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Knowledge Is Power: What Went Wrong in the Mutual Fund Industry

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INTRODUCTION

A COMPLAINT FILED AGAINST THE HEDGE FUND CANARY CAPITAL PARTNERS, LLC, by New York Attorney General Eliot Spitzer just after Labor Day in 2003 accelerated the Securities and Exchange Commission's (SEC's) focus on investment company governance and the role of independent directors.[1] Spitzer alleged that the hedge fund had managed to persuade a mutual fund complex's management to let it make quick profits by rapid trading of fund shares at the expense of other investors.[2] The popular press picked up on the Spitzer charges, which, as other examples of market timing were uncovered, became known as the "mutual fund scandal."[3]

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1. Complaint, State of New York v. Canary Capital Partners, LLC, No. 03-402830, 2003 WL 22341460, (N.Y. Sup. Ct. filed Sept. 3, 2003). Spitzer uncovered a practice involving mutual funds that invested in securities traded in foreign markets. Large, savvy investors, including hedge funds, learned that many of these mutual funds did not take into account events that occurred after the foreign markets closed and that were likely to cause the securities trading in those foreign markets to rise or fall in value when they reopened the next day. For example, a mutual fund invested in securities traded on the Tokyo Stock Exchange would price the value of the fund's shares at 4:00 p.m. New York time, based on the closing price of the securities on the Tokyo Exchange, which had closed 14 hours earlier. Computer modeling, however, taking into account succeeding events known to affect prices in those 14 hours, might well indicate that the Tokyo market for the securities in the fund portfolio would rise when it next opened. In common parlance, the price a mutual fund would set to buy a share of the foreign fund would be "stale." If it was too low, the investor bought mutual fund shares at a bargain price and turned around and sold the shares at the more contemporary price. In effect, these investors skimmed profits from the fund's long-term shareholders.

Word of this technique spread quietly among a class of investors who put it to good use. Although a few academics wrote about the strategy, the mutual fund industry ill appreciated its efficacy. Moreover, while it was described as market timing, it bore little resemblance to the popular understanding of market timing. Popularly, market timing was thought to mean a misguided belief that one could "time" when the Dow Jones would rally, or when technology stocks would decline. In a new era of global trading across markets on a nearly 24-hour basis, "market timing" to Canary Capital and others meant successfully predicting that movements in the European and U.S. markets would directly affect the prices on the Tokyo market the next day. Some of these investors who wanted to enhance their ability to predict the likelihood that a foreign market would open up or down from its close, also cajoled mutual fund personnel into letting them place trades after the 4:00 p.m. New York City cutoff time to take into account later-breaking developments affecting the direction of the markets.

2. *See generally id.*

3. *See, e.g., In re Banc of Am. Capital Mgmt., LLC,* Investment Company Act Release No. 26756 (Feb. 9, 2005); *In re Fremont Inv. Advisors, Inc.*, Investment Company Act Release No. 26650 (Nov. 4, 2004); *In re Invesco Funds Group, Inc.*, Investment Company Act Release No. 26629 (Oct. 8, 2004); *In re Mass. Fin. Serv. Co.*,

Congress threatened to adopt remedial legislation. Ultimately, the SEC responded by proposing and adopting a rule requiring most mutual funds to ensure that at least seventy-five percent of the directors be independent of mutual fund advisers and that the chairman of the board be independent.[4] The SEC Commissioners in favor of the rule said the scandal could have been averted had the rule been in place.[5]

The wrongdoings that made headlines were related to practices surrounding the sale and distribution of mutual fund shares, and for good reason. The investment advisory firms that sponsor and manage mutual funds earn money by charging investment-advice fees calculated as a percentage of the assets under their management, e.g., seventy-five basis points per annum on the multimillion-dollar size of each mutual fund in the complex they advise. In turn, investment advisory firms are valued on the basis of the magnitude of assets under their management. As a result, a crucial goal of investment advisory firms is to increase assets under management if at all possible or, at minimum, to maintain those assets.

This fundamental business goal is unlikely to change. But installing independent fund directors and chairmen in order to protect shareholders from the unrestrained ambition of mutual fund advisers will fail without some critical thought about the role of independent directors. The fix is no panacea. In order to function effectively, independent directors, or at least some of them, must become knowledgeable about the business of mutual funds.

Consider the following hypothetical: The president of a complex of mutual funds is also a senior officer of the adviser to the funds, where his chief responsibility is to direct sales activities and increase assets across the mutual fund complex. His bonus is based on increasing assets. He receives an email from a member of the sales force stating that a large investor is willing to commit $80 million for the long term in the complex's bond fund if the investor is allowed to buy in and out of the complex's Asian equity fund on a nearly overnight basis. The quid pro quo here is that the total assets under management in the fund complex will increase in exchange

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Investment Company Act Release No. 26347 (Feb. 5, 2004); *In re Strong Capital Management, Inc.*, Investment Company Act Release No. 26448 (May 20, 2004); *In re Janus Capital Mgmt. LLC*, Investment Company Act Release No. 26532 (Aug. 18, 2004); *In re Gary L. Pilgrim*, Investment Company Act Release No. 26655 (Nov. 17, 2004); *In re Harold J. Baxter*, Investment Company Act Release No. 26656 (Nov. 17, 2004); *In re Pilgrim Baxter & Assoc., LTD*, Investment Company Act Release No. 26470 (June 21, 2004); *In re Putnam Inv. Mgmt., LLC*, Investment Company Act Release No. 26412 (Apr. 8, 2004).

4. *See* Investment Company Governance, 69 Fed. Reg. 46,378, 46,378–79, 46,381 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270).

5. *Id.* at 46,378–80. The rule was adopted by a split Commission vote, and two of the five SEC Commissioners registered strong dissents. The U.S. Chamber of Commerce subsequently challenged its adoption. Complaint, Chamber of Commerce of the United States of America v. SEC, Case No. 1:04CV01522, 2004 WL 2245645 (D.D.C. filed Sept. 2, 2004). On April 7, 2006, the U.S. Court of Appeals for the District of Columbia Circuit decided that although the Commission had the authority to adopt the rule, it had not complied with § 553 of the Administrative Procedures Act (APA), 5 U.S.C. § 551 *et seq.* The court said it would vacate the rule's challenged requirements unless the Commission took remedial action to comply with the APA, giving the Commission 90 days to report back to the court.

for permitting the investor to trade the international fund rapidly. One of three things may occur:

Scenario 1:

The president perceives no legal issues, and while not entirely happy that it might hurt the performance of the Asian equity fund, he emails the salesman, without consulting anyone else, saying, "I'm not entirely happy with this, but it is, after all, $80 million in long-term assets."

Scenario 2:

The president thinks the proposal should be discussed with counsel to the adviser. Counsel sees two questions: First, does the prospectus of the Asian fund impose restrictions on rapidly trading in and out of the fund? Second, would this activity harm the shareholders of the fund because it would hurt the fund's performance? Counsel determines that the prospectus would permit letting the investor market-time because it is silent as to whether this conduct is acceptable. And the portfolio manager, in this case, states that the proposed market timing will not hurt the fund's performance. The president emails his agreement to the proposal to the salesman.[6]

Scenario 3:

Before signaling acceptance based on the steps taken in Scenario 2, the president tells the board of directors of the international equity fund that the adviser proposes to let a few investors market-time the fund, explaining that both counsel to the adviser and the portfolio manager have signed off on the matter.

Would the independent directors have perceived a problem? Not unless at least one of them understood what this new form of market timing entailed, why it worked, what the dynamics of the daily pricing of fund shares were, and what the fundamental genesis of forward pricing Rule 22c-1 was—a rule designed to prevent an investor from placing a buy order at an older, lower, and obviously stale price.[7]

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6. On the basis of facts set forth in SEC orders, however, in some cases portfolio managers complained about the effect of market timing. *See, e.g., In re Alliance Capital Mgmt., L.P.*, Investment Company Act Release No. 26312A (Jan. 15, 2004). These facts were not disclosed to fund directors.

7. Taking advantage of stale pricing of mutual fund shares is not a new phenomenon. On Sunday, March 31, 1968, President Lyndon Johnson made the surprise announcement that bombing in North Vietnam would be substantially reduced and that he would not run for reelection. Charles J. Elia, *Peace Hopes, Not Exit of Johnson, Are Behind Big Rally, Analysts Say*, WALL ST. J., Apr. 2, 1968, at 33. Much of the trading market expected the stock market to open on Monday morning substantially higher than the Friday close. Traders who counted on this belief flooded the market, buying mutual fund shares at prices reflecting the stale Friday closing prices, thereby allocating to themselves a big piece of the rise in market value of fund shares. *See id.* As a result, it is the author's understanding that a senior fund official called the SEC Chairman, advocating that the SEC require fund shares to be priced prospectively, i.e., at a price determined after an order is received and Rule 22c-1 promulgated under the Investment Company Act of 1940 was adopted. The investors investigated by

The directors would have needed to understand that newfangled "market timing" was far different from relying on a hunch that the Asian sector should outperform other geographical markets. They would have needed to know that computer models had been developed by sophisticated investors to help them reliably predict the likelihood that the securities in an Asian stock fund's portfolio would, based on their correlation with the direction of the U.S. market, rise when next priced, meaning that the price of the fund's shares would also rise. The directors would also have needed to understand that by permitting a particular investor to buy at a lower, stale price and sell a day or two later at the anticipated higher price, the fund was permitting favored investors to allocate to themselves a disproportionate amount of the gain in the price of the fund's shares. In effect, all long-term investors were being asked to hand over some of their gain to the short-term market timer. The directors might also have understood the stakes better had they known how the senior officers of the adviser were compensated and that they would receive bonuses based upon increasing assets under management.

Without question, the adviser should have made a more thorough presentation to the board dealing with the issues of the disproportionate allocation of gains in the portfolio to the market timers and, if so, the portfolio manager's concern as to the negative effect on fund performance. The point here, however, is that familiarity with the mechanics of mutual fund share pricing and the policies underlying Rule 22c-1, as well as with the new market-timing strategy afoot, would have been essential to understanding the issues underlying the President's presentation. Directors knowledgeable about the industry and its practices might well have been able to have challenged a superficial presentation, thereby preventing market timing.

The Focus on the Role of Independent Directors in the Investment Company Act and by the SEC

Since its inception, the Investment Company Act of 1940 has looked to the moderating power of independent mutual fund directors.[8] In 2001, the SEC chose to trump the statutory language that required forty percent of an investment company board to be independent, by requiring, as a practical matter, that a majority of the directors be independent.[9] The SEC increased that percentage to seventy-five per-

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Mr. Spitzer and the SEC offset the purpose of Rule 22c-1 by computer modeling whether a fund share price could be expected to rise or fall when it was next determined.

8. Section 10(a) of the 1940 Act sets the 40% requirement. 15 U.S.C. § 80a-10(a) (2000). Congress initially considered requiring that a majority of the directors be independent, but became concerned that if it did, the independent fund directors would have the power to dismiss an adviser that the investors had "chosen" by virtue of having decided to invest in the fund. *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 109–10 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).

9. Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3,734, 3,736 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, 274). This requirement was imposed as a condition precedent to the use of ten Exemptive Rules that modify flat proscriptions against certain transactions between an investment company and its affiliates found in the 1940 Act (the "Exemptive Rules"). *Id.* The most prevalent form of

cent in the controversial rule it adopted in 2004, which was coupled with a requirement that a mutual fund board chairman be an independent director.[10] In the Proposed Release in which the Commission recommended these changes, it said that recent events, including late-trading and market-timing activities, suggested the need to revisit fund governance because the market timing and late trading indicated "a serious breakdown in management controls in more than just a few mutual fund complexes."[11]

The majority of the Commissioners concluded that the fund complexes that had engaged in market timing and late trading were characterized by situations in which "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."[12] While the Proposed Release indicated that in some cases the board may have lacked information or may have been deceived, the majority of the Commissioners endorsed the view that requiring a supermajority of independent directors and an independent board chairman would, in itself, effectively change board dynamics, empowering the independent directors.[13]

In the Adopting Release, the Commission majority said that "by increasing the independence of fund boards, the amendments are designed to improve the quality of the oversight of the process for the benefit of fund investors. Vigilant and informed oversight by a strong, effective and independent fund board may help to prevent problems such as late trading and market timing."[14] It added that requiring fund boards to be chaired by an independent director would be beneficial because "the chairman of a fund board can have a substantial influence on the fund board agenda and on the fund boardroom's culture."[15] The two dissenting SEC Commis-

investment companies subject to the 1940 Act is the open-end management company, commonly called a mutual fund. Investment companies, including mutual funds, that can forgo using every one of the ten Exemptive Rules need comply only with the 1940 Act requirement that 40% of the board be independent. However, any mutual fund that relies on using Rule 12b-1, a key Exemptive Rule, to help it finance sales and marketing activities—and that includes most mutual funds—must comply with the present or future conditions the SEC has or may establish in order to use any of the Exemptive Rules. It has been estimated that some 90% of funds use one or more of the Exemptive Rules. Investment Company Governance, 69 Fed. Reg. at 46,390 n.7.

10. Investment Company Governance, 69 Fed. Reg. at 46,382.

11. Investment Company Governance, 69 Fed. Reg. 3,472, 3,472 (Jan. 23, 2004) (to be codified at 17 C.F.R. pt. 270).

12. *Id.* at 3,473.

13. *Id.* at 3,478.

14. Investment Company Governance, 69 Fed. Reg. 46,378, 46,386 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270).

15. *Id.* at 46,386. The majority's emphasis on the efficacy of requiring independent directors to be in the majority was based on a tenet that gained substantial support in the corporate governance literature beginning in the 1980s where it was identified with reform in the governance of operating companies. In that arena, Enron and the other major corporate mishaps led more recently, with strong encouragement from the SEC, to adoption in 2003 by the New York Stock Exchange (and the American Stock Exchange and the Nasdaq) of listing standards requiring that a majority of the board be independent. Notices, Self-Regulatory Orgs., Exchange Act Release No. 34-48745, 68 Fed. Reg. 64154, (Nov. 4, 2003) at 16–17.

sioners challenged the legitimacy of the rule on a number of bases, including the cost of implementation and a lack of evidence that the requirements would have averted market timing and late trading.[16] They pointed out, in the Adopting Release, that a common feature among funds that had been used to late-trade and market-time was that their boards were simply not told of those arrangements.[17]

The Commissioners said that a better focus would be to hold investment advisers accountable as having a fiduciary duty of their own to act in the best interest of fund shareholders.[18] This duty was violated, the Commissioners said, when the advisory personnel bartered the right to late trade and market time mutual funds under their management in exchange for increasing the advisers' profitability by increasing the aggregate assets they managed.[19] Moreover, a number of the mutual funds that permitted late trading and market timing were governed by boards with a high proportion of independent directors. In fact, when the market timing scandal occurred, a substantial number of mutual fund boards had more than a simple majority of independent directors, and some had designated an independent director as "lead director" or, on occasion, had named an independent director as chair.[20] This argument was consistent with a "best practices" report published by the Investment Company Institute in 1999 recommending that at least two-thirds of the directors of mutual funds be independent and that independent directors designate one or more lead directors.[21]

It is significant that the SEC did not explain why it believed increasing the percentage of independent directors to seventy-five percent would substantially improve shareholder protection, other than to advance a "more is better" view. The majority merely said in the Adopting Release that the seventy-five percent requirement "will help ensure that independent directors carry out their fiduciary responsibilities."[22] Nor did the majority spell out a proactive role to be played by an independent chairman, stating that "[t]he board chairman can play an important role in setting the agenda of the board, and in establishing a boardroom culture

16. *Id.* at 46,390–93.

17. *Id.* at 46,391.

18. *Id.* at 46,392.

19. *See id.*

20. *Id.* at 46,391 n.22 (citing a letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC (Mar. 10, 2004), responding to the request for comments made in the Proposing Release and stating that the "current practice" was to have a two-thirds majority of independent directors).

21. JOHN J. BRENNAN ET AL., INVESTMENT COMPANY INSTITUTE, ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS: REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS, 10, 25 (1999). The report stipulated that its best-practices recommendations might not be suitable for every fund, but said that in cases where at least two-thirds of the directors were independent, this percentage could help ensure that the independent directors could control the voting process at the board level. *Id.* at 10. While the report did not contemplate the idea of having an independent director chair board meetings, it recommended designating one or more lead directors who could, among other things, serve as a "point of contact" for raising and discussing issues with counsel and the investment adviser. *Id.* at 25.

22. Investment Company Governance, 69 Fed. Reg. at 46,382.

that can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance."[23]

ASKING TOO MUCH OF INDEPENDENT DIRECTORS

While the SEC's emphasis on the crucial role that independent directors play in protecting mutual fund shareholders is important, its focus on their role has, over time and in a perverse way, attenuated the influence and authority of independent directors. The SEC has asked independent directors to undertake oversight duties that, in some cases, cannot realistically be done and, in other cases, have become nothing more than a board-level review of routinized checklists. As a result, independent directors, as well as investment advisers, may have come to believe that independent directors cannot provide meaningful input.

A recent compliance rule the SEC adopted in the aftermath of the mutual fund scandal exemplifies other SEC rules that look on independent directors as wielding talismanic, ceremonial powers.[24] That rule required all investment companies, including mutual funds, to adopt and implement by October 5, 2004, policies and procedures "reasonably designed to prevent violation of the Federal Securities Laws by the [mutual] fund, . . . [its] investment adviser, [its] principal underwriter, administrator and transfer agent. . . ."[25] Using a standard paperback compilation of Federal Securities Laws published by Foundation Press as a rough benchmark, the relevant statutes and related federal rules run to about two thousand pages.[26] Funds, advisers, and other service providers spent months identifying all relevant statutory requirements and related regulations and then prepared policies and related procedures designed to comply with the vast scope of the compliance rule. These procedures and policies were themselves hundreds of pages long. They required the expertise of counsel familiar with every aspect of investment company law, broker-dealer regulation, anti–money-laundering regulation, insider trading, and all forms of federal securities law antifraud provisions, as well as the sustained input of fund personnel familiar with the complex, day-to-day operations of funds and their service providers. Counsel who were asked to look over the final product

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23. *Id.* at 46,383. The language of the rule stipulating that use of any of the ten Exemptive Rules is conditioned on having an independent chairman is consistent with this fairly amorphous role. It simply provides that "[a] disinterested director serves as chairman of the board of directors of the fund, presides over meetings of the board of directors and has substantially the same responsibilities as would a chairman of a board of directors." 17 C.F.R. § 270.0-1(a)(7)(iv) (2005).

24. *See* 17 C.F.R. § 270.38a-1 (2005); *see also* 17 C.F.R. § 275.206(4)-7 (2005) (relating to rule 38a-1 but covering compliance only with the Investment Advisers Act).

25. 17 C.F.R. § 270.38a-1(a)(1) (2005). The rule defines Federal Securities Laws to include the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Graham-Leach-Bliley Act, any rules adopted by the SEC under any of these statutes, the Bank Secrecy Act, as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury. 17 C.F.R. § 270.38a-1(e)(1) (2005).

26. FEDERAL SECURITIES LAWS: SELECTED STATUTES, RULES AND FORMS (John C. Coffee, Jr. & Joel Seligman eds., 2005).

themselves needed days of intensive review to assess the viability of the policies, and even then they could not be confident that the policies would prevent every violation of law, whether or not it was likely to be material.

Nevertheless, the SEC charged independent fund directors with just this responsibility. A key component of the SEC's compliance rule was its reliance on the oversight of independent directors. The compliance rule specifically required that a fund's board of directors, including a majority of its independent directors, make a finding that the policies and procedures presented to them were "reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund."[27] Many would contend that no board is capable of making such a finding, and in making this demand, the SEC in a very real sense signaled to independent directors that they were being asked to undertake an impossible task. In that sense, it made board action more ritualistic than substantive.[28]

The unwanted consequence of the SEC's own oversight of the oversight of independent directors had been raised some twelve years earlier. In contemplation of the fiftieth anniversary of the 1940 Act, the SEC's Division of Investment Management ("Division") took a "fresh look" at the regulation of investment companies and of investment company corporate governance.[29] It concluded that SEC regulation had embroiled fund board independent directors in a welter of detail.[30] In its report issued in 1992,[31] the Division also found that under the terms of the SEC

27. 17 C.F.R. § 270.38a-1(a)(2) (2005).

28. A board of directors might have been expected to assess whether the personnel of the fund and the fund's service providers had engaged in a reasonable process to identify all relevant statutes and regulations applicable to those entities within the scope of the Federal Securities Laws, as defined, and had the competence to draft policies and procedures believed by the drafters to prevent and detect *material* violations. This is consistent with the oversight function of directors. See, for example, Maryland General Corporation Law § 2-405.1 governing the oversight duties of directors, which provides that "[i]n performing his duties, a director is entitled to rely on any information, opinion, report, or statement, including any financial statement or other financial data, prepared or presented by: (i) An officer or employee of the corporation whom the director reasonably believes to be reliable and competent in the matters presented; (ii) A lawyer, certified public accountant, or other person, as to a matter which the director reasonably believes to be within the person's professional or expert competence; or (iii) A committee of the board on which the director does not serve, as to a matter within its designated authority, if the director reasonably believes the committee to merit confidence. MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(b)(1) (Michie 1999 & Supp. 2005).

29. Letter from Marianne K. Smythe, Director, SEC Division of Investment Management, to Richard C. Breeden, Chairman, SEC (May 1, 1992), *Preface* to SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992) [hereinafter PROTECTING INVESTORS].

30. PROTECTING INVESTORS, *supra* note 29, at 266, 270.

31. *Id.* at 266–67. The Division took the then prescient position that the 1940 be amended to require that more than 50% of the fund's directors be independent and that they be self-nominating. Subsequently, rather than seeking to *amend* the statute, the SEC effectively mandated that more than 50% of fund directors be independent and that they be self-nominated through imposing these requirements as a condition of using the Exemptive Rules. *See supra* note 10 and accompanying text.

regulation, independent directors were required to make detailed quarterly and annual findings that, according to the report, created "a major source of frustration."[32]

Citing to Rule 17f-5 as an example, the Division said that according to commentators, "the rule is unduly burdensome and difficult to administer, and embroils the directors in matters involving an inappropriate level of detail."[33] It said that in order to "focus the responsibilities of board members into areas where they perform best—namely exercising business judgment in conflict of interest situations—the Division recommends eliminating provisions in certain rules under the [1940] Act that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance."[34] It specifically recommended modifying or eliminating the board's functions in connection with six of its rules, three of which are, ironically, among the Exemptive Rules the Commission said were so important as to require policing by a board consisting of at least seventy-five percent independent directors and led by an independent chairman.[35]

Because the Division of Investment Management's 1992 recommendation was not adopted, and was, in fact, forgotten, mutual fund board materials continue to be dominated by pages of backup data supporting compliance with the routine and noncontroversial use of a battery of 1940 Act rules. These include rules that the Division of Investment Management characterized as involving more ritual than substance, but which are now enshrined among the ten Exemptive Rules said to be the basis for an independent chair and an increased number of independent directors.[36]

In fact, the pages of detailed backup data set forth in board materials almost always demonstrate meticulous compliance with the procedures mandated by SEC rulemaking, as well as meticulous compliance with other aspects of the 1940 Act. While the precise data changes from quarter to quarter, its purport does not, leading independent directors to conclude that the funds they oversee are in compliance with a bewilderingly picayune and sweeping 1940 Act regulatory structure, that this is all that matters, and that this is what the SEC wants them to oversee. These conclusions are buttressed by the typical inclusion in each board book of detailed regulatory updates provided by counsel, fund auditors, or administrators outlining the details of every newly proposed regulation, SEC enforcement action,

32. PROTECTING INVESTORS, *supra* note 29, at 270 n.78.

33. *Id.* Rule 17f-5 then required a fund's directors to "approve foreign custody arrangements after considering numerous legal matters, country risk factors, and factors relating to the particular foreign custodian." *Id.*

34. *Id.* at 289.

35. *Id.* The six rules were Rules 10f-3, 12d3-1, 17a-7, 17e-1, 17f-4 and 22c-1. In sharp contrast to its 1992 view, the SEC said in the Adopting Release that 75% of the directors should be independent in order to use the Exemptive Rules; that Rule 10f-3, for example, involved complex transactions; and that a fund's board should be "vigilant not only in reviewing the fund's compliance with the procedures required by Rule 10f-3, but also in conducting any additional reviews that it determines are needed to protect the interests of investors." Investment Company Governance, 69 Fed. Reg. 46,378, 46,385 n.67 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270).

36. PROTECTING INVESTORS, *supra* note 29, at 289.

and court decision relevant to the industry. Moreover, the agenda of fund meetings is given over to review of the alphabet soup of regulatory compliance, reinforcing the idea that the role of the independent directors is to review data that almost never calls for questioning or discussion. The subliminal message is that the practical experience and wisdom of the independent directors are of little value.[37]

Consciously or not, independent directors may feel marginalized. And advisers may also have come to believe that the purpose of board meetings is to demonstrate their compliance with specified regulations rather than to engage the board in a discussion of goals and strategies.

FOCUS SHOULD BE ON INFORMED, INDEPENDENT DIRECTORS

Independence is not, of course, the only qualification an independent director should have. "Knowledge is power,"[38] and so long as the adviser has significantly more knowledge about the operation of the funds it advises, the balance of power will remain with fund management. At least some independent directors must be knowledgeable about the fund industry in general and the fund complex in particular. Skepticism is effective only when voiced by someone in a position to raise questions with confidence. And directors must know what questions to raise.

In the corporate world, although airlines are different from pharmaceutical companies or media companies, there is an underlying generic business model that transcends regulation by the Federal Aviation Administration, the Federal Drug Administration, or the Federal Trade Commission. A board member with a professional background at a company that sells cosmetics shares much of a common vocabulary with a counterpart at a corporation that sells cars. The utility of internal budgets is part of a shared experience. For example, they can track, line by line, projected revenues, expenses, net earnings, etc., against results year-to-date and over other relevant periods, permitting a focus on what is going well or awry, and the discipline of 10Ks, 10Qs, and 8Ks. Business leaders from other industries can contribute their relevant experience and judgment in matters of corporate finance, internal controls, information technology, human resources, public relations, etc. As a result, management is more likely to perceive them as capable of providing exactly this sort of input. In the best of circumstances, management believes that independent directors sitting on corporate boards are valuable resources, particularly in highly specialized industries such as biotechnology, which place a premium on a scientific background.

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37. It is worth noting that the content of board materials and the agendas of the boards of operating companies are not laid out by the SEC, but directors can suggest or demand meaningful agenda items. Although Congress reacted to the Enron and WorldCom corporate debacles by adopting a number of structural changes designed to increase the effectiveness of independent directors sitting on corporate boards, it did not seek to dictate the agenda of a corporate board meeting or the materials the boards were to review.

38. SIR FRANCIS BACON, The Essaies of Sir Francis Bacon; Knight, The Kings Attorney Generall: His Religious Mediations, Places of Persuasion and Dissuasion & Meditationes Sacrae (John Jaggard ed., 1623).

In the case of fund boards, few if any boards have one or more independent directors who have experience relevant to the fund industry. As a result, even if seventy-five percent or more of their directors are independent or if the chairman is independent, few fund boards are in a position to exploit fully the nebulous power the SEC expects them to wield.

HELPING INDEPENDENT DIRECTORS BRING MORE THAN INDEPENDENCE TO THE TABLE

Boards that are able to attract at least one independent director with a background in the industry should be in a superior position to provide fund managers with useful support and an effective challenge precisely because they know where the bodies are likely to be buried. While in many cases experienced members of the industry cannot be sensibly considered as board candidates because their employer is in direct competition with a fund complex, in some situations, the conflict will be remote. Candidates for directorships may also include persons who have left the mutual fund industry.

Independent directors might also seek to engage persons with industry experience as consultants. A consultant in tune with what is going on within the industry can coach and mentor independent directors and help them spot practices and trends that deserve their thoughtful attention. Organizations formed to help independent directors perform their role might also develop searching educational programs that candidly focus on industry practices so that independent directors will be in a position to hold their own at board meetings.

Independent directors can also take action to change the content of board materials and meeting agendas. The SEC is unlikely to act to reduce the number of matters that it believes the board must routinely review. The reams of materials responsive to these matters, however, could be sent sufficiently in advance of board meetings so that these items do not dominate the time available for deliberation at board meetings unless, of course, these materials happen to raise an issue that deserves serious discussion.

Independent directors can establish dedicated blocks of board time to discuss industry practices with fund management. These might include a review of all of the written and unwritten sale practices employed by the fund's agents, the use of soft dollars within a particular fund group, procedures undertaken by the fund's trading desk to obtain the best execution of orders put to brokers to effect purchases and sales of securities in a fund's portfolio, resolution of conflicts of interest that may arise when an adviser's clients include hedge funds with contrary investment strategies, and the rationale for an adviser's range of fees paid by different clients, as well as consideration of other topics as they invariably come to the fore. An ongoing, multi-meeting review devoted to a rolling examination of key compliance procedures adopted to prevent violations of law by the fund and its agents might also help the board exercise effective oversight.

Knowledge Is Power

We cannot know whether market timing could have been averted if fund boards had understood just how and why market timing worked to the advantage of the timers. But independent directors are likely to play a robust, interactive role in the oversight of the fund's affairs when they have sufficient knowledge to be confident in their ability to make a contribution and investment advisers are confident of the value of their advice and consent. In short, the presence of independent directors on the board is requisite to promoting meaningful board oversight, but that oversight must also be informed. The collective knowledge of the independent directors is more important than their number.