

DISENTANGLING MUTUAL FUND GOVERNANCE FROM CORPORATE GOVERNANCE

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This Article addresses mutual fund governance, explaining how it has recently become entangled with the norms and rules of corporate governance. At one level, it is understandable that the Securities and Exchange Commission (SEC) and courts have viewed mutual funds as a type of ordinary corporation. Both mutual funds and corporations are separate legal entities, having directors and shareholders. Directors of each are held to fiduciary duties, charged with serving shareholders' interests, and expected to aspire to best practices. However, there are fundamental differences between mutual funds and ordinary corporations. This Article contends that these differences have important implications for governance, differences that should lead to the disentanglement of mutual fund governance from corporate governance.

There are two essential features of mutual funds that differentiate them from ordinary corporations. First, mutual funds are not only separate legal entities, but also financial products (or services) by which fund investors obtain professional investment management from investment advisers. Mutual funds have, therefore, a hybrid nature—both entity and product. Accordingly, fund investors, too, have a hybrid character: they are both customers of the fund's adviser and shareholders of a legal entity. This hybrid character stands in marked contrast to ordinary corporations, whose shareholders and customers are two groups, distinct in the law and the marketplace. For an ordinary corporation, decision-making authority and oversight of all facets of its business rest squarely with the board of directors. By contrast, under federal law (the Investment Company Act of 1940), decision-making over a fund's core business—investing in securities—rests with the fund's investment adviser, a third party who in nearly all cases has borne the risks and expenses of organizing and promoting the fund.

Second, mutual funds are fundamentally different from ordinary corporations due to the right of redemption, a right of the investor to withdraw her capital. This right is antithetical to the organizing principles of ordinary corporations (at least public corporations), whose economic viability depends upon the ability to lock in shareholders' capital. For mutual funds, however, their investors' right to withdraw capital, to redeem their ownership interest from the fund, is a defining feature. The right of redemption is not only a financial right, it is also essential to the governance of mutual funds, imposing direct discipline upon a fund's adviser. As each share is redeemed, a fund adviser's compensation is directly reduced because fees are tied to the amount of assets under management in the fund.

In light of crucial differences between mutual funds and ordinary corporations, this Article argues that fund governance should be evaluated on its own merits, not as a derivative of corporate governance. The emphasis should not be upon expanding the "business judgment" decision-making of a fund's directors, but rather upon their role as monitors of legal and fiduciary duties owed by the fund's adviser. This Article examines, in particular, three areas of rulemaking where the SEC has tended, mistakenly, to equate mutual fund governance with corporate governance. These areas relate to the distribution of mutual fund

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shares, the composition of fund boards, and the “proxy access” right given to mutual fund investors for the nomination of fund directors.

This Article concludes with recommendations for how the SEC can improve its approach to mutual fund rulemaking. These recommendations include specific ways in which the SEC can conduct its rulemaking process as well as two types of mutual funds that can compete in the marketplace alongside traditional mutual funds. One type is the unitary investment fund, which would retain fund boards solely to serve as monitors of fund advisers’ legal and fiduciary duties, while leaving judgments over the competitiveness of an adviser’s fees to the marketplace. The other type is a “crowdfunded” mutual fund that would allow for investors, rather than investment advisers, to initiate and organize funds.

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INTRODUCTION

For years, mutual fund governance has been converging with corporate governance. What makes for sound governance of our nation's public corporations, it is presumed, must do likewise for mutual funds, as they also have boards of directors and shareholders. The Securities and Exchange Commission (SEC), the regulator of mutual funds, has embraced this presumption—not in all instances, but in several of its most important rulemaking initiatives—emphasizing, in particular, the importance of fund directors exercising “business judgment.” As a consequence, fund directors have had heightened expectations thrust upon them, and fund investors have been treated more as shareholders than as consumers of a fiduciary product or service, namely investment management from their fund adviser. Congress, for its part, has enacted laws lumping mutual funds with public companies, as exemplified by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act)¹ and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),² statutes arising from breakdowns in corporate governance, not mutual fund governance.

This regulatory convergence has not always existed. The Investment Company Act of 1940 (ICA) created a framework where boards of directors of mutual funds³ have an important role but are limited in ways not found in the enabling statutes for ordinary corporations. Most notably, the ICA leaves decision-making over a fund's core business—investing in securities—with the fund's investment adviser, a third party who in nearly all cases has borne the risks and expenses of organizing and promoting the fund. From the investment adviser's standpoint, a fund is the means by which it offers investment services to its customers, the fund's shareholders. As for a fund shareholder, she can choose among a multitude of funds and fund advisers, and, at any time, terminate her relationship with the fund and adviser by exercising a right of redemption, obligating the fund to repurchase her shares at a price matching her proportionate ownership interest.

As fund boards are expected to emulate corporate boards and broaden their business judgment role, neither the SEC nor the courts have undertaken a detailed analysis of underlying assumptions and issues.⁴ Do fund govern-

¹ See *infra* note 163. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the U.S. Code) [hereinafter *Sarbanes-Oxley Act*].

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*] (codified as amended in scattered sections of the U.S. Code). See also *infra* note 165.

³ For convenience, any reference herein to “fund” means a mutual fund, in contrast to a “closed-end fund.” A mutual fund, otherwise known as an “open-end fund,” ordinarily is engaged in the continual offer of its shares and upon demand must redeem shares from its investors. See *infra* Part II.A.

⁴ Some scholars and commentators have, however, addressed the influence of corporate governance upon mutual fund governance, arguing generally that the latter's flaws cannot be rectified by, and indeed arise from, reflexive application of the former. See, e.g., Anita K.

ance and corporate governance share the same premises and purposes? How does a corporate governance model square with the provisions of the ICA and the principal role played by the fund's investment adviser? Does it even make sense that fund boards, especially independent directors, are in a position to exercise business judgment over investment management policies or strategies? And, if those decisions are beyond the ken of fund boards, what is left of the notion of business judgment as it is understood in the corporate governance world? Further, do fund shareholders and corporate shareholders have essentially the same stake in governance issues, or does the economic model of a mutual fund suggest that important differences separate fund shareholders from corporate shareholders?

This Article argues that mutual fund governance should disentangle itself from corporate governance. Corporations have shareholders and customers, two groups distinct not only in law but also in the marketplace. Mutual fund investors are *both* shareholders of funds *and* customers of fund advisers. The product provided by fund advisers is investment management which is offered in the form of fund shares.⁵ While investment management is a fiduciary product, it is a product nonetheless. This Article does not contend, however, that mutual funds should be seen exclusively as products. Legal form has consequences, which directly effects mutual funds because they almost always have a separate legal personhood, either as a corporation or a trust. Mutual funds thus have a hybrid nature: both product and legal entity. Consequently, fund governance should be evaluated on its own merits, not as a derivative of corporate governance. In particular, the primary role of fund directors is not to exercise an all-encompassing business judgment over a fund's operations, but instead to monitor the fund adviser for compliance with legal and fiduciary duties. Fund directors can establish policies and procedures to ensure that advisers do not place their interests ahead of those of shareholders. They can establish and oversee an internal reporting regime to oversee compliance, and they can act on behalf of funds in resolving errors or losses for which the adviser is responsible.

Krug, *Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm*, 86 S. CAL. L. REV. 263 (2013); Larry E. Ribstein, *Federal Misgovernance of Mutual Funds*, 2009-2010 CATO. SUP. CT. REV. 301 (2009-2010); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010-2011); Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165 (2006); Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005); Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept That Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045 (2005); and Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927 (1994).

⁵ See Langevoort, *supra* note 4, at 1019 (noting "the primary distinction between mutual funds and business corporations: the convergence of the capital and product markets that occurs when the products being sold by the mutual fund are its own securities.")

It is in these ways that fund directors can exercise a discrete type of business judgment, and this should guide the SEC, courts, and legislators when setting or construing norms of mutual fund governance. A monitoring role for fund boards comports with the economic reality that fund directors do not occupy, and generally do not see themselves as occupying, a position to negotiate with advisers in any sense comparable to the way in which corporate directors or officers negotiate deals. When choosing among competing third parties for the provision of services, ordinary corporations seek optimal contractual terms while retaining the ability simply to walk away from any would-be counterparty. This dynamic is inapposite for mutual funds. It is not only that a fund's very existence is the product of the initiative and entrepreneurial risk of the fund adviser, but also that fund directors are keenly aware that investors, by choosing a fund, have also chosen a fund adviser. This is not to say that improvements cannot be made to mutual fund governance. The point is that a debate over fund governance is not won, or even necessarily advanced, simply by invoking norms of corporate governance. Further, there are other possible constructs for mutual funds that can offer alternatives to the historic model for fund investors, allowing them to choose not only among different funds and different advisers, but also different levels of fund governance.

This Article proceeds as follows. Part I summarizes the role of corporate directors, with an emphasis on their exercise of business judgment and the judicial deference paid to their business decisions. Part II turns to mutual funds, reviewing the regulatory design under the ICA, with an emphasis on the legal constraints placed on the range of fund directors' decision-making. Part III traces how the SEC has changed its views on fund directors from dismissive to keenly supportive. Thereafter, this Article considers three key rulemakings by the SEC dealing with fund governance in which the agency has imported the ideology of corporate governance. Part IV addresses the SEC's rule allowing funds to pay costs of marketing and share distribution, costs which in earlier decades had been borne by advisers or by investors paying sales loads comparable to brokerage commissions. Part V examines the SEC's abortive rulemaking to change the composition of fund boards and permit only directors independent of the fund's adviser to serve as board chairman. Part VI considers another ill-fated rulemaking by the SEC, the "proxy access" rule, creating a federal right for shareholders of both ordinary corporations and mutual funds to place the names of their candidates for directors in the proxy statement of the company or fund. Part VII considers two rules where the SEC has properly taken into account mutual funds' distinctiveness, rules dealing with the compensation of portfolio managers and the role of a fund's chief compliance officer.

Finally, Part VIII turns to recommendations, the first of which is a set of general principles that should guide the SEC's future rulemaking to avoid unnecessary entanglements of corporate and fund governance. This part then recommends two new models for mutual funds, not as replacements but as

alternatives to the traditional model. The first model, the unified fee investment company (UFIC), draws upon prior proposed models considered by the fund industry and the SEC. As proposed here, the UFIC would retain a board of directors to perform solely a legal compliance monitoring role, leaving the reasonableness of a fund adviser's management fees and other financial arrangements to the workings of the marketplace, SEC disclosure regulation, and investor decision-making. The second model proposes launching funds through crowdfunding or other investor-initiated capital raising. These "crowdfunded" models could be structured to allow for periodic reassignment of the advisory contract from one fund adviser to another, and could thus afford investors an alternative to the "adviser-sponsored" fund model. Competing alongside traditional adviser-sponsored funds, these new types of mutual funds could, over time, allow the market to test investors' preferences and yield empirical results that would help inform the debate over mutual fund governance.

I. CORPORATIONS AND THEIR DIRECTORS

Corporate directors and mutual fund directors viewed through a wide-angle lens seem quite alike. They are elected by shareholders, have similarly named committees (nominating, audit, and so on), and draw independent directors largely from the same pool of talent. They are held to fiduciary duties, charged with serving shareholders' interests, and expected to aspire to best practices. It is understandable, therefore, that these similarities would encourage comparable norms of governance between mutual funds and ordinary corporations. However, despite the apparent similarities, mutual fund and ordinary corporation directors possess quite different functions and responsibilities.

As for ordinary corporations, it is axiomatic that decision-making authority and oversight of all facets of a company's business rest squarely with the board of directors.⁶ To be sure, shareholders and corporate managers have differed over whether the former should have a greater say on certain matters, such as takeover bids or executive compensation or, more recently, corporate political speech. But whatever differences there may be, they ultimately serve to confirm that boards of directors hold primacy in the management of the corporation. This is the touchstone of corporate governance in the United States, reflecting not only the enduring state of the law but also a pragmatic solution of corporate governance. Centralized decision-making by a board is the means by which widely dispersed investors overcome what are otherwise intractable collective action problems. Corporate directors can devote time and draw upon resources to inform themselves of the details of a company's business and finances, learn about the industry in which the com-

⁶ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986). See also DEL. CODE ANN. tit. 8, § 141(a) (2014).

pany competes, set strategy, and, perhaps most importantly, hire and fire the chief executive officer.

Courts, for their part, have long recognized that they are ill-suited to pass upon the wisdom of directors' business decisions, and hence courts will not disturb choices made by boards with a modicum of care, absent self-dealing or other breach of the duty of loyalty.⁷ Business judgment law, in Delaware alone, fills volumes.⁸ To protect directors in their decision-making, courts have erected, and over the years fortified, the business judgment rule, shielding directors from personal liability where they take reasonable steps to inform themselves before reaching a business decision in the exercise of good faith. The focus is on the board's process, not the substantive merits (or demerits) of a business decision.⁹ In one sense, the business judgment rule is evidentiary: courts presume that directors exercise due care in their decision making, a presumption that shareholder plaintiffs bear the burden of overcoming.¹⁰ In another sense, the rule relaxes the fiduciary duty of care itself, freeing directors from liability for simple negligence and attaching liability only if their conduct rises to the level of gross negligence or an even higher level of culpability.¹¹

Other policies support the business judgment rule beyond recognition by courts of their own limitations. For directors (especially independent di-

⁷ Indeed, directors may be completely protected from monetary liability even where they fail to exercise a modicum of due care, so long as they have not acted in bad faith or in violation of the law. *See* DEL. ANN. CODE tit. 8, § 102(b)(7) (2014) (allowing companies to adopt charter provisions to insulate directors from monetary damages for violating the duty of due care); § 145(a) (allowing for indemnification of directors and officers when acting in good faith and with a reasonable belief that actions are in, or at least not opposed to, the best interests of the corporation); and § 145(g) (authorizing use of corporate assets to purchase liability insurance for officers and directors).

⁸ For an exhaustive treatment of the theory, history, and practical application of the business judgment rule in Delaware and other states, see Steven A. Radin, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (Wolters Kluwer, 6th ed. 2009).

⁹ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“As for the plaintiffs’ contention that the directors failed to exercise ‘substantive due care,’ we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weight or quantify directors’ judgments. . . . Due care in the decision making context is process due care only.”) (original emphasis).

¹⁰ *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53 (Del. 1989) (explaining that the business judgment rule “operates as both a procedural guide for litigants and a substantive rule of law”). *See also* *Carsanaro v. Bloodhound Technologies, Inc.*, 65 A.3d 618, 637 (Del.Ch. 2013) (explaining that “[u]nder the business judgment rule, the burden of pleading and proof is on the party challenging the decision . . .”) (quoting *Solomon v. Armstrong*, 747 A.2d 1098, 1111–12 (Del.Ch. 1999), *aff’d*, 746 A.2d 277 (Del. 2000)).

¹¹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). *See generally*, William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 868 (2001) (discussing the seeming dissonance of a due care standard of conduct for fiduciaries generally and a gross negligence standard of liability for a subset of fiduciaries, namely, corporate directors, and explaining that “the business judgment standard (“rationality”) diverges from, and becomes more lenient than, the normative standard of expected conduct (“reasonableness.”)). *See also* DEL. CODE ANN. tit. 8, § 102(b)(7) (2014) (permitting a provision in articles of incorporation that exculpates corporate directors from monetary liability for breach of the duty of due care).

rectors), who typically own a very small equity stake in the corporation and thus would be rationally disposed to be highly risk-averse to avoid personal liability, the business judgment rule encourages risk-taking by insulating them from liability for business decisions that, in hindsight, prove to be mistakes or, at least, suboptimal.¹² Further, a legal rule that encourages risk-taking by directors reinforces a fundamental rule of investment, diversification. Under modern portfolio theory, predicated on diversification of investments, the “riskiness” of any one company, and thus the riskiness of a business decision made by any one company, cannot be viewed in isolation. A wise business decision—or at least a reasonable one—might entail bearing a higher risk for a higher probable return. As the Second Circuit has explained:

In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. . . . [C]ourts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying.¹³

Prudent decision-making by boards thus aligns itself with prudent decision-making by diversified investors.

The duty of care of directors extends to their oversight of the corporation’s compliance with governing laws and regulations.¹⁴ Are corporate directors afforded the same protection in their compliance oversight that they are given for their business decisions? The legal standard here seems even more forgiving than the business judgment rule. This is so because, as courts have noted, oversight of legal compliance typically does not turn on discrete business decisions, but rather upon an ongoing vigilance for signs that something might be amiss.¹⁵ Under Delaware law, while directors must be on the lookout for red flags, they need not actively investigate any particular business activity of the corporation to uncover illegal activity. Directors who are ignorant of a corporation’s violations of law face liability under Delaware law only for “a sustained or systematic failure . . . to exercise oversight—

¹² See, e.g., *Gagliardi v. Trifoods International, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (noting the “stupefying disjunction between risk and reward for corporate directors” if held to a negligence standard of liability, and explaining that “it is in the shareholders’ economic interest to offer sufficient protection to directors . . . to allow [them] to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.”).

¹³ *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982); see also, *Gagliardi*, 683 A.2d 1049.

¹⁴ See *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959, 967–68 (Del. Ch. 1996).

¹⁵ *Id.*

such as an utter failure to attempt to assure a reasonable information and reporting system exists.”¹⁶

Protected by the business judgment rule, corporate directors control virtually all aspects of a corporation’s operations and finances. They set the corporation’s strategic path,¹⁷ examine forays into new lines of business,¹⁸ products, or geographies,¹⁹ and evaluate acquisitions of other companies. The directors likewise determine the hiring, compensation, and firing of the company’s chief executive officer and, often, other executive officers.²⁰ In addition, directors control the company’s capital structure and finances.²¹ When should the company issue bonds, other forms of debt, or preferred stock? If issued, how large should these financings be? Should the company issue additional shares of common stock, raising new equity capital while perhaps diluting existing shareholders? Should the company repurchase some of its outstanding shares?²² Perhaps of most immediate concern to shareholders, should dividends be declared and, if so, how much? Even where profits or retained earnings are readily available to support the distribution of corporate earnings, corporate directors might decide that the best interests of the enterprise lie in reinvesting earnings to expand the company’s productive capacity or capital base.²³

The business judgment rule is a function of a zero-sum equation: the more protection afforded to corporate boards by the rule, the less power held by shareholders. In practice, examples of success in litigation by shareholders in challenging directors’ business decisions are remarkably scant. Even to bring a derivative action to challenge board decision-making, shareholders

¹⁶ Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 364 (Del. 2006) (quoting *In re Caremark Int’l Derivative Litig.*, 698 A.2d at 971).

¹⁷ See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989); *Ivanhoe Partners v. Newmount Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 193 (Del. Ch. 2006); *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

¹⁸ See, e.g., *Cuker v. Mikalauskas*, 692 A.2d 1042, 1046 (Pa. 1997). (“For efficiency reasons, corporate decisionmakers [*sic.*] should be permitted to act decisively and with relative freedom from a judge’s or jury’s subsequent second-guessing. It is desirable to encourage directors and officers to enter new markets, develop new products, innovate, and take other business risks.”) (quoting 1 A.L.I., *PRINCIPLES OF CORPORATE GOVERNANCE* (1994) § 4.01(c) comment, p. 174).

¹⁹ See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

²⁰ See, e.g., *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006).

²¹ See, e.g., *Williams v. Geier*, 671 A.2d 1368 (Del. 1994); *Ivanhoe Partners v. Newmount Mining Corp.*, 535 A.2d 1334 (Del. 1987); *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006); *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999).

²² See e.g., *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

²³ *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A.2d 276 (Del. 1984); *Moskowitz v. Bantrell*, 190 A.2d 749 (Del. 1963). For a detailed discussion of directors’ authority over dividend policy, see Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 104 (1980).

must overcome hurdles that are nearly insurmountable as long as corporate boards avoid conflicts of interest and act in good faith.²⁴

If dissatisfied with the business decisions of a corporate board, shareholders may sell their shares into the secondary market at the prevailing market price. These shareholders lack, however, the remedy of a right of redemption, a right to demand that the corporation return their capital.²⁵ The right to sell back one's shares to the corporation, a right of exit, is instead limited to special circumstances, such as a merger, where the law grants appraisal rights to dissenting shareholders.²⁶ Typically, state law contains a "market out" exception, withholding the right of appraisal where a secondary market affords shareholders the ability to dispose of their shares while the corporation retains its capital.²⁷ One can readily see why redemption rights would be a dangerous device for the governance of ordinary corporations. Just as shareholders lack authority to compel the declaration of dividends, so, too, do they lack authority to compel repurchase of their shares. In each case, shareholders would arrogate to themselves power over a company's capital. The capital structure of a company involves a host of core business judgments, including liquidity needs, management of cash flow, optimal levels of debt and leverage, and investment in and replacement of fixed assets.

Because the law of corporate governance vests primacy in the board, it follows that the mechanism for change open to shareholders is their vote to elect (or in some circumstances to remove) directors. Although shareholders must overcome practical obstacles, courts have been zealous in upholding their voting rights, showing little tolerance for attempts by directors to infringe on the shareholder franchise.²⁸ As the Delaware Chancery Court has explained, "[t]he shareholder franchise is the ideological underpinning

²⁴ See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 810 (Del. 1984).

²⁵ See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 435 (2000) ("[S]hareholders generally cannot withdraw their individual share of the firm's assets short of dissolution, and dissolution generally requires consent of the holders of at least fifty percent of the firm's shares."); Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253, 255 ("[E]quity investors . . . commit their financial contributions irretrievably to the firm.")

²⁶ See, e.g., DEL. CODE ANN. tit. 8, § 262 (2014). For a detailed discussion of the corporate governance principles underlying the appraisal remedy, see Robert B. Thompson, *Exit, Liquidation, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995).

²⁷ See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1) (2013).

²⁸ See e.g., *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 651 (Del. Ch. 1988) (holding that incumbent directors breached fiduciary duty by adding two new directors for purpose of impeding effort of insurgent shareholder to elect majority of new directors); *Schnell v. Christ-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (finding directors breached fiduciary duty by changing annual meeting to an earlier date in order to impede a proxy contest over election of new directors); *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1209 (Del. Ch. 1987) (enjoining incumbent directors from postponing annual meeting of shareholders to elect new directors); cf. *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1122 (Del. Ch. 1990) (finding that incumbent directors, who deferred setting date for annual meeting of shareholders in response to a proxy fight and unsolicited tender offer, had not acted "for the primary purpose of impairing or impeding the effective exercise of the corporate franchise").

upon which the legitimacy of directorial power rests.”²⁹ Because efforts to thwart the exercise of this franchise pose a conflict between directors and shareholders, courts will typically not accord those efforts the protection of the business judgment rule.³⁰

II. MUTUAL FUNDS AND THEIR DIRECTORS

A. *The Distinctiveness of Mutual Funds*

Mutual funds are but one of four types of investment companies, though by far the most prominent.³¹ As an economic model, an investment company represents the pooling of monies for investment in stocks or bonds or both. An investment adviser makes decisions on the purchase or sale of securities for the fund’s investment portfolio, in which each investor holds an undivided, *pro rata* ownership interest. By joining with one another, investors gain benefits of economies of scale, obtaining an advisor’s investment management services at a price lower than each could do alone. They can also better diversify their investments and gain exposure to some investments, notably bonds and foreign stocks, that otherwise would be beyond their reach.

A legal description of an investment company is more complicated. Under the ICA, an “investment company” is established in either of two ways. The first, the formal way, turns on whether an issuer “is or holds itself out as being engaged *primarily* . . . in the business of investing, reinvesting or trading in securities.”³² The second, often called the “inadvertent” investment company test, turns on whether an issuer owns or proposes to acquire investment securities that have a value exceeding 40% of the company’s total assets.³³

A pre-condition for investment company status is to be an “issuer” of securities, defined to include, most importantly, a “company.” The ICA sets forth a sweeping definition of a company to include not only a corporation, but also a partnership or trust.³⁴ Indeed, under the ICA, a company need not be a separate legal entity at all; it can be “an association” or “any organized group of persons whether incorporated or not.”³⁵ Thus, according to the

²⁹ *Blasius Indus.*, 564 A.2d at 659.

³⁰ *Id.* at 660. See also *Aprahamian*, 531 A.2d at 1207 (“The business judgment rule . . . does not confer any presumption of propriety on the acts of the directors in postponing the annual meeting.”).

³¹ Investment companies, in the aggregate, held approximately \$17.1 trillion in assets in 2013. Of that amount, mutual funds held approximately \$15 trillion. See INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK 9 (2014).

³² 15 U.S.C. § 80a-3(a)(1)(A) (2010) (emphasis added).

³³ *Id.* § 80a-3(a)(1)(C). For this purpose, the term “investment securities” is defined as a subset of all securities, excluding, *inter alia*, U.S. government securities. *Id.* § 80a-3(a)(2).

³⁴ 15 U.S.C. § 80a-2(a)(8) (2010).

³⁵ *Id.*

SEC, an investment company can exist where an investment adviser makes uniform investment decisions for its clients, though there is no separate legal entity whatsoever in which the clients own interests.³⁶

The term “mutual fund” is a market term. It does not appear in the ICA, which instead employs the term “open-end company,”³⁷ the distinguishing feature of which is the issuance to investors of “redeemable securities.” A redeemable security entitles the investor to tender her shares to the mutual fund for repurchase at any time, receiving in return from the fund “approximately [her] proportionate share of the issuer’s current net assets.”³⁸ Because mutual funds must regularly repurchase their shares when investors exercise redemption rights, they ordinarily must also engage in a continual public offering of shares to new investors to avoid contraction and eventual self-liquidation. The fund’s sales price and redemption price must, by law, be based upon the *pro rata* ownership interest in the fund’s net assets that a share represents, known as the net asset value (NAV). For this and related legal reasons, the statute’s pricing requirements have essentially foreclosed the development of a secondary market for mutual fund shares.³⁹

The alternative to a mutual fund is a “closed-end company,”⁴⁰ colloquially known as a “closed-end fund.” It, too, is a pool of securities and is similar to a mutual fund in almost all respects except that, as its name implies, its investors do not have redemption rights. Closed-end funds’ shares are traded in the secondary market, on a stock exchange, or elsewhere. In contrast to mutual fund shares, closed-end fund shares can, and almost always do, trade at prices deviating from their NAV.⁴¹ It is commonplace for

³⁶ See, e.g., *In the Matter of Clarke Lanzen Skalla Investment Firm, Inc.*, Rel. IC-21140 (SEC 1995) (finding an investment company exists when client assets are invested identically with all the assets of other clients who chose the same investment strategy). The SEC has created a safe harbor exemption from investment company regulation where an investment adviser provides uniform discretionary investment management services to clients so long as the investment adviser, upon opening a client’s account and annually thereafter, obtains information regarding the client’s financial situation and investment objectives and meets other conditions. 17 C.F.R. § 270.3a-4.

³⁷ 15 U.S.C. § 80a-5(a)(1) (1987).

³⁸ *Id.* § 80a-2(a)(8). Payment typically is in cash, but it can take the form of a “redemption in kind,” a *pro rata* distribution of securities from the fund’s investment portfolio.

³⁹ See *U.S. v. National Ass’n of Sec. Dealers*, 422 U.S. 694 (1975).

⁴⁰ 15 U.S.C. § 80a-5(a)(2) (1987).

⁴¹ For a discussion of possible reasons for the discount, see, e.g., Burton G. Malkiel & Yexiao Xu, *The Persistence and Predictability of Closed-End Fund Discounts* (2005), <http://utd.edu/~yexiaoxu/CFDDP.pdf> (attributing discounts to such factors as “dividend yields, unrealized capital gains, turnover, expense ratios, [and] illiquid assets.”), Charles M.C. Lee, Andrei Shleifer & Richard H. Thaler, *Anomalies: Closed-End Mutual Funds*, 4 J. OF ECON. PERSPECTIVES 153, 163 (1990) (describing discounts as “mispricing” caused by irrational “noise traders,” anomalies which persist “because no riskless arbitrage opportunity exists, and the supply of rational investors willing to make long-term bets against the prevailing investor sentiment is limited.”). Some academics attribute the discount from NAV to the market’s response to the potential for opportunistic behavior by closed-end fund managers, who do not face the disciplinary threat of the right of redemption available to mutual fund investors. See Daniel N. Deli and Raj Varma, *Closed-end Versus Open-end: The Choice of Organizational Form*, 8 J. OF CORP. FINANCE (June 2001) at 4.

the market to price closed-end fund shares at a discount, often within a range of 5% to 10% lower than their NAV, although at times shares might trade at a premium.⁴² Because they have no redemption obligations, closed-end funds do not engage in a continual public offering of their shares; like ordinary corporations, they raise capital through an initial public offering, and some might infrequently engage in subsequent public offerings. Closed-end funds thus fall somewhere between mutual funds and ordinary corporations, sharing some features of each.⁴³

B. Redemption Rights and Fund Governance

This Article focuses on mutual funds for two essential reasons. First, funds have a hybrid nature as both product (the provision of investment management) and legal entity. This hybrid character means that fund investors themselves have a hybrid character: they are both customers of the fund's adviser and shareholders of a legal entity. This stands in contrast to ordinary corporations. For example, Procter & Gamble's customers and shareholders are two distinct groups, acting upon different economic objectives, holding different sets of expectations, and benefitting from the protection of different laws and norms. Although a person can be a customer and a shareholder of Procter & Gamble, this dual relationship is not hybrid. In an ordinary corporation, each status is separable. By contrast, in a mutual fund, a person is both a customer and shareholder.⁴⁴ Recognizing the distinction between customer status and shareholder status is critical to understanding the norms of mutual fund governance and the choices that the SEC, as regu-

⁴² The SEC has, by rule, allowed closed-end funds periodically to redeem their shares. *See* 17 C.F.R. § 270.23c-3 (2014). These funds, so-called "interval funds," must provide advance notice to shareholders of an upcoming redemption offer, must pay the net asset value per share, and must limit the frequency of their redemptions to no more than once every three months.

⁴³ A third type of investment company, the unit investment trust (UIT), occupies a specialized niche in the investment management industry. 15 U.S.C. § 80a-4(2) (1940). Before selling its shares to public investors, a UIT assembles its investment portfolio (which remains essentially fixed during the fund's life) and designates a date for its dissolution and liquidation. Some UITs might purchase (and sell) securities from their portfolio after launch but do so only under strict limits designating the securities the fund must purchase. *See* Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 56 (1940) (Testimony of SEC Commissioner Robert E. Healy) (explaining that in a UIT "underlying securities cannot be changed at all, or they can be changed only upon the happening of certain contingencies or events that are specified and spelled out in the trust indenture, for example, upon the passing of a dividend on a security. . . ."). A UIT has no investment adviser for the simple reason that very little investment management discretion is exercised. In the absence of an investment adviser, Congress saw no need to require UITs to have boards of directors. Lastly, the fourth type of investment company, the "face-amount certificate company," 15 U.S.C. § 80a-4(1) (1940), is for all practical purposes, extinct.

⁴⁴ For a discussion of the hybrid status of mutual fund shareholders (as well as shareholders of other mutual financial organizations), see Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, XXVI J. OF LAW & ECON. (June 1981).

lator, can make. On the one hand, the dominant regulatory approach for consumer protection is to promote informed choices and competitive markets by mandating disclosure. On the other hand, corporate governance law focuses on fiduciary duty and shareholder rights.

Second, mutual funds are fundamentally different from ordinary corporations due to the right of redemption, a right to withdraw one's capital. This is not only a financial right; it is crucial to mutual fund governance as a means by which fund investors can impose discipline and accountability on fund advisers for a variety of failings,⁴⁵ including a failure to achieve satisfactory investment returns.⁴⁶ The redemption right is the antidote to the problem of locked-in capital. Withdrawal of capital has a direct, immediate impact on fund advisers because their advisory fees are typically tied to the amount of assets held by their funds. A redemption right empowers a fund investor, as a consumer of an investment service, to act independently of fund boards or, for that matter, collective votes of fellow fund investors. Just as an investor can terminate the services of a personal investment manager, so, too, can a mutual fund investor terminate reliance on the fund's adviser by redeeming her shares. By contrast, for corporate shareholders, a board of directors is the law's response to collective action problems.

While corporate directors mediate between investors and management, fund investors have an unmediated relationship with the fund adviser. The looming possibility of substantial redemptions, whether or not realized, can align the interests of fund advisers and investors, and motivate advisers to deliver acceptable, if not superior, investment results. If enough mutual fund

⁴⁵ For a detailed discussion of the disciplinary impact on fund advisers exacted by investors redeeming their shares in funds caught up in various scandals from 1994 to 2004, including most notably the late trading and market timing abuses of 2003, see Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV.1021 (2007). The authors found that during the 12-month period following public notice of a scandal involving a mutual fund, investors exercising their redemption right withdrew, on average, approximately 19% of the fund's pre-scandal assets. Moreover, the fund adviser was more broadly disciplined, as investors during that same period withdrew approximately 7% of assets from "sister" funds under common management with the scandal-plagued fund, even though those funds were not themselves involved in the scandal. Indeed, the authors found that more severe scandals involving a single fund led to redemptions of 18% of assets of all funds in the family of funds managed by the same adviser. The authors conclude that "the ability to redeem shares for their net asset value gives fund investors an effective method for protecting themselves against continued losses resulting from a managerial wrong-doing and, for certain scandals [namely, those perceived to portend a risk of future harm] for penalizing fund management." *Id.* at 1057.

⁴⁶ For example, Janus Capital, an investment adviser to stock mutual funds that had invested heavily in technology stocks before the tech bubble burst in 1999, saw investors withdraw approximately \$75 billion from those funds by mid-October 2000. See Aaron Lucchetti, *Janus, Once Flooded With Cash, Faces Possibility of Huge Withdrawals*, WALL ST. J., Oct. 16, 2000, at 22. In the last four months of 2014, the fund industry's largest bond mutual fund, the Pimco Total Return Fund (at one time a \$220 billion fund) suffered redemptions of \$79.9 billion, including over \$19 billion in December alone. The overall loss was in response to lagging investment performance and the departure of Bill Gross, Pimco's co-founder and former portfolio manager, who joined a competing firm. See Mike Cherney & Kristen Grind, *Investors Pull \$19.4 Billion from Pimco Fund*, WALL ST. J., Jan. 2, 2015.

investors redeem their shares, the result is partial or even full liquidation, a result that only a board of directors can initiate in the case of an ordinary corporation.

When a fund shareholder withdraws her capital, she receives a payment reflecting her proportionate ownership interest in the fund. This is based on the NAV of the fund, an amount comparable to the fair value paid by an ordinary corporation when a shareholder exercises an appraisal right. In contrast to corporate shares, fund shares never trade in a secondary market or below an intrinsic (or perceived intrinsic) value. This absence of a market for control and the discipline associated with the potential of takeover bids has prompted the observation that mutual fund governance is inferior to corporate governance.⁴⁷ This observation misses two points. First, while it is true that NAV pricing does foreclose takeovers of mutual funds, it does not foreclose takeovers of *mutual fund advisers*, at least publicly-traded ones that chronically underperform. There is the hurdle that a firm that succeeds in taking over an underperforming fund adviser will need a fund's board to approve a new advisory contract,⁴⁸ but this is hardly insurmountable.

There is, however, a more fundamental point: the absence of takeover bids for mutual funds is immaterial because market discipline is imposed by the more immediate and consequential risk that shareholders will exercise their redemption rights. Economists recognize the direct connection between redemption rights and governance.⁴⁹ Addressing mutual funds and other types of financial institutions organized in mutual form (for example, mutual savings banks), Professors Fama and Jensen explain:

There is a special form of diffuse control inherent in the redeemable claims of financial organizations. The withdrawal decisions of redeemable claim holders affect the resources under the control of the organization's managers, and they do so in a more direct fashion than customer decisions in nonfinancial organizations. The decision of the claim holder to withdraw resources is a form of partial takeover or liquidation which deprives management of con-

⁴⁷ See, e.g., Langevoort, *supra* note 4, at 1031.

⁴⁸ See 15 U.S.C. § 80a-15(a)(4) (1987) (providing for the automatic termination of a fund advisor's management contract in the event of its assignment to a different adviser). For discussion of the fiduciary issues implicated by attempts to assign a fund management contract, see *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972) (finding approval by fund shareholders of management contract for new fund adviser does not permit earlier fund adviser to profit from sale of fiduciary office). In response to the *Rosenfeld* decision, Congress in 1975 added Section 15(f) to the ICA, 15 U.S.C. § 80a-15(f) (1987), to allow a departing fund adviser to receive payment from a new adviser subject to certain conditions. One condition is that the affected fund's board maintains a 75% supermajority of independent directors for at least three years following the transaction leading to the new fund adviser.

⁴⁹ See, e.g., Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, XXVI J. OF LAW & ECON. 327 (1983), Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, XXVI J. OF LAW & ECON. 301 (1983), and Deli & Varma, *supra* note 41.

trol over assets. This control right can be exercised independently by each claim holder. It does not require a proxy fight, a tender offer, or any other concerted takeover bid. In contrast, decisions of customers in open nonfinancial corporations, and the repricing of the corporation's securities in the capital market, provide signals about the performance of its decision agents, but without further action, either internal or from the corporate takeover market, the judgments of customers and of the capital market leave the assets owned within the organization under the control of the managers.⁵⁰

Fama and Jensen recognize that the governance power of redemption rights is tied to the hybrid status of a mutual fund investor as both consumer and residual claim holder (that is, shareholder). This convergence of the product and capital markets is feasible for mutual funds, but not for ordinary corporations, because the former hold assets that are liquid and readily capable of valuation. Further, mutual funds' assets are not firm-specific; they retain their value upon transfer from seller to buyer.⁵¹

It is true that redemptions can entail costs for the fund investor and that this can pose some disincentive to the exercise of the redemption right.⁵² Upon purchasing shares, an investor might pay a sales load to a distributor of the fund's shares. Upon reinvesting in a new fund (either with the same adviser or a different one), the investor might have to pay a new sales load. Alternatively, a redeeming investor may be required to pay a "back-end" sales load, deducted from the redemption proceeds. A fund also might charge the investor with a redemption fee, retained by the fund to offset costs incurred in meeting the redemption, including brokerage commissions if portfolio securities must be sold to raise cash for the redemption. A further disincentive to redemption is the prospect of a capital gains tax on redemption proceeds if the investor has realized a profit. The SEC and others have pointed to these disincentives as reasons for retaining the basic governance structure for mutual funds or at least limiting changes to that structure. However, investor behavior belies arguments that costs associated with redemptions are major obstacles to the exercise of the redemption right.⁵³ Whether

⁵⁰ Fama & Jensen, *Agency Problems and Residual Claims*, *supra* note 49, at 338. *See also*, Deli & Varma, *supra* note 41, at 4 ("[A]n important advantage of open-end funds is a reduction in agency costs stemming from investors' ability to redeem shares at NAV.").

⁵¹ Fama & Jensen, *Agency Problems and Residual Claims*, *supra* note 49 at 338. ("Redeemable claims are not an efficient general financing instrument for nonfinancial organizations. Giving every claim holder the right to force contractions of assets would impose substantial costs on nonfinancial activities. For example, nonfinancial corporations typically have large demands for organization-specific assets that have lower value to other organizations. Substantial costs would be incurred in forced sales of such illiquid assets to accommodate redemptions of claims.")

⁵² *See* WILLIAM J. BAUMOL, STEVEN M. GOLDFELD, LILLI A. GORDON & MICHAEL F. KOEHN, *THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION* 126 (Kluwer Academic Press, 1990).

⁵³ For a detailed analysis of how the growing dominance of no-load mutual funds, other market forces, and tax-exempt retirement plans have reduced the disincentives to redemptions,

overall market performance in a given year is strong or not, gross redemptions remain relatively close to gross new sales.⁵⁴ In 2013, for example, gross redemptions totaled approximately \$17.78 trillion, while gross sales totaled approximately \$17.96 trillion.⁵⁵

Over the years, sales loads have become lower and less prevalent, and no-load funds have increasingly gained market share. Moreover, investors in defined contribution retirement plans can move in and out of funds without triggering capital gains taxes. Corporate takeover attempts and proxy fights, too, have costs. Indeed, corporate shareholders incur brokerage commission costs when selling in the secondary market. The essential point regarding fund investors' redemption right is not that it is a cost-free, perfect mechanism of fund governance, but that it is an effective one, dependent not upon fund directors' collective decision-making, but upon autonomous decision-making by individual fund investors.

C. The Role of Mutual Fund Directors

Congress enacted the ICA, the last of the New Deal's securities law enactments, to deal with perceived abuses by advisers of investment companies in the years leading up to the Crash of 1929. In 1936, Congress called for a study of investment companies by the SEC. In response, the agency produced a multi-volume Investment Trust Study,⁵⁶ some, but not all, of which was delivered prior to enactment of the ICA in 1940.

In the Investment Trust Study, the SEC explained that funds typically did not hire their own officers or employees to carry out investment management or the ancillary activities of their business. Rather, though formed as separate legal entities, funds were mere shells, almost entirely dependent on services provided by a third party, the investment adviser. Given these circumstances, the SEC saw an inherent conflict of interest that could play out in different ways: a fund adviser could cause its fund to purchase securities from or sell securities to the adviser's broker-dealer affiliate at unfair prices; the adviser could have the fund buy sticky securities in a public offering underwritten by the adviser's affiliate; or the adviser could cause unnecessary trading in the fund's investment portfolio to generate commission income for an affiliated broker. To address these and other conflicts, the SEC

see John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).

⁵⁴ See INV. CO. INST., *supra* note 31 at 161.

⁵⁵ *Id.* at 9. For an insightful analysis of investor behavior in response to the investment performance of mutual funds, see Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. OF POLITICAL ECON. 1269 (2004) (explaining that investors act rationally in allocating their capital to funds with superior past performance even though future performance is not predictable).

⁵⁶ H.R. Doc. No. 75-707, pt. 1 (1938); H.R. Doc. No. 76-70, pt. 2 (1939); H.R. Doc. No. 76-279, pt. 3 (1939) (collectively, Investment Trust Study).

submitted to Congress in 1940 a draft bill⁵⁷ to create a uniform federal scheme for all investment funds offering their shares to the public. The proposal went beyond the disclosure requirements and minimal substantive business constraints of the Securities Act of 1933 and Securities Exchange Act of 1934.⁵⁸ Although the SEC's proposed bill subjected funds to disclosure requirements, it also included prohibitions and restrictions on funds' operations, while conferring broad exemptive authority to the SEC. Upon its introduction, the bill met with immediate opposition from the fund industry, but rather than working to kill any legislation, the industry collaborated with the SEC to draft a revised bill, one that the industry and the SEC jointly recommended to Congress. This revised version was enacted in a special third session of Congress.⁵⁹

A salient feature of the ICA is the narrowed decision-making role left to fund directors. The statute expressly requires directors' decision-making in only four areas: they must vote to approve and renew a fund's investment management contract with the fund's adviser⁶⁰ and an underwriting agreement with the principal underwriter (who typically is an affiliate of the adviser),⁶¹ engage an outside auditor,⁶² and assign a "fair value" to securities that lack readily available market quotations.⁶³ Directors must also sign the

⁵⁷ The SEC's proposal was introduced in the Senate as S. 3580 and in the House as H.R. 8935.

⁵⁸ The Senate-passed bill, ultimately enacted as the Securities Exchange Act of 1934, had a provision stating that "nothing in this Act shall be construed as authorizing the [SEC] to interfere with the management of the affairs of an issuer." S. 3420, 73d Cong. (2d Sess. 1934). *See also* S. REP. NO. 73-792, (2d Sess. 1934). This language was dropped in the final enactment—in the words of the conference report, "omitted . . . as unnecessary, since it is not believed that the bill is open to misconstruction in this respect." H.R. REP. NO. 73-1838, (2d Sess. 1934).

⁵⁹ For accounts of the legislative history of the ICA and events leading to its enactment in 1940, *see, e.g.,* Note, *The Investment Company Act of 1940*, 50 *Yale L.J.* 440 (1941); Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 *WASH. U.L.Q.* 303 (1941); and Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 *NOTRE DAME L.* 677 (1969).

⁶⁰ 15 U.S.C. §80a-15(a) (1987) (stating that initial approval of a fund's management contract must be by vote of the fund's shareholders, though in the typical case ownership of all shares of a fund at its inception is in the hands of the fund's promoter or adviser, or related persons).

⁶¹ *Id.* §80a-15(b).

⁶² *Id.* §80a-32 (stating that the vote is limited to those directors who are independent of the fund's adviser and affiliates of the adviser, and is subject to ratification by shareholders at their annual meeting in the year following the board's action, if such meeting is held).

⁶³ *Id.* § 2(a)(41). Bowing to reality, the SEC has recognized that fund directors typically lack the time, knowledge, or experience to make case-by-case intra-day decisions on the value of thinly traded securities. Consequently, the SEC staff has allowed fund boards effectively to delegate this responsibility to the fund adviser, subject to policies and procedures that provide direction to the adviser and constrain discretion. *See* Letter from Douglas Scheidt, Assoc. Dir. & Chief Counsel, SEC Div. of Inv. Mgmt., to Craig S. Tyle, Gen. Counsel, Inv. Co. Inst. (Dec. 8, 1999) (discussing how the SEC has recognized that fund boards "typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities," and that fair value methodologies "typically are recommended and applied by [the fund adviser's] management.").

fund's registration statement.⁶⁴ In lieu of directors' business judgment, the statute substitutes governmental mandates in a wide range of areas, prohibiting most transactions between funds and their advisers, prescribing funds' capital structures, placing limits on leverage, dictating how funds must price their shares, regulating the distribution process, and prohibiting or restricting other areas of funds' business. Rather than empowering fund directors to work out exceptions, set conditions, and respond to the particular circumstances of funds under their supervision, Congress conferred wide discretionary authority on the SEC to grant waivers and exemptions from statutory restrictions.⁶⁵

For example, the ICA bars a fund's investment adviser from selling securities to or buying securities from the fund,⁶⁶ from lending to or borrowing from the fund, and from investing in securities alongside the fund unless consistent with SEC rules.⁶⁷ If relief from these restrictions is to be found, it must come from the SEC, acting by rule or order. The ICA also withholds authority from a fund board (even if board action depends on a separate vote by independent fund directors) to waive any of these prohibitions. This is so even though a transaction—for example, the purchase from an adviser of highly sought after securities in short supply—can be done on terms more favorable than available from any third party.⁶⁸ On matters of capital structure, the statute also removes business judgment from a fund board. To be sure, mutual funds cannot issue debt securities and essentially cannot borrow, except under limited circumstances.⁶⁹ Funds cannot issue preferred

⁶⁴ Funds are required to file registration statements under the Securities Act of 1933. 15 U.S.C. § 80a-24 (1996). The Securities Act, in turn, requires that a majority of a company's directors sign a registration statement. Securities Act of 1933, § 6(a).

⁶⁵ The SEC has general power to grant exemptions from any provision of the ICA by rule, or by a broad (and malleable) standard of "public interest" and "protection of investors." 15 U.S.C. §80a-6(c) (2010). Further, the ICA often couples a ban or restriction of a particular type of transaction or activity with authority for the SEC to grant exemptive relief. *Id.* §80a-17(a)(b) (principal transactions between a fund and its adviser).

⁶⁶ 15 U.S.C. § 80a-17(a)(2) (2010).

⁶⁷ *Id.* § 80a-17(d). The statute empowers the SEC to adopt an exemptive rule to allow these joint transactions so long as the rule seeks to prevent funds from participating in transactions "on a basis different from or less advantageous than that of" the fund's adviser. The SEC has adopted a rule that, subject to some limited exceptions (none of which pertain to joint investing activity by a fund and its adviser) requires all joint transactions to gain case-by-case prior approval from the agency. 17 C.F.R. § 270.17d-1 (2013).

⁶⁸ The SEC regularly grants approval to individual applications from funds to purchase thinly traded debt securities, especially municipal bonds, from their advisers or persons related to their advisers. *See, e.g.*, SEC, Notice of Application, BofA Funds Series Trust, 78 Fed. Reg. 41443 (July 10, 2013) (exemption for principal transactions in certain municipal notes, tax-exempt commercial paper and variable rate demand bonds); SEC, Notice of Application, Columbia ETF Trust, 77 Fed. Reg. 69511 (Nov. 19, 2012) (exemption for principal transactions in certain government securities, municipal securities, tender option bonds and asset- and mortgage-backed securities).

⁶⁹ *See*, 15 U.S.C. §80a-18(f) (1998). Mutual funds may borrow only from banks, subject to an "asset coverage" of 300%. Thus, for every dollar borrowed, the fund must have at least \$3 of assets or, in other words, at least \$2 of equity. "Leverage" is commonly understood to mean that a company's debt exceeds its equity. For example, a company with a 7:1 leverage

stock⁷⁰ or create separate classes of common stock with different voting rights.⁷¹

If allowed to act like a corporate board in exercising business judgment on questions of capital structure, fund directors might decide to allow a modest amount of leverage to enhance return, especially if a fund's diversified portfolio comprises of, for example, investment grade bonds or other relatively low risk assets.⁷² Alternatively, fund directors, like their corporate counterparts, might reasonably decide that investors would prefer the choice of investing in preferred stock (thus accepting a cap on dividends in return for a prior claim on fund earnings) or common stock. Of course, there is much to be said in favor of mutual funds' avoidance of leverage, and many fund boards might decide, if allowed to do so, to choose a capital structure consisting solely of common stock. The point here is that the ICA imposes capital structure limits, beyond the reach of fund directors' business judgment.

Nothing is more central to a mutual fund's business than its investment strategy. Here, too, the ICA curtails the role of a fund's directors. For example, the statute restricts a fund's ability to invest in the securities of insurance companies,⁷³ securities broker-dealers,⁷⁴ and other funds.⁷⁵ The SEC can grant relief from these restrictions,⁷⁶ but a fund's board is powerless to invest on its own, no matter how favorable (and lacking in potential for abuse) a particular investment might be. To be sure, a fund's directors hold the ultimate weapon: to terminate a fund adviser's management contract⁷⁷ or to refuse renewal of the contract for an upcoming year.⁷⁸ However, the very structure of the ICA contemplates that investment strategy lies with the fund's adviser, and the typical investment management contract confers in-

ratio has \$7 of debt for every dollar of equity. Mutual funds, in contrast, can have a leverage ratio no higher than .5/1 or, in essence, no leverage at all.

⁷⁰ *Id.* § 80a-18(f)-(g) (1998) (prohibiting mutual funds from issuing any "senior security," while permitting mutual funds to borrow from a bank). A "senior security" is defined to include not only debt securities but also "any stock of a class having priority over any other class as to distribution of assets or payment of dividends," which is, preferred stock. *Id.* § 80a-18(g).

⁷¹ 15 U.S.C. § 80a-18(i)(1998).

⁷² For a detailed argument in favor of permitting leverage in funds, see John Morley, *The Regulation of Mutual Fund Debt*, 30 *YALE J. REG.* 343 (2013).

⁷³ 15 U.S.C. § 80a-12(d)(2) (2010) (prohibiting a fund from acquiring more than 10% of the voting securities of an insurance company).

⁷⁴ *Id.* § 80a-12(d)(3). Although the statute forbids a fund's purchase of any security issued by a broker-dealer, the SEC, by rule, permits a fund to acquire up to 5% of any class of a broker-dealer's equity securities and up to 10% of outstanding debt securities. 17 C.F.R. § 270.12d3-1 (2014).

⁷⁵ 15 U.S.C. § 80a-12(d)(1) (2010).

⁷⁶ *Id.* § 80a-6(c).

⁷⁷ *Id.* § 80a-15(a)(3).

⁷⁸ *Id.* § 80a-15(a)(2) (requiring approval by full vote.); *id.* § 80a-15(c) (requiring separate approval by independent directors).

vestment management solely upon the adviser to be carried out consistent with the fund's public disclosure documents.⁷⁹

What if a fund produces disappointing investment results and directors want to change the fund's investment policies? This might mean that a fund, having a fundamental investment policy of investing in large cap growth stocks of U.S. companies, might do better if it were to invest in stocks of all large cap U.S. companies (whether growth or value) or in growth stocks of both U.S. and foreign large cap companies. This would be akin to a brick-and-mortar bookstore chain deciding to shift strategy to online sales, or an energy company shifting its main focus from oil exploration on land to deep sea exploration. These are quintessential business judgments for corporate boards, decisions not requiring a shareholder vote. However, changes to a fund's fundamental investment policies or industry concentration policies are beyond the unilateral power of a fund board. Any changes must be put to, and gain the approval of, fund shareholders.⁸⁰ This comports with the fundamental economic reality that investors have chosen to acquire a product from a fund's adviser—namely, investment management—rather than to have a fund's directors (in particular, the fund's independent directors) substitute their judgment.

Given the primacy of a fund's adviser in executing the fund's investment strategy, it is understandable that the ICA from its inception has allowed for directors affiliated with a fund's adviser to constitute up to 60% of the fund's board.⁸¹ The SEC, in its original legislative proposal in 1940, called for independent directors to constitute a majority, but this approach did not survive into the enacted bill.⁸² Congress thought it unwise for a fund board (and independent directors) to interfere with the exercise of discretionary investment authority conferred on the fund adviser under the investment management contract, and, thus, Congress made a deliberate decision to allow directors affiliated with the adviser of a fund to constitute a majority of the fund's board.⁸³ As explained by David Schenker, one of the key partici-

⁷⁹ As explained by David Schenker, Chief Counsel of the SEC's Investment Trust Study, the statute's requirement for a description of investment policy in a fund's registration statement was drafted to be "deliberately broad so as not to impede the management in its primary function of managing the portfolio. . . ." Testimony of David Schenker, SEC Hearings before Sen. Banking and Currency, Subcomm. on S. 3580, 76th Cong., 3d Sess. 1112 (1940). In this context, the reference to "management" is to the fund's adviser exercising authority under its investment management contract.

⁸⁰ 15 U.S.C. § 80a-13(a)(3) (2010).

⁸¹ *Id.* § 80a-10(a).

⁸² S. 3580, 76th Cong. § 10(a)(2) (3d Sess. 1940). The bill also required that a majority of a fund's directors be unaffiliated with a fund's "manager." *Id.* The bill distinguished an "investment adviser" from a "manager" of a fund, whereby an investment adviser gave investment advice to a fund, and a manager exercised discretionary investment authority. *Id.* §§ 45(a)(16) & (17). This distinction was eliminated in the ICA as enacted, as "investment adviser" is defined to embrace either activity. 15 U.S.C. § 80a-2(a)(20) (2010).

⁸³ The ICA does call for independent directors to constitute a majority of a fund's board when any director is affiliated with a fund's principal underwriter or "regular broker." 15 U.S.C. §§ 80a-10(b)(1)(2) (2006). But the underlying purpose here has nothing to do with a

pants on behalf of the SEC in drafting the compromise bill that became the ICA:

[T]he argument was made that it is difficult for a person or firm to undertake the management of an investment company, give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice. Now that made sense to us. If the stockholders want A's management, then A should have the right to impose his investment advice on that company.⁸⁴

Fund boards also have little or no business judgment to exercise on a quintessential decision faced every year by corporate boards, whether to distribute earnings to shareholders or retain those earnings for reinvestment in the business. The discretion that corporate boards have with respect to their companies' earnings (both current and retained) is essential to "director primacy." As a practical matter, however, there is little to no discretion exercised by a fund board in this regard, a result not of the ICA, but of federal tax law, which requires that mutual funds pass through to investors essentially all dividends, interest, and net capital gains realized each year. Failure to do so subjects a mutual fund and its shareholders to double taxation on

fund board's exercise of business judgment over investment strategy, and everything to do with strengthening the "watchdog" role of a fund board under conditions deemed to give rise to heightened potential for conflicts when a fund is dependent upon a single enterprise for both investment advice, on one hand, and share distribution or portfolio brokerage on the other. See Testimony of David Schenker, *supra* note 79 ("In the situation where the directors are the brokers for the investment company or . . . are the principal distributors of the securities of the investment company, then a majority of the board has to be independent of those individuals. So you have a situation where there is no element of self-dealing. . . .").

⁸⁴ Testimony of David Schenker, Chief Counsel, Investment Trust Study, SEC Hearings before House Interstate and Foreign Commerce Subcomm. on H.R. No. 10065, 76th Cong., 3d Sess. 109-110 (1940). [hereinafter *House 1940 Hearings*]. The primacy conferred upon the fund's adviser, rather than the fund's directors, in carrying out investment decision-making was confirmed in the study carried out in 1962 for the SEC by the University of Pennsylvania's Wharton School of Finance. See WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. (1962) [hereinafter *Wharton Report*] ("[F]or most investment companies the board of directors does not play an active role in the day-to-day management of company affairs; . . . for many companies the board may have very limited functions as regards investment decision making in general. . . . Only in 18 percent [of mutual fund families surveyed] did the board of directors have to give its approval before a new security (not in the company portfolio or an approved list) could be acquired. None of these were members of an adviser group with assets in excess of \$300 million."). The ICA, itself, imposes very limited constraints upon the exercise of investment discretion by fund managers, allowing funds (more accurately, fund advisers) to choose their investment policies. See Warren Motley, Charles Jackson & John Barnard, *Federal Regulation of Investment Companies Since 1940*, 63 HARV. L. REV. 1134, 1156 (1950) ("There is very little restraint upon the free exercise of management's discretion and judgment regarding investment. In fact, it may fairly be said that the main purpose and effect of the Act is to create and maintain a healthy atmosphere in which the managerial function will be exercised in the best interests of the beneficial owners of the fund.").

dividends and interest, and an excise tax on undistributed capital gains.⁸⁵ While critics disparage mutual funds as “shells” lacking autonomy from their investment advisers, it is this very nature that underlies their favorable flow-through treatment under the Internal Revenue Code.

Another critical area for corporate boards is the marketing and distribution of company products and services. Although the formulation of sales strategy and spending is, in the first instance, the job of a company’s chief executive officer and other senior officers, the board retains the ultimate authority to direct management to change course. By contrast, the ICA prohibits a fund from using its assets to finance the marketing and distribution of its own shares except when in accordance with SEC rules.⁸⁶ If there is any role for a fund board and its business judgment, it is a design crafted by the SEC, not the statute.

In sum, directors of mutual funds occupy a fundamentally different position than do corporate directors, and their range of business decision-making is substantially circumscribed in comparison to that of their corporate counterparts. This is not coincidental, but is, instead, the inevitable consequence of the hybrid nature of mutual funds, resting on both the primacy of the fund adviser and the exercise of choice by fund investors. A tangible reminder of this fundamental distinction between fund and corporate directors is borne out by the number of fund boards on which fund directors serve. It is routine for independent fund directors to sit on multiple boards of funds managed by a single adviser (or affiliated advisers). In contrast to corporate directors who might sit on two or three boards (and at most six or seven boards),⁸⁷ it is not unusual for fund directors to sit on the boards of

⁸⁵ I.R.C. §§ 851, 852. For a thorough analysis of fund taxation, see John C. Coates, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 THE JOURNAL OF LEGAL ANALYSIS 591 (2009). For an historical account of the pass-through tax treatment accorded to mutual funds, see Mark J. Roe, STRONG MANAGERS, WEAK OWNERS—THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 102-110. (Princeton University Press 1994). As Professor Roe recounts, the Supreme Court, in *Morrissey v. Commissioner of Internal Revenue*, 296 U.S. 344 (1935), ruled that investment funds organized as trusts were taxable entities under the Revenue Act of 1926, thereby rejecting the funds’ argument they were merely passive holders of property and not engaged in the carrying on of any business. Congress in later tax legislation granted pass-through treatment to mutual funds, but only if the funds met diversification and income distribution conditions.

⁸⁶ 15 U.S.C. § 80a-12(b) (2010).

⁸⁷ Many corporations have policies that restrict the number of boards upon which their directors may sit. See, e.g., *Proxy Statement for 2015 Annual Meeting of Shareholders* (General Electric Co.), 2015 at 32 (outlining governance policy limiting independent directors to serving on boards of no more than four other public companies). According to a 2013 survey of S&P 500 companies conducted by Spencer Stuart, an executive recruiting firm, 60% of such companies imposed numerical limits on the number of other public company boards on which any of their directors (either management or independent) may serve. Of this group, 5% limited their directors to service on no more than two other public boards, 73% to three or four boards, 21% at five, and 1% at six. S&P 500 companies that do not set numerical limits employ suasion to limit board memberships. Spencer Stuart, *U.S. Financial Services Board Index 2013*, Mar. 2014, at 13. For a scholarly analysis of multiple corporate board memberships and their implications for firm value, see Antonio Falato, Dalida Kadyzhanova & Ugur Lei, *Distracted Directors: Does Board Busyness Hurt Shareholder Value* (Sept. 2013)

twenty, fifty, or even more than one hundred funds. It is inconceivable that corporate directors would entertain the thought of serving on twenty or more boards, let alone muster a plausible explanation that their service could begin to meet the level of care and attention expected of them, even if the protections of the business judgment rule and exculpatory charter provisions would protect them from monetary liability. Yet serving on the boards of all, or a substantial number of boards of mutual funds under management of a common investment adviser is cited as an important factor *enhancing* the effectiveness of a fund director. According to a survey conducted by the Investment Company Institute (ICI) in 2007, 78% of fund families under the management of the same investment adviser had so-called “unitary boards,” where the same individuals served as a director on the board of every fund within the fund family.⁸⁸

III. THE EVOLUTION OF THE SEC’S VIEWS ON FUND DIRECTORS AND FUND GOVERNANCE

A. *Early Views*

For the first twenty years or so following the ICA’s enactment, the SEC had relatively little to say about the role of a mutual fund’s board of directors.⁸⁹ The SEC’s primary focus was on its direct oversight over funds, ruling on a large number of applications for exemptions from restrictions imposed by the ICA.⁹⁰ By the 1960’s, however, as the fund industry saw dramatic growth, the SEC turned its attention to management fees, retaining the Uni-

(presenting evidence that “independent directors’ busyness is detrimental to board monitoring quality and shareholder value”).

⁸⁸ INV. CO. INST. & INDEP. DIRECTORS COUNCIL, OVERVIEW OF FUND GOVERNANCE PRACTICES (2007). The Investment Company Institute (ICI) has explained that:

[S]ervice on multiple boards can provide the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature. It also can give the independent directors greater access to the fund’s adviser and greater influence over the adviser than they would have if there were a separate board for each fund in the complex. Moreover, it would be much more difficult to attract highly qualified directors if they were limited to service on the board of only one fund in a complex.

INV. CO. INST., REPORT OF ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS 28 (June 1999).

⁸⁹ See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 349-350 (3d ed. 2003) (“Throughout most of its post-World War II years, the [SEC] had interpreted its statutory responsibilities narrowly, focusing primarily on the noncontroversial tasks of administering a corporate disclosure system and preventing fraud. . . . In part, the SEC’s post World War II performance was the consequence of the low priority that successive Presidents and successive Congresses had assigned to securities regulation.”).

⁹⁰ For background on the SEC’s administration of the ICA in the first decade after its enactment, see Warren Motley, Charles Jackson Jr., & John Barnard, *Federal Regulation of Investment Companies Since 1940*, 63 HARV. L. REV. 1134 (1950). A considerable area of attention for the SEC related to applications for exemptions from the reach of Section 17(a) of the ICA, which prohibits securities trades and loans between a fund and its adviser. In the first

versity of Pennsylvania's Wharton School to conduct a study which culminated in the production of the *Wharton Report* in 1962.⁹¹ Following up on the *Wharton Report*, the SEC issued its own report, *The Public Policy Implications of Investment Company Growth*, in 1966.⁹² Both reports concluded that mutual funds' growth in assets⁹³ had produced economies of scale, lowering fund advisers' marginal costs for research and investment management.⁹⁴ Both the *Wharton Report*⁹⁵ and *PPI Report*⁹⁶ criticized fund advisers for not sharing the benefits of their cost savings by offering discounts (known as "breakpoints") to their management fee rates.⁹⁷

decade after the ICA's enactment, out of a total of 551 orders issued by the SEC relating to applications for exemptions under the ICA, 172 orders dealt with Section 17(a). *Id.* at 1150.

⁹¹ *Wharton Report*, *supra* note 84. For a contemporaneous rebuttal to the *Wharton Report*, see Nathan D. Lobell, *Critique of the Wharton School Report on Mutual Funds*, 49 Va. L. Rev. 1 (1963).

⁹² SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (2d Sess. 1966) [hereinafter *PPI Report*].

⁹³ The SEC noted in its *PPI Report* that mutual funds had grown in size from only \$450 million in 1940 to \$4 billion by 1952, to about \$13 billion by 1958, and to over \$38 billion by 1966. In 1965, mutual funds brought in \$5.2 billion in capital through issuance of new shares, surpassing the total of \$2.3 billion in capital raised by public corporations through public offerings of stock in that year. *PPI Report* at 2. By 1967, mutual fund assets had grown to about \$45 billion. Hearings on H.R. 9510 Before the Subcomm. of the Committee on Interstate and Foreign Commerce, 90th Cong., (1st Sess. 27-28 1967).

⁹⁴ As the SEC explained, "In large measure . . . economies [of scale] reflect the fact that the management of a small security portfolio requires much the same general economic and market forecasting, analyses of various industry groups and evaluations of particular securities—the basic elements in the investment advisory process—as does the management of a large one." *PPI Report* at 11.

⁹⁵ *Wharton Report*, *supra* note 84, at XIII ("While the benefits to the adviser of more or less indefinite growth by intensive sales of mutual fund shares are fairly obvious, the benefits to a fund's shareholders from such indefinite growth are not equally apparent where the management fee rate is not scaled down with increases in the size of the fund."). The *Wharton Report* conducted a survey of eighty-six fund advisory firms operating in the corporate form, finding that these firms' operating ratios (operating expenses as a percent of total income) fell from 81.5% for advisers with under \$50 million of fund assets under management to 36.7% for advisers with between \$300 to \$600 million. At odds with its general conclusions, however, the report found operating ratios actually *increased* to 48.8% for advisory firms with fund assets of \$600 million or more, the largest category included in the survey. *Id.* at 503. The *Wharton Report* did not explain this incongruity.

⁹⁶ *PPI Report* at 94 ("It is generally recognized that . . . increases in the assets of a fund do not lead to a commensurate increase in the cost of furnishing it with investment advice and other managerial services."). The SEC did not conduct its own survey but instead offered anecdotal evidence. In the case of one large fund management firm, Investors Diversified Services, the *PPI Report* stated that the firm's operating ratios fell from 50% in 1955 to 30% in 1962, contributing to an increase in fee revenues from \$4.9 million to \$15.7 million during this period. From 1955 to 1962, the SEC also stated that firm's operating expenses increased by only \$2.3 million. *Id.* at 95.

⁹⁷ The *Wharton Report* stated:

[T]he effective fee rates charged the funds tend to cluster heavily about the traditional rate of one-half of 1 percent per annum of average net assets, with approximately half of the investment advisers charging exactly this rate. This concentration around the one-half of 1 percent level occurs more or less irrespective of the size of a fund's assets managed by an investment adviser, although operating expenses of the adviser were found to be generally lower per dollars of income received, and also lower per dollar of assets managed, as the size of a fund's assets increased.

Breakpoints are comparable to progressive income tax brackets, except that as a fund's assets grow larger (whether through market appreciation or sales of new shares or both), fee rates marginally decline rather than increase.

Further, the SEC criticized rulings by state courts against fund investors challenging allegedly excessive management fees.⁹⁸ State courts in these derivative actions required investors to show that fund directors had wasted fund assets, which was a difficult burden that led predictably to judgments absolving defendants (including independent fund directors) from liability. In the leading case, *Saxe v. Brady*,⁹⁹ the fund had paid a flat fee rate of 0.5%, with no breakpoints for increases in fund size. The fund had grown from \$130 million in 1952 (producing a management fee of \$680,000) to \$590 million in 1960 (producing a management fee of \$2.78 million). Independent directors constituted 60% of the fund board and, in keeping with the requirements of the ICA, voted to approve the management contract. Applying essentially the same waste of assets test that governs ordinary corporations, the Delaware Chancery Court rejected investors' claims that fund directors breached their fiduciary duty,¹⁰⁰ explaining that its review was:

[I]imited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction.¹⁰¹

Wharton Report, *supra* note 84, at XII. In summarizing the *Wharton Report*'s findings, the SEC noted that "in approximately four out of every five cases mutual fund advisory fee rates were fixed and did not vary with the size of the assets managed." *PPI Report* at 96. *But see*, Lobell, *supra* note 91, at 40 (discussing how "[a] vital fact ignored by the [*Wharton Report*] is that no bank, private counselor, trust or any similar organization managing accounts for a fee reduces the fee charge on the basis of the aggregate amount of capital of all clients under management. No one . . . suggests that the bank or trust company is under obligation to volunteer fee-rate cuts based on the aggregate amounts under management, or on profits being made from management.") (emphasis original). This Article proposes an alternative avenue for the formation and launch of mutual funds that could shift "ownership" of economies of scale from fund advisers to fund shareholders through the crowdfunding of mutual funds. *See* Part VIII.C. *infra*.

⁹⁸ *PPI Report* at 133.

⁹⁹ *Saxe v. Brandy*, 184 A.2d 602 (1962).

¹⁰⁰ In *Saxe*, plaintiffs did not argue that the fund's independent directors violated the ICA by approving the fund adviser's contract nor that the directors did not satisfy the ICA's criteria for independence. As for state law, the plaintiffs argued in the alternative, alleging either that the independent directors were dominated by the management directors (that is, those affiliated with the fund's adviser) or that they had failed to perform their fiduciary duty to protect the fund's interests. *Id.* at 605. The chancery court, for purposes of decision, assumed, without finding, that the independent directors were not disinterested under state law. Accordingly, the court took into account that the fund's shareholders had also voted to approve the adviser's contract. The court applied the corporate waste test in light of the shareholder vote. *See, id.* at 610

¹⁰¹ *Id.*

The fact that other funds paid their advisers somewhat lower fee rates had little relevance for the *Saxe* court.¹⁰²

The SEC characterized *Saxe* and other state cases¹⁰³ as “defects” under existing law. These cases, however, reflect well-settled principles of corporate law involving waste of corporate assets, a doctrine which, when applied to directorial decisions (rather than shareholder ratifications), itself evokes the business judgment rule.¹⁰⁴ In the *PPI Report*, the SEC did not call for a more plaintiff-friendly legal standard by which to measure the actions of fund directors in approving an adviser’s fees. Nor did the SEC call for a restructuring of fund boards, displacing some or all of adviser-affiliated directors. Indeed, the SEC dismissed, as “wholly unrealistic,” the proposition that independent fund directors could function as effective negotiators over management fees.¹⁰⁵ The SEC acknowledged that fund directors were not comparable to corporate directors in this regard because fund investors were deciding for themselves in choosing their funds and their fund advisers.¹⁰⁶ Rather than proposing a board-oriented solution to advisers’ management fees, the SEC focused on an investor-oriented approach as a new federal

¹⁰² The defendants presented evidence that 58% of funds in the industry paid a 50 basis point management fee without breakpoints and that 29% of funds, in fact, paid a higher management fee rate. Plaintiff shareholders had sought to narrow the comparison to large funds, but evidence here was mixed: of funds with assets of \$200 million or more, eight out of 20 paid management fees of at least 50 basis points; and of funds with \$500 million or more of assets, three out of six did likewise. *See id.* at 611.

¹⁰³ *See* Meiselman v. Eberstadt, 170 A.2d 720 (Del. Ch. 1961); and Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963).

¹⁰⁴ *See e.g.*, Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000). In *Brehm*, shareholders of The Walt Disney Company brought a derivative claim for corporate waste against directors for approving an employment contract for the company’s president, Michael S. Ovitiz. In dismissing the claim, the Delaware Supreme Court explained:

The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk, for reasons explained elsewhere. Courts are ill-fitted to attempt to weigh the “adequacy” of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk.

746 A.2d at 263 (*quoting* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997)).

¹⁰⁵ *PPI Report* at 148.

¹⁰⁶ *Id.* at 131 (“[N]egotiations between the unaffiliated directors and fund advisers over advisory fees would . . . lack an essential element of arm’s-length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services. In view of the fund’s dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser’s reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry.”).

cause of action empowering fund shareholders, on behalf of funds, to sue advisers (not fund directors) over the level of management fees. What weight was a reviewing court to give to the approval by fund directors of the adviser's management contract?¹⁰⁷ According to the SEC: absolutely none, a court's adjudication should "be unaffected by either shareholder or directorial approval of advisory contracts."¹⁰⁸ However, this view soon changed.

B. *The 1970 Amendments, Burks, and the SEC's Reversal of View on Fund Boards*

Four years after the *PPI Report*, Congress amended the ICA and dealt with fund boards and management fees in two respects.¹⁰⁹ First, Congress heightened the eligibility criteria for persons serving as independent directors of funds. Prior to 1970, a person could qualify as an independent fund director simply by not being an "affiliated" person of a fund.¹¹⁰ As amended in 1970, the ICA casts a wider net, requiring that an independent director also avoid being an "interested person."¹¹¹ Second, the 1970 amendments

¹⁰⁷ Beginning with the original enactment of the ICA, initial approval and annual renewal of a fund adviser's management contract has depended on a vote in favor not only by a majority of a fund's entire board but also by a majority of the fund's independent directors. 15 U.S.C. § 80a-15(c) (1987).

¹⁰⁸ *PPI Study* at 144 (recommending that a court's review of the reasonableness of a fund adviser's fee "be unaffected by either shareholder or directorial approval of advisory contracts or other compensation arrangements."). The SEC did not limit its recommendation only to funds with external advisers but included, as well, funds that were managed by its own employees. Here too, the SEC asserted, conflicts of interest abide. *Id.* ("Relationships between internally managed investment companies and their officers and directors are not arm's-length relationships"). It is curious, therefore, that the SEC stated that it had considered, and rejected, as "too sweeping at this time," the alternative of "compulsory internalization of the management function." *Id.*

¹⁰⁹ Investment Company Act Amendments of 1970, Pub. L. No. 91-547, 84 Stat.1413 (1970) [hereinafter *1970 Amendments*]. In its *amicus* brief to the Supreme Court in *Burks*, the SEC stated that Congress amended the ICA in 1970 "at the recommendation of the [SEC]." Brief for the Securities and Exchange Commission as *Amicus Curiae*, *Burks v. Lasker*, 441 U.S. 471 (1979) at 13 [hereinafter *SEC amicus brief*], 1978 WL 207114 (Nov. 20, 1978).

¹¹⁰ An "affiliated person" of a fund means any individual who directly or indirectly controls or owns 5% or more of a fund's outstanding voting securities, any officer or employee of a fund, and the fund's investment adviser. 15 U.S.C. § 80a-2(a)(3) (2010).

¹¹¹ An "interested person" of a fund includes not only an affiliated person of a fund, but also a person who is: (i) an affiliated person (notably, any officer, director or employee) of a fund's adviser or principal underwriter, (ii) a member of the immediate family of any affiliated person of the fund's adviser or principal underwriter, (iii) a person who knowingly owns any security issued by the fund's adviser, principal underwriter, or parent of either, (iv) a person who has acted as lawyer for the fund, its adviser or principal underwriter in the preceding two years, (v) a person affiliated with any broker who has carried out trades for the fund within the preceding six months, and (vi) a person affiliated with any firm that has lent money to the fund within the preceding six months. Finally, the SEC is empowered to designate anyone else as an interested person, after notice and opportunity for hearing, upon finding that the person, within the preceding two years, has had a "material business or professional relationship" with the fund, any sister fund, the fund's investment adviser or principal underwriter, or any parent company of the fund's investment adviser or principal underwriter. *Id.* § 80a-2(a)(19).

added Section 36(b),¹¹² establishing a federal cause of action for fund shareholders to sue an adviser over management fees or any other fees paid by the fund to an adviser or an adviser's affiliate. Although suits are brought as derivative actions on behalf of a fund (and any recoveries paid to the fund), a plaintiff need not make demand on the fund board.¹¹³ A single shareholder may bring suit, without meeting any minimum ownership requirement or pre-suit holding period. However, Congress chose not to include the SEC's "reasonableness" test for management fees in Section 36(b). Instead, Congress chose a standard turning on whether an adviser has breached its fiduciary duty in respect to the fees it has charged.¹¹⁴

Section 36(b) also reflects Congress' rejection of the SEC's proposal made in 1966 that reviewing courts be explicitly directed to give no weight to the deliberations of fund directors underlying their approval of advisers' management contracts. To the contrary, Section 36(b) states that a reviewing court *should* take into account fund directors' (and fund shareholders') approval of an adviser's management contract by "giv[ing] such consideration . . . as is deemed appropriate under all the circumstances."¹¹⁵

¹¹² 15 U.S.C. § 80a-35(b) (2010) (amending 15 U.S.C. § 80a-35(b) (1987)) .

¹¹³ Section 36(b) is itself silent on whether a fund shareholder must first make demand on the fund board, as is typical for claims brought in derivative actions. But in the absence of express statutory language, the Supreme Court has ruled that no demand is required. *See Daily Income Fund v. Fox*, 464 U.S. 523 (1984).

¹¹⁴ 15 U.S.C. § 80a-35(b) (2010) (indicating that a fund's adviser "*shall be deemed* to have a fiduciary duty with respect to the receipt of compensation for services" (emphasis added)). This wording is rather curious given that fund advisers undisputedly are (and not merely "deemed to be") fiduciaries under state law. The implication is that, but for federal law, a fund adviser's fiduciary duty, while governing its provision of fiduciary services to its clients, does not encompass its compensation arrangements with those clients. In choosing a fiduciary duty standard, Congress rejected the SEC's recommended "reasonableness of fees" test. In so doing, Congress responded to the fund industry's concerns that such a test might compel fund advisers to accept "cost-plus" fee arrangements similar to those in public utility industries, and that such an approach might embroil the SEC and the courts in proceedings akin to ratemaking. *See* Investment Company Amendments of 1970, S. REP. No. 91-184 (2d Sess. 1970). *See also Daily Income Fund*, 464 U.S. at 538. The fiduciary standard of Section 36(b) has spawned extensive litigation, culminating in *Jones v. Harris Associates L.P.*, 559 U.S. 335 (2010), where the Supreme Court, essentially adopting the Second Circuit's approach in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), stated that "[T]o face liability under §36(b), an investment adviser must charge a fee that 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." *Jones*, 559 U.S. at 345.

¹¹⁵ 15 U.S.C. §80a-35(b)(2) (2010). On its face, this instruction to the courts seems tautological. What else would a court be expected to do, give an issue consideration that it does *not* deem appropriate under all the circumstances? To the extent the directive makes any sense, it reflects Congress' deliberate rejection of the SEC's recommendation in the *PPI Report* that courts give no weight to fund board approvals of management contracts for advisers. The Supreme Court, in its recent decision in *Jones v. Harris Associates*, has infused this seemingly innocuous language with important implications, endorsing the Second Circuit's reading that:

[T]he expertise of the independent [directors] of a fund . . . and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether they and the [investment adviser] are guilty of a breach of fiduciary duty in violation of § 36(b).

The 1970 amendments to the ICA did not immediately dispel doubts about the effectiveness of mutual fund boards. The apogee of judicial skepticism is the Second Circuit's decision (later reversed by the Supreme Court) in *Lasker v. Burks*.¹¹⁶ A fund had bought the commercial paper of Penn Central a few months before the company filed for bankruptcy in 1970, which at the time was the largest corporate failure in U.S. history. Two fund shareholders brought a derivative action against directors affiliated with the fund's adviser alleging liability and seeking monetary damages. The fund's board set up a special committee of independent directors, who then retained an expert (former chief judge of the New York Court of Appeals, Judge Stanley H. Fuld). Upon Fuld's advice, the independent directors decided that proceeding with the lawsuit would not serve the fund's interests and moved for dismissal. Finding the independent directors to have met the standard for disinterestedness in a derivative action, the district court dismissed the complaint.

The Second Circuit in *Lasker* overturned the lower court's ruling, and in so doing evoked the SEC's negative views about fund directors. According to the Second Circuit, fund directors could not be permitted to terminate derivative actions because the very structure of mutual funds, tied inextricably to their advisers, meant that independent directors *per se* lacked the capacity in derivative actions to oppose the adviser's interests and act in the interests of the fund's shareholders. This structural weakness, in the Second Circuit's eyes, obviated any need to inquire into particular facts as to whether any independent director met the test of disinterestedness relevant to derivative actions.¹¹⁷ Whatever their status, the Second Circuit expounded, "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the action of" directors affiliated with the adviser.¹¹⁸ The Second Circuit, in effect, ruled out the possibility that dismissal of a derivative suit (at least a non-frivolous derivative suit) could ever be in the interests of both fund shareholders and the adviser, or that independent directors could ever be trusted to reach that conclusion.¹¹⁹

Jones, at 559 U.S. at 349, citing *Gartenberg*, 694 F.2d at 930. One difficulty with the Court's statement is that it misstates the law: the fiduciary duty identified (or created) by Section 36(b) is only that of the fund adviser. Moreover, such duty is not an all-encompassing fiduciary duty but rather a focused one—a fiduciary duty “with respect to the receipt of compensation for services. . . .” 15 U.S.C. §80a-35(b) (2010) (emphasis added). Fund directors are subject to liability under a different provision, 15 U.S.C. §80a-35(a) (2010), which authorizes civil actions by the SEC (while silent on suits by private parties) against fund directors, fund advisers and others for “breach of fiduciary duty involving personal misconduct” in respect of mutual funds or other investment companies.

¹¹⁶ *Lasker v. Burks*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, *Burks v. Lasker*, 441 U.S. 471 (1979).

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 1212. The Second Circuit allowed for the possibility of a modest exception in cases where a court finds the suit to be frivolous.

¹¹⁹ The Second Circuit also drew a strained inference from the ICA. As discussed earlier, Congress in 1970 added an express cause of action, §36(b), to the ICA in 1970 authorizing

The Supreme Court, taking its cue from the 1970 amendments, repudiated the Second Circuit's dim view of fund boards.¹²⁰ But perhaps more noteworthy was the about-face taken by the SEC. In its *amicus* brief filed with the Supreme Court, the SEC urged that courts *should defer* to fund directors' decisions to terminate derivative actions if "the directors are truly independent, are fully informed of the material facts, and render a business judgment that is reasonable under all the circumstances."¹²¹ No longer, in the view of the SEC, were independent directors presumed to be *per se* incapable of acting independently.

The Supreme Court in *Burks* agreed with the SEC's new embracing view of independent directors, describing them as the "cornerstone" of the ICA's effort to address conflicts.¹²² The Court explained that state law in this context operated alongside federal law.¹²³ Notwithstanding the ICA's regulatory regime, the Supreme Court stated that independent fund directors, like corporate directors, could derive authority to terminate derivative actions under state law, at least where there was no cognizable conflict with the policies of the federal scheme.¹²⁴ It was irrelevant to the Supreme Court that the ICA happened to have no provision empowering fund directors to dismiss derivative actions.¹²⁵ What was relevant was the *absence* of any provision in the ICA that preempted state law in this respect.¹²⁶ The Supreme Court stopped short of reaching any particular finding under state law and

fund shareholders to sue advisers over management fees. In so doing, Congress did not require that plaintiffs make a demand on fund boards. From this, the Second Circuit in *Lasker* reasoned that demand on a fund board must not be required in *implied rights of action* brought under the ICA, as federal courts should infer a legislative purpose to preclude independent directors from terminating any derivative action. *Id.* at 1211.

¹²⁰ *Burks v. Lasker*, 441 U.S. 471 (1979).

¹²¹ SEC *amicus* brief, *supra* note 109, at 10. The SEC cited three decisions by the Supreme Court, pre-dating *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), to underscore its explanation of the business judgment rule. *United Copper Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Delaware & Hudson Co. v. Albany & Susquehanna Co.*, 213 U.S. 435 (1909), and *Hawes v. Oakland*, 104 U.S. 450, 461 (1881). *Erie Railroad*, however, erased a century-old swath of federal court jurisprudence by establishing that "there is no federal general common law." *Erie Railroad Co.*, 304 U.S. at 78.

¹²² *Burks*, 441 U.S. at 482.

¹²³ Speaking first of ordinary corporations, the Court observed that "[I]t is state law which is the font of corporate directors' powers. By contrast, federal law in this area is largely regulatory and prohibitory in nature; it often limits the exercise of directorial power, but only rarely creates it." *Id.* at 478. From this first principle, the Court declared "[f]ederal regulation of investment companies and advisers is not fundamentally different in this respect." *Id.*

¹²⁴ *Id.* at 486. The applicability of state law, the Court said, "relieves federal courts of the necessity to fashion an entire body of federal corporate law out of whole cloth." *Id.* at 480.

¹²⁵ *Id.* at 483-84.

¹²⁶ *Id.* The Court drew precisely the opposite inference than did the Second Circuit from the amendment to the ICA adding Section 36(b) creating an express federal cause of action for fund shareholders to sue advisers over fees without the necessity of first making a demand on a fund's board. The absence of a similar express cause of action for the claims brought in *Burks* implied, the Supreme Court reasoned, that Congress did not intend to foreclose the power of independent directors to terminate the derivative action. *Id.* at 484.

instead remanded the case for the determination of the state law question.¹²⁷ But in so doing, the Supreme Court made clear that inconsistent outcomes under the laws of different states would not mean that the law of any state would necessarily be in conflict with federal policies underlying the ICA because “[t]his is not a situation where federal policy requires uniformity”¹²⁸

In sum, upon enactment of the ICA and for more than three decades thereafter, the SEC placed few of its regulatory chips on independent directors and fund governance. Even the 1970 amendments, by their terms, gave no new powers to independent directors and did nothing to change the ICA’s original allocation of board seats between management directors and independent directors. Yet, by the time *Burks* was decided in 1979, the SEC embraced a different view of independent directors and began to pull on the thread of business judgment, perhaps in recognition that growth in the mutual fund industry was outpacing the SEC’s capacity for direct oversight. Whatever its reasons might have been, the SEC has increasingly depended on independent fund directors as the agency has reshaped important elements of the regulatory scheme for mutual funds. With this new regulatory dependence in mind, this Article will now examine the distribution of fund shares, the composition of fund boards, and shareholder access to mutual funds’ proxy statements for the nomination of directors.

IV. SEC RULEMAKING ON THE DISTRIBUTION OF FUND SHARES

A. *Statutory Restraints on Fund Directors*

One place to test the idea that fund directors, like corporate directors, exercise business judgment is the marketing and distribution of mutual fund shares. For ordinary corporations, the way they deliver their goods and services to customers is a crucial part of their business model, a key expense in their cost structure, and an important factor in the pricing of their product. Although corporate officers develop distribution strategies, directors retain ultimate authority to approve or change these strategies. But what about mutual funds? Mutual funds do not sell themselves. They must be sold and their

¹²⁷ *Id.* at 486. The Court made clear, however, that the requirement to determine state law did not emanate from *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), a diversity jurisdiction case. *Burks*, 441 U.S. at 476. *Burks* was a federal question case involving implied rights of action under the ICA and its sister statute, the Investment Advisers Act of 1940. Thus, the Court stated that here “state law does not operate of its own force.” *Id.* State law would be given effect, however, if on remand it was found to create no conflict with the policies underlying the federal regulatory regime for mutual funds. Justice Stewart, in his concurring opinion (joined by Justice Powell), left no doubt that he saw no such conflict. *Id.* at 487. (holding that “[s]ince Congress intended disinterested directors of mutual funds to be ‘independent watchdogs,’ I can see no possible conflict between this generally accepted principle of state law and the federal statutes in issue.”).

¹²⁸ *Burks*, 441 US at n.6.

distribution cost must be borne at one or more points along the way. If mutual funds are simply a type of corporation, one might expect that funds, like ordinary corporations, would initially bear distribution costs and in some fashion pass them on to customers in the purchase price. The comparison of mutual funds to ordinary corporations, however, breaks down because the “product” sold by mutual funds—collective investment management—takes the form of their own shares.

Marketing and distribution expenses can take different forms. Some funds are so-called “no load” funds, sold directly to investors by fund management firms through an affiliate, the fund’s principal underwriter. These firms incur expenses from advertising, toll-free phone centers (often operating 24 hours a day), and websites where investors can carry out purchases and redemptions, as well as obtain investment guidance and extensive information about funds being offered. The adviser adhering to this business model typically looks to its management fees to recover not only its investment management costs, but also its distribution costs. This model has the virtue of aligning incentives and reflecting economic reality. The fund adviser offers investment services to customers and, thus, has an incentive to market those services. Historically, although investment management firms that have marketed no load funds directly to investors have comprised a small minority of the industry’s participants, they include some of the industry’s largest companies, such as Vanguard, Fidelity, and T. Rowe Price. This Article will demonstrate, however, that the SEC has created uncertainty over the permissibility of bundling investment management and distribution services into a single fee agreement between fund and fund adviser.¹²⁹

Most fund management firms do not sell their funds’ shares directly to investors. Rather, they rely on third party broker-dealers for distribution. In the early decades after passage of the ICA, these broker-dealers received most, if not all, of their compensation from investors, who paid these broker-dealers sales loads, which are similar to brokerage commissions. The ICA deals with sales loads by allowing price fixing, not by the broker-dealers themselves but by mutual funds, which incorporate sales loads into the price that investors must pay for their shares. Broker-dealers, to be eligible to receive sales loads, must be in privity of contract with mutual funds to act as their dealers, and must agree to charge sales loads only at the levels set by the fund. To buttress these arrangements, the ICA actually *prohibits* fund dealers from negotiating sales loads with investors,¹³⁰ which is a striking

¹²⁹ See *infra* notes 156, 157, and accompanying text.

¹³⁰ 15 U.S.C. §80a-22(d) (1987). See *U.S. v. National Association of Securities Dealers*, 422 U.S. 694 (1975). An investor buying mutual fund shares that carry a sales load pays a single price, which covers not only the proceeds received by the fund (and the investor’s ownership interest in the fund) but also the compensation received by the dealer. Neither component of this bundled sales price is subject to negotiation. Section 22(d) of the ICA prohibits underwriters and dealers of mutual funds from selling fund shares at a price other than the “offering price described in the [fund’s] prospectus.” 15 U.S.C. §80a-22(d) (1987). Section 2(a)(35) clarifies that a sales load is part of the offering price, defining “sales load” to mean,

departure from the way broker-dealers buy and sell corporate stocks and bonds for their customers' accounts.

With the emergence of the Internet, a different model for distributing fund shares has evolved: online trading platforms, so-called "fund networks," operated by brokerage firms such as E*TRADE Securities and Schwab. This model accommodates different ways to compensate distributors of fund shares. Most notably, an investor can pay a commission to the online brokerage firm, acting as agent, rather than pay a fixed sales load to a dealer acting on behalf of the fund. Like commissions on individual stocks, these commissions are set by competitive forces.¹³¹

Whatever form distribution payments might take, Section 12(b) of the ICA,¹³² absent exemptive relief from the SEC, prohibits mutual funds from paying for the marketing and distribution of their shares.¹³³ Congress' design is clear: the prohibition is meant to mitigate a conflict of interest on the part of the fund adviser. The adviser is paid a management fee, which in the vast majority of cases is calculated as a percentage of the fund's net assets.¹³⁴ An

essentially, the difference between the public offering price per share and the portion of sales proceeds received by the fund for investment. See 15 U.S.C. § 80a-2(a)(35) (2010). If a sales load were unbundled from the offering price of fund shares, it would be expressed as a higher percentage. Take, for example, a 5% sales load incorporated into a fund's share price of \$100, meaning that the fund receives \$95 and the dealer \$5. If an investor pays the \$5 sales load separate from the \$95 price paid for her ownership interest, it would represent 5.26% of her share purchase price.

¹³¹ For example, in early 2015, E*TRADE Securities offered customers opening accounts with at least \$10,000 the opportunity to enter into up to 500 trades without commission for the first 60 days, and thereafter pay a commission of \$9.99 per trade for the next 149 trades, and \$7.99 thereafter for the next 500 trades. E*TRADE SECURITIES, <https://www.etrade.wallst.com/research/Screener/MutualFund> (last visited Oct. 25, 2015).

¹³² 15 U.S.C. § 80a-12(b) (2010).

¹³³ Section 12(b), hardly a paradigm of clarity, provides that:

It shall be unlawful for any [mutual fund] . . . to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. On its face, Section 12(b) would seem to be qualified in two respects, as by its terms: (1) it has no legal force unless implemented by SEC rule and (2) it seems to allow a fund to distribute its securities so long as it acts through an underwriter. See *id.* The SEC, however, has rejected both qualifications. First, the SEC has ignored the conditional language regarding SEC rules. See Bearing of Distribution Expenses by Mutual Funds, 44 Fed. Reg. 54014 (proposed Sept. 17, 1979) [hereinafter *Rule 12b-1 Proposing Release*] (suggesting that "[t]raditionally the [SEC] and the staff have taken the position that it is generally improper under the [ICA] for [mutual funds] directly or indirectly to bear expenses related to the distribution of their shares."). Second, the SEC has said "to the extent a mutual fund [makes] payments to promote the distribution of shares issued by it, the fund would be acting as a distributor of its shares, and . . . it would be doing so *in addition to* any functions which might be performed by an underwriter." Advance Notice, Bearing of Distribution Expenses by Mutual Funds, Rel. 43 Fed. Reg. 23589 n. 4 (May 31, 1978) [hereinafter *Advanced Notice of Distribution Expense Proposal*] (emphasis added).

¹³⁴ See *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 112 (1940) (statement of David Schenker). The bigger the fund, the more an adviser earns, all other things being equal. Take the case of a fund with \$100 million in assets and mediocre investment

adviser whose investing acumen produces strong returns for the fund can expect higher compensation under its asset-based fee, as securities held in the fund's portfolio appreciate in market value and as investors are attracted to purchase new shares in the fund. If, however, a fund grows in size only by heightened marketing or other distribution efforts, and the fund itself pays for such efforts, the adviser stands to reap greater compensation for reasons divorced from the fund's investment performance. Section 12(b) therefore precludes a fund from paying for its own distribution, but in so doing, also precludes fund directors from exercising their own business judgment on the matter.

As discussed later, in 1980, the SEC adopted a rule, Rule 12b-1, to lift this statutory prohibition. Before this rule was adopted, however, an industry practice emerged that enabled fund advisers to promote the sale of fund shares without paying distribution expenses. In the 1960s and early 1970s, the securities markets were straining under brokerage commission rates fixed by a cartel of U.S. stock exchanges, led by the New York Stock Exchange, with the indulgence (some might say, complicity) of the SEC. Until Congress in 1975 finally passed legislation to eliminate fixed rates, funds and other large investors could not negotiate the commissions paid to their brokers to act as their agents in the purchase and sale of securities for their investment portfolios. Although the exchanges set volume discounts, brokers were prohibited from negotiating discounts individually with customers. Under these circumstances, fund advisers assumed that since rates were non-negotiable, it was advantageous to send buy and sell orders to brokers to compensate them not only for executing portfolio trades, but also for distributing fund shares. By favoring brokers who performed in both capacities, the fund adviser could enlarge the size of its fund and, thus, the amount of its own compensation.

Sometimes the broker executing portfolio trades might be different from the broker distributing fund shares. How could the latter be compensated through commissions? The fund adviser could direct the executing broker to share (in the market vernacular, "give up") a portion of its brokerage commission to the distributing broker.

However, a different type of commission sharing arrangement offered a way, in theory at least, to benefit funds. Exchange rules allowed for the sharing of commissions among brokers as long as they were members of the same exchange. One broker might be the "executing" broker for an investor, that is, the one that actually performs trades. A second broker might clear

performance, paying its adviser, say, an annual management fee of 1%. Suppose that the adviser has free use of the fund's assets to pay for advertising or to compensate brokers for distributing fund shares. Every dollar so spent is one less dollar that could be invested for the fund. What happens if the fund over a few years doubles its size to \$200 million based not on investment gains, but rather on the adviser's use of fund assets to pay for marketing and distribution? The adviser's annual compensation would double to \$2 million, unrelated to the fund's investment performance.

and settle trades, arranging for delivery of securities and cash proceeds. Still another broker might furnish investment research helping an investor decide what to buy or sell. A single commission could be shared among these brokers, and an investor could (at least if it were an important customer, such as a mutual fund) instruct the executing broker to share the commission with other brokers. The question thus arose: was it feasible and permissible under the rules of the exchanges for a fund adviser to establish a broker-dealer affiliate for purposes of recapturing part of the commissions paid by the fund? This was a possible way for mutual funds to achieve the ability to negotiate commission rates with brokers. The adviser would send trade orders only to brokers who would agree to rebate part of the commission to the adviser's affiliated broker. The fund would gain the benefit of this arrangement by requiring the adviser to agree, on a dollar-for-dollar basis, to an offset of management fees in exchange for commission rebates paid to the fund's broker affiliate.

At the time of fixed commission rates, however, the permissibility under exchange rules of these commission rebate arrangements was far from clear. The SEC eventually came to view stock exchanges as a type of public utility, concluding that membership should be available only to brokers who would serve public investors at large on an equal footing.¹³⁵ The SEC contended that it would be unfair to smaller investors if mutual funds and other institutional investors were allowed to take advantage of their size and establish (or have their advisers establish) affiliated brokers to circumvent fixed commission rates.¹³⁶

Before the SEC reached this view, however, the feasibility of affiliates of fund advisers becoming members of a stock exchange was an unsettled question. This led to uncertainty about the duties owed by fund advisers with respect to commissions paid by their funds. Unclear, too, was the role to be played by fund directors. Courts addressed these questions in a trio of cases.¹³⁷ In the first, *Moses v. Burgin*, the First Circuit found fault with Fidelity, the fund adviser, which had not sought to establish a broker affiliate to recapture commissions and, instead, had caused funds to steer commissions to brokers engaged in distributing their shares. The court held that members of Fidelity's management had breached their duties for failing to be forth-

¹³⁵ See Utilization of Membership on National Securities Exchanges for Public Purposes, 38 Fed. Reg. 3902 (1973) (adopting Rule 19b-2 compelling stock exchanges to require their members to conduct a "public securities business," where at least 80% of trades are for the accounts of customers unaffiliated with the member) [hereinafter *Rule 19b-2 Adopting Release*].

¹³⁶ *Rule 19b-2 Adopting Release*, *supra* note 135, at 3911 ("[A]ny entity wishing to join or remain a member of an exchange must be predominantly engaged in the business of being a broker-dealer with public, unaffiliated customers and no entity . . . can be permitted to utilize an exchange membership solely for its own private trading purposes."). The SEC overlooked that mutual funds aggregate the savings of small, "public" investors.

¹³⁷ *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), and *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977).

coming with fund directors about the potential for recapturing commissions through a captive broker. The court, noting the role of “watchdog directors,”¹³⁸ found a duty on the part of the adviser to inform directors “where there was even a possible conflict of interest between [the adviser’s] interests and the interests of the fund.”¹³⁹ This special duty arose, according to the court, because “unlike an ordinary trust, or business,” the fund adviser’s activities are “frequently touched with self-interest.”¹⁴⁰

In *Fogel v. Chestnutt*, the Second Circuit followed the First Circuit’s lead, finding that the fund adviser breached its fiduciary duty by failing to apprise fund directors about the potential of commission recapture. By withholding information, the fund adviser, the court reasoned, prevented fund directors from exercising their business judgment on whether to pursue this option.¹⁴¹ In *Tannenbaum v. Zeller*, the Second Circuit reached a different conclusion, holding that the fund adviser had adequately apprised fund directors of the possibility—and attendant difficulties—of trying to recapture commission payments. Having been sufficiently informed, the fund directors, the Second Circuit reasoned, were in a position to exercise business judgment and the court thus deferred to their decision to forego the seemingly difficult and uncertain strategy of recapture. The court framed its ruling in negative language, stating that “[w]e have found nothing in the structure or legislative history of the [ICA] which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund’s board of directors.”¹⁴²

¹³⁸ *Moses*, 445 F.2d at 376.

¹³⁹ *Id.*

¹⁴⁰ *Id.* The court made clear that this standard of disclosure was independent of “whatever may be the duty of disclosure owed to ordinary corporate directors.” *Id.* In its decision, the court appeared to leave no room for fund directors’ business judgment, stating that “if recovery [of commissions] was freely available to [the fund], the fund’s directors had no . . . choice” but to require such recovery. *Id.* at 374. The court cited a provision in the fund’s charter requiring that the full proceeds of sales of the fund’s shares be paid over to the fund. The court construed this provision as prohibiting the adviser from steering brokerage commissions to reward distributing brokers because this reduced the proceeds received by the fund (albeit at an earlier time) in the sale of its shares. The issue, therefore, was not a matter of business judgment but instead simply a factual question as to whether commission reduction through a captive broker was permissible. *Id.* at 384.

¹⁴¹ *Fogel*, 533 F.2d at 750 (holding that “[i]f . . . the independent directors had concluded that, because of legal doubts, business considerations or both, the [fund] should make no effort at recapture, we would have a different case. But when there has been inadequate communication to the independent directors, it is no defense to the [adviser] . . . that a decision not to recapture, taken after proper communication, would have been a reasonable business judgment.”).

¹⁴² *Tannenbaum*, 552 F.2d at 417. The Second Circuit said that the directors in *Tannenbaum* could have exercised business judgment over recapture of brokerage commissions, but the directors in *Moses* could not, noting the fund charter provision that the First Circuit in *Moses* construed to require commission recapture whenever feasible. But the charter provision in *Moses* did nothing more than reiterate what the ICA, by operation of law, requires for all funds. See 15 U.S.C. §§ 80a-2(a)(35) (2010), 80a-22(d) (1987).

B. The SEC's Experiment in Directorial Business Judgment: Rule 12b-1

Court decisions regarding use of commissions to reward brokers for distributing fund shares presaged the SEC's relaxation of the statutory prohibition under Section 12(b) against use of fund assets to pay for distribution of fund shares. Even though brokerage rates were fixed at the time, fund advisers arguably were violating Section 12(b) by deliberately steering commission payments to brokers to reward them for their distributing activities. During the 1960s, the fund industry made little effort to persuade the SEC to loosen the statutory ban under Section 12(b). However, by the mid-1970s steady declines in stock prices took their toll on stock mutual funds. As stock prices drifted downward, the value of stock funds' investment portfolios declined, leading to redemptions that outpaced new sales. One obvious strategy to reverse this trend would have been to use fund assets to promote the sale of fund shares.

One view that the SEC could have taken was that the shrinkage of stock mutual funds was in the natural order of things as the value of stocks dropped. Market forces were working, allowing investors in stock mutual funds to reclaim their capital and re-allocate it to other investments, such as corporate bonds or bond mutual funds. This view would have been consistent with the SEC's historic approach to remain agnostic about investment decisions made by investors, so long as those investors had been afforded accurate information on which to make their decisions. However, the SEC was receptive to pleas from the fund industry that steps should be taken to stem the outflows from stock mutual funds. As a result, the SEC undertook a rulemaking process leading eventually to the adoption of Rule 12b-1,¹⁴³ which creates an exemption under Section 12(b), allowing funds, with approval of their boards, to pay for at least some of the costs of distributing their shares.

The SEC began this rulemaking process in 1978 by issuing a notice setting forth its preliminary views and soliciting public comment.¹⁴⁴ The SEC indicated that if an exemptive rule were to be established, certain conditions would attach. Fund advisers, rather than continuing to be paid management fees based on the size of their funds, might be required to agree to a flat dollar payment. This payment, moreover, might be capped at the amount that the adviser had been paid in the prior year when the fund had not been paying distribution costs. Further, for some specified period of years thereafter, a fund adviser might be required to continue to receive a flat dollar payment for investment management services, rather than an asset-based fee,

¹⁴³ 17 C.F.R. § 270.12b-1 (2013).

¹⁴⁴ The SEC, in 1978, did not formally propose a rule under Section 12(b) but instead took the preliminary (and unusual) step of providing "advance notice" of proposed rulemaking. *Advanced Notice of Distribution Expense Proposal*, *supra* note 133.

although a fund board could agree to raise the flat fee.¹⁴⁵ Changing the structure of the adviser's compensation, the SEC explained, could mitigate the conflicts of interest engendered by asset-based fees when a fund's growth is due simply to the sale of new shares rather than appreciation of the fund's investments.¹⁴⁶

What about existing shareholders of a fund? These investors, the SEC understood, had already paid a sales load and, if not, the adviser had already absorbed the distribution expense attendant to their purchases. Accordingly, the SEC proposed that these shareholders be "grandfathered," protected against indirectly bearing, in any part, payments out of fund assets to sell new shares to investors. Not to do so, the SEC stated, would result in current shareholders providing a subsidy to new shareholders.¹⁴⁷ Existing shareholders could be protected by creating a new class of shares for new investors, shares which would then bear the distribution payments made by the fund.

However, these two conditions—flat management fees for advisers and grandfathering of existing shareholders—were dropped in the face of fund industry opposition. In their stead, the SEC embraced a fund governance approach in which fund directors would play a controlling role. The SEC issued a proposed rule in 1979,¹⁴⁸ including a condition that a fund's independent directors separately approve any proposal that a fund pay distribution expense, and that the terms of such arrangements be set forth in a written plan.¹⁴⁹ Approvals by independent directors to renew any fund-paid distribution plan would also be required annually. The SEC, quite clearly, modeled its approach on the ICA's process for approval and renewal of advisers' management contracts.

The SEC went further: it proposed an explicit requirement that fund directors apply "reasonable business judgment" when approving a fund's

¹⁴⁵ The management fee increase, the SEC explained, would be "on the basis of portfolio performance." *Advanced Notice of Distribution Expense Proposal*, *supra* note 133 at 23591.

¹⁴⁶ The SEC was also concerned about the prospect that increases in fund assets could trigger higher compensation for officers of mutual funds that were internally managed. Accordingly, the SEC stated that it was considering "whether mutual funds which might bear distribution expenses should be prohibited from paying their officers salaries which vary directly with changes in the fund's assets, except for changes resulting from portfolio performance." *Id.* at n.6.

¹⁴⁷ *Id.* at 23592 (suggesting that "the use of fund assets to pay distribution expenses might be in the interest of one group of investors, but contrary to the interest of another group of investors. . . . [E]xisting shareholders would in effect be asked to pay further amounts for distribution and, to the extent that they did not invest in additional shares of the fund, they would not enjoy any direct benefit from the reduction or elimination of the sales load."). The SEC had expressed its position in even stronger terms several years earlier. SEC, Statement on the Future Structure of the Securities Markets, 37 Fed. Reg. 5291 (Feb. 2, 1972) (suggesting that "the cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing investors of the fund who often derive little or no benefit from the sale of new shares.").

¹⁴⁸ *Rule 12b-1 Proposing Release*, *supra* note 133.

¹⁴⁹ But the SEC proposed that only a vote by independent directors would be needed to terminate any plan for fund payments of distribution expense.

distribution plan and that any approval be based upon their determination that “there is a reasonable likelihood that the plan [to allow a fund to pay the costs of distribution] will benefit the company and its shareholders.”¹⁵⁰ At first blush, this requirement would seem redundant. Mutual funds are creatures of state law and fund directors are already subject to state fiduciary law regarding their decision-making.¹⁵¹ Why then would the SEC find it useful to incorporate state law into their new Rule 12b-1? A logical inference is that the SEC fully expected that fund directors, in the exercise of their ostensible business judgment, would decide not to tie fund advisers’ compensation to fixed dollar amounts nor grandfather existing shareholders. Perhaps this delegation of discretion to fund directors was the better part of valor, but the upshot of the SEC’s broadened embrace of fund directors’ business judgment was to allow practices which the SEC itself, only two years earlier, had viewed as undermining the interests of fund shareholders. Whereas the SEC had first envisioned fund directors’ business judgment as supplementing conflict mitigating rule conditions, the SEC, in adopting Rule 12b-1 seemingly saw fund directors’ business judgment as supplanting the SEC itself.

The SEC adopted its exemptive rule, Rule 12b-1, in 1980.¹⁵² The rule, the SEC explained, would permit fund directors “to exercise wider latitude in making business judgments without [SEC] approval and to enhance the role of directors, particularly the [independent] directors, in scrutinizing [fund] affairs.”¹⁵³ To underscore this “wider latitude,” the SEC dropped from Rule 12b-1 a list of factors that the rule, when proposed, would have required fund directors specifically to address. These factors included both (1) consideration of “the nature of the problems” that gave rise to the need to cause a fund to pay for distribution and (2) weighing the possible benefits to be gained by the fund adviser against the benefits to be gained by fund shareholders.¹⁵⁴ The SEC explained that its decision to delete these and other enumerated factors from the final rule was “to avoid the appearance of either unduly constricting the directors’ decision making process or of creating a mechanical checklist.”¹⁵⁵

What ensued after the SEC adopted Rule 12b-1 was predictable. Fund directors, in the supposed exercise of their business judgment, agreed to al-

¹⁵⁰ *Rule 12b-1 Proposing Release*, *supra* note 133, at 54020 (“[T]he authority for making the decision to use fund assets for distribution must carry with it accountability for that decision. What constitutes reasonable business judgment in a given case would depend on all the pertinent facts and circumstances of that case.”)

¹⁵¹ *Burks*, *supra* note 120.

¹⁵² *Bearing of Distribution Expenses by Mutual Funds*, 45 Fed. Reg. 73898 (Nov. 7, 1980) (to be codified at 17 C.F.R. pts. 239, 270, 274) [hereinafter *Rule 12b-1 Adopting Release*].

¹⁵³ *Id.* at 73903.

¹⁵⁴ *Rule 12b-1 Proposing Release*, *supra* note 133, at 54022.

¹⁵⁵ *Rule 12b-1 Adopting Release*, *supra* note 152, at 73904. The fund industry, while arguing against the fixed dollar fee and grandfather conditions, argued for an enumeration of factors in the rule to provide guidance (and perhaps safe harbor protection) for fund boards. Although it dropped these factors from Rule 12b-1 itself, the SEC included them in its release accompanying adoption of the rule to “provide helpful guidance to directors.” *Id.*

low advisers to be paid an asset-based management fee. As a consequence, increases in funds' size did indeed redound to the benefit of fund advisers. Fund shareholders in many if not most cases were not grandfathered from future distribution expenses. But in other ways, Rule 12b-1 produced results that were not readily predictable, opening the way for a range of distribution charges not clearly envisioned by the SEC in 1980. New funds were created with multiple classes of shares having varying levels of Rule 12b-1 expenses. While the SEC had anticipated that funds would pay distribution costs primarily for advertising and marketing, in practice most payments by funds went to broker-dealers as distributors of fund shares. Sales loads did not, however, disappear from the marketplace. Rather, funds in many cases combined two types of distribution payments in the same share classes, fund-paid Rule 12b-1 fees and investor-paid sales loads.

The SEC's decision to rely upon fund directors to exercise business judgment over whether to allow funds to pay distribution costs has led to a virtually unbroken streak of approvals by fund boards for over thirty years. With unerring consistency, fund directors have approved Rule 12b-1 plans during booms as well as busts. After all, it has not been difficult to rationalize a determination that funds and their shareholders are likely to benefit from the sale of new shares. If a fund has been shrinking because of net redemptions, how could it not be better off by selling new shares to offset redemptions? Even if a fund has been increasing in size, would it not be better for the fund to grow even larger by spending fund monies to bring in even more investors? In either event, the fund is in a better position to take advantage of economies of scale. This has meant, most importantly, an opportunity to take advantage of breakpoints built into the fund's investment management contract. True, the money spent by a fund to pay distributing dealers could have been put into new investments for existing shareholders, and those investments, if chosen wisely, could appreciate in value thereby leading to growth through performance rather than sales. But, the standard set by the SEC for board approvals under Rule 12b-1 has been exceedingly malleable, which befits the business judgment rule.

The SEC in 1980 need not, however, have treated distribution expense as a business judgment decision for fund directors. Market forces are in play, as is investor choice. Within a competitive market, funds have evolved with a range of different distribution expense options for investors. At one end of the spectrum, investors can choose no load funds sold directly by the likes of Vanguard, T. Rowe Price, and others. Internet broker-dealer firms like E*TRADE, Schwab, and ScottTrade operate web-based platforms for investors trading in mutual funds and individual stocks. At the other end of the spectrum, the traditional distribution system survives, reliant on broker-dealers, such as Edward Jones and Merrill Lynch, firms looking to sales loads and 12b-1 fees for their compensation.

For funds paying 12b-1 fees, the market has settled on a minimum fee of 0.25% (25 basis points). Where does this leave a fund (and its adviser) if

the fund's directors decide in the exercise of their business judgment that it would be in the interest of fund shareholders for the fund to pay no more than, say, 10 basis points to selling dealers? If the directors cling to this business judgment, dealers will decline to market the fund's shares and the fund will self-liquidate over time, as existing shareholders redeem their shares and are not replaced by new investors.¹⁵⁶ For a new fund, it might never get launched unless dealers are paid the minimum going rate for distribution services.

To wean funds from 12b-1 fees altogether, fund advisers might absorb distribution expenses themselves. More fund advisers might build their own distribution systems and sell their funds directly, and other advisers might use their own resources to pay third-party distributors. Fund advisers who use their own resources, rather than fund assets, to pay distribution expense must look to their management fees to offset not only their investment management expenses, but their distribution expense as well. Fund directors would be expected to take all of the adviser's expenses into account when approving the adviser's management contract. To illustrate, consider two funds, identical in all respects except for the allocation of distribution expenses. Fund A utilizes a 12b-1 plan to pay from its own assets a distribution fee of 25 basis points to dealers. Fund B employs an adviser who maintains its own distribution system with a 24 hour call center and website. Suppose further that the two advisers seek an annual fee of 1% of fund assets to compensate them for their investment management services. The adviser to Fund B, in addition, wants to offset its costs of distribution, which it estimates to be about 20 basis points, resulting in a total annual fee of 1.20%.

Fund B would thus bear slightly lower overall costs (1.20%) compared to Fund A (1.25%). However, Fund B's arrangement with its adviser, according to the SEC, could run afoul of Section 12(b). The SEC has warned fund directors not to approve management contracts if any "allowance" is made in recognition of the adviser's distribution expenses.¹⁵⁷ Whether such illicit allowance is made, in the SEC's view, depends on whether the fees paid to the adviser are "not excessive"—*if viewed as made solely for the adviser's investment management services*—in other words, ignoring the adviser's costs in distributing fund shares.¹⁵⁸ If fund directors reach this counterfactual conclusion, then the monies received are the adviser's "own

¹⁵⁶ See *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971).

¹⁵⁷ The SEC in its *Rule 12b-1 Adopting Release* stated:

[A]n indirect use of fund assets [in violation of ICA, § 12(b)] results if any allowance is made in the adviser's fee to provide money to finance distribution. Therefore, when an adviser finances distribution, fund directors, in discharging their responsibilities in connection with approval of the advisory contract, must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution or that Rule 12b-1 has been complied with.

Rule 12b-1 Adopting Release, *supra* note 152, at 73902.

¹⁵⁸ *Id.* at 73903.

resources,” and can be spent on anything the adviser so wishes, including paying dividends to its own shareholders or marketing fund shares. However, if payments to the adviser stray beyond what is “not excessive” for investment management services alone, then, in the SEC’s view, payments lose their status as the adviser’s own assets and revert to being fund assets, used impermissibly to pay distribution expense.

Returning to the illustration, one can see how the SEC’s metaphysics confound the notion of fund directors’ business judgment. Fund B’s shareholders arguably are getting a slightly better overall deal on expenses than Fund A’s shareholders, yet the SEC might view Fund B’s management contract as violating Section 12(b) because fund directors have agreed to an allowance to compensate the adviser for distribution expense. Further, and more seriously (given the disgorgement remedy available), the SEC has also elicited a question over whether the fund adviser has breached its fiduciary duty under Section 36(b).¹⁵⁹

In sum, Rule 12b-1 has spawned unnecessary complexity and has distorted the proper functioning of mutual fund boards. The SEC has, itself, signaled recognition of this result. In 2010, the SEC issued a proposal to rescind Rule 12b-1 and in its place to adopt new rules that would reduce regulatory hurdles.¹⁶⁰ In so doing, the SEC proposed a retreat from fund governance and business judgment, dropping the requirement that fund boards and independent directors decide whether fund-paid distribution plans are in the interests of fund shareholders. In one of its most significant statements about fund governance and competitive markets, the SEC explained that “one of the fundamental premises of rule 12b-1—that independent directors would play an active part in setting distribution fees—does not reflect the current economic realities of fund distribution. . . .”¹⁶¹ Particularly telling was a comment letter that the SEC received from an association of independent fund directors, informing the SEC that “[w]e are not aware of any board that has failed to renew a 12b-1 plan (or is likely to do so).”¹⁶²

In considering the role of fund directors, the experience that has unfolded over more than three decades under Rule 12b-1 provides the SEC with an opportunity for reevaluation. The value of fund boards arises from their policing role, safeguarding funds and their shareholders from overreaching by fund advisers. This is distinct from exercising business judg-

¹⁵⁹ To counter the confusion created by the SEC, some directly-sold funds have entered into so-called “defensive 12b-1 plans” with their advisers to go alongside their management contracts. By entering into these plans, the adviser takes the position that management fees are “legitimate” and “not excessive,” and hence may be spent on distribution. But, just in case the SEC were to disagree, the adviser has the fallback position that fund directors have, in any event, authorized the indirect use of fund assets to pay for distribution.

¹⁶⁰ SEC Mutual Fund Distribution Fees, 75 Fed. Reg. 47064 (proposed Aug. 4, 2010) (to be codified at 17 C.F.R. pts. 210, 239, 240, 249, 270, 274).

¹⁶¹ *Id.*

¹⁶² *Id.* at n. 139, quoting Comment Letter of the Independent Directors Council (July 19, 2007).

ment over the growth (or shrinkage) of funds due to net sales or net redemptions. On matters of distribution expense, latitude must be left for fund management firms to exercise their own business judgment and for investors to make their own choices based upon full and fair disclosure.

V. COMPOSITION OF FUND BOARDS AND THE INDEPENDENT CHAIRMAN PROPOSAL

A. 2001 Rulemaking: Requiring a Simple Majority of Independent Directors

The SEC's efforts to foster more business judgment by fund directors took on a wider cast in the agency's rulemaking to restructure fund boards. For ordinary corporations, the Sarbanes-Oxley Act¹⁶³ enlarged the federal thumb on the scale by requiring that audit committees of public companies consist entirely of directors meeting independence standards specified in the Act.¹⁶⁴ Further, the Dodd-Frank Act¹⁶⁵ added independence requirements for compensation committees of public companies.¹⁶⁶ Though not mandating the establishment of independent nominating committees, federal law, in the form of SEC proxy rules, requires public companies that have such committees to explain their structure, practices and policies, and for corporations that do not have them, to proffer an explanation.¹⁶⁷ Neither Congress nor the SEC has compelled corporations to separate the positions of chief executive

¹⁶³ *Sarbanes-Oxley Act*, *supra* note 1.

¹⁶⁴ The Sarbanes-Oxley Act directs the SEC to adopt rules mandating that U.S. stock exchanges include in their listing rules a requirement for independent audit committees. Mutual funds are not listed for trading on stock exchanges and therefore are not covered by the Act's audit committee composition requirements. The SEC implemented the Sarbanes-Oxley Act's audit committee requirement in 2003 by adopting Rule 10A-3. *See* SEC Standards Relating to Listed Company Audit Committees, 17 C.F.R. pts. 228, 229, 240, 249, 274 (2014).

¹⁶⁵ *Dodd-Frank Act*, *supra* note 2.

¹⁶⁶ Congress, here too, took the indirect approach of directing the SEC to compel the stock exchanges to include compensation committee requirements in their listing standards. Again, because mutual funds are not listed on exchanges, they are not subject to these requirements. The SEC implemented the Congressional mandate by adopting Rule 10C-1. *See* SEC Listing Standards for Compensation Committees, 17 C.F.R. pts. 229, 240 (2014).

¹⁶⁷ *See* 17 C.F.R. § 240.14a-101. For an explanation of the SEC's proxy disclosure rules regarding nominating committees, see SEC Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors 17 C.F.R. pts. 228, 229, 240, 249, 270, 274 (requiring corporations lacking nominating committees to "state the basis for the view of the board of directors that it is appropriate for the company not to have such a committee and identify each director who participates in the consideration of director nominees."). The SEC's rules on nominating committees are an example of how the SEC's disclosure requirements are designed not only to elicit information but also to shape behavior. Although the federal law does not require corporations to establish nominating committees nor dictate their composition, the listing rules of the nation's stock exchanges do. For example, The New York Stock Exchange requires that its listed companies have nominating committees consisting entirely of independent directors. *See* NYSE Listed Company Manual, § 303A.04(a) (Nov. 25, 2009). The NASDAQ does as well, though allowing for an exception where independent directors constitute a majority of the board and cast a separate vote on

officer and board chairman, or to install independent directors in the latter post. Nonetheless, Congress, in the Dodd-Frank Act, has nudged (or pushed) companies to separate the positions of chief executive officer and board chairman by requiring corporations who combine these two positions in one individual to explain their reasons to their shareholders.¹⁶⁸ The justifications given for superseding state law and private ordering in regard to the structure of corporate boards are, of course, to strengthen corporate governance, foster integrity in corporate operations and financial reporting, and serve shareholders' interests, which are all goals to be achieved by enlarging the presence and responsibilities of independent directors.¹⁶⁹

The reformist tide, with its emphasis on the importance of independent directors, has predictably spread to mutual fund boards. Recall that the ICA allows mutual funds, at least under certain conditions, to have a board composed of a majority (up to 60%) of directors who are affiliated with the fund adviser. By adopting the ICA in 1940, Congress deliberately chose to allow this governance structure because of its concern that a board comprising a majority of independent directors might wrest control from the fund adviser over portfolio management decisions, the very essence of the fund's business.¹⁷⁰

The process to restructure fund boards, without amending the ICA, began in 1992 when the SEC's staff delivered a report recommending that fund boards have a majority of independent directors. Not surprisingly, the staff

director nominations. See NASDAQ Listing Rules, Corporate Governance Requirements, § 5605(b)(1) (Jan. 1, 2015).

¹⁶⁸ See *Dodd-Frank Act*, *supra* note 2. In some cases, the explanation given by a company for combining the position of chief executive officer and chairman of the board in one individual can be quite succinct. See Proxy Statement of Berkshire Hathaway Inc. (2014) available at <http://www.sec.gov/Archives/edgar/data/1067983/000119312514099027/d656997ddef14a.htm> ("It is Mr. [Warren] Buffett's opinion that a controlling shareholder who is active in the business, as is currently the case and has been the case for Mr. Buffett for over the last 40 years, should hold both roles. This opinion is shared by Berkshire's Board of Directors."). Other companies have created the position of "lead independent director" in lieu of empowering an independent director to serve as chairman of the board, thereby simplifying their explanation. See, e.g., Proxy Statement of General Electric Corp. (2014) available at http://www.sec.gov/Archives/edgar/data/40545/000120677414000746/ge_def14a.htm#a_005 (stating that "[o]ur CEO also serves as the chairman of the Board. An independent director—selected by our independent directors—serves as the Board's lead director, with broad authority and responsibility over Board governance and operations. We believe that this structure is appropriate for GE because it allows one person to speak for and lead both the company and the Board. . . .").

¹⁶⁹ For a broader view of the purposes of the *Sarbanes-Oxley Act*, see Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1831 (contending that the purposes of the Sarbanes-Oxley Act are not only investor protection but also avoidance of social and economic dislocation and noting that "research . . . suggests independent directors do not necessarily create additional firm value, but may tolerate less fraud and illegality."). For a less sanguine view of recent legislation promoting the role of independent directors, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011), and Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855 (2014).

¹⁷⁰ See *House 1940 Hearings*, *supra* note 84, at 1113.

invoked advances in corporate governance.¹⁷¹ The staff's recommendations lay dormant until 1999, when the SEC convened a roundtable to discuss the role of fund directors.¹⁷² This then led the SEC, in 2001, to use its rulemaking authority to both require independent director majorities and allow only incumbent independent directors to vote on the nomination or appointment of their successors.¹⁷³ Strictly speaking, the SEC could not force these governance changes on fund boards in light of the ICA's explicit language allowing for a 60/40 split between management directors and independent directors. The SEC, instead, took an indirect route. Most funds depend on various SEC rules for exemptions from certain restrictions under the ICA, and the SEC has wide latitude in fashioning those rules. Here, the SEC crafted its fund governance requirements as conditions for funds seeking to take advantage of one or more of the agency's exemptive rules.¹⁷⁴

The fund industry put up little resistance to the SEC's independent director majority requirement and, indeed, by and large supported the change.

¹⁷¹ Indeed, the SEC staff contended that the case for a majority of independent directors on fund boards was even stronger than for corporate boards. SEC DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION, at 267-68 (1992) [hereinafter *Protecting Investors Report*] (stating that "[o]ur recommendation to require that a majority of investment company directors be disinterested is also consistent with a trend in large industrial or commercial companies, which do not have the unique structural conflicts faced by investment companies. . . . It would be anomalous if investment companies had boards with proportionately fewer independent directors than most large industrial companies."). As of 1992, the trend on corporate boards was a voluntary one. It was not until 2003 that the NYSE or NASDAQ required their listed companies to have independent director majorities. See SEC NASD and NYSE Rulemaking: Relating to Corporate Governance, Rel. No. 34-48745 (Nov. 4, 2003); see also SEC NYSE Rulemaking, Rel. No. 34-47672 (Apr. 11, 2003).

¹⁷² Then SEC chairman Arthur Levitt, at the outset of the roundtable, posed the (presumably) rhetorical question, "How should [fund] directors strike a proper balance between indifferent acquiescence and overzealous interference with management?" SEC Transcript of the Conference on the Role of Independent Investment Company Directors (Feb. 23, 1999). The irresistible conclusion that the optimal level of involvement lies somewhere in between.

¹⁷³ SEC Role of Independent Directors of Investment Companies, 17 C.F.R. pts. 239, 240, 270, 274 (2014) [hereinafter *SEC 2001 Fund Governance Rule*].

¹⁷⁴ The SEC drafted its fund governance rules not as stand-alone mandates but instead as conditions for funds or their advisers availing themselves of any of ten rules granting exemptions from various restrictions imposed by the ICA, namely, (1) Rule 10f-3, 17 C.F.R. § 270.10f-3 (2014) (permitting a fund's purchase of securities in a primary offering underwritten by an affiliate of its adviser); (2) Rule 12b-1, 17 C.F.R. § 270.12b-1 (2014) (permitting a fund to use its own assets to pay for distribution of its shares); (3) Rule 15a-4(b), 17 C.F.R. § 270.15a-4(b) (2014) (permitting fund board approval of interim investment advisory contract with new adviser without shareholder vote); (4) Rule 17a-7, 17 C.F.R. § 270.17a-7 (2014) (permitting funds with a common adviser to buy and sell portfolio securities between one another); (5) Rule 17a-8, 17 C.F.R. § 270.17a-8 (2014) (permitting mergers between funds with a common adviser); (6) Rule 17d-1, 17 C.F.R. § 270.17d-1 (2014) (permitting funds with a common adviser to buy joint liability insurance policies); (7) Rule 17e-1, 17 C.F.R. § 270.17e-1 (2014) (permitting a fund to execute portfolio trades through a broker affiliated with its adviser); (8) Rule 17g-1, 17 C.F.R. § 270.17g-1 (2014) (permitting funds with a common adviser to maintain joint insured bonds); (9) Rule 18f-3, 17 C.F.R. § 270.18f-3 (2014) (permitting a fund to issue more than one class of common stock); and (10) Rule 23c-3, 17 C.F.R. § 270.23c-3 (2014) (permitting closed-end funds intermittently to repurchase their shares).

To be sure, the fund industry's trade association, the ICI, issued a best practices report in 1999, endorsing an independent director majority for fund boards.¹⁷⁵ The actual impact of the new requirement was minimal because the industry by 2001 had overwhelmingly, and voluntarily, embraced the independent director majority model on its own. Nonetheless, the SEC, as a matter of procedural nicety, had to explain its action, achieving by rule what Congress had declined to do by legislation. The SEC noted that circumstances had changed since enactment of the ICA, that independent directors had assumed more responsibilities, and that, in any event, the industry supported the rule changes.

The SEC advanced one other reason: because a fund adviser "is separate and distinct from the fund it advises," the SEC stated that the adviser therefore owes "primary responsibility and loyalty to its own shareholders."¹⁷⁶ The SEC cited no legal authority for this contention,¹⁷⁷ which would invert fiduciary duties owed by an investment management firm to its clients and its shareholders. But a higher fiduciary duty is, of course, owed by the investment adviser to its fiduciary clients, not its owners, and it is irrelevant whether the adviser happens to be a sole proprietorship, a general partnership, a corporation, or any other business enterprise.¹⁷⁸ To be sure, conflicts of interest exist, but shareholders, as residual claimants, have no cognizable right or expectation to earnings achieved by an investment firm gained by unlawful means, including breach of fiduciary duty owed to clients. Indeed, this is the premise of Section 36(b) of the ICA. As for similar fiduciaries, no court would agree, for example, that a bank or trust company, in the exercise of its fiduciary powers over an estate or trust, owes a higher degree of fiduciary duty or loyalty to its own shareholders.

B. 2004 Rulemaking: Requiring a Supermajority of Independent Directors and an Independent Chairman

Within three years of requiring independent director majorities on fund boards, the SEC sought further change. In response to the "market timing" and "late trading" abuses that came to light in 2003,¹⁷⁹ the SEC proposed in

¹⁷⁵ INV. CO. INST., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS (1999) [hereinafter *ICI Best Practices Report*]

¹⁷⁶ SEC 2001 Fund Governance Rule, *supra* note 173, at 3735.

¹⁷⁷ Instead, the SEC cited its staff's earlier report for a factual assertion that did not establish its legal view. See SEC 2001 Fund Governance Rule, *supra* note 173, at n.3 (available at <https://www.sec.gov/rules/final/34-43786.htm>) (contending that "[a]s a result of their extensive involvement, and the general absence of shareholder activism, investment advisers typically dominate the funds they advise.").

¹⁷⁸ See RESTATEMENT (THIRD) OF TRUSTS § 29 cmt E. (2003) (explaining that "[a] trustee is ordinarily under a duty to the beneficiaries not to carry out a trust purpose or provision that the trustee knows or has reason to know is unlawful.").

¹⁷⁹ These abuses led to a swell of SEC enforcement proceedings against a number of mutual fund management firms, virtually all ending in settlements. See, e.g., In the Matter of Alliance Capital Management, L.P., IC Rel. No. 26312A (Jan. 15, 2004); In the Matter of

2004 a requirement that independent directors comprise a supermajority of at least 75% on fund boards and that only independent directors serve as fund board chairmen.¹⁸⁰ Emphasizing again the need to confront adviser conflicts,¹⁸¹ the SEC adopted changes later in 2004,¹⁸² stating that “many boards continue to be dominated by their management companies,” and that a 75% supermajority rule “will better assure that the independent directors can carry out their fiduciary responsibilities.”¹⁸³ Further, the SEC stated, any fund board chairman affiliated with the fund’s adviser has a personal conflict of interest,¹⁸⁴ tainted by a loyalty “divided between the fund and its investment adviser.”¹⁸⁵ The fund board chairman, the SEC intoned, cannot serve two masters.¹⁸⁶ Left unaddressed was whether fund boards should therefore

Putnam Investment Management, LLC, IC Rel. No. 26255 (Nov. 13, 2003); In the Matter of Pilgrim Baxter & Assoc., Ltd., IC Rel. No. 26470 (June 21, 2004). Market timing and late trading, though often tied together, are two discrete types of trading abuse. The former, in itself, is not necessarily illegal. In the broadest sense, all trading of securities, including mutual fund shares, can be said to involve market timing, that is to say, the time-honored strategy of buying low and selling high. In the case of mutual funds, market timing trades, like any trades, impose costs on funds, given that funds themselves are necessary counterparties. When investors try to time the market in a rapid flurry of trades occurring within two or three days, the costs to funds can mount, not only out-of-pocket costs (notably, brokerage commissions), but also the opportunity cost of having to keep excess cash in the fund to pay redemptions. To counter market timing trades, funds took steps to ward off offending traders. Market timing abuses entailed concerted efforts by traders to evade these measures, at times with the complicity of fund advisers. Notwithstanding the abuses associated with market timing trading, the SEC has not banned it. Instead, the SEC has amended its rules to require that mutual funds disclose whether they have policies and procedures to prevent market timing, and funds that have such policies must provide details of how they are applied. See Disclosure Regarding Market Timing And Selective Disclosure Of Portfolio Holdings, 68 Fed. Reg. 70402 (Dec. 17, 2003). Late trading, in contrast to market timing, is per se illegal. SEC rules have long required that the price of each trade—whether a purchase or a redemption—be based upon a “forward” price for a mutual fund’s shares, that is, a price that is set based upon the net asset value of a fund’s holdings as of a time after an investor places his or her purchase or redemption offer. See SEC Rule 22c-1, 17 C.F.R. § 270.22c-1 (2014). Prior to adoption of “forward pricing,” purchase and redemption prices were based on the NAV of a fund’s assets as of the close of trading on the prior business day. This “backward” pricing allowed fund adviser insiders (and those with whom they shared information) to buy and redeem shares knowing whether the fund’s NAV was increasing or decreasing during the current day and thereby to capture essentially risk-free profits. See *U.S. v. National Ass’n. of Securities Dealers*, 422 U.S. 694 (1975).

¹⁸⁰ *Investment Company Governance*, 69 Fed. Reg. 3472 (proposed Jan. 23, 2004) (to be codified at 17 C.F.R. pt. 270).

¹⁸¹ The SEC stated that “[o]ur concern is that in many fund groups . . . , the fund adviser exerts a dominant influence over the board. Because of its monopoly over information about the fund and its frequent ability to control the board’s agenda, the adviser is in a position to attempt to impede directors from exercising their oversight role. *Id.* at 3473.

¹⁸² *Investment Company Governance*, 69 Fed. Reg. 46378 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270) [hereinafter *Investment Company Adopting Release*].

¹⁸³ *Investment Company Adopting Release*, *supra* note 182 at 46381-82.

¹⁸⁴ The SEC stated that “[w]e believe that a fund board is in a better position to protect the interests of the fund, and to fulfill the board’s obligations . . . when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser.” *Id.* at 46382.

¹⁸⁵ *Id.* at 46383.

¹⁸⁶ The SEC took note of objections of some commentators—including some independent directors—that its rule would deprive fund directors of the ability to choose a chairman from among the full slate serving on a fund board, including, at least in some cases, an adviser-

consist solely of independent directors, since any director affiliated with a fund adviser would also suffer from a divided loyalty.¹⁸⁷ Rather, the SEC turned again to notions of corporate governance, stating that “the first important initiative is for the [corporate] board . . . to develop an identified independent leadership, by separating the roles of chairman of the board and CEO and appointing an independent director as chairman. Independent leadership is critical to positioning the board as an objective body distinct from management.”¹⁸⁸

In adopting its rule changes, the SEC claimed that the rule’s objective was to strengthen the “watch dog” role of independent directors, yet the SEC simultaneously emphasized that an independent chairman “can play an important role in . . . negotiating the best deal for shareholders when considering the advisory contract.”¹⁸⁹ Here, the SEC embraced a business judgment role for independent directors.¹⁹⁰ But, under the ICA, every approval or renewal by a fund board of the adviser’s management contract must gain the affirmative vote of a majority of a fund’s independent directors.¹⁹¹ This unilateral power of independent directors does not depend upon who the chairman of the fund board happens to be or whether independent directors make up a minority, a simple majority, or a supermajority of the entire board. It also does not depend upon the agenda-setting power of a fund board chairman. Independent directors can decide for themselves as to when, and how frequently, they will meet to deliberate on their separate vote. Further, the independent directors are in a position to demand whatever information they view to be relevant to enable them to cast an informed vote on the adviser’s management contract. Indeed, the ICA places an affirmative obligation upon the fund adviser to furnish relevant information to fund directors in connec-

affiliated director who is seen as the most qualified and capable to serve as chairman. The SEC stated that its rule “[does] not prevent the independent directors from choosing the most qualified and capable candidate” to serve as fund chairman as long as that person is not affiliated with the fund adviser. *Id.*

¹⁸⁷ The SEC stated “[w]e fully expect that [adviser-affiliated] executives will continue to serve on fund boards, although not in the capacity of chairman, and thus will have every opportunity to engage the board on issues important to the fund investors as well as the management company.” *Id.* at 46384.

¹⁸⁸ *Id.* at n. 53 (citing PAUL W. MACAVOY & IRA M. MILLSTEIN, *THE RECURRENT CRISIS IN CORPORATE GOVERNANCE* 119 (2004)).

¹⁸⁹ *Investment Company Adopting Release*, *supra* note 182 at 46383. Fusing (or perhaps confusing) fund governance with market economics, the SEC proffered that “the best way to ensure that funds obtain fair and reasonable fees is through a marketplace of vigorous, independent and diligent mutual fund boards, coupled with fully informed investors . . .” *Id.* at 46381.

¹⁹⁰ *Id.* at n. 17. The SEC attributed significance to one “particularly insightful” comment letter from an independent fund director who claimed, according to the SEC, that the presence of an independent chairman was “instrumental in causing the board to switch fund advisers.” *Id.* at n. 51 (citing Letter from James J. McMonagle to William H. Donaldson, Chairman, SEC (Jan. 14, 2004) available at <http://www.sec.gov/rules/proposed/s70304/s70304-5.pdf>).

¹⁹¹ 15 U.S.C. § 80a-15(c) (1987).

tion with their deliberations over the adviser's investment management contract.¹⁹²

Two SEC commissioners dissented from approval of the Independent Chairman Rule. The dissenting commissioners asserted that fund advisers are themselves fiduciaries and that their interests (and those of management directors serving on fund boards) are not necessarily at odds with fund shareholders' interests.¹⁹³ The commissioners contended that the SEC, in approving a 75% independence requirement, imposed unnecessary costs on funds and acted precipitously, cutting off the opportunity to evaluate the impact of the independent director majority requirement adopted only three years earlier. As for the independent chairman requirement, the dissenters contended that the record could not support the proposition that funds with independent chairmen were likely to achieve higher investment returns than funds with management chairs.¹⁹⁴ Further, the dissenters rejected the contention that funds with management chairmen were more apt than independently chaired funds to be complicit in late trading or market timing abuses.¹⁹⁵ In place of the Independent Chairman Rule, the dissenting commissioners proposed a disclosure alternative, one that would have required funds to disclose whether their board chairman was a management or independent director, allowing investors to decide how much weight, if any, to give to this variable.

Defending its rule, the SEC twice met with defeat in the D.C. Circuit. In its first review, the court faulted the SEC for failing to undertake a cost-benefit analysis and remanded the case back to the agency.¹⁹⁶ Within nine

¹⁹² 15 U.S.C. § 80a-15(c) (1987).

¹⁹³ *Investment Company Adopting Release*, *supra* note 182, at n.31 & 32 (discussing how "[i]nterested fund directors have an incentive to maximize fund performance because good performance matters to fund investors, who factor it into their investment decisions. Thus, market forces compel fund advisers to offer fund shareholders good performance for a reasonable fee in order to preserve the integrity and hence, marketability, of its brand.")

¹⁹⁴ The dissenters pointed to a study commissioned by Fidelity Investments and submitted in a comment letter from this author on behalf of Fidelity. See Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Co. to Jonathan G. Katz, SEC (Mar. 10, 2004) available at <http://www.sec.gov/rules/proposed/s70304/fidelity031004.htm>; GEOFFREY H. BOBROFF & THOMAS H. MACK, ASSESSING THE SIGNIFICANCE OF MUTUAL FUND BOARD INDEPENDENT CHAIRS: A STUDY FOR FIDELITY INVESTMENTS (Mar. 10, 2004) [hereinafter *Bobroff-Mack Study*]. The Bobroff-Mack Study found, in fact, that funds with management chairmen outperformed those with independent chairmen. The three Commissioners voting to approve the Independent Chairman Rule sought to minimize the relevance of the Bobroff-Mack Study, because it was not a "pre-existing" study. See *Investment Company Adopting Release*, *supra* note 182, at n. 52. Regulatory agencies, of course, regularly accord weight to empirical studies undertaken in response to their rulemaking.

¹⁹⁵ *Investment Company Adopting Release*, *supra* note 182, at n.26 (noting that while proponents of the Independent Chairman Rule claim that 80% of the funds involved in late trading and market timing abuses had management chairs, "approximately eighty percent of all fund firms have interested chairpersons, . . . suggest[ing] only that funds with [management chairmen] are proportionally implicated in the abusive activity.")

¹⁹⁶ *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) [hereinafter *Chamber of Commerce I*]. The D.C. Circuit found that the SEC erred in failing to evaluate the costs of its rule. With respect to the 75% independent director requirement, the SEC had

days of the D.C. Circuit's initial remand, on a 3-2 vote, the SEC re-approved its rule,¹⁹⁷ having engaged in a truncated cost-benefit analysis without re-opening the record for public comment.¹⁹⁸ The agency found that benefits exceeded costs, in part because "many, if not most, funds" would meet the 75% requirement by dropping management directors rather than adding new independent directors. This outcome, which would have merely retained rather than increased the number of independent directors on the boards of many funds, would appear less than ideal given the SEC's stated objective of strengthening the role of independent directors.¹⁹⁹ In any event, the D.C. Circuit vacated the SEC's rule,²⁰⁰ finding upon its second review fatal procedural irregularities, including the SEC's reliance on data outside the public rulemaking record and failure to re-open the public comment period to allow

claimed that it had no reliable basis for determining how funds might comply, but the court explained that the agency must nonetheless undertake an effort to do so, even if this were to be only an estimate of a range of costs. *See id.* at 143. In *Chamber of Commerce I*, however, the D.C. Circuit affirmed the SEC's broad powers under the ICA to include fund governance conditions in its exemptive rules, notwithstanding the statute's silence on who may serve as a fund board chairman and a general mandate that independent directors need constitute only 40% of a fund board. *See id.* at 138-39 (noting that § 6(c) of the ICA "conspicuously confers upon the [SEC] broad authority to exempt transactions from rules promulgated under the ICA, subject only to the public interest and the purposes of the ICA.") The D.C. Circuit rejected plaintiff's argument that the SEC lacked authority to impose a 75% independent director supermajority condition in its exemptive rules because Congress had itself chosen to impose such a requirement only in a different and more limited circumstance in Section 15(f) of the ICA. Enacted in 1987, Section 15(f) permits a departing fund adviser to receive payment from a new fund adviser if, among other things, the fund maintains a 75% supermajority of independent directors for at least three years. *See* 15 U.S.C. § 80a-15(f) (1987).

¹⁹⁷ Investment Company Governance, 70 Fed. Reg. 39390 (July 7, 2005) (to be codified at 17 C.F.R. pt. 270) [hereinafter *SEC Response to Remand*].

¹⁹⁸ The SEC refused to re-open the record for public comment notwithstanding its earlier contention that it had "no reliable basis" for estimating costs. *See Investment Company Adopting Release, supra* note 182, at n.81. The agency explained that it had taken into account publicly available cost data outside of the public rulemaking record, and that allowing time for further public comment was "not only unnecessary, it risks significant harm to investors without corresponding benefits. . . ." *SEC Response to Remand, supra* note 197, at 39391. The SEC's hasty re-adoption of the Independent Chairman rule coincided with the previously announced retirement date of the agency's chairman, William Donaldson, whose vote was essential to the rule's re-approval. The SEC invoked the importance of the "unique familiarity" that outgoing Chairman Donaldson, along with his fellow commissioners, had of the rule proposal. *Id.* In contrast to the 9-day interval between the D.C. Circuit's remand and the SEC's re-approval, the period between the SEC's original proposal and initial adoption of the Independent Chairman rule spanned more than six months. Donaldson's successor as SEC chairman, Christopher Cox, was confirmed by the U.S. Senate 34 days after Donaldson's departure.

¹⁹⁹ The SEC also explained that the costs of its Independent Chairman rule were "extremely small relative to the fund assets for which fund boards are responsible." *SEC Response to Remand, supra* note 197, at 39395. But in other settings, the SEC has emphasized how fund expenses, seemingly small as a percentage of fund assets, can have a significant impact over time on investment returns. *See, e.g.,* SEC, Mutual Fund Investing: Look at More than a Fund's Past Performance available at <http://www.sec.gov/investor/pubs/mfperform.htm> (last visited Jan. 19, 2015) (discussing how "[e]ven small differences in [mutual fund] fees can translate into large differences in returns over time.").

²⁰⁰ Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890 (D.C. Cir. 2006) [hereinafter *Chamber of Commerce II*].

interested parties an opportunity to submit comments following the appellate court's remand.²⁰¹

Since the SEC met its dual defeats before the D.C. Circuit in 2004 and 2006, the agency has not sought to resurrect its Independent Chairman Rule. The prospects for a future attempt, however, loom, which would perhaps be predicated again on the theory that competition among hundreds of fund advisers in the United States has yet to bring about competitive management fee rates, and that independent directors can transform themselves into effective negotiators if their proportion on fund boards is increased.

VI. SHAREHOLDER NOMINATION OF DIRECTORS

A. Background

The historical practice in the United States has been for a public corporation's board of directors (directly or through a nominating committee) to nominate candidates for election at an upcoming annual meeting of shareholders. This exercise rarely augurs change in the corporation's business strategies or operations because the nominees are usually incumbent directors standing for re-election. To prepare the stage, the board authorizes drafting of the company's proxy materials, consisting of a proxy statement and proxy card. The former is a disclosure document, providing detailed information called for by SEC rules, including the background and experience of the board's nominees, as well as an explanation of other matters, such as stock option plans, on which management is seeking shareholder approval. The latter is a form of ballot for each matter to be voted on, and in the election of directors, only the names of candidates nominated by the board appear. The company must file its proxy materials (and any later supplements thereto) with the SEC and arrange for the company's distribution to all shareholders.

Drafting and vetting a proxy statement, and attending to other steps preparatory to the shareholders' meeting, is an elaborate and extended process, laden with legal risks for missteps.²⁰² For many public corporations, this means hiring experienced (and expensive) outside lawyers, often working together with inside counsel. Senior executives frequently travel to meet with major shareholders as part of the annual exercise (especially when other items, such as stock option plans, are on the agenda), retaining outside firms (proxy solicitors) to help garner votes for the company sufficient not only to

²⁰¹ *Chamber of Commerce II*, *supra* note 200, at 908-09. When a court of final disposition vacates an agency's rule, the rule has no legal effect. Yet, the Code of Federal Regulations has not been revised to delete the long-vacated 75% independent director supermajority and independent chairman requirement. See 17 C.F.R. § 270.0-1(a)(7)(i) & (iv) (2014). The SEC apparently has neglected to correct the record or, if it has sought to do so, has been unsuccessful.

²⁰² The SEC's proxy rules impose liability for material misstatements or omissions in proxy statements. See Securities Exchange Act, 17 C.F.R. §240.14a-9 (2014).

ensure a quorum, but also a successful outcome. All expenses attendant to the election of board nominees are borne not by the nominees, but by the company.

A mix of practice and law over the years has relegated a shareholder's voice in the election of directors to low decibels. Boards can and often do elicit input from major shareholders about potential candidates, but are under no duty to act upon shareholders' recommendations. Boards are free to nominate candidates exceeding the number of open seats, but the practice has been to nominate only the bare minimum, akin to a political election where only one party nominates candidates. Until recently, nearly all public companies have treated a plurality rather than a majority of shares voted as sufficient to elect unopposed candidates.²⁰³ Thus, when candidates run unopposed, only one share cast in favor of each nominee is needed to elect all.

Shareholders typically have a right under state law to nominate candidates at the meeting, but by this time it is too late. Shareholders rarely attend these meetings and instead act earlier on their preferences by filling out and returning proxy cards, which confer upon their proxy agent (also chosen by the company) authority to attend the meeting on their behalf and to vote their shares according to instructions. The only way that insurgent shareholders traditionally have advanced their own candidates has been by waging a proxy contest and bearing their own expenses, including the drafting, distribution and filing of their own proxy statements.

Insurgent shareholders who wrest control of a company's board are typically reimbursed by the newly constituted board. Further, recent changes in state legislation now allow bylaw changes by shareholders to authorize corporate reimbursement of insurgents. This is true for corporations organized in Delaware²⁰⁴ and in other states (approximately thirty) which have adopted recent changes to the Model Business Corporation Act.²⁰⁵ Reimbursement can go not only to insurgents whose candidates prevail but also to those

²⁰³ In recent years, corporations, in great numbers, have abandoned plurality voting in unopposed elections of directors and embraced majority voting. The shift to majority voting, however, has for the most part taken place with the nation's largest public corporations, and most mid-size and smaller public corporations retain plurality voting. *See* COMM. ON CORPORATE LAWS, REPORT OF THE COMMITTEE ON CORPORATE LAWS ON VOTING BY SHAREHOLDERS FOR THE ELECTION OF DIRECTORS 6 (2006).

²⁰⁴ In 2009, the Delaware Supreme Court held that shareholders in Delaware corporations, incidental to their authority (shared with directors) to initiate bylaw changes, could propose and adopt bylaws to establish procedures by which shareholders can gain access to company proxy statements to nominate their own candidates for election as directors. *See* *CA, Inc. v. AFSCME*, 953 A.2d 227 (Del. 2008). The Delaware Code, following that decision, was amended to elaborate this right and to authorize bylaws providing for corporate reimbursement of proxy solicitation expenses incurred by shareholders, even in instances where shareholders' candidates are defeated. DEL. CODE ANN. tit. 8, §§ 112, 113.

²⁰⁵ The Model Business Corporation Act, drafted by a committee of the American Bar Association and adopted in substantial form in a majority of states, has been revised to provide for proxy access and proxy solicitation expense reimbursement. MODEL BUS. CORP. ACT § 2.06(c)(2) (2010).

whose candidates gain a designated minimum percentage of votes in a losing effort. Yet, these developments do not assure parity. Whereas board members never bear expenses for their candidates (even if defeated), insurgent shareholders do bear expenses if their candidates fail to muster sufficient votes.

To reduce this continuing imbalance, some have pressed for a “proxy access” right that would entitle shareholders (or at least some shareholders) to include the names of their nominees in companies’ proxy statements (and proxy cards), alongside the names of the board’s nominees. This right would grant nominating shareholders the ability to include an argument in favor of their nominees. Advocates for proxy access see this as a forceful and practical way to confront advantages of director incumbency.²⁰⁶ In its absence, the argument goes, the power of shareholders to elect directors, a cardinal principle enshrined in corporate law, is reduced to a formalism with a preordained outcome.²⁰⁷ Opponents of proxy access, not surprisingly, assert the primacy of boards to manage the business of the corporation, and contend that independent nominating committees are (or are designed to be) responsive to shareholders’ concerns. It is not self-evident, however, that nominating directors is simply an exercise in business decision-making. It is, first and foremost, a governance decision. In this light, proxy access arguably serves to legitimize board primacy, as shareholders who seek change in a company’s business strategies can create such change only indirectly, by electing new directors.²⁰⁸

B. *The SEC’s Proxy Access Rule*

Although the debate over proxy access has spanned a decade, the case for sweeping change in mutual funds appears mostly as an afterthought. The SEC’s foray into such rulemaking began in 2003, when the agency proposed granting some shareholders a federal right of proxy access. The right would be available only to shareholders who met the minimum ownership and

²⁰⁶ Another alternative, a technological one, has emerged: use of the Internet to communicate with shareholders. The SEC has adopted a rule allowing companies to post their proxy statements online and simply to send a postcard or brief letter to shareholders to apprise them of the availability of the online proxy statement. Internet Availability of Proxy Rules, 17 CFR § 240.14a-16 (2010). The rule requires companies to send hard copy proxy statements only to shareholders who request them. Insurgent shareholders seeking to wage an otherwise conventional proxy fight to replace some, or even all, of the incumbent directors, can likewise make use of these rules. *See id.* E-access holds out some promise to reduce the costs of waging proxy fights by cutting back substantially on printing and mailing costs, but other substantial costs of a conventional proxy fight remain, including the costs of drafting the proxy statement, legal fees, proxy solicitors’ fees and the like.

²⁰⁷ Lucian Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 Bus. Law. 43 (2003).

²⁰⁸ *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) (observing that the “shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

holding period thresholds set by the SEC, not by state law.²⁰⁹ The right was further conditioned on one of two triggering events, which, according to the SEC, suggested that “the company has been unresponsive to security holder concerns as they relate to the proxy process.”²¹⁰ The first suggested triggering event was a vote of disapproval by shareholders on at least one board nominee who runs for director unopposed.²¹¹ A shareholder would convey disapproval by withholding his vote in favor of a candidate named in the company’s proxy card. It would not be necessary that a majority of shares represented at the meeting be withheld; a withholding of 35% of shares would be sufficient.²¹² The second suggested triggering event was approval by shareholders of a proposal that the company submit itself (opt-in) to the SEC’s proxy access rule.²¹³ In this circumstance, the rule would not mandate a right of proxy access, but rather would afford the means for shareholders to gain the federal right.

The SEC extended its proposal to mutual funds (as well as closed-end funds)²¹⁴ but did not explain why, reflecting a presumption that mutual fund governance should simply fall in line with corporate governance. In its proposing release, the agency shifted the burden to objectors to demonstrate why funds should be excluded.²¹⁵ Otherwise, the SEC limited its discussion of mutual funds to details about their filing requirements and sporadic, rather than annual, shareholders’ meetings.

²⁰⁹ Security Holder Director Nominations, Release No. 34-48626 (October 23, 2003). The requisite shareholding was five percent of a company’s outstanding shares, and the minimum holding period was two years, tied to a requirement that the nominating shareholder or shareholder group declare an intention to continue to hold the requisite percentage through the date of the shareholders’ meeting. The SEC explained that its proposal would not impinge upon the prerogatives of state legislatures and courts, because “nothing in the proposed procedure establishes a right of security holders to nominate candidates for election to a company’s board of directors; rather, the proposed procedure involves disclosure and other requirements concerning proxy materials that are conditioned on the existence of such a right under state law. . . .” *Id.* at 60787. But state law typically recognizes the right of *every* shareholder attending a shareholders’ meeting, without regard to the amount or duration of her share ownership, to nominate one or more persons for election as directors.

²¹⁰ *Id.* The SEC further characterized these events as “showing that the proxy process may be ineffective.” *Id.* at 60816.

²¹¹ Traditionally, a company’s proxy card does not afford shareholders the option of voting “against” a board nominee. Rather, the choice is “for,” “withhold,” or “abstain.” So, under the SEC’s proposal, the triggering event would occur if shareholders of at least 35% of shares represented at the meeting marked their proxy cards as “withheld” for a nominee, even if that nominee were elected by a plurality (or a majority) of shares. The withhold vote must have taken place at a shareholders’ meeting within the current year or one of the two preceding years. Security Holder Director Nominations, *supra* note 209, at 60816.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.* at 60804.

²¹⁵ *Id.* at 60805. (“Are the triggering events . . . appropriate for funds? Are there other nomination procedure triggering events that should be used?”)

The 2003 proposal drew strong opposition from corporations and the corporate bar.²¹⁶ Corporate opponents argued that the SEC had no authority and should leave the matter to the states, which have historically had primary responsibility for governing shareholders' rights and internal corporate affairs. Opponents argued, too, that provisions of the recently-enacted Sarbanes-Oxley Act needed time to work, and that trends toward independent nominating committees and majority voting for director elections further reduced the need for the SEC's intervention. Finally, opponents warned that special interests, notably labor unions, would use proxy access to promote their parochial agendas at the expense of other shareholders.

The SEC's proposal lay dormant until 2009, when it was resurrected in revised form.²¹⁷ Gone were triggering events. A federal right of proxy access would be conferred on any shareholder or shareholder group which met newly-fashioned ownership and holding duration thresholds.²¹⁸ The 2009 proposal, like its predecessor, met with strong opposition from the corporate sector.²¹⁹ In addition to earlier objections, opponents argued to maintain the

²¹⁶ See, e.g., Letter from James J. Johnson, Chief Legal Officer, Procter & Gamble, to the SEC (Dec. 19, 2003) ([available at http://www.sec.gov/rules/proposed/s71903/s7-19-03-426.pdf](http://www.sec.gov/rules/proposed/s71903/s7-19-03-426.pdf)), Letter from Laurel A. Holschuh, Senior Vice President, Assistant General Counsel and Secretary, Wells Fargo & Company, to the SEC (Dec. 19, 2003) ([available at http://www.sec.gov/rules/proposed/s71903/s7-19-03-437.pdf](http://www.sec.gov/rules/proposed/s71903/s7-19-03-437.pdf)), Letter from Dixie Johnson, Chair, Comm. On Fed. Regulation of Sec.; Robert Todd Lang, Co-Chair, Task Force on Shareholder Proposals; Charles Nathan, Co-Chair, Task Force on Shareholder Proposals, to the SEC (Jan. 7, 2004) ([available at http://www.sec.gov/rules/proposed/s71903/aba010704.htm](http://www.sec.gov/rules/proposed/s71903/aba010704.htm)), Letter from the Bus. Roundtable to the SEC (Dec. 22, 2003) ([available at http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf](http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf)), Letter from Mark C. Smith, Chair, Task Force on Security Holder Director Nominations, the New York City Bar Ass'n. to the SEC (Dec. 22, 2003) ([available at http://www.sec.gov/rules/proposed/s71903/nycbar122203.htm](http://www.sec.gov/rules/proposed/s71903/nycbar122203.htm)), and Letter from Thomas J. Donahue, U.S. Chamber of Commerce, to the SEC (Dec. 19, 2003) ([available at https://www.sec.gov/rules/proposed/s71903/tjdonohue121903.htm](https://www.sec.gov/rules/proposed/s71903/tjdonohue121903.htm)).

²¹⁷ Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (June 18, 2009) (to be codified at 17 C.F.R. pt. 200, 232, 240, 249, and 274) [hereinafter *Shareholder Nomination Proposing Release*].

²¹⁸ A nominating shareholder or shareholder group would be required to own a minimum percentage of outstanding shares. The required amount varied depending on the size of the company (measured by amount of assets): 1% for the largest companies, 3% for mid-sized, and 5% for the smallest. The duration-of-ownership threshold was one year, instead of the two-year requirement proposed in 2003. *Id.*

²¹⁹ See, e.g., Letter from Jeffrey W. Rubin, Chair, Comm. on Fed. Regulation of Sec., to SEC (Sept. 18, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-535.pdf](http://www.sec.gov/comments/s7-10-09/s71009-535.pdf)), Letter from Alexander M. Cutler, Chair, Corp. Leadership Initiative, Bus. Roundtable to Elizabeth M. Murphy, Sec'y., SEC (Aug. 17, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-267.pdf](http://www.sec.gov/comments/s7-10-09/s71009-267.pdf)), Letter from David T. Hirschmann, Senior Vice President, U.S. Chamber of Commerce to Elizabeth M. Murphy, Sec'y., SEC (Aug. 14, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-181.pdf](http://www.sec.gov/comments/s7-10-09/s71009-181.pdf)), Letter from Arden T. Phillips, Chair, Corp. and Sec. Law Comm. of the Ass'n of Corp. Counsel to SEC (Aug. 17, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-337.pdf](http://www.sec.gov/comments/s7-10-09/s71009-337.pdf)), Letter from Richard Whiting, Fin. Serv. Roundtable to Elizabeth M. Murphy, Sec'y., SEC (Aug. 14, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-515.pdf](http://www.sec.gov/comments/s7-10-09/s71009-515.pdf)), and Letter from Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins LLP, Simpson Thacher & Bartlett LLP, Skadden Arps, Slate, Meagher & Flom LLP, Sullivan & Cromwell LLP, and Wachtell, Lipton, Rosen & Katz LLP, to SEC (Aug. 17, 2009) ([available at http://www.sec.gov/comments/s7-10-09/s71009-212.pdf](http://www.sec.gov/comments/s7-10-09/s71009-212.pdf)).

enabling character of state law through private ordering instead of a uniform mandate. They contended that circumstances differ among corporations, and that proxy access should therefore take the form of a default rule, which would allow companies to impose additional conditions on the use of proxy access or to opt out of it altogether.

Comments from the mutual fund industry and their representatives were limited.²²⁰ The ICI submitted two comment letters opposing application of a proxy access rule to mutual funds and other investment companies. It protested that the SEC's approach was "reflexively to 'lump in' investment companies with ordinary corporations,"²²¹ and to make no attempt at separately evaluating whether proxy access was needed for investment companies.

The ICI asserted that proxy access would destabilize the governance of the two main categories of investment companies: mutual funds and closed-end funds. These funds are offered to investors as part of a family (or complex) of funds, marketed by or on behalf of the firm that serves as their investment adviser. Larger fund families, such as Vanguard, Fidelity, and T. Rowe Price, consist of scores of sister funds. For most fund families, the ICI contended, it would be impractical and inefficient to populate the board of each fund with different individuals, particularly because many issues which directors must address are common to most or all sister funds. Consequently, within a fund complex, it is typical that the same individuals serve as directors on multiple boards. Some serve on unitary boards, overseeing all of the funds managed by the adviser. Others serve on cluster boards within a fund family, arranged so directors serve on the boards of similar types of funds. For example, one group of individuals might serve as directors on the boards of the adviser's equity funds and another on the boards of the bond funds. The ICI cited its own recent survey of fund complexes, indicating that 81% of those responding had unitary boards and 15% had cluster boards.²²²

The ICI explained that much of the oversight carried out by fund directors involves areas common to funds within a single fund complex, notably the nature and quality of compliance and back office operations such as the

²²⁰ See Letter from Paul Stevens, President and Chief Exec. Officer, Inv. Co. Inst. and Michael S. Scofield, Chair, Governing Council, Indep. Dirs. Council to SEC (April 7, 2010) ("ICI 2010 Letter") (available at <http://www.sec.gov/comments/s7-10-09/s71009-649.pdf>), Letter from Paul Stevens, President and Chief Exec. Officer, Inv. Co. Inst. to Elizabeth M. Murphy, Sec'y., SEC (Aug. 17, 2009) ("ICI 2009 Letter") (available at <http://www.sec.gov/comments/s7-10-09/s71009-360.pdf>), Letter from David B. Smith, Exec. Vice President and Gen. Counsel, Mut. Fund Dirs. Forum to Elizabeth M. Murphy, Sec'y., SEC (Aug. 17, 2009) (available at <http://www.sec.gov/comments/s7-10-09/s71009-285.pdf>), and Letter from Heidi Stam, Managing Dir. and Gen. Counsel, Vanguard Grp., Inc. to Elizabeth M. Murphy, Sec'y., SEC (Aug. 18, 2009) (available at <http://www.sec.gov/comments/s7-10-09/s71009-326.pdf>).

²²¹ ICI 2009 Letter, *supra* note 220, at 14.

²²² See ICI 2009 Letter, *supra* note 220, at 15 (citing ICI and Indep. Dirs. Council, OVERVIEW OF FUND PRACTICES, 1994-2006 (2007)). The ICI noted that its survey included not only mutual funds and closed-end funds, but exchange-traded funds and business development companies as well.

processing and recordkeeping of shareholders' transactions (performed by a transfer agent), the safekeeping of a fund's investments and cash (performed by a custodian bank), and the marketing of fund shares.²²³ Efficiency is gained by holding joint, concurrent meetings of multiple boards to consider and act on these common aspects of fund operations. The ICI also suggested that fund directors have greater influence with fund advisers when they serve on multiple boards and, conversely, that recruiting the best candidates for board service would be hampered if directors could serve on only one board. A proxy access rule, the ICI asserted, threatened to destabilize unitary and cluster boards by creating the possibility of different compositions of boards within a fund complex, prompting the need for separate board meetings, which would engender inefficiencies, problems of coordination among boards, and uneven decision-making.

The ICI noted a further complication: many mutual funds formed under state trust law do not have a separate board of directors (or, to be precise, a separate board of trustees). These funds take the form of segregated sub-portfolios within a trust. The single, overarching trust, rather than the mutual fund itself, registers with the SEC as an investment company.²²⁴ The trust can and, in large and mid-size complexes typically does, have many different mutual funds organized as sub-portfolios.²²⁵ For most purposes, the ICA treats each mutual fund as a stand-alone legal entity.²²⁶ However, for the election of directors, it views the funds as part of the consolidated whole, requiring the election to occur at the higher trust level with shareholders of all funds within the trust voting together to elect a single board of directors.²²⁷ A proxy access rule, the ICI explained, would thus affect all funds in the trust even though the nominating shareholder might hold shares in only one fund.

The ICI further asserted that fund shareholders have less need for a proxy access rule because they have broader voting rights than corporate

²²³ ICI 2009 Letter, *supra* note 220, at 15.

²²⁴ See 17 C.F.R. § 270.18f-2. In this structure, the trust is known as a series investment company (or series company), with each mutual fund therein constituting a series. The series company structure offers procedural advantages and cost savings for fund sponsors. New mutual funds can be placed within an existing trust through a post-effective amendment to the trust's previously approved registration statement dually filed under the Securities Act of 1933 and the ICA. This shortens the waiting period before shares of the new fund can be sold to investors.

²²⁵ Excluding registration requirements, the SEC's regulatory regime largely treats each mutual fund within a trust as if it were a separate investment company, including applying similar standards governing investment policies, limits on leverage, management fees, and so on.

²²⁶ This is true, for example, for approval of investment advisory contracts and changes to investment policies affecting a particular fund. In these cases, shareholders of the affected fund must vote to approve, and shareholders of other funds do not vote. See 17 C.F.R. § 270.18f-2(c),(d).

²²⁷ See 17 C.F.R. § 270.18f-2(g).

shareholders, including the right to vote on a range of investment matters.²²⁸ The ICI suggested that fund shareholders not only have a greater collective voice than their corporate counterparts, but are less focused on the role of boards in their individual investment decisions. Thus, the ICI pointed out, “the fund board must take into account that fund shareholders have chosen the adviser,” having had the opportunity to inform themselves of a fund’s investment objectives, risks, and fees.²²⁹

The ICI’s arguments held no sway with the SEC. The SEC adopted its proxy access rule in 2010, sweeping mutual funds (and other investment companies) in with ordinary corporations. One legislative event intervened. The Dodd-Frank Act²³⁰ was enacted earlier in the year, ending the debate over the extent of the SEC’s purview by expressly conferring on the SEC authority to adopt proxy access rules for all public companies (including investment companies).²³¹

The SEC adopted its proxy access rule, Rule 14a-11, with some changes.²³² The share ownership threshold was fixed at 3% for all companies (including investment companies) regardless of size, and the holding period requirement was set at a minimum of three years. A qualifying shareholder or shareholder group could nominate at least one candidate and possibly more, provided that the individuals so nominated would collectively constitute less than 25% of a company’s board. With its authority to adopt the rule settled by legislation, the SEC rejected remaining objections, including the argument for private ordering. The SEC cited the importance of having a uniform rule that set minimum standards for all public companies, although companies would be free to adopt a proxy access bylaw with terms that were less restrictive for shareholders.

In keeping with its generally negative attitude toward SEC rulemaking in recent years,²³³ the D.C. Circuit, in *Business Roundtable v. SEC*,²³⁴ over-

²²⁸ The ICI pointed out that fund shareholders have the right to vote on a number of proposed changes to a fund’s operations, including any change to fundamental investment policies, any change to a policy governing concentration of investments in a particular industry, changing from a mutual fund to a closed-end fund (or vice versa), and other matters.

²²⁹ See ICI 2009 Letter, *supra* note 220, at 19.

²³⁰ Dodd-Frank Act, *supra* note 2.

²³¹ Dodd-Frank Act, *supra* note 2, at § 971 (providing express authority to the SEC to “issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the [SEC] determines are in the interests of shareholders and for the protection of investors.”)

²³² See SEC, Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pt. 200, 232, 240, 249) [hereinafter *Shareholder Nomination Adopting Release*].

²³³ See *Chamber of Commerce v. Sec. and Exch. Comm’n*, 412 F.3d 133, 143 (D.C. Cir. 2005) (overturning rule requiring independent chairmen and 75% supermajority of independent directors for mutual fund boards); *Fin. Planning Ass’n v. Sec. and Exch. Comm’n*, 482 F.3d 481 (D.C. Cir. 2007) (overturning rule exempting broker-dealers from investment adviser registration requirements even though advisory compensation is not commission-based); *Goldstein v. Sec. and Exch. Comm’n*, 451 F.3d 873 (D.C. Cir. 2006) (overturning rule requiring registration of hedge fund managers as investment advisers); and *Am. Equity Inv. Life Ins. Co.*

turned the proxy access rule, citing procedural errors and analytical flaws on the SEC's part. The court faulted the SEC for cherry-picking among empirical studies that had been submitted in the proceeding, for overstating likely benefits, and for understating likely costs. In particular, the court found that the SEC ignored costs arising from the diversion of management's time and attention by attributing them to pre-existing rights of shareholders to nominate directors rather than to the new rule.²³⁵ The court also found that the SEC had failed to answer objections that a proxy access rule would create an avenue for labor unions and other shareholders with special interests to seek concessions from corporate management that had little or nothing to do with advancing the interests of all shareholders.²³⁶

While stating that these errors produced a rule that was "arbitrary and capricious on its face,"²³⁷ the court added it was "assuredly invalid as applied to investment companies" and considered "the more serious of the concerns posed by investment companies but left unaddressed by the Commission."²³⁸ The court found that the SEC had failed to establish a need for sweeping in mutual funds and other investment companies—especially in light of fund shareholders' unique voting rights—and that it had ignored the rule's disruptive effect on unitary and cluster boards.²³⁹ The court further criticized the SEC for putting its thumb on the cost-benefit scales: the SEC had boosted the rule's expected benefits based on one estimate of the frequency of its use, but reduced expected costs based upon a different and lower estimate.²⁴⁰

C. Reassessing Proxy Access for Mutual Funds

The SEC's cursory treatment of mutual funds is instructive not only for the reasons cited by the D.C. Circuit, but also because the SEC took pains when proposing its rule to characterize it as procedural not substantive. No new rights were created, the SEC reasoned, and the rule was in keeping with the agency's longstanding approach "to take as a touchstone the rights of shareholders under state corporate law."²⁴¹ This was an important issue when

v. Sec. and Exch. Comm'n, 613 F.3d 166 (D.C.Cir.2010) (overturning rule deeming indexed annuities to be securities).

²³⁴ Bus. Roundtable v. Sec. and Exch. Comm'n, 647 F.3d 1144 (D.C. Cir. 2011).

²³⁵ *Id.* at 1151.

²³⁶ *Id.* at 1152.

²³⁷ *Id.* at 1154.

²³⁸ *Id.* The court explained its purpose was to educate the SEC "lest the [SEC] on remand apply to investment companies a newly justified version of the rule, . . . only to be met in court again by valid objections. . . ."

²³⁹ *Id.* at 1155 (noting that state law was "perhaps a necessary but not a sufficient cause").

²⁴⁰ *Id.* at 1155-56 (stating that "this rationale is tantamount to saying the saving grace of the rule is that it will not entail costs if it is not used, or at least not used successfully to elect a director. That is an unutterably mindless reason for applying the rule to investment companies.").

²⁴¹ *Shareholder Nomination Proposing Release*, *supra* note 217, at 29025 (citing *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R.*

the SEC proposed its rule in 2009 because opponents argued that the SEC was seeking to create a new substantive governance right for shareholders, going beyond its authority under the federal securities laws and arrogating to itself authority properly vested in the states. Of course, as noted earlier, after the rule's proposal, the Dodd-Frank Act gave express power to the SEC to adopt a proxy access rule.

Even so, the SEC upon adopting the rule did not withdraw its initial premise, reaffirming that "the rights to nominate and elect directors are traditional State law rights of all shareholders and . . . the current proxy rules [can] better facilitate the effective exercise of these State law rights."²⁴² True, a federal rule would for the first time entitle shareholders to include their nominees in the company's proxy statement,²⁴³ but this, the SEC asserted, was in line with the longstanding purpose of its proxy rules: to enable the proxy process to function "as nearly as possible, as a replacement for an actual in-person meeting of shareholders . . . [and] approximate the conditions of the shareholder meeting."²⁴⁴

As adopted, the rule had a negative test for its applicability: it would not apply to a registrant (a public corporation or registered investment company) if "applicable state or foreign law or a registrant's governing documents prohibit the registrant's shareholders from nominating a candidate or candidates for election as director."²⁴⁵ Explaining this negative standard, the SEC explained that "we are not aware of any states that currently prohibit shareholder nominations for director."²⁴⁶

2019 *Before the House Comm. on Interstate and Foreign Commerce*, 78th Cong., 1st Sess., at 17-19 (1943) (Statement of SEC Chairman Ganson Purcell) ("The rights that we are endeavoring [in proxy rules] to assure to the stockholders are those rights that he has traditionally had under State law.")

²⁴² *Shareholder Nomination Adopting Release*, *supra* note 232, at 56680.

²⁴³ While all shareholders, the SEC assumed, have the right under state law to nominate directors, the rule would empower only those shareholders meeting the 3% ownership minimum to make use of the company's proxy statement. Should consistency have required the SEC to extend the rule to all shareholders? The SEC said no, stating that in adopting its proxy rules "we balance[d] competing interests." *Id.* at 56690.

²⁴⁴ *Id.* at 56670.

²⁴⁵ Rule 14a-11(a)(2).

²⁴⁶ *Shareholder Nomination Adopting Release*, *supra* note 232, at 56754 n. 852. The SEC also noted that "[s]everal commenters also stated that they were unaware of any law in any state . . . that prohibits shareholders from nominating directors." *Id.* n. 853. The rule might not have applied, it appears, to corporations (or investment companies) domiciled in states that permitted, but did not require, a right for shareholders to nominate directors. In these circumstances, a registrant could have a bylaw or charter (or trust) provision denying nomination rights. Those opposing a mandatory proxy access rule urged the SEC to draft it as a default, allowing companies to develop their own, tailored proxy access with terms differing from the rule. The SEC rejected this approach but retained the more far-reaching provision allowing companies to adopt charter or bylaw provisions to withhold nominating rights altogether if consistent with state law. *Id.* at 56677 at n. 68 ("We are not aware of any law in any state or in the District of Columbia or in any country that currently prohibits shareholders from nominating directors. Nonetheless, should any such law be enacted in the future, Rule 14a-11 will not apply."). If state law permits companies incorporated in that state to prohibit security holder nominations through provisions in companies' articles of incorporation or bylaws, the proposed

In justifying why the rule would apply not only to ordinary corporations but also to mutual funds, the SEC, without citing authority, again asserted that it would “facilitate the exercise of shareholders’ traditional State law rights to nominate and elect directors. . . .”²⁴⁷ Further, the SEC stated:

[F]or fund complexes that utilize unitary or cluster boards, the election of a shareholder director nominee may . . . increase costs and potentially decrease the efficiency of the boards. We note, however, that these costs are associated with the traditional State law right to nominate and elect directors, and are not costs incurred for including shareholder nominees in the company’s proxy materials.²⁴⁸

This premise, however, is incorrect for many, if not most, mutual funds. Three states are the domicile of almost all mutual funds: Massachusetts, Delaware, and Maryland.²⁴⁹ Only in Maryland do mutual funds take corporate form, incorporated under the state’s general corporate code as modified by a number of provisions tailored for mutual funds.²⁵⁰ Under Maryland law, for example, mutual funds, unlike ordinary corporations, are not required to hold annual meetings of shareholders,²⁵¹ but fund shareholders, like corporate shareholders, are entitled to vote in the election of directors.²⁵²

In Delaware, mutual funds are formed as trusts under a business trust statute crafted specifically for mutual funds.²⁵³ The statute designs statutory trusts “with flexibility in mind. . . . [and an] emphasis on freedom of contract.”²⁵⁴ Consistent with this approach, the Delaware enabling statute provides that the governing instrument of the trust may “grant to (or withhold from) all or certain . . . beneficial owners . . . the right to vote . . . on any

procedure would not be available to security holders of a company that had validly included such a provision in its governing instruments.

²⁴⁷ *Shareholder Nomination Adopting Release*, *supra* note 232, at 56684. The SEC also declared that “[w]e do not believe that the regulatory protections offered by the Investment Company Act . . . serve to decrease the importance of the rights that are granted to shareholders under State law.” *Id.* at 56763.

²⁴⁸ *Id.* at 56767.

²⁴⁹ For a detailed analysis of the process for forming mutual funds and choices of state domicile, see Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 *BUS. LAW.* 107 (1993).

²⁵⁰ MD. CODE ANN., CORPS. & ASS’NS §§ 2-101 to 2-112 (West 1957). *See, e.g.*, MD. CODE ANN., CORPS. & ASS’NS § 2-208.1 (accommodating continual issuance of shares by mutual funds), § 2-208.2 (authorizing one or more classes or series of stock and allowing for multiple mutual funds to be established within a single corporation with each fund insulated from liabilities incurred by sister funds).

²⁵¹ MD. CODE ANN., CORPS & ASS’NS § 2-404 (2014); MD. CODE ANN., CORPS & ASS’NS §2-501(b) (2008).

²⁵² MD. CODE ANN., CORPS & ASS’NS § 2-501(b) (2008).

²⁵³ DEL. CODE ANN. tit. 12, §§ 3801-3826 (2014).

²⁵⁴ *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1111–12 (Del. Ch. 2008), (*citing* DEL. CODE ANN. tit. 12, § 3825(b) (2012) (“It is the policy of this subchapter to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments.”)).

matter”²⁵⁵ Given the breadth of this provision, Delaware law does not require that shareholders in mutual funds formed as statutory trusts be afforded a right to vote for fund trustees.

In Massachusetts—the domicile of many funds, including those in major fund families managed by Fidelity, Putnam, MFS, Wellington, and others—mutual funds are organized as common law trusts known as Massachusetts business trusts.²⁵⁶ They are creatures not of statutory enabling acts, but of the common law of trusts,²⁵⁷ and the rights of holders of beneficial interests are created by trust instrument, not by statute. Two cases are illustrative.

In *Williams v. Inhabitants of Milton*,²⁵⁸ the issue was whether an investment trust, the Boston Personal Property Trust, was subject to taxation as a business trust or as a partnership.²⁵⁹ The business enterprise was formed under a declaration of trust, but the court did not deem this dispositive. Rather, the court examined what rights the declaration of trust conferred upon holders of beneficial interests. The holders had no right to elect trustees. Their only governance rights were to vote on trustees’ proposals to amend the trust instrument or to terminate the trust. Beyond that, the court found, the “sole right [of beneficial interest holders] . . . is to have the property administered in their interests by the trustees, who are the masters, to receive income while the trusts lasts, and their share of the corpus when the trust comes to an end.”²⁶⁰ In light of these limits, the court found that the enterprise was, indeed, a trust rather than a partnership.

A second case, *Commissioner of Corporations and Taxation v. City of Springfield*,²⁶¹ clarifies that, while a right to elect trustees is not required under Massachusetts law, such a right, when granted by trust instrument, is not fatal to trust status. The court found that the declaration of trust conferred sufficient powers and discretion on the trustees, insulating them from the control of beneficial interest holders, as to establish a trust rather than a partnership. Consequently, for Massachusetts business trusts, private ordering through trust instrument, not state law, defines the governance rights of beneficial interest holders. The right to elect trustees is not required by state law, and, by extension, neither is the right to nominate them.

²⁵⁵ DEL. CODE ANN. tit. 12, § 3806 (2014).

²⁵⁶ See Sheldon A. Jones, Laura M. Moret, & James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421 (1988). Discussion in this Article on Massachusetts business trusts draws substantially on *Jones, Moret & Storey*.

²⁵⁷ Settlers of Massachusetts business trusts must file a declaration of trust with the state, but “[f]iling . . . is not a condition precedent to the existence of the trust [and] . . . if no filing of any kind is made, the trust entity will still exist, even though its trustees are in violation of Massachusetts law. *Id.* at 424 (citing MASS. GEN. LAWS ANN ch. 182, § 2 (1926)).

²⁵⁸ *Williams v. Inhabitants of Milton*, 102 N.E. 355 (1913).

²⁵⁹ The question had fiscal significance. If a partnership, the enterprise could be taxed by the city of Boston, where it had its offices, and if a trust, by the towns of Milton, Brookline and Waltham, where the trustees resided.

²⁶⁰ *Id.* at 358.

²⁶¹ *Comm’r of Corp. and Taxation v. City of Springfield*, 71 N.E. 2d 593 (1947).

Additional rights can, of course, derive from federal law, and this is precisely what the ICA provides. The ICA leaves chartering to the states, thus allowing those establishing mutual funds to choose a trust or corporate form. The ICA's purpose is to establish a uniform federal regulatory scheme for mutual funds, whether formed as corporations or trusts, and part of this scheme is to ensure that fund shareholders, under certain circumstances, have the right to elect directors, regardless of state law. For this purpose, the ICA defines "director" to include any person serving as "a member of a board of trustees of a [mutual fund or closed-end fund] created as a common-law trust."²⁶² The right of mutual fund shareholders to elect directors is not absolute. The statute does not require that shareholders' meetings occur annually or at any other specified interval. Nor does the statute impose limits on the period of time over which a fund director may serve. When vacancies on a fund board occur, the ICA generally allows incumbent fund directors to fill the vacancies, so long as after the vacancies are filled at least two-thirds of the directors on the resulting board have been elected by shareholders. If, at any time, less than a majority of directors have been elected by shareholders, the board must promptly call a meeting of shareholders to elect new directors.²⁶³

These requirements, part of the ICA as originally enacted in 1940, applied readily to mutual funds organized as corporations. What about mutual funds formed as trusts, some of which had trust instruments that did not grant any election rights to shareholders? For these funds, Congress included a grandfather provision, one clearly recognizing the absence of any state law rights in this context: mutual funds (and closed-end funds) existing as trusts upon the ICA's enactment were exempted from the election rights provision.²⁶⁴ In considering its proxy access rule, the SEC did not take into account the absence of election rights under state law for shareholders of mutual funds formed as trusts, at least those formed under Massachusetts or Delaware law. As we have seen, the SEC's focus was on ordinary corporations, and the agency reflexively broadened its rule to include mutual funds without addressing their unique governance features.

Another issue left unaddressed by the SEC was the ICA's prohibition on cross-ownership. Here, Congress gave force to the SEC's statutory finding that investment companies "may dominate and control or otherwise affect the policies and management of" the corporations in which they invest.²⁶⁵ Cross-ownership arises when a mutual fund owns at least 3% of the voting

²⁶² 15 U.S.C. § 80a-2(a)(12) (2010).

²⁶³ 15 U.S.C. § 80a-16(a) (1940).

²⁶⁴ 15 U.S.C. § 80a-16 (c) (1940). Though withholding election rights for shareholders of these funds, the ICA gave them limited removal rights, providing that no person could continue to serve as a director if holders of at least two-thirds of a fund's shares voted to remove him from the board. Further, a grandfathered fund's board is required to call a meeting of shareholders to vote upon removal of a director when requested to do so by holders of at least 10% of the fund's shares.

²⁶⁵ 15 U.S.C. § 80a-1(a)(3) (1940) .

securities of a company and the latter, in turn, owns at least 3% of the shares of the fund.²⁶⁶ There need not be any agreement or understanding between the two for a cross-ownership to exist. In this circumstance, the ICA imposes a duty on the fund, not the company, to reduce or eliminate its investment to undo the cross-ownership. The statutory prohibition could operate as a sort of reverse poison pill. Rather than issuing securities, a company could buy securities to ward off a foe. For example, under the SEC's rule, a company could ward off a mutual fund intent on wielding a proxy access right, if this right was founded on a 3% minimum ownership threshold. The ICA similarly prohibits circular ownership, a more complicated situation involving three or more entities tied together through a series of investments in which one entity owns at least 3% of another and is, in turn, the object of an investment of at least 3% by another. This casts a wider net that could ensnare sister funds within a mutual fund family and could cut off proxy access by sister funds to two or more companies.²⁶⁷

Would directors breach their fiduciary duties by spending corporate monies to buy shares of a fund, not for purposes of investment, but as a defensive measure to create cross- or circular-ownership to prevent a fund from gaining or exercising a proxy access right? The answer might depend upon particular facts and circumstances, but the D.C. Circuit in *Business Roundtable v. SEC* suggests that the answer, in at least some cases, might be "no." Indeed, the court pointedly rejected "as mere speculation" the SEC's reasoning that directors would view themselves constrained by fiduciary duty from expending corporate resources to oppose shareholders' nominees under a proxy access rule.²⁶⁸

Another example of the short shrift given by the SEC to mutual funds concerns funds formed as sub-portfolios (or series) within a single trust. As we have seen, the ICI argued that a proxy access rule threatened to undermine this structure by creating the possibility that a shareholder (or group) holding shares in one fund could force one of their candidates onto a board at the trust level, which oversees all the funds. One can also ask how plausible this action is, particularly for some trusts that house a number of large funds. As difficult as it might be for a shareholder to meet the 3% ownership level in one large fund, how practical would a proxy access rule be where that fund is nestled in a trust with other large funds? Remember, the investment company subject to the proxy rule is the trust, not any single mutual fund held within the trust. Thus, a shareholder would have to amass an own-

²⁶⁶ 15 U.S.C. § 80a-20(c) (1987).

²⁶⁷ 15 U.S.C. § 80a-20(c) (1987).

²⁶⁸ *Bus. Roundtable v. Sec. and Exch. Comm'n*, 647 F.3d 1150 (D.C. Cir. 2011) (noting that "[a]lthough it is possible that a board, consistent with its fiduciary duties, might forgo expending resources to oppose a shareholder nominee . . . the [SEC] has presented no evidence that such forbearance is ever seen in practice."). The court approvingly noted a comment letter submitted by the American Bar Association Committee on Federal Regulation of Securities, which contended that fiduciary duty might require directors to expend corporate resources, just as the practice has been in traditional proxy contests.

ership interest representing at least 3% of all the outstanding shares of *all the funds* in the trust. The SEC, in adopting its rule, recognized this difficult and unlikely situation,²⁶⁹ but did not explain why it made no adjustments in the rule to deal with the unique nature of these series companies (for example, by lowering the ownership threshold) and did not separately evaluate the costs and benefits of the rule as applied to series companies.

A proxy access rule for mutual funds raises a more fundamental question: how meaningful or useful is the rule for shareholders who have redemption rights? One way to approach this question is to ask why a fund shareholder or group of shareholders might be dissatisfied with their fund and seek to place one or more (but not a majority) of new directors on a fund board. One reason looms over all other possible reasons: mediocre (or worse) investment returns by the fund, whether measured over one year, three years, or some other period. As we have seen, mutual funds are not required to hold annual meetings of shareholders. From time to time, but quite infrequently, a fund might have to call a meeting to fill vacancies that incumbent directors cannot fill on their own. Otherwise, a fund will hold a shareholders' meeting for particular reasons, such as approval of changes to the fund's management agreement or changes to a fund's investment policies, not because of any set schedule.

What is the likelihood that fund shareholders will hold onto their shares in the face of unsatisfactory investment returns in the expectation (or hope) that (1) the fund will soon hold a shareholders' meeting; (2) at the meeting, the election of directors will be on the agenda; (3) their candidate(s) will win election; (4) the new directors will mobilize the fund board either to fire the fund's adviser and hire a better adviser, or force changes that will lead the adviser to provide better investment advisory services to the fund; so that (5) the fund will achieve better investment results in the reasonably near future? What rational fund shareholder would choose this speculative course of action over redeeming out of a fund, receiving the pro rata ownership proceeds, and investing in other funds with superior investment results?

There might, however, be another scenario. Perhaps a fund has produced good investment results, but its adviser has run afoul of SEC rules, as occurred in the late trading abuses ten years ago. Fund shareholders might want to retain their holdings in the fund but prefer to have a fund board that will be more active, and more effective, in overseeing compliance by the fund and its adviser with governing laws and rules. In this circumstance, perhaps a proxy access rule might be of some use.

These examples reflect how the role of fund directors differs substantially from that of corporate directors. Fund shareholders look primarily to fund directors for oversight of compliance, and primarily to the fund adviser

²⁶⁹ *Shareholder Nomination Adopting Release*, *supra* note 232, at 56735 (explaining a new filing requirement for a series company to disclose the total number of shares outstanding for all funds within the single trust).

(not fund directors) for the exercise of business (that is, investment) judgment. This does not necessarily obviate the utility of a proxy access rule, but it does suggest that the SEC, if it takes up proxy access once again, should do so for ordinary corporations and mutual funds in entirely separate rulemaking proceedings.

VII. FUND-CENTRIC GOVERNANCE RULES

A. *The Chief Compliance Officer Rule*

Although the SEC has defaulted to the ideology of corporate governance in several key fund governance rulemakings, the agency, in one key and relatively recent rule, eschewed the business judgment decision-making role of fund directors and properly focused on directors as monitors of legal and fiduciary compliance by the fund adviser. The Chief Compliance Officer Rule (CCO Rule),²⁷⁰ adopted in 2003, requires that mutual funds appoint a chief compliance officer charged with overall responsibility and accountability for the fund's compliance policies and practices. While the chief compliance officer can be (and typically is) an employee of, and compensated by, a fund's adviser, the SEC's rule requires that the chief compliance officer have a direct reporting line to the fund's board of directors. The chief compliance officer is required to report to a fund's board at least annually on how the fund and its adviser are meeting their legal duties. Further, the chief compliance officer must bring to the board's attention changes to the fund's compliance policies and explain any compliance violations. The SEC's rule vests in the fund's board of directors and, by separate vote, the fund's independent directors authority to approve not only the fund's compliance policies but also the hiring, compensation, and firing of the chief compliance officer.²⁷¹

The SEC's CCO Rule has strengthened not only the role of the chief compliance officer (and the compliance function within the fund industry generally), but also the legal and fiduciary monitoring role of fund boards. Meetings of mutual fund boards include as part of their regular agenda reporting by the chief compliance officer and review of compliance issues. Some fund boards have even established separate compliance committees and channels of communication between a chief compliance officer and fund directors that are open throughout the year.

This Article disagrees with arguments for eliminating fund boards altogether, arguments which are predicated on the notion that fund directors are institutionally incapable of carrying out any type of compliance monitoring

²⁷⁰ 17 C.F.R. § 270.38a-1. See CCO Rule, Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74714 (Dec. 24, 2003) (to be codified at 17 C.F.R. 270, 275, 279).

²⁷¹ The CCO Rule also requires that a fund's CCO meet separately with the fund's independent directors at least once each year. 17 C.F.R. § 270.38a-1(a)(4)(iv).

role. Professor Krug, for example, has written that mutual fund boards cannot provide effective oversight “not because [fund] boards are incompetent but, rather, because that function cannot exist given how investment companies are structured,”²⁷² characterizing efforts in this context as attempts to oversee “a veritable black box.”²⁷³ There is, however, nothing intrinsically dysfunctional or inevitably ineffectual in the conduct of compliance fund oversight by fund boards. In lieu of monitoring fund boards, Professor Krug would subject fund advisers to direct regulation under the federal securities laws.²⁷⁴ Yet, this is a false choice. Fund advisers can be subject to both fund director oversight and SEC oversight. Indeed, they already are. To be sure, fund directors meet only periodically—some funds may meet quarterly while many others meet six or more times each year. But, whatever the frequency (and length) of these meetings, they certainly outstrip the frequency of SEC examinations of fund advisers.

The point is not that SEC examinations cannot or should not be carried out more frequently (or with greater or lesser focus). It is, rather, to say that *both* SEC oversight and fund director oversight can be strengthened. And, as for the latter, the CCO Rule has made, and likely will continue to make, a meaningful difference. As for the service provider and customer relationship between the fund adviser and fund investors, this Article contends that the latter, having a wide array of fund advisers and funds to choose from, has created little room for the exercise of business judgment by fund directors in matters such as the level of management fees, especially in an industry as competitive as the fund industry. Compliance oversight is an inherently different matter because fund investors expect that their fund advisers—even if seen primarily as service providers—will adhere to their legal and fiduciary duties. There is no dissonance here between investor choice and compliance oversight.

B. *The Portfolio Manager Compensation Rule*

In a second instance, the SEC approved a rule dealing with the compensation that a fund adviser pays to fund portfolio managers, the individuals who make investment decisions on behalf of a fund. Initially, this might appear to be yet another instance in which the dog of corporate governance wags the tail of fund governance. Indeed, in the corporate governance world, perhaps no issue has been more contentious in recent years than executive pay, and perhaps no trend has been more relentless than the push toward greater shareholder involvement in the decision-making process. In the

²⁷² Krug, *supra* note 4, at 318.

²⁷³ *Id.*

²⁷⁴ *Id.* at 268 (“[A]n investment adviser should be accountable for its actions not to an ‘independent’ board of directors . . . but, rather, to the securities regulator charged with maintaining the integrity of the securities markets and to the shareholders who have placed their capital under the adviser’s management.”).

Dodd-Frank Act,²⁷⁵ Congress conferred on corporate shareholders a federal right to cast a non-binding vote on executive compensation (a say-on-pay) and this right has been implemented by SEC rule.²⁷⁶ Calls are now being made to make these shareholder votes binding,²⁷⁷ keeping pace with corporate governance developments outside the U.S.²⁷⁸

For mutual fund investors, one might assume that compensation paid to any officer or employee of a fund's investment adviser is of little importance. After all, SEC rules have for many years required detailed disclosure of the fees paid to investment advisers under management contracts with their funds, and fund shareholders have an opportunity to vote on any material changes to those contracts (including any increase in management fee rates) upon their annual renewal. Investment management fees are paid by the fund and, in turn, the fund adviser decides how (and how much) to pay any of its officers or employees. Even when management contracts are renewed without any material changes (and hence can be approved by a fund's board and independent directors without a shareholder vote), individual fund shareholders are empowered under Section 36(b) of the ICA to bring a federal right of action on behalf of the fund alleging that the fund adviser is being paid excessive fees.

In light of the controversies over compensation paid to corporate chief executive officers, however, the governance debate predictably spilled over to executives of mutual fund management firms, even though many of those firms are not publicly traded. Those concerned about excessive pay were not, however, the shareholders of the management firms (whether privately or publicly held), but, instead, the investors in mutual funds managed by

²⁷⁵ Dodd-Frank Act, *supra* note 2 at § 951, adding Section 14A to the Securities Exchange Act of 1934, 15 U.S.C. § 78n-1.

²⁷⁶ Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240, and 249).

²⁷⁷ John Bogle, former head of the Vanguard family of funds, urged that the SEC, in fact, require disclosure of compensation paid to the five highest-paid executives of mutual fund management firms. Letter of John C. Bogle to Jonathan G. Katz, Secretary, Sec. and Exch. Comm'n (May 21, 2004) (*available at* <http://www.sec.gov/rules/proposed/s71204/jcboogle052104.txt>). See Statement of John C. Bogle, Oversight Hearing on the Mutual Fund and Investment Advisory Industry Before the U.S. Senate Governmental Affairs Comm., Subcom. on Financial Management, 108th Cong., 1st Sess. (Nov. 3, 2003). See, also, Russel Kinnel, *Fund Investors Should Demand Equality*, Morningstar.com, (Aug. 6, 2001) (*cited in* Proposing Release, Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. 12752 (March 17, 2004) [hereinafter *PM Pay Proposal*]).

²⁷⁸ The United Kingdom, which initially required an advisory vote by shareholders, now requires that UK companies afford shareholders a binding vote on executive pay. See IR Magazine, *U.K. Investors Get Binding Say on Pay Votes*, <http://www.irmagazine.com/articles/proxy-voting-annual-meetings/19788/uk-investors-get-binding-say-pay-votes/>. The European Commission has proposed to amend its Shareholder Rights Directive to require that public companies obtain shareholder approval of executive pay at least once every three years. European Commission, Press Release (April 9, 2014), http://europa.eu/rapid/press-release_IP-14-396_en.htm. For a comprehensive review of shareholder voting requirements on executive compensation, see Randall S. Thomas & Christoph Van der Elst, *Say on Pay around the World* (Jan. 20, 2014).

those firms. Voices could be heard from some quarters calling for a required public disclosure of the compensation paid to chief executive officers of mutual fund management firms and to portfolio managers. Those urging that the SEC compel disclosure of compensation contended that this information, separate from disclosure of amounts paid by the fund to its adviser, would be useful to fund investors.

The SEC, however, rightly rejected an approach based upon a corporate governance analogy and instead took into account that fund investors, in choosing among funds, are acting as consumers of a financial service or product. The SEC thus turned aside arguments to compel disclosure of compensation received by a fund management's chief executive officer and adopted in 2004 its Portfolio Manager Compensation Rule (PM Compensation Rule), which required disclosure not of how much compensation portfolio managers are paid, but how that compensation is structured. In this way, investors can evaluate whether a portfolio manager's pay incentives are based upon a fund's investment performance rather than a fund's size.²⁷⁹ In short, in setting a portfolio manager's pay, do investment results count, and, if so, how much? The SEC stated that it would not require disclosure of the level of compensation because "individual portfolio managers typically are employees of a fund's investment adviser and are compensated by the adviser."²⁸⁰ In contrast, the SEC explained, information about the structure and method of compensation is useful for fund investors because "it would help them to assess the [portfolio] managers' incentives and whether their interests are aligned with shareholders, not because it would help them better understand the amount being paid from fund assets for management services."²⁸¹ The PM Compensation Rule, in fact, goes beyond the structure of portfolio managers' compensation to require disclosure of the extent of their share ownership in the funds they manage, a requirement aimed, again, at informing investors, as consumers, as to the alignment of their interests with the incentives of portfolio managers.

It is fair to ask whether this sort of disclosure, at least with regard to the structure of a portfolio manager's compensation, is particularly useful to most fund investors. The type of disclosure called for is apt to be so generalized that investors will find it difficult, if not impossible, to draw any useful comparisons across funds of competing mutual fund families. It is true that an investor is able to ascertain, as to any fund, *whether* a portfolio manager's compensation is tied, at least in part, to investment performance, but determining how much performance counts is another matter altogether.²⁸²

²⁷⁹ Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. 52788 (Aug. 27, 2004) (to be codified at 17 C.F.R. pts 239, 249, 270 and 274) [hereinafter *IC Rel. No. 26533*].

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² An example of the generality of disclosure is provided by the Statement of Additional Information (SAI) of the T. Rowe Price Funds, an omnibus document covering over 100 T.

Notwithstanding shortcomings in the PM Compensation Rule, it does at least allow fund investors to determine whether investment performance counts toward compensation. It is reasonable to infer that, for at least some fund management firms that had not tied their portfolio managers' pay to performance prior to adoption of the rule, the sunlight emanating from the rule has induced them to do so. A recent study indicates that funds that tie portfolio manager pay to fund performance tend, as a group, to outperform funds that do not.²⁸³ In sum, two things can be said about the SEC's rulemaking on portfolio manager compensation. First, it adheres to the Hippocratic

Rowe Price funds. The SAI provides a uniform explanation of portfolio manager compensation for all funds, which includes, in pertinent part, the following:

Investment performance over 1-, 3-, 5-, and 10-year periods is the most important input. The weightings for these time periods are generally balanced and are applied consistently across similar strategies. T. Rowe Price . . . evaluate(s) performance in absolute, relative, and risk-adjusted terms. Relative performance and risk-adjusted performance are typically determined with reference to the broad-based index (e.g., S&P 500) and the Lipper index . . . set forth in the total returns table in the fund's prospectus, although other benchmarks may be used as well. Investment results are also measured against comparably managed funds of competitive investment management firms. . . . Compensation is viewed with a long-term horizon. The more consistent a manager's performance over time, the higher the compensation opportunity. The increase or decrease in a fund's assets due to the purchase or sale of fund shares is not considered a material factor.

Statement of Additional Information for T. Rowe Price Balanced Fund, et al, (Oct. 1, 2014), at 90-91, <http://individual.troweprice.com/staticFiles/Retail/Shared/PDFs/SAI.pdf>. The SAIs of funds managed by other investment advisers are even more succinct. For example, the SAI for the Janus family of funds explains that portfolio managers' compensation consists of both fixed and variable compensation and that:

A portfolio manager's variable compensation is discretionary and is determined by Janus Capital management. . . . In determining individual awards both quantitative and qualitative factors are considered. Such factors include, among other things, consistent short-term and long-term performance (i.e., one-, three-, and five-year performance), client support and investment team support through the sharing of ideas, leadership, development, mentoring, and teamwork.

Statement of Information for Janus Investment Fund, (Jan. 28, 2014), at 100-101, [https://janus.onlineprospectus.net/janus/47103C654/index.html?where=eengine.goToDocument\(%27Statement%20of%20Additional%20Information%27\)](https://janus.onlineprospectus.net/janus/47103C654/index.html?where=eengine.goToDocument(%27Statement%20of%20Additional%20Information%27)).

²⁸³ Linlin Ma, Yuehua Tang & Juan-Pedro Gomez, Portfolio Manager Compensation in the U.S. Mutual Fund Industry (March 2015) (*available at* https://warrington.ufl.edu/departments/fire/docs/seminar/2015Summer_YuehuaTang.pdf) (finding that "portfolio managers with performance-linked pay exhibit superior fund performance as measured by both raw and risk-adjusted returns compared to managers without these incentives"). Using data made available under the SEC's PM Compensation Disclosure rule, the study examined portfolio manager pay based on compensation structures in place in 2009, taking into account 4,138 mutual funds and 4,010 portfolio managers employed by 669 different investment advisers. The study found that 21% of sample funds based bonus compensation on asset size of the funds, while 75% based bonus compensation on investment performance. The study included regressions to compare portfolio managers with performance-linked pay to those whose pay was based on the size of their funds or to the fund adviser's profits. The authors found that funds whose managers' compensation was tied to performance outperformed other funds by 1.30% per anum on a net return measure and by 0.70%-0.96% per anum on a risk-adjusted measure. A limitation of the study is that the data, consistent with the SEC's disclosure rule, disclosed only whether investment performance, asset size or adviser profits was a factor in determining a portfolio manager's compensation. The data did not disclose the amount of overall compensation, relative

oath of doing no harm. The information required arguably might be marginal for most investors, but the cost of producing it seems marginal as well, while the market discipline that the rule helps bring to bear has the potential to benefit all investors even if only a minority devote the effort to review the disclosure of compensation incentives. Second, and more importantly, the SEC wisely abstained from imposing unnecessary and obtrusive decision-making responsibility on fund directors regarding how a fund adviser should pay its own employees. Instead, the SEC chose a path consistent with the notion that fund investors, as consumers, can make choices for themselves, and that the role of fund directors, in important respects, is to allow these choices to be made rather than attempting to supplant the market place in the name of fund governance.

VIII. IMPROVING THE FUND GOVERNANCE RULEMAKING PROCESS

A. *Rulemaking for Mutual Funds*

Several lessons can be drawn from past SEC rulemaking initiatives implicating fund governance. In adopting Rule 12b-1 to allow funds to finance distribution of their shares, the SEC, invoking a corporate model for fund boards, assigned to fund boards an unrealistic business judgment decision-making role. Not surprisingly, this has led to a board ritual of annual approval of 12b-1 plans, regardless of whether funds are attracting or losing shareholders, or growing or contracting their assets. No matter the circumstances, fund directors have unerringly reached the business judgment that it would be in the best interests of fund shareholders to authorize continued payment by funds to compensate broker-dealers to distribute their shares. What exactly is the business judgment at work here? Fund investors have a multitude of funds from which to choose, many with 12b-1 fees and many without. If the “best interests of fund shareholders” test under Rule 12b-1 means only that fund shareholders should be given the widest possible choices, then there is no meaningful business judgment role for fund directors to play.

The SEC staff has, at times, appeared to acknowledge this lack of meaningful business judgment, but it remains to be seen whether the SEC will end the requirement that fund directors approve 12b-1 fees. Perhaps the reason that the SEC has not done so is that it is difficult to articulate a limiting principle. If the marketplace should act as the ultimate arbiter of 12b-1 fees, why should it not do likewise for an adviser’s management fees? Ending the board approval requirement for 12b-1 fees will call into question the ostensible value to investors of requiring fund directors to approve the adviser’s management fees. Both 12b-1 fees and management fees are paid

amounts of fixed or bonus compensation, or the weight given to any factor in determining bonus compensation.

as a percentage of fund assets, and the underlying rationale for board decision-making in both contexts has been the fund adviser's presumed conflict of interest tied to the size of the fund. But, seen from the investor's standpoint, management fees, 12b-1 fees, and any other fees paid by funds are simply expenses that bear on investment returns. Why should fund directors be called upon to determine the reasonableness of management fees when investors can make this decision, especially when Congress has seen fit to create a direct cause of action for investors to challenge, on behalf of their fund, the level of management fees?

As for the SEC's attempts to reconstitute fund boards to require a supermajority of independent directors and an independent chairman, the SEC could have taken a different route. Instead of forcing all funds into a procrustean bed of independent director supermajorities and chairmen, the SEC, as two of its Commissioners had urged, could have left the matter to private ordering and disclosure, allowing investors to decide how important (if at all) an SEC-favored fund board structure was to them. Underlying the SEC's effort to re-engineer the structure of fund boards was, quite clearly, an effort to change the outcome of board decisions, particularly with regard to management fees. Yet, if independent directors had shown little propensity to negotiate aggressively over those fees, there was little to suggest that increasing their proportionality on a board would transform them into more formidable negotiators. However fund boards are constituted, the ICA already requires independent directors to approve by separate vote the adviser's management fees. It is difficult to see how changing the composition of a fund board will unleash the business judgment of independent directors, because the changed composition does nothing to alter the board's understanding that investors have chosen their fund adviser as well as their fund.

The SEC's failed rulemaking initiative to create a federal right of proxy access illustrates, in three respects, the hazards of conflating mutual fund governance and corporate governance. First, the SEC started with the implicit and questionable presumption that because proxy access is fitting for corporations, it must therefore be fitting for mutual funds. Rather than addressing proxy access for mutual funds in a separate rulemaking, or otherwise treating the subject independently from corporate proxy access, the SEC imposed on objectors the burden of rebutting the presumption that a proxy access rule should be extended to mutual funds. Second, the SEC's conflation of mutual fund governance and corporate governance led the agency to overlook unique issues of state law relevant to mutual funds, including differences in voting rights in Delaware and Massachusetts between corporate shareholders and shareholders in mutual funds formed as trusts. Third, the SEC glossed over questions of federal law relating to mutual funds, particularly for sister funds that have unitary or cluster boards.

However, the SEC has, in some instances, avoided the pitfall of conflating corporate governance and fund governance. In its PM Compensation Rule, the SEC did take a disclosure rather than governance approach, al-

lowing fund investors to decide if they care about how a fund adviser pays an employee (the portfolio manager) before deciding whether to invest, or stay invested, in a fund. One might question whether this is of any practical importance to investors, but the SEC has at least followed the regulatory Hippocratic oath of first doing no harm. Even if fund shareholders pay little attention to portfolio manager compensation, the sunshine of disclosure holds out the prospect that at least some fund advisers were prompted to reexamine pay structures for their portfolio manager employees.

As this Article has explained, the hybrid nature of mutual funds—both product and entity—poses the question whether, in any rulemaking for mutual funds, investors would likely derive greater benefit from more disclosure to allow them to make informed investment decisions rather than from more decision-making by fund directors. There should be no presumption that a governance rule is necessarily preferable to a disclosure rule. Second, if the SEC pursues a governance rule, this should be done separately, not as an ancillary part of rulemaking for ordinary corporations, weighing the discrete costs and benefits relevant to mutual funds. This should heighten awareness of substantive issues peculiar to a particular rule, such as the ICA's cross-ownership prohibition and the special status of Massachusetts common law trusts, questions overlooked in the SEC's omnibus rulemaking. Separate rulemaking will also strengthen the SEC's own litigation position by narrowing the reasons for courts to fault the agency's processes. Witness the proxy access rule, where a plaintiff attacked the rule on behalf of its corporate constituents, and the D.C. Circuit struck it down, largely due to procedural infirmities dealing with mutual funds.

Finally, and most importantly, the SEC should strengthen the role of fund directors as compliance monitors and not attempt to transform them into the procrustean corporate mode of business decision-makers. The business of funds—investment management—is fundamentally the province of the fund adviser, and investors can make their own business decisions on whether to entrust their capital to the adviser.

B. A Unified Fee Investment Company

Beyond improving its rulemaking process, the SEC should also revive consideration of an alternative model of a mutual fund, one that would leave questions over the reasonableness of an advisor's management fees to the marketplace and to the SEC's disclosure rules. The mutual fund industry first put forward a proposal along these lines in 1980, the so-called unitary investment fund (UIF), which would have eliminated fund boards' involvement with management fees by the simple expedient of eliminating fund boards altogether.²⁸⁴ Advisers sponsoring UIFs would form them as trusts

²⁸⁴ For a description of the fund industry's proposal, first put forward in a speech by Stephen K. West of Sullivan & Cromwell at the ICI's general meeting in 1980, see Advance

whose indentures would specify a single fee as compensation for all services, from investment management to transfer agent and distribution services, rendered by the adviser and its affiliates.²⁸⁵ The trust indenture would also specify other terms of performance under which the fund adviser would be bound. The UIF would not charge sales loads to investors. The adviser could not raise its unitary fee for a specified period, such as five years. If it wished to raise its unitary fee after that period, it would have to amend the trust indenture and provide advance notice to investors, who would then have an opportunity to redeem if they were unwilling to accept the higher fee. Shareholders would have no collective vote on fees; their only vote would be the individual choice to buy into the fund or redeem their shares.

The SEC staff considered and rejected a UIF model having no board of directors, stating that advocates had offered no substitute for the monitoring role played by fund directors.²⁸⁶ The staff, however, proposed a modified version, dubbed a unified fee investment company (UFIC), which, like the industry's proposal, would pay a single fee to its adviser for all services and would not charge sales loads to investors. As envisioned by the staff, a UFIC would retain a board to monitor operational conflicts of interest of the adviser. As for management fees, the staff sought a middle ground. The fund adviser would not be subject to Section 36(b) of the ICA, and thus shareholders would have no federal cause of action to challenge the adviser's unitary fee. The staff explained that "competitive forces and ease of shareholder redemption may provide adequate discipline with respect to the single fee aspect of the UFIC."²⁸⁷

The staff was not prepared, however, to take management fee review entirely away from the board. Rather than applying a fiduciary or reasonableness standard to the adviser's fee, the UFIC board would be called upon to determine whether the fee met the minimal test of "not unconscionable or grossly excessive."²⁸⁸ As long as this test was met, "the board would not be responsible for negotiating the level of the fee."²⁸⁹ The staff thus proposed to incorporate into the federal rules governing UFICs the state law standard of corporate waste—the very standard that the SEC had long viewed as wholly ineffectual—prompting the agency to recommend adoption of what became

Notice and Request for Comment on Mutual Fund Governance, 47 Fed. Reg. 56509. (hereinafter 1982 Release). See also Division of Investment Management, Securities and Exchange Commission, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (May 1992) (available at <http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf>) [hereinafter SEC 1992 STUDY].

²⁸⁵ The fund would, however, bear certain expenses arising from trading and holding securities, such as brokerage commissions and custodial fees. Also, the unitary fee would not cover any litigation expenses and other extraordinary expenses that the fund might incur.

²⁸⁶ *Protecting Investors Report*, *supra* note 171, at 285 ("Without a third party monitor to oversee the level of services, investors would be virtually left to their own devices, but typically without the expertise, incentive or power to assess the quality of these services.").

²⁸⁷ *Id.* at 288. (proposing that a UFIC could not impose redemption fees).

²⁸⁸ *Id.* at 332–33.

²⁸⁹ *Id.* at 333.

Section 36(b). The SEC did not enact its staff's UFIC proposal, but in the more than 20 years following that proposal, the mutual fund industry has become even more competitive and investors are afforded an ever expanding range of information about funds' performance and fees. The ability to obtain this information online, of course, further enhances investors' ability to make informed investment decisions.

The contours of a revised UFIC model thus seem clear. A board of directors should be retained to act as compliance monitors, but should not be assigned any decision-making role over the level of the adviser's fee. Fund shareholders would make their own decisions when buying into or redeeming out of a UFIC, exercising the same type of individual choice as an investor does when opening a discretionary investment account with an investment adviser or broker-dealer.

Retaining a board for compliance oversight of UFICs is consistent with the broader argument advanced in this Article: in general, mutual fund boards can serve, as they have historically, as monitors of the legal and regulatory duties of fund advisers, even though they are not positioned to make most business decisions inherent in the investment management of funds. In fact, many, if not most, compliance problems stem not from the adviser's intentional overreaching or bad faith, but from operational errors and mistakes, often arising from computer software flaws or other sorts of technological problems. One example is the striking of an inaccurate daily NAV price for a fund, an error that can, depending on rounding error, lead to overcharging purchasers or underpaying redeemers of fund shares. A board independent of the adviser can act on behalf of investors to reach a proper resolution, not only protecting fund investors, but also doing so in an expeditious way. Congress, in enacting the ICA, recognized that fund boards could play this positive role, and accordingly did not incorporate into the statute a provision sought by the SEC that would have required funds to obtain court approval before settling any claim against fund investment managers and other insiders.²⁹⁰

The UFIC would not charge sales loads, thus eliminating one possible disincentive to investors' exercise of redemption rights. What about redemption fees? This Article proposes that UFICs should be able to charge redemption fees because their purpose is to protect the fund (and its remaining shareholders) from the costs that are occasioned, including brokerage commissions, for portfolio trades carried out to generate cash for redeeming shareholders.

²⁹⁰ See Investment Company Act of 1940, Pub. L. No. 76-768, § 33(a), 54 Stat. 789 (1940). See also *Burks v. Lasker*, 441 U.S. 471, 483-84 (1979).

C. Crowdfunded Mutual Funds

Enacted as part of the JOBS Act, passed in 2012,²⁹¹ the CROWDFUND Act²⁹² authorizes the SEC to promote capital-raising by start-up businesses through crowdfunding, a process by which investors come together over the Internet to pool their capital.²⁹³ The purposes of the legislation are two-fold: to promote access to the capital markets for start-up businesses by relieving them of the requirements and costs of a registered public offering, and to offer venture capital investment opportunities to smaller investors.²⁹⁴ The CROWDFUND Act contains a host of conditions, including ones limiting the amount of capital that companies may raise²⁹⁵ and investors may contribute,²⁹⁶ restricting advertising,²⁹⁷ mandating minimum levels of disclosure,²⁹⁸ requiring escrow of investors' monies and a right of investors to cancel sub-

²⁹¹ Jumpstart Our Business Startups Act, (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C. (2012)). See also Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013).

²⁹² Evidencing its 21st century penchant for strained legislative acronyms, Congress named Title III of the JOBS Act, as the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or the "CROWDFUND Act." See JOBS Act §§ 301-05 (codified as amended at 15 U.S.C. §§ 77d(a)(6), 77d-1, 77r(b)(4), (c)(1), (c)(2)(F), 78c(a)(80),(h), 78l(g)(6), 78o(i)(2)).

²⁹³ The SEC has adopted rules to implement the crowdfunding authority granted by the JOBS Act. See Crowdfunding, SEC Rel. 33-9974 (Nov. 16, 2015), [hereinafter *Crowdfunding Adopting Release*].

²⁹⁴ See, e.g., 157 CONG. REC. S8458-02 (daily ed. Dec. 8, 2011) (statement of Sen. Jeff Merkley) ("Low-dollar investments from ordinary Americans may . . . provid[e] a new venue of funding to the small businesses that are the engine of job creation. The CROWDFUND Act would provide startup companies and other small businesses with a new way to raise capital from ordinary investors in a more transparent and regulated marketplace.").

²⁹⁵ While the CROWDFUND Act does not impose eligibility limits based on a company's asset size or revenues, a company is permitted to raise through crowdfunding no more than \$1 million over any 12-month period. 15 U.S.C. § 77d(a)(6).

²⁹⁶ The Act differentiates between investors whose annual income or net worth fall under \$100,000 and those whose annual income or net worth meets or exceeds that amount. As for the former, a company cannot accept investments within a 12-month period exceeding the higher of \$2000 or 5% of annual income or net worth. As for the latter, a company within a 12-month period may accept investments not exceeding the lower of 10% of annual income or net worth, subject to a cap of \$100,000. 15 U.S.C. § 77d(a)(6)(B). The Act inadvertently creates an undistributed middle, leaving uncertain to which category an investor belongs whose annual income exceeds \$100,000 but whose assets fall below that amount (or vice versa). The SEC resolved the ambiguity by allowing such investors to avail themselves of the more generous investment limits. Separate from crowdfunding by any single company, the intermediary (either a broker-dealer or a funding portal) through which a company engages in crowdfunding must make efforts, as the SEC prescribes by rule, to ensure that no investor within a 12-month period exceeds these dollar limits for crowdfunding investments in all companies. 15 U.S.C. § 77d-1(a)(8) (2012).

²⁹⁷ The company cannot engage in any advertising of its offering other than notices directing investors to the broker-dealer or funding portal conducting the crowdfunding. 15 U.S.C. § 77d-1(b)(2).

²⁹⁸ This includes a description of the company's business, its anticipated business plan, and its financial condition. A company raising within a 12-month period through crowdfunding \$100,000 or less must make available to potential investors its most recent income tax return and financial statements certified by its Chief Executive Officer. If the amount is over \$100,000 but no more than \$500,000, a company must make available financial statements,

scriptions prior to closing,²⁹⁹ restricting re-sales by investors,³⁰⁰ and requiring the furnishing of financial reports at least annually to the SEC and investors after the offering is completed.³⁰¹ The Act requires that either a registered broker-dealer or a funding portal³⁰² act as an intermediary through which crowdfunding occurs and upon whom much of the Act's disclosure and investor screening requirements fall.

Mutual funds, however, cannot take advantage of crowdfunding, as the statute excludes them and other investment companies from eligibility.³⁰³ The CROWDFUND Act's legislative history does not elaborate on the reasons for this exclusion, and it appears that sponsors of legislative proposals for crowdfunding legislation never considered extending coverage to mutual funds.³⁰⁴ The reasons might well have been that Congress understood (correctly) that entry barriers for mutual fund management funds are not particularly high, that small investors face no significant obstacles to investing in mutual funds, and mutual funds actually cater to small investors. Crowdfunding could, however, be tailored to fit within the comprehensive regulatory framework of the ICA by taking the model of the investment club and allowing the fund to utilize the Internet to expand beyond the 100-shareholder limit crafted by Congress in 1940. In contrast to the traditional investment club, however, these crowdfunded mutual funds (if they exceeded 100 investors and did not qualify for any other exemption) would be subject to

though unaudited, that have been reviewed by an independent public accountant; and if more than \$500,000, audited financial statements. 15 U.S.C. § 77d-1(b)(1)(D).

²⁹⁹ 15 U.S.C. § 77d-1(a)(1)(7) (2012).

³⁰⁰ Within the first year after purchasing securities through crowdfunding, an investor generally cannot re-sell to anyone other than the company issuing the securities, an accredited investor, or a family member, unless the re-sale is part of a registered public offering. 15 U.S.C. § 77d-1(e) (2012).

³⁰¹ 15 U.S.C. § 77d-1(b)(4) (2012).

³⁰² A "funding portal" is defined to mean a person acting as an intermediary in the offer or sale of securities solely through permissible crowdfunding, while abstaining from offering investment advice or recommendations, soliciting investments, holding or managing investors' funds, or paying commissions to employees or others based on level of sales. 15 U.S.C. § 78c(a)(80) (2012). A firm qualifying as a funding portal is exempted from the broker-dealer registration requirements of the Securities Exchange Act of 1934 and hence from the broader regulatory duties of broker-dealers. The activity-limiting conditions contained in the definition of "funding portal" were first suggested by Prof. John Coffee in Congressional hearings. See SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS, HEARINGS BEFORE THE SEN. COMM. ON BANKING, HOUSING & URBAN AFFAIRS, 112th Cong. 62-66 (2011) (statement by Prof. John C. Coffee, Jr., Columbia Univ. Law School) (*available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d580503c-a7f3-4db5-b9f5-968d03af374f). Although exempt from broker-dealer registration and regulation, funding portals must become members of the brokerage industry's self-regulatory organization, FINRA 15 U.S.C. § 78c(h) (2012).

³⁰³ 15 U.S.C. § 77d-1(f)(3) (2012).

³⁰⁴ For a discussion of the CROWDFUND Act's legislative history, see Brian Farnkoff, *Crowdfunding for Biotech: How the SEC's Proposed Rule May Undermine Capital Formation for Startups*, 30 J. CONTEMP. HEALTH L. & POLICY 131, 153-56 (2013). While the House of Representatives passed the Entrepreneur Access to Capital Act (H.R. 2930, a crowdfunding bill, and incorporated it into the House version of the JOBS Act, the Senate substituted provisions in the eventual CROWDFUND Act when it passed its version of the JOBS Act.

registration and regulation under the ICA. Substantive requirements such as leverage limits, investment policies, pricing of fund shares, redemption rights, prohibitions against affiliated transactions, and other standards governing the operation of mutual funds could largely apply to funds created through crowdfunding.

Although allowing crowdfunding for mutual funds likely would do no harm, are there affirmative reasons to do so? The answer is that crowdfunding would create opportunities for investor-sponsored mutual funds as an alternative to investment adviser-sponsored funds, which in turn could open opportunities for developments in fund governance. These opportunities will likely depend on how crowdfunding takes place. It is conceivable that mutual fund crowdfunding could evolve in a way where like-minded investors could find each other directly. For example, an investor or investor group wishing to invest in emerging market equities might create a website or social media platform to seek other investors with similar investment objectives. However, the opportunities for fraud would appear to be substantial and, therefore, as with conventional startups, a broker-dealer or funding portal could be required to act as intermediary. Unfortunately, there is a chicken-and-egg problem here: no mutual fund yet exists and broker-dealers and funding portals might not be willing or particularly well suited to act as incorporators or settlors.

One solution is to broaden the crowdfunding network to include firms with both economic incentives and capabilities to provide services to crowdfunded mutual funds. Banks seeking to expand their custodian business are one obvious choice. The ICA generally requires mutual funds to place their portfolio securities and cash with U.S. banks unaffiliated with their advisers. This requirement should be applied to crowdfunded mutual funds. Firms that specialize in performing recordkeeping, reporting, and other back-office services for mutual funds are also positioned (alone or in tandem with custodian banks) to act as sponsors of crowdfunded mutual funds. Legislation, accordingly, could condition crowdfunding authority for would-be mutual fund investors to first enlist the services of a sponsoring custodian bank or fund servicing firm, meeting standards prescribed by the SEC through rulemaking. These sponsors could establish inactive, asset-less mutual funds on the shelf that could be activated, funded, and used by crowdfunding investors. To encourage this approach, the SEC could adopt rules that would relieve such unfunded funds of complying with all, or nearly all, requirements of the ICA until they are activated.

As with crowdfunded startup businesses, crowdfunded mutual funds could be given an exemption from Securities Act registration (at least temporarily), and the SEC could be given authority to devise a scaled-down offering document. The exemption from full-blown Securities Act registration requirements could be tied either to the size of the fund (for example, assets of \$50 million or less) or time period (for example, the first five years of a fund's existence) or both. Alternatively, the SEC could allow these

funds to use the streamlined, summary prospectuses available for all mutual funds, allowing them to make the prospectuses available solely online and relieving the funds, at least until they reach a specified asset size or age, from the requirement to make a full statutory prospectus available upon request or to prepare audited financial statements. Dollar limits could be imposed on amounts that a crowdfunded fund may raise or which any investor can contribute. Because they will be subject to SEC regulation, crowdfunded mutual funds should not be limited to the \$1 million cap to which non-fund startups are subject under the CROWDFUND Act. To be viable, a crowdfunded fund needs to gain some economies of scale, and thus should be allowed to raise significantly more money (a suggested minimum cap is \$20 million, whether raised in one year or over several years) before losing its crowdfunding privileges.

Two indispensable steps remain: appointing a crowdfunded fund's initial directors and engaging an investment adviser. These can occur in either of two ways. One approach involves investors drawing upon the wisdom of the crowd to reach a collective decision on the selection of a fund's adviser. Investors wishing to crowdfund an emerging markets stock fund could, for example, invite bids from investment advisory firms that have demonstrated expertise in this particular area. The sponsoring custodian bank or servicing firm could be enlisted in this effort, putting out invitations to these investment advisers to compete for selection, and perhaps narrowing the field to the top three or so advisers based on investment track records and fees. There is good reason to expect that, over time, this bidding and selection process will become refined and give rise to best practices that would be adopted by sponsoring banks and servicing firms. Legislation could create an exemption from existing requirements to allow investment advisory contracts to have terms longer than annual terms (such as three or five years), after which investors could conduct another bidding process to renew the adviser's contract or engage a new investment adviser.

As for the selection of directors, the sponsoring bank or servicing firm would be expected to recruit and appoint the fund's initial directors, drawn from a pool of experienced individuals. The SEC, by rule, could develop criteria to address possible conflicts of interest that might arise from any business relationships or arrangements between these individuals and the sponsoring firms.³⁰⁵

Alternatively, the fund's directors could select the fund's adviser. The sponsoring bank or servicing firm would again take responsibility for selecting the fund's initial directors. This approach would be a fundamental departure from the historic model of the adviser-sponsored fund, where a new

³⁰⁵ The development of "professional" independent directors for mutual funds would put into practice a proposal first made regarding corporate directors. See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STANFORD L. REV. 863, 883-92 (1991).

fund's directors are chosen by the adviser or, more typically, where directors of affiliated sister funds essentially self-appoint themselves as directors of a new fund.³⁰⁶ These crowdfunded funds would not owe their formation to any particular adviser, but to sponsoring banks or service firms and, ultimately, to the fund's investors. In these circumstances, fund directors could seek shareholder voting on whether to renew a fund adviser's contract or to hire a new adviser, or directors could conduct their own bidding process.

It is, of course, not possible to predict how investors, fund advisers, or individuals asked to serve as fund directors would view these new, crowdfunded funds, or whether such funds would even carve out a niche in the mutual fund market place. One foreseeable objection to crowdfunding authority for mutual funds is that entrenched investment advisers, with their sunk costs and established distribution arrangements, will view this model as disruptive and refuse to participate in any bidding process. If well founded, this objection might mean only that crowdfunding will not take hold and that an experiment to develop an alternative to the adviser-sponsored fund will have failed. In such a case, little, if any, harm will have been done. If one takes a longer term view, however, it seems inevitable that the mutual fund industry, like many other industries, will prove not to be immune from forces of competition, technology, and innovation. The fund industry has already transformed itself largely into an Internet-based industry. And, especially because funds' assets are intangible and mobile, and because intellectual capital is paramount, it seems that the industry is particularly well suited for crowdfunding. The question is only whether its regulatory construct will adapt sooner or later to this inevitability. Just as importantly, from the SEC's standpoint, crowdfunded funds can serve as a useful experiment, subject to proper controls and the SEC's oversight. In contrast to adviser-sponsored mutual funds, they offer conditions under which fund investors and fund directors could, in a realistic sense, develop an alternative to the historic model of mutual funds serving essentially as conduits for the marketing of investment management services by fund advisory firms.

CONCLUSION

Mutual funds differ fundamentally from ordinary corporations, reflecting their hybrid nature as legal entity and fiduciary financial product, and the unique right of mutual fund investors to withdraw their capital by exercising a right of redemption. Business judgment decision-making within a mutual fund lies primarily with its investment adviser, not its directors, because the adviser makes the investment decisions on behalf of the fund's customers: the fund's investors. The focus of SEC rulemaking, therefore, ought not to be

³⁰⁶ Another common occurrence is that a new fund is formed as a separate portfolio of a series trust that is already registered as an investment company. In this case, the new fund simply inherits the sitting directors.

to expand the business judgment decision-making role of fund directors, but rather to strengthen their effectiveness as monitors of compliance by the fund adviser, who has legal and fiduciary duties. Consequently, norms and rules of mutual fund governance should be considered on their own merits, and no presumption should arise that an innovation or trend in corporate governance applies to mutual fund governance. This approach will improve the SEC's rulemaking process regarding mutual funds and can open the way for alternative types of mutual funds, including UFICs and crowdfunded mutual funds.