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# FUND GOVERNANCE

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## I. FUND GOVERNANCE

PROF. HAAS: Our first panel's main focus is on mutual fund governance. It addresses a simple issue: is there a better way to govern mutual funds so that the investments of mutual fund shareholders, that is, us, are more fully protected? We have a stellar panel today. I am extremely delighted with this panel in particular. We have Steve Howard, a partner at Paul, Weiss, Rifkin, Wharton & Garrison; Mark Jacobs, general counsel at the Dreyfus Corporation, and also a New York Law School alumnus, which means he will receive about 150 resumes after today.

MR. JACOBS: That is fine. Send them in.

PROF. HAAS: We have Mark Sargent, Dean of Villanova University School of Law. And lastly we have Victoria Schonfeld, who is general counsel at Mitchell Hutchins Asset Management, which is Paine Webber's mutual fund subsidiary. What I'd like to do right now is turn it over to Dean Sargent, who is going to discuss why mutual funds have boards of directors in the first place, and what inherent conflicts of interest exist between a mutual fund and its investment advisor. I introduce to you Dean Sargent.

DEAN SARGENT: Thank you, Jeff. It is a pleasure to be here at another law school. Deans like visiting other law schools because we have absolutely no responsibility for what happens at them. So it is certainly very relaxing.

My job is to talk about fund governance the way it exists today, because my colleagues are going to talk about fund governance the way it should be. They have some very intriguing ideas, and they are going to be evaluating proposals that the Investment Company Institute (ICI) and the Securities and Exchange Commission (SEC) have made recently.

Fund governance is newly controversial and the controversy has been pretty intense. Directors of mutual fund investment companies are whipsawed. They are damned if they do, that is, act independently of the fund managers, and damned if they do not, that is, do not act independently of the fund managers. For example, there have been notorious situations in which independent directors who exercised their authority to remove fund managers under the appropriate circumstances have, as a result, faced proxy battles to remove them from office or lawsuits initiated by well-financed fund advisors. In this way, they are damned if they do act independently. On the other hand, there are instances of the SEC bringing actions against funds for various violations of the Investment Company Act of 1940[1] (the '40 Act) or other securities acts. There have also been further instances where the SEC brings actions against directors for dereliction of one of their duties. In this sense they are damned if they do not act independently. Therefore, fund directors are in a very conflicted position.

There are other problems, too. There is tremendous controversy over the substantial fees which mutual fund directors often receive. There is also the ongoing controversy involving the independence of so-called house directors. In particular, I refer to the *Strougo* decisions[2] in which there is a tension between what appears to be well-settled federal law with respect to the independence of house directors and the evolving body of case law which questions the independence of such directors.[3] The new controversy is causing, for the first time in quite a while, a rethinking of what fund governance is all about. Before we get to the rethinking, I will put all of this agitation in context by describing in a basic way how fund governance works.

The first point is that directors of investment companies share many of the same duties as directors of ordinary corporations. They have the basic fiduciary duties of care and loyalty, although they are substantially insulated from judicial review through the application of the business judgment rule. They also have specific responsibilities that are basically the same as for directors of any

1. 15 U.S.C. § 80 a-2 (Supp. 1999).

2. *See* Strougo v. BEA Assocs., Fed. Sec. L. Rep (CCH) P90742 (S.D.N.Y. Jan 19, 2000), *available at* 2000 U.S. Dist. LEXIS 346; Strougo v. BEA Assocs., Fed. Sec. L. Rep (CCH) P90457 (S.D.N.Y. 1999), *available at* 1999 U.S. Dist. LEXIS 3021; Strougo ex rel. Brazil Fund v. Padegs, 27 F. Supp.2d 442 (S.D.N.Y. 1998); Strougo ex rel. Brazil Fund v. Padegs, 1 F. Supp.2d 276 (S.D.N.Y. 1998); Strougo ex rel. Brazilian Equity Fund, Inc. v. Bassini, 1 F. Supp.2d 268 (S.D.N.Y. 1998); Strougo ex rel. Brazil Fund v. Padegs, 986 F. Supp. 812 (S.D.N.Y. 1997); Strougo ex rel. Brazil Fund v. Scudder, Stevens & Clark, Fed. Sec. L. Rep. (CCH) P99533 (S.D.N.Y. 1997);

3. *See* Evangelist v. Fidelity Mgmt. & Research, 554 F. Supp. 87 (D. Mass. 1982). *See also* Hasan v. Clevetrust Realty Investors, 548 F. Supp. 1146 (N.D. Ohio 1982), *vacated on other grounds* 729 F.2d 372 (6th Cir. 1984).

company. They review financial reports and regulatory filings; they select independent auditors; they call shareholders' meetings; they declare dividends; they approve mergers and other fundamental transactions, and they adopt and amend bylaws. But there are also duties unique to being the director of an investment company. The principal unique duty is hiring and, theoretically, firing fund managers and other service providers. That is absolutely crucial. Another duty is setting up procedures for valuing securities. The board does not value the securities themselves, but they have to set up valuation procedures and to monitor the process. They also oversee trading practices and procedures. They approve the fund's code of ethics. They monitor investments and investment performances, and they oversee personal trading by managers. Thus, there is a whole host of specialized duties which the directors of investment companies are required to discharge.

Perhaps more importantly, the key difference between the board of an ordinary corporation and the board of an investment company is in the composition of the board. There is a fundamental difference in the composition of the board that is a function of the peculiar nature of investment companies. In an ordinary corporation, the shareholders elect the directors, who hire the officers, who are employees of the company, albeit powerful ones. In contrast, an investment company has no true employees. Typically, the board selects the fund managers to manage the fund, underwrite the sale of shares and provide services to the fund. The notion that the fund manager is a sort of hired service provider is purely a legal fiction. The fund companies organize the investment company, serve as the brand name that attracts the investor, provide all the services and are really the driving force behind the investment company. This results in a built-in, structural conflict of interest for the fund managers. They have fundamental interests in compensation that may not be congruent with the shareholder's interest in maximizing return. One can argue that the market will have the effect of rendering those interests congruent, but the mere existence of the '40 Act reflects congressional judgment that market forces are insufficient to eliminate that conflict. Recognizing this conflict, the '40 Act insists that a certain percentage of the directors be independent[4] of the fund managers so that they may effectively monitor the managers' potential conflicts of interest.

Now, this is very different from what is required under the state corporation statutes. State corporation law does create some incentives to have independent directors. For example, independent directors play a crucial role in derivative litigation and in setting executive compensation. But there is nothing in state corporation law like the requirement of the '40 Act that 40% of the directors not be "interested persons."[5] The percentage is being reviewed at the moment, both as a matter of best practices[6] and as a matter of SEC requirements.[7] The SEC has historically recommended the use of a majority of independent directors.[8] Some fund complexes have voluntarily adopted a majority requirement for disinterested persons and those with affiliated distributors have a 60% requirement. The important thing, leaving the question of exact percentage aside, is that there has always been this notion that a substantial portion of the board of an investment company should be independent, that is, not "interested persons."

There are statutory definitions of what constitutes an interested person.[9] They consist of obvious factors. They include people with any range of relationships with the investment advisor, ranging from its counsel, to its shareholders, to people with personal business or familial relationships with the advisor, registered broker-dealers, and so on. But it is crucial that there is the requisite percentage of independent directors, because certain basic arrangements have to be approved by the independent directors. For example, you need a majority of independent directors to approve advisory and distribution arrangements.[10] If you do not have advisory and distribution arrangements, you are not operating a fund.

4. *See* 15 U.S.C. § 80a-10(a) (1994).

5. *See* 15 U.S.C. § 80a-2(a)(1994).

6. *See* Investment Company Institute, *The Advisory Group on Best Practices for Fund Directors*, *at* http://www.ici.org/issues/fund_governance.html#TheAdvisoryGroup.

7. *See* Role of Independent Directors of Investment Companies, Exchange Act Release No. 33-7754, 70 SEC Docket (CCH) 1867 (Oct. 14, 1999) [hereinafter SEC Proposals].

8. *See* Role of Independent Directors of Investment Companies, Exchange Act Release No. 33-7932, *available at* 2001 SEC LEXIS 15, at *14 (Jan. 2, 2001).

9. *See* 15 U.S.C. § 80a-2(a)(19)

10. *See* 15 U.S.C. § 80a-15(c) (1994).

You have to have a majority of independent directors for that to happen; otherwise, the arrangements are not valid.[11] Now, suppose you meet the statutory definition of independence, of not being an interested person. Does that mean that the fund directors are truly independent? The nature of directorial independence has been a major issue in state corporation law for a long time, but it is increasingly becoming an issue in investment company law. The problem is that there is a tendency to treat your friends well, to bring your cronies on the board. A method of selection may be used that is haphazard and not systematic, and thus not designed to identify truly independent individuals. There is a psychological tendency on the part of directors, even if they appear to have some degree of independence, to go along with the rest of the board and not be the critical dispassionate voice that they are supposed to be. There is the question of whether even the most independent director can be compromised by large fees. And there is also a very serious question, which we will hear about later today, with respect to the competence of independent directors. Let us imagine you have someone who is truly independent, has no relationship really to the fund managers, but has absolutely no idea what he or she is doing—does not understand the industry and does not understand the regulatory structure. As Jeff mentioned, understanding how the '40 Act works is not easy, even for ordinary securities lawyers, let alone people who may have business experience but no legal experience. And then, of course, you have the problem of the house director, someone who serves as the director on multiple boards in a complex or family of funds. Can they really be sponsored by the same entity? Can this person be described as truly independent?

PROF. HAAS: Mark, a quick point on that.

DEAN SARGENT: Sure.

PROF. HAAS: The whole notion of house director, which we will talk about in just a little bit, is that you qualify as an independent director, according to the statutory definition, but you are paid so much money to serve on the board complex. We are talking anywhere from $50,000 to $250,000 a year to show up to a few meetings and basically look out, hopefully, for the shareholders' best interests, and we all know that human nature tells us that some

11. *See id.*

people can be swayed by money. Where is the point at which house directors are swayed? Where is the point where these directors are going to be compromised because they are being paid so much money. And I want to throw out one statistic. The Morningstar Company in 1996 found that the more money directors were paid, the more shareholders paid in management fees, implying that if you pay your directors handsomely, they will rubber stamp a fee structure as high as the investment advisor would like. With that I turn it back.

DEAN SARGENT: That problem is compounded when the director sits on more than one board for the same sponsor. They may be sitting on four or five separate boards in the family, and if you multiply the fees by five, that really raises a question.

How does the board operate? Since we are all lawyers here, let me approach this from a legalistic perspective by rephrasing the question. What standards have the courts imposed when the board, particularly the independent directors, have made decisions regarding apparent conflicts of interest between the investment company and the investment advisor? What do you have to do then?

The key point is process, not a substantive review of the decision to determine whether it was correct. Did the board follow proper procedures? Was there a valid decision-making process? The factors that go into this are rather sensible. You look at the relative number of independent directors. Did you have, for example, a majority of independent directors rather than the statutory minimum? How independent was the board? Second, you look at the experience and the expertise of the directors. Did they, in fact, know what they were doing? Did they have the type of background which enabled them to act? Third, what were the methods used in selecting the directors? Was it a question of recruiting old college buddies or was there a systematic attempt to identify people who are appropriate? Fourth, what was the extent and the quality of information provided to the directors? Did the directors meet their obligation under the statute to request and evaluate adequate information, or were they simply operating in the dark? Did they have independent counsel advising them of their legal obligations? Fifth, and finally, did they have full and substantive deliberations, or did they just let things go by? If these procedures are followed, chances are it will be regarded as a valid decision-making process and the decision will not be second guessed. So, it is a matter of process.

Another essential concept is the fact that the directors do not truly run the mutual fund. Their function is to select service providers and to monitor the adequacy of internal controls and compliance programs. Their job is to look for warning flags, identify problems and initiate remedial action when necessary. For example, they have to monitor the compliance program with respect to any SEC requirements. They have to have an oversight perspective with respect to investments, even though they do not make investments themselves. They also have to oversee what is going on with brokerage allocations. Now, that is easy to say: oversee, monitor. How exactly do you do that, though? Let me give you an example of how it is done, and let us deal with the basic problem of compliance.

Compliance is the notion that the fund has to comply with a whole range of reporting and, perhaps, inspection requirements of the SEC. First of all, the independent directors have to understand what compliance is all about: what it is, why you have to do it, and what the consequences are for not complying with the law. The directors have to implement a compliance training program and they must know something about the program. They must conduct meetings, to some extent, or at least obtain reports from senior personnel so that they can make judgments about how seriously all this has been taken. They have to be informed of major interactions with the SEC, especially where questions have come up. So, we are not talking about the directors actually running the compliance program; rather, they oversee it.

Now, with all of that stated as background, the question for today is: does this work, given the tremendous size and importance of investment company interests? Another question is the potential for a debacle, in the event of a serious market correction. There are going to be very hard questions raised about fund governance, principally whether the independent directors are sufficiently independent. Were there sufficient assurances of directorial competence? And even more fundamentally, does the built-in structural conflict in the organization of investment companies require a different type of shareholder protection? Is even the presence of genuinely independent and genuinely competent directors enough to provide shareholder protection? This is a polite way of asking whether more regulatory intervention is required, even in a highly regulated industry. I am not going to offer answers to any of these questions. My colleagues will have some thoughts. Certainly the ICI and the SEC have been debating the issues intensively in recent years.

PROF. HAAS: Let me just add a couple quick points on that before I turn it over to Mark Jacobs, a couple of examples showing that maybe the system does not work and maybe our directors are not doing the jobs they should do. First, there are funds that have continually dismal performance records, that lose money year after year. The investment advisors of those funds do not get the boot. Very infrequently will they get the boot. If we performed poorly in our jobs year after year after year, it would not be surprising that we would get fired. Yet fund advisors are not fired, or are fired only in the rare instance. This is interesting, because sometimes fund advisors do not manage the portfolio of a particular mutual fund directly. They farm it out to a sub-advisor. A sub-advisor has a contractual relationship with the fund and is overseen by the investment advisor. The interesting point to consider is that while it is extremely unusual for directors to fire a fund advisor for poor performance it is not unusual at all for a fund advisor to fire a sub-advisor when that sub-advisor performs poorly.

The second thing that might indicate that directors are not doing what they should be doing is that it is generally understood that larger funds, funds which have billions and billions of dollars in assets, are not as nimble as smaller funds. And thus the performance of those funds suffers. Yet very few funds close off to new investors, something you would think the directors would desire, so that existing shareholders benefit from enhanced performance going forward.

Now, having said that, we have got a couple of proposals out there right now to make things better. One is coming from the Investment Company Institute, which is the mutual fund industry trade group and is very proactive in this and other matters.[12] The

12. *See* Investment Company Institute, *supra* note 6.

SEC itself, particularly Chairman Arthur Levitt, has made the role of fund directors his rallying cry for trying to fix what he perceives to be wrong with the industry. So we have two proposals and I'd like to try to talk about those quickly before we get to something that Steve Howard is going to propose. Mark, are you in a position to take us through them?

MR. JACOBS: Let me pick up with what you were saying, Jeff, about Chairman Levitt's interest in this whole area. Just last February, he held a roundtable in Washington D.C. on the role of independent investment company directors, in order to focus on what their appropriate role and specific responsibilities should be.[13] After the roundtable, he announced that the SEC would consider certain regulatory proposals to enhance their effectiveness. At the same time that he made his announcement, the ICI announced the creation of an advisory group on best practices for fund directors.[14] Now, the advisory group's mission was to identify the best practices used by fund boards to enhance the independence and the effectiveness of fund directors, and to recommend practices that should be adopted by all mutual fund boards. In preparing their report, the group looked at practices utilized by fund boards. They consulted a variety of experts, from fund managers, independent directors, prominent academics, attorneys, accountants, and they received a great deal of input.

By June of 1999, they issued their report on the role of independent investment company directors.[15] The report recommends fifteen different policies and practices for adoption by mutual fund boards. In July, the board of governors of the ICI recommended that all members of the ICI implement the practices in the report.[16] When I mention the ICI and its membership, you are really talking about organizations representing approximately 95 percent of the assets in the mutual fund industry today.

The best practices identified in the report, and I will go through them with you in a moment, surpass the statutory and the

13. *See* SEC Roundtable on the Role of Independent Investment Company Directors, Washington D.C. February 23-24, 1999.

14. *See* Investment Company Institute, *supra* note 6.

15. *See id.*

16. *See* Investment Company Institute, *ICI Board Adopts Resolution Urging Fund Industry to Strengthen Governance, at* http://www.ici.org/issues/dtrs_best_prac.html.

regulatory requirements of the '40 Act applicable to registered investment companies.[17] However, they do not carry the force and effect of law. Fund directors must consider whether, to the extent that the practices are not in place, they should adopt these practices. In fact, SEC staff members have stated on several occasions that when they come in and examine mutual funds and go through the records of the fund and examine the minutes, they are going to be looking to the consideration the directors gave to these various practices. If the directors rejected a particular practice or practices, the SEC staff will want to see their reasoning very well-documented. It is also important to mention, however, that the report acknowledged that not every single recommendation will be applicable to every single investment company, and that boards may determine that there are other practices which may be more suitable for them. So it really will be a matter of individual circumstances. I am going to review the practices now. I would say that the majority of the practices recommended are already in place in most of the major mutual fund complexes. The recommendations generally are designed to fulfill three different objectives: first, to ensure that the board is structured to be independent; second, to ensure that the independent directors can, in fact, act independently; and third, to enhance the effectiveness of all directors, irrespective of whether they are independent or non-independent directors.

The first recommendation is that at least two-thirds of the directors of all investment companies be independent directors. Now, as Dean Sargent just told you, this recommendation goes beyond what is currently required under the '40 Act, and, in fact, what even may be subsequently required. The purpose of this recommendation, the report said, is to ensure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment advisor or other service providers. The report did acknowledge that funds may have to either add or remove directors in order to meet this two-thirds requirement.

The next recommendation—and we can come back and discuss these, but I think we just want to get through all of them now—is that former officers or directors of a fund's investment ad-

17. *See* Investment Company Institute, *supra* note 6.

visor, principal underwriter or other affiliates not serve as independent directors of the fund. And the report did acknowledge that these former insiders may be highly desirable candidates for board membership, but that it would be difficult, in both fact and appearance, for a former insider to switch sides. The report emphasized that the fund boards can still benefit from their expertise and experience by having them serve as either interested directors or in an advisory capacity. And this practice clearly exceeds the provisions of the '40 Act and its regulations, which more liberally define a non-interested director.[18] Just one parenthetical here. The '40 Act, the rules and regulations talk about interested versus non-interested directors. What the ICI advisory group really spoke of, however, was not interested or non-interested directors, but independent directors.

The third recommendation made by the group is that independent directors be selected and nominated by the incumbent independent directors. The report states that the reasoning was that control of the nominating process by the independent directors helps dispel any notion that the directors are hand-picked by the advisor. As you may know, this practice is widely followed, because any mutual fund which operates pursuant to a Rule 12b-1 distribution plan already would have a nominating committee composed of non-interested directors.[19] So, we do not think that this particular recommendation or practice is going to cause a big wave in the industry. The advisory group did say that the investment advisor would not be precluded from giving input during the selection and nomination process.

The last recommendation that falls within the category of what I would call "ensuring that the board is structured to be independent" is that independent directors complete, on an annual basis, a questionnaire on their business, financial and family relationships, if they have any, with the advisor, the underwriter or other service affiliates. Again, the purpose of this is to ensure that the director does not assume any relationships which might impair his or her independence. This questionnaire would go beyond, I think, what many of the current questionnaires ask, in that they ask about mate-

18. 15 U.S.C. § 80a-2(a)(19) (1994).
19. 17 C.F.R. § 270.12b-1 (2000).

rial business relationships. In this case, they would be talking about all relationships, business relationships, financial relationships, and even family relationships. It was noted in the report that this questionnaire would be available to the SEC staff when they come in and examine the mutual fund. It should also be available to the nominating committee of the board and to fund counsel, as well.

Moving now to the second category of recommendations, the group recommended that the independent directors have qualified investment company counsel who is independent from the investment advisor and the fund's other service providers to ensure that independent directors have adequate resources to act independently. The advisory group also recommended that the independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise. This proposal has been somewhat controversial. Obviously, what the advisory group wanted to do was to see that there are no conflicts of interest. But the question may be, what if the fund's counsel actually does some minor work for the advisor, which really is not a conflict? So you have to look at whether or not it impinges on the role that the firm is playing as counsel. I think you are going to hear a lot more about this recommendation and about this proposal in the future.

Toward the same objective of ensuring the independence of board action, the advisory group also recommended that independent directors should establish the appropriate compensation for serving on fund boards. The advisory group believed that providing the directors themselves with control over their compensation would help to ensure their independence and effectiveness. The report recognized that compensation may vary greatly, depending on the size and the complexity of the funds served by a particular board, the number of meetings that a board has, and other duties that the directors have. The report also recognized, however, that compensation levels had to be at a certain level in order to attract the highly qualified individuals you want to attract.

In a similar vein, the advisory group recommended that independent directors meet separately from management when considering a fund's advisory and underwriting contract, and that independent counsel should attend these separate meetings. I do not know of any situation where, currently or pre-June of 1999, you did not have the independent directors meeting in closed session. It was common practice that their counsel would sit in on that session and meet with them and advise them at that time. So, again, I do not think that this particular practice brings anything very new.

The next recommendation is that investment company boards should establish audit committees composed entirely of independent directors; that the audit committees should meet with the fund's independent auditors at least once a year outside the presence of management representatives; that the audit committee should secure from the auditor an annual representation of its independence from management; and finally that the audit committee should have a written charter that spells out its duties and powers. One thing that the directors would have to do in connection with serving on an audit committee is to determine whether the auditor does consulting work for the advisor, and whether or not the auditor's relationship with the advisor compromises the auditor's independence in any way.

Next, the advisory group recommended that the independent directors should designate one or more lead independent directors. This person would coordinate the independent directors' activities, chair the separate meetings of the independent directors, and coordinate with counsel and management. Boards can determine whether it would be better to have more than one lead independent director, perhaps one who would be the lead independent director on financial matters, but perhaps somebody else is better suited to be the lead independent director when there are trading-related issues being discussed. It was also pointed out that if you have a very small board, for instance, three members on the board, then it might not be necessary to have a lead independent director at all.

Next, it was recommended that fund boards should obtain errors and omissions insurance coverage and/or indemnification for its directors and officers that is adequate to ensure the independence and effectiveness of the independent directors. And again, it was the thinking of the advisory group that independent directors must be able to take any action that they believe in good faith is necessary for the protection of shareholders without any concern over personal liability from litigation.

The final group of recommendations made by the advisory group actually would enhance the effectiveness of all directors, be they independent or non-independent. The first is that fund directors should invest in one or more of the funds on whose boards they serve. The purpose of this, of course, is to align the interests of the directors with the interests of the shareholders. It was recognized, of course, that it is unnecessary for the fund directors to own shares of the funds for all the boards on which they serve if they serve on multiple fund boards, and that there are certain funds in which it may not be suitable for the director to invest. For instance, it would serve no purpose for a director of a Massachusetts municipal money market fund to invest in that fund if that director is a resident of New York and is headquartered in New York.

The advisory group also recommended that fund boards be organized either as unitary boards for all of the funds in the complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each fund. That brings us back to the discussion of earlier this morning. It is expected, then, that a director is not a director only of a single fund in the complex. In the unitary structure, the director would sit on every board in that complex. Cluster boards would consist of separate boards for groups of funds. You might have them clustered according to channels of distribution or, because of the investment objective of the fund or in some other way. The reasoning behind the group making this recommendation is that such a board would have greater familiarity with the fund complex and its operation, and greater leverage when dealing with the investment advisor.

PROF. HAAS: There are many fund families out there that do not have one mutual fund. They have multiple mutual funds. For instance, Fidelity Investments. Maybe many of you have investments with Fidelity and its mutual funds. Fidelity, it is my understanding, has 247 different funds under one roof. I do not know if there is any one director that sits on all 247 of the boards, but there might be.

MR. JACOBS: I believe they do have a unitary structure. At Dreyfus, we have about 170 portfolios, and that is broken down into almost a dozen different clusters.

PROF. HAAS: Mark, how do you decide which director would sit on a particular cluster?

MR. JACOBS: A lot of these funds grew up historically, and so it may be dependent on when the fund was first organized. So in our case you will have directors who sit on equity funds, municipal funds, and taxable fixed income funds in a particular cluster.

Fund boards should adopt policies on the retirement of directors. This is something we are going to come back to later, but the advisory group believed it important that the fund board should consider whether setting a specific mandatory retirement age would enhance the board's effectiveness. In doing that, the board is going to have to balance the need for fresh perspectives against the benefits that experience and the institutional memory of existing directors can provide. It was suggested in the report that, as an alternative, fund boards may wish to consider setting specific term limits on the service of fund directors.

The advisory group also recommended that fund boards periodically review their overall performance. They would look, for instance, at a number of issues: whether the materials they are receiving are useful to them, whether they are focusing and spending enough time on the right issues, and whether they have enough professional diversity in the background of all the board members. There are just a whole range of issues that they should be thinking about.

The final recommendation of the advisory group is that new fund directors should receive appropriate orientation and that all fund directors should keep abreast of industry and regulatory developments. Again, I think that is a practice that has gone on in the industry and it is certainly something that should be continued. New directors should receive orientations. For example, there are multiple conferences for investment company directors which they can attend on at least an annual basis. As the fund industry has grown it has gotten more and more complicated. It is extremely important that directors keep abreast of what is going on.

PROF. HAAS: That is an interesting proposal because I would have thought, from a corporate governance point of view, that in order to fulfill your duty of care and decision-making you would have to keep abreast of industry developments and be apprised of what your fund complex is doing almost at all times. So, that proposal struck me as a little odd.

MR. JACOBS: Yes, I think that is one of the best practices which really has been followed by the majority of mutual funds.

PROF. HAAS: Well, let us talk quickly about what the SEC is doing. The ICI is a trade group. It came out with best practices. They are only recommendations. You do not have to adopt them. I think Mark makes an excellent point when he says that many of the proposals that have been adopted were in effect before the proposals came out. What about the SEC? In direct response to Arthur Levitt, saying we want directors to be more responsible, what does the SEC come out with in terms of making directors more effective? Vicki, you are going to walk us through some of those things quickly?

MS. SCHONFELD: Yes, I will. I am happy to talk about the SEC's role in this area.

PROF. HAAS: How many funds does Mitchell Hutchins have?

MS. SCHONFELD: We have 58 funds in our complex.

PROF. HAAS: Assets under management?

MS. SCHONFELD: We have $70 billion under management, about two-thirds of it in mutual funds. But we originally had a system in which we had lots of funds and five or six different boards. Especially after we bought Kidder, Peabody & Co., Inc., we had a hodge-podge of different boards. It takes a huge amount of management time, as you can imagine, to organize board meetings for different clusters.

So we created a Corporate Governance Task Force, put all the key players from all these funds in a room, and really hashed out, over a period of months, all the different alternatives: clusters, unitary boards, or keeping the system the way it was. We ended up creating a unitary board, which involved proxying all of our shareholders. A number of directors opted to retire, so that we could make room for a unitary board.

There is a lot of talk about the role of independent directors. I cannot underestimate the role of experienced counsel in dealing with the boards. I do not think it comes through in the SEC's suggestions. As you indicated, the laws in this area are extremely complicated. The board members who show up five times a year with the best of intentions, trying to stay current with the law, have a hard time remembering all the details of applicable law. For example, what is a Class C share and what is a CBSC? It is not easy to retain. So, it is very important for there to be experienced counsel to walk directors through the issues that they should be considering.

One time, when I was counsel to the independent directors, we were talking about the management fee, the profitability of which turned out to be around seventy-six percent. The directors were asked to vote on the contract. One of the directors said, "Well, I say, if they can get it, good for them." I think it is important for outside counsel to be sufficiently experienced to be able to say, "No, it is up to you to say whether they can get it. Do you think it is fair? Do you think it is reasonable? It is up to you."

Similarly, like Professor Haas indicated, there is a tendency for bad management to stay in place. I represented the independent directors of a mutual fund on a board which had three years of being in the last quintile of performance. I said to the board members in closed session, "Do you really think this is reasonable? Before we fire the manager, maybe we should ask them to put another portfolio advisor on this now." That is what they did and the performance turned around. But the directors often do not know what they should be thinking about, what options they have, or what in fact is their role or their power. So, in that context, I am going to talk briefly about the SEC's proposal.

The SEC came out with its proposed rules in October of 1999.[20] The comment period is just ending. The proposed rules are less restrictive than the ICI's best practices, as they should be. Best practices are just best practices and a board can decide whether to accept them or not. With a regulatory framework, you are stuck with it. And if you do not want to abide by it, you have to either get an exemptive order or a no-action letter. So I think that

20. *See* SEC Proposals, *supra* note 7.

regulation should be more conservative because one size does not fit all in this world, as in most worlds.

All mutual fund complexes, in order to function, rely on a number of exemptive rules which allow certain affiliated transactions, including brokerage with their affiliates, transactions with their affiliated underwriters. Exemptive rules are relied upon day in, day out to do the business of the funds. Under the SEC's proposal, these exemptive rules would be conditioned on following these rules regarding independent directors. This is an interesting approach and is applauded by most of the industry, I believe.

The SEC's key proposal is that fund boards should have a majority of independent trustees.[21] As everyone has mentioned, that is pretty much the industry norm now. In fact, all management companies that have affiliated distributors, and most do, have a supermajority requirement. The proposed nominating process, that all independent directors be nominated by independent directors, is also largely in place now. All funds that have a special kind of distribution method, a 12b-1 plan, have that in place now.

Another proposal, the most controversial one, at least in my view, is the availability of legal counsel. The proposed rule states that you do not have to have independent counsel to the independent directors.[22] But if you do, that counsel has to be truly independent. Only the most minor conflicts can be waived.[23] A minor conflict, for example, is if another partner in the firm did a real estate transaction for the management company. That is a very minor conflict. The narrow definition of independent counsel can present a problem for the fund company.

In connection with commenting on the proposed rule, I did an informal study. I went through the ICI's list of attendees at the mutual fund conference, listed all the law firms that I thought were proficient in this area and that I thought would make good counsel for independent directors, and cross-referenced them to see how many of them do work for Paine Webber or one of its affiliates. Paine Webber, mind you, is not the largest or most diverse broker-dealer. At the end of the study, only one law firm would meet the

21. *See id.* at 1875.
22. *See id.*
23. *See id.*

proposed definition of independent counsel. So, I do not think that is a realistic standard because, again, I think it is more important that you have experienced counsel than that you have truly independent counsel. Good experienced counsel is not likely to be swayed by the fact that their corporate partners across the country are doing deals for subsidiaries of the management company. I just do not think that is realistic.

Now, as to fund ownership. There seems to be a sense that the directors should own shares of the funds of the boards on which they sit. The SEC's proposals would require disclosure in the fund's proxy or the annual report not only of the dollar amount owned of the fund on which the director is sitting, but the dollar amount of securities owned in all funds owned in the entire complex, so that a shareholder can see when the interests of the director are aligned with the interests of the shareholders.[24] In a simultaneous release, the SEC issued guidance on what it considers ways to encourage fund ownership.[25] One of the things that is being done more frequently to say the directors in shares of the fund. That is being actively encouraged.

Another controversial proposal concerns additional disclosure about fund directors.[26] There seems to be a sense that there is not enough information given about the fund directors and that shareholders' publications need to disclose more about the fund's directors. SEC proposal would require extensive disclosure about the ownership and possible conflicts of interest of not only the director, but an extended circle of sisters, cousins, aunts, and in-laws.[27] Technically, you would have to disclose information about a brother who lives across the country and to whom you are not speaking.

PROF. HAAS: One point on that, Vicki. The SEC wants disclosure about sisters- or brothers-in-law. What if I'm not speaking to my sister-in-law? What does that mean for me?

MS. SCHONFELD: That is precisely the issue that we focused on in our comment letter- that the SEC would be putting an affirm-

24. *See* SEC Proposals, *supra* note 7, at 1890.
25. *See id.*
26. *See id.* at 1891-92.
27. *See id.* at 1893.

ative burden on directors to obtain certain information. If your sister-in-law says, "You know what? I do not want to give you that information," does that mean you cannot serve on the board? It is not a realistic type of requirement. The ICI has suggested in its comment letter that there be disclosure, even this greater disclosure, of people whom you support or who live with you, which is consistent with a lot of other regulatory frameworks, certainly of the stock exchange and the beneficial ownership rules.[28] What is interesting is that the SEC has gone much further in this proposal than they have in any other of their beneficial ownership rules. And the underlying theory for that just is not clear.

PROF. HAAS: Let me make one quick comment before we turn it over to Steve Howard and the bull's eye on his back. The SEC, in rejecting the super-majority requirement that the ICI has proposed, stated the following: "We are rejecting this because it would change the dynamic of board decision-making in favor of the interests of investors."[29] I thought that was the whole point. That is, we want directors solely serving the interest of the shareholders. And the SEC rejects super-majority independence because it could shift the balance too much in the favor of shareholders.[30] So I found that very curious. Now we will have some fun. Steve Howard has come up with his own approach to fund governance, something dramatically different, which has, I think, a number of extremely interesting ideas which we can use for the future. And so Steve, I will turn it over to you.

MR. HOWARD: Thank you, Professor Haas. I think as a starting point for my presentation I'd ask everyone to think about why the SEC is even concerned about the independence of directors. I mean, what is it that they are concerned about? There is not a good or straightforward answer to that question. I suggest that what the SEC is really concerned about is that the industry could be on the verge of a huge debacle, a debacle that is similar to the thrift industry debacle of fifteen years ago, which shattered the institu-

28. *See* Investment Company Institute, *ICI Files Comment Letter on SEC Fund Governance Proposals, at* http://www.ici.org/issues/dtrs_rule_cvr.htmt.

29. SEC Proposals, *supra* note 7, at 1875.

30. *See id.*

tional integrity of that industry. It is possible that we could be on the verge of that in the mutual fund industry.

Now, why do I say that? We are told by statistical reports that almost half of the families in the United States are invested in mutual funds through pension plans or directly, that the amount of assets have gone from $135 billion in 1980 to $7 trillion currently in mutual funds. When I started my career twenty years ago, banks were where people had money. And they bought insurance policies from time to time. Now the banks sponsor mutual funds, which was not permitted when I began my career. Now the money, as Vicki pointed out, is not in banks; it is in mutual funds. That is where America invests and also, more and more, that is where the world invests. I practice law outside of the country. Mutual funds in various forms are the way the world is investing now. Whether it is Singapore or Hong Kong or London or Paris or Germany or Britain or South America, mutual funds have become the chosen form of investment for diversification and tax purposes.

So, what does that mean? You have to look at the SEC's concerns, not so much just what is in the releases, but from an economic point of view. You have a huge market sector which has developed in the last twenty years. Unprecedented. The shape of the economic landscape was banks and insurance companies for the first three quarters of the century. Now, money is in mutual funds. How do you regulate that? The SEC, I think, does a tremendous job of regulating the industry, but you still need people out in the industry monitoring what is going on with funds. And that is what we do not have.

In the same time that assets have gone from $135 billion to $7 trillion, the SEC has hired only 200 additional auditors for mutual funds. The number of auditors that the SEC has for the over 15,000 funds in the United States is something a little north of 300. And when the SEC audits funds, they send in two or three auditors. So, if you divide the 300 for any given audit, there are really only 100 audit teams dedicated to mutual funds—that is it for 15,000 funds and $7 trillion worth of assets. The SEC knows this is inadequate. The SEC has also been told by Congress that it will not increase the SEC's budget for more people. So what do you do? You start to get real concerned about the boards and the boards' independence. And that, I suggest, is what is really going on here. The SEC is very concerned about independence because they need the help of the boards, and particularly the independent directors, to make sure that the mutual fund industry does not crater.

So with that as kind of a preface, I would like to propose a different concept, and then I would like my panelists to shoot holes in it. It is not air-tight by any means, but I think we will have some fun. And please, anyone in the audience, please ask questions about it, because this is a work in progress. And I have some of my clients here, as well, so I am going to particularly ask them to ask questions and see if we cannot spark some creative thinking.

The premise that this proposal is based on is that everyone is in agreement that we need independent, knowledgeable and experienced directors. I think, for the most part, we have that. But the question in my mind is are the directors truly independent? Now, I am privileged to serve as fund counsel for many fund groups. One fund group in particular has a board on which Professor Haas sits, which is unusual in that it is composed of completely independent directors. That is very, very unusual in the industry. Most fund groups do not have that. Most fund groups do, I think, have a majority, although there are many fund groups which have 40% independent directors. The reason I point that out is that it will be very interesting to see what the SEC does with that voting requirement. If the industry does not adopt a majority standard, my prediction is that there will be significant problems in the future. I think that, if they do not have a majority of independents, present boards have too close a relationship to fund management. They cannot make the hard decisions, and there will be hard decisions because there will be a market downturn.

So everyone is in agreement that we need independent directors, that they need to be knowledgeable, and that they need to be experienced. My proposal basically suggests that we ought to have a self-regulatory organization which oversees the independent directors and protects them in this conflicted position, which Mark Sargent described, I think, very well. We want to preserve their independence as best we can within an institutional framework that works. So the institutional framework that I am proposing is a self-regulatory organization similar to the NASD,[31] which regulates broker-dealers and securities dealers in the country, called the National Association of Independent Mutual Fund Directors. The entity would basically oversee the independent directors for mutual funds in the United States.

How do these independent directors get selected? Well, it would be a self-selective process. All the directors throughout the country would be required to take a qualifying examination, and it would test things like the '40 Act and other aspects that are important to mutual fund governance. They would have to take that test every year so that the industry continually ensures that directors have the credentials for mutual fund governance. That, I would also suggest, is a way to deal with mandatory retirement issues. If you can continue to pass the exam, you ought to be able to continue to sit on a board. Therefore, there should not be an arbitrary retirement age. There is a simple way to handle mandatory retirement through a testing mechanism. If you are an eighty-year-old and you pass this exam, you are perfectly fit to sit on a board, as far as I am concerned.

PROF. HAAS: Steve, would that be an essay exam or multiple choice?

MR. HOWARD: I leave that to the professors.

PROF. HAAS: Open book or closed book?

DEAN SARGENT: Steve, would it not only test your knowledge of the law, but your knowledge of the industry and how mutual funds operate?

MR. HOWARD: Yes, very much so, Mark. Very much so.

DEAN SARGENT: Being an independent director of a small board investment company, I had no trouble grasping the '40 Act constraints of what it is we were doing. But the mysteries of what the investment manager was doing were a little harder to understand.

MR. HOWARD: I think that is exactly right. I think it needs to be a balanced exam, and not something that is meant to eliminate people, but something that is meant to have people gear up with

31. Referring to the National Association of Securities Dealers, Inc., which oversees the activities of its broker-dealer members. *See* NASD Regulation, Inc., *A Resource for Investors and the Securities Industry, at* http://www.nasdr.com.

testing services and that kind of thing so that they are better informed and feel comfortable dealing with the issues that they have to deal with in the context of their board meetings, which is very challenging. I spend all of my time keeping current with the plethora of regulations that the SEC and the IRS and the Department of Labor issue every day. It is quite a challenge. Board directors are, for the most part, only there in a part-time capacity. So, it is really unreasonable, I think, for the SEC or anybody else to expect them to devote the same amount of time to their duties as professionals who work on a full-time basis unless—and this is another part of the proposal—they are paid more.

The big controversy is how much do you pay independent directors. Well, if you had an agency which oversaw the status of independent directors, you could also charge that agency with coming up with flexible compensation arrangements so that the independent directors would not feel that they are raiding the corporate assets of the investment company every time there is a compensation issue. It is my view that, except for the very large funds—some of which are represented here, of course, on this panel—the typical mutual fund director is underpaid, not overpaid. It is an important consideration. If you want to encourage people to spend more time in governance, you also have to pay them, I think. If they are being paid by the funds, but not at the direction of the sponsoring investment company, that breaks the linkage which would otherwise taint their independence. I think that is the important consideration.

DEAN SARGENT: But under one of the recommendations of the ICI's Advisory Group, the compensation level would be set by the independent directors themselves, even in our current scheme, and not by the advisor.[32] Just a question for you, Steve. Would it only be existing independent directors who could sign up for this test? Or could anybody say, "Hey, I think I'd like to be an independent director of a mutual fund," and just throw her hat or his hat in the ring?

MR. HOWARD: I think that is a great question, Mark, and I struggled with it. I definitely do not think it ought to be an exclusive club of existing directors. I think the National Association

32. *See* Investment Company Institute, *supra* note 6.

ought to deal with that issue, but I do not want to punt it to them because it is a non-existent entity at this point. I think that we would want individuals who have some modicum of experience in business and financial services.

PROF. HAAS: Steve, could this lead to a B.A. in mutual fund leadership at the college level?

MR. HOWARD: Absolutely.

MS. SCHONFELD: Dean Sargent and I are going to start a Stanley Kaplan type of training pool.

MR HOWARD: It is not a bad idea.

MR. HOWARD: Anyone who takes Professor Haas is automatically eligible for this pool.

DEAN SARGENT: Steve, would this also function as a kind of control on the selection process? Inevitably there is going to be a desire on the part of fund sponsors to go out and select independent directors the way they always have. Are you in effect saying that you can go out and select your college buddy, but he has to pass the exam?

MR. HOWARD: I take it one step further. This National Association, which would make the selection as to who from the vast pool of thousands of directors are qualified to be directors, would also place independent directors on particular boards throughout the country. The individual sponsors of the funds would not be involved in that, nor would they consult with the respective nomination committees. The current selection process would be dismantled. The designations would be made by the National Association. To further break the link between fund management and the independent directors, the independent directors should be rotated to a new fund group every four to six years. Reassignment would ensure that there is a constant replenishment of new faces on boards so that personal linkages cannot taint independent directors' judgment.

PROF. HAAS: Would this be a rolling process so that there is some continuity of information and understanding of what is going on in a particular fund family?

MR. HOWARD: Yes. It would be staggered. Every effort would be made to ensure that there are always a majority of experienced directors who had been at the table of the board for a number of years so that you have that institutional wisdom which is always very important.

DEAN SARGENT: Can I just interject one point? Perhaps it is too early to start throwing darts, but I cannot resist. In some respects I think that is the most optimistic aspect of your plan. It is hard to argue against the notion of required competence. That independent directors should have to pass an exam or otherwise demonstrate their competences, is a notion that the industry can perhaps get its arms around. But the more radical aspect of what you are talking about is really severing the managers themselves from the selection process for independent directors entirely.

MR. HOWARD: Yes. That is exactly right, and the reason for that, Mark, is because in my twenty years experience as a practicing attorney—and I have advised hundreds of funds—these so-called independent directors are far from independent. As you said, there is independence and then there is being truly independent. Most directors are on boards in the country because they are friends with the sponsoring investment company. There is nothing wrong with that; it is certainly the way business is done. But they are not independent. We all know that in the industry and there is no one saying this—except me. And now I will probably lose all my clients.

DEAN SARGENT: You do not believe that the best practice of having the incumbent independent directors nominate future independent directors would solve that?

MR. HOWARD: Absolutely, Mark, I think it is a step in the right direction. I think it is a very important step. Just as there was a rule that came out twenty years ago called Rule 12b-1, which allowed mutual fund companies to use their fund assets for marketing and distribution.[33] The SEC cleverly attached a requirement that if you adopted this rule and started spending shareholder money on marketing, you had to have a nominating committee that would pick the independent directors.[34] It was the first time that the SEC started getting into this area, insisting that boards break the linkage with fund management as to the selection process. It was a very helpful change.

33. *See* 17 C.F.R. § 270.12b-1 (2000).
34. *See id.*

In my view, the SEC has not done anything really concrete since then. These proposals are the first step. There has been a twenty year hiatus. It takes a long time to change boards. What we are seeing in the industry is that as people live longer, the individuals on these boards are well into their sixties, seventies, eighties. Getting people who are friends of management off boards takes a very long time. My proposal would sever those relations overnight.

MS. SCHONFELD: Like most very radical ideas, I do not think it is going to get adopted in toto in the near future.

MR. HOWARD: Only with your help.

MS. SCHONFELD: I think there are some interesting kernels in there. For instance, creating a pool of talent. Independent directors are becoming much more knowledgeable. The ICI has been running conferences for them. Other groups have been running conferences and the directors realize that they are empowered. I think that if a few fund groups were to start using that pool even for one or two of their members and it works, and then they would start talking to other directors at these conferences. It becomes more or less a best practice to go to that pool for one or two people. You would then start seeding the industry with this kind of professional director and that could have a snowball effect.

MR. HOWARD: I think that is right. If that is all that comes out of this proposal, that would be tremendous.

MS. SCHONFELD: There is one other part of directors' dynamics that does not get talked about so much, that is, the size of the board as opposed to the percentage of independent directors. I represented a board that had two independent directors and one in-house director. Although two-thirds of the board, was technically independent. They were very reluctant to speak out. Another board I represented had seven members, five independents. It was also a two thirds board. But those five people, when they were alone with their counsel, were incredibly powerful. There is a minimum number of independent directors needed for them to be secure enough to have a frank airing of issues and not feel that they are going to be singled out as bad guys in some way.

MR. HOWARD: That is exactly right. This proposal would not change the size of boards. That could be a decision made by the boards themselves. I do not have any problem with that. This proposal really does hinge on the notion that a majority of the directors would be independent under the SEC regulations.[35] Otherwise, it does not work at all.

MS. SCHONFELD: I think the SEC proposals are clearly going to be adopted in some form.

MR. HOWARD: That idea was discussed at the roundtable last February and then, of course, it found its way into the report of the ICI's Advisory Group and the SEC proposal.[36] It was commented on there. I have not seen statistics, but most mutual fund boards today do have a majority of independent directors.

PROF. HAAS: Why not 100 percent independent directors? That is not often talked about. Why not 100 percent?

MS. SCHONFELD: One of the reasons people give is that it is important to have management sitting at the table. But you can have management sitting at the table, anyway.

PROF. HAAS: That is my response, too.

MS. SCHONFELD: But there is another dynamic. When management is a director and has the responsibility, the state law and federal law requirement, of acting in the shareholders' best interests, they act differently. They realize that they are on the hook as directors, subject to state law, and that their loyalty in that context is to the shareholders, not just to the management company. It makes them more independent and less willing to just push for the management company. It actually helps.

PROF. HAAS: However, if a director from management were not on the board at all, she would not be faced, in the first place, with the choice of either adhering to her fiduciary duties under state law and the Investment Company Act of 1940[37] or not. That would be my response to that. I would rather not allow them to breach those fiduciary duties. I would rather not put them in a position where they have that decision-making capability in the first place.

MS. SCHONFELD: I have found it to be a very useful tool to sit down with the president of a management company and say, "Look, I understand you want higher fees, but can you defend it

35. *See* Investment Company Institute, *supra* note 6.
36. *See id.*
37. *See* 15 U.S.C. §§ 80a-1 – 80a-64 (1994).

under state law? Do you really feel that it is in the shareholders' best interests to raise fees?"

PROF. HAAS: In 1997, Tufano and Cevek did an article in the Journal of Finance and Economics.[38] The empirical analysis that they did showed that boards with a larger fraction of independent directors tend to have lower management fees.[39] That is why I am pushing for 100 percent. As a mutual fund investor myself, I am thinking about my own pocketbook.

MS. SCHONFELD: A while ago Steve West of Sullivan and Cromwell suggested having no independent directors; the theory being that people vote with their feet and that shareholders have information about their returns. The prospectuses now have very clear fee tables. You can look at it and say, "Ninety-five basis points? Too much money. I am out of here." There is some of that going on, too, with much better financial information.

PROF. HAAS: I am intrigued by two proposals, well, three. Steve's, certainly. Also 100 percent independent directors. But I am also intrigued with the notion of no directors. Let shareholders with the information vote with their feet. If there are improprieties going on, whether those are fiduciary oriented or fees are just too darn high, considering the returns I am earning, I am going to take my money out. So, we have market forces at work there.

MS. SCHONFELD: Exactly.

PROF. HAAS: But I would add to that. Under the '40 Act, we have Section 36, which gives the SEC the ability, under Subsection (a), to sue for breach of fiduciary duty relating to personal misconduct,[40] and we have Section 36(b), allowing shareholders to sue for breach of fiduciary duty with respect to excessive fees.[41] What other protections do we need?

DEAN SARGENT: Let us go back to the point that Steve made about the 300 auditors at the SEC. That argument has been made with respect to corporate governance issues not only in the investment company context but throughout corporate law for a long time. It assumes not just the rapid flow of information, but almost

38. *See Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 43 J. FINANCIAL ECON. 321 (1997).

39. *See id.*

40. *See* 15 U.S.C. § 80a-35 (1994).

41. *See id.*

perfect information, if we are going to conclude that the market can be an effective constraint on essentially self-dealing behavior by managers. It is particularly problematic in the investment company area, where the opportunities for self-dealing are not only rampant, they are inherent. I am not sure that voting with your feet is going to be a sufficient constraint on fund managers' self-dealing. SEC enforcement is entirely a forlorn hope. Then you have the built-in problems with investor self-protection through litigation, which we have seen in numerous contexts giving rise to the Private Securities Litigation Reform Act.[42] I am not a red-hot regulatory type, and I am not wildly enthusiastic about government intervention. But it strikes me as one area in which the establishment of fairly substantial ground rules has been effective.

PROF. HAAS: We have talked about the qualifications of mutual fund directors. I certainly would advocate the Steve Howard approach, that is, anyone who is capable of doing the job—whether they are young or old, regardless of race, ethnicity, et cetera—ought to be able to do the job. What is going on in the industry to provide more diversity on mutual fund boards? Or is anything going on? We hear a lot about it with respect to operating companies in corporate America. Anything going on in the mutual fund industry?

MR. JACOBS: There is nothing formal of which I am aware, except to say that diversity is something to which I know our boards, and I am sure the boards of the other fund complexes, are very sensitive. Diversity is something our boards consider. One thing that we have done with regard to age considerations is to have a director emeritus policy. It allows a director, when she or he reaches a certain age, to continue, not as a voting director at that point, to attend any and all of the board's meetings. Even though they cannot vote, the board still benefits from their experience and wisdom.

MS. SCHONFELD: We did a study of the industry and found that most fund groups had a retirement age of seventy-two. We instituted that policy. Sure enough, three years later one of our key directors turned seventy-two. We waived the policy for him. That was the right decision, because it would have been a shame to lose

42. *See* 15 U.S.C. § 78a (Supp. 1995).

such a valuable resource. In that situation, I think the director emeritus policy may be the perfect solution.

PROF. HAAS: And what about the issue of house directors? Do we have house directors?

MS. SCHONFELD: Well, as I said to Mark, I really do not like that term. To me it connotes a house pet, and I think it is really just the opposite. In its best practices, the ICI, itself, suggested a unitary board.[43] Having fifty-eight boards is obviously impossible. It is impossible to have, I think, even twelve boards.

There is more and more movement to utilize unitary boards because there are a great many overlapping issues at every fund meeting. To review the same code of ethics fifty-eight times would be absurd. There are a lot of economies of scale that are realized by using a unitary board. However, instead of a one day or half a day board meeting, we expanded ours to two days. Every board meeting is a two-day meeting, with the first board meeting concerning portfolio performance reviews, discussions of possible issues, and analysis with outside counsel. The second day we go through some of the more routine things. This method has worked extremely well because we give the directors lots of information and they commit the time. A quarterly commitment of two days at a time is one of the conditions for being on the board.

DEAN SARGENT: It is important to recognize what *Strougo*[44] is about and what it is not about. One thing it is not about is the '40 Act, in the sense that it is well-established, and the post-*Strougo* case law has sustained the position that for purposes of defining independence or disinterestedness under the '40 Act, someone who sits on the boards of multiple funds within a family of funds or in a cluster is independent for purposes of the '40 Act.[45] This whole issue has arisen in the context of derivative litigation where the issue is whether demand on the board is excused because the board members are all interested in the litigation. At least one court reached the conclusion that a director or directors who takes substantial fees from sitting on a number of boards for the same

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43. *See* Investment Company Institute, *supra* note 6.

44. Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997).

45. *See, e.g.*, Krantz v. Fidelity & Research Co., 98 F. Supp. 2d 150 (D. Mass. 2000).

sponsor cannot be considered disinterested for purposes of the '40 Act.

PROF. HAAS: Who has the burden of proof in that context, to show disinterestedness? Is that in *Strougo*,[46] who brought the litigation, claiming that because these directors were so highly paid, nobody on that board was really independent, and thus measures that should have been passed by truly independent directors, were passed by interested directors?

DEAN SARGENT: The derivative plan carries the burden of proof. Most of this has not reached evidentiary consideration as a matter of law, but the burden of proof would be on the derivative plan.[47]

MR. HOWARD: You know, I had mentioned, when talking about the best practices recommended by the ICI's Advisory Group, that, of course, that group recommended that you have the unitary board and they decided against it. One could say they are aligned with the industry. But we should note that Chairman Levitt also has said he is disinclined to agree with the allegations of *Strougo*.[48] Conflicts of interest only come up when there is a tie to an organization, whether it is personal or material, in terms of some kind of material benefit. If a director does not look to the advisor for compensation or increases in compensation, that effectively breaks the tie. You can certainly be friends and go out and play golf and do everything that you would otherwise do. But if your compensation is not being decided by that entity, I think that pretty substantially eliminates, if not all conflicts of interest, an awful lot of them.

46. *See* Strougo, 964 F. Supp. 783.

47. *Id.* at 790.

48. *See* Arthur Levitt, SEC Chairman, Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds, Remarks at Mutual Funds Conference, Palm Springs, CA, *at* http://www.sec.gov/news/speeches/spch259.htm (Mar. 22, 1999).