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Changes to the Independent Director Requirements: The 2004 Amendments in Context

I. Introduction: The New Rules and the Protests to Them.

The Securities and Exchange Commission (the "SEC" or the "Commission") recently promulgated new rules regulating an investment company's board of directors.[1] The controversial fund governance package—which became effective on September 7, 2004—includes a requirement that 75 percent of a fund's board of directors be independent and that the chairman of the board to be independent.[2] The new rules (the "2004 Amendments") amend the exemptive rules of the Investment Company Act (the "ICA" or the "40 Act").[3] Funds relying on any of the exemptive rules must comply with all requirements of the new governance package by January 16, 2006. The SEC estimated that, at the time it proposed these amendments, 4,610, or 90 percent of, mutual funds relied annually on at least one exemptive rule.[4]

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[1] *See* Securities and Exchange Commission, *Final Rule: Investment Company Governance*, 17 CFR 270, Release No. IC-26520 (July 27, 2004), *available* at http://sec.gov/rules/final/ic-26520.htm (last visited April 19, 2005) [hereinafter the "2004 Amendments"]. The rules were proposed on January 16, 2004. *Id. See also* Deborah Solomon, *SEC is Sued over Fund-Board Rule*, WALL STREET J., Sept. 3, 2004 (describing the new rules).

[2] *See* 2004 Amendments, *supra* note 1. If the fund has only three directors, 2/3 of the directors must be independent. *Id.* This represents a change from the original proposed rule, which did not make an exception for three-director boards. *See* Securities and Exchange Commission, *Proposed Rule: Investment Company Governance*, 17 CFR 270, Release No. IC-26520 (Jan. 15, 2004), *available at* http://sec.gov/rules/proposed/ic-26323.htm (last visited April 19, 2005) [hereinafter the "Proposal for 2004 Amendments"]. The Investment Company Governance package contains five new rules regarding directors. In addition to the 75 percent independent director requirement and the mandate of an independent board chairman, the 2004 Amendments also require that: (1) the board must perform a self-assessment at least once annually; (2) the independent directors must meet separately at least once a quarter; and (3) the independent directors must be affirmatively authorized to hire their own staff. An additional new rule in the governance package amends Rule 31a-2 to require that a fund retain copies of written materials that the board considers when approving the fund's advisory contract. *See* 2004 Amendments, *supra* note 1. This paper addresses only the rules regarding board composition (i.e. the 75 percent and chairman requirements).

[3] The ten exemptive rules at issue are: Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7 (permitting securities transactions between a fund and another client of the fund investment adviser); Rule 17a-8 (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting funds to maintain joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors). *See* 2004 Amendments, *supra* note 1, at n.9.

[4] *See* Proposal for 2004 Amendments, *supra* note 2.

The SEC adopted the 2004 Amendments in the wake of, and in response to, the fund trading scandals of 2003.[5] In 2003, New York Attorney General Eliot Spitzer unveiled a sweeping industry-wide probe of abusive trading in funds. Federal and state regulators investigated reports of late trading and market timing. Late trading is the illegal practice of a fund or intermediary permitting an investor to purchase fund shares "late"—after the fund's Net Asset Value ("NAV") for the day has been calculated—as though the purchase order had been placed before the NAV was calculated. Market timing is not illegal per se but was often used in contradiction of investment strategies outlined in funds' prospectuses. Market timing allows some investors to buy fund shares seeking to capitalize on information they think will affect a fund's NAV, but which is not yet reflected in the NAV.[6] Abuses related to market timing also can involve the overriding of stated market timing policies by fund executives to benefit large investors at the expense of small investors, or to benefit the fund's investment adviser; many funds say they forbid these practices because it can raise costs and lower performance for long-term fund investors.[7]

Not long after the mutual fund scandals broke, the Commission articulated its plan to combat the scandals by strengthening fund director independence. In a speech at the Investment Company Institute 2003 Securities Law Development Conference, Commissioner Harvey

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[5] *See Independent Fund Chairman Proposal Added to June 23 SEC Meeting Agenda*, SEC. REG. & LAW REP. 1113 (June 21, 2004).

[6] An example of market timing is "time-zone arbitrage." In this type of market timing, a market timer typically purchases shares of a mutual fund that invests in overseas markets. This purchase decision would be based on events occurring after foreign market closing prices are set, but before the fund's NAV calculation, that are likely to result in higher prices in foreign markets the following day. The market timer would redeem the fund's shares the next day when the fund's share price reflects the elevated prices in foreign markets. *See* Securities and Exchange Commission, Proposed Rule: *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, 17 CFR Parts 239 and 274, Release No. 33-8343 (Dec. 11, 2003), *available at* http://sec.gov/rules/proposed/33-8343.htm (last visited April 19, 2005) [hereinafter "Disclosure Regarding Market Timing"].

[7] *See* Judith Burns, *Money Managers Believe Moves to Combat Abuses Will be Ineffective, Costly*, WALL STREET J., Dec. 28, 2004. Market timing abuses can also cause funds to invest their assets in ways that disadvantage the shareholders taken as a whole, such as by keeping a large percentage of the assets highly liquid in order to accommodate the investors who buy and sell quickly. It can also lead to increased transaction costs. *See* Disclosure Regarding Market Timing, *supra* note 6.

Goldschmid expressed his disappointment with the market timing and late trading scandals and described the Commission's response to them. Goldshmid stated, "[G]iven the fundamental need for directors to scrutinize the fees of investment managers … and to review with rigor the practices and performances of fund managers, a critical mix of at least 75 percent of independent directors now seems right." [8] He added that, "[T]he board's chair should always be an independent director. The current scandals highlight the need for a chair who will independently ensure proper information flows, help establish sensible board priorities and agendas, and encourage candid and thorough discussions in the boardroom."[9] In the 2004 Amendments release, the SEC explicitly stated that it adopted the board composition rules to deal with a "serious breakdown in management controls" that resulted in the 2003 mutual fund scandals.[10] The SEC, by increasing the proportion of independent directors and disallowing an interested chairman of the board, sought to place fund boards in a better position to require management's adherence to a higher standard of compliance.[11]

Not everyone was on board with the Commission's move to require a greater percentage of independent directors and an independent chair. The 2004 Amendments were adopted only after a contentious 3-2 vote. Democratic commissioners William Donaldson (the SEC's chairman), Harvey Goldschmid, and Roel Campos voted in favor of the mutual fund governance package. Republican commissioners Cynthia Glassman and Paul Atkins voted against it and wrote a dissenting opinion in opposition to the 75 percent and independent chair requirements. [12] In their dissent, Glassman and Atkins expressed their support for strengthening investor

[8] Speech by Commissioner Harvey Goldschmid, Mutual Fund Regulation: A Time for Healing and Reform (Dec. 4, 2003), *available at* http://sec.gov/news/speech/spch120403hjg.htm (last viewed Feb. 17, 2005).
[9] *Id.*
[10] 2004 Amendments, *supra* note 1.
[11] *See* 2004 Amendments, *supra* note 1.
[12] *See* 2004 Amendments *supra* note 1. *See also U.S. Chamber of Commerce Sues SEC to Overturn Fund Governance Rules*, SEC. REG. & LAW. REP. 1639 (Sept. 20, 2004) (describing how commissioners voted and the dissent's reasons for opposing the rules).

protection for fund shareholders but felt that "the path chosen to achieve this objective may lead in the opposite direction—at a substantial cost to fund shareholders."[13] Prior to the vote, Glassman had expressed particularly strong opposition to the independent chair requirement, and stated that, if the 75 percent and the independent chair requirements were considered separately, they would receive different votes.[14]

Shortly after the SEC promulgated the 2004 Amendments, the U.S. Chamber of Commerce, for the first time in history, brought suit against the SEC.[15] The September 2 suit was filed in the U.S. District Court for the District of Columbia and the U.S. Court of Appeals for the D.C. Circuit and seeks to overturn the SEC's rules on independent directors.[16] On September 20, the Chamber of Commerce filed a motion for stay in the U.S. Court of Appeals for the District of Columbia, requesting that the court issue an order by October 18 staying the SEC rules, pending the resolution of the filed suit. The Chamber argued that the new rules are already imposing and will continue to impose significant costs on funds as investment companies scramble to hire additional independent directors or find independent chairmen.[17] The Chamber of Commerce requested that, if the court did not grant a stay, that it at least expedite the case's briefing. [18] The

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[13] *See* 2004 Amendments *supra* note 1.
[14] Glassman explored the possibility of having these rules considered separately, but ultimately the governance package was voted on as a whole. *See Independent Fund Chairman Proposal Added to June 23 SEC Meeting Agenda*, *supra* note 5, at 1113-14.
[15] *See* Deborah Solomon and Michael Schroeder, *Back Off! Businesses Go Toe to Toe With SEC*, WALL STREET J., Oct. 27, 2004.
[16] *See* Solomon, *supra* note 1.
[17] *See* Petitioner's Motion for Stay, or, alternatively, for expedited Briefing at 16-17, Chamber of Commerce v. U.S. Securities and Exchange Commission (No. 04-1300) [hereinafter "Motion for Stay,"]. *See also* Judith Burns, Dow Jones Newswire, *Federal Judge Rejects Move To Block New Requirement For Independent Chairmen,* WALL STREET J., Oct. 19, 2004.
[18] *See* Motion for Stay, *supra* note 17. *See also* Dow Jones Newswire, *Stay Sought for Mutual-Fund Directors Rule*, WALL STREET J., Sept. 21, 2004.

court denied the stay but granted the motion for expedited briefing.[19] Oral arguments were held April 15, 2005.[20]

In its opening brief, the Chamber argues that the SEC does not have the statutory authority to require that 75 percent of the board of directors and the chairman of the board be disinterested. According to the Chamber, the SEC does not have the statutory authority to regulate corporate governance; its powers under the exemptive rules to free funds from certain statutory prohibitions do not allow the SEC to impose affirmative requirements on investment companies. It also opposes the rules because it believes they are arbitrary and capricious. The Chamber's initial brief explains that the Commission did not deal individually with the exemptive rules it was amending and did not adequately consider the 2004 Amendments' cost, public comments to the new rules, and alternatives to the 2004 Amendments. [21]

Commissioners Glassman and Atkins and the Chamber are not the only parties who have questioned the new independent director requirements. On December 8, 2004, President Bush signed the Omnibus Consolidated Appropriations Act, 2005, H.R. 4818. A provision of the Act requires the Commission to review the independent chair requirement. By May 1, 2005, the SEC must submit a report to the Senate Appropriations Committee that "provides a justification" for the independent chair requirement. The SEC must examine whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors. The SEC must act upon recommendations of this report by January 1, 2006.[22] Republican Senator Judd Gregg, from New Hampshire, where

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[19] *See* Order filed Oct. 18, 2004, Chamber of Commerce v. U.S. Securities and Exchange Commission (No. 04-1300). *See also* Judith Burns, Dow Jones Newswire, *Federal Judge Rejects Move To Block New Requirement For Independent Chairmen*, WALL STREET J., Oct. 19, 2004.
[20] *See* Opening brief of petitioner, Chamber of Commerce v. U.S. Securities and Exchange Commission, (No. 04-1300) cover [hereinafter "Chamber Opening Brief"].
[21] *See* Chamber Opening Brief, *supra* note 20, at 24. *See also* Solomon, *supra* note 1.
[22] See Chamber Opening Brief, *supra* note 20, at 23.

Fidelity Investments is a large employer, inserted this provision into a bill providing $913 million of funding for the SEC.[23]

The combination of the vigorous dissent, the Chamber's first-ever suit against the SEC, and the rider to the budget demanding a justification for the independent chair requirement might lead one to believe that the SEC is breaking new ground by influencing funds' board composition and the "level" of independence in the fund boardroom.[24] However, this is not the first time that the government or the SEC has tinkered with independent director requirements. In the past, Congress and the SEC have prohibited certain transactions absent an independent director vote, have altered who can qualify as a non-inside director, and have even altered the percentage of independent directors a board must have.[25]

On the surface, the 2004 Amendments seem roughly in line with Congress and the SEC's increasing reliance on independent directors to act as "watchdogs" of funds.[26] This paper looks back at some of the amendments and rules that point to this increasing reliance. This paper argues that, although, along some criteria, the 2004 Amendments bear a strong resemblance to previous modifications to the Act's independent director requirements, the 2004 Amendments

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[23] *See* Deborah Solomon and David Rogers, *Rule Backed by Fidelity Would Force SEC to Study Independent-Chairman Rule*, WALL STREET J., Nov. 17, 2004.

[24] A review of the final rules from January 1, 2003 until February 4, 2005, reveals that the SEC passed 77 final rules during that time. Only two have contained official dissents. One of those is the 2004 Amendments. The other is a rule requiring certain hedge fund advisers who previously did not have to register under the Investment Advisers Act to do so. *See* Securities and Exchange Commission, *Final Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 17 C.F.R. 275 and 279, Release No. IA-2333 (Dec. 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm (last visited April 19, 2005) (Glassman and Atkins dissent). A Wall Street Journal Editorial describes the dissent to the 2004 Amendments as a "rare official dissent." *See* Editorial, *Mutual Displeasure*, WALL STREET J., Jan. 17, 2005.

[25] *See infra* Part III (highlighting some of these changes).

[26] *See, e.g.*, Moses v. Burgin, 445 F.2d 369, 376 (1st Cir. 1971) (stating that Congress responded to conflict-of-interest problems of funds "by enacting a mandatory provision for unaffiliated, that is, independent, watch-dog directors"). *See also* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 IOWA J. CORP L. 609, 616 (2001) (describing the 40 Act's creation of the independent directors' "watchdog" role); *Mutual Fund Regulation in the Next Millennium Symposium Panels: Fund Governance*, 44 N.Y.L. SCH. L. REV. 431, 451-52 (panelist Steve Howard arguing that the Securities and Exchange Commission has come to rely increasingly heavily on independent directors to monitor funds because the mutual fund has grown tremendously in recent years without a commensurate increase in the SEC's budget and staff).

differ from those changes in significant ways. The similarities and differences can be divided into three categories: “Costs,” “Benefits,” and “Authority to Make changes.” The main ways in which the 2004 Amendments differ from past changes are: 1) the absence of a true benefit that the new rules impart, given the existing requirements for fund boards; 2) the lack of a negotiating process between the SEC and the industry whereby the industry bargains to lower the costs it has to bear; and 3) the use of conditions to create far-reaching governance changes. This paper concludes that the differences between the 2004 Amendments and previous changes may explain and perhaps justify the vigorous objection that many have voiced over the 2004 Amendments.

Although the 2004 Amendments apply to all investment companies using any of the exemptive rules, this paper frequently refers to mutual funds specifically, because they are by far the most popular type of investment company.[27] The paper proceeds as follows: Part II provides context for the discussion surrounding the new rules. It explains the structure of mutual funds, the role of independent directors, and the reasons why one would want disinterested directors serving on a fund board. Part III highlights some of the past changes to the independent director requirements. It briefly introduces the ICA, the 1970 Amendments, § 15(f), Rule 12b-1, and the 2001 Amendments to the exemptive rules; it also mentions other actions requiring an independent director vote. Part IV describes the three categories of complaints about the 2004 Amendments: 1) that the amendments provide no significant benefit; 2) that their costs are too high; and 3) that the SEC did not have the authority to promulgate them. It then evaluates the provisions described in Part III to see whether the allegations directed at the 2004 Amendments would apply with the same force to past changes to independent director requirements. The goal in this section is not to make an explicit assessment of whether the 2004 Amendments’ costs and

[27] *See* CLIFFORD E. KIRSCH, MUTUAL FUND REGULATION, § 1:1. Additionally, the press tends to describe the recent amendments in terms of their effects on mutual funds, and this paper follows that convention. *See, e.g.*, *Mutual Displeasure*, *supra* note 24 (describing the recent “mutual fund” reforms”).

benefits are high or low or whether the SEC had the authority to promulgate these rules, but instead to provide historical points of comparison for the 2004 Amendments in an effort to understand why the complaints about it are louder than the protests to these past provisions. Part V concludes, providing a final assessment of the differences between the 2004 Amendments and historical alterations along the three criteria. This Part also provides a tentative analysis of why the SEC promulgated the 2004 Amendments and hypothesizes that the differences discussed in Part IV indicate that the SEC promulgated these rules to appear proactive in the face of the 2003 trading scandals.

II. Why Independence Matters in the Fund Context.

A. Mutual Fund Industry and Structure.

At year-end 2003, there were $7.414 trillion invested in U.S. mutual funds.[28] Ninety-one million individuals in 53.3 million[29] U.S. households held 77 percent of mutual fund assets in 2003. Fiduciaries (banks and individuals serving as trustees, for example) held the other 23 percent of assets.[30] Investors can choose from an astounding 8,126 U.S. mutual funds.[31] This growth has occurred at a remarkably rapid rate: In 1970, investors had about $50 billion invested in mutual funds.[32]

A mutual fund is an investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, or other securities.[33] All mutual funds have a sponsor. Any individual or entity can serve as a mutual fund sponsor.

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[28] INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 5 (44th ed. 2004), *available at* http://ici.org/stats/mf/2004_factbook.pdf (last visited April 20, 2005) [hereinafter "FACT BOOK"].
[29] This represented 47.9 percent of all U.S. households in July 2003. *See id.* at 80.
[30] *Id.* at 79.
[31] *Id.* at 13.
[32] *See* REGULATION OF FINANCIAL INSTITUTIONS 821 (Howell E. Jackson & Edward L. Symons, Jr., eds., 1999).
[33] Steven G. Schulman, et al., *Fallout from 'Canary': Private Civil Litigation and Legal Remedies Beyond Regulatory Measures*, AMERICAN LAW INSTITUTE - AMERICAN BAR ASSOCIATION CONTINUING LEGAL EDUCATION ALI-ABA CONFERENCE 53 (May 6-7, 2004). *See also* 15 U.S.C. §80a-3 (defining an investment company).

Common sponsors are investment advisory firms, brokerage firms, and insurance companies. The sponsor creates, organizes, and promotes the fund. The sponsor also organizes the fund's service arrangements, such as the distribution agreement, the shareholder servicing agreement, and the transfer service agreement.[34]

The investment adviser or investment manager supervises and manages the fund's assets, including the fund's portfolio transactions.[35] Often the sponsor or one of its affiliates serves as the investment adviser.[36] Unlike corporations, mutual funds do not operate on their own or employ a full time staff. Instead, they usually contract with "external" investment advisers, underwriters, and others to provide services to the fund. [37] Thus, the portfolio manager, analysts, and other staff are the investment adviser's employees, and not the fund's. These service providers often are companies affiliated with each other. The investment adviser is paid a fee, which is usually based on a percentage of the fund's net assets. [38] The investment adviser frequently performs the role of the fund's administrator. Otherwise, the administrator is a separate, unaffiliated company. The administrator of a mutual fund provides the executive, administrative, clerical personnel, office facilities, and supplies necessary for the firm to conduct its day-to-day operations. It also provides accounting services and may be responsible for determining the fund's daily price.[39]

In the nascent days of the mutual fund industry, mutual fund sponsors operated only one or two funds. In more recent years, sponsors began creating large "fund families" or "fund

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[34] *See* KIRSCH, *supra* note 27, § 1:2.1.
[35] *See* KIRSCH, *supra* note 27, § 1:2.2.
[36] *See* KIRSCH, *supra* note 27, § 1:2.1
[37] *See* 1 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 1.01[B] (2d ed. 2001). Although advisory services can be offered internally, open-end investment companies (i.e. mutual funds) are typically managed externally. *See id. See also* INVESTMENT MANAGEMENT REGULATION 134 (Tamar Frankel & Clifford E. Kirsch eds., 2d ed. 2003) (explaining that "[t]oday, the external model is far more prevalent.").
[38] *See* KIRSCH, *supra* note 27, § 1:2.2.
[39] *See* KIRSCH, *supra* note 27, § 1:2.4.

complexes" which contain numerous funds. [40] The SEC defines "family of investment companies" as "funds that share the same investment adviser or principal underwriter and hold themselves out to investors as related companies for purposes of investment and investor services."[41] It defines a "fund complex" as "two or more registered investment companies that: (1) Hold themselves out to investors as related companies for purpose of investment and investor services; or (2) Have a common investment adviser or have an investment adviser that is an affiliated person of the investment adviser of any of the other registered investment companies."[42]

The fund's shares are sold to the public through an underwriter or distributor.[43] Individuals and institutions invest in a mutual fund by purchasing shares issued by the fund. It is through these sales of shares that a mutual fund raises the cash used to invest in its portfolio of stocks, bonds, and other securities. Each investor shares in the returns from the collective investment portfolio of the mutual fund.[44] The vast majority of mutual funds are open-end companies, meaning that they are management companies "offering for sale or [which have] outstanding any redeemable security of which it is the issuer."[45] This means that mutual funds are required to buy back outstanding shares on demand at the shareholder's option. The buy-back price is based on the current value of the fund's net assets. Almost all open-end funds offer new shares to the public on a continuous basis.[46]

B. Independent Directors: Purpose and Practice.

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[40] *See* KIRSCH, *supra* note 27, § 1:3.1. Each fund is separately registered—as opposed to the whole fund family registering as one entity. *See id.*
[41] *See* Securities and Exchange Commission, *Final Rule: Role of Independent Directors of Investment Companies*, 17 C.F.R. Parts 239, 240, 270, 274, Release Nos. 33-7932; 34-43786 (Jan. 2, 2001), *available at* http://sec.gov/rules/final/34-43786.htm2001 (last visited April 21, 2005) [hereinafter the "2001 Amendments"].
[42] *Id.*
[43] *See* KIRSCH, *supra* note 27, § 1:3.3.
[44] FACT BOOK, *supra* note 28, at 1.
[45] 15 U.S.C. § 80a-5a.
[46] FACT BOOK, *supra* note 28, at 12.

The 40 Act requires that all investment company boards of directors meet certain composition requirements and that shareholders elect those directors.[47] The sponsor initially selects the fund's board of directors, because the sponsor is the fund's initial shareholder. The 40 Act, when enacted, required that 40 percent of those directors not be affiliated with the investment company[48] and, in particular cases where conflicts of interest were likely to result, that a majority of the board of directors be unaffiliated.[49] The SEC and Congress have fiddled with this composition requirement over time.[50] The directors now must be "disinterested" as opposed to "unaffiliated."[51] Since 1970, the ICA has defined an "interested" person (non-independent) broadly and has included a person affiliated with the investment company, a family member of someone affiliated with the company, a person affiliated with the investment advisor or underwriter.[52] The 2004 Amendments—the most recent change in this line of alterations—require that, by January 16, 2006, all mutual fund boards relying on certain exemptive rules under the ICA[53] will need to have a board made up of 75 percent disinterested directors, plus an independent chairman of the board.

Independent directors often serve on the boards of all of the funds in a mutual fund complex, although some complexes have several sets of independent directors for different types

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[47] *See* ICA § 10(a), (b) (board composition); § 16(a) (shareholder election of directors).

[48] *See* ICA § 10(a) (requiring 40 percent of directors to be unaffiliated). The term "affiliated" was narrowly defined in the 40 Act and did not necessarily bar close personal friends, relatives, or business associates of the adviser. *See* WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. No. 2274, 87th Cong., 2d Sess. (1962) [hereinafter the "WHARTON REPORT"], at 8.

[49] *See* ICA of 1940 § 10(b)(1) (requiring that, when the investment company employs as a regular broker any director, officer, or employee—or any person of which they are affiliates—of such investment company, a majority of the directors not be those brokers or affiliates of those brokers); § 10(b)(2) (requiring that a majority of the board be unaffiliated with the principal underwriter if the principal underwriter is an officer, director, employee or affiliate of the investment company); and § 10(b)(3) (requiring that, when the investment company has as an investment banker any director, officer, or employee—or any person of which they are affiliates—of such investment company, a majority of the directors not be those investment bankers or affiliates of those investment bankers).

[50] *See* Part III *infra*, highlighting some of these changes.

[51] This is the case for § 10(a) and § 10(b)(2). As for § 10(b)(1) and § 10(b)(3), the term "affiliated" remains. *See* 15 U.S.C. §80a-10(a); 80a-10(b); *compare with supra* note 49.

[52] *See* 15 U.S.C. § 80a-2(a)(19) for the definition of an "interested person." *See also* KIRSCH, *supra* note 27, § 1:2.3

[53] Except those with three directors, which will only need a 2/3 independent board. *See supra* note 2.

of funds.[54] The Investment Company Institute Advisory Group considers either having a unitary board for all funds in a complex or cluster boards for groups of funds within a complex to be a "best practice."[55]

The mutual fund board is not involved in the daily management of the fund; rather, its primary purpose is to serve as a "watchdog," curbing abusive management practices.[56] Causes of management abuse can be divided into two main categories. The first is the separation of ownership from control, an agency problem not unique to mutual funds.[57] Thus, it is beneficial to have a board of directors charged with the duty of protecting and advocating for shareholders, to help bring management's practices more in line with shareholder interests.[58] The second major set of causes is unique to funds, and helps explain why "a managed fund registered under the Act is the *only* type of business entity required by statute to have independent directors."[59] These causes include problems of disclosure, because manager discretion regarding portfolio investments gives them a degree of freedom to change the nature of the company's investment policies without shareholders having a say. The liquidity of the fund's assets lends itself to management embezzlement. Finally, and most importantly in the context of the problems that independent directors were designed to rectify, is self-dealing.[60]

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[54] ROBERT C. POZEN, THE MUTUAL FUND BUSINESS 101 (2d ed. 2002). For example, a fund complex may have a different set of independent directors for its money market funds than it does for its equity funds. *See id.*
[55] *See* POZEN, *supra* note 54, at 102-03.
[56] *See* KIRSCH, *supra* note 27, § 1:2.3.
[57] *See* Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, INV. CO. INST. PERSPECTIVE 6 (Aug. 2003), *available* at http://www.ici.org/perspective/per09-03.pdf (describing this agency problem that publicly held companies face).
[58] *See id. See also* KIRSCH, *supra* note 27, § 13:1.
[59] *See* ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 3.01.
[60] *See* JACKSON, *supra* note 32, 815 (describing these sources of management abuse).

As one court put it, in mutual funds, "self-dealing is not the exception but, so far as management is concerned, the order of the day."[61] The mutual fund, unlike most corporations, is created and managed by the "external" investment adviser/sponsor. The advisory firm has its own investors who are often distinct from the shareholders of the funds that the advisory firm sponsors. The adviser usually provides the fund with all its management services and typically the fund's officers and several of its directors are officers and directors of the adviser and are compensated by the adviser. Thus, realistically, the fund cannot sever its ties with the adviser and thus arm's-length bargaining does not play the same role that it plays in other American business entities.[62] The inside management will be motivated not only to create a successful fund (which will increase assets under management and thus increase the advisory fee) but also to benefit the interests of the fund sponsor/advisor. For example, the management may want the fund to grow by selling additional shares, despite evidence that this growth does not benefit portfolio performance. Although funds can serve the purpose of pooling investors' assets and allowing investors to "cheaply" diversify, this growth can reach a point where it negatively impacts shareholders. If the benefits of diversification are outweighed by the manager being unable to find additional or replacement assets with a return as high as the current pool of assets, the NAV per share will drop. The original shareholders find their share of the fund's assets "diluted" because of this increase in size. However, because the adviser bases his fee on the NAV, the

[61] *See* Moses v. Burgin, 445 F.2d 369, 376 (1st Cir. 1971) (explaining that "management's normal activities are frequently touched with self-interest" and that Congress responded to this problem by enacting a mandatory provision for unaffiliated, that is, independent, watch-dog directors.").
[62] *See* ROBERTSON, *supra* note 59, § 3.01, § 3.01 n.2. *See also* Speech of President of ICI Matthew Fink, March 22, 1999, *available at* http://www.ici.org./statements/remarks/99_mfimc_fink.html#TopOfPage ("It may be that U.S. mutual funds and closed-end funds are the only companies in the world that are required by law to have independent directors and to delegate certain critical decisions to those independent directors.").

adviser will gain under this scenario—more assets equate to a higher fee for the adviser, even if individual shareholders find their share of the assets worth less.[63]

The Supreme Court stated that, " [T]he Investment Company Act indicate[s] that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders."[64] Like any corporation, trust, or partnership, a mutual fund must be operated for the benefit of its owners, the shareholders.[65] Thus, the board polices conflicts of interest between the fund and the fund's service providers. For areas in which management's choices are especially "suspect"—because of the potential for conflicts of interest—the board's independent directors are often required to vote on the matter separately.[66] Thus, the independence of directors is expected to matter both in aligning shareholder and management interest generally and by taking on the task of separately approving transactions that are prone to management abuse.

III. "Highlights" of Changes to the Independent Director Requirements.

The SEC and Congress have made numerous changes to fund independent director requirements, which all aim to "strengthen" the role of independent directors. These changes do so by either: 1) requiring independent directors to comprise a particular percentage of the board; 2) giving independent directors special duties; 3) putting measures in place to ensure that independent directors are not beholden to management.

A. The 40 Act.

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[63] *See* Samuel S. Kim, *Note: Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard*, 98 COLUM. L. REV. 474, 480-81 (1998) (offering this example of a conflict between shareholders and the adviser).
[64] Burks v. Lasker, 441 U.S. 471, 486 (1979).
[65] 2001 Amendments, *supra* note 41.
[66] Two of these situations, approval of the fund's contract with its investment adviser and its associated fees, under 15 U.S.C. § 15(c), and approving the use of fund assets to market the fund's shares to potential purchasers, under Rule 12b-1, will be discussed in greater detail in Part III, *infra*. Other rules requiring an independent director vote will be referenced but not discussed in Part III.F., *infra.*

The Investment Company Act of 1940 was designed to comprehensively regulate the investment company industry. The 40 Act sought, not only to provide disclosure to investors, but also to prevent management abuses in the funds.[67] The most important regulation under the Act, in terms of independent director requirements, was that only 60 percent of the directors on a fund board could be investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, the investment company.[68] A fund whose principal underwriter is an affiliate of its investment adviser was required to have a majority of directors that were not affiliated vis-à-vis that underwriter.[69]

B. The 1970 Amendments.

The first major change to fund governance since the adoption of the 40 Act was the passage of a set of amendment to the 40 Act in 1970 (the "1970 Amendments").[70] Congress added section 2(a)(19) of the Act which defined an "interested person." The term "interested person," was broader in scope than "affiliated person" under § 2(a)(3). The term "interested person" was substituted for the term "affiliated person" in places, including § 10(a) which now requires that no more than 60 percent of the directors be interested.[71]

Additionally, the 1970 Amendments altered § 15(c) of the Act. In the original 40 Act, § 15(c) required that a contract with an investment adviser or principal underwriter be approved *either* "by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, *or* … by the vote of a majority of the outstanding voting securities of such company."[72] The 1970 Amendments substituted the § 15(c) from the original

[67] *See* ROBERTSON, *supra* note 59, § 1.02[3].
[68] *See* ICA § 10(a).
[69] *See* ICA § 10(b).
[70] ROBERTSON, *supra* note 59, § 3.02.
[71] *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547 (1970). These amendments also altered ICA § 10(b) to substitute "interested" for "affiliated." *See id. See also* ROBERTSON, *supra* note 59, § 3.02.
[72] Investment Company Act of 1940, 54 Stat. 789, 813, § 15(c) (1940) (emphasis added).

40 Act for one which reads: "it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement … whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party…."[73] Thus, the 1970 Amendments stripped the investment company of the option of shareholder approval of these contracts and mandated that the disinterested directors approve them.[74] The 1970 Amendments also imposed a statutory duty on fund directors to request and consider the information necessary to evaluate advisory contracts and underwriting agreements in order to negotiate those contracts more effectively.[75] Under this same provision, management was required to provide the directors with this information.[76]

C. § 15(f).

In 1975, another set of amendments altered § 15 of the Act. The major change that these amendments made to § 15 was adding § 15(f), which dealt with the sale of an investment advisory contract. This provision required that, "[a]n investment adviser … of a registered investment company or an affiliated person of such investment adviser or corporate trustee may receive any amount or benefit in connection with a sale of securities of, or a sale of any other

[73] *See* 15 U.S.C. § 80a-15(c).
[74] *See infra* note 150 (explaining the conflicting case law regarding whether, prior to the 1970 Amendments, unaffiliated always had to approve § 15(c) contracts or whether the shareholders *or* the unaffiliated directors could approve them).
[75] *See* 15 U.S.C. § 80a-15(c).
[76] *See* 15 U.S.C. § 80a-15(c). The corollary to § 15 is § 36(b), which the 1970 Amendments also added to the ICA. *See* 84 Stat. 1413, 1429 (1970). Section 36(b) gives the SEC and private parties a cause of action against any person, including fund directors, on behalf of the fund for breach of its fiduciary duty with respect to the fee it charges. *See id.* While § 15 requires directors to gather information on contracts with the adviser, the case law that § 36(b) has spawned guides directors as to the standards for evaluating this agreement. The test of whether a violation of § 36(b) has occurred is whether "a fee is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." *See* Gartenberg v. Merrill Lynch Asset Management, 694 F.2d 923, 928-29 (2d Cir. 1982). *See also* ROBERTSON, *supra* note 59, § 6.03[2], [3].

interest in, such investment adviser … which results in an assignment of an investment advisory contract with such company or the change in control of or identity of such corporate trustee, if-- (A) for a period of three years after the time of such action, at least 75 per centum of the members of the board of directors of such registered company … are not (i) interested persons of the investment adviser of such company or such corporate trustee, or (ii) interested persons of the predecessor investment adviser … and (B) there is not imposed an unfair burden on such company as a result of such transaction or any express or implied terms, conditions, or understandings applicable thereto."[77]

Thus, the percentage requirement for independent directors was raised if an advisory contract was sold and the investment adviser made a profit. The 1975 Amendments also added another nuance to § 15, by appending a sentence to §15(c), which states that "[i]t shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction [involving the assignment of an advisory contract]."[78]

D. Rule 12b-1.

Under Rule 12b-1,[79] the SEC outlined conditions under which it would allow mutual funds to use fund assets to pay the expenses of distributing their shares—and the conditions heavily involved independent directors. Rule 12b-1 requires that any decision by a mutual fund to use its assets to finance distribution be approved by its shareholders and directors, including separate approval by a majority of the funds' disinterested directors. To insure that the

[77] *See* Act of June 4, 1975, P.L. 94-29.
[78] *Id.*
[79] *See* 45 F.R. 73898 (Nov. 7, 1980) [hereinafter "Rule 12b-1"].

disinterested directors are genuinely disinterested, any fund using Rule 12b-1 must have its disinterested directors selected and nominated by the fund's disinterested directors. In approving the distribution plan, the directors must consider "all pertinent factors" and, in the exercise of their reasonable business judgment and in light of their fiduciary duties, determine that there is a reasonable likelihood that the distribution plan will benefit the fund and its shareholders.[80]

E. 2001 Amendments.

On January 2, 2001, the SEC promulgated *Final Rule: Role of Independent Directors of Investment Companies* (the "2001 Amendments"). This rule amended the same ten exemptive rules that the 2004 Amendments altered. For any fund relying on any of the exemptive rules, the 2001 Amendments required that they have 1) independent directors comprise a majority of the board; 2) independent directors select and nominate other independent directors; and 3) any legal counsel to the independent directors be independent legal counsel.[81]

F. Other Transactions Requiring a Separate Independent Director Vote.

The ICA and the SEC have assigned independent directors other tasks that this paper does not discuss extensively but which merit mention. Other responsibilities that the ICA assigns to independent directors require them to supervise management and auditing. These additional requirements are: 1) annually selecting the independent accountant;[82] and 2) selecting and nominating persons to fill independent director vacancies for three years after the sale of an advisory contract.[83] Additionally, the SEC has promulgated regulations that imbue independent directors with special duties designed to police conflicts of interest. Aside from the previously mentioned Rule 12b-1, the independent directors must: 1) adopt procedures for purchases from

[80] *See* Rule 12b-1.
[81] *See* 2001 Amendments, *supra* note 41. The additional, less major, requirements are listed *infra* note 188.
[82] 15 U.S.C. § 80a-32(a)(1).
[83] 15 U.S.C. § 80a-16(b).

affiliated underwriters and determine compliance quarterly;[84] 2) approve any interim advisory contract prior to a shareholder vote;[85] 3) adopt procedures for purchases from and sales to affiliated funds, and determine compliance quarterly;[86] 4) make certain determinations for mergers of affiliated funds;[87] 5) adopt procedures for brokerage transactions with affiliates, and determine compliance quarterly;[88] 6) determine compliance annually of joint fund insurance policies;[89] 7) determine compliance annually of bonding of fund officers and employees;[90] 8) determine fair allocation of gains and losses for a multi-class agreement[91]; and 9) approve a redemption fee to counteract asset dilution or decide that no redemption fee is necessary.[92]

IV. Complaints Regarding the 2004 Amendments: What They Are and How Do They Apply to Past Changes to the Independent Director Requirements?

The Commissioners' dissent to the 2004 Amendments, the Chamber's argument against the new independent director requirements, Congress's response to the independent chair requirement, and the statements by those in the industry and press who oppose the 2004 Amendments boil down to: 1) the 2004 Amendments do not offer significant benefit; 2) the costs of implementing the independent director requirements are high; and 3) the SEC does not have the authority to promulgate this rule. This Part elaborates on the particulars of those complaints and then evaluates the changes to the independent director requirements described in Part III to see if similar complaints did or could apply to those changes as well. The aim in pursuing this exploration is not to make an ultimate assessment of whether the "costs" of the 2004

[84] Rule 10f-3(b)(10).
[85] Rule 15a-4.
[86] Rule 17a-7(e).
[87] Rule 17a-8(a).
[88] Rule 17e-1(b).
[89] Rule 17d-1(d)(iii)
[90] Rule 17g-1(d).
[91] Rule 18f-3(c)(1)(v).
[92] Rule 22c-2(a)(1).

Amendments outweigh the "benefits" or whether the SEC "had authority" to amend the exemptive rules to alter board composition, but rather to offer historical context for the current debate surrounding the 2004 Amendments with the intention of shedding light on why the response to the 2004 Amendments has been so negative.

A. No significant benefit.

<u>1. The 2004 Amendments.</u>

The Commission stated that a "principal purpose of the [2004] [A]mendments is to strengthen the independent directors' control of the board and its agenda, so that the interests of the investors are paramount."[93] Despite the existing requirement that funds relying on any of the exemptive rules have a majority of independent directors, the Commissioners voting for the 2004 Amendments were "concerned that many boards continue to be dominated by their management companies…. Requiring that each fund that relies upon any Exemptive Rule have a board of directors whose independent directors constitute at least 75 percent of the board, will help ensure that independent directors carry out their fiduciary responsibilities."[94] The SEC also stated that the fund board was "in a better position to protect the interests of the fund" when its chairman was independent and thus did not have the conflicts of interest associated with a management chair.[95]

In stark contrast to the majority's assertion of the benefits of the new rules, Commissioners Glassman and Atkins argued in their vigorous dissent to the 2004 Amendments that the existing requirements related to independent directors are sufficient to influence meaningfully a fund's board as a whole.[96] The existing requirements that the dissent points to are

[93] See 2004 Amendments, *supra* note 1.
[94] *Id.*
[95] *Id.*
[96] *See id.*

the 40 Act's board composition requirements,[97] the various provisions of the 40 Act in which a majority of independent directors are required to vote on particular transactions before they can take place,[98] the 2001 Amendments,[99] and, on a general level, that all directors have a fiduciary duty to shareholders and reasons to want the fund to perform well, to the benefit of both the adviser and the shareholders.[100] Thus, changing the board composition from 40 percent (or a majority for most funds complying with the 2001 Amendments or other ICA provisions) to 75 percent adds little to prevent fund abuse.[101]

The Chamber has a theory similar to the dissent's—that the 75 percent requirement does not add any benefit, given the existing safeguards. The Chamber highlights this theory with a specific example of a safeguard already in place and how it is impacted. The 2004 Amendments amend Rule 17g-1(j) which provides an exemption from § 17(d) of the Act. Section 17(d) makes it unlawful for persons affiliated with a fund or fund underwriter to jointly participate with the fund in a transaction. Rule 17g-1(j) provides an exemption for bonds insured jointly by an investment company and at least one other party if the fund meets certain requirements, including having a majority of the independent directors approve the bond at least annually.[102]

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[97] Specifically, they point to the 40 Act requirements of at least 40 percent independent directors on all boards and a majority of independent directors on boards where the fund's principal underwriter is an affiliate of the fund's adviser. *See* ICA §10(a), (b); 15 U.S.C. § 80a-10(a), (b). Originally, the requirement was that the directors be unaffiliated. *See supra* Part III.B (describing the 1970 Amendments' change to these sections of the ICA).

[98] The dissenting commissioners highlight 15 U.S.C. § 80a-15(c) as a significant example of the independent directors' sway. *See also supra* Part III(B) (discussing this section of the ICA).

[99] The dissent states that the 2001 Amendments enable independent directors to control a fund's corporate machinery because they constitute a majority of the board. *See* 2004 Amendments, *supra* note 1.

[100] *See* 2004 Amendments, *supra* note 1. *See also supra* Part II.B (discussing the alignment and misalignment of director and shareholder incentives).

[101] *See* 2004 Amendments, *supra* note 1. *See also* Comment Letter to the Proposal for the 2004 Amendments from Richard G. Cline, Hawthorne Investors, Inc. (explaining that the 75 percent did not add much protection above current levels of independence); Comment letter Comment Letter to the Proposal for the 2004 Amendments from Phillip Goldstein, President of Kimball & Winthrop, Inc. (stating that there is no reason to believe that the 75 percent requirement will add any benefit to the majority independent director requirement of the 2001 Amendments and arguing that the 2001 Amendments did not provide an effective check on management) [hereinafter the "Goldstein Comment Letter"].

[102] *See* 17 C.F.R. § 270.17g-1(j); 15 U.S.C. § 80a-17(d); Chamber Opening Brief, *supra* note 20, at 17.

Thus, the Chamber did not see a reason to require a 75 percent independent board for funds using this rule when this rule already mandated a "check" on management authority by requiring that the fund's independent directors approve of this action by a majority vote.[103]

In evaluating the independent chair requirement, the Glassman and Atkins pointed out that, while the majority stated that 80 percent of the funds involved in the scandals regarding late trading, market timing, and other abuses had inside chairpersons, this statistic is misleading because 80 percent of *all* funds have inside chairpersons.[104] Thus, the statistic means that funds with inside chairpersons were just as likely as funds with independent chairpersons to have participated in abusive fund practices; changing the status of the chairperson does not put the fund into a category that is more or less likely to have participated in a scandal. Additionally, as the dissent points out, one of the big problems with trying to use changes to the independent director requirements to thwart abusive fund practices is that the 2003 fund scandals were characterized by unawareness of the abuse on the part of fund boards.[105] The dissent takes this analysis a step further by arguing that, in light of this unawareness, there is a benefit to be gained from having an interested chair: An inside chairperson might be more in tune with the daily operations of the fund and the workings of management and thus be able to spot and thwart abuse.[106]

The dissent also argued that the independent chair requirement does not benefit shareholders by increasing the return on their investments. Glassman and Atkins criticized the lack of evidence to show that the inside chairperson will lead to benefits for shareholders. The

[103] *See* Chamber Opening Brief, *supra* note 20, at 17.
[104] *See* 2004 Amendments, *supra* note 1.
[105] *See id*.
[106] *See id*. There is a problem, however, with the dissent's argument that an interested chair will have more ties to management and thus be more informed about scandals: The 80/20 inside/disinterested chair statistic that the Commissioners cite does not point to this outcome. If funds with independent chairs and funds with interested chairs are statistically just as likely to commit abuses, there is only an unsupported hypothesis that an inside chair can keep itself informed regarding management and thus prevent abuses.

limited empirical data that was received indicate that an inside chairperson and superior fund performance are correlated and that the inside chairperson has no statistically significant effect on fees.[107] This is essentially the same concern Congress expressed by passing the bill requiring the SEC to justify the independent chair requirement. Congress asks the SEC to show that shareholders benefit from this requirement, either through better fund performance, lower fees, or better compliance records.[108]

The dissent also pointed out that the SEC is taking many other actions that specifically target the abusive practices of the 2003 scandals. The SEC has brought enforcement actions and passed or proposed new rules. Rules have been adopted to disclose market-timing policies, provide increased information about the approval of advisory contracts, and require a chief compliance officer. Proposed rules include those related to fair value pricing, increased transparency of fund transaction costs and expenses, pricing of fund shares, and fund distribution agreements.[109] Implicit in the dissent's discussion of these other rules is that the rules that specifically target the abusive practices at issue will be effective while the independent director requirements will not be. The Chamber makes a similar argument, noting that the SEC did not

[107] *See* 2004 Amendments, *supra* note 1 (discussing Geoffrey H. Bobroff and Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs, A Study for Fidelity Investments* (Mar. 10, 2004) (attached to Comment letter to the Proposal for the 2004 Amendments from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company to Jonathan G. Katz, SEC (Mar. 10, 2002)). Additionally, because of the 2001 Amendment majority independent director requirement for funds using the exemptive rules, the independent directors could insist on an independent chairman if they wanted one. *See* 2004 Amendments, *supra* note 1. *See also* ICI Comment letter to the Proposal for the 2004 Amendments, *available at* http://sec.gov/rules/proposed/s70304/ici031004.htm (last visited April 20, 2005) [hereinafter "2004 ICI Comment Letter"] (stating that "virtually all fund boards are required to have a majority of independent directors, meaning that the independent directors are in a position to select the most appropriate person - independent or not - to serve as chairman. The Commission's proposal, however, would not permit the board to select that person for the position.").

[108] The Chamber of Commerce also made this argument in its opening brief, and criticized the lack of empirical data supporting the mandate of an independent chair. *See* Chamber Opening Brief, *supra* note 20, at 14.

[109] *See* 2004 Amendments, *supra* note 1.

suggest that late trading, market timing, and other funds abuses resulted from activities related to the exemptive rules being amended.[110]

There are, not surprisingly, some faults with these arguments against the 2004 Amendments. For example, although Glassman and Atkins make the point that the 2001 Amendments did not take effect until July 1, 2002—and thus have only been in effect for two years—making it difficult to show that those reforms are inadequate, they do not say why the existing level of independence is adequate. Glassman's and Atkins' argument thus boils down, not to the current level of independence working so well, but to the 75 percent requirement not adding anything useful to the mix.[111] The dissent asserts that "[t]he majority's choice of seventy-five percent is puzzling."[112] What the dissent alludes to, but does not say explicitly, is that the reason why a majority requirement is "less arbitrary" than a 75 percent requirement, is that, if votes are determined by a majority (of the board as a whole), and all the independent directors were aligned, the independent directors would always determine the vote if they comprised a majority of the board.[113]

The majority offers multiple reasons for why a 75 percent requirement is more effective than a majority requirement and thus provides greater benefit to fund and fund shareholders. Three of them are: 1) a greater percentage of independent directors fosters a more independent boardroom culture, even if it does not matter for voting purposes ("A fund board whose independent directors constitute at least 75 percent of the fund board should strengthen the hand of the independent directors when dealing with fund management…."[114]); 2) if an independent

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[110] *See* Chamber's Opening Brief, *supra* note 20, at 20.
[111] Additionally, most boards already had a majority of independent directors, so even if not "officially in effect" for more than two years, it is difficult to argue that the SEC did not have significant experience with the workings of majority-independent boards.
[112] 2004 Amendments, *supra* note 1.
[113] The Goldstein Comment Letter, *supra* note 101 makes this point as well.
[114] *See* 2004 Amendments, *supra* note 1.

director is absent and the board has 51 percent independent directors without the absence, the independent directors lose their majority[115]; and 3) some of the independent directors may be aligned with the adviser ("We recognize that 'legal' independence does not equate with 'real' independence. We therefore encourage independent directors ... to identify individuals who have the background, experience, and independent judgment to represent the interests of fund investors.").[116]

However, even if there are problems with aspects of the dissent's argument, overall the collective complaints regarding the lack of benefit to be gained from the 2004 Amendments are heard loud and clear: existing safeguards are sufficient, independent chairs are no better at preventing scandals than interested ones, and other, more specific, measures are being taken to combat mutual fund abuse.

<u>2. Comparison to previous changes: The benefits prior alterations to the independent director requirements aimed to achieve and/or did achieve.</u>

a. 1940 Act.

Before the 40 Act, there was almost no governmental regulation or supervision of funds.[117] With few outside checks, most of the "protection" of investors was based on the integrity of the individuals running the fund, and therefore the integrity of the sponsors (who were heavily represented on the fund's board). Management and director duties were blended,

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[115] *See* 2004 Amendments, *supra* note 1, n.37 (citing a comment letter).

[116] *See* 2004 Amendments, *supra* note 1. Only the first argument seems plausible. The second point seems like it would come up rarely. (There is no reason to assume that independent directors frequently miss meetings or that non-independent directors would not miss meetings.) The third point has the opposite problem of the second point--it is too broad. If the real problem is that the independent directors are not truly independent, then adding more faux-independent directors is not likely to remedy the situation.

[117] See ROBERTSON, *supra* note 59, § 1.01[1][b]. State trust and corporate law provided some protection to investors, but it had minimal effect in practice. *See id.* The predecessors of mutual funds were investment trusts, which were engaged companies or trusts in the business of holding other companies' securities. *See id.* § 1.01[1][b].

with many funds' directors involved in choosing the fund's portfolio transactions.[118] This set-up engendered a fertile ground for self-dealing, such as temptation for sponsors to dump low-value securities into one of their affiliated funds and sponsors borrowing money from the funds.[119] In the 1920s, as funds grew substantially (from under $1 billion of assets in 1926 to over $7 billion by the end of 1929[120]), the temptations of self-dealing only grew stronger as the potential "rewards" for self-dealing grew.[121]

The 1929 stock market crash and the Great Depression hit investment companies hard.[122] Closed-end funds did especially poorly in comparison to other companies because many were leveraged and/or had sold their shares at premiums above the asset value.[123] The abuses that came to a head in the Great Crash were a major reason for, and were highlighted by, the 1939 SEC Report on Investment Trusts. This report concluded that price declines of funds in the Great Crash related in part to abusive management practices. The Report also highlighted the self-dealing that many funds had engaged in. Detailed descriptions of particular funds' abuses were

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[118] *See* ROBERTSON, *supra* note 59, § 1.01[1][b].

[119] *See id.* § 1.01[1][b]. *See also* Investment Trust Study. Investment Company Act of 1940 and Investment Advisers Act of 1940, H.R. No. 76-2639 (statement of Robert E. Healy, Commissioner of the SEC) *in* INVESTMENT MANAGEMENT REGULATION 30 (Tamar Frankel & Clifford E. Kirsch eds., 1998) (describing problems of self-dealing in investment companies); Kim, *supra* note 63, at 480-81 (explaining problems of self-dealing that the 40 Act sought to remedy); Mark J. Roe, *Political Elements in a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1488 (1991) (explaining the self-dealing problems of the adviser "using the control exerted by the mutual fund to obtain securities underwriting business from the controlled portfolio company" and "unload[ing] unwholesome securities of that controlled company onto a gullible public."). For detailed examples of fund abuses that took place prior to the 1940 Act's enactment, see ROBERTSON, *supra* note 59, § 1.02[2].

[120] *See* ROBERTSON, *supra* note 59, § 1.01[3][a].

[121] *See id.* § 1.01[3][c].

[122] *See* William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. REV. 1059, 1068 (1982) ("The precipitous drop in the size of investment company assets between 1929 and 1935, in part due to the Depression, also stemmed from mismanagement and fraud in the industry. The SEC estimated that mismanagement caused losses totaling more than $ 1 billion."). *Cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that, instead of the Great Crash decimating investment companies, "[t]he Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's.").

[123] As a result of these problems, fixed trusts grew in popularity after the crash. These trusts had a fixed portfolio of securities and redeemable shares. *See* ROBERTSON, *supra* note 59, § 1.01[4]. In the early thirties, mutual funds started gaining greater investor acceptance. *See id.* § 1.01[5][b].

provided to illustrate these problems.[124] This Report led directly to the Investment Company Act of 1940 and the Investment Advisers Act.[125] The ICA was designed to put needed regulation in place, where there was little before, or where existing regulation was insufficient.[126] The ICA regulates investment companies through a variety of strategies: 1) disclosure; 2) prohibitions or heavy regulation of particular transactions thought to lead to abuses; 3) shareholder voting; and 4) a board of directors.[127] The requirement that 40 percent of the directors of a fund be independent (or, as originally enacted, unaffiliated) has been described as the "cornerstone" of the 40 Act's efforts to police conflicts of interest.[128] The board of directors, and in particular, the unaffiliated/independent directors, were the "first line of defense against self-dealing by investment advisers."[129]

Thus, the benefits of the 40 Act can be broadly categorized as two-fold: 1) the Act put into place regulation where there was none previously; and 2) the regulation responded to what was generally acknowledged as a severe problem of abuse in the industry.[130] And, specifically,

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[124] *See* ROBERTSON, *supra* note 59, § 1.02.

[125] *See* ICA § 1. ("Policy. Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935 [the SEC Reports described above]… it is hereby declared that the national public interest and the interest of investors are adversely affected [by the listed practices, including self-dealing].") *See also* JACKSON, *supra* note 32, at 817 (describing this cause-and-effect chain).

[126] Some thought that even funds that would need to register offerings under the 33 and 34 Acts were not sufficiently regulated. *See, e.g.*, Hearings on S. 3580 at 38, April 2, 1940 (statement of Robert E. Healey, Commissioner, SEC) ("It would hardly be necessary to point out that existing legislation is not adequate to meet the problems presented by the investment company. The mere recital of the abuses which have occurred since 1933 and 1934, tends to prove that the Securities Act of 1933 and the Securities Exchange Act of 1934, valuable as they are in most fields, are inadequate here. Because of the peculiar character of investment companies and their resemblance to savings banks, mere disclosure is inadequate as a remedy.").

[127] *See* JACKSON, *supra* note 32, at 818.

[128] *See* Burks v. Lasker, 441 U.S. 471, 482 (1971). *See also* James K. Sterrett, *Reward for Mutual Fund Sponsor Entrepreneurial Risk*, 58 CORNELL L. REV. 1095, 207 (1973) (describing the independent director requirement as the "backbone" of the 1940 Act).

[129] *See* Rogers, *supra* note 122, at 1070.

[130] *See supra* note 126. *See also* Hearings on S. 3580 at 38, April 2, 1940 (statement of Robert E. Healey, Commissioner, SEC) ("…too often investment trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of their stockholders. Too often, sponsors and managers and insiders disregarded their basic fiduciary obligation to their investors.").

the 40 Act was designed to counteract the unearthed problems of self-dealing and management-dominated funds with independent director requirements that were intended to provide a "check" on self-dealing.

b. 1970 Amendments.

Like the 40 Act, it is important to understand the industry conditions prior to the 1970 Amendments in order to understand the benefit that the 1970 Amendments were designed to impart. Between the time of the ICA's adoption and 1966, mutual fund assets had grown from $450 million to $38.2 billion.[131] During that time, the number of mutual fund investors had grown from 300,000 to 3.5 million.[132] Throughout this period, mutual funds were also becoming more performance-oriented and less likely to take cautious investment approaches, engendering controversy surrounding the riskiness of mutual funds.[133] In 1958, in response to concerns that the fund governance structure was not providing a truly independent check on management, the SEC commissioned the Wharton School at the University of Pennsylvania to study the mutual fund industry. The Wharton school published the resulting study, the "Wharton Report," in 1962. The Wharton Repot found that "the most important current problems in the mutual fund industry appear to be those which involve potential conflicts of interest between fund management and shareholders, the possible absence of arm's-length bargaining between fund management and

[131] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 363 (1982).
[132] *See id.* at 363.
[133] *See id.* at 363. Seligman cites an ICI study stating that, in 1953, the average mutual fund turned over 13 percent of its common stock holdings. In 1960, that figure rose to 17.6 percent. It reached 46.6 percent in 1968 and 55.6 percent in the second quarter of 1969. *See id.* at 363. Thus, funds were moving from a conservative buy-and-hold strategy to one of aggressively buying and selling fund assets in an effort to generate greater return. *See also* Arthur Levitt, Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds, (March 22, 1999) *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch259.htm [hereinafter "Levitt, Keeping Faith Speech"] (stating that, "During the 1960's, many mutual funds discarded their historically cautious investment approaches and emphasized, instead, performance. In the process, many people raised questions about levels of fees and risk as well as fund impact on the securities markets. As a result, many—including lawmakers—were clamoring for action.").

investment advisers. . . ."[134] One particular conflict-of-interest problem that the Wharton Report found was that the advisory fees charged to funds was higher than those fees charged to the adviser's non-fund clients at similar asset levels. Economies of scale savings were not being passed along to the shareholders, in terms of lower fund fees.[135]

The Wharton Report highlighted how the organization and control of mutual funds leads to ambiguity regarding who was really in control of the fund. The Wharton Report noted that it was often management, and not the board of directors, that was calling the shots on mutual fund transactions:

> [A]llocation of actual decision-making functions to groups within and external to open-ended investment companies is complicated by the fact that active roles in and control of open-end companies is usually concentrated in the hands of relatively few individuals who function in multiple capacities. These extensive overlaps of key personnel between investment company and adviser point to a fundamental ambiguity concerning the locus of control as between the board of directors … of the investment company and its presumptive agent employed to advise it or to manage its security portfolio under board supervision.[136]

An additional problem with the effectiveness of the board of directors was that the term "affiliated" was narrowly defined in the ICA and did not necessarily bar close personal friends, relatives, or business associates from being consider unaffiliated under the 40 Act.[137]

At the same time Wharton was conducting its study of the mutual fund industry, the SEC was conducting a study of the securities markets, including the sale of mutual fund shares, entitled "Report of the Special Study of Securities Markets." The Special Study Chapter on Mutual Funds was published in August 1963.[138] The Commission finished another study in 1966 entitled "Report of Public Policy Implications on Investment Company Growth" (the "PPI

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[134] *See* WHARTON REPORT, *supra* note 48, at 3.
[135] *See id.* at XIII (letter of transmittal).
[136] *See id.* at 51.
[137] *See id.* at 8.
[138] *See* SELIGMAN, *supra* note 131, at 369.

Report").[139] In the PPI Report, the Commission expressed concerns about advisory fees and the effectiveness of unaffiliated directors. The concern about fees stemmed from the PPI Report's conclusion that, as between lowering prices to appeal to investors and appealing to compensation-conscious fund retailers, the fund underwriters aim to please the retailers. Thus, instead or a competitive industry where funds competed with one another through lower prices, sales loads on fund shares had increased in the 1950s as funds competed to increase commission rates because those selling fund shares would be more likely to push shares of the fund paying them the higher commission.[140] The unaffiliated directors' effectiveness was considered limited in part because directors often worked for the fund part-time, without independent staff, and without independent counsel. The unaffiliated directors also obtained their information from people affiliated with the fund's adviser.[141] In the PPI, the SEC put forth their official view on how the investment company industry should be reformed.[142]

In direct response to these reports, Congress enacted the 1970 Amendments,[143] described *supra* in Part III.[144] The 1970 Amendments added § 2(a)(19), which defined "interested person."[145] In certain sections of the act, including sections 10 and 15, "interested person" was substituted for "affiliated person," thus broadening the scope of who would count as a non-"inside" director.[146] After the 1970 Amendments were passed, an independent director not only could not be affiliated with the fund's adviser but also: 1) could not be an immediate family

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[139] *See* ROBERTSON, *supra* note 59, § 3.02.
[140] *See* SELIGMAN, *supra* note 131, at 365
[141] *See* SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 89-2337, at 12 (1966) [hereinafter the "PPI REPORT"]; ROBERTSON, *supra* note 59, § 3.02; *See also* Kim, *supra* note 63, at 484-86.
[142] *See* SELIGMAN, *supra* note 131, at 371.
[143] Although not until the SEC had proposed and had rejected an earlier bill based on its recommendations. *See* Part IV.B.2.b. *infra* (describing the proposed and rejected bills that preceded the 1970 Amendments).
[144] *See* An Act To amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes, 84 Stat. 1413 (1970).
[145] 84 Stat. 1413, 1413-14.
[146] *See* 84 Stat 1413, 1416 (§ 10); 84 Stat. 1413, 1420 (§ 15).

member of an affiliated person of an adviser; 2) could not have a beneficial interest in securities issued by the adviser or the principal underwriter or any of their controlling persons[147]; and 3) could not generally be affiliated with a broker dealer[148] or have an affiliation with any recent legal counsel to the fund.[149] Thus, the 1970 Amendments tried to counter the problem of the unaffiliated directors being beholden to management by creating a more stringent standard for disinterested directors.

In response to concern about advisory fees that were unrelated to performance or services and which did not reflect economies of scale, Congress also altered § 15(c) of the Act. This change was designed to give independent directors a stronger role in approving the fund's major contracts. Through explicit mandate of independent director approval,[150] a switch from requiring unaffiliated directors to disinterested directors, and the requirement that the directors evaluate the contract information and that the management provide them with that information, independent

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[147] In the 2001 Amendments, the Commission adopted rule 2a19-3, which conditionally exempts an individual from being disqualified as an independent director solely because he or she owns shares of an index fund that invests in the investment adviser or underwriter of the fund, or their controlling persons. *See* 2001 Amendments, *supra* note 41.

[148] This part of the definition of interested was modified by § 213(a)(1) of the Gramm-Leach-Bliley Act. As amended, § 2(a)(19) now permits an independent director to be an affiliate of a broker-dealer, but not if the director or his or her affiliate has executed portfolio transactions for, engaged in principal transactions with, or distributed shares for the fund or certain related funds or accounts within the past six months. *See* Pub. L. No. 106-102, § 213, 113 Stat. 1338, 1397-98 (1999), codified at 15 U.S.C. § 80a-2(a)(19)(A)(v) and (B)(v).

[149] *See* 84 Stat. 1413, 1413-14 (1970) (amending the Investment Company Act to add § 2(a)(19)).

[150] Conflicting case law exists over whether unaffiliated director approval was required prior to the 1970 Amendments (and thus whether the 40 Act's version of § 15(c) contained a genuine "or"). *See supra* Part III.B. (describing the change to the language of § 15(c)). *Compare* Glicken v. Bradford 35 F.R.D. 144, 156 (S.D.N.Y. 1964) (citing ICA § 15(c) and concluding "the approval of the contract by a majority of the non-affiliated directors would have been unnecessary if the contract was approved by the shareholders.") *and* Saminsky v. Abbott, 40 Del. Ch. 528, 545 (Del. Ch. 1961) (describing the purpose of different subsections in § 15 and stating, "[t]he purpose of § 15(b) is to afford the shareholders (or non-affiliated directors) an opportunity annually, after the first two years, to pass upon the continuation of that relationship.") *with* Acampora v. Birkland, 220 F. Supp. 527, 544 (D. Colo. 1963) ("Section 15(c)[ ] says that the renewal must be approved by a majority of the directors who are not affiliated persons of the investment adviser.") *and* Brown v. Bullock, 194 F. Supp. 207, 235 (S.D.N.Y. 1961) ("Section 15(c) provides, in addition, that the board shall not extend the underwriting contract unless a majority of the disinterested (non-affiliated) directors approves."). The SEC's PPI Report, however, clearly contemplates that, pre-1970 Amendments, either the shareholders or unaffiliated directors could serve this function. "The Act's safeguards with respect to advisory fees consist [of initial approval by shareholders] … and annual renewal, by *either* the shareholders or the board of directors including a majority of the unaffiliated directors." PPI REPORT in INVESTMENT MANAGEMENT REGULATION, *supra* note 37, at 263 (emphasis added). Regardless of the differing judicial interpretations, the 1970 Amendments clearly mandated that independent directors approve the advisory and underwriting contracts.

directors were given more leverage to ensure the fees were reasonable. In conjunction with this, § 36(b) imposed a fiduciary duty on the fund's investment adviser as to any fees received.[151] This section also stated that shareholders, the Commission, affiliates of the investment adviser, and anyone who has a fiduciary duty with respect to this compensation have a cause of action against the adviser.[152] Section 36(b) can be considered a corollary to § 15(c) because the directors play a role in an assessment of whether the adviser breached his fiduciary duty with respect to management fees. A court evaluating a § 36(b) claim gives weight to the directors and disinterested directors' approval of the fees. Disinterested directors were to play a role in Federal courts' assessment of breach of fiduciary claims.[153]

Thus, although the 1970 Amendments did not address all of the problems the studies of the sixties had highlighted,[154] it addressed a major concern of the reports: that management's interests were not aligned with shareholders, allowing management to collect larger fees, and that the "unaffiliated" directors were ill-equipped to counteract this self-dealing. Thus, if faced with the complaint against leveled against the 2004 Amendments that there was no significant benefit provided, Congress has a strong argument that the 1970 Amendments contributed real value to the role independent directors played in controlling fees.

c. § 15(f).

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[151] *See* 84 Stat. 1413, 1429 (1970), codified at 15 U.S.C. § 36(b).
[152] *See id.* § 36(b).
[153] *See* Rogers, *supra* note 122, at 1092-93. To evaluate whether the fund's decision "did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act," the Tannenbaum Court used a three-part test and found no fiduciary violation "if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors …; and (3) fully aware of this information, reached a reasonable business decision … after a thorough review of all relevant factors." *See* Tannenbaum v. Zeller, 552 F.2d 402, 418-19 (2d Cir. 1977). This 3-part test had been proposed to the court by the SEC. *See id*. at 419, n.24. Thus, the Tannenbaum Court explicitly brought § 15(c)'s requirements for approving contracts into its evaluation of plaintiff's § 36(b) claim.
[154] See JACKSON, *supra* note 32, at 821 (stating that the reports described concerns regarding managerial compensation, sales loads, competition among retail sellers, brokerage commissions, the increasing size of some funds, and advertising, and that the 1970 Amendments addressed management compensation).

To understand what benefit Congress intended when it added § 15(f) to the ICA in 1975,[155] one must examine *Rosenfeld v. Black.*[156] Indeed, in the Senate Report[157] on the Securities Acts Amendments of 1975, of which the change to § 15 of the ICA was a small part,[158] it was noted that "[t]he bill would clarify the law in light of the 1971 decision of the Court of Appeals in *Rosenfeld v. Black* … by removing the uncertainty surrounding the circumstance in which an investment adviser can receive any profit upon the transfer of its business without incurring liability to the company or its shareholders."[159] This change to the 40 Act was introduced even more closely on the heels of Rosenfeld than the final bill indicates. In 1972, a bill with essentially the same requirements as the bill adding § 15(f) to the ICA was introduced to the Senate.[160]

In *Rosenfeld*, plaintiffs, shareholders in The Lazard Fund, had brought suit to get an accounting of profits allegedly realized by Lazard Freres, the organizer and investment adviser of The Lazard Fund. In 1967, nine years after the fund began, Freres ceased to be the adviser of the fund and was replaced by Moody's Advisors & Distributors.[161] Freres accomplished this by merging the Lazard Fund into Moody's Capital Fund, essentially selling his role as adviser to Moody's for 75,000 shares of Moody's Capital Fund.[162]

The *Rosenfeld* Court held that, if an advisory business is sold, a profit cannot be made from it. The Court "start[ed] from one of the 'well-established principles of equity,' … 'that a

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[155] P.L. 94-29 (1975).
[156] Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971).
[157] S. Rept. No. 94-75.
[158] *See* P.L. 94-29. Most of the Securities Acts Amendments was devoted to amending the Securities Exchange Act.
[159] S. Rept No. 74-75 at 71.
[160] *See* S. 4071, 92nd Cong. 2d Sess (1972). Another similar bill was introduced even earlier. *See* S. 368, 92nd Cong. 2d. Sess (1972). This bill called for the fund's board to be composed entirely of disinterested directors for five years after the sale. *See id. See also* Sterrett, *supra* note 128, at 251 (describing this earlier bill).
[161] Rosenfeld, 445 F. 2d at 1338.
[162] *Id.* at 1339.

personal trustee, corporate officer or director, or other person standing in a fiduciary relationship with another, may not sell or transfer such office for personal gain.'"[163] The Court reasoned that:

> we see no reason to doubt that … Lazard in its position as investment adviser came within the scope of this principle.… Lazard had organized the Fund, and people had bought shares in it because of their trust and confidence in Lazard. All the Fund's personnel were furnished by Lazard. … If Lazard did not wish to continue as adviser and chose to recommend a successor and assist in the latter's installation, it was obliged to forego personal gain from the change of office, no matter how deeply or rightly it was convinced it had made the best possible choice.[164]

The bill adding § 15(f) to the ICA was designed to make it clear that an investment adviser *can* make a profit on the sale of its business subject to two principal safeguards to protect the fund and its shareholders. The first safeguard is the requirement that 75 percent of the directors of the investment company be independent directors for three years after the sale or transfer of the investment advisory business.[165] The second requirement is that the sale or transfer must not impose any unfair burden on the investment company.[166] Although Congress disagreed with and eradicated *Rosenfeld's* holding, it inserted statutory protections for shareholders in cases of sale of the advisory business.[167]

This change to the 40 Act provides two main benefits. One is that it allows advisers to be less chained to a particular fund. The ability to sell an advisory business at a profit makes it more

[163] *Id.* at 1342 (internal citation omitted).
[164] *Id.* at 1342-43 (footnotes omitted)
[165] *See* Senate Report No. 94-75; 15 U.S.C. § 80a-15(f).
[166] *See* 15 U.S.C. § 80a-15(f)(2)(B). This section defines an "unfair burden on the investment company" as:

> includ[ing] any arrangement, during the two-year period after the date on which any such transaction occurs, whereby the investment adviser or corporate trustee or predecessor or successor investment advisers or corporate trustee or any interested person of any such adviser or any such corporate trustee receives or is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services. *Id.*

[167] *See* Wexler v. Equitable Capital Management Corp., 1994 U.S. Dist Lexis 1651 at *6-7 (S.D.N.Y. 1994) (describing this change).

attractive for an adviser who wants to leave the fund to do so.[168] This lessens the concern that, by denying the adviser a profit from a transfer of its advisory duties, *Rosenfeld*'s rule might eliminate an "important source of entrepreneurial reward for organizers and promoters of mutual funds."[169]

The second benefit relates to the funds' shareholders and it is the one that the Senate Report references. As the Commission explains in the 2004 Amendments, "This increased independence of the board was designed to help protect the fund from receiving unfair treatment in circumstances involving potential conflicts of interest."[170] Although not outlined explicitly in the bill, the theory behind not imposing an unfair burden and having a 75 percent independent board might be to prevent a purchaser of the advisory contract from overpaying for it and then raising fund fees to compensate for this overpayment.[171]

d. Rule 12b-1.

The SEC adopted Rule 12b-1 in 1980 to permit the use of fund assets to pay the expenses related to selling fund shares.[172] Under the 40 Act, § 12(b) prohibits a mutual fund, other than one compliant with § 10(d) of the ICA,[173] from acting as distributor of its own shares except through an underwriter in contravention of SEC rules. The SEC had historically taken the

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[168] *See* Sterrett, *supra* note 128, at 1096 (describing the investment company industry as "surprised and alarmed to learn [from Rosenfeld] that mutual fund investment advisers may not profit form the transfer of the management of a mutual fund.").
[169] *See id.* at 199.
[170] 2004 Amendments, *supra* note 1.
[171] *See* Sterrett, *supra* note 128, at 251 (describing this as a motivation behind an earlier version of this bill) and *id.* at 257 (describing the S. 4071 bill as possibly offering the protection of limiting the consideration a purchaser is willing to pay for the business because he may not be able to recoup it with a 75 percent independent director board in place).
[172] Rule 12b-1.
[173] *See* 15 U.S.C. § 80a-10(d). This section allows a no-load fund to act as a distributor of its own shares provided it complies with eight listed requirements including that: no sales load may be charged on shares issued by the company; any premium above net asset value that the company charges upon the issuance of such security, plus any discount from net asset value charged on redemption, may not exceed 2 percent; and the company may have only one adviser whose management fee must not exceed 1 percent per year of the value of the company's net assets. *See id.*

position that it was inappropriate for a mutual fund to finance the distribution of its own shares with fund assets. [174] The investment adviser or sponsor usually absorbed the expense of self-distribution, in order to comply with the SEC's position.[175] However, as no-load funds increased in popularity, in an effort to compete with load funds, sponsors of these funds asked the SEC to allow them to use fund assets to pay for distribution.[176]

Following 1976 public hearings on the subject, a reiteration of the view that it is improper to use fund assets to pay for share distribution, a 1978 Advance Notice of Proposed Rulemaking describing conditions under which this practice would be allowed, and a 1979 proposal of what would ultimately become Rule 12b-1, the SEC promulgated Rule 12b-1 in November 1980.[177] Employing the type of rule making that detractors find so objectionable in the 2004 amendments, Rule 12b-1 placed specific governance requirements on funds using fund assets to distribute shares. The SEC required that a fund using a Rule 12b-1 plan must 1) have independent directors select and nominate other independent directors[178]; 2) draft a written plan describing all material aspects of the proposed financing of the distribution and all agreements relating to implementation of the plan must be in writing and have provisions similar to those the ICA requires for advisory contracts; 3) have the plan approved annually by: a majority of the shareholders, the board of directors as a whole, and separately by the fund's independent directors who also have no financial interest in the plan or any of the related agreements; 4) have the fund's directors determine, considering all pertinent factors and using their reasonable

[174] *See* Rule 12b-1. *See also* KIRSCH, *supra* note 27, § 17:6.1[A].
[175] *See* Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. LAW. 107 (1993) in JACKSON, *supra* note 32, at 825, 833.
[176] *See id*.
[177] *See* Rule 12b-1.
[178] Notice that this does not directly deal with the fact that, originally, the fund's sponsor nominated *all* of the directors, interested and disinterested alike. Presumably, the SEC intends for the interested directors' ties to the sponsor to become increasingly attenuated over the course of subsequent nominations. This complaint complies with equal force to other settings in which the SEC required independent directors to select and nominate other independent directors, such as the 2001 Amendments.

business judgment in light of their state law fiduciary duties, that there is a reasonable likelihood that the plan will benefit the fund and its shareholders.[179] The Commission stated that the rule was putting "a great deal of responsibility on fund directors, especially the disinterested directors…."[180] The conditions were designed to insure that the disinterested directors were not beholden to management, the directors would have the relevant information for deciding on a Rule 12b-1 plan, and the directors would exercise reasonable business judgment in line with their fiduciary duties.[181]

The benefits to Rule 12b-1 can be characterized in two main ways. The first way is from the industry's perspective. Rule 12b-1 allowed funds to transact in a way that the SEC had previously prohibited.[182] This gave no-load funds the "edge" they needed to compete against load funds,[183] thus offering fund consumers greater choice and flexibility.[184]

The other major benefit is the protection that 12b-1 plans provide to shareholders, especially a fund's existing shareholders. The SEC was concerned that the existing shareholders of a fund would bear the expense of potential share purchases avoiding the sales load. By attempting to make independent directors "more independent" (through self-selection and nomination) and mandating their separate approval of the plan, the SEC tried to mitigate the

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179 *See* Rule 12b-1.
180 *Id*.
181 *See id*.
182 The analysis of Rule 12b-1's benefits turns in part on what baseline one uses. Some commenters on the proposal believed that directors had always been able to authorize the use of fund assets to finance distribution of shares, and thus saw little benefit to Rule 12b-1 from the perspective of being granted permission for a previously prohibited transaction. *See* Rule 12b-1 (describing this perception among some commenters).
183 *See* Schonfeld, *supra* note 175, at 833. Note that part of the desire to compete with load funds through no-load funds stems from shareholders being less able to understand no-load funds and thus finding their shares more attractive. *See Mutual Fund Summit: Transcript*, 73 MISS. L.J. 1153, 1196-97 (2004) (statement of Barbara Roper) ("I think it's important to note that the complexity we have in the way we pay for distribution is not a chance occurrence. We got to where we are because investors didn't like paying front loads…. [F]ront loads have virtually disappeared because it's easier to sell those products with a 12b-1 fee which people don't understand as well.… I think distribution costs have intentionally gone into hidden channels or less well understood channels because it makes it easier for the broker to tell the investor that they're getting a good deal….").
184 *See id* at 1191 (2004) (statement of Paul Roye) (explaining that 12b-1 fees have facilitated different ways for investors to bear costs and pay for distribution as opposed to front-end loads.").

potential inequities that could result as between pre-12b-1 shareholders and post-12b-1 plan shareholders. Once again, the independent directors were given the duty of thwarting a conflict of interest.[185] A potential conflict of interest might be management wanting to make shares of the fund more attractive to potential buyers by selling them without a load. He might take this action even if it harms existing shareholders—because expenses would be paid by the fund's assets, lowering the fund's net asset value per share and thus the pre-existing shareholders pro-rata share—because of the higher fee that would result from a greater NAV.

e. 2001 Amendments.

Although ICA § 15(f) and Rule 12b-1 altered the role of independent directors, the biggest change to the function of fund independent directors after 1970 came in 2001,[186] with the SEC's release of the Role of Independent Directors of Investment Companies[187] (the "2001 Amendments"), which amended the same exemptive rules as the 2004 Amendments. Post-2001 Amendments, any investment company relying on any of the exemptive rules needed to have independent directors constitute a majority of the board, independent directors select and nominate other independent directors, and any legal counsel for the independent directors be independent legal counsel. There were other, less major, new requirements under the 2001 Amendments, as well, which tinkered with the investment company structure to try to strengthen

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[185] *See* Rule 12b-1 (expressing concern over the conflict of interest that can arise out of a decision to use fund assets for distribution).

[186] *See* ROBERTSON, *supra* note 59, § 3.05[1] (describing the 1999 Roundtable that produced the 2001 Amendments and stating that "this degree of change had not occurred since the Investment Company Act was amended in 1970." And stating that 1999 "along with 1940 and 1970—will be marked in securities law calendars as a watershed year in the evolving duties of fund directors."). *See also* PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION, SEC STAFF REPORT (1992) [hereinafter "PROTECTING INVESTORS"] (stating, in 1992, that "[i]n spite of this dramatic growth … the Investment Company Act has been amended significantly only once, in 1970.").

[187] *See* 2001 Amendments, *supra* note 41.

the independent directors' hand in dealing with fund management, and rules which aimed to provide better information to investors about the fund directors.[188]

The 2001 Amendments did not crop up overnight. The SEC had been mulling over the major requirements of the 2001 Amendments for a significant period before promulgating rules based on them. In its 1992 report on the investment company industry,[189] the SEC concluded that, while the fund governance model that the ICA set out was "sound and should be retained." However, because independent directors were taking on increasingly significant responsibilities, changes should be made to strengthen director independence. One of the major suggestions was that legislation should be passed to increase the minimum proportion of independent directors from forty percent to a majority. Another major recommendation as to fund governance was that independent director vacancies be filled by persons chosen by remaining independent directors.[190] These recommendations were made seven years before the Roundtable and nine years before the rules implementing these suggestions were promulgated.[191]

Made more urgent by huge growth in the fund industry, the drive shortly prior to the 2001 Amendments to improve mutual fund governance grew out of several difficult years for fund directors. In the few years before the Proposal for the 2001 Amendments, fund governance

[188] *See* 2001 Amendments, *supra* note 41. These additional rules and amendments are as follows: a conditional exemption to an individual from being disqualified from being an independent director because he owns shares of an index fund that invests in the investments adviser or underwriter of the fund, or their controlling persons, subject to conditions; amending rule 17d-1(d) to permit funds to purchase "errors and omissions" joint insurance polices for their officers and directors only if the policy does not exclude coverage for litigation between the adviser and the independent directors; requiring funds to keep records of their assessments of director independence; temporarily suspend the independent director minimum percentage requirements if a fund falls below a required percentage due to an independent director's death or resignation; and exempt funds from the requirement that shareholders ratify or reject the directors' selection of an independent public accountant, if the fund establishes an audit committee composed entirely of independent directors. The 2001 Amendments also required that funds provide the following information about the directors: basic information about the identity and business experience of directors; fund shares owned by directors; information about directors that may raise conflict of interest concerns; and the board's role in governing the fund. *See* 2001 Amendments, *supra* note 41.
[189] *See* PROTECTING INVESTORS, *supra* note 186.
[190] *See id.* at 254-55.
[191] 2004 Amendments *supra* note 1.

made a splash in the press and in court: The media questioned independent directors' effectiveness; proxy fights between management and independent directors took place[192]; private litigants brought suits challenging independent directors' independence; and the Commission brought enforcement actions against independent directors for failing to fulfill their legal obligations.[193]

The *Strougo* line of cases figured prominently into this period of upheaval.[194] These cases encompass a number of judicial decisions involving Robert Strougo, who brought class action suits against investment advisers and fund directors.[195] In *Strougo v. Scudder, Stevens & Clark, Inc.*, plaintiff shareholder Strougo claimed that fund directors were not really independent even though their funds considered them not to be interested persons as defined in the ICA.[196] Strougo brought a suit for a violation of the duty of loyalty by the Brazil Fund's directors.[197] The Brazil Fund was one fund in a fund complex advised by Scudder, Stevens, & Clark. Many board members served as directors of other funds in this fund family. [198] Under Maryland law, a

[192] Richard A. Oppel, Jr, *S.E.C. Chairman Seeks Mutual Fund Change*, NY TIMES, at C24 (March 23, 1999). Two proxy battles in the late 1990s contributed to independent directors' distress. *See* David J. Carter, *Mutual Fund Boards and Shareholder Action*, 3 VILL. J.L. & INV. MGMT. 6, 27 (2001). Carter describes these two proxy battles, both of which pitted the fund's adviser against the independent directors. In the first case, the independent directors of the Navellier Series Fund tried to replace the investment adviser, Navellier Management, Inc. with a different adviser. Navellier instigated a proxy contest to prevent shareholders from approving the new adviser. At the end of the battle, Navellier emerged victorious and continued as the fund's adviser. In the second case, Don Yacktman, adviser to the Yacktman Fund, threatened to file a proxy statement to replace the independent directors, unless they resigned. While the fight between Yacktman and the independent directors raged, many of the fund's shareholders redeemed their shares. In the end, the shareholders supported Yacktman; he remained the investment adviser and the independent directors were replaced. *See id.* at 28-29.

[193] *See* Securities and Exchange Commission, *SEC Interpretation: Matters Concerning Independent Directors of Investment Companies*, Release No. IC-24083 (Oct. 14, 1999), *available at* http://www.sec.gov/rules/interp/ic-24083.htm#foot21 (last visited April 20, 2005).

[194] *See e.g.*, Freeman, *supra* note 26, n.197 (explaining that plaintiff shareholders in Strougo v. Scudder, Stevens, & Clark, Inc. won the argument that payments to fund directors who serve on multiple boards could call into question a director's independence; the Maryland legislation designed to prevent other plaintiff shareholders from pursuing this type of litigation; and the Maryland Court of Appeals subsequently finding that legislation unconstitutional). *See also* KIRSCH, *supra* note 27, § 13:5.3.

[195] *See* ROBERTSON, *supra* note 59, § 3.03[4].

[196] *See* Strougo v. Scudder, Stevens, & Clark, Inc., 964 F. Supp. 783, 793-94 (S.D.N.Y. 1997).

[197] *See id.* at 788.

[198] *See id.* at 787-88.

derivative suit by a shareholder ordinarily was not permitted until the shareholder pursued intra-corporate remedies and found them unsuccessful. That meant that the shareholder "must make a demand for remedial action on the corporation itself, first by application to the directors, and then by application to the body of the stockholders."[199] However, demand was excused in this case because the Court determined it would be futile.[200] The Court stated that, while the fact that a director serves on multiple boards in a fund complex is "not necessarily determinative" of the director's independence, "the receipt of substantial remuneration from a fund complex does call into question the director's independence from the manager of that complex."[201]

While at first it looked like *Strougo* may have changed how independent directors were evaluated—with technical "disinterestedness" under the ICA not counting as sufficiently "independent" for the courts.[202]—*Strougo* did not redefine how directors' independence was evaluated.[203] Since *Strougo*, courts have not found violations of state law or the ICA based on an independent director's service on multiple boards in the same fund complex.[204] Arthur Levitt, subsequent to the *Strougo* litigation, stated his view that serving on multiple boards within the

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[199] *See id*. at 793.
[200] *See id.* at 795.
[201] *Id.* at 795.
[202] One participant in a conference on Mutual Funds summed up the shake-up that the Strougo litigation might have caused as follows:

> 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--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. The new controversy is causing, for the first time in quite a while, a rethinking of what is all about.
> *Mutual Fund Regulation in the Next Millennium Symposium Panels*, *supra* note 26, at 432 (statement of panelist Mark Sargent) (footnotes omitted).

[203] *See, e.g.*, Krantz v. Prudential Invs. Fund Mgmt., 305 F.3d 140, 143 (3d. Cir. 2002) (holding that the fact that directors served on multiple boards and were well-compensated was inadequate to support the claim for excessive fees and the claim that the directors were controlled by the fund's adviser); Migdal v. Rowe Price-Fleming Int'l, 248 F.3d 321, 329-30 (4th Cir. 2001) (stating that serving on multiple boards within a fund complex does not make otherwise disinterested directors interested). *See also* Carter, *supra* note 192, at 34 (stating that, as of the time of his article, "[n]o subsequent decisions have found violations of state law or the Investment Company Act based on an independent director's service on multiple boards in the same fund complex.").
[204] *See id*.

same fund complex does not in and of itself compromise director independence. He did, however, point to the importance of investors knowing the compensation the directors receive.[205]

In the wake of this turmoil, the SEC took action to strengthen the independent directors' hand in fund operations and to attempt to bolster their independence. The 2001 Amendments were crystallized during the SEC Roundtable in 1999.[206] The Roundtable included independent directors, investor advocates, executives of fund advisers, academics, and legal counsel.[207] It was designed to "explore the critical watchdog role that independent directors play in protecting the interests of fund shareholders."[208] Some of the impetus for this event was the growth of mutual funds[209] and revived concern about fees,[210] although the SEC Chairman at the time described the need for action as possibly being less urgent than it was prior to the 1970 Amendments.[211]

The panel topics included: fund fees and expenses, fund distribution and brokerage arrangements, fund disclosure, and valuation of fund portfolio securities.[212] For SEC chairman Arthur Levitt, the three primary questions to be dealt with at the roundtable were: 1) Are

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[205] *See* Levitt, Keeping Faith Speech, *supra* note 133.
[206] The Roundtable was held February 22 and 23, 1999. *See SEC to Hold Roundtable on Role of Independent Directors*, SEC. REG. & LAW. REP. 133 (Jan. 29, 1999).
[207] *See* 2001 Amendments, *supra* note 41.
[208] *See* Securities and Exchange Commission, *Press Release, SEC to Host Roundtable on the Role of Independent Investment Company Directors*, (Jan. 22, 1999) *available at* http://www.sec.gov/news/press/pressarchive/1999/99-7.txt (last visited March 9, 2005).
[209] *See* Isaac C. Hunt, Jr., Remarks to the Fifth Annual Advanced ALI-ABA Course on Investment Management Regulation (Oct. 22, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch311.htm (last visited March 9, 2005) (describing investors' substantial mutual fund holdings and stating, "It is because of this success that we must be vigilant in ensuring that the foundation of the mutual fund industry is solid….”). *See also Improved Mutual Fund Governance One of Top SEC Priorities, Levitt Says*, SEC. REG. & LAW. REP. 265 (Feb 26, 1999) (quoting Levitt as commenting on how because there are "66 million people invested in mutual funds" the SEC needs to be sure the funds are run in their best interest).
[210] *See* ROBERTSON, *supra* note 59, § 3.05[2].
[211] *See* Levitt, Keeping Faith Speech, *supra* note 133 (contrasting the changes growing out of the 1999 Roundtable with the call for action in the 1960s and stating that, "Today, there may not be the same urgent desire for action."). The Chairman noted, however, the significant role of fund directors and stating that they impact shareholders every day. *Id.*
[212] The Roundtable was held February 22 and 23, 1999. *See SEC to Hold Roundtable on Role of Independent Directors*, SEC. REG. & LAW. REP. 133 (Jan. 29, 1999).

independent directors effective?; 2) Can independent directors act as an effective check on management?; and 3) Are independent directors serving investors' interests above all others?[213]

A major topic at the roundtable discussion was how to increase independent directors' effectiveness. The panelists were in agreement that the minimum percentage of independent directors should be increased to at least a majority.[214] Some panelists also believed that the nominating committee for independent directors should be comprised only of the current independent directors, although others felt that the adviser should have some involvement in the selection process. Several panelists strongly recommended independent counsel for the independent directors.[215]

Many of the benefits that the Commission articulated in the 2001 Amendment release are similar to those benefits described in the 2004 Amendment release. The Commission adopted the new rules and amendments "to enhance the independence and effectiveness of independent directors of investment companies…."[216] With respect to the majority independent director requirement, the SEC stated that, "[a] majority requirement will permit … the independent directors to control the fund's 'corporate machinery,'…. As a result, independent directors who comprise the majority of a board can have a more meaningful influence on fund management and represent shareholders from a position of strength."[217] The SEC argued that the benefit of independent directors selecting and nominating other independent directors "fosters an independent-minded board that focuses primarily on the interests of a fund's investors rather than its adviser."[218] The independent legal counsel requirement was meant to provide

[213] See Levitt, Keeping Faith Speech, *supra* note 133.
[214] *See* ROBERTSON, *supra* note 59, § 3.05[2]
[215] *See, e.g.*, Roundtable transcript *available at* http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm (last visited April 20, 2005) (statements of Butowsky and Hankin).
[216] 2001 Amendments, *supra* note 41.
[217] *Id.* (footnotes omitted).
[218] *Id.*

independent directors with legal advice from those who would be free from conflicts of interest.[219] Thus, the overall benefit of the 2001 Amendments was related largely to the culture of independence in a fund's board.

3. Overall Comparison of Benefit.

Looking back over these past changes to what is required of independent directors, one is struck by the pattern of "problem-investigation-solution" and how the solution is based largely on independent directors. After the SEC reports of the 30s, the 40 Act mandated that 40 percent of a fund's board of directors be comprised of independent directors.[220] The 1970 Amendments, on the heels of three reports on the fund industry's dilemmas, tightened the definition of non-inside director and gave the independent directors more responsibility.[221] Following a case that held that advisers could not sell an advisory business and receive a profit, Congress added § 15(f) to the ICA, allowing the advisers to make a profit, but stymieing the conflict of interest that might develop with a 75 percent independent board requirement.[222] After relenting on the use of fund assets to distribute shares, the SEC conditioned this practice on conditions designed to strengthen independent directors' independence and give them a significant role in approving the plan.[223] Given growth of funds, concerns about fees, and other conflicts between independent directors and management, the SEC conversed with the industry and eventually promulgated the 2001 Amendments.[224] Following the 2003 fund scandals, the SEC crafted the 2004 Amendments.[225]

[219] *Id.*
[220] *See supra* Part IV.A.2.a.
[221] *See supra* Part IV.A.2.b.
[222] *See supra* Part IV.A.2.c.
[223] *See supra* Part IV.A.2.d.
[224] *See supra* Part IV.A.2.e.
[225] *See supra* Part IV.A.1.

Specific aspects of this cycle can be explored in further detail to assess why the "benefits"—or lack thereof—of the 2004 Amendments might be different form those of prior changes to the independent director requirements.

(A) Nexus Between Problem and Solution.

One place to start the analysis of the pattern is to look at the nexus between the changes made to the independent director requirements and the problem. One of the major arguments of the dissent to the 2004 Amendments and the Chamber was that the 2004 Amendments did not relate to the 2003 scandals.[226] On this front, the changes made seem more in line with the 40 Act and the 2001 Amendments. There was a much tighter nexus between the 1970 Amendments and the problem they set out to rectify (giving independent directors more power over major contracts so that fees would not reflect a conflict of interest between the fund's managements and its shareholders)[227]; § 15(f) (having more independent directors on a board after a sale when one is concerned that the profit made from the sale reflects a conflict of interest)[228]; and Rule 12b-1 (strengthening the independence of directors and requiring their separate vote on a plan that has a high potential for conflicts of interest).[229] On the other hand, the 40 Act's use of independent directors was in conjunction with other methods of regulation (such as disclosure) and aimed to foster a more independent board culture in an effort to generally rectify the conflict of interest situations that the SEC Report revealed.[230] Showing a similarly loose nexus, the 2001 Amendments aimed to strengthen independent director culture by giving independent directors control of "corporate machinery."[231]

[226] *See supra* notes 109 and 110 and accompanying text.
[227] *See supra* Part IV.A.2.b.
[228] *See supra* Part IV.A.2.c.
[229] *See supra* Part IV.A.2.d.
[230] *See supra* Part IV.A.2.a.
[231] *See supra* note 217 and accompanying text.

The 2004 Amendments follow this line: They counter conflict-of-interest-based scandals with a general toughening of independent director culture—along with additional regulation that is not focused on independent directors.[232] In terms of the nexus between problem and solution, the 2004 Amendments are not wildly out of line with past changes to the independent director requirements. There may not be a tight nexus between independent directors and market-timing, for example, in that the directors may not even be aware that this practice is going on. This certainly contrasts with the 1970 Amendments, Rule 12b-1, and to some extent § 15(f), where the board must inform itself about the potential conflict of interest (or, in the case of § 15(f), will be aware of it and have a no unfair burden standard to uphold) and then pass judgment on the situation. However, the 2004 amendments, in their lack of a tight nexus to the problem they aim to fix, resemble the 40 Act and the 2001 Amendments, responding to general concerns with a broad push toward a greater culture of independence. Thus, the dissent to the 2004 Amendments and the Chamber may be correct in arguing that altering the percentage of independent directors and mandating an independent chair is not directly responsive to abusive practices such as market timing and late trading. Yet, this does not distinguish the 2004 Amendments from past changes that saw problems, and added or strengthened "watchdog" watchdog independent directors in the hope that they would serve in the shareholders' best interest.

<u>(B) Adding real value (even theoretically)?</u>

The most distinguishing factor of the 2004 Amendments and the strongest argument that its detractors may have is that the 2004 Amendments do not add any benefit above the current safeguards.[233] One could marshal an effective argument that the 40 Act's implementation of its 40 percent independent director plan did not directly address the specific problems of self-

[232] *See* 2004 Amendments, *supra* note 1.
[233] *See supra* note 96 and accompanying text.

dealing that were occurring, and that those could be better dealt with the ICA's disclosure requirements and prohibitions on particular activities. However, if one was to argue that the 40 percent requirement did not add anything "new to the mix," one would have a hard time doing so. Where previously boards were dominated by management, independent directors *at least* nominally imbued with the task of protecting shareholders were required.[234] Similarly, the 1970 Amendments fundamentally changed and narrowed who could be considered disinterested for purposes of this composition requirement. It also gave independent directors a new role in approving contracts.[235] Section 15(f) was similar in that where, prior to the amendment in 1975, there was no additional statutory requirement for independent directors when a business was sold, it implemented one that was designed to give independent directors control of the board.[236] Rule 12b-1 changed how funds using fund assets for distribution costs chose their independent directors as well as the way plans had to be approved.[237] The 2001 Amendment, by requiring a percentage of independent directors above and beyond statutory requirements and *by giving independent directors a majority of the votes*, really did put control of the board in the independent directors' hands—if they chose to take it.[238] However, once independent directors are in place and can outvote management if they desire, the 75 percent requirement's benefit hinges purely on the board's culture. And if board culture is a problem (because independent directors are not truly independent or are uninformed, for example) then simply increasing the proportion of independent directors likely will not alter the board culture in any significant way.

As for the independent director chair adding to the strength of board independence: This forces the chair to be one of the independent directors, which is something not previously

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[234] *See supra* Part IV.A.2.a.
[235] *See supra* Part IV.A.2.b.
[236] *See supra* Part IV.A.2.c.
[237] *See supra* Part IV.A.2.d.
[238] *See supra* Part IV.A.2.e.

required. But in some ways the requirement adds nothing new, because a majority independent board could always choose to vote in an independent chair. And if the independent chair is uninformed, or not truly independent, then, once again, very little has been added.

B. High Cost.

<u>1. The 2004 Amendments.</u>

Commissioners Glassman and Atkins rightfully point out that the costs of the independent director requirements will be borne by the shareholders. To the extent that the shareholders do not see decreased costs elsewhere (for example, if the changes to the independent director requirements lessened market timing such that transaction costs went down and so shareholders saw a greater return for their investments), the shareholders will see a net cost due to the higher fees they will pay to cover the cost of compliance with the 2004 Amendments.[239]

The dissent bemoans the majority's unwillingness to adopt a 2/3 independent director requirement, explaining that "most funds already satisfy" that threshold and that the ICI recommends a 2/3 independent board as a fund "best practice."[240] The 75 percent minimum means that about half of all funds will need to make changes to their boards.[241] The dissent acknowledges that the cost of this change could be incurred either by recruiting and paying new independent directors or by suffering the loss of quality inside directors (if a fund was to meet

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[239] The dissent points to Securities and Exchange Commission, *Invest Wisely, An Introduction to Mutual Funds*, to explain how small differences in fees can have a large impact on investor returns: "Even small differences in fees can translate into large differences in returns over time…. [I]f you invested $10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly $49,725. But if the fund had expenses of only 0.5%, then you would end up with $60,858 — an 18% difference." *See* Securities and Exchange Commission, *Invest Wisely, An Introduction to Mutual Funds*, *available at* http://www.sec.gov/investor/pubs/inwsmf.htm. (last visited March 10, 2005).

[240] *See* 2004 Amendments, *supra* note 1. *See also* Investment Company Institute, *ICI Board Recommends Two New Governance Standards; Urges Universal Adoption of 17 Best Practices for Mutual Fund Directors* (2003), *available at* http://www.ici.org/statements/nr/2003/03_news_best_practices.html#TopOfPage (last visited March 1, 2005).

[241] *See* 2004 Amendments, *supra* note 1. *See also* 2004 ICI Comment Letter, *supra* note 107.

the percentage requirement by letting go of one or more of its inside directors).[242] The Wall Street Journal expresses a similarly pessimistic view of the costs imposed. It highlights this cost by describing one small fund with $218 million in assets that estimated that the 75 percent independent director requirement will cost its shareholders $20,000 a year.[243]

The dissent maintains that, despite the majority not identifying any out of pocket costs for the independent chair requirement, 80 percent of funds will need to expend money and effort to hire an independent chair. If an existing independent director on the fund's board is made chair of the fund, he will need to be paid more because he will take on additional responsibilities. The dissent points to evidence that an independent chairperson can command a 25-50 percent premium over other board members.[244] If the fund does not use a current independent director, it will have to search for a new independent director to be chair and compensate him. Additionally, the independent chair will likely have to hire a staff,[245] which will impose costs on the fund. Another major cost of the independent chair requirement is that the fund may lose valuable management insight and the benefit of having a chair with knowledge of the fund's day-to-day operations.[246] The dissent argues that there is a significant cost to forcing a board to choose a chairperson who may not be the most qualified chairperson.[247]

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[242] The median compensation for an independent director at the 50 largest fund groups was $113,000 a year. *See* Rick Miller, *In Off Year, these Cats Get fatter: Fund Board Directors Collect a Big Pay Raise,* INV. NEWS, April 7, 2003, at 1 (quoted in 2004 Amendments, *supra* note 1, at n.24).
[243] *See* Editorial, *supra* note 24.
[244] *See* 2004 Amendments, *supra* note 1, at n.34.
[245] The 2004 Amendments require funds to explicitly authorize the independent directors to hire employees and advisers necessary to carry out their director duties. *See id.* Thus, the independent directors are not *required* to hire their own staff. The dissent only discusses the costs of hiring a staff in the context of independent chairs, not independent directors generally. Perhaps this is because Glassman and Atkins perceive the independent chair as more likely to need a staff in order to fulfill his duties. The Chamber expresses concern about the costs of hiring a staff in the context of independent directors generally. *See* Motion for Stay, *supra* note 17, at 17.
[246] *See* 2004 Amendments, *supra* note 1, at n.38 and accompanying text. *See also* Comment Letter from Senator Judd Gregg (stating that interested chairmen are better for shareholders because they have a personal and professional stake in the fund's success); 2004 ICI Comment Letter, *supra* note 107 ("the proposed independent chair requirement could deprive some funds and their boards of the most highly qualified candidate for the position of chairman"). On not being able to find qualified independent directors generally, *see* Comment letter from

2. Comparison to prior changes: The costs previous independent director alterations imposed.

a. The 1940 Act.

The path to the passage of the 40 Act was arduous, even though the industry and the government recognized the need for regulation, because the industry wanted to limit the costs it bore. Even before the introduction of the bill to regulate investment companies was introduced to the 76th Congress, its provisions were compromised in order to increase its chances of enactment. Initially, the SEC had proposed to sever fully the ties between investment companies and investment banking firms, end previously issued debt securities and preferred stock, and redistribute securities voting rights. These provisions were all dropped before the bill was introduced.[248] Many considered the SEC-drafted bill that was introduced by Senator Robert F. Wagner in the Senate and by Clarence F. Lea in the House (the "Wagner-Lea" bill) balanced and moderate.[249] The Wagner-Lea bill was based on the SEC's Report and aimed to eliminate the deficiencies and abuses that the SEC Report highlighted in the fund industry.[250] The reaction in the fund community was strongly negative; the industry worried that the legislation would put them out of business. Lengthy hearings were held before the Senate Committee on Banking and Currency.[251] Certain provisions of the Wagner-Lea bill were contested, such as the requirement that a director could not serve on more than one fund board. Presumably, this was because of the

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Association for Investment Management and Research (requesting that the SEC move boards toward greater independence with a 2/3 as opposed to 75 percent independent requirement because there must be a critical mass of directors who are very familiar with the mutual fund's business model and management, even if these directors are not necessarily independent, and there are a limited pool of qualified independent directors from which to draw).

[247] In the Chamber's Motion for Stay, the Petitioner makes an argument similar to the dissent's about the cost of these new requirements. *See* Motion for Stay, *supra* note 17, at 9, 16-17. The Chamber argues that funds will 1) incur costs of searching for and hiring independent directors; 2) suffer costs that come from losing interested chairs that the fund had deemed optimal; 3) have to pay additional costs to hire staff for independent directors; and 4) have to pay a premium for independent chairs above interested chairs. *See id.*

[248] *See* SELIGMAN, *supra* note 131, at 226-27. This bill was introduced on March 14, 1940. *See* S. 3580 and H.R. 8935. *See also* ROBERTSON, *supra* note 59, § 1.02[3].

[249] *See* SELIGMAN, *supra* note 131, at 227 (describing those who considered the bill to be "moderate and well considered).

[250] *See* ROBERTSON, *supra* note 59, § 1.02[3].

[251] *See* SELIGMAN, *supra* note 131, at 228.

huge costs that the limitation would entail, both in terms of salary and transaction costs and the increased inflexibility for funds. There was also concern that the legislation went further than necessary to safeguard investors' interest and that the severe restrictions would hinder investment companies' operations to the extent of making them futile.[252]

However, there was a general consensus that some legislation was necessary to rectify and prevent past abusive practices. Industry members stated their willingness to work with the SEC on substitute legislation, less consequential provisions of the initial bill were accepted, and negotiations for a substitute bill began in April 1940. [253] The original bill was withdrawn and a substitute bill was introduced into the Senate and the House in 1940.[254] In describing the compromise, Senator Wagner, who introduced the initial and the substitute bills in the Senate stated:

> I think I speak on behalf of the entire subcommittee in congratulating you gentlemen on reaching an accord. It shows what can happen when reasonable men sit around a table. It also seems to me that cooperation between Government and industry, as is evidenced by the results here, is the way to secure reasonable, sound legislation. While I cannot speak for the subcommittee as to what ultimately will be adopted, I am sure they were all gratified when they heard that you gentlemen decided to confer with one another. [255]

The substitute bill, with small alterations, became the 1940 Act. This bill represented a compromise between the industry and the SEC.[256] The compromise the SEC had to make to get the Investment Company Act enacted was described by at least one author as "[t]he SEC's greatest legislative defeat during the Roosevelt administration.…"[257] The SEC's main

[252] *See id.* at 228 (quoting Lehman Corporation's Arthur H. Bunker, Senate Hearings on S. 3580, at 326)
[253] *See* Tamar Frankel, *The Ninth Annual Abraham L. Pomerantz Lecture: Regulation and Investors' Trust in the Securities Markets*, 68 BROOK. L. REV. 439, 448 (2002) (noting the industry's support for the Investment Company Act).
[254] The substitute bill was S. 4108 in the Senate (introduced by Wagner) and H.R. 10064 in the House (introduced by William P. Coles, Jr.).
[255] *See* Hearings on Senate Bill 3580, at 1110, 76th Cong. 3d. Sess. (1940).
[256] *See* FRANKEL & SCHWING, *supra* note 37, §1.02[B], n.148.
[257] *See* SELIGMAN, *supra* note 248, at 222.

concessions had been: 1) investment company officers were not required to register with the SEC; 2) only 40 percent of the investment company's directors had to be outside directors, as opposed to the originally-proposed majority requirement;[258] 3) there was no maximum size limit on investment companies; 4) there was no limitations on the number of investment companies a person could sponsor; 5) there was not a complete prohibition against issuance of new debt securities or preferred stock in favor of a limitation on the amount each firm could issue; 6) and it limited the SEC's power to enjoin reorganizations.[259] The SEC officially described that law as "the minimum workable regulation of investment companies."[260]

Despite the fact that the SEC's initial requirements, which the industry considered to be too burdensome had been watered down, the SEC supported the bill.[261] Thus, what was initially deemed as "too costly" was substituted for something with which the industry, Congress, and the SEC could live.

Nonetheless, it would be ludicrous to suggest that the 40 Act did not impose huge costs on the industry. Just bringing this industry under regulation whereas it had not been regulated before imposes huge costs on funds, as well as to society as a whole, which bears the expenses of regulation through higher mutual fund fees and through taxes supporting the SEC.[262] While it is

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[258] Originally, S. 3580 required a majority of investment company directors to be independent. *See* S. 3580, 76th Cong., 3d. Sess. § 10(a) (1940). However, that provision was dropped for fear that the directors would not heed the advice of management because the board would be "too independent." *See* Levitt, Keeping Faith Speech, *supra* note 133. *See also* PROTECTING INVESTORS, *supra* note 186, at 267, n.64 (stating that the majority requirement was changed to a 40% requirement "out of fear that a board with an independent majority would repudiate the recommendations of the adviser, depriving investment company shareholders of the benefits of those recommendations" and adding that "[o]bviously, experience has proven this fear to be unfounded.").
[259] *See* SELIGMAN, *supra* note 131, at 228-29.
[260] *See id.* at 222 (quoting SEC seventh annual report at 2).
[261] *See id.* at 229.
[262] *See* Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 911 (1994) (describing generally the costs that government regulation imposes because of both the cost to the entity being regulated and the cost of the regulators); Mark J. Roe, *Political Elements in a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1480 (1991) (stating that whether or not a fund takes advantage of Subchapter M, it must bear the costs of regulation under the 1940 Act). *Cf.* Erik J. Greupner, *Hedge*

hard to place a dollar figure on these costs, implementing an entirely new regulatory regime is undeniably expensive.

b. 1970 Amendments.

Like in situation leading up to the passage of the 40 Act, the SEC was unable in the late sixties to wave a regulatory wand and impose its desired standards on the industry, because of the industry's resistance. In the SEC's PPI Report, the Commission recommended substantial revision of the 40 Act to address problems with management fees. Specifically, the Commission proposed that compensation received by persons affiliated with investment companies, including their advisers, be judged on a reasonableness standard, which would be determined in light of "all relevant factors." In addition, the SEC recommended that the application of this reasonableness standard be impacted neither by shareholder nor director approval of advisory fees, that recoveries be limited to excessive compensation paid in the two years prior to commencement of an action, and that the Commission have the power to bring actions or to intervene in private suits.[263]

A bill based on the PPI was introduced in Congress on May 1, 1967.[264] Even before the bill was introduced, the mutual fund industry was assembling a lobby to defend existing practices. The ICI, supported by NASD, the Investment Bankers Association, and the NYSE, all opposed the SEC's legislative proposal. One of the arguments that they put forth was that the SEC's proposed limitations on mutual fund sales loads and advisory fees would have caused three out of five of ICI's members to operate at a loss and, in particular, would hurt small

Funds are Headed Down-market: A Call for Increased Regulation?, 40 SAN DIEGO L. REV. 1555, 1578-79 (2003) (explaining that hedge funds would face additional costs if the SEC required them to be registered under the 40 Act).
[263] *See* Rogers, *supra* note 122, at 1081.
[264] *See* SELIGMAN, *supra* note 131, at 378 (describing S. 1659).

investment companies.[265] The study that this bill was based on was attacked as being analytically deficient and lacking economic justification.[266] The SEC was ridiculed for failing to assess and respond to the economics of the mutual fund industry. Before this bill was submitted to hearings, compromises were made which weakened the bill.[267] Although this bill represented a compromise between the industry and the SEC and had the SEC's official support, the bill still died in the House in September 1968.[268]

This bill finally enacted in December 1970 represented a number of additional compromises, above and beyond the earlier Senate-passed bill. It left the Glass-Steagall Act in place, thus eliminating the possibility of bank-operated commingled investment accounts from competing with mutual funds (which potentially would have cost the mutual funds business). It also altered the reasonableness standard for appraising investment adviser fees.[269] Instead of the 1968 bill's standard of "reasonableness,"[270] which took into account "all relevant factors," which included the fees other clients of the adviser paid, the nature and extent of services provided, and other factors, the fees charged by rival investment advisers, and management costs of internally managed funds, the 1970 act provided that the investment adviser would have a fiduciary duty with respect to the receipt of compensation for services.[271]

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265 *See id.* at 378
266 *See id.* at 379.
267 For example, instead of the bill requiring a 5% sales charge limit, the SEC compromised and asked for a reasonable mutual fund sales load standard subject to SEC oversight. *See id.* at 379.
268 *See id.* at 379-80.
269 *See* Kim, *supra* note 63, at 477 (describing the political compromise that prompted this change).
270 There had been an interim step between these two standards of reasonableness ("all relevant factors" vs. fiduciary duty). During Senate debate on S. 3724 (the 1968 bill), the bill was amended to establish a rebuttable presumption that advisory fees were reasonable if shareholders and a majority of the fund's independent directors approved the fees. Many strongly opposed this change because it was thought to vitiate the "reasonableness" standard and thus gut a central purpose of the legislation. *See* Rogers, *supra* note 122, at 1083.
271 *See* SELIGMAN, *supra* note 131, at 380-81. *But compare id.* at 381 ("the evidentiary burden of a plaintiff proceeding under the 1970 act in some instances would be greater than it would have been under the reasonableness standard of the 1968 Senate Bill) with Diane Fruchter Martucci, *The Inapplicability of the Demand Requirement of Rule 23.1 to Mutual Fund Shareholder Suits Under Section 36(b)*, 51 FORDHAM L. REV 1403, 1411-12 (1983) ("Concern with the inability of fund directors or shareholders to control advisory fees was an overriding factor in

Thus, the 1970 Amendments display the necessity of compromise between the SEC and the industry.[272] Seligman explains the "agency's meager 1970 statutory harvest" as follows: "By failing to make a rigorous analysis of the economics of the mutual fund industry … the SEC was vulnerable to industry charges of performing inadequate research…. SEC reform initiatives that relied on marketplace competition to protect investors were far more likely to command bipartisan support … than direct agency rate regulation."[273] If the industry views regulation as too costly or too likely to "put them out of business," the industry will resist changes that the SEC claims protect investors. The 1970 Amendments show the SEC having to make concessions again and again until the costs are low enough for the industry to bear.

c. § 15(f).

Like the previously-discussed changes to independent director requirements, the addition of § 15(f) represents a scaled-back version of initial, more costly proposals. However, the first thing to note is that, in the face of the *Rosenfeld* decision, almost any proposal allowing advisers to make a profit on the sale of their contract would reduce costs for advisers (in the sense of allowing a profit). The investment company industry was outraged by the *Rosenfeld* decision.[274] The cost of following *Rosenfeld*, and not being allowed to build up equity in an advisory

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Congress' decision to amend the ICA. The industry's fear of strike suits and rate-making by the SEC or the judiciary led initially to be a bevy of proposed bills which, in comparison to section 36(b) as enacted, would have given the shareholders far less ability to bring an excessive fee suit.…") (footnotes omitted).

[272] The 1970 Act also loosened the 1968 bill's front-end-load limitation. *See* SELIGMAN, *supra* note 131, at 381.

[273] *See id.* at 382.

[274] *See The Problems of Rosenfeld v. Black*, SEC. REG. & LAW. REP. B-1 (Sept. 22, 1971) (stating that Judge Friendly's opinion "has been castigated by others for depriving entrepreneurs of the justly deserved fruit of their labors. But nobody has disregarded it."). This article also predicted that if the Supreme Court did not overturn the Second Circuit's decision, the investment company industry would ask Congress to pass legislation negating it, although they would be reluctant too, being fresh off the battle over the 1970 Amendments. *See id.* at B-1, B-12.

company, was not only that the advisers could not profit from their businesses but that these potential advisers would be discouraged from starting new companies.[275]

Section § 15(f) reduced the costs to advisers and the industry by allowing them to profit from sales of their advisory business.[276] The bill implementing § 15(f) also represented reduced costs for the industry as compared to prior versions of the bill. The initial bill on this matter[277] required that the fund have a 100 percent disinterested board for five years after the sale. Although this bill was designed to protect investors, the industry vehemently opposed it for being excessively "harsh" and imposing costs on the fund because they would have to hire new people not connected with management.[278] Thus, while § 15(f) undoubtedly poses some costs similar to the costs in relation to the 2004 Amendment's 75 percent independent board requirement,[279] these costs are probably outweighed by the benefit the adviser gains, which keeps advisers' entrepreneurial drive alive and well, and also represents fewer costs to funds than initially proposed.

d. Rule 12b-1.

With Rule 12b-1, the SEC once again compromised with the industry to arrive at a palatable result for all parties. While for years the Commission had prohibited the use of fund assets to pay for distribution of a fund's shares,[280] the pressure on the SEC to permit this practice eventually resulted in Rule 12b-1. Investment companies demanded the ability to use fund assets

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[275] *See The Problems of* *Rosenfeld v. Black*, SEC. REG. & LAW. REP. B-12 (Sept. 22, 1971); Sterrett, *supra* note 128, at 196 (describing how *Rosenfeld* could prohibit reward for an investment adviser's entrepreneurial risk).
[276] Although, the flip-side of this cost reduction for the adviser and the industry is the concern that shareholders would have to pay higher fees so that a purchaser could recoup its losses that allowed the seller to make a profit. *See supra* note 171.
[277] *See* S. 3681, 92nd Cong., 2d Sess. (1972).
[278] *See* Sterrett, *supra* note 128, at 251 (explaining the industry's resistance to this bill). Presumably the costs would come both from having to find, recruit, and compensate the independent directors as well as from the loss of management's knowledge, similar to the alleged costs of the 2004 Amendments.
[279] However, § 15(f) imposes this cost on a much narrower range of situations.
[280] *See* Rule 12b-1.

for distributions so that it could afford to offer no-load funds, which had become increasingly popular.[281]

Another reason for the passage of Rule 12b-1 was that, because the cost of distribution was usually borne by the investment adviser, who would increase his fee to compensate for this cost, the fund shareholders were already paying for the cost of distribution indirectly.[282] Note though that there is a question of *which shareholders* bear this cost. In the case of an increased fee, all shareholders will pay the fee. In the case of no-load funds, where share distribution is paid for out of the fund's assets, existing shareholders may find their value diluted, as they "pay for" the absence of a load on the later shares. Also note that the manager will have an incentive to use net assets to pay for no-load shares because buyers will find those shares attractive and purchase them, increasing the NAV of the fund and therefore the adviser's fee.

Rule 12b-1 also exhibited another compromise. An earlier version of the rule required shareholders to approve the Rule 12b-1 plan by a 2/3 vote. People in the industry thought that garnering this level of shareholder approval would be "expensive."[283] Thus, while there are some costs to gathering the information and votes necessary to implement a Rule 12b-1 plan, these costs seem relatively light and represent a reduced version of the initially proposed costs.

e. 2001 Amendments.

The 2001 Amendments also embodied compromises between the industry and the Commission. These Amendments represented a scaling-down of some of the earlier farther-reaching proposals.[284] At the 1999 Roundtable, possible changes that had been discussed

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281 *See* Schonfeld, *supra* note 175, at 833.
282 *See Commission Approves Rule Allowing Use of Mutual Fund Assets for Distribution*, SEC. REG. & LAW. REP. A-1 (Oct. 29, 1980).
283 *See* Rule 12b-1; *See Commission Approves Rule Allowing Use of Mutual Fund Assets for Distribution*, SEC. REG. & LAW. REP. A-1 (Oct. 29, 1980) (describing complaints that the 2/3 requirement would be "unworkable").
284 *See* Oppel, *supra* note 192 (describing how Levitt abandoned more aggressive proposals in favor of the modest proposals for the 2001 Amendments, which most boards were already in compliance with).

included: giving independent directors the power to terminate a fund manager's contract at any time, requiring former fund company officers to wait up to five years before serving as independent directors, and examining whether fund directors who are also executives of the fund management company should be paid for their board service.[285] Even by the time of the Proposal for the 2001 Amendments, the SEC was still debating requiring a 2/3 independent director board.[286]

The three major regulations of independent directors that the final 2001 Amendments put in place were: 1) a majority independent board; 2) self nomination and selection of independent directors; and 3) independent legal counsel for independent directors (if they chose to obtain counsel).[287] At the time the SEC proposed the 2001 Amendments, most fund boards met with the majority independent director requirement. The SEC noted, however, that the funds that did not already have a majority of independent directors and would like to rely on the exemptive rules would incur costs. The SEC stated that it had "no reasonable basis for estimating those costs."[288]

One might guess that the complaints regarding the high cost of the 2004 Amendments' board composition requirements would apply with similar force to the 2001 Amendments' board composition requirement because, in both cases, funds were required to maintain a percentage of independent directors greater than what law at the time required. However, the industry offered much more support for the majority independence requirement and the 2001 Amendments

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[285] *See* Oppel, *supra* note 192.

[286] *See* Securities and Exchange Commission*, Proposed Rule: Role of Independent Directors of Investment Companies*, Release Nos. 33-7754; 34-42007 (Oct. 15, 1999), *available at* http://sec.gov/rules/proposed/34-42007.htm (last visited April 20, 2005) [hereinafter "Proposal for 2001 Amendments"].

[287] *See supra* note 188 for additional 2001 Amendment requirements.

[288]Proposal for 2001 Amendments, *supra* note 286. This foreshadowed the SEC's conclusion in the 2004 Amendments that it had "no reliable basis for determining how funds would choose to satisfy this [the 75 percent independent director] requirement and therefore it is difficult to determine the costs associated with electing independent directors." *See* 2004 Amendments, *supra* note 1. Similarly, as for the independent chairman requirement, the SEC stated that "our staff is not aware of any out-of-pocket costs that would result from [this requirement]." *See id*.

generally than for the 2004 Amendments and its 75 percent requirement. Given that the 2001 Amendments did not result in either a dissent, litigation against the SEC, or a congressional call to action, the 2001 Amendments were arguably "better received" than the 2004 Amendments. Additionally, as opposed to the 200 comments from fund investors, management companies, independent directors to funds, and members of which "many were divided on some of our proposals,"[289] the SEC received 142 comment letters on the proposal for the 2001 Amendments "generally commend[ing] our efforts to enhance the independence and effectiveness of und directors, although many offered recommendations for improving portions of the proposals … [which were] helpful to us in formulating the final rules and amendments."[290]

The major key to the industry's support of the 2001 Amendments was that the costs of implementing the new rules were relatively low *because most investment companies already fulfilled the requirements of most of these rules.* Even in 1992, seven years before the Roundtable discussion, the SEC reported that "the change to require that a majority of investment company boards be composed of independent directors could be accomplished at a relatively small cost. Indeed, many, if not most, major investment company complexes already have boards with independent majorities.[291] By the time the SEC proposed the 2001 Amendments, it was confident in saying that most mutual fund boards had at least a simple majority of directors.[292] Part of the reason for this was that some funds needed to maintain at least a majority of independent

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[289] *See* 2004 Amendments, *supra* note 1.
[290] 2001 Amendments, *supra* note 41. For example, in its summary of the comments received on having independent directors constitute a majority of the board, the SEC stated that, "Nearly all commenters who addressed increasing the percentage of independent directors on fund boards supported the proposal. Only two commenters opposed increasing the percentage of independent directors, while four commenters criticized the Commission's proposal to tie the increased independence condition to the Exemptive rules." *See* Securities and Exchange Commission, *Summary of Comments on Proposal*, *available at* http://www.sec.gov/rules/extra/brownin1.htm (last visited April 20, 2005).
[291] *See* PROTECTING INVESTORS, *supra* note 186, at 268.
[292] See Proposal for 2001 Amendments, *supra* note 286, at n.139 and accompanying text (basing this assessment on an ICI Advisory Group Report).

directors in order to comply with certain sections of the ICA or SEC rules.[293] In constructing its cost-benefit analysis for the 2001 Amendments, the SEC stated that "Because … most mutual funds today have boards with independent majorities, it appears that the Amendments will not impose substantial costs on funds as a group."[294]

The same rationale applies, although to perhaps a lesser extent, to the independent directors selecting and nominating other independent directors. In assessing the costs of the other 2001 Amendment rules, the Commission noted that the director self-selection and self-nomination should not impose significant new costs on funds because many funds have already adopted this practice.[295] Despite the debate that occurred amongst the panelists about the appropriate level of management input into these decisions, the ICI supported this proposal and noted that it was "common practice in the fund industry."[296]

In a speech at the 1999 Mutual Fund and Investment Management Conference, then ICI president Matthew Fink expressed his alignment with the proposed governance reforms: "[T]he mutual fund industry welcomes and applauds the SEC's effort to determine whether our strong

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[293] *See* Proposal for 2001 Amendments *supra* note 286, at n.139. The SEC used the examples of ICA § 10(b)(2) (independent directors must comprise a majority if the fund's principal underwriter is an affiliate of the fund's investment adviser); § 15(f)(1) (providing a safe harbor for the sale of an advisory business if directors independent of the adviser constitute at least 75 percent of a fund's board for at least three years following the assignment of the advisory contract); Rule 6e-3(T)(b)(15) (exempting certain funds underlying insurance products from various Investment Company Act provisions if the fund has a board with an independent director majority); and Rule 23c-3(b)(8) (independent directors comprising a majority of the board is one of the conditions of permitting the operation of interval funds). *See id.*

[294] *See* 2001 Amendments, *supra* note 41 (footnote omitted). The SEC based this information on the same source as it used for the Proposal for 2001 Amendments. *See also* Roundtable transcript *supra* note 215 (statements of McDonough and Haire that even though only 40 percent independent directors are required by statute, it is of little consequence because almost all funds have at least a majority of independent directors, either because of 12b-1 plans, the § 15(f) requirement, or because they consider it good practice).

[295] *See* Proposal for 2001 Amendments *supra* note 286, at n.66 and accompanying text (citing an ICI report and explaining that funds with 12b-1 plans and thus funds with independent directors selecting and nominating other independent directors constitute a majority of funds and many funds without 12b-1 plans have independent directors select and nominate other independent directors).

[296] ICI Comment Letter to Proposal for 2001 Amendments, *available at* http://ici.org/statements/cmltr/2000/00_sec_fund_gov_com_cvr.html#TopOfPage (last visited April 20, 2005).

system of fund governance can be made even better."[297] Fink stated that mutual funds previously have embraced governance standards exceeding those required by rule and statute. In an effort to continue that, Fink announced that the ICI would be forming the Advisory Group on Best Practices for Fund Directors.[298] That same year, the Advisory Group recommended 15 "best practices" to fund boards of directors. Three of these best practices were: 1) all fund boards be comprised of at least two-thirds independent directors; 2) independent directors select and nominate other independent directors; and 3) independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers.[299] Despite the ICI's objection to the requirement that independent directors hire independent legal counsel,[300] given that the ICI best practices accorded with the 2001 Amendments' major requirements, it is not surprising that the ICI was generally supportive of the 2001 Amendments, even if it disagreed with particular points. Because the Advisory Group created Best Practice guidelines that many funds already met and more aimed to meet after they were outlined, the ICI realized that the SEC was taking some steps that were already common practice, and therefore low cost to the industry.

In contrast to the relative support of the "low-cost" board composition and self-nomination/self-selection process, there was more cost entailed by the requirement that, if the

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[297] Matthew P. Fink, Institute President's Keynote Address at the 1999 Mutual Funds and Investment Conference, (March 22, 1999), *available at* http://www.ici.org/issues/dir/99_mfimc_fink.html (last visited April 20, 2005) [hereinafter "Fink Speech"]. *See also Levitt Unveils Four-Step Plan to Boost Mutual Fund Governance*, SEC. REG. & LAW. REP. 393, 393-94 (March 26, 1999) (speech *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch259.htm) (last visited April 22, 2005).
[298] Fink Speech, *supra* note 297.
[299] See Investment Company Institute, *ICI Board Adopts Resolution Urging Fund Industry to Strengthen Governance* (July 7, 1999), *available at* http://www.ici.org/issues/dir/news_99_best_practices_adopt.html#TopOfPage (last visited April 20, 2005).
[300] *See infra* notes 301-304 and accompanying text.

independent directors were to hire legal counsel, it must be independent legal counsel.[301] There was also more disagreement over this proposal. Although 43 commenters stated that the advice of an independent legal counsel is useful and important to fund independent directors, 50 commenters argued that selection of independent counsel is an issue best left to the independent directors themselves. Only three commenters stated that the Commission's independent counsel proposal would serve fund shareholders well.[302] The ICI's comment letter is representative of the arguments that most commenters made against the rule. The ICI supported the Commission's objective to ensure that independent directors have access to unbiased legal advice. However, the ICI asserted that the manner in which the Commission proposed to accomplish this objective was seriously flawed. The Commission's approach "would impose a rigid independence standard, thereby supplanting the directors' business judgment." The Institute believed that the selection of counsel is an issue best left to the directors themselves.[303] The ICI worried that there would be indirect costs imposed on the boards: 1) the broad definition of "independent legal counsel" would discourage independent directors from seeking counsel at all; 2) the broad definition would limit the pool of eligible counsel so that independent directors would be unable to find independent legal counsel even if they were not discouraged from seeking it; and 3) in some situations, independent directors would need to break off relationships with counsel they had for many years, causing them to lose someone they trusted who was educated as to the intimacies of the fund.[304]

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[301] *See* 2001 Amendments, *supra* note 41. The Commission noted that if the fund's independent directors hired legal counsel, which they did not have to do, they might have to switch legal counsel, thus incurring costs.

[302] *See* Securities and Exchange Commission, *Outline of Comments on Proposed Rules Regarding the Role of Independent Directors of Investment Companies* (Aug. 9, 2000), *available at* http://www.sec.gov/rules/extra/brownin1.htm#seciic (last visited April 20, 2005).

[303] *See* ICI Comment Letter to Proposal for 2001 Amendments, *supra* note 296. *See also SEC Adopts Rules to Enhance Effectiveness of Mutual Fund Directors*, SEC. REG. & LAW. REP. 5 (Jan. 8, 2001).

[304] ICI Comment Letter to Proposal for 2001 Amendments, *supra* note 296.

In summary, even though the compromises necessary to arrive at the 2001 Amendments cannot be tracked by bill number, those compromises occurred over the years that the 2001 Amendments incubated. Additionally, two of the three major requirements—the board composition and self-selection/self-nomination of independent directors—under the 2001 Amendments could be characterized as common industry practices and thus imposing little or no cost on most funds. The independent legal counsel requirement, while not necessary for all funds, would have imposed at least indirect costs on funds that wanted to retain its interested council for the independent directors, which is probably why the objections to this requirement were louder than to the other two.

<u>3. Overall Comparison of Costs.</u>

<u>(A) Absolute costs.</u>

Figures that would be useful in comparing the costs of these requirements include a dollar figure indicating "cost to industry" and "cost to investors." These figures should be inflation-adjusted and indicate both aggregate and per-fund/per-investor costs. They would be even more useful if broken down into direct and indirect costs or spliced even more finely to indicate the exact source of the cost. Unfortunately, much like there is no measure of "absolute benefit" of these amendments and rules, there are few good statistics for absolute costs.[305]

One can inquire into relative costs, but that is only marginally more helpful, given the lack of data. Are the 2004 Amendments more costly than the implementation of the 40 Act? Likely they are not, although the 40 Act did more than change requirements for independent directors—it put a whole new regulatory system in place. Are the 2004 Amendments more costly

[305] The SEC tries to estimate costs in its Rule release "cost-benefit analysis" sections, typically calculated as a cost per hour times hour statistic. *See* 2004 Amendments, *supra* note 1 (discussing the cost of the new record-keeping requirement by multiplying cost per hour by number of hours the task is assumed to take). However, an even more typical estimate is that there is "no reliable way to estimate." *See supra* note 288 and accompanying text.

than the 2001 Amendments? Perhaps, given the level of compliance already in place prior to the 2001 Amendments. While it is difficult to place the 2004 Amendments precisely on a cost spectrum, it is fair to say that they are not completely out of synch with the absolute costs incurred under other changes to the independent director requirements, so it is unlikely that absolute cost is the main reason for the uproar over the 2004 Amendments.

(B) Compliance rates.

In terms of the level of compliance in place prior to the 2004 Amendments, it seems that the 2004 Amendments require greater change than the 2001 Amendments, where the level of compliance was already high.[306] However, here again, the 2004 Amendments are not out of line overall with past changes. Even though half of the industry's funds will need to make changes to meet the board composition requirement and 80 percent will need to acquire an independent chair,[307] this pales in comparison to the changes that had to be made under the 40 Act. The 1970 Amendments also put entirely new definitions and procedures in place, and while it is uncertain what percentage of investment companies had unaffiliated directors who also met the definition of disinterested directors, there were surely changes that needed to be made. Similarly, although it only impacts investment companies in the sale setting, the 75 percent independent director requirement presumably impacts funds at the same rate that the current 75 percent requirement does. While the Rule 12b-1 plan requirements are arguably "lower cost" than the 2004 Amendments, pre-existing compliance was probably non-existent given the novelty of the rule. Thus, it seems unlikely that the feature that makes the 2004 Amendments unique is that it is out of line with current industry practices whereas former changes simply brought the ICA or SEC

[306] *See supra* Part IV.B.2.e.
[307] *See supra* Part IV.B.1.

rules in line with what the industry was already doing—that is true probably only for aspects the 2001 Amendments.

<u>(C) The process to reach the conclusion.</u>

In the "problem-investigation-solution" chain described *supra* in Part IV.A.3., one notices that the 2004 Amendments stand out in their lack of an investigatory and compromise period. Unlike the years of investigation subsumed by the SEC Report of the 1930s, the three reports on the fund industry in the 1960s, the several years it took to get § 15(f) added to the ICA, the four-year discussion period the SEC used to arrive at Rule 12b-1, and the Protecting Investors Report/1999 Roundtable that finally lead to the 2001 Amendments—after nearly a decade of considering those changes, the 2004 Amendments happened with lightning speed.[308] As a direct response to the 2003 scandals, the 2004 Amendments were promulgated a year later. Such speedy changes to the independent director requirements are an anomaly.[309]

One might argue that bureaucratic delay is bad and that a speedy promulgation of rules indicates that the SEC is learning how to take action more efficiently. While generally speed is a good thing, delay has benefits as well. The first is the investigation into the problem that delay allows. While thorough reports can take years, they can indicate the problems that need to be resolved and gather industry and government input.[310]

Another major benefit to delay is that it allows time for compromise.[311] While this may be perceived as watering down regulation designed to protect investors,[312] it helps prevent after-

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[308] Recall that the 2004 Amendments were proposed in January, 15, 2004 and became effective July 27, 2004. *See supra* note 1 and accompanying text.
[309] Note, however, that the 2004 Amendments did modify the Proposal for the 2004 Amendments with respect to funds with three directors, requiring only 2/3 of those directors to be independent. *See supra* note 2.
[310] Of course, it helps if these reports are well thought-out. *See supra* note 273 and accompanying text (explaining Seligman's allegation that the PPI Report was not in tune with market realities and thus lead to difficulty in passing the 1970 Amendments).
[311] Or perhaps compromise provides for delay.

the-fact industry uproar that might eradicate the regulation altogether.[313] The 2004 Amendments lack the push-and-pull between the SEC, the legislature, and the industry that has been a dominant feature of the other changes to the independent director requirements. Thus, even if the costs or existing level of compliance cannot be said to be different with regard to the 2004 Amendments, the process that has so often resulted in the industry being able to reduce the cost it bears under the ICA and SEC rules is noticeably absent.

C. No authority.

<u>1. The 2004 Amendments.</u>

The final complaint leveled at the 2004 Amendments is that the SEC lacked authority to promulgate these new rules. The Chamber's Opening Brief focuses largely on the SEC's lack of authority to promulgate the 2004 Amendments. The Petitioner argues that the SEC does not have the general authority to regulate corporate governance and there is no provision in the 40 Act permitting them to do so.[314] The Chamber argues that the SEC cannot circumvent that lack of authority by using its authority to exempt funds from certain prohibitions of the Act to achieve the same end of regulating corporate governance.[315]

The Petitioner highlights that, at the time when Congress was passing the 40 Act, they considered requiring a majority of an investment company's board to be independent. Congress

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[312] *See, e.g., supra* note 257 and accompanying text (describing the 40 Act as a legislative defeat for the SEC because of the compromises made).

[313] This might be the result of Congress requiring a report on the independent chair requirement or the Chamber winning its suit.

[314] The Chamber states that matters of corporate governance are traditionally determined by state law. *See* Chamber Opening Brief, *supra* note 20, at 27 (citing Santa Fe Industries v. Green 430 U.S. 462, 479 (1977) and Business Roundtable v. SEC, 905 F.2d 406, 412 (D.C. Cir. 1990) (listing "requirements for independent directors" as "traditionally governed by state law").

[315] *See* Chamber Opening Brief, *supra* note 20, at 2. The SEC has the authority to exempt funds from certain provisions of the Act under, for example, 15 U.S.C. § 80a-6(c). The Chamber notes that because almost all funds rely or anticipate relying on one of the exemptive rules, the SEC's Amendments to those rules amounts to a requirement for all funds. *See* Chamber Opening Brief, *supra* note 20, at 11. The Chamber seems to be arguing that creating governance rules that will apply to almost all funds is a qualitatively different use of authority than exempting funds from particular 40 Act rules in specific situations *provided that certain conditions are met*—which the Chamber acknowledges the SEC has a right to do. *See id.* at 10.

instead decided to make the requirement 40 percent. The Chamber points to a previous SEC statement that requiring funds to have more than 40 percent independent directors would take a statutory amendment as evidence that the SEC did not have the authority to alter the percentage of independent directors a fund board must have.[316] The Chamber cites to *Business Roundtable v. SEC*[317] for the principle that, where the statute is clear and the agency seeks to alter the clearly expressed intent of Congress—as the Chamber argues is the situation in light of the 40 Act's explicit provisions regarding board composition—Chevron deference is inapplicable.[318]

The Chamber bolsters its argument by adding that, even if the Commission did have the authority to adopt the independent director requirements, the 2004 Amendments involved an impermissible way of doing so under the 40 Act and the Administrative Procedure Act (the "APA"). The APA requires that a Court invalidate a rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[319] The Chamber explains that the SEC ignored the purpose and terms of the rules it amended; refused to consider fund performance; and did not adequately consider the 2004 Amendments' costs, the comments received, and the alternatives to the independent director requirements. The Chamber argues that these SEC actions exhibited no rational connection between the facts it found and the choices it made in the 2004 Amendments, thus violating the APA. It also violated its ICA statutory requirement to consider the provisions' effect on "efficiency, competition, and capital formation." The Petitioner explains that this is so for the same reasons that the 2004 Amendments do not meet the

[316] *See* Chamber Opening Brief, *supra* note 20, at 11. *But see infra* Part IV.C.2. (indicating that this may be an overstatement of the SEC's position).
[317] 905 F.2d 406, 408 (D.C. Cir. 1990). *See* Chamber Opening Brief, *supra* note 20, at 25.
[318] *See* Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837 (1984).
[319] 5 U.S.C. § 706(2)(A).

APA standards.[320]

2. Comparison to Prior Changes: Arguments about authority.

The SEC's use of authority in promulgating the 2004 Amendments is a factor that fundamentally distinguishes the 2004 Amendments from the 1940 Act, the 1970 Amendments, and the addition of §15(f). Without belaboring this distinction, it is worth pointing out that it was Congress who passed the legislation to create these changes, and not the SEC. The Commission—as well as the investment company industry—undoubtedly played a substantial role in shaping the legislation.[321] However, because they did not create the rules or amendments in those circumstances, no one could question their authority for doing so.

The Chamber's statements that a "1992 internal Commission report recognized that a statutory amendment would be needed to require that funds have more than 40 percent independent directors,"[322] is somewhat of a mischaracterization. In *Protecting Investors,* the SEC Division of Investment Management did recommend that "the Commission recommend *legislation* that would increase the minimum proportion of independent directors on investment company boards from forty percent to more than fifty percent."[323] While this does not mean that the SEC "conceded" that Congressional legislation was the *only* way in which it could change the board composition requirement, it does indicate that the SEC at least considered taking its usual route of making recommendations that Congress would pass.

Rule 12b-1 represents a different strategy to regulate independent directors and was subject to the same complaints about a lack of authority that the 2004 Amendments have faced. While, the SEC noted that the "prevalent view" was that the SEC had the authority under the

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320 *See* Chamber Opening Brief, *supra* note 20, at 40.
321 *See supra* Part IV.B.2.a., b. (describing the SEC's influence in the bills that were passed creating the 40 Act and the 1970 Amendments).
322 See Chamber Opening Brief, *supra* note 20, at 11 (citing PROTECTING INVESTORS).
323 PROTECTING INVESTORS, *supra* note 186, at 253 (emphasis added).

ICA to prohibit or limit financing of distribution by funds, a significant number of commentators questioned the SEC's legal authority to promulgate this rule.[324] The SEC justified its authority based primarily on § 12(b) of the ICA, which prohibits most funds from distributing shares of which it is the issuer "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[325]

The 2001 Amendments represented an even greater divergence from the pattern of SEC recommendations and negotiations, with Congress ultimately passing the legislation. In the 2001 Amendments, the SEC amended exemptive rules, as they did in the 2004 Amendments. Many of the same concerns about the SEC's authority to take this action were raised in the context of the 2001 Amendments, although perhaps less loudly. While the ICI accepted the 2001 Amendment's approach of mandating governance standards if a fund relies on an exemptive rule,[326] seven commenters argued that amending the exemptive rules was not appropriate. Three commenters stated that tying the governance conditions to the exemptive rules would require virtually all funds to follow the conditions; the Commission should instead recommend legislative changes to Congress.[327] In contrast to Rule 12b-1, which dealt with conditions placed on specific transactions that would otherwise be prohibited under a particular rule, the 2001 Amendments, like the 2004 Amendments, sought to alter boardroom culture by placing conditions on the exemptive rules, without tying those conditions to the specific exemptive rules, other than to say those rules are situations involving conflicts of interest.[328]

<u>3. Overall assessment of authority.</u>

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[324] *See* Rule 12b-1.
[325] *See* 15 U.S.C. § 80a-12(b). The Commission also relied on 15 U.S.C. § 80a-37(a) and § 17(d) of the Act.
[326] *See* ICI Comment Letter to Proposal for 2001 Amendments, *supra* note 296.
[327] *See Outline of Comments*, *supra* note 302.
[328] This lack of discussion of particular exemptive rules is a focal point of the Chamber's Brief. *See, e.g.*, Chamber Opening Brief, *supra* note 20, at 16-17.

The 2004 Amendments represent a different strategy for regulating investment companies than past changes to the independent director requirements. The previous changes this paper has examined involved either legislative change,[329] with the SEC needing to negotiate bills with Congress and the industry in order to put its regulations in place, or dealt with a specific rule providing a particular escape from a prohibition of the Act.[330] The major pre-2004 Amendment exception to these "strategies" are the 2001 Amendments, which broadly regulate boardroom culture by placing conditions on commonly used rules, with little tie-back to those rules.[331] In that sense, the 2004 Amendments follow a relatively recent "trend" of broad governance requirements through conditions that are functionally the same as regulating all funds—which may be cold comfort to those in the industry who do not want broad agency interference with business practices.

V. Conclusion.

In light of past changes to the independent director requirements, are the complaints about the 2004 Amendments so different as to justify the stir they have caused in the investment company industry? Is it just a fluke that there was a formal dissent, a Chamber of Commerce suit, a Congressional bill, and a media response questioning the 2004 Amendments? This paper has indicated a surprising array of similarities between the 2004 Amendments and previous changes. The Commission responded to the 2004 Amendments ("the problem") with a beefing up of the role of independent directors ("the solution") which is little different from how past problems have been dealt with under the 40 Act, the 1970 Amendments, § 15(f) Rule 12b-1, and the 2001

[329] I.e. the ICA, the 1970 Amendments, and § 15(f).
[330] Rule 12b-1.
[331] *See, e.g.*, 2001 Amendments, *supra* note 41 ("We selected these rules because they require the independent judgment and scrutiny of independent directors in overseeing activities that are beneficial to funds and investors, but involve inherent conflicts of interest between the funds and their managers."). Similar language is used in the 2004 Amendments. *See* 2004 Amendments, *supra* note 1. Why these particular conditions will resolve the conflict of interest associated with these rules and how this is functionally distinguishable from placing direct requirements on boards is the lacking information in these releases.

Amendments. When there are problems in the industry, the SEC and Congress cannot return fast enough to the "cornerstone" of the 40 Act—independent directors, despite persistent queries of whether independent directors are effective in the mutual fund context and whether current requirements render them truly independent from management.[332] Additionally, it seems that costs, at least in terms of absolute cost and adjustments necessary, given existing levels of compliance, are not drastically different as between the 2004 Amendments and previous changes to the independent director requirements. The authority analysis points to useful differences between the 2004 Amendments and previous changes, but does not explain why the industry was not more alarmed over the modification to the exemptive rules when the 2001 Amendments were promulgated. It is possible that, while along each of these factors, the 2004 Amendments do not, on the whole, seem hugely different from past alterations to fund independent director requirements, the "balance" of these factors weights against the implementation of the 2004 Amendments.[333]

But it is also possible that the upheaval over the 2004 Amendments is not based on either a different balance of benefits, costs, and authority, or on a fluke. It is possible that the upheaval is based on the *ways* in which costs, benefits, and authority have played out in the promulgation of the 2004 Amendments. One of the most salient benefit differences under the 2004 Amendments is that the board composition and independent chair requirements may not be adding any real value, *even on a theoretical level*, given current board majorities. It is not necessarily true that existing "levels" of independence are working but that, if they are not, this is not the right next step to take to make independence work. If the problem with independent

[332] *See, e.g.*, Sterrett, *supra* note 128, at 252.
[333] I.e., it could be that, while the way the benefits are designed to work are not all that different from past benefits from prior independent director changes, and that the costs are not that much greater than past changes' costs, the costs in the case of the 2004 Amendments outweigh their benefits, thus causing the industry's outcry.

directors is that they are beholden to management despite nominal independence, that should be changed by how they are selected (as was done under Rule 12b-1 and the 2001 Amendments) or how they are defined (as was done with the 1970 amendments). Once the ability to outvote management is in place, a "greater potential for outvoting" seems to add little to the mix; a culture of independence may be fostered better in other ways.

It may not be that absolute costs (or even costs relative to the benefits received) are out of line with past changes. However, the speed in which the SEC promulgated the 2004 Amendments, and the resultant lessening of the industry's ability to force a compromise as to the costs it bears under the 2004 Amendments is a break from the drawn-out processes and compromises that went into past alterations to the independent director requirements.

The SEC's use of authority in the promulgation of the 2004 Amendments is similar that in the 2001 Amendments (broadly regulating corporate governance through conditions on exemptive rules), but dissimilar from many past changes which were either 1) legislation passed by Congress that the SEC influenced; or 2) narrowly-tailored conditions relating to specific transactions.

What, if anything, underlies these differences? Glassman's and Atkins' statement that "We fear that the Commission is acting simply to appear proactive,"[334] has a persuasive ring in light of the differences discovered between the 2004 Amendments and previous independent director alterations. Perhaps, in the wake of the widely-publicized 2003 fund scandals,[335] the SEC rushed to its tried-and-true strategy of responding to management abuses or potential abuses in the industry by attempting to "strengthen" the role of independent directors in a broad manner,

[334] *See* 2004 Amendments, *supra* note 1.
[335] The ICI reported that more than three-fourths of fund owners were aware of the scandals. *See* Investment Company Institute, *Shareholder Sentiment of the Mutual Fund Industry*, FUNDAMENTALS: INV. COM, INST. RESEARCH IN BRIEF 3 (Oct. 2004), *available at* http://www.ici.org/pdf/fm-v13n4.pdf (last visited April 21, 2005).

without legislative assistance or discussions with the industry. In this case, however, there seems to be little value to the composition and chair requirements, given the current level of independence on boards. But in the rush to appear responsive to the scandals, the SEC may have overlooked this mismatch between the changes to independent director requirements and the benefit they were designed to impart. The rush also may have resulted in them not taking enough time to negotiate with the industry, prior to promulgating the rules. The SEC notes that "[t]hese benefits [of "vigilant and informed oversight by a strong, effective and independent fund board"] may increase investor confidence in fund management."[336] The dissent responds by stating that "[u]nder the cover of 'good atmospherics' and the and the shroud of 'investor protection,' the majority has decided to adopt measures the benefits of which are illusory, but the costs of which are real. We … fear that it provides investors with a false sense of security."

In light of the differences this paper has shown between the 2004 Amendments and past changes to the independent director requirements, this statement seems to accurately sum up the SEC's most widely-derided response to the mutual fund scandals of 2003.

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[336] *See* 2004 Amendments, *supra* note 1. *But see Shareholder Sentiment of the Mutual Fund Industry*, *supra* note 335, at 1 (stating that even after the fund scandals, 72 percent of fund owners had a favorable view of the fund industry). The SEC might argue, though, that some of that favorable view is the result of the SEC's quick response to the scandals. Or, the SEC might point out that over half of the ¾ of fund shareholders aware of the fund scandals of 2003 had a lower opinion of the industry after the scandals, necessitating SEC action. *See id.* at 3.