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COMMENTS

Duties of the Independent Director in Open-End Mutual Funds

I. INTRODUCTION

The mutual fund industry is regulated largely through the Investment Company Act of 1940, enacted to provide broad relief against such widespread abuses as inadequate capital structures, fraud on investors, theft from fund treasuries, and insider dealings in loan and security transactions, which were prevalent in the industry during the 1920's and 1930's. It is generally conceded that the Act abated most of these abuses, which had threatened the existence of the industry. This was accomplished primarily by requiring registration of investment companies and disclosure of financing and investment policies, by regulating the custody of assets and the issuance of debt securities, by requiring adequate reserves for redemption of investment securities, and by prohibiting transactions in loans and securities between the funds and their officers, directors, and affiliates.

As a whole the mutual fund industry has prospered under the Act. A comprehensive report recently published by the Securities and Exchange Commission (SEC) indicates that the net assets held by registered open-end mutual funds as of June 30, 1969, were 54.7 billion dollars, a great increase from the less than one-half

11. An open-end mutual fund offers to sell new shares on a continuing basis and stands ready to redeem any outstanding shares. 15 U.S.C. § 80a-5 (1970). It is to be distinguished from a closed-end fund, which after initial capitalization does not engage in the continuous sale of securities or redeem outstanding securities. As of December 31, 1970, the net assets of closed-end funds amounted to $2,825,620,000, far less than their open-end counterparts. MOODY'S BANK & FINANCE MANUAL, appendix (1971).
12. INSTITUTIONAL INVESTORS REPORT, supra note 10, at 150. Net assets have slipped
billion dollars in 1940.\textsuperscript{18} As of December 31, 1970, open-end shares were held in over 11 million accounts as opposed to 296,000 accounts in 1940;\textsuperscript{14} the average number of shareholders per fund is now 3,169.\textsuperscript{15} These statistics are some indication of the confidence that the public has placed in mutual funds as a mode of investment.

Although the curtailment of self-dealing and other abuses has certainly contributed to the success and prosperity that mutual funds today enjoy, recent cases indicate that significant problems remain. Perhaps the most critical problem is the relationship of the investment adviser to the fund. As the incidents of adviser misconduct have become more prominent\textsuperscript{16} and the litigation directed against them more frequent,\textsuperscript{17} interest in revitalizing the position of the independent director as guardian for the fund has quickened.\textsuperscript{18}

This Comment will analyze the role of independent directors in open-end mutual funds. It will consider the potential impact of recent decisions and statutory amendments and explore the possibilities of a more significant role for such directors. The discussion will focus on the following aspects of the directors' role: (1) the duty to review contractual arrangements between the fund and the external adviser; (2) the duty to serve as a "watchdog"\textsuperscript{19} over fund policy, brokerage allocation on portfolio transactions, and miscellaneous fund operations; and (3) the responsibilities upon the sale or merger of the investment adviser. In order to appreciate the role intended for the independent director by Congress and the role he has actually come to play, the nature of the mutual fund industry must first be briefly reviewed.


14. Id.
15. INSTITUTIONAL INVESTORS REPORT, supra note 10, at 168.
16. See, e.g., Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), in which the court found it a breach of fiduciary duty for the adviser to transfer its management function at a profit. Industry analysts estimate that if Rosenfeld is followed, the potential liability of transferring advisers to their former funds could approach 100 million dollars. N.Y. Times, Sept. 12, 1971, at 5, col. 1.
17. In Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. denied, 404 U.S. 994 (1971), the court found an adviser and the affiliated directors of a mutual fund liable for failing to inform the independent directors of the possibility of recapturing brokerage commission give-ups on certain local stock exchanges. It has been estimated that there are over fifty cases pending that involve issues similar to those in Moses. Wall St. J., June 7, 1971, at 5, col. 1.
II. THE OPEN-END MUTUAL FUND INDUSTRY

Like that of any other corporation, the capital of a mutual fund consists largely of shareholder contributions. Unlike other corporations, virtually all the assets are in the form of securities purchased with these contributions. Yet the most distinctive feature of the open-end mutual fund industry is the externalization of management. This external adviser is an independent entity that provides a full range of clerical services in addition to managing the assets of the fund. As direct compensation for performing such services the adviser receives as a fee either a set percentage or a "sliding scale" percentage of the fund's net assets. The adviser may also receive indirect compensation in several ways. Most advisers have an underwriter affiliate that will initially offer the shares of the fund to the public or to a captive sales force or at least to designated brokers who will seek new customers for the fund. Some advisers have a broker-affiliate, or the adviser itself may be a broker, which means it may keep commissions on portfolio transactions within the advisory complex. Furthermore, many advisers manage several funds, the so-called "fund complexes," which give rise to peculiar conflict-of-interest problems. The ultimate compensation for any adviser comes with the successful sale of the entire advisory structure, usually at a very handsome profit.

The anomaly of the duty-compensation arrangement between the fund and the adviser is apparent—while the duty of the adviser can be characterized as investing and managing the combined funds of many investors so as to maximize the return on these funds, the compensation structure places a high priority on fund activity and raw size. These two interests are frequently inconsistent.

Within an industry so structured, the issue is whether there is any practical way to safeguard the rights of the investor. Perhaps the most obvious answer is that the shareholder who is dissatisfied with the adviser's performance is free to redeem his shares. However, this solution may not be as simple as it sounds. The shareholder in a

20. Much of the descriptive data that follows is based upon Public Policy Implications, supra note 4, at 33-77.
21. Public Policy Implications, supra note 4, at 45. Internally managed funds are uncommon in the industry, although the large closed-end funds are so managed. Id. at 49-50 & n.107.
22. Approximately 73% of fund advisers are compensated on the basis of a percentage of assets. The majority of these advisers charge an average fee of between 4% and 6% of net assets on an annual basis. The average advisory fee is 4.5%. Institutional Investors Report, supra note 10, at 216-18. See also Public Policy Implications, supra note 4, at 46.
23. See Public Policy Implications, supra note 4, at 9.
25. See text accompanying notes 148-49 infra.
normal corporation will incur a sales commission upon selling his interest in one corporation and a similar commission upon investing his funds in another corporation. The fund shareholder may be more inclined to retain his present fund holdings because, upon the purchase of his shares, a sales load of 7½ to 9%\(^26\) was deducted from his investment, an amount significantly higher than the normal brokerage commission.\(^27\) Therefore, even assuming there is no redemption fee, an investor will be wary of redeeming shares and incurring another sales load to purchase shares of another fund.

Recognizing these problems, Congress sought to provide more tangible safeguards for the fund's investors by enactment of the Investment Company Act of 1940. As an initial matter, section 15 of that Act requires that the original advisory contract be approved by holders of a majority of the outstanding voting securities.\(^28\) Since it is the adviser who typically creates the fund as an adjunct to its own business, and since it controls the initial voting securities, such approval has proved to be perfunctory.\(^29\) Renewals of the contract may be submitted to the shareholders, but this is not required by the Act.\(^30\) Thus, the shareholders may never have an effective chance to challenge the management contract; further, as is the case with most large corporations, the incumbents' control of the proxy machinery will serve to squash serious challenges to management's prerogatives.\(^31\) Finally, it is likely that despite full disclosure to the shareholders, many may fail to understand the terms of the management contract. Recently, at an annual meeting of one fund a mere 14.56% of the shares were voted in favor of a proposal to require the fund's directors to justify the merits of the external management fee arrangement with the adviser.\(^32\) And this may be the highest favorable vote any shareholder proposal has ever received in the industry!\(^33\)

Given the control exercised by the external adviser, the use of affiliated underwriters and brokers, and the conflicts of interest inherent in mutual fund complexes, it is understandable why it has been said that "nothing—but nothing—approaches the open-end mutual fund for incestuous relationships."\(^34\) To counter such undue influence, section 10\(^35\) of the Investment Company Act provides an

\(^{26}\) See Public Policy Implications, supra note 4, at 204-05.


\(^{29}\) Public Policy Implications, supra note 4, at 74-75, 128-30.


\(^{32}\) See N.Y. Times, July 24, 1971, at 31, col. 1.

\(^{33}\) Id.

\(^{34}\) Conference, supra note 19, at 739 (remarks of A. Pomerantz).

additional internal check on the external management. This section requires that the fund's board of directors contain a specified number of directors who are not directly or indirectly affiliated with the adviser. A majority of the board must consist of such "independent" directors if the adviser is directly or indirectly affiliated with a broker, underwriter, or investment banker; otherwise, at least 40% of the board must be independent. 36

The Act provides few specific duties for these special directors. A majority of them must approve the renewal of the advisory contract 37 and the appointment of the fund's certified public accountants. 38 But more important, Congress hoped to provide a check on the adviser and to represent the interest of the fund shareholders by making the independent directors the "watchdogs" over the fund's operations. 39 This was accomplished by giving both the SEC 40 and shareholders 41 a cause of action under section 36 to remedy a violation of the fiduciary duty of assuring that the fund is operated solely for the benefit of the shareholders. 42 The fiduciary obligations of the independent directors, however, would exist absent the Investment Company Act. Because the shareholder entrusts his money to the fund there is an inherent duty in the directors to assure to the fullest extent of their abilities that the fund is managed in the best interests of the shareholders. 43 Thus, the independent directors are subject to traditional standards of directorial responsibility imposed by

36. In most cases the adviser is affiliated with an underwriter or broker so the majority of the board must be "independent." Public Policy Implications, supra note 4, at 162.
40. See 15 U.S.C. § 80a-35(a) (1970). Prior to the 1970 amendments, the SEC was empowered to seek injunctive relief only if the conduct of the independent directors amounted to "gross misconduct or gross abuse of trust." Ch. 686, tit. I, § 36, 54 Stat. 841. The statute now speaks of "a breach of fiduciary duty involving personal misconduct." The legislative history indicates that the revised language was intended to end the reluctance of some courts to find a breach of fiduciary duty because of the "punitive overtones" associated with "gross misconduct." S. REP. No. 184, 91st Cong., 1st Sess. 36 (1969). It is also clear that the "personal misconduct" language is not a lesser standard of fiduciary duty than under the former section or under common-law principles. H.R. REP. No. 1282, 91st Cong., 2d Sess. 37 (1970). See generally Comment, Private Rights of Action Against Mutual Fund Advisers: Amended Section 36 of the 1940 Act, 120 U. PA. L. REV. 143, 154-63 (1971).
43. See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 2 & comment b (1959).
common law and state statute. Section 36 was not intended to pre-empt traditional remedies, but rather to provide new remedies for injurious conduct by the directors. Indeed, most cases charging the independent directors with a breach of their fiduciary duty are brought jointly under the Investment Company Act and common-law principles.

Unfortunately, the independent director safeguard proved to be a disappointment. He was often found not to be independent in fact, in some measure because of the inadequacies of the 1940 Act. "Unaffiliated" did not mean "unrelated" for the purposes of the Act. Hence, independent directors were permitted to own up to 4.9% of the outstanding stock of the external adviser; likewise, directors were deemed to be independent despite substantial business relationships with the fund or external adviser, or despite a close relationship by blood, marriage, or friendship with the management. In addition, some courts strained to find a director independent, although by the nature of his contacts with the fund and adviser his independence was doubtful.

Even when the independent director was not financially interested he was frequently morally bound to the adviser. The adviser's domination permitted it to nominate whom it wished, and its control of the proxy machinery assured the nominees' election. It has been noted that "the men who need to be watched pick the watchdogs to watch them." The adviser will not choose a director who is likely to be hard on it, or for that matter, take the job seriously. As one observer has noted, "[the independent director] only has some power. He is probably reluctant to exercise that in a vigorous way, because


45. See McMenomy v. Ryden, 276 Minn. 55, 148 N.W.2d 804 (1967).

46. See text accompanying notes 75-99 infra.


50. See PUBLIC POLICY IMPLICATIONS, supra note 4, at 67-68.


52. Conference, supra note 19, at 729 (remarks of A. Pomerantz).
it's unpleasant to [countermand] people that he has worked with for years and likes and respects, and probably that's the only reason that he is on the board." Even assuming their independence, the directors may receive information from the adviser that is not impartial. Moreover, those upon whom the directors may seek to rely for counsel may not be the best sources. For example, it is common practice for advisers and funds to retain the same attorney and certified public accountants.

In response to studies of the industry, Congress concluded that the statutory definition of independent directors did not ensure an independent check on management and provide an adequate means for the representation of shareholder interests in fund affairs. Thus, the Act was amended in 1970 to speak of "interested persons" in order to exclude those having close family ties or substantial financial or professional relationships with advisers, underwriters, officers, and those persons who have beneficial or legal interests as fiduciaries in securities issued by the adviser or underwriter and their controlling persons.

Even if a fully independent director is chosen as a result of the amendments, the special nature of a mutual fund suggests that the fund director must assume a different role from that of the director of the ordinary industrial corporation. The fund director seldom has effective control over the individual investment decisions, other than to ensure that the external management is adhering to broad fund objectives and performing reasonably well. Even if an objective should prove unprofitable, he has no power to invoke a new objective, in contrast to the power of regular corporate directors to seek profits for the shareholders by switching to different products or strategies.

The functions of the independent directors should nonetheless be subjected to close scrutiny by the courts because of the highly liquid nature of the fund's assets. The Institutional Investors Study concludes: "As with all corporations ... the ultimate responsibility for the investment company's activities lies with its Board of Directors."

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53. Id. at 759 (remarks of P. Loomis).
54. Public Policy Implications, supra note 4, at 74.
55. Public Policy Implications, supra note 4; Wharton Report, supra note 48.
58. Under § 8 of the Act, each mutual fund is required to set forth in its charter and registration statement its policy objectives with respect to concentration of investments in particular industries as well as its fundamental policy concerning profits in the form of ordinary income, capital gain, or a combination thereof. 15 U.S.C. § 80a-8 (1970). The adviser is bound by these policies when executing fund transactions, but effective review of the adviser's adherence to such policies is difficult. See Public Policy Implications, supra note 4, at 45-46.
The problem is thus one of defining clear duties and standards and providing effective remedies that will protect the investing public.

III. DUTIES OF THE INDEPENDENT DIRECTOR

A. The Investment Advisory Contract

As previously indicated, the compensation the adviser receives is typically a fixed annual percentage of the fund's average daily assets, usually one half of one per cent.\(^61\) The trend, however, is to a sliding scale rate, which decreases as the assets held by the fund increase.\(^62\) In either case the absolute fee increases as the assets of the fund increase through the sale of additional fund shares or through an increase in the market value of the portfolio. However, the economies of scale that result only rarely accrue to the fund through reduced fees or better services.\(^63\)

In light of the dominance of the adviser over both the negotiating process and the day-to-day operations of the fund, there are several alternatives that would theoretically provide some measure of control in the contracting and compensation process. One alternative would be to impose direct restrictions on the adviser. This could be accomplished by setting an industry-wide maximum fee schedule imposed either by statute or through a regulatory body.\(^64\) An alternative would be to impose a fiduciary duty upon the adviser and thus expose it to the threat of damages if a breach of trust were found. This is the course that Congress has recently taken. Although a broad fiduciary duty had been implied from the Act,\(^65\) Congress in 1970 imposed an explicit fiduciary duty on the adviser with respect to the contractual compensation it receives.\(^66\) This provision replaced a proposal calling for a "reasonable" fee that was passed in the Senate but later died in the House.\(^67\) The legislative history indicates that comparison of the fee with "best industry practice" and a determination whether the fee reflects economies of scale will be influential in establishing a breach of duty.\(^68\) The precise contours of the test will

\(^{61}\) See note 22 supra and accompanying text.

\(^{62}\) See Public Policy Implications, supra note 4, at 97-100.

\(^{63}\) Institutional Investors Study, supra note 10, at 214.

\(^{64}\) The SEC already possesses broad powers under the Act in other areas. See, e.g., 15 U.S.C. §§ 80a-37 to -39 (1970) (rule-making power); 15 U.S.C. § 80a-35(a) (1970) (power to seek injunctive or other relief to remedy or prevent a breach of fiduciary duty).

\(^{65}\) See note 41 supra.


be etched out only after the amendment becomes effective in June 1972. It may be pointed out, however, that the imposition on a business entity of a largely undefined fiduciary duty that effectively compels that entity to agree to contractual terms which fail to maximize its profits is hazardous at best.

Another approach to the problems would be to delegate the responsibility for the contractual process to someone who clearly represents the fund rather than the adviser. Congress tried to implement such a policy in the 1940 Act by requiring approval of contracts and renewals by the shareholders or the independent directors, and giving the directors special termination rights over the contract. However, because of the adviser's power and the emasculation of shareholder control, the usual contract was not the result of an arms-length bargaining transaction. With the extraordinary growth of the industry in the 1950's and 1960's, the fees accruing to many advisers were enormous, and a number of shareholder derivative suits were brought alleging "excessive" or "unfair" fees. Yet the courts generally applied the common-law "corporate waste" standard, which served to protect the director if the management fee approximated the industry average and full disclosure of the fee had been made to the shareholders. This test effectively precluded a finding that fees were excessive because the lack of price competition in the industry rendered the standard for comparison meaningless.

A case in point is *Meiselman v. Eberstadt*. The plaintiff claimed that the affiliated directors of a fund, who were also shareholders in the external management company, had paid themselves excessive compensation through the management company, as measured by a common-law reasonableness standard, and that the independent directors had acquiesced in the illegal fee arrangement. The advisory contract provided for a sliding fee arrangement. The court dismissed the complaint against the independent directors, finding "no possibility of liability of their part." Ultimately, the court dismissed the entire complaint, finding that the compensation was not "legally excessive."
independent directors, who were not proved to be under the control of the other defendants, had approved the management contract annually, that the shareholders had twice approved the arrangement, and that the fees were lower than the industry average. Recognizing that fiduciaries may not legally receive excessive compensation, the court, in dictum, did caution the nonaffiliated directors to the "responsibility to make appropriate reviews of the reasonableness of the arrangement from every point of view."78

In the leading case of Saxe v. Brady,79 the plaintiff sued the adviser and the independent directors, under both common-law principles and the Investment Company Act, charging that a flat fee of one half of one per cent of average daily net assets was unreasonably excessive and constituted corporate waste. The plaintiff alleged, inter alia, a breach of fiduciary duty by the independent directors in passively renewing the management contract and in allowing themselves to be dominated by the adviser. As in Meiselman, the court recognized that the independent directors had an obligation to guard the fund against the type of abuses alleged. However, it did not reach the issue under section 15 of the Act80 of director liability in continuing to approve the advisory contract, because it first considered whether the fee arrangement was a waste of corporate assets. Framing the issue as whether the services received by the fund were so inadequate in value that no person of ordinary sound business judgment would deem them worth what the fund had paid,81 the court found the fee arrangement to be reasonable and dismissed the complaint. The court stated that the average fee for the industry was entitled to "very weighty consideration," especially when the fund shareholders had overwhelmingly ratified previous payments and like future fees.82 The court did indicate, however, that the fee could be held unreasonable when the net profits of the adviser became unconscionable or "shocking."83

The court also cautioned that an independent board could not wait until the size of the management fee warranted a finding of waste before attempting to negotiate a more favorable contract with the adviser, and that in this case the fees were approaching a point of unreasonableness.84 Two tests were suggested for the board to consider: Comparing the adviser's net profits with those of other advisers, and comparing the adviser's ratio of expenses to fees with

78. 39 Del. Ch. at 568, 170 A.2d at 723.
81. 40 Del. Ch. at 486, 184 A.2d at 610.
82. 40 Del. Ch. at 488, 184 A.2d at 611.
83. 40 Del. Ch. at 496, 184 A.2d at 615.
84. 40 Del. Ch. at 498, 184 A.2d at 616.
those of similar advisers. Comparison of the latter statistics between large and small advisory firms would be a great help in uncovering economies of scale that are not being reflected in the fees. It is doubtful whether such statistics could be easily obtained by the independent directors. If advisers were periodically required to report such data to the SEC for public dissemination, the directors' task would, however, be greatly facilitated. The SEC apparently has the power to command such reports under section 204 of the Investment Advisers Act. In any event, takes implies an obligation to seek adjustment of the management fee to reflect a diminution in the adviser's expenses resulting from economies of scale.

In Meiselman and takes the courts recognized the independent directors' duty to control the fees of the adviser, but were reluctant to consider possible liability for failure to exert control. The court cannot be faulted for dismissing the complaint against the independent directors in Meiselman in light of the sliding fee arrangement, which was instituted in some measure at the initiative of the nonaffiliated directors. In Saxe, on the other hand, the court may have been hesitant to impose liability because of the inherent problem of adviser domination of the directors in the industry, and the consequent lack of any effective internal control. Yet the court felt compelled to lay down some guidelines on directorial responsibility. As a result of these and similar cases, it appears clear that the independent directors have some common-law affirmative obligation to review the adviser's compensation, to compare it with that received by similar advisers, and to take action before the level of compensation reaches the point of waste.

The Delaware court squarely considered the duties of independent directors in Lutz v. Boas. Without informing the directors, the adviser in effect delegated its authority to another adviser in violation of the fund's charter. The two advisers and those independent directors subject to the court's jurisdiction were held jointly and severally liable for the advisory fees paid to the principal fund manager and for the losses resulting from superfluous sales entered into in reliance upon the unauthorized advice. The court found the in-

85. 40 Del. Ch. at 495, 184 A.2d at 615.
86. There has been a trend toward higher profit ratios for larger advisory firms. See INSTITUTIONAL INVESTORS REPORT, supra note 10, at 230; PUBLIC POLICY IMPLICATIONS, supra note 4, at 121-25.
88. See 39 Del. Ch. at 568, 170 A.2d at 723.
89. See text accompanying note 84-86 supra. The court considered shareholder approval to be a relevant factor in finding the fee reasonable, or at least in putting a stricter burden of proof on plaintiff, despite the pro forma nature of such votes. 40 Del. Ch. at 489, 184 A.2d at 611-12.
91. 39 Del. Ch. at 610, 171 A.2d at 396.
dependent directors grossly negligent in failing to discover the illegal transactions, stating that the directors "gave scant attention" to the fund's management and "made no efforts to be informed." 92

The willingness of the Delaware court to impose directorial responsibility hinged on the extent to which the directors had relinquished their functions. Specifically, the court found that the directors gave "almost automatic approval" to the management contract. 93 But a court would be more likely to find a breach of fiduciary duty when the automatic renewal is an approval of an adviser guilty of blatant violations of the terms of the fund's charter than when the automatic renewal is of an approval of an adviser whose performance is comparable to general industry levels.

In Brown v. Bullock 94 a federal court dealt with a complaint under the Investment Company Act. The plaintiff alleged excessive management fees and void advisory and underwriting contracts because of the emasculation of the independent directors by the external adviser, the knowing acquiescence of the independent directors in abuses by the adviser, and an abdication by these directors of their functions. The primary significance of the case lay in its sanctioning of a private right of action under section 36 of the 1940 Investment Company Act, a section that on its face permitted actions only by the SEC. 95 The court did, however, go beyond this threshold issue and attempted to delineate guidelines regarding the duties of independent directors. Fiduciary duties exist under the Act for matters beyond the scope of traditional common-law concern. Thus independent directors must honestly and diligently exercise their best judgment solely for the interests of the fund and its shareholders. 96 They must determine whether the renewal of an adviser's contract is desirable, and "keep alert" for reasons that might render termination of the contract advisable. 97 However, the court stated that ordinary negligence, mere mismanagement, or vicarious fault were not grounds for finding liability. 98 In affirming, the Second Circuit agreed that section 15 of the Act required not merely "formal" but "substantial" 99 annual approval of the management contract.

A court has yet to hold an independent director liable because of an unreasonable management fee, despite convincing evidence of favorable economies of scale which could have been partially passed on to the fund. Several funds have switched to graduated fees pursu-

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92. 39 Del. Ch. at 609, 171 A.2d at 396.
93. 39 Del. Ch. at 609, 171 A.2d at 395.
95. See note 41 supra.
96. 194 F. Supp. at 238.
97. 194 F. Supp. at 235.
98. 194 F. Supp. at 238.
tant to settlements of shareholder suits\textsuperscript{100} or in apprehension of the dictum in Saxe that fees can approach the point of waste and that directors have a duty to act before that point is reached. The only case imposing liability on independent directors, Lutz, can be characterized as involving a gross disregard of a fiduciary obligation of due care—when the adviser engages in an egregious breach of his duties and the directors fail to take appropriate action.

The advisory fee problem may also be attacked collaterally. If it can be shown that the board that approved the adviser's contract did not contain a sufficient number of independent directors, then the contract is void under section 46\textsuperscript{102} for failure to satisfy the approval requirements of section 15.\textsuperscript{102} Fees paid to the adviser under the void contract would then be subject to review under general principles of restitution. The courts, however, have tended to engage in strained interpretations of the section 15 requirements in concluding that the directors were, in fact, “unaffiliated” or independent. For example, in Acampora v. Birkland,\textsuperscript{103} the plaintiff charged that various directors were not independent and therefore that section 10(b), which requires a majority of the board to be independent,\textsuperscript{104} was violated. One director did printing for the adviser and fund, another was a broker whose firm did some of the fund's business, and a third was vice-president and treasurer of the fund and was associated with a firm which received give-up commissions. Before the 1970 amendments, a director was deemed independent if he was not an “affiliated person” within section 2(a)(3).\textsuperscript{105} The court correctly interpreted that provision as not preventing independent directors from having economic ties with the adviser or fund. With respect to the officer-

\textsuperscript{100} The few cases involving advisory contracts and fees decided on the merits represent but a small portion of the shareholder suits in this area. Settlements in other suits have resulted in graduated fee arrangements or a return in a lump sum of past fees. See, e.g., Kerner v. Crossman, 211 F. Supp. 397 (S.D.N.Y. 1962). Factors which usually lead the court to find the proposed settlement “fair” include “the difficulty of convincing a court that the fees are so excessive as to be beyond the reasonable business judgment of the directors” (Kurach v. Weissman, 49 F.R.D. 504, 506 (S.D.N.Y. 1970)); full disclosure of the fees made to the shareholders (49 F.R.D. at 506); shareholder ratification of the settlement (Saminsky v. Abbot, 41 Del. Ch. 320, 327, 194 A.2d 549, 552-53 (1963), cert. denied, 379 U.S. 900 (1964)); and approximation of the contested fees to the industry average (Klienman v. Saminsky, 41 Del. Ch. 572, 579, 200 A.2d 572, 577 (1964), cert. denied, 379 U.S. 900 (1964)). Thus, as a noted fund critic has said, “There have been times when fees have been reduced, but that's in spite of the unaffiliated directors.” Conference, supra note 19, at 753 (remarks of A. Pomerantz).


\textsuperscript{103} 220. F. Supp. 527 (D. Colo. 1963).

\textsuperscript{104} 15 U.S.C. § 80a-10(b) (1970).

\textsuperscript{105} 15 U.S.C. § 80a-2(a)(3) provides that an affiliated person of another person means “any person directly or indirectly controlling, controlled by, or under common control with, such other person.” Under 15 U.S.C. § 80a-2(a)(9) (1970) a “natural person shall be presumed not to be a controlled person . . . .”
director, the court held that he was not independent for purposes of section 10.\textsuperscript{106} It went on to nullify that finding, however, by holding that section 10 must be read separately from section 15. Even though section 2(a)(3)(D)\textsuperscript{107} specifically includes "any officer" as an "affiliated person," the court held that the officer-director was unaffiliated for purposes of section 15.\textsuperscript{108} It defies logic to suggest that Congress would set up the independent director safeguard of section 10 and yet intend some different group of directors for section 15 contract approvals, which is one of the primary statutory functions of the independent director. The decision may be justified on the ground that the officer of the fund, who had a substantial interest in fund shares, would have had the fund's best interests in mind. But it is also true that he not only received give-up commissions from portfolio transactions that were directed to him by the adviser, but also sold insurance to the fund,\textsuperscript{109} which was likely ordered for the fund by the adviser. This demonstrates the impossibility of true independence if directors have economic ties to the fund or adviser.

A similar situation was involved in \textit{Coran v. Thorpe},\textsuperscript{110} in which five of the eight independent directors were partners or employees in brokerage firms handling portfolio business for the fund or special technical advisers to the external management company. The court held that proof of an economic relationship between a fund director and its adviser, underwriter, or broker did not ipso facto compel a conclusion that he was a controlled or affiliated director.\textsuperscript{111} The court summarized the real meaning of this case and \textit{Acampora} when it stated, "[P]laintiff is really arguing as to what the Act \textit{should} provide."\textsuperscript{112}

Partially in response to the failure of the courts to mitigate excessive fees, Congress passed the 1970 amendments to the Act.\textsuperscript{113} The amendments provide that an approval of the advisory contract by the independent directors or shareholders is to be given only such weight as the court deems appropriate in the circumstances of the particular case.\textsuperscript{114} Arguably, the amendments do not authorize the court to substitute its business judgment for that of the directors, or to ignore concepts developed by the courts regarding director au-

\begin{itemize}
  \item \textsuperscript{106} 220 F. Supp. at 543-44.
  \item \textsuperscript{107} 15 U.S.C. § 80a-3(a)(3)(D) (1970) provides that an affiliated person of another person means "any officer, director, partner, copartner, or employee of such other person."
  \item \textsuperscript{108} 220 F. Supp. at 544.
  \item \textsuperscript{109} 220 F. Supp. at 556.
  \item \textsuperscript{110} 42 Del. Ch. 67, 203 A.2d 620 (1964).
  \item \textsuperscript{111} 42 Del. Ch. at 72, 203 A.2d at 623.
  \item \textsuperscript{112} 42 Del. Ch. at 73, 203 A.2d at 623 (emphasis added).
  \item \textsuperscript{113} S. REP. No. 184, 91st Cong., 1st Sess. 5 (1969).
\end{itemize}
The amendments are "not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors . . . to the judiciary." Congress intended the directors to continue to have a fiduciary duty with respect to "all of the affairs of the fund" and to have "an important role" in the management fee area.

Will the amendments assist shareholders in obtaining the best investment advice for a fair cost? They may, but it will be despite any role the independent director might play in reviewing the cost of fund management and regardless of the rhetoric in the legislative history concerning the continuing important role of the independent director. While section 36(b) now authorizes a derivative action against the adviser and any director, officer, or underwriter regarding advisory fees, under section 36(b)(3) no such action can be brought against, and no relief obtained from, any person other than the recipient of the compensation, which in most cases will be the adviser alone. Moreover, relief is limited to actual damages, but no more than the compensation paid the recipient; it is also limited to the damages suffered within one year before filing suit.

The apparent lack of remedy against the independent director in advisory fee cases need not undermine the substantive provisions for director responsibilities. Since the court must give directorial approval only such consideration as it deems appropriate in such cases, it may now actually be to the advantage of the adviser to have a truly independent and active board. For example, in weighing all the relevant factors the court would undoubtedly consider such things as the substance and genuineness of the deliberations of the independent directors, the type of information the directors requested or received, and their ultimate evaluation of the contract. The adviser may thus have a vested interest in having the independent directors engage in an impartial review of the management contract. Finally, the independent director will still be subject to the SEC's power to seek relief against violations of fiduciary duties.

116. Id. at 7.
117. Id. at 6. To assist the directors in discharging their responsibilities, the Act now specifically requires that the directors request, and the adviser furnish, all information reasonably necessary to evaluate the management contract. 15 U.S.C. § 80a-15(c) (1970).
not relating directly to the management fee arrangement, under section 36(a).122

The 1970 amendments will ensure a more truly independent board since they modified the “interested person” test.123 The independent directors will no longer be able to own stock in the advisory firm,124 nor will they be able to act as legal counsel to the fund or adviser.125 However, the strongest prohibition, that barring a director with a material business or professional relationship with the fund or adviser, will be effective only if the SEC formally determines that he is an interested person.126 Affiliations like those in Acampora127 and Coran128 will undoubtedly continue unless the SEC actively polices the underlying relationships between the adviser and the independent directors.

In the management contract and fee area, the cases acknowledge and the legislative history glorifies the duties and responsibilities of the independent director. But because of the external domination of the fund, the independent director has not proved to be an effective control. This might have been anticipated since regulation through independent directors was originally the result of a compromise proposed by the investment company industry to stave off more rigorous regulation.129 It can be argued that the role of the independent director should be a weak one and that the duty to review management performance and fees should not be interpreted to mean “swords-point” combat, since there was full disclosure of the fees to the shareholders, who are free to redeem their shares if dissatisfied with fund performance.130 Moreover, if the independent directors were to refuse to renew a contract it would leave the fund temporarily without management and could lead to a costly proxy battle,131 which the directors could not hope to win since the proxy machinery is controlled by the adviser. Not only are most independent directors technically incapable of managing a large fund for

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123. See text accompanying notes 56-57 supra.
127. See text accompanying notes 103-05 supra.
128. See text accompanying notes 110-11 supra.
any length of time, but also the resulting proxy costs might be to the
detriment of the fund.

These arguments do not mean that the independent directors
should avoid active review of the management contract and fee.
Shareholders also invested in the fund in reliance on the declared
investment policy of the fund and with the expectation of fair dealing
from the adviser. Many shareholders may have purchased their shares
when the fee in relation to fund assets appeared reasonable, not
having considered the growth that might occur because of the nature
of an open-end fund. The redemption provision is always an ax over
the head of management, but it is seldom an economically sound
alternative for the shareholder.132

If the independent director requirement is to be retained, it
should be made a meaningful requirement. At a minimum the in­
dependent directors should be under an obligation to justify formally
an approval of renewal of the advisory contract to the shareholders.
The report should present an evaluation of the adviser’s performance,
a comparison of its fee to that of similar funds, and the reasons for
believing that the adviser’s present fee is fair, or the steps they have
taken to seek reduction of the fee, all in terms understandable to the
layman. This report could easily be included in the regular quarterly
or annual report sent to fund shareholders. The SEC could require
such a report under its rule-making power;133 this requirement would
be consistent with the policy of full disclosure established in the
various federal security laws.134 In any case, most shareholders are
unlikely to be influenced by such disclosures if they are satisfied with
the income and capital gains earned by their shares.135 If disclosure,
however, leads to even a small increase in shareholder suits contesting
the management fee, advisers may be more willing to bargain at arms­
length to avoid not only litigation expense, but also the damaging
publicity of a suit, which could affect potential investors.

The independent directors should be under a duty to review
regularly the feasibility of internalizing fund management. If the
proposal has merit, it should be submitted to the shareholders. In­
ternalization should be considered especially for the very large funds
in which a fee based upon a percentage of assets results in an unre­
sable entrepreneurial reward because of the great economies of
scale. Internalization could be accomplished by terminating the

132. See text accompanying notes 26-27 supra.
135. The disclosure requirement in securities regulation has been criticized as
having little impact on the decisions of investors, especially for new issues. Id. at 97-98.
In effect “the buyer in these transactions gets his prospectus more as a memento than
as a vehicle of information.” Lobell, Revision of the Securities Act, 48 COLUM. L. REV.
513, 523 (1948).
advisory contract and hiring expert investment counselors as salaried employees of the fund. Alternatively, the fund could purchase control of the current adviser and retain its technical personnel. Internalization should always be considered in cases when the adviser already wishes to divorce itself from the fund.\footnote{The recent case of Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), provides a notable example of a situation in which internalization might well have been considered. For a discussion of the case, see text accompanying notes 203-07 infra.}

A decision to internalize management is not without its difficulties. As a practical matter, the adviser's domination of the fund and its directors would usually lead to defeat of the proposal; hence the adviser must be willing to accept internalization if the plan is to be implemented. Its reluctance to accept internalization is understandable. The adviser founded and developed the fund and to require internalization because, for example, the fund has reached a certain size would be to deprive the adviser of its entrepreneurial reward. Moreover, the shareholders of the fund could enjoy the same economic benefits if the external adviser would simply consent to a reduction in fees. Nevertheless, in some situations internalization may prove to be the most viable alternative and should receive the attention of the independent directors.

B. \textit{The Watchdog Function}

A second major responsibility for the independent director is that of "watchdog" over the normal operations of the fund. This role includes overseeing the adherence by the investment adviser to the investment policies of the fund; the allocation and rebate of brokerage; the direction and supervision of fund expenses and miscellaneous operations; and the selection of certified public accountants and attorneys for the fund. It is here that it may be said that the director's duties are most analogous to the regular corporate director.

1. \textit{Fund Investment Policies}

The investment policies in the fund's charter cannot be changed unless authorized by the vote of a majority of the outstanding voting securities.\footnote{15 U.S.C. § 80a-13 (1970).} Since the adviser controls the day-to-day investment decisions,\footnote{Few boards of directors of mutual funds review individual portfolio trading decisions of the adviser prior to actuation. See \textit{INSTITUTIONAL INVESTORS REPORT}, supra note 10, at 167, 184.} the directors owe a duty to the shareholders to keep the adviser from departing from the stated objectives.\footnote{15 U.S.C. §§ 80a-1(b)(6) & -36(a) (1970).} In view of the disparate objectives pursued by various funds, such control is an essential safeguard to shareholders, who invested in the fund primarily upon the basis of these declared objectives.
The classic case of breach of duty in this area is *Aldred Investment Trust v. SEC.*\(^{140}\) The investment adviser, in an abrupt departure from the fund’s declared policy, sold thirty per cent of the fund’s portfolio of utility stocks and purchased control of a race track. The SEC obtained injunctions against any further acts by the officers and independent directors\(^ {141}\) and had receivers appointed to manage the fund. The court found a breach of fiduciary obligations in that the directors were at all times subject to the adviser’s wishes and readily acquiesced in all his plans for management of the trust.\(^ {142}\)

In *Taussig v. Wellington Fund, Inc.*,\(^ {143}\) the court went a step further: the independent directors were found to have a duty not only to protect the investment policy of the fund, but also to preserve the right of the shareholders to change the investment policy.\(^ {144}\) The adviser formed a common-stock fund, Wellington Equity Fund, while currently managing a balanced fund, Wellington Fund. The plaintiff, a shareholder in the latter fund, sued to prevent the use of the name “Wellington” by the new fund, a use which the directors of his fund had approved. The court enjoined such use, finding it a gift of a corporate asset and invalid absent unanimous shareholder approval.\(^ {145}\) The decision was based upon two considerations. First, Wellington Fund would be effectively pre-empted from changing its investment objectives because of the interest of the adviser in retaining distinctive funds in order to attract a wide range of investors while availing itself of the investment reputation associated with “Wellington Fund.”\(^ {146}\) Second, the court indicated that it would not be fair to the shareholders or to the directors to have the respective funds exposed to potential conflicts of interest.\(^ {147}\)

The problem of fund complexes with interlocking directorates looms large in the investment company field.\(^ {148}\) Numerous conflicts may arise among such funds, particularly when they have different investment policies. How is a high demand, limited quantity new issue, for example, to be allocated between a balanced fund and a high-risk fund? Or what determination is to be made when both funds wish to sell stock that the market can absorb only in small

\(^{140}\) 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

\(^{141}\) The independent directors were actually trustees because of the business form chosen by the fund. However, the sanctions of the Act apply equally to directors or trustees under \( \text{§} 36. \)

\(^{142}\) 151 F.2d at 257.


\(^{144}\) 187 F. Supp. at 203.

\(^{145}\) 187 F. Supp. at 211-12.

\(^{146}\) *See* 187 F. Supp. at 207-09.

\(^{147}\) *See* 187 F. Supp. at 210.

It has been suggested that the independent director of a fund within a complex should determine whether the fund is in danger of receiving prejudicial treatment from the adviser of the complex by comparing the benefits the adviser stands to receive from each fund within the complex. Although theoretically sound, such a review would be largely ineffectual if the independent director serves several funds within the complex.

The court in Taussig recognized that if a duty to either fund is breached, a suitable remedy is available. Yet it was not willing to find, as a matter of law, a conflict of interest when the adviser and independent directors serve more than one fund. The 1970 amendments do not appear to have directly addressed this problem. An independent director serving more than one fund in the complex may be deemed to be an “interested person” only if he has a material business or professional relationship with the other fund, and then only upon order of the SEC. Yet arguably a directorate itself should be considered a material relationship. It is unlikely that an independent director could serve two or more related funds without conflicts arising and it is unfair to the shareholders of either fund to permit the directors to balance the competing interests of shareholders.

Not only must the independent director assure that the adviser adheres to the fund’s investment policy, but he must also assure that the adviser pursues it in such a manner as to achieve the optimal performance consistent with the investment objectives. The nature of the shareholders’ investment demands close scrutiny by the directors to protect the investors’ profit expectations. The fund shareholder is likely to be a small, unknowledgeable investor relying on the adviser to supply the investment skill that he lacks. While the adviser’s performance is to be considered when its contract is being renewed, this review cannot displace current review throughout the contract period. If review is undertaken only at the time of renewal, poor performance may have already become history, and the shareholders’ investment may have been damaged.

2. Regular Portfolio Transactions

In the regular portfolio transactions of a mutual fund, the watchdog role of the independent director is one of ensuring best execution, as well as preventing certain specific abuses involving com-

149. Id. at 277-82.
150. 187 F. Supp. at 216.
153. Best execution is the payment of the lowest possible commission on portfolio transactions, while receiving the highest price on sales and lowest price on purchases
mission give-ups, reciprocals, recapture, and portfolio churning. If best execution on a trade is not obtained, the fund does not receive the full asset value of the stock, and hence there is a diminution of fund assets. However, because of the many intricacies involved in obtaining best execution, any liability of the independent directors should be limited to a failure to use common business judgment, or to a failure to review the adviser's brokerage allocations.

A recent case, Moses v. Burgin, concerned numerous issues including that of best execution. The district court found that best execution had been obtained. In so concluding the district court noted with approval that the independent directors had received and evaluated oral and written reports from the adviser concerning the placement of brokerage, and had determined that the adviser's policy of allocating brokerage as a reward for selling fund shares and providing investment advice was to be followed only if best execution could be obtained from such broker. It is open to question whether best execution really is the paramount consideration when brokerage is allocated to a broker who is also a substantial seller of the fund's shares. These rewards encourage increased sales efforts by the broker, which increase the fund's net assets and the adviser's compensation. This indirect benefit to the adviser should be a factor to be considered both by the courts and the independent directors in determining the fairness of the advisory fee, once it is determined that best execution has been obtained.

Closely related to the question of best execution is the practice consistent with the volume, the exchange used, market conditions, and the nature of the security. It is generally a factor only in large block transactions since most brokers can handle trades involving a few thousand shares or less equally well. See generally Note, Conflict of Interest in the Allocation of Mutual Fund Brokerage Business, 60 YALE L.J. 372, 375-77 (1970).

154. In addition to obtaining the best price, the broker must keep the fund's intention secret and prevent adverse effects on the market for the particular security. Moreover, transactions in the third or fourth market should be considered. The third market consists of trades in New York Stock Exchange listed securities through non-member brokers. The fourth market consists of direct sales between funds and other institutional investors.


156. Other issues in the case are discussed in text accompanying notes 166-78 infra.

157. 316 F. Supp. at 39. The finding on this issue was not appealed.


159. In a recent public statement, William J. Casey, Chairman of the SEC, announced that the SEC will request the National Association of Security Dealers to establish rules terminating the practice of placing portfolio executions with brokers in consideration of their sales of fund shares. If the Association fails to act, the Commission will consider rule-making to accomplish this result. W. Casey, statement upon release of the SEC Policy Statement on the Future Structure of the Securities Markets, Feb. 2, 1972, CCH FED. SEC. L REP., Special Report No. 409, at 39-43 (Feb. 4, 1972) [hereinafter Casey Statement].
of adviser-directed reciprocity. Reciprocity is an indirect form of a give-up\(^{160}\) in which the executing broker, upon direction of the fund manager, rewards another broker with unrelated business on another stock exchange. Questions of liability only arise if best execution has not been obtained as a result of this practice. In Moses the Court of Appeals for the First Circuit found no reason to reject the SEC's conclusion that awarding reciprocals even to brokers who have done nothing to benefit the fund is unobjectionable if it "does not in any way operate as a detriment to the funds and if the funds have themselves derived as much as they can from these benefits."\(^{161}\) However, since reciprocals are frequently of benefit to the adviser, they should be considered in determining the reasonableness of the advisory fee.

Before adviser-directed give-ups were abolished on all stock exchanges,\(^{162}\) recapture of commissions on portfolio transactions could be accomplished by channeling give-ups through a broker affiliate who was a member of some stock exchange or through the fund's underwriter if the underwriter was a member of the National Association of Security Dealers.\(^{163}\) Now that such give-ups are forbidden, recapture for the benefit of the fund is limited to brokerage commissions that are directly refunded. This can be accomplished by the fund through affiliation with a broker on regional exchanges that permit broker-fund affiliation.\(^{164}\) Because of the nature of the industry, however, it is more likely that the adviser, not the fund, would have a broker affiliate. Recapture for the fund would then be accomplished by applying the recaptured portion of the brokerage commissions to the advisory fee.

The duty of the independent director with regard to recapture of commissions on portfolio transactions is largely an open question.\(^{165}\) Perhaps the leading case that has dealt with the problem is Moses,

\(^{160}\) Give-ups involve the relinquishment of the broker, upon order of the fund adviser, of some portion of the sales commission for portfolio transactions to another broker who took no part in the transaction. Give-ups are used to reward brokers for selling fund shares or for furnishing statistical data and advice. The issue of give-ups is largely moot since they were banned by the New York Stock Exchange in 1968. NYSE Constitution, art. XV, § 1, CCH NYSE Gums § 701 (1970). See Moses v. Burgin, 445 F.2d 369, 381 (1st Cir.), cert. denied, 404 U.S. 994 (1971).


\(^{162}\) See note 160 supra.

\(^{163}\) See Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35, 55-59 (1971).

\(^{164}\) The SEC has announced that it will request exchange action to exclude from membership those brokerage firms whose primary function is to route portfolio execution orders in order to recapture brokerage commissions. The SEC is also to consult with the exchanges concerning expulsion from membership of firms whose business is not predominantly with the public, which would include many brokers affiliated with funds and their advisers. Affiliation with a broker doing substantial business with the general public would be allowed. Casey Statement, supra note 159, at 44-56.

\(^{165}\) See Miller & Carlson, supra note 163, at 55-59.
in which the adviser and affiliated directors were found to have engaged in gross misconduct by failing to inform the independent directors of the possibility of recapturing give-ups. The court acknowledged that independent directors have a duty to consider such matters on their own, but found no violation of their duty to discover and explore issues important to the fund in this instance because recapture was a new problem and they were entitled to rely upon information and advice of the management defendants who devoted full time to the investment industry. The court noted that the independent directors were "legally unaffiliated and factually independent," and without a "personal conflicting interest." This suggests that the court might have found a breach of duty for not having discovered and explored such an important issue if the directors were more closely tied to the adviser or affiliated with a brokerage house doing business with the adviser. The court also noted that the attention of the independent directors had not been drawn to a recent study dealing with recapture through an underwriter affiliate. While it is debatable whether a mutual fund director should have the duty to read an important document affecting its function, Moses suggests that if actual knowledge could be shown, responsibility might attach.

The court specifically held that it was the responsibility of the directors, not the management, to determine whether recapture was practicable. If the directors decided in the affirmative, they could not choose between directly recapturing the give-ups for the fund's benefit and awarding them to brokers for its indirect benefit, but were obligated to seek recapture for the fund. However, if the adviser is not affiliated with an underwriter, the independent directors are not required to establish a broker affiliate for recapture if that would not be in the best interests of the fund. Although the directors in Moses had not been informed of the possibility of using an underwriter affiliate of the adviser, they had been informed of the possibility of recapture through a broker-affiliate. The directors rejected the latter course on the ground that any benefits which the fund might derive through credits against the management and receipt of give-ups might be outweighed by poorer executions. The

166. 445 F.2d at 383.
167. 445 F.2d at 384.
168. 445 F.2d at 371 n.1.
169. 445 F.2d at 384.
170. 445 F.2d at 378-79, referring to Public Policy Implications, supra note 4.
171. See 445 F.2d at 378.
172. 445 F.2d at 383.
173. 445 F.2d at 374.
174. 445 F.2d at 374-75.
court found this to be a sound business reason for the decision.\textsuperscript{175} The result is basically in accord with the view of the SEC, although the SEC contends that such recapture may be demanded if there is existing affiliation with a broker and the exchange rules permit it.\textsuperscript{176}

The decision in \textit{Moses} clearly indicates that if the independent directors are aware of the possibility of recapturing some or all of a broker-affiliate’s profits from transacting fund business, at a minimum they have a duty to explore the feasibility of such recapture. Although an affiliate is permitted to retain profits out of transactions it handles for the fund under section 17(e) of the Act,\textsuperscript{177} the court maintained that the independent directors have a duty to negotiate with the adviser for a credit of these funds toward the advisory fee.\textsuperscript{178}

But given the limited power of these directors in the management fee area, and the general reluctance to impose liability on the directors, the problem of affiliated-broker profits might be more successfully attacked on the ground of fairness of the management fee in determining whether the adviser has breached its fiduciary duty under section 36(b) by accepting and charging excessive compensation.

This appears to be the approach followed by shareholder suits settled before the effective date of the 1970 amendments. In \textit{Kurach v. Weissman}, an excessive fee case, the court approved a settlement calling for future offsets against the management fee of the profits earned by an affiliated broker on execution of fund transactions on a regional exchange, with a minimum offset of at least one million dollars over five years.\textsuperscript{179} The arrangement is to continue indefinitely unless the stockholders vote to discontinue it. Similarly, in a recent proposed settlement of an excessive-fee case, the adviser agreed to form an affiliated broker, seek to have the broker admitted to two regional exchanges, and credit the recaptured brokerage fees against advisory fees over a period of ten years, with a minimum rebate of $1\frac{1}{2}$ million dollars.\textsuperscript{180}

A related issue is whether the profits of an adviser-affiliated broker from reciprocal business should also be credited against management fees. Here the independent directors would clearly appear to have neglected their duty to the shareholders if the credit was not demanded. As previously noted, section 17(e) of the Act permits reten-

\textsuperscript{175} 445 F.2d at 375.
\textsuperscript{178} 445 F.2d at 374.
\textsuperscript{179} 49 F.R.D. 304 (S.D.N.Y. 1970).
\textsuperscript{180} 49 F.R.D. at 305.
\textsuperscript{181} See \textit{Wall St. J.}, June 7, 1971, at 5, col. 1. The use of affiliated brokers in this manner is limited to certain regional exchanges, the Philadelphia-Washington-Baltimore Exchange and the Pacific Coast Exchange, because of the anti-rebate rules of other exchanges.
tion of profits upon the execution of fund transactions by an affiliate. Reciprocity profits, however, do not result from the execution of a fund transaction, but rather they come as a windfall to the affiliate because the fund has executed a transaction on another exchange. Thus this profit is derived because of the mere existence of the fund, and therefore it should accrue to the benefit of the fund shareholders. This is the position taken by the SEC.\footnote{182}

A final problem warranting director attention is that of portfolio churning.\footnote{183} A study has found that the average turnover rate of mutual fund portfolios is 56.7\%, as compared with insurance company portfolio turnover of 20.6\% and individual and personal trust account turnover of 20.2\%.\footnote{184} When the turnover rate becomes excessive, serious problems arise. Asset value may decline not only because best execution could not be attained, but also because of the unnecessary commissions that are generated. The independent director should carefully compare the adviser's performance with the fund's investment policy for evidence of churning. The directors must also guard against a more subtle ruse—effectuating portfolio sales in order to generate excessive capital gains, thereby increasing the marketability of the fund's shares.\footnote{185}

3. General Fund Operation

A minor role of the independent directors is that of over-all control of the fund's operations and miscellaneous expenses.\footnote{186} Because his duty here is the same as that of any other corporate director, the

\footnote{182. The SEC has adopted the position that under § 17(e), only compensation for actual brokerage services rendered may be retained by the adviser or affiliated broker. SEC, Securities Exchange Act Release No. 8746 (Nov. 10, 1969).\footnote{See Miller & Carlson, supra note 163, at 47-49.}}

\footnote{183. Portfolio churning involves excessive purchases and sales of securities, often with little regard for fund objectives, in order to generate brokerage commissions or to reward brokers for selling fund shares. See INSTITUTIONAL INVESTORS REPORT, supra note 10, at 170.} A study has found that the average turnover rate of mutual fund portfolios is 56.7\%, as compared with insurance company portfolio turnover of 20.6\% and individual and personal trust account turnover of 20.2\%. When the turnover rate becomes excessive, serious problems arise. Asset value may decline not only because best execution could not be attained, but also because of the unnecessary commissions that are generated. The independent director should carefully compare the adviser's performance with the fund's investment policy for evidence of churning. The directors must also guard against a more subtle ruse—effectuating portfolio sales in order to generate excessive capital gains, thereby increasing the marketability of the fund's shares.

\footnote{184. Id. at 189.}

\footnote{185. Since capital gains are basically passed through to the shareholders from a qualifying mutual fund, INT. REV. CODE OF 1954, §§ 851-52, many investors are attracted by the more favorable capital gains tax rates, INT. REV. CODE OF 1954, §§ 1201-02. If the fund's capital gain position attracts new investors, the adviser profits through an increased fund asset base upon which his fee is based, and by the sales lead he receives for new investments. In addition, if the adviser is affiliated with a broker, he may have been able to recapture in part the commissions on the portfolio transactions generating the capital gains. Moreover, many shareholders automatically reinvest their capital gains, thus preventing any drain on the fund's assets and a consequential reduction in the adviser's fee. Such considerations might lead an unethical adviser to sell securities before they have reached their full gain potential. This is a danger even in those funds with a specific statutory investment objective of generating capital gains.\footnote{186. These expenses include transfer fees, custodian fees, taxes, interest, insurance, filing fees, legal and auditing, shareholder reports, stationary, directors' fees, registration fees, and administrative and safekeeping expenses. See generally INSTITUTIONAL INVESTORS REPORT, supra note 10, at 207-08.}}
independent director should be held to the normal standard—waste of corporate assets. In many mutual funds, all such expenses are covered by the adviser’s fee. Thus, only directors of those funds that provide their own services or have separate expense contracts with external management will have a duty here. When the management contract covers some or all such expenses, the directors are obligated to scrutinize the acts of the adviser with care according to Acampora. The court there held that the standard of care for interpreting the expense contract and insisting upon the adviser’s assuming the expenses allocable to it is gross negligence, or at least bad faith. The court found that the independent directors’ conduct evidenced merely a lack of prudence; the fund was entitled to restitution from the adviser for the misallocated expenses only.

Another minor, but nonetheless important duty of the independent director is the appointment and approval of the fund’s attorneys and certified public accountants. Because most independent directors are not investment or mutual fund experts they rely upon the reports and advice of others, frequently the adviser. Often the adviser and fund retain the same lawyers and accountants, which deprives the directors of fully independent counsel and creates opportunities for conflicts of interest. While there are cost advantages to sharing attorneys and accountants, the added expense would appear to be justified in the interest of better protection of the shareholders. Independent accounting and legal counsel can serve to remind the individual directors of their obligations, assist in evaluating and negotiating the management contract, and provide a base for the better exercise of business judgment in general.

Under section 31 of the Act, which requires approval of the accountants by a majority of the independent directors, the directors clearly have the power to appoint separate certified public accountants. On the other hand, the Act gives the directors no power to control the appointment of legal counsel. Clearly the Act should be amended to remove this inconsistency, as well as to require the fund’s accountants and lawyers to be distinct from those of the adviser.

4. Suggestions

The watchdog function can be summarized as the duty of the independent directors to prevent damage to the fund by maintaining

189. PUBLIC POLICY IMPLICATIONS, supra note 4, at 130.
190. Id. at 74, 130. “[T]he unaffiliated directors necessarily obtain most of their information about fund operations from persons who owe allegiance to, and obtain the preponderance of their compensation from the adviser-underwriters and who cannot be expected to look at such matters as advisory fees in a disinterested way.” Id. at 131.
close current review of the adviser’s activities. It may be suggested that this duty should be a minimal one. Perhaps the strongest argument for an insignificant role is that the shareholders invested in the fund in reliance upon the reputation of the adviser, and to interfere with the adviser’s broad discretion in areas other than fraud frustrates the expectation of these shareholders. The reluctance of the courts to scrutinize the activities of independent directors indicates that the judiciary may have implicitly accepted this argument.

On the other hand, it can be argued that the role of the independent director should be strengthened so that it can be an effective prophylactic force. The case for holding the independent directors to a higher standard of fiduciary duty can be justified by the failure of the independent director to fulfill the role envisioned by Congress, the lack of effective shareholder control, the limited enforcement capabilities of the SEC, and the inherent potential for abuse within the industry. The mutual funds are entrusted with savings of millions of small, unsophisticated investors and in the aggregate these funds are sufficient to permit a significant impact on the investment market. Finally, it may be that a more significant role might lead to the selection of personnel with the time and expertise that should characterize the industry.

To what standard then should these directors be held? The most extreme position would be to make independent directors strict trustees, with a standard as high or higher than that of the adviser inasmuch as the adviser is chosen and approved, at least theoretically, by the independent directors. This position is unrealistic, and has been explicitly rejected by the courts. It ignores the basic structure of the industry—the adviser created the fund, makes the investment decisions, and reaps the rewards. It ignores the difficulty of finding directors not only qualified but also willing to assume such an obligation. The fund would have to engage a separate staff to assist the directors, which would result in increased expenses. The independent directors would then need veto power over the adviser in addition to their power to terminate the contract. This would lead to suits challenging the decisions of the directors in opposition to the adviser, and the courts would be forced to decide which group properly exercised its function.

A better basis for the higher standard, it has been suggested, would be to hold the independent directors to the same standards as bank or insurance company directors; that is, a higher standard

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192. Public Policy Implications, supra note 4, at 131. See also Jaretzki, Duties and Responsibilities of Directors of Mutual Funds, 29 LAW & CONTEMP. PROB. 777, 786-87 (1964); Lobell, Rights and Responsibilities in the Mutual Fund, 70 YALE L.J. 1258, 1262 (1961); Lobell, supra note 188, at 43.


than that expected of directors of nonfinancial corporations. Directors of financial institutions that obtain and manage the money of others, especially that of the general public, are held to a higher standard of fiduciary care and their conduct is subjected to closer scrutiny by the courts. The higher standard is imposed because of the liquid nature of such enterprises, the relative unsophistication of the depositor, and the purpose of the depositor in accumulating capital—usually for emergencies or retirement. The courts expect the reasonably prudent director to exercise more care in the direction of such an institution.

These same factors are present in a mutual fund. In a pre-Investment Company Act case, the Virginia supreme court held the fund directors to at least the same duty of care as bank directors. The Act clearly does not preclude the courts from holding fund directors to a high standard of care in their watchdog function. The courts must not accept purely nominal board action nor must they countenance negligence on the part of the directors in failing to detect abuses by the adviser. On the other hand, the standard of care expected should not be as high as the duty imposed upon the external adviser because the latter is the entity in full control.

The recurring impediment to an effective requirement of an independent directorate is the dearth of qualified volunteers. This problem will become more acute if interlocking directorates are to be eliminated from fund complexes. A theoretical solution would be to replace one or all independent directors with a "public interest" director, who would be technically competent and free of any ties to the adviser or its affiliates. His duties would be those of a true "watchdog," obligated to advise the board and shareholders of his recommendations for contract renewal, the fairness of the fee, and questionable practices that he might detect. This information would provide a reasonable basis upon which the directors could act. If he detects violations of the Act, and the directors fail to take action, the public interest director could file a complaint with the SEC for possible administrative action. The special director's findings should not be conclusive, but, if he is an expert, they should be given great weight by the court or the SEC.

Even if a sufficient number of these special directors could be found, this proposal runs contrary to the traditional form of business

195. See Eisenberg & Lehr, supra note 44, at 183-92.
197. 3 Fletcher, Cyclopaedia of the Law of Corporations § 1068 (perm. ed. 1968).
organization and practice. Indeed, there is some question how effective a special director would be in light of the inconclusive results thus far achieved by special interest directors in other industries. 200 But it does demonstrate the extreme measures that would be needed to protect the shareholder and assure that he is obtaining good service for his investment at a reasonable fee. It would be possible for the independent directors of very large funds to achieve a similar result by hiring a specialist to assist them in evaluating the performance of the outside management. Retention of such a specialist is not forbidden by the Act and is within the power of the directors in the exercise of their fiduciary duty to exercise due care.

Even if aided by an expert or shareholder interest director, the independent directors should be more qualified to fulfill their responsibilities and their qualifications should be made known to the fund shareholder at elections. In addition, a higher standard of independence than that provided by the 1970 amendments should be required. Those with business or professional connections with the fund or adviser should be challengeable by less extreme measures than an SEC action. Different funds within a complex should be required to have different independent directors. Or, if interlocking directorates are retained, to discourage unfavorable or prejudicial treatment, directors should not be allowed to hold unequal stockholdings in different funds.

It would also be beneficial to amend the Act to require that the independent directors nominate their own successors. 201 This practice may forestall the election of directors who, though technically unaffiliated with the adviser, are selected because they are adherents to the adviser’s point of view. Although this would not eliminate the adviser’s influence, such a procedure would at least provide a buffer between the adviser and new director. Even without legislation many advisers would likely acquiesce in the practice if the courts indicated that the decisions of a more independent board would be given greater weight in deciding the fairness of the management fee and the potential liability of the adviser.

C. The Role of the Independent Director in the Sale of the Advisory Office

Under traditional common-law principles a fiduciary office could not be sold or transferred for personal gain. 202 In a decision that

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201. This is apparently being encouraged by some advisers. See Glazer, supra note 44, at 234-35.
could have considerable impact on the mutual fund industry, the Second Circuit, in *Rosenfeld v. Black*, held that it was a breach of the adviser's fiduciary duty to transfer its business (through a merger) to another fund management firm for an amount in excess of book value. The court stated that any premium paid "represents consideration . . . primarily for the use of influence in securing shareholder approval of the successor," and hence trafficking in a trust. The premium represents the buyer's expectation that the management contract will be renewed and that profits will continue to be received.

The court in *Rosenfeld* refused to accept the argument that it was solely within the adviser's discretion to decide whether to retire its position in favor of another adviser. Rather, the court referred to the independent directors' having an affirmative responsibility to seek out a successor, if they agreed with the managing company that its continuance as adviser was not in the best interest of the fund. The court also stated that a fiduciary endeavoring to influence the selection of a successor must do so with an eye only to the best interests of the beneficiaries—the shareholders of the fund. In *Rosenfeld*, the adviser had informed the shareholders that the directors had recommended approval of the merger, and the adviser did in fact have the advance knowledge and approval of the directors in approaching the purchaser. Clearly the directors did not exercise any independent function in seeking a new adviser, since there was no evidence that the directors did anything other than to approve routinely the adviser's choice. However, liability of the directors was not at issue, since the court was faced with a summary judgment for the defendant adviser.

In *Krieger v. Anderson*, a case in which the issue of the duty of the independent directors was squarely presented, the court expressed a different opinion. It held that the independent directors had not breached their fiduciary duty by working for shareholder approval of reinstatement of a management contract following sale of a controlling interest in the management company. As in *Rosenfeld*, the sale was conditioned upon shareholder approval of a management contract with the new adviser. The court held that the

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204. 445 F.2d at 1344.

205. 445 F.2d at 1347 n.14.

206. 445 F.2d at 1345.

207. 445 F.2d at 1346.


209. 40 Del. Ch. at 367, 182 A.2d at 909.
premium paid for the adviser's stock was not an asset of the fund, and that it would be unfair to deprive the owners of an advisory contract of its full value.\textsuperscript{210} The court accepted plaintiff's allegation that the independent directors were in fact controlled by the outgoing adviser and thus that the fund was conceivably deprived of an opportunity to invite competing advisers to bid for the management contract. But the court felt that it was a question of business judgment whether to solicit bids or to deal with a single purchaser. If the directors were shown to have been dominated by the adviser, their decision called for close scrutiny concerning the fairness of the transaction.\textsuperscript{211} The court found nothing wrong with the transaction since it preserved the advisory personnel of the outgoing adviser, which had been successful, even though the purchaser obtained greater than a seventy per cent interest in the advisory company.

The court in \textit{Krieger} relied upon an earlier Ninth Circuit decision, \textit{SEC v. Insurance Securities, Inc.}\textsuperscript{212} Although recognizing the principle that a fiduciary may not sell or transfer his office for personal gain, the \textit{Insurance Securities} court held that this principle was not applicable.\textsuperscript{213} It viewed the fiduciary relationship as arising from the advisory contract and since, by statute, such a contract automatically terminates with a shift in control,\textsuperscript{214} the price received could not be said to represent compensation for the sale of a fiduciary office involving the fund.\textsuperscript{215} The court also rejected the concept that the premium paid represented the capitalized value of the advisory contract and therefore an asset of the fund, even though it did agree that the portion paid above book value was based upon the expectation that the advisory contract would be renewed.\textsuperscript{216}

If the \textit{Rosenfeld} theory were followed, changes in advisory firms would necessarily be few. It is only when the adviser is so determined to sell its office that it is willing to forgo economic gain on the transfer that the directors must play an active role in selecting a successor. If the incumbent adviser did not unduly influence the shareholders and directors, if the independent directors had a significant role to play in choosing the new adviser, and if the price paid for the controlling interest was not greatly in excess of asset value, or if the portion clearly representing a premium went to the fund, the sale might be upheld. To hold otherwise "might well be unfair insofar as it denies to the retiring management any compensation for the ele-

\textsuperscript{210} 40 Del. Ch. at 365, 182 A.2d at 908.
\textsuperscript{211} 40 Del. Ch. at 367, 182 A.2d at 909.
\textsuperscript{212} 254 F.2d 642 (9th Cir.), \textit{cert. denied}, 358 U.S. 823 (1958).
\textsuperscript{213} 254 F.2d at 650.
\textsuperscript{215} 254 F.2d at 650.
\textsuperscript{216} 254 F.2d at 650-51.
ments of value in the relationship [with the fund] which they may have built up over the years.”

Under Insurance Securities, the sale of the advisory office is given a presumption of validity, and thus the role of the independent director is virtually emasculated. Yet Insurance Securities is based upon fantasy in ignoring the fact that the real value in an advisory company's stock is the profits to be derived from its contracts with the mutual funds.

Whichever theory is adopted, the independent directors should have a strict duty to protect the interests of the fund shareholders in this area. They should determine whether the transfer is fair to the fund’s shareholders, review the competency and reputation of the prospective adviser, and solicit and evaluate competing offers. Because of the importance of this transaction the sale should perhaps be conditioned upon unanimous approval by the independent directors and approval by a high percentage of the shareholders. Imposition of this responsibility would require an amendment to the Investment Company Act.

Unless Rosenfeld or a similar case is accepted by the Supreme Court, Congress must resolve the conflict between the circuits. Rosenfeld is based on classic fiduciary principles and provides the utmost protection to the fund shareholders, but is unfair to the transferring adviser because it deprives him of all entrepreneurial reward. One solution would be to obviate the role of the independent directors by requiring that the terms of any transfer of fiduciary office be subject to advance review by the SEC. Alternatively, the Act could provide detailed requirements for such transfers, or provide for profit splitting between the selling adviser and the fund.

IV. CONCLUSION

In finding the independent directors liable in Lutz, the court said: “These men are prime examples of what can happen when a man undertakes a substantial responsibility with public overtones without any appreciation of his obligations thereunder.” It can also be said that the independent director requirement is a prime example of what can happen when Congress undertakes to legislate shareholder safeguards without an appreciation of the nature of the industry. The reluctance of the courts to require strong independent directors cannot be faulted since it is based on a recognition of the directors' lack of effective power under the Investment Company Act and the nature of the mutual fund industry itself. To its credit, Congress finally did recognize the ineffectiveness of independent directors in

217. PUBLIC POLICY IMPLICATIONS, supra note 4, at 152.
218. Id. at 149.
the broadest area of concern—management fees. It codified the dicta of the courts that at some point fees could become so excessive that even the independent directors could be liable for breach of their fiduciary duties. 220

The independent directors with their “watchdog” functions remain in the amended Act. Congress has reiterated that they are still responsible for the over-all operations of the fund. If the independent director requirement is to be retained, some stronger standard calling for an affirmative and aggressive overseeing of fund operations should be required.

The role of the independent director on a transfer of the advisory function appears to be largely negative—not to campaign actively for and influence shareholder approval of the new adviser. Shareholder protection demands an affirmative obligation to play an active if not predominant part in selecting the new adviser.