

The \$7 Trillion Question: Mutual Funds & Investor Welfare - Fund Governance Going Forward

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ALAN PALMITER, AND EARL WEINER

The \$7 Trillion Question: Mutual Funds & Investor Welfare

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RICHARD BOOTH: It's time to get going with our second panel. They're going to tell us how to fix the mess. The moderator of this second panel is Jim Hanks, another distinguished alumnus of the law school and a new father. Take it away, Jim.

JAMES HANKS: A first-time father. Thanks very much, Rich. Your introduction of our panel and your forecast that we were going to say how to fix the mess reminds me of a time when I worked on Capitol Hill for a member of the Senate from Maryland, and fortunately he had a good sense of humor. We were asked to prepare a speech for him during his campaign. The first page we wrote up said, "I plan to reduce taxes, reduce inflation, increase employment, protect Social Security, and make Maryland safer for all of its citizens throughout the state, cities, and suburbs, increase the benefits for our farmers, and here's how I'm going to do it." Turn to page two: "OK, Senator, now you're on your own." [laughter] So, now we're on our own.

We have another very distinguished panel here today. First, Diane Ambler, who is a partner at Kirkpatrick & Lockhart in Washington. Diane specializes in fund governances and is a frequent speaker and writer on that and other '40s Act-related matters.¹ She was also the co-chair, with Tom Smith, of the taskforce that drafted the current second edition of the *Fund Director's Guidebook*² published by the ABA. And, before I forget, I ought to note that other members of the taskforce were Jay Baris, Earl Weiner, and myself. In fact, Tom and Diane, I think we probably have a quorum of the taskforce if we want to convene it later today.

Next, a man for whom it is tempting to use the cliché that "he needs no introduction," but he really doesn't need any introduction. Jack Bogle is well known for many, many reasons. His interest in the mutual fund area started with his senior thesis at Princeton. Thereafter he joined Wellington Management Company, where

1. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80a-64 (2000).

2. FEDERAL REGULATION OF SECURITIES COMMITTEE, AMERICAN BAR ASSOCIATION, *FUND DIRECTOR'S GUIDEBOOK* (2d ed. 2003).

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he eventually served as CEO from 1967 to 1974. He was fired by Wellington in 1974, which proved to be a watershed event in the mutual fund industry as he went on to found Vanguard. He is now president of Bogle Financial Markets Research Center. In 1999, *Fortune* magazine picked him as one of the four investment giants of the twentieth century,³ and earlier this year *Time* magazine said that he is one of the 100 most powerful and influential people in the world.⁴ So we are particularly happy to welcome Jack to Baltimore, to the Maryland School of Law, and to this panel.

Bill Foulk is the relatively new independent chairman of the AllianceBernstein funds, having served on the Alliance Capital mutual fund boards since 1983. Bill began a career in investments in Wall Street. Thereafter, he became an investment manager and served as president of two major private investment companies. For a brief period of public service, he was chief investment officer and deputy comptroller of the state of New York. He is currently, in addition to his duties as independent chairman of the AllianceBernstein Funds, an investment adviser and consultant. I know he is particularly proud of being a Wahoo, a graduate of the University of Virginia, where he also attended law school.

Amy Olmert is one of our own, a recent alumna of the University of Maryland School of Law and the new chief compliance officer for the Legg Mason and Western Asset Funds. Moving along, Alan Palmiter teaches and writes about corporate law and securities regulation at Wake Forest Law School in Winston-Salem, North Carolina. His main writing interest is in investor self-protection. Before beginning his academic career eighteen years ago, Alan practiced with Cleary Gottlieb in Washington. He tells me that his credential for being on this panel is that he is a mutual fund investor, representing a constituency that has been talked about a lot so far, but I think you are our first pure representative.

ALAN PALMITER: Self-professed investor.

JAMES HANKS: Finally, Earl Weiner is one of our own in the sense that he is a native of Baltimore and, for many years after graduating from Yale Law School and Dickinson College, a partner at Sullivan & Cromwell. He has advised funds, independent directors, and advisers for more years than I have known him and more years than he would like to admit. And as I mentioned earlier, he was also a member of the task force that drafted the current edition of the *Fund Director's Guidebook*.

I'd like to start by asking our panel what they think we should be doing. What should we be doing to address the problems discussed in the first panel? What views do you have, either overarching or closer to the ground? What do you think the effects will be of the reforms that were talked about this morning and that we will talk about later in this panel? In particular, do you think regulation is going to

3. Carol Vinzant, *The Pavers of Wall St.*, FORTUNE, July 5, 1999, at 164.

4. Eliot Spitzer, *Time 100: Heroes & Icons; Jack Bogle: The Investors' Advocate*, TIME, Apr. 26, 2004, at 128.

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work? I'd like to start by asking Alan Palmiter, because I know he has a particular view in this area, and then I'm going to call on Jack Bogle to give his view.

ALAN PALMITER: This is a paper in formation. So I'm casting before you incomplete ideas that, I hope, will have some value, maybe even small pearls.

JAMES HANKS: A particularly appropriate metaphor in Chesapeake Bay country. [laughter]

ALAN PALMITER: The paper I am working on begins with the hopeful title, *Mutual Fund Directors: From Supervisors to Visionaries*.⁵ My impression from the morning discussion is that independent directors are lately being tasked with a much broader oversight and supervisory role; a somewhat overwhelming and frightening role, but one that, in my view, is none too late.

As a mutual fund investor I ask myself what role I would want for independent directors in the funds in which I invest. That is, what is important to me and how can independent representatives help further my interests? Ultimately, what is important to me are financial returns. In thinking about the discussion this morning about hard closes and continuous valuations, along with the other technical questions that go into the timing and late-trading issues, I ask how much this really affects me. Are fund directors focusing on the matters important to me and to other fund investors? How much will correcting the timing and late-trading problems contribute to investor returns? The answer, I am told, is one or two basis points to my overall return, and maybe not even that. So, I'm a little concerned that we're focusing on problems that, though real, aren't really significant. They aren't the problems that, as investors, we would ask our representatives on fund boards to focus on.

Which problems would I want fund boards and independent directors to face? First, because I generally want good returns from my portfolio, I want to have portfolios and funds designed for my purposes. Then I want to be told what I have to choose from in ways that I can understand. As representatives of fund investors, fund boards must understand that I and my fellow fund investors are pretty ignorant about these things and disposed to a lot of foolishness. Although the industry has taken some good steps in offering and selling life-cycle funds, for example, there's much more that can be done. And independent directors should be leading the charge.

Second, to make sure my returns aren't being filched, I want an industry that is honest and competent, that isn't stealing from me. Now there is a lot of the discussion about fund expenses, about abusive practices in funds, and about excessive trading within fund portfolios. All of this concerns me, but I worry that focusing all of the board's attention on management self-interest and wrongful conduct misses the larger picture of investor returns.

5. See Alan Palmiter, *Mutual Fund Boards: A Failed Experiment in Regulatory Outsourcing*, BROOK. J. CORP. FIN. & COM. L. (forthcoming) (advocating the abolition of mutual fund directors).

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Third, I guess, is the governance issue. I want my fund to exercise its voting power in a way that maximizes my overall return. This is a question the Securities and Exchange Commission has addressed in its rule requiring funds to disclose their voting policies and actual voting practices.⁶ As the governance role of mutual funds continues to grow, I would want my fund directors to make sure that funds, particularly fund families in a coordinated fashion, are paying attention to this.

The questions of fund design, wrongful conduct, and portfolio voting, as important as they are, may miss the point. In looking at where the big money is for me as a mutual fund investor, I borrow some of the calculations Jack Bogle has put together. Assuming that the stock market is returning about 11% annually but equity funds on average are returning only about 8.5%, the industry is charging investors a lot of my money, about 2.5%, for its services. Investors, rightly, have reason to question whether this is too much.

But then, after these charges for distribution, management, account, and brokerage services, the industry is leaving me and other investors to our own devices. Like most investors, I'm pathologically "buying high and selling low." In fact, the excessive and misguided trading in mutual funds is costing me and other fund investors another 2.5% annually in lost returns.

Why is this happening? My view is that it's because of the ways funds are being designed, packaged, and marketed. For example, think of the funds that are marketed based on their Morningstar⁷ five-star ratings. Most investors assume that a five-star rating is like a safety rating for cars. The rating, like that for a car, suggests that if the fund survived a crash in the past it is probably going to survive one in the future. Or like a red circle reliability rating in *Consumer Reports*:⁸ The past reliability of a particular model suggests there will be good reliability in the future for that model.

The truth, though, if you look at the performance of funds with Morningstar five-star ratings, is that the rating is a very powerful predictor of future performance—but negatively! That is, strong performance in the past is a statistical predictor of weak performance in the future. But most fund investors don't know that and aren't told that. So, I and other fund investors end up buying these funds that have done well in the past and then they flop. We say to ourselves, "OK just bad luck of the draw. Better buy another high-flying fund." We read *Barron's*, find out what others are recommending, and buy another fund that is done well. The problem is that there is this reversion to the mean, but fund investors just don't know

6. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 33-8188, Exchange Act Release No. 34-47304, Investment Company Act Release No. IC-25922 (Apr. 14, 2003); 17 C.F.R. §§ 239, 249, 270, 274 (2005).

7. Christine Benz, *Introducing Morningstar's New Star Rating*, Morningstar.com Special Reports, http://news.morningstar.com/article/article.asp?id=77455&_QSBPA=Y (last visited May 24, 2006).

8. *Consumer Reports: Ratings, Buying Guides, & Product Reviews*, <http://consumerreports.org> (last visited Mar. 22, 2006).

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about it. We just keep on buying high, selling low. In fact, my losses in that strategy appear to be about as large as, if not larger than, the expenses the industry is charging me for its services.

So, as an investor, I ask, "How should you help me and other fund investors deal with our ignorance and foolishness?" In study after study, finance economists are finding that by and large, fund investors are not rational. This is not to say that we fund investors are completely helpless. We are able to pay attention to some things. We pay attention to loads and commissions when we are deciding to buy funds, but we don't pay attention to expenses after we are in the fund. That is, we pay attention to expenses up front, but not to expenses as they change.

In the end, I entertain the hope that independent directors can take on a role that we fund investors are unable to take on for ourselves. Part of the role involves what has been identified here and lately by the SEC: looking at operational expenses and activities and how they affect the bottom line.

But the real role comes with fund design and marketing, that is, taking a measure of control over fund design and distribution agreements. I have done some research about how directors are charged with respect to fund design and marketing. What I find is that not much attention gets paid to a problem that is costing me and other fund investors about 2.5% in annual returns. The *Fund Director's Guidebook*, for example, says not much is understood about how distribution agreements are presented to boards and what boards know about them. It is sort of a dark closet where the industry has not been going. It is as though the industry is saying it is a matter for the distributors and the sellers to worry about and we are not focused on it. As an investor that worries me. I have also looked at the "best practices" described by the ICI [Investment Company Institute] and put together by the new Mutual Fund Directors Forum. The focus of "best practices" is on fund operation, but not on fund design and marketing. So I guess the industry is saying to me and other fund investors that I am being left to my own devices.

This leads me to ask myself how I can get independent directors to pay attention to me and my cognitive deficiencies as a fund investor. I can see a few ways. One, the SEC should pay attention to this problem. The SEC, I think, should be considering and promulgating rules that make disclosure much more clear, that hit me across the head with a two-by-four; disclosure that says if you buy a five-star fund it is going to revert to the mean, statistically. The disclosure should say that if investors pursue funds with strong past performance you are going to "buy high and sell low." There are gobs of studies that show that this is what investors do. That might help—mandatory disclosure might help. Two, I think that the best practices should begin to focus on the question of fund design, fund consolidations and mergers, and marketing. The "best practices" should understand the role of fund directors as being broader than just maintaining operational integrity by the management company.

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But ultimately, there has to be some way of giving an incentive to independent directors to really put them in my shoes, that is, into my often ignorant and foolish shoes. I'm not sure that the current structure of duties does that. State fiduciary duties are not designed to deal with this nuanced question of helping investors who don't know how to help themselves. Duties of care are more or less swallowed by the business judgment rule. Duties of loyalty aren't an issue here.

How can independent directors be focused, be re-tasked, as I see it? My answer is some kind of statutory fiduciary duty with clearer guidelines on the standards of care, oversight, and vision that independent directors are supposed to bring to the table. How might enforcement work? This statutory duty should be linked to an enforcement mechanism that could be extra-judicial, for example, an SRO [self-regulatory organization] oversight mechanism. I'm not sure that the courts, federal or state, would be up to the task. The federal courts, if you think about their history in dealing with fiduciary duties, have been abysmally poor. They were tasked with figuring out fiduciary duties with respect to insider trading, and it took them twenty years to answer the basic questions, and then they left a lot of peripheral questions open. State courts are unlikely to be able to pick up the slack, and the current litigation over mutual fund practices and management fees, I have a feeling, is going to prove that to us.

So I am imagining some kind of extra-judicial enforcement mechanism for these new fiduciary rules. Either the SEC functions to serve as a kind of arbitral panel, in the way that the agency currently serves as arbitrator with respect to shareholder proposals, or if you don't like that (and I have some qualms about that), maybe the mutual fund industry should take the lead and adopt an SRO structure, like the NASD [National Association of Securities Dealers]. The SRO regulators could set up standards rules for director independence, give "best practices" guidance to independent directors, and enforce fiduciary duties. Those are my thoughts.

JAMES HANKS: Now let's turn the mike over to Jack.

JOHN BOGLE: Thank you, Jim, and good morning, everybody. I have to make one comment about my firing. It is true that I was fired in 1974, but it gave me the ability to use one of the great lines of American business: I left my old job the same way I took on my new job at Vanguard—fired with enthusiasm. [laughter] And so I did.

JAMES HANKS: When you were fired for the first time, in that comment, was the enthusiasm yours or your former employer's?

JOHN BOGLE: It was my former employer's, my former partners'; they seemed to take great delight in it. I was heartbroken, but that's life. It turned out to be the best thing that ever happened to me and, as history will write maybe 100 years from now, to this industry, too. I should say that when I picked the name "Vanguard" (I happened to come across the name in a book of naval history) I thought it was perfect because it meant leadership of a new trend. But I can tell you that the name I chose for this new firm that we created back in 1974 (in which the management

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company is owned by and run for the exclusive benefit of the fund shareholders) turned out to be a very poor choice. While we were supposed to be a leader, thirty years have gone by and we have yet to find our first follower. So, I'm afraid it doesn't make me much of a leader, no matter what *Time* or anybody else said. But that's another story.

For now, I'd like to pick up where the morning panel left off. The issues that affect the mutual fund industry do not revolve around the market-timing scandals. That is only the tip of the proverbial iceberg. The issue in this industry, brought to light by the market-timing scandals and time-zone trading scandals, is about the primacy of the interest of the managers over the interest of fund shareholders. In our industry, managers' capitalism, in which corporations are run for the benefit of their managers, has supplanted owners' capitalism, the traditional form of capitalism in which corporations are run for the benefit of their owners. The managers are in the driver's seat.

The problem with this development is that it is in direct opposition to the Investment Company Act of 1940,⁹ our constitution, if you will. The '40 Act says mutual funds must be "organized, operated [and], managed . . . in the interest of" fund shareholders rather than in the interest of managers and distributors.¹⁰ And if anybody in this room thinks that is the actual operating model for the industry, you really have to be dreaming or living on another planet.

We are not doing what the Act says. We have some reforms moving in that direction, but before I get to them, I just want to say a word about the fundamental economics (an obvious tautology) of this industry. If the financial markets deliver a return of "X" and the fund managers take out their cost, which happens to be about \$120 billion a year counting management fees, marketing costs, turnover costs and the like, the fund investors get what is left: gross return in the financial markets, minus cost, equals net return. It's all about arithmetic, and the arithmetic is undeniable, absolutely undeniable. So when Senator Peter G. Fitzgerald calls mutual funds a giant skimming operation, and when Attorney General Eliot Spitzer calls mutual funds a giant fleecing machine, one may not like their choice of terms, I don't happen to care for it myself, but it is tautologically true. The mutual fund managers take their share, and the mutual fund investor gets what is left. Come to think of it, skimming or fleecing is not a bad way to spin it.

So, what do we do about that? Well, we first have to put mutual fund shareholders back into the driver's seat. We have to give the fund board enough substance to be able to stand one to one with the management company; to do, if you will, what the '40 Act says. How do we do that? Well, the Vanguard model came pretty close to the way it ought to work, but before I get to that, I will say we have made a good start in a lot of ways because we are trying to make sure the fund directors serve

9. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2000).

10. *Id.* § 80a-1(b)(2).

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one master (the fund shareholders), rather than serving two masters (the fund shareholders and the management company's shareholders), as is the case today throughout the industry. The Good Book is right: No one can serve two masters.¹¹ Mandating that all fund boards have an independent chairman is not going to change the world, but it is a wonderful start.

We also have an SEC regulation that requires that a super majority (seventy-five percent) of the fund's board be independent of the management company.¹² To which I can only ask, Why isn't 100% of the board independent of the adviser? How is the adviser entitled to any representation on the board of directors at all when the adviser clearly has two fiduciary duties (one to the owner of the management company and one to the owners of the funds)? I don't think disclosing it away is enough, but seventy-five percent is a good start.

Further, the SEC has authorized fund directors (I would say "encouraged" and certainly "implicitly encouraged") to have their own staff of consultants to give them information. That is essential, and I would not make that an authorization or an encouragement, I would make it mandatory for any fund group that has, say, more than ten mutual funds. Just think about it for a minute. How in God's name can an independent director exercise his fiduciary duty with 100 to 350 mutual funds—350! that's a lot of fiduciary duty spread over one fund complex—and still get all the information he needs solely from the manager of that complex? It simply doesn't work. So I would require such a board to have an independent staff.

Finally, I would add a federal statute of fiduciary duty, which would require congressional legislation. Such a statute would preempt all the state laws and would give mutual fund directors a fiduciary duty, and it would spell out precisely what we mean by "fiduciary duty." Directors have a fiduciary duty, to come back to the words of the 1940 Act, to ensure that mutual funds are "organized, operated, [and] managed . . . in the interest of" their shareholders rather than in the interest of their directors, distributors, and managers.¹³

In the Vanguard model, which is not perfect but is a step in the right direction, the fund complex controls its own operations. It goes beyond having just consultants and actually does the boring things that people don't pay much attention to in fund operations: the transfer agency, the shareholder recordkeeping, the fund accounting, the legal compliance, and the provision of information to the directors on the performance of their manager and distributor. All of a sudden the funds are in control.

And all of a sudden the directors might say to the manager, "You're out on Fund A; you haven't done a good job. You're still going to manage B, C, and D, but we're

11. *Luke* 16:13 (King James) ("No servant can serve two masters: for either he will hate the one, and love the other; or else he will hold to the one, and despise the other.").

12. 17 C.F.R. § 270.0-1(a)(7)(i) (2005).

13. 15 U.S.C. § 80a-1(b)(2) (2000).

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bringing in someone new to manage Fund A.” Or to a distributor, “You are just not selling the funds in the way we would like to have you sell them. We are going to get a new distributor, and we are going to separate pricing for management and for distribution, which are two distinct functions.” All of a sudden the funds are running their own operations, and spending their own money, instead of filtering it through a management company and paying the manager. There is obviously a big profit margin on these functions, and they are controlling their own destiny.

So that is my remedy for this. It’s not going to come about tomorrow; it’s not going to come about the next day. But when you think through the reasoning (making the funds independent, giving the directors the fiduciary duty, giving them information they need to make good decisions), that is the model we ought to be moving toward.

JAMES HANKS: Jack, I am intrigued by your comment that Vanguard is not perfect. In what ways would you further improve the Vanguard model?

JACK BOGLE: Well, it was created by a very imperfect human being, so by definition it’s not perfect. And, in all honesty, it may not be possible to avoid all imperfections. You get to a point where you are in business and you create new funds, as we have done on a couple of occasions, to go along with the market. Maybe there is a sound reason for creating them, and maybe there is not. You can get too focused on market share. Once you are in business, no matter your structure, you encounter pressures to be a competitor, and this industry is loaded with very competitive people. I am probably the worst in that respect, in that I’m the most terrifyingly competitive person you’ll ever meet. A lot depends on human beings rather than structure, and you just can’t get that out of the model, I don’t think. Everybody—*everybody*—can do better, and Vanguard was not when I was running it, and is not now with someone else running it, an exception to that rule.

JAMES HANKS: I’m going to invite the other panelists to jump in whenever they like. Earl, can I call on you to react to what you have heard so far?

EARL WEINER: Sure, Jim, and thank you. Our topic for the day is “Fund Governance Going Forward,” with the subquestion “Can the industry self-regulate?” What I’d like to do, in reaction to some of the things I have heard, is to comment on both of those. Since my practice seems to be centered on advising independent directors, in fact, I’m spending a lot more time advising the same independent directors than I used to spend on the same task, I’d like to focus on fund governance going forward from the perspective of what is already in place and its current and potential effect. I would also like to provide just a brief thought on self-regulation.

I guess listening to the first panel and, to some extent, this panel, I am thinking that the regulators may have disproved one of Newton’s laws of motion: that for every action there is an equal and opposite reaction.¹⁴ On the one hand, it sounds

14. See CHARLES A. PAYNE ET AL., *PHYSICAL SCIENCE* 114 (Jeffrey L. Hahn ed. Wm. C. Brown Publishers 1992) (1974).

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as if there are people here who think that the regulatory reaction has been an overreaction in some respects or at least has been aimed at the wrong audience. On the other hand, some people feel that it hasn't gone far enough in addressing the areas that need to be addressed by new regulation. It is clear, however, that a major compliance regime change has been put in place.

Parenthetically, I can't help but think of the new regime in terms of that old series of movies about the *Revenge of the Nerds*.¹⁵ With due respect to one of my fellow panelists and to others whose talents and skills I admire greatly, I would call this the *Revenge of the Compliance Officers*. As you know, compliance officers have been the sort of people who have been tolerated but clearly underappreciated and underpaid. With the new regime, they are now coming back with a vengeance. For any of you who have been following the market for chief compliance officers lately, people who have those talents are now commanding salaries from the major complexes well up into the six figures. This is, indeed, a turnaround.

One idiosyncratic thought on the question of self-regulation: I would like to suggest that it is already here. Not the NASD model or the New York Stock Exchange SRO model with dues-paying members, administrators, lawyers, and compliance examiners to self-police the statutes and the regulations. Rather, under what I would suggest may be a novel form of self-regulation, the SEC has required all participants in the industry either to hire new compliance officers or to increase the responsibilities of current internal compliance officers, so as to provide compliance personnel whose loyalties are to the independent directors. This new breed of compliance officer is likely to be the principal point of contact with the SEC, and I suggest that it will effectively be viewed by the SEC and its staff as their representative on the ground. The peculiar nature of this compliance officer's duties and loyalties may well result in a new paradigm of self-regulation in the mutual fund industry. But these are early days, and it remains to be seen how this will play out.

In terms of current effect of the new regime, I think it was Tom Smith who referred to one of the regulations that didn't get a lot of attention when it was out for comment. I refer to the increased disclosure requirements with regard to renewals of advisory contracts.¹⁶ It is clear that the new disclosure requirements were intended to affect behavior. The need to articulate publicly in some detail the factors considered and conclusions reached will have a significant influence on the deliberations of directors regarding renewals. The minutes of board meetings and related documentation are going to be a major focus going forward. They are what

15. *REVENGE OF THE NERDS* (Interscope Communications 1984); *REVENGE OF THE NERDS II: NERDS IN PARADISE* (Interscope Communications 1987); *REVENGE OF THE NERDS III: THE NEXT GENERATION* (20th Century Fox Television 1992); *REVENGE OF THE NERDS IV: NERDS IN LOVE* (Zacharias-Buhai Productions 1994).

16. 17 C.F.R. § 240.14a-101. *See also* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8,433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 7852 (proposed Feb. 11, 2004).

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the examiners are going to look at and what will demonstrate the diligence of directors in the lawsuits that the plaintiffs' bar will inevitably bring as a result of this increased disclosure. These minutes will perhaps be of greatest importance to investment advisers, who will want them to present the strongest possible case for the independence and careful deliberation of the independent directors to protect the advisers in the section 36(b) suits¹⁷ that will inevitably follow the new disclosure regime. The detailed disclosure of factors considered and conclusions reached in the renewal process will provide a road map for the plaintiffs' bar that will enable them to greatly sharpen their initial complaints.

Another theme from the last panel was whether you needed special expertise to serve on investment company boards. Do you have to have actual knowledge of the industry, distribution channels, and so forth? There is no doubt that having such expertise on a board, like that of an ACFE [Audit Committee Financial Expert] on an audit committee, would be useful. On the other hand, I agree with Dick Phillips that you don't have to have all members of that ilk. That said, it's very clear to me that independent directors are going to have to understand the business of the sponsors better than they have in the past and to better appreciate potential conflicts of interest, both obvious and subtle.

For example, I think that in the new regime directors will need to have a better understanding of the sponsor's business model to address the required articulation of their consideration of economies of scale. In addition, directors may need to understand distribution and distribution channels more than in the past. For instance, directors have known for some time that payments were being made by sponsors to distributors, so-called revenue sharing, but their sensitivities have been heightened by recent regulatory activity. When proposals, which may have been viewed as routine, are made to boards about a new distribution channel, there will be a greater perceived need to understand all the potential conflicts of interests and other business relationships between the management company and the new distribution channel.

One last point: I'd like to go back to some comments that have been made about independent chairmen. When the proposal requiring independent chairmen was out for comment, my view was, and continues to be, that while an independent chairman could be a very good model for good corporate governance, the success of the model depended very much on the people who were available at a particular fund complex at a particular time. If you've got someone on the board who has the ability and willingness to take on that job diligently, then there's a lot to be said for it. But the opposite is also true. The requirement of a seventy-five-percent independent board can certainly provide adequate balance against the conflicts inherent in having an inside chairman. And of course, there are clear benefits to having an inside chairman who really knows the business of the investment manager and has

17. The Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (2000).

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clout. Having lived through a serious metamorphosis of one major fund complex from an inside chairman to an independent chairman, I can tell you that the right independent chairman can make a world of difference in the dynamics of board meetings and board action. When you think about the fact that the independent chairman can now decide when the board meets, how long it meets, what the topics on the agenda should be, who the presenters should be, etc., the changes that an independent chairman can make in the way the board functions and what it focuses its attention on can be major, even extreme. I do think that it is important to have an inside director with a senior position at the investment adviser to offset the loss of this important asset when an inside chairman is replaced by an independent. Perhaps I'll stop there, Jim.

JAMES HANKS: Sure. Diane, I think I saw your hand a few minutes go.

DIANE AMBLER: Thank you. I'll add to the mix. I think there are a lot of themes evolving from this. I've heard it said that this activity in the last year, this so-called mutual fund scandal, may be a suggestion that the mutual fund industry is now a mature industry and, as a result, there need to be changes made to reflect the evolving dynamics in a more mature industry. I think, though, that in the governance arena what we're seeing is governance in its adolescence. To borrow an analogy of one of my independent directors, directors right now are in a very adolescent phase. They are given all the responsibility, but they are trusted for nothing. That has become a real issue. We will be talking later on about state control-share statutes and issues that have come up where the SEC has begun to question whether and to what extent the board is properly exercising its fiduciary duty. Fund boards now have been given a driver's license, but they still have to go to the SEC for the keys to the car. What the future bears out depends on how the SEC is going to exercise its discretion, how it's handing out those keys, and how it's allowing boards to evolve and develop.

I think the SEC initiatives that have recently come out reflect the Commission's realistic view that conflicts have become more and more prevalent in board management over the last many years, certainly since the '40 Act was passed. In 1940, the only requirement that was created and embedded in the Act was the board's requirement to approve the adviser, approve the underwriter, and be involved in the approval of the auditor. Those were the basic conflicts that were articulated there. Over the years we have seen the development of many rules under section 17,¹⁸ the conflict arena. We have seen the board requirement to approve various sorts of specific conflicts. They have to police potential conflicts under 17(a)(7), 17(e), (d), and (g),¹⁹ the various affiliated transaction provisions that have been laid out. Boards now have to oversee and monitor a much more specific and rigorous compliance program.

18. *Id.* § 80a-17.

19. *Id.*

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Dick mentioned in the earlier panel the rule 38(a)(1) initiative,²⁰ which, I agree, is probably one of the most significant and helpful things to come out of the Commission. In all of the various regulations adopted in the last year, I honestly think the compliance rule has the potential for making the most difference. The board is responsible for overseeing the entire process. The chief compliance officer is obligated to report to the board regularly at each quarterly meeting, independent of management. That's where there will be a real sharing of information and a real involvement of the board in oversight of the compliance and management of the fund. Boards have also gotten involved in overseeing conditions to exemptive orders and no-action letters over the years, as well as a number of other things. The Alliance settlement²¹ and other settlements that have come out recently have certainly identified the board as a key in overseeing specific operations of the fund over time. So there has been a real development of conflicts, a real development of the board's responsibility and expansion. There has also been an expansion of who is managing, of who the regulators of funds are. Traditionally, of course, it has been the SEC and the NASD, and now we have seen Eliot Spitzer. We have also seen other states get involved in various activities that really do get to the heart of how a fund is governed. We see the newspapers having a terrific influence. There is a tremendous influence in newspaper reporting over the last year and how that affects funds and their governance.

Congress was involved. I think one of the real incentives for the SEC to be as active as it has been in the rulemaking area in the past year has been pressure from Congress—that if rules are not enacted from the SEC, Congress will enact another statute. The SEC, of course, has been very anxious to avoid that. Multistate reform initiatives have also affected governance issues because, to the extent that state assets are being invested, the states have been seeking to impose certain governance responsibilities on fund boards. We are seeing many more fingers in the pie, and many more involved parties have also taken a greater interest, including omnibus accounts and collective investors.

But the governance rules as they are coming out are borrowed from a corporate model, and I think that one has to be very careful in lifting corporate-governance issues and moving them directly into the fund model. They are very different. In the corporate area, of course, state laws reign. Mutual funds, on the other hand, are highly regulated. The SEC's governance initiatives intersect with state law, and that intersection has to be carefully analyzed. I think the SEC has to be very careful in how it asserts its authority in the governance area, particularly given all the state laws and the influence of state laws on many of the responsibilities that boards have. Again, when we get to some of the more recent activities, certainly in the

20. *Id.* § 80a-38.

21. Alliance Capital Mgmt., L.P., Investment Advisers Act Release No. 2205, Investment Company Act Release No. 26, 312, 81 SEC Docket 2800 (Dec. 18, 2003).

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closed-end arena, you can see the danger of the SEC's not understanding the basis of some of these state-law requirements.

Mutual funds are highly liquid assets. The true value is not in the assets, but how they are managed. The fund shareholder's decision is to purchase the manager and not independent directors. To the extent independent directors are overseeing a manager's involvement, the directors have to be very careful to recognize what the manager stands for from the investor's perspective, what the disclosure has been, what the investor is expecting, and not necessarily the independent directors substituting their own expectations for those of the investors.

Paul Roye, the division director of the SEC, said, "[W]hat [other] industry chairs its boards with vendor or service provider representatives?"²² But in what other industry is the investment, the security being issued, also the product being manufactured? I think that decisions about who is to populate the board and how it is to be governed need to take into account that the product, the widget being created by a mutual fund, is the security that is being issued. There is a structural and significant substantive difference there from a General Motors or a normal operating company.

We have talked some about resources in the industry, and we've talked about independent directors. Certainly, there are independent directors out there and people still willing to take these positions. But what is an independent director? What's independent? The statute lists a variety of independent standards. Those, of course, are in place, and we look for those things. As the industry consolidates, it is becoming harder and harder to find people who do not otherwise intersect with the adviser or an affiliate of the adviser. One has to be very careful, of course, when looking for an independent director that the director satisfies the statute. But recently, the SEC has also said that independence under the statute may not be good enough and that the board really needs to be composed of independent-minded people in addition to people who satisfy the strict statutory obligations. Now, some of the most independent-minded board members I have seen have actually been management team people, so I'm not sure that having an independent spirit or being independence-minded is necessarily what the statute had in mind. But it is something to need to be careful to consider what kind of individual an independent director is for purposes of a particular board. The more removed that person is from the industry, the more time and effort that individual will have to put into the process. To the extent that the person is not educated in how the industry operates, he or she is going to have to spend a good bit of time self-educating. That increases the need for service providers like independent counsel, the chief compliance officer, and various other resources, in the nature that we have been poten-

22. Paul F. Roye, Director, Division of Investment Management, SEC, Remarks Before the Investment Company Institute General Membership Meeting: Mutual Fund Industry at a Crossroads (May 20, 2004). Mr. Roye was the director of the SEC's Division of Investment Management from November 1998 through March 2005.

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tially evolving toward: explaining what resources there are to help educate the directors in terms of the operation of the industry, what is normal in the industry, and what is appropriate to be expected of a director and of management in the industry.

The SEC is saying that funds are more conflict-ridden than in 1940, that the reins are being tightened, that boards can no longer be dominated by management, and that having management as the chair is a dominance that is no longer appropriate. To the extent that we are peopling the board with independent chairs and others, there is certainly a related cost. The *Wall Street Journal*, about a week or so ago, had an article about the time commitment that is being asked of directors under these rules and the expense that's commensurate with that.²³ I think what funds will certainly experience is an increased expense to these independent obligations; that needs to be taken into account. This is along the lines of what you were talking about earlier: Is this an expense that I, the shareholder of the fund, am willing to bear?

I agree that with all the consolidation in the industry—of the financial services industry overall and of funds as well—we will be seeing greater consolidations of funds. I think there also will be a developing network along the lines we are talking about: a network of chief compliance officers and resources that chief compliance officers will look for outside of the fund complex and outside of fund management. Similarly, independent chairs will be looking for resources. To the extent these various networks (extraterritorial networks, if you want to call them that, or networks that are outside of the existing fund and the existing management) are developing that will create a new environment of fund management.

Our panels have asked where we are going and what the future of fund governance is. I think we'll see much more externalized governance in the board room. That externalization will be informed, as it has been currently, by independent counsel but even more informed by chief compliance officers, potentially staff, and others who will be bringing ideas to the table.

JAMES HANKS: Thanks, Diane. I'd like to ask Bill Foulk to give some perspective as a longtime independent director of many funds and as a new independent chairman of many funds. Then, because we have been hearing so much about chief compliance officers, I'd like to ask Amy to react to what she has been hearing here.

WILLIAM FOULK: Jim, the first thing I should disclose, as speakers from the SEC do, is that my remarks are my own and not necessarily those of my fellow directors. Earl here is our independent counsel and has been marvelous counsel over the years. We have enjoyed his firm's support since 1986, and Earl has said and touched on many things that we have been doing recently.

I just celebrated my first year as the independent chairman. I am involved as chairman of the board of a few different groups of funds at Alliance, each with four

23. Ian McDonald, *Depending on Independent Directors*, WALL ST. J., Oct. 12, 2004, at C17.

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to seven or eight directors, of whom seventy-five percent or more are independent. The first thing I did in my new job was to set the agenda, to run the meetings, and to facilitate communications between my fellow directors and management. I have the advantage of being a fund director for over twenty years at Alliance, and that has been very helpful.

We have been delayed in doing a lot of things on our list for a year now because of the changes that have occurred, the new regulations that have come about, and those that are still forthcoming. We have always had good cooperation from the management, but what I'm hearing from my fellow directors most recently is that there has been a marvelous change in communications. It has gone from, say, a monthly basis to almost a daily basis, and it is back and forth, not only between my fellow directors and me, but between management and me as well. We are always talking face to face or over the phone or through e-mail, and that has helped us to do our jobs better.

We do have a responsibility that will be bigger. I am not sure that it has taken on a greater role than what we have done in the past, but we will be doing our work in more depth than in the past. We are in the process of streamlining our job to some extent; this will mean a few more committees. We have generally operated with two committees—an Audit Committee and a Governance and Nominating Committee. We have all participated on these two. Most likely we will be splitting up into four or five committees and not be sharing duties on all the committees. Right now all of us are on all of the committees, sharing duties. This will give us a chance to focus in more depth than in the past. The changes in the chairman are welcomed, not only by my fellow directors, but also by management. It has been helpful for them because they are hearing sooner from the directors about their concerns.

JAMES HANKS: Before I turn it over to Amy, I would just like to get Jack's reaction to the independent-chairman rule. Is this an unalloyed good thing? Are there any downsides to it? And what was your role in the Vanguard funds when you were at Vanguard?

JOHN BOGLE: In principle, it's an absolutely necessary step. A board with a chairman who is affiliated with management is going to be dominated and controlled by the management. That was my experience at Wellington Management Company, and like everybody in this industry, I know that it is simply human nature. You really can't expect somebody to be the boss of the board and the boss of the business, whether it is in corporate America or mutual fund America. My own rule at board meetings was to tell the directors every single piece of bad news that came up in the previous months. Some months we weren't too busy, and other months we were busier.

Changing the structure of mutual fund boards has to be the initial part of reforming the industry. Once you get the board operating independently, the question is, What should they be focusing on? This is a really important point because this is an industry, in many respects, built on witchcraft. We in the mutual fund

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business are in a commodity business; we are selling a commodity, and I don't think that anyone would dispute that. It's obvious in the case of a money market or a bond fund. While it is not as obvious in the case of a stock fund, the records are overpoweringly clear that in the long run all funds are average, less cost. Of course you'll have the occasional manager who will beat the market. Probably one out of every 1,024 can beat the market over ten years, which is exactly what a probability table is going to tell you should happen. But there's no escaping the basic math: Fund managers as a group can't beat the market because they *are* the market.

We have to realize that everything reverts to the mean. Newton's third law of motion says that everything reverts to the mean.²⁴ Think of a standard frequency distribution curve, a bell curve, showing how funds perform over time. Then shift it over to the left because, while fund performance follows a normal distribution, funds do much worse than "normal" because they have cost. All of a sudden the average fund is lagging the market by nearly three percent per year, instead of matching the market's return. They can't get the total market return. I don't mean to keep harping on that, but think about this: The intellectual case for indexing is gross return minus cost equals net return. If you can get the cost out of there, the investor gets the market return.

If that's the intellectual case for indexing, what, then, is the intellectual case for active management of equity funds? For bond and money market funds? Ask an active manager and you know what he will point to as the intellectual case? Me. He points to himself. It is impossible to argue that active managers as a group enhance the returns that fund investors get, so they argue that they're the exception to the rule. The record is crystal clear, however, that they are all average, less cost. There is absolutely no argument about it.

Another problem is that we let our funds get to such a size that they can't be managed anymore. This is a tremendous industry problem. We refuse to close funds to new investors, they get too large and then, even if there wasn't reversion to the mean, you find that you're trying to outperform the market when you've got a 0.99 correlation (R-squared, as they call it) with the market.²⁵ In such a case, investors are paying a 1.5% management fee to have 1% of their assets managed.

Then consider the fees that investors are paying. How can the industry, which charges the average equity investor three percent annually, ensure that their investors earn their fair share of the market's returns? Well, there are two very simple ways. One, all managers can be above average, and outperform the market by at least the total amount of their fees. Think about that: Lake Wobegon written in the

24. See PAYNE, *supra* note 14, at 53.

25. R-squared is the measurement of how closely a fund's performance correlates with an index. It can range between 0.00 and 1.00. An R-squared of 1.00 indicates perfect correlation, while an R-squared of 0.00 indicates no correlation. Vanguard Investments, Glossary, http://www.vanguard.com/international/hAmeEN/invest/topic_glossaryEN.html (last visited May 26, 2006).

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largest possible type with an exclamation point.²⁶ The other way: Take the three-percent cost down to one percent, and then all investors will come within one percent of the market's return. That would be a huge improvement. I'll let you decide which is the more reliable method of increasing the returns our fund investors earn.

We are talking, after all, about the financial futures of American families. We are not talking about "product manufacturing"—what an awful term. By and large, the industry is selling the manager, the manufacturer of these returns, and that's what people are buying. They are not buying that at Vanguard, I can assure you, because in the vast majority of cases our investors couldn't even identify the managers of our funds; we just do our best to give them a decent return. That's what happens when you view your work as asset management (which, really, is a sacred trust) rather than asset gathering (in which market share and revenue are the most important considerations).

So, we have to change the culture and move back to a system in which the directors are trying to get a higher portion of the market return for their fund shareholders. Over a fifty-year investment lifetime, if the market return is ten percent (it's not going to be that high, I don't think, but let's go with ten percent) the average investor will get seven percent in the average fund. That's not speculation or hyperbole; that's the tautology. And that means that after forty years—think about this for a minute—you, the investor, put up 100%. You, the investor, took 100% of the risk. You, the investor, got thirty percent of the market's cumulative return. The distribution and management system put up zero percent of the capital. The distribution and management system took zero percent of the risk. The distribution and management system took seventy percent of the return. That's the stunning effect these costs have when they are compounded over time.

This is why it is so important that the directors focus on fees. I have estimated that management expenses total about \$70 billion annually, which is not a bad estimate. Total transaction costs are another \$30 billion or so. Add sales charges into that and you get up to roughly \$120 billion. But of the \$70 billion that investors are paying managers, how much goes to the actual process of investment management? I would estimate it to be about \$4 billion a year. The rest, at least the rest that's not profit, goes to administrative services that are really just marketing, focused on getting people to do things on a very short-term basis.

The system is broken, and it has to be fixed. An important first step, I think, is getting directors to focus on the utility of the costs their fund investors are paying:

26. The reference is to Garrison Keillor's fictitious hometown of Lake Wobegon, Minnesota, where "the women are strong, the men are good looking, and all the children are above average." The town is the setting for *A Prairie Home Companion*, a weekly radio variety show created and hosted by Mr. Keillor. *A Prairie Home Companion: The News from Lake Wobegon* (Prairie Home Productions and American Public Media 2006), available at <http://prairiehome.publicradio.org> (last visited May 26, 2006).

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what the costs are, and how useful they are in furthering a fund's objectives of delivering the investor a fair share of the market's return.

JAMES HANKS: Does your emphasis on costs indicate that you think the directors have little or no role in selecting the advisers and that they're just stuck with average performance no matter what they do? And, therefore, the only thing they can really do to improve stockholders' return is bring pressure on cost?

JACK BOGLE: I believe that to be correct, and if you look at the records of funds, they come and go. Managers have their hot streaks, and then they revert to the mean. The record is not mysterious on this; you see it every day. If you look at the low-cost quartile of funds and compare it with the high-cost quartile over just about any meaningful time period, the spread is about 275 to 325 basis points a year in return, all because of cost. It revolves around cost. I don't know why we can't get people to focus on that. I'm getting all excited now. [laughter]

JAMES HANKS: We'll let you cool down just a bit. I see Bill has something he wants to say, and then we will get to Amy.

WILLIAM FOULK: One thing we have accomplished this year, and we continue to work on, is what Jack has been talking about the most, and that's the reduction of shareholder costs. But I believe that as independent directors, our first focus should be on performance and then on expenses. Obviously our number-one focus, before performance, is actually, to answer Alan, the shareholder. We have always felt that we represent the shareholder, period. Performance has been where we have devoted the most time. Along with expenses you have to look at service. You can always reduce costs to a certain point, and I'm sure Jack will agree with me, but at some point you could cut into service. We are very much concerned about making sure of service to the shareholder. We monitor this to some degree and will be monitoring it more. We'll be looking further at shareholders' complaints, their letters, their phone calls, and so on.

JAMES HANKS: Amy, we have been talking a lot about you and your role. What can you tell us about it? In particular, can a chief compliance officer who is an employee of a fund complex really be a chief compliance officer for the funds?

AMY OLMERT: That's a question we are dealing with. I just want to mention first that I was with a group of CCOs on Monday. We are not a bunch of fat cats drinking martinis. I mean, it's a very nervous group of people—very, very nervous. [laughter]

I feel we're dealing with three main issues as CCOs. First, the day-to-day complexity of the regulation around the funds. I provided to my board 350 pages of summaries of procedures. The board, when I provided it to them, had some duty to read it; obviously I had to read it. Then you think about the scope of the procedures that were underneath those 350 pages, and consider that we are a medium-sized fund company. I'm dealing with the fact that I have to oversee very large service providers. So how do I go into a major fund accounting shop, a major custodian, a major transfer agent, and perform my duty as chief compliance

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officer? In addition to dealing with the day-to-day stuff, I then have to think about the big-picture issues because most of these SEC actions revolve around conflict situations like that. So I am writing detailed procedures, and yet my procedures may not even cover a conflict that isn't addressed by the statute as it currently exists.

Regarding your question on the "right model," people are struggling with that because you can look at it two different ways. On the one hand, the model where I work is that I report directly to the board and I have no other direct responsibilities. That is an attractive model because I'm not conflicted with respect to my responsibilities.

JAMES HANKS: You report to the board, but who hires you and who can fire you?

AMY OLMERT: The board; management cannot fire me. On the other hand, if the board fires me, I can never have a job for the rest of my life, according to the word in the industry. [laughter] But there are disadvantages to that model. There are clearly two different models in the industry. There is a model that the adviser employee is the CCO, and there are benefits to that model, too, because those are the people in the trenches. They are seeing what's happening day to day. My job is more difficult because I am having to rely on other people to tell me what goes on, and I don't want to get into the situation where I am getting certifications and reading certifications and reports. It is necessary to strike a balance between being independent and being close enough to the business so you really see what's going on.

The third issue I am dealing with is the testing and monitoring programs. Now that I have presented to my board 350 pages of summaries, I have to test it all and report to the board. I have to tell the board about material violations and how that is defined. The inclination, for me, is to give the board more, and then all of a sudden I am loading the board up with reams and reams of paper.

So, I am looking for three things. As a CCO, I'm looking for additional guidance from the SEC as to how I implement this program. The guidance was pretty helpful on the written procedures, but now that we have to implement the program there is not a lot of guidance. I think CCOs are very concerned about rulemaking through enforcement. Somebody had asked whether that is how the rules are set. I'm very nervous that some CCO is going to be subject to an enforcement action because there was not enough guidance and their program wasn't robust enough, or it didn't follow a certain format when there is no guidance. It's nerve-racking for CCOs.

Second, I need to get guidance from the board. Do I give them all the material? What would they like to see? What would they not like to see? We're developing that relationship right now with our boards, talking to other people in the industries to the level of material, the level of staff that I have as a CCO. It's an exciting role. I think it's a great regulation, but we really do need more guidance from the regulators and from the board as to how we implement this.

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JAMES HANKS: Thanks very much. Professor Frankel?

TAMAR FRANKEL: On the 28th of October we had a panel, and Jim Gulkey, who is really the one who acts in the compliance area, talked about exactly your position. One of the things that struck me was that I had never heard that tone and this kind of approach before. What he really implied, maybe didn't say it outright, is that the CCOs are part of a group of enforcement people. He wanted the CCOs to call. My sense was that if other people from the industry called he would not be as available to them as to the CCOs. He also wants them to raise the status that you have, the access, which they do not. He was almost begging. He kept on saying that we are working on it together: "Let's work it out together. Come and talk to us anytime about this kind of thing."

DIANE AMBLER: I think that is exactly right, Tamar. I certainly think the SEC has gotten such a complex network that it is looking to the CCOs as its first line of, not enforcement, but certainly of compliance. It is viewing the CCOs as an arm that will feed ultimately to the SEC. Paul Roye has as much as said that. He has indicated he expects to develop a direct line of communication with CCOs.

WILLIAM FOULK: But, Diane, has that changed all that much? The SEC has told many of us, as independent directors, that it looks to us for help in doing its job, as well, and the Commission keeps telling us its door is open. So, in essence, hasn't it just added on to that with the new CCO?

DIANE AMBLER: I think that is exactly right. It focused it in a particular key person who is the repository of the information, who actually operates as the funnel for information in that organization directly to the SEC.

WILLIAM FOULK: I think we have to be careful that we don't put the CCO in a position where he is on the spot, because it is a job that is developing just as the independent director's is. The independent chairman model has been in Europe for some time for major corporations. And we have had independent chairmen here in the mutual fund industry for some time among a few funds.

JAMES HANKS: Well, I've got to be careful about the clock, so I'm going to adjourn this panel with great thanks to our panelists for a very lively discussion.