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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

John E. Logan

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September 30, 1999

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, D.C. 20554

Re: *Ex Parte* submission
North American Numbering Administrator
CC Docket 92-237
NSD File No. 98-151

Dear Ms. Salas:

On September 29, 1999, Dr. H.G. Miller, Vice President, Mitretek Systems, and I met with representatives of the Common Carrier Bureau to discuss the above matter. At the meeting were Mr. Yog Varma, Ms. Diane Griffin Harmon, Ms. Tejal Mehta, Ms. Jeannie Grimes, and Mr. Les Selzer. In the meeting we conveyed the position Mitretek that the present proposal of the incumbent North American Numbering Administrator (NANPA) violates the neutrality standard required of the NANPA. The enclosed documents were discussed at the meeting.

The necessary copies are enclosed.

Respectfully,

John E. Logan

John E. Logan

Enclosures
Copy to: Mr. Varma, Ms. Griffin, Ms. Mehta, Ms. Grimes, Mr.Selzer

No. of Copies rec'd 0+3
List ABCDE

**Control and Ownership of NeuStar**

1 NeuStar Board of Directors
- In order to be independent of Warburg Pincus, the proposed NeuStar board must be structured so that independent directors make up a clear majority
  - Minimum of three independent directors out of five of both the initial board and all successor boards
  - Directors are only independent of Warburg Pincus if Warburg Pincus cannot exercise control over their selection
- Will the initial and successor boards contain a minimum of three independent directors? No.
  - Two direct representatives of Warburg Pincus
  - One "independent" director initially named as Jeffrey Ganek selected by Warburg Pincus
  - Two "independent" trustees initially selected by Warburg Pincus
- Can Warburg Pincus exercise control over of the "independent" directors and "independent" trustees? Yes.
  - No "independent" trustee or director can be elected without the approval of one of the two direct representatives of Warburg Pincus

2 Independent Voting Trust
- Warburg Pincus may cede voting control over its shares to an independent voting trust
- For the trust to be truly independent, Warburg Pincus must give up control over:
  - Who serves as an independent trustee (i.e., appointment authority – Warburg Pincus must cede power to remove them or to determine their successors in the event of removal, resignation, expiration of term, or death)
  - How trustees are compensated
- Does Warburg Pincus cede appointment authority? No, the proposed trust does not cede appointment control:
  - A simple majority of the NeuStar board of directors can remove a trustee without cause at any time, and Warburg Pincus can control the NeuStar board of directors
  - Successor trustees are selected by the vote of a simple majority of the NeuStar board
  - According to the Trust Agreement, no trustee can be selected without the approval of a representative of Warburg Pincus, giving Warburg Pincus veto power
- The second essential criterion that must be met for the trust to qualify as independent is that Warburg Pincus must be unable to influence the level of compensation received by the trustees
  - Warburg appears to have agreed to this condition
- Additionally, Warburg Pincus has limited the scope of trustee responsibilities

# Securities Regulation

## *Cases and Materials*

**Second Edition**


**James D. Cox**
*Professor of Law*
*Duke University*

**Robert W. Hillman**
*Professor of Law*
*University of California, Davis*

**Donald C. Langevoort**
*Lee S. and Charles A. Speir*
*Professor of Law*
*Vanderbilt University*



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1 2 3 4 5

To Bonnie, Olympia, and Joni

2. *Freedom of Speech.* The regulation of invesment advisers is only one — albeit the most visible — of many areas where there is a tension between the values underlying securities regulation and the values underlying the First Amendment. Under the Securities Act, for example, a "quiet period," is imposed upon issuers and underwriters prior to filing a registration statement, barring many otherwise innocent forms of publicity. The content of the registration statement is carefully reviewed by a government agency, with changes often compelled; "free writing" and numerous other communications are prohibited while this review is ongoing. This is far from a free market of (economic) "ideas," but the assumption is that such regulation is permissible. Why?

Similar problems arise in the market regulation field. The SEC carefully controls the dissemination of market-related information, insisting on certain formats and inclusions to promote the goal of a competitive national market system. Indeed, there is a specific requirement in Section 11A(b) of the Securities Exchange Act, added as part of the Securities Acts Amendments of 1975, that so-called securities information processors — persons engaged in the business of collecting and disseminating information relating to market activity (transactions, prices, quotations), with certain exceptions — register with the Commission and adhere to its rules.

And then there is the subject of proxy regulation. Proxy solicitations — broadly defined — are subject to precommunication filing and review requirements and, where necessary, restraint and injunction. Here disputes can become plainly political. In *Long Island Lighting Co. v. Barbash,* 779 F.2d 793 (2d Cir. 1985), the court dealt with whether the proxy rules were violated when a person placed in a newspaper an antinuclear advertisement that, arguably, was intended to influence the election of directors of a public utility. The district court rejected plaintiffs' claim on First Amendment grounds, holding that the procedures required by the rules (prepublication filing with the Commission, etc.) could not properly be required for this sort of political speech. The Second Circuit reversed, remanding to the trial court for a determination of whether or not a solicitation was involved, which the court viewed as a prior determination necessary to resolving any First Amendment claim.

Finally, there is the fraud context. While clear-cut falsehoods might be outside the protection of the First Amendment, what about nondisclosure of conflicts of interest — a case like *Capital Gains,* involving a scalping problem, or one like *Zweig v. Hearst Co.,* 594 F.2d 1261 (9th Cir. 1979), noted in earlier chapters, involving a journalist who failed to tell his readers that he owned securities in companies that were the subjects of his columns.

Is there a coherent way of accommodating securities regulation and the First Amendment? Is government supervision presumptively justified simply because the speech in question seeks to part people from their money? The literature is only beginning to build. *See* Neuborne, The First Amendment and Government Regulation of Capital Markets, 55 Brook. L. Rev. 17 (1989) (part of a symposium on the subject); Symposium: The First Amendment and Federal Securities Regulation, 20 Conn. L. Rev. 261 (1988); Schoeman, The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933, 41 Bus. Law. 377 (1986); Note, A Political Speech Exception to the Regulation of Proxy Solicitations, 86 Colum. L. Rev. 1453 (1986); Lively, Securities Regulation and the Freedom of the Press: Toward a Marketplace of Ideas in the Marketplace of Investment, 60 Wash. L. Rev. 843 (1985).



### PROBLEM

**17-4.** Herb Finemon is a well-known freelance business writer in California. In November 1988, he wrote a story that was printed in a local Los Angeles business weekly that included favorable information about a particular small start-up company located in Southern California. Shortly before publication, Finemon bought a substantial amount of stock in that company; after the article was published, the market price of the stock rose substantially. Soon after that, Finemon sold at a considerable profit. Within six months, the stock price dropped precipitously after it was discovered that there was little basis for the optimism expressed in the article. Upon investigation, government officials concluded that Finemon honestly believed that the upbeat information he received from company officials — which was the basis for the optimistic statements in the article — was accurate. Has Finemon violated any provision of the federal securities laws? Are any First Amendment interests at stake?

## B. *Mutual Funds and Other Investment Companies*

There are many types of institutional investors, and it is well recognized that regulation is required to deal with the potential for abuse when persons manage large pools of other people's money. *See* Clark, The Four Stages of Capitalism, 94 Harv. L. Rev. 561 (1981). For the most part, however, the substantive task of regulating the activities of financial institutions (e.g., bank trust departments, pension funds, insurance companies) has not been made part of securities regulation. The exception is the investment company. Pursuant to the Investment Company Act of 1940 ('40 Act), investment companies are subject to an intense degree of federal oversight in their day-to-day governance and operations, even though they are also chartered or established (and thus also regulated) as business associations under state law. This assignment to the SEC no doubt reflects the fact that unlike the other principal types of financial institutions, the investment company performs no significant economic or social function apart from its role as an institutional investor.

Before turning to the specifics of investment company regulation, one question that could be asked is why have such special federal regulation at all. Given the lack of a separate societal interest rising to the level of national significance (e.g., control over the money supply by banks, protection of retirement savings for pension funds), why should we treat investment companies any differently from other issuers of securities, where basic issues of governance are left to state law (albeit with the disclosure-oriented supplementation of the federal securities laws)?

The answer, as usual, is to be found in some mix of history and politics. The legislative deliberations of the early 1930s uncovered substantial evidence of abuse by promoters of investment companies, and the newly created SEC persisted in its desire to bring the activities of such entities under federal control. *See* J. Seligman, The Transformation of Wall Street 222-229 (rev. ed. 1995). In large part, this desire stemmed from the same sort of suspicion (or evidence) that often leads to special regulation of financial institutions: the belief that control of large, liquid pools of capital is particularly appealing to those with dishonest motives, since self-dealing and misuse are much harder to detect than in situations where most of the company's assets are in the tangible form of something like a steel mill. There is also the fear of the economic power that comes from concentrated share ownership, even if legitimately exercised. *See* Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. Pa. L. Rev. 1469 (1991).

The materials that follow are not intended to be exhaustive of the subject of investment company regulation. The '40 Act is one of the most complicated and technical of all the securities statutes. One reason for this, among many, is Section 6(c), which gives the Commission plenary exemptive authority under the Act, either through rule or order, and with the attachment of such terms and conditions as it sees fit in the public interest. As a result — unique to the '40 Act — the Commission has the ability over time to refine or reformulate the entire regulatory structure, and it has exercised this authority in some form or another under a large portion of the Act's provisions.

Instead, these materials will concentrate on the principal regulatory strategies under the '40 Act that represent striking departures from those applied to corporations generally under state law. As you study them, try to assess the soundness of those choices, keeping in mind the fast-growing importance of the mutual fund — the primary form of investment company — as an investment vehicle in the United States. From fewer than $100 million in assets at the end of the 1970s, the mutual fund industry has now passed the $3 *trillion* mark, with more than 25 percent of all American households holding fund shares. Recent changes in ERISA rules are likely to encourage even more retirement savings through defined contribution plans, which are the domain of the mutual fund, further accelerating the growth of this market. *See* Rock, Foxes and Hen Houses?: Personal Trading



by Mutual Fund Managers, 73 Wash. U. L.Q. 1601, 1601-1602 (1995). Fortunately, we are guided in the task of assessing the regulatory structure by the fact that the SEC itself recently completed its own thorough reevaluation to ensure its contemporary efficacy. The SEC staff report entitled Protecting Investors: A Half-Century of Investment Company Regulation (May 1992) contains numerous recommendations for modernization, reconceptualization, and refinement, some of which have already been put into place.

The dominating issue in all of this — as in so much of securities regulation generally — is how much to rely upon the discipline of the marketplace, aided by mandatory disclosure, to control the behavior of investment companies and how much substantive supplementation is needed. If there is one thing clear about the industry, it is competitive, and mutual funds, at least, must constantly search for new money. There are many and varied companies competing for investor funds, and new entrants appear constantly. The financial press regularly evaluates fund performance, and substantial evidence shows that investors as a group are sensitive (perhaps hypersensitive) to evidence of good performance. To a disproportionate degree, new money flowing into mutual funds goes to funds that recently have outperformed their competitors. *E.g.*, Gruber, Another Puzzle: The Growth of Actively Managed Mutual Funds, 51 J. Fin. 783 (1996); Ippolito, Consumer Reaction to Measures of Poor Quality: A Study of Mutual Fund Performance 1965-84, 35 J.L. & Econ. 45 (1992). This might suggest that a disclosure regime should be sufficient, supplemented by the kinds of fiduciary duties of loyalty and care normally imposed upon managers — not a system of detailed and burdensome federal standards governing the structure and behavior of mutual funds and other investment companies. *See generally* W. Baumol et al., The Economics of Mutual Fund Markets: Competition Versus Regulation (1990).

Before making any judgments, however, consider two things. One is the teachings of the efficient market hypothesis. Whatever the theoretical debate about market behavior, evidence is slim that investors systematically benefit from the research that justifies the relatively high advisory fees charged by many funds. On average, actively managed mutual funds underperform the market. Thus, most have reason to be disappointed in what their funds deliver for what they charge, although there is some evidence that top-performing funds do deliver above-average returns with surprising consistency. *See* Gruber, supra; Elton, Gruber, & Blake, The Persistence of Risk-Adjusted Mutual Fund Performance, 69 J. Bus. 133 (1996); Hendricks, Patel, & Zeckhauser, Hot Hands in Mutual Funds, 48 J. Fin. 93 (1993). Second, there seems to be an asymmetry in the movement of funds in response to performance: While top performers do attract a large percentage of new investment, investors are not quick to sell shares of poor ones. *See* Ippolito, supra, at 61-62; Rock, supra, at 1618-1619. Professor Gruber argues that this is evidence of a two-tiered market for mutual funds, one quite sophisticated, the other "informationally disadvantaged," with no opportunity to arbitrage the difference because of the way mutual fund shares are priced and sold. Gruber, supra, at 807. Do these observations suggest any dilemmas with respect to regulatory intervention?

## 1. The Terminology of the '40 Act

In many ways, the model of investment company regulation is the same as that for broker-dealers and investment advisers. That is to say, it is unlawful under Section 7 of the Investment Company Act for any investment company to engage in a wide range of activities considered characteristic of such companies unless it has registered with the SEC. Impermissible activity by an unregistered investment company can lead to a wide variety of civil and criminal penalties, and any contract made in violation of the Act is voidable.

This makes the definitional question a crucial one, and, unfortunately, Section 3 of the Act is quite complicated in this respect. Because most investment companies are unmistakably such, it would be distracting at the outset to delve into the definitional margins and detailed exemptions. That we will do at the end of the chapter, once the basic structure of regulation is understood. For now, let us concentrate on some basic concepts and terminology.

The '40 Act separates investment companies into a variety of categories upon which variations in substantive regulation may well turn. Under the statute, there are three levels of separation. First, there are types of investment companies. One type is the unit investment trust, which arises when interests in a fixed group of securities are deposited with a trustee and sold. These are not managed (i.e., there is no turnover of the portfolio). Unit investment trusts are increasing in popularity and use. *See* Harman, Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Vehicles, 1987 Duke L.J. 1045. But the overwhelming majority of investment companies are referred to as management companies. And among these, there is an important subclassification found in Section 5(a). *Closed-end companies* are those that issue a fixed number of shares to their investors (which may be increased from time to time through new issues). Closed-end company shareholders wishing to dispose of their shares therefore must find some third-party purchaser; such shares are often listed on exchanges to facilitate secondary trading. By contrast, an *open-end company* — better known as a mutual fund — is one that continuously sells new shares to the public and stands ready to redeem its shares from shareholders at current net asset value. In that event, no secondary market develops; all purchase and sale transactions are with the issuer. The mutual fund is far and away the dominant type of management company and, as noted in the previous section, has been the fastest-growing category of institutional investor. For this reason, we shall concentrate in the materials that follow on the mutual fund as the prototypical form of investment company.

Next, there is a distinction set forth in Section 5(b) between diversified



and nondiversified management companies. A *diversified company* is one in which at least 75 percent of the company's assets are invested in cash and securities, where the calculation is limited in respect to any one issuer of securities acquired by the investment company to an amount not greater than 5 percent of the investment company's assets and 10 percent of the outstanding voting securities of such issuer. Virtually all mutual funds are diversified companies. In part, this is because diversification is appealing to investors as a means of reducing risk, but an equally important incentive is found in the Internal Revenue Code, which limits favorable pass-through tax treatment (i.e., no separate tax at the investment company level with respect to income that is distributed to shareholders) to investment companies that meet similar diversification requirements.

Although not reflected in the statute itself, mutual funds may be subdivided further into categories based upon their investment portfolios. Equity funds are those largely invested in common stocks, although almost inevitably other investments will be present as well. Among these, one would find aggressive "growth" company funds, more conservative blue-chip-type funds, those specializing in specific sectors of the economy, and so-called global funds, which invest largely in foreign securities markets. Bond or "income" funds also run quite a gamut, with separate markets for taxable and tax-free bonds as well as those that focus on high-yield debt. Finally, there is the phenomenon of the *money market mutual fund,* which invests in highly secure, short-term government and private debt instruments, thus offering investors a product that bears a strong resemblance to a bank account, albeit without federal deposit insurance. Many mutual funds are part of large "families," where investors are given substantial freedom to switch money from one fund to another as investment needs and preferences change.

Of particular note here is Section 13 of the '40 Act. That provision prohibits any investment company from changing its open/closed or diversified/nondiversified status without the affirmative approval of its shareholders. It also imposes such an approval requirement upon certain actions (though not all) that would constitute a deviation from its fundamental investment policy as set forth in its registration statement. Courts have implied rights of action on behalf of fund shareholders to enjoin impermissible deviations. *E.g., Potomac Capital Markets Corp. v. Prudential-Bache Corp. Fund,* [1989-1990] Fed. Sec. L. Rep. (CCH) ¶94,837 (S.D.N.Y. 1989).

## 2. The Structure and Management of a Mutual Fund

To understand the nature of the mutual fund industry and the associated regulatory problems, it is first necessary to consider how and why mutual funds are established in the first place. By and large, the incentive to enter the industry is the promise of compensation for successfully managing a portfolio of investments. To this end, the sponsor or promoter typically organizes the investment company (usually under state corporate law, although the Massachusetts business trust is also a common form) and installs the initial board of directors. With this, the process of selling shares to the public begins, generating the money to be reinvested. But unlike the typical business corporation context, the sponsor does not expect to retain any equity interest in the investment company or seek executive office. Rather, the initial board of directors enters into a management contract with the promoter whereby the sponsor — now called the adviser — manages the fund (i.e., makes all investment decisions on its behalf) in return for a management fee determined by reference to the assets of the fund. It is the expected return from this contract, together with income from any activities related to distributing the fund's shares or transacting its business, that justifies the expenses incurred in sponsoring the fund initially. *See* Schonfeld & Kerwin, Organization of a Mutual Fund, 49 Bus. Law. 107 (1993).

What this means is that the mutual fund shareholders come to own all the equity of the mutual fund and are represented by a board of directors whom they are entitled to elect. But in all but a few instances, the fund itself is inactive in terms of internal management. All visible activity relating to the operation of the fund will be found in the sponsor's offices.

At first glance, this seems to leave the adviser in an exposed position, since under Section 15(a) of the '40 Act such contracts cannot be more than two years in duration and must be approved periodically by the company's board of directors and its shareholders. But in fact, terminations of advisory contracts are extremely rare. In large part, this is a function of rational shareholder apathy and the resulting self-perpetuation of the board initially chosen by the sponsor. Even more than with respect to the average business corporation, shareholders of mutual funds lack any meaningful incentive to express dissatisfaction with incumbent management by any means other than demanding redemption of their shares or, in some cases, instituting a lawsuit. From time to time, mutual funds have been unable to achieve the quorum necessary to hold their annual meeting because so many investors simply neglected to return their proxy cards.

Coupled with the Investment Advisers Act (which regulates the activities of fund advisers), the Investment Company Act exists in order to compensate for the perceived inadequacy of shareholder voting rights in this setting as a mechanism for addressing managerial conflicts of interest and the possibility of misbehavior. Indeed, it has been seriously suggested that voting rights be eliminated entirely in the mutual fund context. *See* Phillips, Deregulation Under the Investment Company Act — A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 Bus. Law. 903, 908-910 (1982). While this has not been done (and the Commission's 1992 staff report recommends that it not be done), it is worth noting that some states (including the most important ones for investment companies, Maryland and Massachusetts) allow investment companies to



Act. It seems clear that the Act relies largely upon other forms of control in order to be effective.

The starting point for analyzing the issue of governance under the '40 Act is an important structural rule. Under Section 12(d) of the Act, investment companies are generally prohibited from making more than de minimis investments (defined in terms of impact upon both acquiror and acquiree) in other registered investment companies. This antipyramiding rule, which was amended in 1996 to facilitate interlocking investments in a family of affiliated funds, is designed to ensure that control of investment companies resides in the hands of the public investors, rather than other investment companies, and to prevent a "domino effect" for redemptions (i.e., a fund facing the need for cash as a result of an unexpectedly high rate of redemptions by its shareholders might have to redeem its shares in the other mutual fund, causing that fund to need more cash, and so on). One effect of the rule is to create a stumbling block to the hostile takeover of an investment company, since it is so easy for an acquiring company to itself fall within investment company status. *See Bancroft Convertible Fund Inc. v. Zico Inv. Holdings Inc.*, 825 F.2d 731 (3d Cir. 1987). The antipyramiding rule is supplemented by statutory restrictions on the issuance by investment companies of senior securities, such as bonds or debentures. As set forth in Section 18(f), this restriction is for all practical purposes absolute (except insofar as certain bank loans are concerned) for mutual funds.

Having mandated a relatively simple capital and control structure, the '40 Act then seeks to ensure that the public owners of fund shares will be duly represented in its governance. One mechanism for this is a set of rules governing the composition of the board of directors of an investment company. Under Section 10(a), no more than 60 percent of the board may be "interested persons" of the company — a defined term found in Section 2(a)(19) that broadly covers persons whose affiliation, employment, or family relationship with the company; its adviser; or its underwriter could reasonably be expected to create a conflict of interest. This requirement is waived with respect to a limited class of mutual funds (those, for example, that charge no sales loads, pay no salaries or expenses of the adviser, and pay advisory fees of not more than 1 percent of net asset value). These need have only one disinterested director. The introduction of the statutory concept of "disinterested" director was a conscious effort by Congress in 1970 to offer additional protection to fund shareholders; before that, a more forgiving notion of "unaffiliated" director had prevailed in the statute. Recently, the SEC has given consideration to asking Congress to require that a majority of directors be disinterested. SEC Staff Study, supra, at ch. 7.

Disinterested directors are assigned crucial roles under the Act. Most importantly, Section 15 requires that the directors of the fund approve the initial entry into an advisory contract and each renewal, and this approval must be by a majority of the disinterested directors. The duty to approve carries with it a correlative obligation "to request and evaluate . . . such in-

[such] contract," coupled with an obligation on the part of the adviser to provide such information upon request. The disinterested directors must also select the fund's independent accountants (Section 32(a)). In addition, as we shall soon see, a long series of SEC rules assigns responsibilities to the disinterested directors with respect to a variety of types of transactions that pose conflict of interest problems.

Beyond these statutory and rule-based responsibilities, the courts have also emphasized the special roles of disinterested directors. For example, decisions involving some form of conflict of interest can be resolved only by the disinterested directors, and they are owed a duty of full disclosure by the investment adviser. In *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), *cert. denied*, 404 U.S. 994 (1972), for example, the court held an investment adviser liable for failing to cause the fund to take steps to "recapture" certain brokerage commissions. *Recapture* is the process of using the fund's bargaining power to require its brokers to give up certain of their commissions to third parties, who in turn would provide something of value to the fund — a practice that had been authorized by the NASD. In speaking of the adviser's relationship to the unaffiliated directors, the court said:

> Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion is unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund. . . . Except where it may be fairly assumed that every affiliated director will have such knowledge, effective communication is called for. And, in testing that assumption, it must be borne in mind that they are not full time employees of the fund and it may be — as with the Fund's unaffiliated directors — that neither their activities nor their experience are primarily connected with the special and often technical problems of fund operation.

Id. at 376-377.[1]

1. The "give-ups" problem was illustrative of a broader issue, the extent to which investment company advisers could direct brokerage to higher-charging brokers in return for "soft dollar" payments. In 1975, the industry won some protection for this practice via Section 28(e) of the Securities Exchange Act, which protects an investment manager from a charge of fiduciary breach if the manager determined in good faith "that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member . . . viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts for which he exercises investment discretion." Is this too much protection? What about directing brokerage to firms that provide research advice to advisers at seminars in the Caribbean? Or provide them computer equipment and software that reduces the money manager's own expenses? *See* Exchange Act Release No. 23,170 (Apr. 23, 1986); In re Goodrich, 46 S.E.C. Dock. 760 (1990) (allegations that order flow was traded for marketing and training seminars for advisory employees).



As the materials on fiduciary responsibility that will follow shortly make clear, courts have also adopted a posture of deference to the decisions of the unaffiliated directors as a means of cleansing the self-dealing taint that would otherwise call into question transactions involving the fund and its adviser so long as the kind of disclosure called for in *Moses* occurs. In *Burks v. Lasker*, 441 U.S. 487 (1979), for instance, the Supreme Court ruled that the independent directors of any investment company could, consistent with federal law, terminate a shareholders' derivative suit in an appropriate case over the objections of the plaintiffs. After a lengthy exposition of the role of the disinterested director under the '40 Act, the court concluded that Congress intended such directors to assume the position of independent "watchdogs" over the fund, adding that "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." Id. at 485.

How successful is this approach? Given what you recall from your corporations course about corporate governance, do you agree that such deference is warranted? Especially if shareholders seem to have so little to do in practice with the selection of the outside directors? A number of commentators have expressed doubts. *E.g.*, Brudney, The Independent Director — Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 617-619 (1982) (pointing out that few, if any, instances of investment adviser misconduct show that "independent" directors tried to do much to stop it). On the other hand, could it be that marketplace discipline in the mutual fund context is sufficiently strong that decisions by those without a direct pecuniary interest in a transaction can in fact be trusted to generate an arm's-length result? We shall return to these questions when we explore the fiduciary obligations of those who manage investment companies and the disclosure philosophy of the '40 Act.

The SEC has concluded that full disclosure in this area is vitally important and has given increasing attention to providing investors with information so that they can evaluate the performance of those who run and those who advise their funds. In 1993, for example, the Commission adopted a requirement that fund annual reports include a management discussion and analysis of fund performance and standardized performance data, including graphic comparison of the fund's performance to a broad-based securities market index. Funds are also required to disclose the identity of the individual person or persons primarily responsible for the day-to-day management of the fund's portfolio. Query, why this latter requirement? Are there any hidden costs to such a requirement? *See* Kitch, The Theory and Practice of Securities Disclosure, 61 Brook. L. Rev. 763, 834-836 (1995). And with increased attention to derivatives and other risky financial products, the SEC has also stepped up its requirement that funds effectively disclose the riskiness of their portfolios. On the question of risk, could the hypercompetitiveness of the market for new money result in mutual fund managers increasing their levels of risk excessively if they fear that they may be lagging behind their peers? *See* Brown et al., Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry, 51 J. Fin. 85 (1996).

There is one other approach to the question of who can govern that represents a noteworthy departure from state law. Section 9(a) of the '40 Act bars from association with a registered investment company any person who (1) has been convicted of a securities-related crime within the last ten years or (2) is subject to a permanent or temporary injunction by a court with respect to securities-related activity. This automatic bar is ameliorated, however, by Section 9(c), which gives the SEC the power to remove this bar, upon such terms and conditions as it sees fit, if it makes a finding that the impact of the bar is "unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application." Section 9(b) gives the Commission discretionary authority to bar any person from association with a registered investment company upon a finding of a willful violation of the federal securities laws. In this regard, the authority of the Commission over persons affiliated with investment companies is much the same as that over broker-dealers and investment advisers.

### *PROBLEM*

**17-5.** Consider whether any of the following persons is a "disinterested" person with regard to a mutual fund for purposes of Section 10(a):

a. the spouse of an attorney who acts as the principal outside counsel to the fund's adviser;
b. the chief executive officer of an industrial company if the fund owns 5.5 percent of the voting shares of that company;
c. a person who is otherwise disinterested, but who also serves on the board of directors of a number of other funds in the same fund complex.

## 3. Sales and Redemptions of Mutual Fund Shares

### *a. Prices and Distribution Charges*

The system of pricing and distributing mutual fund shares is fixed firmly by a combination of statute and SEC rules. Section 22(d) essentially limits the sale of mutual fund shares to the public at the current offering price described in the prospectus, thus imposing a system of retail price maintenance for the distribution of fund shares — eliminating the possibility of direct price competition by those distributing the fund's shares. (This regime is controversial, and the SEC staff has called for its abolition. SEC Staff Report, supra, at ch. 8.) Within this framework, in turn, the most important regulatory requirement in practical terms is Rule 22c-1, which provides, with limited exceptions, that both sales and redemptions of fund shares must occur at the net asset value that is *next* computed after the receipt of the order or tender. In general, net asset value must be computed no less than once daily (Monday through Friday) at the time prescribed by the fund's board of directors.



The fund's pricing discretion, then, is effectively limited to issues relating to sales charges and expenses. Here there are a number of variations. Some funds are classified as "load" funds and charge the investor a certain percentage of the purchase price of the security. This load is used to compensate those involved in the selling of the security: the underwriters, brokers, and dealers — who may or may not be affiliates of the sponsor. Section 26 of the NASD Rules of Fair Practice limits the maximum sales charges that can be imposed upon mutual fund shares to 8.5 percent. In 1985, the SEC adopted Rule 22d-1, which permits variations or the elimination of sales loads with respect to "particular classes of investors or transactions" so long as all participants in the distribution apply the scheduled variation to all offerees of the specified class and there is full disclosure of the variation and its impact. An alternative to the front-end load is the so-called contingent deferred sales charge, pursuant to which the investor is charged a fee upon redemption. The fee typically varies over time, diminishing the longer the investor holds the mutual fund shares.

Funds that charge no sale or redemption fee are referred to as "no-load" funds. For the most part, this occurs when the fund itself or its affiliates undertake to internalize most or all of the advertising and marketing expenses associated with the sale of shares, seeking compensation for this elsewhere. One of the most notable recent developments in mutual fund marketing is the distribution of multiple classes of shares in the same fund, where the differences among classes relate largely to expense charges. Some shares might be no-load and sold via advertising to one market segment, while others with distribution charges would be sold by a brokerage sales force targeting different groups of investors. See SEC Staff Report, supra, at 330-332. An alternative that accomplishes much the same result is the so-called hub-and-spoke structure, which establishes a number of affiliated funds with separate expense structures, each of which in turn purchases shares in a master portfolio.

The question of the financing of distribution expenses other than through front-end or deferred sales loads is an extremely controversial regulatory issue. Historically, the SEC had taken the position — with support from the legislative history of Section 12(b) — that distribution expenses, such as advertising, printing and mailing costs, and commissions and other compensation paid to sales personnel to promote sales of fund shares, should not be borne by the fund itself. The underlying rationale no doubt was concern about conflict of interest, since a principal beneficiary of increased sales of fund shares is the adviser, and, thus, a level of expenditures might be made that would be unjustified in terms of benefit to the fund's shareholders. In 1980, however, the Commission adopted Rule 12b-1, permitting in certain circumstances a distribution fee to be charged to the fund's shareholders as a group. In operation, the Rule works as follows:

> As adopted, rule 12b-1 makes it unlawful for an open-end management investment company to act as a distributor of securities of which it is the issuer, other than through an underwriter, unless any payments by the company in connection with the distribution are made pursuant to a written plan that describes all material aspects of the proposed distribution financing and that is adopted in accordance with the rule. The rule provides that a fund will be deemed to be acting as a "distributor of securities of which it is the issuer, other than through an underwriter," if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of fund shares.
>
> Rule 12b-1, as adopted, reflects the Commission's heavy reliance upon fund directors, particularly disinterested directors, to protect the interests of the fund and its shareholders and to minimize the conflicts of interest that would exist if the fund's investment adviser were to make the decisions of whether and to what extent the fund should bear distribution costs. Thus, the rule provides that a fund's 12b-1 plan and all related agreements must be approved initially by a majority of the fund's board of directors and by a majority of the fund's disinterested directors. The plan must also be approved initially by the holders of a majority of the fund's outstanding voting securities. Finally, the 12b-1 plan must provide, in substance, that it will continue in effect for more than one year *only* if it is approved annually by a majority of the fund's board of directors and of the disinterested directors.
>
> Rule 12b-1 places on fund directors a duty to request and evaluate such information as is reasonably necessary to make an informed determination of whether to adopt or continue a 12b-1 plan. The rule also instructs the directors to consider and give appropriate weight to all pertinent factors in deciding whether to implement or continue a 12b-1 plan, and provides that fund directors may implement or continue such a plan only if the directors who vote in favor of the plan find that there is a reasonable likelihood that the plan will benefit the fund and its shareholders. Additionally, the rule requires every 12b-1 plan to provide that it may be terminated at any time by a vote of a majority of the fund's disinterested directors or of the fund's outstanding voting securities. Each plan must also provide that it may not be amended to increase materially the amount to be spent for distribution without shareholder approval and that all material amendments to the plan must be approved by a majority of the fund's board of directors and of the disinterested directors.
>
> The rule also requires a fund relying on the rule to commit the selection and nomination of its disinterested directors to existing disinterested directors. This requirement was intended to increase the likelihood that a fund's



> disinterested directors would be able to act independently of fund management. The Commission considered such independence essential, given the shareholder protection role assigned to the disinterested directors by the rule.
>
> Rule 12b-1 states that each 12b-1 plan and related agreement must require all persons authorized to direct the disposition of money paid or payable by the fund ("12b-1 payments" or "12b-1 fees") to provide the fund's board of directors with a quarterly report of the amounts expended and the purposes for which expenditures have been made. . . .
>
> In addition to adopting rule 12b-1, the Commission adopted the related disclosure and reporting requirements essentially as proposed. The Commission also restated the position (which it later reversed) that it would be inappropriate for a fund that finances the distribution of its shares to hold itself out as "no-load" or use equivalent terminology.

Investment Company Act Release No. 16,413, [1988-1989] Fed. Sec. L. Rep. (CCH) ¶84,243 (June 10, 1988). In terms of possible benefits to shareholders, it is possible that the increased sales generated by such marketing expenditures may create some efficiencies, such as lowering the per unit cost of research expenses charged to each shareholder or improving the liquidity position of the fund, so that management can concentrate on performance without having to worry excessively about an unexpectedly high level of redemptions. And for new funds, at least, the use of 12b-1 plans may obviate the need for front-end sales loads. As implemented, most 12b-1 plans have fallen into one of two categories. One is the *compensation plan,* whereby the fund allocates a percentage of its assets for distribution use, without necessarily requiring that such expenditures actually be made. The other is the *reimbursement plan,* which permits expenses to be charged as incurred, usually up to some specified limit. *See* Note, Mutual Fund Distribution Expenses: Shareholder Investment Costs and the Propriety of 12b-1 Plans, 22 N. Eng. L. Rev. 453 (1987).

The difficult 12b-1 issue is whether the amounts paid out pursuant to such plans are likely to be fair or not in relation to potential benefits to fund investors, given the influence that advisers may have even over these disinterested directors. Some evidence calls into question whether increased expenditures on sales and marketing do produce compensating benefits for fund shareholders. *See* Dukes & Wilcox, The Difference Between Application and Interpretation of the Law as It Applies to SEC Rule 12b-1 Under the Investment Company Act of 1940, 27 New Eng. L. Rev. 9 (1992) (finding a negative relationship between the adoption of a 12b-1 plan and performance); Malkiel, The Regulation of Mutual Funds: An Agenda for the Future, in Modernizing U.S. Securities Regulation 476 (K. Lehn & R. Kamphuis eds., 1993) ("What has been happening is that . . . new 12b-1 distribution charges have been imposed that greatly exceed any potential gain from the economies of scale that could come from an expanded asset base.") Recognizing some basis for concern, the SEC has heightened the disclosure requirements regarding all investor- and fund-borne charges — including advisory fees and 12b-1 charges — which must be presented in tabular form in the synopsis found at the beginning of the fund's prospectus. The presentation of performance data (discussed below) must reflect these recurring charges. The NASD has also sought to address this issue in connection with its authority over maximum sales charges; in 1990, it reformulated its rules in Article III, Section 26(b)(4) and (d) of the Rules of Fair Practice to impose limits upon asset-based and deferred charges in much the way it does front-end loads (discussed above) and to restrict the use of the "no-load" label to ensure that it is not misleading. Query, is disclosure of fees likely to be an effective discipline? Would you suspect that average investors are likely to be blinded by performance measures and dismiss, or be confused by, fee-related information? Or should we trust the presence of a critical mass of sophisticated investors to provide adequate protection by forcing mutual funds to act reasonably in order to compete for those investors' money? On this latter question, remember the movement toward multiple class structures noted above. As a separate, but related, matter, note that the Commission has instituted enforcement proceedings where persons involved in distributions pursuant to 12b-1 plans allegedly have characterized certain of their expenses improperly as distribution expenses, rather than as administrative or management expenses. *See* Continental Equities Corp., [1988-1989] Fed. Sec. L. Rep. (CCH) ¶84,323 (Sept. 19, 1988) (settled admin. proc.).

### b. *Sales Literature and Advertising*

Mutual funds sell shares either through brokers (typically with load charges) or directly. Those that engage in direct marketing use advertising as their primary means of reaching potential investors. But because a mutual fund is by definition continuously engaged in the distribution of its securities, the entire process of selling is governed by the Securities Act of 1933. It is there, as a result, that are found many of the restrictions on what funds, underwriters, and dealers can and cannot do to promote their shares. Rules 480 through 494 set forth the standards for '33 Act compliance specifically applicable to investment companies.

Their standard registration form, in the case of the mutual fund, is Form N-1A — the same as its registration form for '40 Act purposes. The integration of the disclosure requirements under the two statutes is an important facet of investment company regulation, specifically authorized under Section 24 of the '40 Act.

Investment companies are given a choice between registering a specific amount of shares for distribution or an indefinite amount (*see* '40 Act, Rule 24f-2). Regardless of the choice, posteffective amendments become a matter of routine in order to keep the basic financial material in the prospec-



tus in compliance with Section 10(a)(3) of the '33 Act. And to aid in the decisionmaking of existing shareholders with respect to redemptions or reinvestment, as well as to promote the proper governance of mutual funds, funds are required to engage in semiannual disclosure to shareholders pursuant to Section 30(d). Such disclosure in turn also becomes part of the disclosure materials as the distribution process continues. Here, as we have already seen, the SEC has been quite aggressive in promoting disclosure on a variety of crucial topics — performance, fees, and (most recently) risk — in standardized form that hopefully allows for easy comparison among funds. In 1995, the Commission began experimenting with allowing funds to use a very abbreviated "profile" prospectus, which would contain little more than highlights of the formal disclosure, to make the sales process more user-friendly. *See* Investment Company Institute, SEC No-Action Letter, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,043 (July 31, 1995).

The most interesting of the distribution rules relate to permissible product advertising. As you will recall, selling material not accompanied or preceded by a prospectus is unlawful under Section 5 except pursuant to an exemption, and so far as mutual funds are concerned, essentially all product advertising is in the form of a prospectus, since shares are all the company sells. Regulation in this area is driven by a number of conflicting objectives. On one hand, the SEC has indicated a desire to promote advertising because of its pro-competitive effect. Given concerns about fiduciary responsibility, a vigorous marketplace may be the best discipline; aggressive advertising is particularly necessary, moreover, to allow no-load funds to compete effectively with broker-sold ones (since brokers are largely unrestrained in their oral solicitations). On the other hand, the Commission has also worried about the fairness of advertising, especially with respect to performance-related claims, and wants to get a significant amount of information into investors' hands before they make their investment decisions. Advertising that is too potent may further diminish the significance of prospectus disclosure.

The Commission has adopted a number of initiatives to strike the right balance. One exception for issuers generally that you may recall from Chapter 4, Rule 134, has a special exemption from the definition of prospectus for advertisements by investment companies that are designed to advise investors about the availability of fund shares and indicate the source for further information; subsection (a)(3)(iii) gives investment companies far more leeway in the sorts of descriptive information that can be included than is afforded other issuers — including permission to include "attention-grabbing" headlines, so long as the ads do *not* contain performance-related information. A special rule for investment companies, Rule 135A, further exempts "generic" advertising that avoids reference to the desirability of investing in a specific security.

Rule 482 permits funds to advertise performance data. It allows advertisements that include any material also found in the prospectus (which

# MEMORANDUM

INVESTMENT COMPANY INSTITUTE

[11082]

June 28, 1999

TO: INVESTMENT COMPANY DIRECTORS No. 7-99

RE: REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS

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As you know, mutual fund governance has been under increased scrutiny recently. In February, SEC Chairman Arthur Levitt convened a special Roundtable on the Role of Independent Investment Company Directors, and in March, he announced specific regulatory proposals addressing mutual fund board governance that the SEC would consider. He also challenged the industry to enhance the effectiveness of fund directors.

In response, the Institute formed an Advisory Group on Best Practices for Fund Directors, consisting of three senior industry executives and three independent directors. The Advisory Group was charged with reviewing current practices of investment company boards and identifying those practices that may be appropriately considered best practices for the entire industry. The Advisory Group's Report was released on June 24th. Its recommendations focus on those best practices that enhance the independence of independent directors and the effectiveness of fund boards as a whole. The recommendations cover practices relating to the structure of fund boards and the processes they follow. The Report did not seek to develop guidelines that would govern how fund boards should address specific issues (*e.g.*, brokerage allocation or portfolio valuation) as such issues were felt to involve considerations specific to each fund board.

A summary of the Advisory Group's recommendations follows:

**1. Supermajority of Independent Directors**

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

**2. Persons Formerly Affiliated with the Adviser, Principal Underwriter and Certain Affiliates**

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

### 3. Control of the Nominating Process by Independent Directors

The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

### 4. Compensating Independent Directors

The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

### 5. Fund Ownership Policy

The Advisory Group recommends fund directors invest in funds on whose boards they serve.

### 6. Qualified Independent Counsel and Other Experts

The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

### 7. Annual Questionnaire on Relationships with the Adviser and Other Service Providers

The Advisory Group recommends that independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, or other service providers and their affiliates.

### 8. Organization and Operation of the Audit Committee

The Advisory Group recommends (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

### 9. Separate Meetings of the Independent Directors

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

### 10. Lead Independent Director or Directors

The Advisory Group recommends that independent directors designate one or more "lead" independent directors.

11. **Insurance Coverage and Indemnification**

The Advisory Group recommends that fund boards obtain directors' and officers'/errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.

12. **Unitary or Cluster Boards**

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

13. **Retirement Policy**

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

14. **Evaluation of Board Performance**

The Advisory Group recommends that fund directors evaluate periodically the board's effectiveness.

15. **Orientation and Education**

The Advisory Group recommends that new directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

***

The Advisory Group is urging early action on its recommendations by the Institute's Board of Governors and the industry. The Board of Governors will convene July 7th to consider the Advisory Group's recommendations.

Craig S. Tyle
General Counsel

# Report of the Advisory Group on Best Practices for Fund Directors

## Enhancing a Culture of Independence and Effectiveness

June 24, 1999

**John J. Brennan**, Chairman of the Board of Governors, Investment Company Institute and Chairman and CEO, The Vanguard Group, Inc.

**Dawn-Marie Driscoll**, Independent Director, Scudder Funds

**Paul G. Haaga, Jr.**, Executive Vice President, Capital Research and Management Company

**Dr. Manuel H. Johnson**, Independent Director, Morgan Stanley Dean Witter Family of Funds

**William M. Lyons**, President and COO, American Century Investments

**Gerald C. McDonough**, Independent Director, Fidelity Funds

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## ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS -- REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS

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# EXECUTIVE SUMMARY

## FORMATION OF THE ADVISORY GROUP

The regulatory requirements governing investment company boards of directors are unique in the world of American business. Independent directors of investment companies in particular play a critical role in overseeing fund operations and policing conflicts of interest between the fund and its investment adviser or other service providers. In fulfilling this role, independent directors act as "watchdogs," protecting the interests of fund shareholders.

There is broad consensus that this governance system has worked well for investment companies and their shareholders. Nevertheless, this system, like any other, must periodically be reexamined to ensure its continuing effectiveness.

Toward that end, in February 1999, the Securities and Exchange Commission held a Roundtable on the Role of Independent Investment Company Directors in order to focus on the appropriate role of independent directors and their specific responsibilities. Shortly thereafter, SEC Chairman Arthur Levitt announced that the SEC would consider certain regulatory proposals to enhance the role of independent fund directors and called on the fund industry to work with the SEC to further enhance the effectiveness of fund directors.

At the same time, the Investment Company Institute[*] announced the creation of an Advisory Group on Best Practices for Fund Directors. The Advisory Group's mission was to

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[*] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,576 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.86 trillion, accounting for approximately 95 percent of total industry assets, and have over 73 million individual shareholders.

identify the best practices used by fund boards to enhance the independence and effectiveness of investment company directors, and to recommend those practices that should be considered for adoption by all fund boards. This Report carries out that mission. In preparing this Report, the Advisory Group considered various practices currently utilized by fund boards and other suggested practices. The Advisory Group consulted a variety of experts, including independent directors of investment companies, fund management representatives, former SEC officials, representatives of the accounting and legal communities, prominent academics, and representatives of consumer organizations.

## THE ROLE OF FUND DIRECTORS

Meaningful recommendations to enhance the independence and effectiveness of fund directors require an understanding of their unique role. The Investment Company Act of 1940 specifically requires investment companies to have on their boards at least a certain percentage of independent directors, and strictly defines independence for this purpose.

The Act also assigns investment company directors a series of specific responsibilities, including approval of the fund's contract with its investment adviser. In addition, fund directors must monitor and protect against various conflicts of interest in order to ensure that the fund is operated in the best interests of shareholders. The fundamental responsibility of fund directors, in the opinion of the Advisory Group, is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law and in accordance with the fund's prospectus and other disclosure documents.

## RECOMMENDATIONS

This Report recommends a series of policies and practices that go beyond what is required by law and regulation and that are designed to enhance the role of investment company directors.

Many of these recommendations are already in use by many fund boards. The recommendations are designed to ensure that the outside directors are independent from the fund's investment adviser, principal underwriter and their affiliates, and to enhance the effectiveness of all fund directors in fulfilling their oversight responsibilities.

The specific recommendations of the Advisory Group are set forth below:

1. Super-Majority of Independent Directors

   The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

2. Persons Formerly Affiliated with the Adviser, Principal Underwriter and Certain Affiliates

   The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

3. Control of the Nominating Process by Independent Directors

   The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

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The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

# ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS -- REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS

## I. INTRODUCTION AND BACKGROUND

The regulatory requirements governing investment company boards of directors are unique in the world of American business. Unlike any other type of business entity, investment companies are required to have on their boards at least a certain percentage of directors who are independent of fund management.[1] The Investment Company Act of 1940 (the "Act") assigns to the independent directors specific obligations to oversee the fund's relationship with management. These directors serve a "watchdog" function, providing independent oversight of the management of investment companies to ensure that the companies are being operated in the interests of shareholders.[2]

There is a broad consensus that this governance system has worked well for investment companies and their shareholders. In its 1992 report on investment company regulation, the Division of Investment Management of the Securities and Exchange Commission ("SEC") concluded: "The oversight function performed by investment company boards of directors,

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1 The terms "fund management," "investment adviser," "investment manager," "management company," and like terms are used interchangeably throughout this Report.

2 As the Supreme Court observed in Burks v. Lasker, 441 U.S. 471, 486 (1979): "[T]he structure and purpose of the Investment Company Act indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders." In recognition of such responsibility, court decisions often refer to the independent directors as "independent watchdogs" for the funds and their shareholders. See, e.g., Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).