letters).

111. See Business Relationships Letters, *supra* note 82.

112. S&P Counselors Fund, Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,619, at 81,319 (Jan. 2, 1972), available at 1972 SEC No-Act. LEXIS 153 (Jan. 2, 1972).

as coauthors of the revised book, they would earn royalties from its sales. The status of one director (“director #1”) was not in question. Director #1, in addition to being a director of the investment company, served on the board of directors of the investment adviser to the investment company, chaired the board of the entity that wholly owned the adviser and principal underwriter for the investment company, and held an option to purchase stock of the parent. As a result, director #1 was indisputably interested in the investment company.¹¹³

Whether the second director (“director #2”) was interested, however, was not clear. Director #2 had been the senior of two authors of the first edition of the book.¹¹⁴ In revising the book, director #2 would not only work with director #1 but would also utilize the library of the parent of the investment adviser and principal underwriter for a pe-

113. Director #1 was not interested in the investment company by virtue of being a director of the company. 15 U.S.C. § 80a-2(a)(19)(A) (2000 and Supp. II 2002). Instead, director #1 was interested in the investment company through § 80a-2(a)(19)(A)(iii), which provides that any person interested in an investment adviser to or principal underwriter for an investment company is interested in the investment company. Section 80a-2(a)(19)(A)(iii) applied to director #1 in two ways. 15 U.S.C. § 80a-2(a)(19)(A)(iii). First, as a director of the investment adviser to the investment company, director #1 was affiliated with the adviser through § 80a-2(a)(3)(D) and hence interested in the adviser through § 80a-2(A)(19)(B)(i). 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(19) (2000). Under § 80a-2(a)(19)(A)(iii), he was then interested in the investment company. *Id.* Second, a person is interested in an investment adviser to or principal underwriter for an investment company under § 80a-2(a)(19)(B)(iii) if the person knowingly owns, directly or indirectly, a security of an issuer that controls such an adviser or principal underwriter. 15 U.S.C. § 80a-2(a)(19)(B)(iii). An option is a security under § 80(a)-2(a)(36), and a parent is presumed by § 2(a)(9) to control a subsidiary when it owns in excess of 25% of the voting securities of the subsidiary. Since director #1 knowingly held a security (i.e., an option) issued by the entity that wholly owned, and thus presumptively controlled, the investment adviser to and principal underwriter for the investment company, he was interested in the adviser and principal underwriter. 15 U.S.C. §§ 80a-2(a)(9), 80a-2(a)(19), 80a-2(a)(36) (2000). Section 2(a)(19)(A)(iii), in turn, caused him to be interested in the investment company.

Director #1 would also be interested in the investment company if the principal underwriter and its parent are treated as a single entity because the former is a wholly owned subsidiary of the latter. See *Southwestern Investors, Inc.*, SEC No-Action Letter, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,172, at 80,537 (May 14, 1971), available at 1971 SEC No-Act. LEXIS 1204 (May 14, 1971) (collapsing a parent with an indirectly, wholly owned subsidiary). If the two entities are combined in the analysis, director #1 would be considered a director of the principal underwriter because he was a current director of the parent. As a director of the principal underwriter, director #1 would be deemed by § 80a-2(a)(3)(D) to be affiliated with the principal underwriter, and his affiliation with the principal underwriter would make him interested in the principal underwriter through § 80a-2(a)(19)(B)(i). As a person interested in the principal underwriter, director #1 would be interested in the investment company by virtue of § 80a-2(a)(19)(A)(iii). 15 U.S.C. §§ 80a-2(a)(3)(D), 80a-2(a)(19) (2000).

114. JEROME B. COHEN & EDWARD D. ZINBARG, *INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT* (R.D. Irwin 1967). The letter sent to the Commission gives the title of the book and the name of director #2 as an author of the book; other information on the book was obtained from the Library of Congress Online Catalog, at <http://catalog.loc.gov> (last visited Feb. 7, 2006).

riod that was expected to last a maximum of nine months. Director #2, who was a retired university professor, also expected to use the library of his university, but the latter library evidently lacked resources that were available in the library of the parent of the adviser and principal underwriter. The parent controlled its subsidiaries (*i.e.*, the investment adviser and principal underwriter) by owning all of their voting securities.¹¹⁵ In addition, director #1 may have controlled the subsidiaries¹¹⁶ by chairing the board of their parent.¹¹⁷ A relationship with an entity or natural person controlling the investment adviser or principal underwriter for an investment company is within the scope of paragraph (B)(vii).

The staff concluded that the arrangement proposed for the revision of the book “may” involve director #2 in a “material business or professional relationship” under § 2(a)(19)(B)(vii).¹¹⁸ Unfortunately, the response of the staff names both directors, as well as the parent of the adviser and principal underwriter, in stating that the arrangement might produce a relationship covered by the section. Key questions therefore cannot be answered: Did the staff believe that the relationship would be *business* (and material) in nature, because the two directors would receive royalties from sales of the revision? If so, did the staff think that the presence of director #1 as a coauthor of the revised book might be expected by director #2 to increase substantially the sales of the book and, hence, the royalties received by director #2? Did the staff conclude that the library of the parent had significant monetary value and that access to it was thus a distinct financial benefit to director #2? The resources of this library were apparently unavailable at the library of the university at which director #2 was a professor emeritus and were presumably exceptional. The parent of the adviser and principal underwriter had undoubtedly expended appreciable sums for the books and journals in its library and for its operation.

115. 15 U.S.C. § 80a-2(a)(9) (2000).

116. Section 80a-2(a)(9), in referring to “a controlling influence,” allows for the possibility that control of a company may be exercised by more than one party. Indeed, the section creates a rebuttable presumption that a company is controlled by any owner of more than 25% of the voting securities of the company; through voting securities, therefore, three parties can control a company. 15 U.S.C. § 80a-2(a)(9) (2000).

117. Section 80a-2(a)(9) of the Investment Company Act defines “control” as “the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.” 15 U.S.C. § 80a-2(a)(9) (2000). Because of the exclusion for “an official position,” director #1 cannot be deemed to control the parent, but the exclusion does not preclude a finding that, as chair of the board of the parent, director #1 controlled the subsidiaries, which are different companies.

118. S&P Counselors Fund, *supra* note 112, at 81,320.

Apart from the above possibilities, however, the staff could have found that, in revising and co-authoring the book, the two directors might be engaged in a relationship that was *professional* (and material) in character. A plausible argument can be made that the elements of such a relationship were present: the subject of the book (*viz.*, the analysis and management of investments) involved theoretical concepts and sophisticated principles. Indeed, the preface to the revised edition states that the revision was mainly concerned with incorporating and describing the application of “the major advances which have been made in portfolio theory and risk management,” and that the revision was effected in part by the addition of a third author, namely director #1, to the two authors of the first edition.¹¹⁹

Moreover, the revision of the book required that the authors exercise judgment and be free from inflexible rules in selecting, explaining, and critiquing relevant concepts and principles. At the same time, preparation of the book was governed by the standards that have been established by scholars themselves (*e.g.*, as to the acceptance of concepts and principles in the discipline). Finally, since the book was produced and marketed by a prominent publishing house, the revision could be expected to be read by numerous investors and hence have a public benefit.

On the other hand, director #2 was unlikely to have been motivated primarily by monetary gain to revise the book with director #1 as a co-author. Director #2 probably could not anticipate increased royalties from the revision and, indeed, could well anticipate reduced royalties because the addition of director #1 as a co-author would presumably require the division of royalties with one more author. Instead, director #2 was more likely to have wanted to co-author the revision with director #1 because he expected personal satisfaction from improving the book and from being the lead author of a recognized text.

The case thus presented an opportunity for the Commission staff to apply the concept of a professional relationship. Regrettably, advantage was not taken of the opportunity. Instead, the staff chose neither to discuss whether it believed the arrangement would give rise to a professional relationship nor to explain how the decision was reached.

119. JEROME B. COHEN, EDWARD D. ZINBARG, & ARTHUR ZEIKEL, *INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT* viii (R.D. Irwin rev. ed. 1973). The first edition of the book had been published in 1967. COHEN & ZINBARG, *supra* note 114. The senior author of the revision is director #2; the second-listed author of the revision was the junior author of the first edition; and director #1 is named last as an author of the revision. A third edition of the book was published in 1977, a fourth edition in 1982, and a fifth edition in 1987. Authorship of the third, fourth, and fifth editions was by the same three authors, with no change in the order in which they were listed. Library of Congress Online Catalog, *supra* note 114.

B. *CG Fund, Inc.*¹²⁰

The facts presented by CG Fund, Inc. are relatively simple. The president of a private university was a member of the board of three registered investment companies (“funds”) and designated as an independent director of these funds. Whether he could continue as an independent director came into question when the individual who chaired the board of the investment adviser to the funds, and who served as president of the funds, was proposed for election to the regents (*i.e.*, the governing board) of the university. The regents, whose number was limited to 46, included alumni, residents of the geographic area where the university was located, and current faculty members and students. The president of the university, by virtue of his position as chief executive officer of the university, was also a regent. No regent received financial compensation for serving as a regent.

Would the presence on the board of regents of the officer of the three funds and chair of the board of their adviser alter the status of the president of the university as a director of the funds? The staff concluded that it would not recommend action by the Commission under paragraph (B)(vii)¹²¹ to ascertain whether a material business or professional relationship would exist between the president of the university, on the one hand, and the principal executive officer (the chair of the board) of the funds’ adviser, on the other, if the latter were elected a university regent.¹²² As a prerequisite, however, the staff expressly required the lawyer who represented the investment companies to conclude that the president of the university would continue to qualify as an independent director of the funds.¹²³

Given the substantial compensation that some college and university presidents have garnered in recent years,¹²⁴ a question exists

120. CG Fund, Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,712, at 81,496 (Feb. 10, 1972), available at 1972 SEC NoAct. LEXIS 690 (Feb. 10, 1972).

121. 15 U.S.C. § 80a-2(a)(19)(B)(vii).

122. Although the individual chairing the board of the investment adviser was also the president of the funds, the staff reply makes no reference to his role as president. If the president of the funds was their principal executive officer and had a material business or professional relationship with the president of the university, the latter would be an interested director of the funds through paragraph (A)(vii). 15 U.S.C. § 80a-2(a)(19)(A)(vii).

123. The letter of inquiry sent to the staff focused only on whether a “material business relationship” might be present. In its response, the staff refers to a “material business or professional relationship. CG Fund, Inc., *supra* note 120, ¶ at 81,497. In so doing, the response raised the matter of a professional relationship but failed to clarify the difference(s) between a professional relationship and a business relationship. *Id.*

124. Julie L. Nicklin, *74 Private-College Presidents Earned More Than \$300,000 in 1998-99*, CHRON. HIGHER EDUC., Nov. 24, 2000, at A26 (individuals recruited for university presidencies “are negotiating harder for higher compensation these days, even bringing in lawyers to do the

whether the response of the staff in this case should be applied to all college and university presidents at the present time. A regent of a college or university votes on the appointment (including the renewal of the appointment) of its president and on the amount of compensation to be received by the president. As a result, a material business relationship could well currently exist between the president of a college or university and a regent.

The pertinent question here, however, is whether in the 1970s there would have been a material *professional* relationship between the university president who was an investment company director and a regent who was the president of the investment company and chair of its adviser. The question can be answered in the affirmative because, as a manager of and/or policy maker for a university, both individuals were required to: (i) appreciate, even if they did not possess a comprehensive and detailed grasp of, the body of advanced knowledge with which the university dealt;¹²⁵ (ii) exercise the sophisticated judgment necessary to preserve and promote the standing of the university;¹²⁶ (iii) possess the intellectual skills that allow the nature and needs of a university to be analyzed and understood; and (iv) develop and implement the formal and informal standards set by the regents.¹²⁷ Moreover, if the university president in this case would not have been involved in a business (*i.e.*, financial) relationship with the officer of the funds and the chair of the board of their adviser once the latter was a regent – a conclusion the staff was willing to accept – service to the public and to students, rather than pecuniary gain, was presumably the main motivation for both individuals in their respective roles at the university.¹²⁸

The situation facing the CG Fund, then, involved the possibility that a professional relationship would be present and that it would be ma-

bargaining for them”); Julianne Basinger, *Proving Presidential Worth*, CHRON. HIGHER EDUC., Nov. 19, 2004, at 11 (in the 2003 fiscal year, the number of presidents of private colleges who were paid in excess of \$500,000 reached 42, an increase of 56% from the prior year; Derek Bok, *Are Huge Presidential Salaries Bad for Colleges?*, CHRON. HIGHER EDUC., Nov. 22, 2002, at 20 (noting that high compensation for university presidents is recent).

125. See Bok, *supra* note 124.

126. Lloyd H. Elliott, *How Much Does a College President Deserve to be Paid?*, CHRON. HIGHER EDUC., March 10, 2000, at A64. See Bok, *supra* note 123.

127. See NAT’L ASS’N OF INDEPENDENT COLLEGES & UNIVERSITIES, *THE RESPONSIBILITIES OF INDEPENDENCE: APPROPRIATE ACCOUNTABILITY THROUGH SELF-REGULATION (FINAL REPORT OF THE NAICU TASK FORCE ON APPROPRIATE ACCOUNTABILITY)* (1994), at <http://www.naicu.edu/pubs/PubsOrder.shtml> (last visited Jan. 28, 2006).

128. See Bok, *supra* note 124. “After all, few presidents enter college administration and accept leadership positions to make money. For them, the real appeal of the job is the chance to make a difference, to exercise influence in a worthy cause, to deal with interesting issues and tackle challenging problems.” *Id.* See Elliott, *supra* note 125.

terial, but the staff sidestepped the task of deciding whether a professional relationship would exist. Neglecting the concept of a professional relationship, however, is inconsistent with congressional intent for paragraphs (A)(vii) and (B)(vii) of § 2(a)(19).

C. *Securities Groups*¹²⁹

The last of the no-action letters that will be examined involved a registered investment company ("fund") being established by a subsidiary of an investment bank. The subsidiary would be the investment adviser to the fund, and a proposed independent director of the fund would be an economist who was a member of an "International Monetary Advisory Board" of the bank. The sole responsibility of a member of the advisory board of the bank was to make presentations at symposia organized semiannually by the bank for individuals working in the financial sector, in corporations, in government, or in religious entities. For the one symposium held since the fund was incorporated, the bank had paid the economist \$2000 for his presentation in addition to reimbursing his travel expenses. If the economist were to become a director of the fund, however, he would receive no compensation for his presentations at subsequent symposia.

Both paragraphs (A)(vii) and (B)(vii) of § 2(a)(19) apply to material business and professional relationships, but the economist was potentially covered just by paragraph (B)(vii): the economist had a relationship with a person (specifically, the bank) that presumptively controlled the investment adviser to the fund.¹³⁰ If a material business or professional relationship had been present between the economist and the bank, paragraph (B)(vii) would have caused the economist to be an interested person of the adviser, and paragraph (A)(iii) would have caused him to be an interested person of the fund.¹³¹ However, the staff did not discuss whether a business and/or professional relationship between the economist and the bank had existed in the past

129. Securities Groups, SEC No-Action Letter 1981 SEC NoAct. LEXIS 3490 (April 20, 1981).

130. Securities Groups, *supra* note 129, at *3. The investment adviser was a corporation and a subsidiary of the bank. Accordingly, more than one-half of the voting stock issued by the adviser was owned by the bank. *Id.* See JOHN DOWNES & JORDAN ELLIOT GOODMAN, BARRON'S FINANCE & INVESTMENT HANDBOOK 853 (Barron's 6th ed. 1995) (definition of "subsidiary"). The Investment Company Act establishes a rebuttable presumption that a corporation is controlled by a beneficial owner of more than 25% of its voting securities. 15 U.S.C. § 80a-2(a)(8)-(9) (2000).

131. 15 U.S.C. §§ 80a-2(a)(19)(A)(iii), 80a-2(a)(19)(B)(vii) (2000 & Supp. II 2002). Paragraph (B)(vii) includes a material business or professional relationship with *inter alia* a person controlling the investment adviser to the investment company. 15 U.S.C. § 80a-21(19)(B)(vii)(2000 & Supp. II 2002).

or would exist in the future; it merely concluded that a material relationship was absent. In terms of the symposium presentation for which the economist had been paid \$2000 by the bank, the staff believed that the amount was “not so significant as to tend to impair his independence.”¹³² Given this conclusion, it should not be surprising that the staff also decided that future presentations, for which the bank would provide no compensation, would not create a material relationship.

The position of the staff, however, bypasses the initial question that ought to be posed regarding the symposia presentations, namely, whether there is a business relationship or a professional relationship. As explained in part III of this article,¹³³ the materiality of a relationship ought to arise as an issue only *after* one of the two types of relationship is found to exist. The question that is important here, of course, is whether a professional relationship (rather than a business relationship) was present. That the staff furnished no answer to the question evidences an unwillingness to deal with the nature of professional relationships under § 2(a)(19). The avoidance of the question is especially notable because the inquiry sent to the staff by the bank explicitly referred to the possibility of a professional relationship between the economist and the bank without mentioning the possibility of a business relationship.¹³⁴

The staff reaction to the Securities Groups thus manifests what appears to be a general resistance on the part of the Commission to accepting professional relationships in their own right. That the question of a professional relationship in the case was sidestepped is significant because economics clearly possesses the attributes of a profession. Specifically, the concepts of economics are abstract, and its principles are complex. Moreover, the economist here had undergone extensive training in that he had earned a Ph.D. degree and held a position com-

132. Securities Groups, *supra* note 129, at *3.

133. See *supra* text accompanying note 64.

134. The investment bank pointed out that the economist, after becoming a director, would receive no financial compensation for participating in symposia sponsored by the bank, and contended that this would “preclude any question of a professional relationship existing in the future” with the bank. Securities Groups, *supra* note 129, at *5. The letter to the staff thus explicitly associated professional relationships with monetary compensation in terms of future symposia. However, the bank acknowledged in the same paragraph that the relationship in the past between the economist and the bank “might” be characterized as “a professional one” because the economist was a member of the advisory board of the bank. *Id.* The bank argued that a professional relationship, if it existed, could not be deemed material in degree, but whether prior monetary remuneration for symposia presentations was the basis for this contention is unclear. *Id.* Since the bank raised the possibility of a professional relationship, the staff could have discussed the nature of such a relationship and linked it to the attributes of a profession described in part IV of this article. The staff did not do so presumably because it assumed that a professional relationship is a type of business relationship.

mensurate with a doctorate.¹³⁵ Accordingly, he would have been exercising sophisticated judgment in dealing with the phenomena comprising his occupation, would have had considerable latitude in his work, and would have been subject to the precepts of science as to *inter alia* standards for the analysis of quantitative data. The economist was also significantly involved in important matters of public policy¹³⁶ and, hence, in public service.

VI. CONCLUSION

As is apparent from parts IV and V of this article, paragraphs (A)(vii) and (B)(vii) of § 2(a)(19) of the Investment Company Act place us at the intersection of law and social science. Research in the sociology of occupations suggests that the defining elements of a profession are more numerous and less certain than the defining elements of a business, indicating that professional relationships are more difficult to identify than business relationships. Over time, moreover, the United States has evidently developed new types and a larger number of professions,¹³⁷ as well as become generally more heterogeneous.¹³⁸ Societal heterogeneity may present an obstacle to determining the existence of a professional relationship because whether a relationship is professional may vary from one subpopulation to another.

Given the inherently uncertain and multifaceted nature of professions, the task of the Securities and Exchange Commission under paragraphs (A)(vii) and (B)(vii) is more complicated when dealing with professional relationships than when dealing with business relationships. In addition, the hurdle posed by the need to understand a non-law discipline (*viz.*, sociology) may contribute to the reluctance of the Commission to recognize professional relationships and distin-

135. The economist, Arthur B. Laffer, received a Ph.D. in economics from a Stanford University and headed a firm he had founded that provided economic research and consulting to asset managers at financial institutions. Greater Talent Network, Inc., at <http://www.greatertalent.com/biography.php?id=504> (last visited Feb. 6, 2006); Keynote Speakers, Inc., at http://www.keynotespeakers.com/speaker_detail.asp?id=702 (last visited Feb. 6, 2006).

136. *Id.*

137. See LARSON, *supra* note 89, at 178. Cf. Gregory Williams, *The Changing U.S. Labor Force and Occupational Differentiation by Sex*, 16 DEMOGRAPHY 73, 79 (1979) (the number of occupations in the United States increased from 252 in 1900 to 670 in 1970).

138. U.S. CENSUS BUREAU, *supra* note 8, at table 42 (proportion of U.S. population that was born in another country was 6.2% in 1980, 7.9% in 1990, and 11.1% in 2000); Frank M. Gollop & James L. Monahan, *A Generalized Index of Diversification: Trends in U.S. Manufacturing*, 73 REV. ECON. & STAT. 318 (1991); Anthony Bianco, *The Vanishing Mass Market*, BUS. WK., JULY 12, 2004, AT 61.

guish them from business relationships.¹³⁹ Difficulty, however, cannot excuse the persistent unwillingness of an administrative agency to regulate an activity that Congress has decided should be regulated, especially when the congressional decision is explicitly stated in legislation.¹⁴⁰ All, not just some, facets of a statute must be enforced. If for no other reason than that independent directors are increasingly regarded in the United States as essential to the fortunes of corporations and their shareholders,¹⁴¹ the independence of directors should be determined by each and every factor specified in legislation. The Commission is obligated to do no less under the Investment Company Act if it is to fulfill the mandate expressly imposed on it by Congress to protect investors and promote the public welfare.¹⁴²

The statutory mandate of the Commission has implications that extend beyond those that are economic in nature, and it is unfortunate that the non-economic implications of this mandate are infrequently acknowledged. Since an economy functions within a society, the Commission has effects on the broader social system. The Commission, as the administrative agency responsible for implementing federal securities statutes,¹⁴³ is charged with maintaining (and, when needed, restoring) the trust of the public in securities and securities markets, a task that is critical for our society given the evident impact of the level of trust on the robustness of the financial sector of a country.¹⁴⁴ In addition, the rules and enforcement actions of the Commission symbolize fundamental values embedded in the social order (e.g., as to equality of treatment) and affect the reputation of the organizations that comprise and participate in securities markets.¹⁴⁵ If these social outputs —

139. Douglas W. Vick, *Interdisciplinarity and the Discipline of Law*, 31 J.L. & Soc'y 163 (2004).

140. See *Pub. Serv. Comm'n v. Fed. Power Comm'n*, 511 F.2d 338, 354 (D.C. Cir. 1975); *Exxon Corp. v. Phillips Petroleum Co.*, 265 F.3d 1249, 1252 (Fed. Cir. 2001).

141. Grover C. Brown et al., *Director and Advisor Disinterestedness and Independence under Delaware Law*, 23 DEL. J. CORP. L. 1157, 1157-1158 (1998) (noting a trend toward an increasing number of "disinterested and independent directors" on boards of corporations and attributing the change partially to judicial deference to "decision makers who are capable of making an impartial business decision").

142. 15 U.S.C. §§ 80a-1(b), 80a-37 (2000). See 15 U.S.C. § 80a-41 (2000 & Supp. II 2002). "The Commission may make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this subchapter or of any rule, regulation or order hereunder. . . ." *Id.*

143. 15 U.S.C. § 77s(a) (2000); 15 U.S.C. §§ 78u(a)(1), 78u-3(a) (2000 & Supp. II 2002); 15 U.S.C. § 80a-41 (2000 & Supp. II 2002); 15 U.S.C. § 80b-3(e) (2000 & Supp. II 2002). See *Stead v. Sec. & Exch. Comm'n*, 444 F.2d 713, 717 (10th Cir. 1971), *cert. denied*, 404 U.S. 1059 (1972). The Commission was created by the Securities Exchange Act. 15 U.S.C. § 78d(a) (2000).

144. Calderón et al., *supra* note 15; Zak & Knack, *supra* note 15.

145. Barnett, *supra* note 23.

trust, perceptions of fairness, and reputation — promote the operation of the social system, society benefits, but positive outputs will be unnecessarily limited if *ceteris paribus* the Commission continues to ignore the congressional directive in paragraphs (A)(vii) and (B)(vii) to focus on the professional relationships of investment company directors.