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The Regulation of Mutual Fund Boards of Directors: Financial Protection or Social Productivity?

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THE REGULATION OF MUTUAL FUND BOARDS OF DIRECTORS: FINANCIAL PROTECTION OR SOCIAL PRODUCTIVITY?

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I. INTRODUCTION

"The conventional view serves to protect us from the painful job of thinking."[1]

During the last quarter of a century, mutual funds in the United States achieved a remarkable degree of public acceptance as a means of investing in securities. The change is manifested in both the number and assets of mutual funds. Between 1980 and 2006, for example, the number of mutual funds grew from fewer than 600 to more than 8100, and the assets managed by mutual funds expanded from approximately $135 billion to $10.4 trillion.[2] The increased popularity of mutual funds has made the funds an important factor in the financial well-being of Americans—in 2006, mutual fund shares were owned by nearly half of all U.S. households and mutual funds held almost one-fourth of the total financial assets of U.S. households.[3] Given the current importance of mutual funds, instances of exploitation of fund shareholders may damage the economic welfare of individuals and reduce investments in securities by the public.

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[1] John Kenneth Galbraith, *quoted in* The Quotations Page, Michael Moncur's (Cynical) Quotations, http://www.quotationspage.com/quote/11267.html (last visited Feb. 3, 2008).

[2] INVESTMENT COMPANY INSTITUTE, 2007 INVESTMENT COMPANY FACT BOOK 93 (47th ed. 2007), *available at* http://www.icifactbook.org. The data in the text for the number and assets of funds include money market funds. The number of funds from 1940 to 2006 is visually depicted in the instant article *infra* in Figure 1.

[3] *Id.* at 12, 58. Money market funds are evidently counted in the percentage of households with an investment in a mutual fund.

Under its mandate to protect investors in mutual funds, the Securities and Exchange Commission ("Commission") has, since 2001,[4] devoted considerable attention to the boards of directors of the funds.[5] In particular, the Commission has acted to require funds to fill more seats on their boards with "independent" directors and thus to exceed the minimum percentage of independent directors specified by Congress in the Investment Company Act ("Act"), the principal federal statute governing mutual funds.[6] The instant article explores the basis of the actions that have been taken by the Commission and by Congress to regulate the composition of fund boards.

An overview of the article may be helpful. I begin with an explanation of the distinction currently made by the Act between "interested" directors and non-interested directors. This distinction is important because the Act requires that non-interested directors, i.e., directors who are "independent," hold at least 40% of the seats on the board of a registered investment company.[7] With this background, I review a measure that has been implemented, as well as a measure that has been proposed, by the Commission to increase further the percentage of fund directors who are independent and reduce the percentage of directors who are interested.

The difference between interested and non-interested directors forms the foundation for my analysis. In particular, I identify the rationale that has been advanced by Congress and by the Commis-

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[4] Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24816, 66 Fed. Reg. 3734 (Jan. 16, 2001) [hereinafter Release No. IC-24816].

[5] SEC, EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION, A REPORT IN ACCORDANCE WITH THE CONSOLIDATED APPROPRIATIONS ACT (Apr. 2005), *available at* 2005 SEC LEXIS 1031.

[6] Investment Company Act, 15 U.S.C.A. §§ 80a-1 to -64 (West 1997 & Supp. 2007). The managers of the securities portfolios of mutual funds and other investment companies are investment advisers under the Investment Advisers Act and subject to that Act. 15 U.S.C.A. §§ 80b-2(a)(11), -3(a) (West 1997 & Supp. 2007). In addition, the Securities Act and the Securities Exchange Act apply to mutual funds because the funds issue securities that are offered and sold to investors. 15 U.S.C. § 80a-24 (2000); 15 U.S.C. §§ 77a to 77z-3 (2000 & Supp. V 2005); 15 U.S.C. §§ 78a to 78mm (2000 & Supp. V 2005).

[7] *See* 15 U.S.C. § 80a-10(a) (2000).

sion for limiting the fraction of board seats held by interested directors. I then review quantitative social science research to ascertain whether this rationale, which presently appears to be unquestioned,[8] has factual support. If the rationale for such regulatory requirements is not empirically justified, a different *raison d'être* must exist for designating certain directors as "interested" and curtailing their allotment of seats on fund boards. The concepts and doctrines of law that prevail in a society are not fortuitous; rather, concepts and doctrines are adopted by the institution of law because they facilitate the operation of the society in which the law exists, and when prevailing concepts and doctrines of law hamper society, they are replaced.[9] Therefore, if interested directors are as likely as, or almost as likely as, independent directors to protect investors from being exploited, regulatory measures that are based on the "bad name" of interested directors presumably do not offer protection to investment company shareholders but benefit society in some other manner.

In this regard, I suggest that current measures to regulate investment company boards have largely a sociological basis and, in particular, that they benefit society by their social productivity.[10] The social productivity of law leads me to propose a possible

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[8] The rationale has not been questioned even by commissioners of the Securities and Exchange Commission who have criticized a Commission attempt to reduce the percentage of interested directors on investment company boards. *E.g.*, Investment Company Governance, Investment Company Act Release No. IC-26520, 69 Fed. Reg. 46,378, 46,391 (Aug. 2, 2004) [hereinafter Release No. IC-26520] (dissenting opinion of Commissioners Glassman and Atkins) (contending that the statutory criteria that determine whether a director is interested should be amended by Congress if non-interested directors are insufficiently independent).

[9] Larry D. Barnett, *The Roots of Law*, 15 AM. U. J. GENDER SOC. POL'Y & L. 613, 615, 636–37, 672 [hereinafter *The Roots of Law*]; Larry D. Barnett, *Law as Symbol: Appearances in the Regulation of Investment Advisers and Attorneys*, 55 CLEV. ST. L. REV. 289, 290, 294–95, 302–03, 330–31 (2007) [hereinafter *Law as Symbol*].

[10] Larry D. Barnett, *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, 3 CARDOZO PUB. L., POL'Y, & ETHICS J. 793 (2006) [hereinafter *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*].

Commission response to instances of exploitation of investment company shareholders. The proposed response has the potential to enhance the social productivity of law by contributing to public trust in, and the reputation of, investment companies and by serving as a symbol that helps to bond Americans to their society. In supplying these benefits, the approach would strengthen the social order while avoiding the contentious matter of interested directors versus non-interested directors and the fraction of board seats that each type of director should hold.

II. THE INVESTMENT COMPANY ACT AND INVESTMENT COMPANY DIRECTORS

The analysis undertaken in the instant article involves three basic concepts, viz., "investment company," "mutual fund," and "director." The Act defines an investment company in pertinent part as an entity that (i) issues securities to its investors and that (ii) employs, or proposes to employ, the assets received from investors to engage in the business of seeking profit from securities issued by other entities.[11] An investment company, therefore, not only issues securities of its own but holds a portfolio of securities of other issuers, and if securities are absent at either point, an investment company does not exist under the Act.[12]

While the Act specifies the nature of an investment company, it is silent on the nature of a "mutual fund." In the securities industry, however, a mutual fund is generally regarded as an investment company (i) that publicly sells the securities it issues; (ii) that, when requested by investors holding its securities, redeems these

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[11] 15 U.S.C. § 80a-3(a) (2000).

[12] *See generally* C. Steven Bradford, *Expanding the Investment Company Act: The SEC's Manipulation of the Definition of Security*, 60 OHIO ST. L.J. 995 (1999) (discussing and rejecting the position of the Securities and Exchange Commission that the criteria determining whether instruments are securities differ between the instruments issued by an investment company to its investors and the instruments in the portfolio of the investment company).

securities;[13] and (iii) that manages the securities in its portfolio.[14] To use the nomenclature of the Act, a mutual fund is an open-end management investment company.[15] Accordingly, mutual funds are one type of investment company, and while the instant article refers frequently to mutual funds, its discussion of directors is applicable to all types of investment companies that have directors.[16] Indeed, mutual funds and investment companies are, in one sense, almost coextensive because the net assets of mutual funds constitute approximately 93% of the net assets of all investment companies.[17]

The third concept requiring definition is that of "director." The Act considers a director to be

> any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust.[18]

Under the Act, therefore, a person may be a director of an entity even though the entity is not a corporation. For example, a person managing a limited partnership that is an investment company will be treated by the Act as a director of the partnership if the responsibilities of the person are comparable to the responsibilities of a

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[13] The Act defines a "redeemable security" in section 2(a)(32). 15 U.S.C. § 80a-2(a)(32) (2000).

[14] INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 145; JOHN DOWNES & JORDAN E. GOODMAN, BARRON'S FINANCE & INVESTMENT HANDBOOK 442 (4th ed. 1995). This definition is also used by the Securities and Exchange Commission. *See, e.g.*, Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. IC-26299, 68 Fed. Reg. 74,714, 74,714 (Dec. 24, 2003).

[15] 15 U.S.C. §§ 80a-4(3), -5(a) (2000).

[16] Unit investment trusts, which are one of the three types of investment companies enumerated by the Act, do not have boards of directors. 15 U.S.C. § 80a-4 (2000). For an explanation of unit investment trusts, *see* Thomas S. Harman, *Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Investment Vehicles*, 1987 DUKE L.J. 1045 (1987).

[17] INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 7, 8.

[18] 15 U.S.C. § 80a-2(a)(12) (2000).

director of a corporation.[19]

As indicated in Part I *supra*, the Act at the present time classifies directors as interested or as not interested. Conventional wisdom in the regulation of investment companies is that independent (i.e., not interested) directors are essential to protecting investment company shareholders from financial exploitation. Thus, the staff of the Commission has described independent directors as fulfilling a "critical role" in preventing actions that take advantage of investment company shareholders,[20] and one court has characterized independent directors as performing "a vital function" in safeguarding the shareholders.[21]

The implication of this position is that, even though fairness is at the heart of the fiduciary duties of all directors,[22] the interested directors of an investment company will not consistently be fair to the shareholders of the company. The misgivings about interested directors seem to be a result, or at least a concomitant, of the apparent belief of Congress and the Commission that, because the interested directors are involved in certain types of situations that are personally important to them and/or to other persons having ties to them, the interested directors possess an incentive to sacrifice the goals of the shareholders when dealing with matters which implicate these situations. The prevailing approach to regulating mutual fund boards, in short, reflects a lack of confidence in interested directors.[23]

When is a director designated as independent? The answer re-

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[19] Integrated Resources, Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2940, at *1–2 (June 1, 1979).

[20] Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. IC-24083, 64 Fed. Reg. 59,877, 59,877 (Nov. 3, 1999) (statement of staff position) [hereinafter Release No. IC-24083].

[21] Papilsky v. Berndt, No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442, at *43 (S.D.N.Y. June 24, 1976).

[22] J. Robert Brown, Jr., *Disloyalty without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 57 (2006).

[23] *See* Burks v. Lasker, 441 U.S. 471, 485 (1979), where the Court writes that the welfare of shareholders was "entrusted" by Congress to the noninterested directors and thus implies that Congress did not trust the interested directors to prevent the exploitation of shareholders. *Id.* at 485, 485 n.15.

quires an understanding of the detailed criteria specified by the Act for determining the status of a director. The criteria that prevent a director from being independent have changed since the Act became law in 1940. As originally enacted, the Act prohibited an entity that was required to register with the Commission as an investment company[24] from filling more than 60% of the seats on its board of directors with persons who were an investment adviser to, affiliated with an investment adviser to, or an officer or employee of the investment company.[25] Directors who were not in any of the preceding categories were regarded as independent,[26] and Congress believed that such directors were essential to representing the shareholders of the company.[27] As discussed in Part II.A below,

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[24] Investment Company Act of 1940, ch. 686, §§ 3, 6, 7, 54 Stat. 789, 797, 802 (1940) (codified as amended at, respectively, 15 U.S.C. § 80a-3 (2000 & Supp. V 2005) and 15 U.S.C. §§ 80a-6, -7 (2000)). Section 3 of the Act designates the features of an investment vehicle that make the vehicle an investment company; section 7 requires an investment company to register with the Commission unless the investment company is exempt from registration under section 6.

[25] Investment Company Act of 1940, ch. 686, § 10(a), 54 Stat. 789, 806 (1940). A limited exception to the maximum was provided in section 10(d). If the conditions of section 10(d) were met, all but one of the directors of a registered investment company could be affiliated with the investment adviser to the company or could be officers or employees of the company. *Id.* at § 10(d), 54 Stat. at 807. The conditions creating affiliation are discussed in the text *infra*. Section 10(d) was intended to cover an investment company established by an investment adviser specifically for clients not having substantial assets available for securities investments. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 14 (3d sess. 1940). Section 10(d) was amended in 1970 and now allows all but one of the directors of a registered investment company to be "interested" in the investment adviser to the company or to be officers or employees of the company. Investment Company Amendments Act of 1970, Pub. L. 91-547, § 5, 84 Stat. 1413, 1416 (codified at 15 U.S.C. § 80a-10(d) (2000)). The criterion of "interest" is discussed in Part II.A, *infra*, of the instant article.

[26] SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 14 (3d sess. 1940).

[27] Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977).

Congress subsequently amended the criteria for determining the status of a director, but the label "independent" continues to be conferred only on directors who are free of all of the ties that troubled Congress.

The reader will note both from the discussion *supra* and from the discussion in Part II.A *infra* that the Act makes the concept of affiliation a key factor in the status of a director. The Act considers affiliation to exist between two persons when, inter alia, (i) at least 5% of the voting securities[28] of one person[29] directly or indirectly are owned by or can be voted by the other person; (ii) one of the persons directly or indirectly controls or is controlled by the other or is, along with the other person, controlled by a third person;[30] or (iii) one person is currently an "officer, director, partner, copartner, or employee" of the other person or, if the other person is an investment company, is currently its investment adviser.[31] The Act has included the concept of affiliation since its enactment in 1940, and notably, the definition of the concept has not changed. However, subsequent legislation altered the role of affiliation in determining whether a director is independent. This legislation is discussed next.

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[28] The Act currently defines a "voting security" in section 2(a)(42). 15 U.S.C. § 80a-2(a)(42) (2000). The statutory definition has not been revised since the Act was adopted in 1940. *See* Investment Company Act of 1940, ch. 686, § 2(a)(40), 54 Stat. 789, 796 (1940). For interpretations of section 2(a)(42) by the staff of the Commission, *see* Real Estate Investment Trusts, SEC No-Action Letter, 1998 SEC No-Act. Lexis 1145, at *4 (Nov. 4, 1998) (staff reply); Wells Fargo Alternative Asset Management, LLC, SEC No-Action Letter, 2005 SEC No-Act. Lexis 116, at *7–8 (Jan. 26, 2005) (staff reply).

[29] Under the Act, a "person" is either "a natural person or a company." 15 U.S.C. § 80a-2(a)(28) (2000). The statutory definition of "person" has not changed since the Act was adopted in 1940. *See* Investment Company Act of 1940, ch. 686, § 2(a)(27), 54 Stat. 789, 794 (1940).

[30] The Act defines "control" in section 2(a)(9). 15 U.S.C. § 80a-2(a)(9) (2000). The statutory definition of "control" has not been altered since the Act was adopted in 1940. *See* Investment Company Act of 1940, ch. 686, § 2(a)(9), 54 Stat. 789, 791–92 (1940).

[31] Investment Company Act of 1940, ch. 686, § 2(a)(3), 54 Stat. 789, 791 (1940) (codified at 15 U.S.C. § 80a-2(a)(3) (2000)).

A. Section 2(a)(19) of the Investment Company Act

In 1970, Congress reexamined the statutory criteria establishing the status of a director and concluded that the criteria adopted in 1940 were not furnishing sufficient protection to the shareholders of investment companies.[32] Consequently, the framework for defining an independent director was reworked,[33] and with some modifications, the framework devised in 1970 is still in effect. As with the original (1940) legislation, the board of a registered investment company is required by the Act to fill no less than 40% of its seats with independent directors, but in 1970 Congress introduced into the Act the concept of an "interested" person[34] and thus distinguished interested directors from independent directors.[35] The concept of the interested person, which is defined by section 2(a)(19) of the Act,[36] is the foundation of the current structure of investment company boards. Under this structure, a maximum of 60% of the directors of a registered investment company can be "interested" in the company.[37]

In general terms, a person is not an independent director if she or he is interested in the investment company either directly through ties to the company itself or indirectly through ties to an

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[32] S. COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 32 (1st Sess. 1969); H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. REP. NO. 91-1382, at 13–14 (2d Sess. 1970).

[33] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413.

[34] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, §§ 2(a), 5, 84 Stat. 1413, 1413, 1416.

[35] S. COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 33 (1st Sess. 1969); H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. REP. NO. 91-1382, at 14 (2d Sess. 1970).

[36] 15 U.S.C. § 80a-2(a)(19) (2000 & Supp. V 2005).

[37] 15 U.S.C. § 80a-10(a) (2000). As explained in note 25 *supra*, section 10(d) allows more than 60% of the directors of a qualifying investment company to be interested.

investment adviser or principal underwriter for the company.[38] Given the congressional goal of preventing harm to the shareholders of investment companies, the ties of a person that are included in section 2(a)(19) are evidently those believed likely to create a significant temptation for the person to disadvantage the investment company and its shareholders in favor of (i) the person and/or (ii) an individual or entity having ties to the person. A director will be independent only if the director possesses *none* of the ties listed by the Act; a director having *any* of the ties will not be independent, i.e., will be "interested."[39]

The main concern of the Act, accordingly, is with conflicts of interest[40]—situations in which an individual is pulled toward mutually exclusive alternatives and is prevented, or appears to be prevented, from basing decisions on the relative merits of each alternative for the investment company and its shareholders. If a society is to operate effectively, however, its organizations, including its business organizations, must avoid conflicts of interest because such conflicts, inter alia, generate distrust in and damage the reputation of the organizations as well as make the organizations socially dysfunctional symbols. Trust, reputation, and symbols

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[38] The Act defines "investment adviser" in section 2(a)(20) and "principal underwriter" in section 2(a)(29). 15 U.S.C. §§ 80a-2(a)(20), -2(a)(29) (2000). These statutory definitions have not changed since the adoption of the Act in 1940. Investment Company Act of 1940, ch. 686, §§ 2(a)(19), 2(a)(28), 54 Stat. 789, 793, 794 (1940).

[39] It may be helpful to note here that the Commission has taken the position that an individual who serves as a director of a registered investment company can act just for herself or himself, and not as an agent or as a delegate of another individual or an entity, except in certain situations involving a limited partnership. Investment Company Act Release IC-19658, 58 Fed. Reg. 45,834, 45,836 (Aug. 31, 1993); 17 C.F.R. § 270.2a19-2(a) (2006). The position taken by the Commission—viz., that an entity normally cannot be a director of a registered investment company—may not have been intended by Congress. Larry D. Barnett, *When is a Mutual Fund Director Independent? The Unexplored Role of Professional Relationships under Section 2(a)(19) of the Investment Company Act*, 4 DEPAUL BUS. & COMM. L.J. 155, 165 n.54 (2006) [hereinafter *When is a Mutual Fund Director Independent?*].

[40] *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24082, 64 Fed. Reg. 59,826, 59,827 (Nov. 3, 1999) [hereinafter Release No. IC-24082].

seem to be fundamental aspects of every organized group, and they either promote or reduce the effectiveness of the group.[41]

Thus, in mandating that some directors of registered investment companies be non-interested persons, Congress was attempting to protect society as a whole. The responsibility of independent directors to deal with conflicts of interest became a central tenet of the Act in an attempt to protect shareholders from the damaging effects of such conflicts.[42] Independent directors, being free from the conflicts of interest that Congress found problematic, were expected to be the shareholders' defense against financial abuse.[43] In the words of the U.S. Supreme Court, Congress intended the independent directors to perform "the role of 'independent watchdogs,' who would 'furnish an independent check upon the management' of investment companies."[44]

If a person can be an independent director of an investment company only if she or he is not "interested" in the investment company, in an investment adviser to the company, or in a principal underwriter for the company, when is a person interested? The statutory determinants of interest are listed in the two subsections—(A) and (B)—of section 2(a)(19) of the Act and have undergone some refinement since 1970. The review below deals with the two subsections as they are currently written.[45]

The statutory determinants of whether a person is an interested director of an investment company are more easily explained by starting with subsection (B) and subsequently considering subsection (A). Subsection (B) specifies the types of situations that make a person interested in an investment adviser or principal underwriter for the investment company. Subsection (A), on the other

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[41] *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, *supra* note 10, at 814, 821, 825–27.

[42] Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and Their Investment Advisers and Principal Underwriters, Investment Company Act Release No. IC-21341, 60 Fed. Reg. 47,844, 47,847 (Sept. 14, 1995) ("The role of independent fund directors in policing conflicts of interest is central to the Investment Company Act.").

[43] Release No. IC-24082, *supra* note 40, at 59,827–828.

[44] Burks v. Lasker, 441 U.S. 471, 484 (1979) (citation omitted).

[45] 15 U.S.C. § 80a-2(a)(19) (2000 & Supp. V 2005).

hand, specifies the types of situations that make a person interested in the investment company itself, and under subsection (A)(iii), any person interested in an investment adviser or principal underwriter for an investment company pursuant to subsection (B) is interested in the investment company.[46]

In what circumstances does subsection (B) cause a person to be interested in an investment adviser or principal underwriter for an investment company? Such interest exists when, inter alia, the person is affiliated with the investment adviser or principal underwriter,[47] has certain types of kinship ties to someone who is so affiliated,[48] or is aware of having a direct or indirect beneficial interest in a security that has been issued by the investment adviser, by the principal underwriter, or by a party controlling either of them.[49]

A person is also interested in an investment adviser or principal underwriter when that person is, or is a partner or employee of, a person that has served as legal counsel for the investment adviser or principal underwriter at any time since the beginning of the last two completed fiscal years of the investment company.[50] Further, a person is interested in an investment adviser or principal underwriter when that person is, or is affiliated with, a person that during the previous six months has executed securities transactions or distributed securities for, had principal transactions with, or extended a loan to, inter alia, an investment company served by the investment adviser or principal underwriter.[51]

Finally, an individual is interested in an investment adviser or principal underwriter when the Commission has issued an order

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[46] 15 U.S.C. § 80a-2(a)(19)(A)(iii) (2000).

[47] 15 U.S.C. § 80a-2(a)(19)(B)(i) (2000).

[48] 15 U.S.C. § 80a-2(a)(19)(B)(ii) (2000). Section 2(a)(19)(B)(ii) covers individuals who are related as spouses, as parent and child, as siblings, as child and spouse of a parent of the child, or as parent and spouse of a child of the parent. The preceding relationships are included even if they are step or adoptive in nature and apply to both subsection (A) and subsection (B) of section 2(a)(19). 15 U.S.C. § 80a-2(a)(19) (2000).

[49] 15 U.S.C. § 80a-2(a)(19)(B)(iii) (2000).

[50] 15 U.S.C. § 80a-2(a)(19)(B)(iv) (2000).

[51] 15 U.S.C. §§ 80a-2(a)(19)(B)(v), 80a-2(a)(19)(B)(vi) (Supp. V 2005).

designating the individual as interested because, at any time since the start of the last two completed fiscal years of the investment company, the individual has had "a material business or professional relationship" with the investment adviser or principal underwriter or with the principal executive officer of, or a person in control of, either the adviser or underwriter.[52]

While subsection (B) specifies the determinants of interest in an investment adviser or principal underwriter for an investment company, subsection (A) specifies the circumstances in which interest exists in the investment company per se.[53] The clauses of subsection (A), in focusing on the investment company, parallel the clauses of subsection (B) with one exception. The exception is that, under subsection (A), interest in an investment company cannot arise from a beneficial interest in a security issued by the company unless at least 5% of the voting securities of the company are owned or controlled, or can be voted, by the person whose status is in question.[54] As indicated above, however, a person knowingly holding a beneficial interest in a security that has been issued by the investment adviser or principal underwriter for an investment company, or by a person controlling the investment adviser or principal underwriter, is interested in the investment company, and any quantity of such a security suffices to make the holder interested in the company.[55]

To recapitulate, the Act requires an investment company that must be registered with the Securities and Exchange Commission

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[52] 15 U.S.C. § 80a-2(a)(19)(B)(vii) (Supp. V 2005).

[53] 15 U.S.C. § 80a-2(a)(19) (2000 & Supp. V 2005).

[54] Such a person would be affiliated with the investment company. 15 U.S.C. § 80a-2(a)(3)(A) (2000). A person affiliated with an investment company through holdings or control of voting securities is interested in the company. 15 U.S.C. § 80a-2(a)(19)(A)(i) (2000).

[55] 15 U.S.C. §§ 80a-2(a)(19)(A)(iii), 80a-2(a)(19)(B)(iii) (2000). *See* SAFECO Asset Management Co., SEC No-Action Letter, [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,425, at 88,911, 88,912 (Dec. 2, 1977), *available at* 1977 SEC No-Act. Lexis 2834 (SEC staff concluded that an individual who had an indirect beneficial interest in just 0.63% of the common stock of the entity that controlled the investment adviser and principal underwriter for a family of investment companies would be an interested director of the investment companies).

to fill at least 40% of the seats on its board with directors who do not possess any of the interest-generating ties listed in the Act and who, accordingly, are deemed to be independent. Because of the importance attached to independent directors, the requirement that 40% of the directors be independent is merely a statutory minimum. As discussed in Part II.B *infra*, the Commission, under its congressionally delegated authority to promulgate rules,[56] has raised the required percentage for almost all registered investment companies.

B. Rulemaking by the Securities and Exchange Commission

Since July 2002, mutual funds using any of ten specified rules promulgated by the Securities and Exchange Commission to gain an exemption from a mandate of the Act have been required by the Commission to fill a majority of the seats on their boards with independent directors and to assign the responsibility for selecting and nominating the independent directors solely to the independent directors.[57] Because use of the rules was widespread, nine out of ten funds were estimated to be covered by the requirement.[58] Illustrative of the ten rules[59] was the rule allowing a fund and specified affiliates to engage in securities transactions with one another;[60] a fund that relies on the rule to avoid violating the ban on such transactions imposed by section 17(a) of the Act[61] must have a board that is comprised of a majority of independent directors who are chosen by the independent directors. The ten rules that were designated involve activities that the Commission concluded are characterized by inescapable conflicts of interest between the fund and its management.[62] The Commission believed that with a majority of seats on the board of a fund that relies on any of the rules, the independent directors would be able

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[56] 15 U.S.C. § 80a-37(a) (2000).

[57] Release No. IC-24816, *supra* note 4.

[58] *Id.* at 3747 n.120.

[59] *Id.* at 3736 n.17 (identifying and summarizing the ten rules).

[60] 17 C.F.R. § 270.17a-7 (2006).

[61] 15 U.S.C. § 80a-17(a) (2000).

[62] Release No. IC-24816, *supra* note 4, at 3736.

> to control the fund's "corporate machinery," i.e., to elect officers of the fund, call meetings, solicit proxies, and take other actions without the consent of the [investment] adviser . . . [and] have a more meaningful influence on fund management and represent shareholders from a position of strength.[63]

Did fund investors receive appreciable added protection from the requirement that independent directors form a majority of the membership of fund boards? The answer seems to be in the negative because "few funds," according to the Commission, had boards whose membership was altered by the requirement.[64] Nonetheless, independent directors may be helpful in protecting shareholders. Unfortunately, there is a dearth of rigorous social science research on whether, and the extent to which, fund shareholders benefit from independent directors, from any particular number or percentage of independent directors, or from a requirement that independent directors be chosen by independent directors. Indeed, the two studies I now review are apparently the sole pertinent studies thus far completed.

In the first of these studies, tests of statistical significance indicated that the financial performance of domestic-stock mutual funds increased with the size of the board, and hence with the *number* of independent directors, but was unrelated to the *percentage* of board seats held by independent directors.[65] However, whether the relationship between the number of independent directors and fund performance was due to the status of directors under section 2(a)(19) has been questioned,[66] and whether there was an effect that was sufficiently large to be of practical consequence is uncertain.[67] In the second of the studies, the financial performance

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[63] *Id.*

[64] Release No. IC-24082, *supra* note 40, at 59,830.

[65] Bill Ding & Russ Wermers, *Mutual Fund Performance and Governance Structure: The Role of Portfolio Managers and Boards of Directors* 22, 26, 40 (Dec. 9, 2005), *available at* http://ssrn.com/abstract=687273.

[66] Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 200 (2006).

[67] *See* Ding & Wermers, *supra* note 65, at 22 (concluding from Fama-MacBeth regression that "board independence is not an important influence in

of mutual funds that invested in equity securities was weakly and *inversely* related to the percentage of board seats occupied by independent directors; i.e., fund performance declined to some extent as the fraction of independent directors rose.[68]

In light of the inconsistent findings of the two studies, whether mutual fund shareholders financially benefit from independent directors is uncertain. However, even if the two studies furnished evidence of such a benefit, neither study was available when the Commission acted. Thus, the Commission adopted the requirements that independent directors constitute a majority of an investment company board and nominate the independent directors because the requirements *seemed* desirable.[69]

The unproven assumption that independent directors are key to protecting mutual fund shareholders was also present in an attempt by the Commission in 2004 to further increase the percentage of seats on investment company boards for such directors. Under a policy approved on a split vote of the commissioners but not yet implemented, a fund that relies on any of the ten rules to avoid breaching the Act would be required to place independent directors in three out of every four seats on its board; if such a fund has a board with just three members, at least two directors would need to be independent.[70] The proposed requirement, therefore, would raise the percentage of independent directors from 50% to 75% for a covered fund having four or more directors. In addition, the individual chairing the board would need to be an independent director.[71] However, neither requirement can be implemented until the

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ongoing fund performance.").

[68] Felix Meschke, *An Empirical Examination of Mutual Fund Boards* 17–18, 33–34, 36 (Univ. of Minnesota, Twin Cities, Carlson School of Management, Working Paper, Mar. 15, 2007), *available at* http://ssrn.com/abstract=676901. Based on tests of statistical significance, the percentage of board positions held by independent directors was not clearly related to the performance of funds whose portfolios consisted of debt securities. *Id.* at 33, 35, 37.

[69] *Cf.* Palmiter, *supra* note 66, at 208 ("At worst the fund board creates an illusion of investor protection.").

[70] Release No. IC-26520, *supra* note 8, at 46,389.

[71] *Id.*

Commission, pursuant to a court decision,[72] receives and assesses additional evidence on the cost of the requirements to investment companies. The Commission has requested comments and evidence pertinent to the proposed requirements[73] but has not acted on submitted materials even though the submission period ended in August 2006.

III. FIDUCIARY DUTIES OF INVESTMENT COMPANY DIRECTORS

In believing that it is the independent directors of investment companies who safeguard the shareholders of the companies from company-related financial exploitation,[74] current law assumes that there is an unacceptable probability the interested directors (as defined in section 2(a)(19) of the Act) will financially abuse the fund's investors. The established view suggests that shareholders will be financially injured by interested directors considerably more often than by independent directors because interested directors are subject to inherent conflicts of interest from exposure to situations where their goals and the goals of the shareholders differ.[75] Thus, interested directors are seen as inclined to act in ways that favor them or persons linked to them, and instances of exploitation of shareholders by interested directors are thought to result from selfishness. Financial injuries to shareholders caused by independent directors, on the other hand, are thought to result from

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[72] Chamber of Commerce v. Sec. & Exch. Comm'n, 443 F.3d 890 (D.C. Cir. 2006).

[73] Investment Company Governance, Investment Company Act Release No. IC-27395, 71 Fed. Reg. 35,366 (June 19, 2006).

[74] See *supra* notes 20–23 and accompanying text.

[75] Although its content has not been articulated with precision, the established view probably does *not* assume that the interested directors of a fund act for their own benefit in all situations where the goals of the interested directors diverge from the goals of the fund's investors. Rather, the established view seems to assume that interested directors act for their own benefit in a significant and unacceptable proportion of situations that involve such divergence. *See generally* Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003) (suggesting from social and behavioral science research that directors frequently, and perhaps typically, act for the benefit of others).

errors in assessing the advantages and disadvantages of particular courses of action.

Conflicts of interest admittedly exist for the interested directors of investment companies, but should the assumption be made that these conflicts render interested directors an actual or probable menace to the investors in the companies? State law has a clearly expressed set of fiduciary duties for directors of entities, including investment companies, and the duties are imposed on *all* directors, interested as well as independent.

Before discussing the duties of directors, the reader should note that an investment company can be structured as a corporation, as a business trust, or as a limited partnership.[76] However, as explained in Part II *supra*, the structure of an investment company is irrelevant to whether a person is a director, because under the definition of "director" in the Act, persons are directors if their functions "with respect to any organization, whether incorporated or unincorporated," are "similar" to those of a director of a corporation.[77] The definition, accordingly, is not confined to a person on the board of a corporation but extends to a general partner of an investment company that is a limited partnership and to a trustee of an investment company that is a business trust.[78]

Because Delaware is the leading U.S. jurisdiction in the field of corporation law,[79] its view of directors is particularly instructive.

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[76] Mutual funds are either corporations or business trusts, and both are common among mutual funds. INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 146; John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 171 n.40 (1997). Investment companies can also be limited partnerships. Executive Discount Realty Co., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 731, at *4 (April 1, 1993). The Act defines the word "company" to cover, inter alia, corporations, trusts, and partnerships. 15 U.S.C. § 80a-2(a)(8) (2000). Consequently, all three structures come within the definition of an investment company.

[77] 15 U.S.C. § 80a-2(a)(12) (2000). *See supra* text accompanying note 18 for the full definition.

[78] Integrated Resources, Inc., SEC No-Action Letter, 1979 WL 14861, at *1 (June 1, 1979); Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 435 n.91, 451 (1988).

[79] David L Cohen, *Theories of the Corporation and the Limited Liability*

As the Supreme Court of Delaware makes clear in the passage quoted below, directors are deemed to be fiduciaries. The passage is phrased in terms of corporations, but the position it states is not limited to directors of corporations because fiduciaries of all types and in all settings are subject to similar requirements of law:[80]

> The fiduciary nature of a corporate office is immutable. As this Court stated long ago:
>
> > Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its shareholders . . . .
>
> Thus, directors are required to demonstrate both their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally.[81]

Pursuant to this doctrine, the failure of a director to fulfill a fiduciary duty renders the offending director liable for damages that stem from the failure.[82] However, while the potential for liability is assumed to shape the conduct of directors for the benefit of the public, the fact that the duties apply to interested directors seems to be overlooked.

The duties of interested directors that are expressed in doctrines of law may be simply words, of course, and have no influence on the behavior of directors. After all, the human capacity for selfishness and shortsightedness should never be underestimated, and directors may pursue their own, immediate goals regardless of principles embodied in law. From a macrosociological perspective,

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Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?, 51 OKLA. L. REV. 427, 472 n.252 (1998).

80 Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795, 797, 804, 818 (1983).

81 Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (internal citations omitted).

82 FRANKLIN A. GEVURTZ, CORPORATION LAW 301 (2000).

however, doctrines of law as widespread and prominent as the fiduciary duties of directors exist because they reflect the character of the society in which the law is embedded and endorse behavioral patterns valued or needed by the system.[83] Consequently, directors' fiduciary duties in state law are important—though they may be important in ways that are not widely understood and acknowledged.

With this background, I review the fiduciary duties of directors, and given the topic of the instant article, I do so in the context of investment companies. The review begins with the duty of care and then considers the duty of loyalty, both of which are well-entrenched and widely accepted in state law for a director of a corporation[84] and for a director (general partner) of a limited partnership.[85] Following the discussion of the duty of care and of loyalty, I consider the requirement contained in state law that the directors of an entity act in good faith. Good faith is taken up separately because, as explained in Part III.B *infra*, uncertainty currently exists as to whether good faith will achieve the status of a fiduciary duty and, if it does, what its content will be.

While corporations and limited partnerships are traditional (or at least popular) arenas for examining director duties, business trusts appear not to be. Thus, business trusts and the duties of their directors (i.e., trustees) merit comment here. For mutual funds, the law on business trusts of two states—Delaware and Massachusetts—is of primary importance because mutual funds that operate as business trusts seem normally to be established under the law of one of these states.[86] In states that have decided the issue, the di-

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[83] *The Roots of Law*, *supra* note 9, at 615–26.

[84] GEVURTZ, *supra* note 82, at 273–86.

[85] UNIF. P'SHIP ACT § 404, 6 U.L.A. 143 (2001); REV. UNIF. LTD. P'SHIP ACT § 403(a), 6A U.L.A. 365 (2003). *See also* Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981) ("When the provisions of the Uniform Partnership Act and the Uniform Limited Partnership Act are read together, it is clear that the general partner in a limited partnership owes a fiduciary duty to the limited partners."); *accord*, *In re* Fid. Am. Fin. Corp., 43 B.R. 74, 77 n.7 (E.D. Pa. 1984).

[86] Jeffrey J. Haas & Steven R. Howard, *The Heartland Funds' Receivership and its Implications for Independent Mutual Fund Directors*, 51 EMORY L.J. 153, 200 n.232 (2002). However, no count is evidently available on the number

rectors of a business trust are generally deemed to have a fiduciary relationship to the holders of beneficial interests in the trust.[87] The fiduciary relationship includes both a duty of care and a duty of loyalty.[88] The Delaware statute on business trusts, however, allows the document that governs a business trust to alter or remove fiduciary duties of a trustee, although the document cannot "eliminate the implied contractual covenant of good faith and fair dealing."[89] The current wording of the section became effective on August 1, 2006,[90] but even in the absence of the legislative prohibition on removing the obligations of good faith and fair dealing, it was unlikely that Delaware courts would allow a trustee of a business trust to escape these obligations.[91] In Delaware, then, a trustee of a business trust is subject to the requirements—good faith and fairness—that are inherent in and central to the role of director.[92]

In short, the obligations of care and loyalty are applicable to the directors of every investment company having a board of directors regardless of whether the company is structured as a corporation, a limited partnership, or a business trust.[93] In examining each

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of investment company business trusts that have been created in each state.

[87] Herbert B. Chermside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704, 753 (1978); William K. Sjostrom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940*, 54 KAN. L. REV. 251, 274 (2005) ("[S]tate courts have generally analogized the duties of trustees of business trusts to those of directors of corporations.").

[88] Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 80 (2004); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993).

[89] DEL. CODE ANN. tit. 12, § 3806(c) (LEXIS through 2006 Sess.).

[90] 75 Del. Laws 418 (2006), *available at* http://legis.delaware.gov (using Bill Search to locate session law, select GA 143 from Session menu, select HB from Bill Type menu, and enter 445 for No.).

[91] Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325, 332 (2001).

[92] The Supreme Court of Delaware acknowledges that these requirements are fundamental to the role of a director of a corporation. *See* text accompanying note 81 *supra*. *See also* Brown, *supra* note 22, at 57 ("The sine qua non of a director's fiduciary duty is fairness.").

[93] Section 36(a) of the Act authorizes the Securities and Exchange Commission to ask a federal court to impose injunctive and/or other relief on, inter

duty, accordingly, the three structures need not be distinguished, and as used in this article, the terms "investment company" and "fund" will encompass all of them.

A. Duty of Care and Duty of Loyalty

We begin with the content of the fiduciary duties of care and of loyalty. Although the two duties overlap and are thus not fully separable,[94] they can be distinguished as concepts[95] in terms of the type of conduct expected of a fiduciary. Specifically, the duty of care mandates reasonable caution and foresight by a fiduciary in handling the affairs of the entity to which, or the individual to whom, the duty is owed; the duty of loyalty, on the other hand, forbids a purposeful action by a fiduciary in the context of a conflict of interest that advantages the fiduciary and disadvantages the person owed the duty.[96] In the words of one court:

> The duty of loyalty . . . is rooted in intentional tort law. Thus, this aspect of fiduciary duty is commonly expressed in the form of a prohibitive rule. In short, a fiduciary . . . must not abuse his position of trust in order to advance his own selfish interests. On the other hand, the duty of due care is rooted in negligence principles, and is commonly expressed affirmatively. The fiduciary, therefore, must ex-

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alia, a director of a registered investment company for violating a "fiduciary duty involving personal misconduct." 15 U.S.C. § 80a-35(a) (2000). Because it does not distinguish investment companies by their structure, the section applies to all investment companies that have a board of directors. However, according to recent court decisions, the section furnishes only the Commission, and not investment company shareholders, with a cause of action. *E.g.*, Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100, 107 (D. Mass. 2006); Hamilton v. Allen, 396 F. Supp. 2d 545, 555 (E.D. Pa. 2005); Jacobs v. Bremner, 378 F. Supp. 2d 861, 866 (N.D. Ill. 2005). Moreover, section 36(a) may cover just the duty of loyalty of investment company directors. *See Jacobs*, 378 F. Supp. at 866.

[94] Fed. Deposit Ins. Corp. v. Gonzalez-Gorrondona, 833 F. Supp. 1545, 1549 (S.D. Fla. 1993); Omnibank of Mantee v. United S. Bank, 607 So. 2d 76, 84 (Miss. 1992).

[95] Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 40 (2005).

[96] *Id.*; *In re* Chavez, 140 B.R. 413, 424 (W.D. Tex. 1992).

> ercise at least that degree of care that a reasonably prudent person would devote to his own affairs under like circumstances.[97]

To understand more fully the two duties, it is helpful to identify what the directors of an entity do in their role as directors. At least three functions are expected to be performed by a director of an entity. Specifically, a director is expected to (i) monitor the affairs of the entity, (ii) inquire into entity-related matters about which the director receives information that suggests a major problem exists in the entity, and (iii) make decisions for the entity.[98] In carrying out each of these functions, directors are subject both to a duty of care and to a duty of loyalty.

For investment company directors, the chief functions appear to be the first and third,[99] and because both functions implicate the

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[97] Wright v. Nimmons, 641 F. Supp. 1391, 1402 (S.D. Tex. 1986).

[98] Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 951–52, 956, 958–59 (1990). The functions of directors of a corporation—the focus of Professor Eisenberg's article—are also the functions of persons qualifying as directors of an investment company that is a business trust or a limited partnership. As explained in note 76 *supra*, investment companies that are mutual funds are established as business trusts if they are not established as corporations, and investment companies can also take the form of limited partnerships.

Directors of a non-corporate investment company necessarily carry out the third function listed in the text (i.e., decision-making for the entity) because the function inheres in their role as directors. In addition, the first two functions of directors are embedded in the supervisory responsibilities of the directors of investment companies. As the Securities and Exchange Commission has pointed out, "[d]irectors are generally responsible under state law for the oversight of all of the operations of a mutual fund, and the Investment Company Act assigns many specific responsibilities to fund boards." Release No. IC-26520, *supra* note 8, at 46,379 n.8. Because mutual funds can be business trusts, the Commission's statement applies to the directors (i.e., trustees) of funds formed as business trusts. The statement also applies to the directors (i.e., general partners) of investment companies that are limited partnerships. *See* UNIF. P'SHIP ACT § 401(f), 6 U.L.A. 133 (2001); REV. UNIF. LTD. P'SHIP ACT § 403(a), 6A U.L.A. 365 (2003).

[99] *See* Release No. IC-26520, *supra* note 8, at 46,379 n.8. The second function occurs just sporadically in the typical company. Eisenberg, *supra* note 98, at 956. Because the second function is presumably infrequent in investment companies as well, it is not discussed further.

business judgment rule, the rule must be satisfied by directors when performing these functions. In terms of the first function, the requirements of the business judgment rule must be met when directors decide whether an activity in their organization will be monitored. If the directors decide to monitor the activity, they must also satisfy the rule in selecting the manner in which the activity will be monitored.[100] In terms of the third function, directors must meet the requirements of the rule with regard to the procedure they follow in reaching decisions for the entity but not necessarily with regard to the substance of the decisions.[101]

The business judgment rule is thus a centerpiece of law relevant to both the duty of care and the duty of loyalty of directors. When directors have satisfied the rule, they have not breached either duty.[102] But what is the rule? One major text on corporation law contends that a single business judgment rule does not exist.[103] The unease that exists with the rule is illustrated by three current or former members of the Delaware judiciary who, in a law review

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[100] Eisenberg, *supra* note 98, at 955–56. If directors do not monitor a particular activity because they have inadvertently overlooked it, their mistake must have been reasonable under the circumstances in which it occurred. GEVURTZ, *supra* note 82, at 274–78. *But see In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (requiring directors to act in good faith in selecting a system to detect and disclose problems in the organization).

[101] GEVURTZ, *supra* note 82, at 286–88; *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d at 967–68.

[102] Stephen Fraidin & Radu Lelutiu, *Strategic Alliances and Corporate Control*, 53 CASE W. RES. L. REV. 865, 890–91 (2003); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1993) (The business judgment rule "is premised on a presumption that the directors have severally met their duties of loyalty . . . and that the directors have collectively, as a board, met their duty of care."). *See also* Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 67 (1993) (contending that the duties of care and loyalty create a standard of conduct for directors and describing the business judgment rule as "a specific application of this directorial standard of conduct").

[103] GEVURTZ, *supra* note 82, at 279. *See also* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1488 (1991) (describing the business judgment rule as "amorphous" and plagued by "vagueness and various manifestations").

article, wrote:

> [A] standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process.[104]

At the same time, however, the authors contend that the rule as formulated is not employed by Delaware courts to evaluate the inherent merits of a board action as the basis for determining whether the action breached the directors' duty of care and/or duty of loyalty. Instead, according to the authors, the rule as stated establishes a presumption that places on plaintiffs the burden of proof.[105] The determinations of a court that matter with respect to the business judgment rule, the authors argue, concern whether the requirements specified in their description of the rule have been met, and the substance of the board decision is irrelevant to the outcome of the judicial process.[106] In essence, then, the rule identifies the circumstances in which the directors of an entity escape liability for a loss arising from an action they approved, but the merits of the board decision are not involved in the burden-shifting presumption of the rule.

If any element of the business judgment rule is not satisfied when the directors of an entity make a decision—e.g., if the directors participating in the decision were subject to a conflict of interest or were acting in bad faith—the rule will be unavailable to the directors as a defense. In this event, the directors responsible for the decision will be liable for losses sustained by the entity they

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[104] William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1298 (2001).

[105] *See generally* Basic Inc. v. Levinson, 485 U.S. 224, 245 (1987) (explaining that presumptions can function to impose the burden of proof on one party and stem from "considerations of fairness, public policy, and probability, as well as judicial economy").

[106] Allen et al., *supra* note 104, at 1297; William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 457 (2002).

serve unless they are able to establish that the decision, and the procedure employed to reach it, were fair to the entity.[107] The latter standard, in requiring directors to prove both the substantive fairness and the procedural fairness of the decision to avoid liability, is more demanding than the business judgment rule.[108]

B. Good Faith

In addition to a duty of care and a duty of loyalty, courts may have also started to recognize in the director role a duty to act in good faith.[109] Whether good faith will be accepted in U.S. law as a fiduciary duty is uncertain, and because a common-law fiduciary duty of good faith is only in the process of emerging—if it emerges at all—its content is yet to be determined.[110] However, the meaning of the phrase "good faith" in law applicable to directors will be consistent with the meaning of the phrase to the public generally because the concepts and doctrines of law arise from, and are

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[107] Block et al., *supra* note 102, at 69; Bud Roth, *Entire Fairness Review for a "Pure" Breach of the Duty of Care: Sensible Approach or Technicolor Flop*, 3 DEL. L. REV. 145, 165–67 (2000).

[108] Lyman P. Q. Johnson, *The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 46 (2005).

[109] Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 4, 74 (2006). A portion of a June 2006 opinion of the Supreme Court of Delaware is consistent with the contention of Professor Eisenberg that a duty of good faith is being recognized. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (en banc). On the one hand, the court reasoned that "[a] vehicle is needed to address . . . doctrinally" situations in which the duties of care and loyalty have not been breached by a director, and this "doctrinal vehicle is the duty to act in good faith." *Id.* at 66. On the other hand, the court also stated that it was not deciding whether "good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors." *Id.* at 67 n.112. In November 2006, the Supreme Court of Delaware adopted a position that is inconsistent with the contention of Professor Eisenberg. Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006), which is discussed *infra* in the text accompanying notes 115 and 116.

[110] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 63–64 (en banc) (describing a duty of good faith as "not a well-developed area of our corporate fiduciary law" and "up to this point relatively uncharted").

molded by, the society in which law operates.[111] Notably, the *Oxford English Dictionary* defines "good faith" to include "fidelity . . . [in] fulfilling one's trust."[112] Thus, the obligation of good faith for directors that is manifested in law can be expected to entail, in large part, conduct that preserves and promotes trust in interpersonal relationships. By doing so, law will express the vital role of trust in promoting the effective operation of a society.[113]

A macrosociological treatment of the institution of law approaches the doctrines (as well as the concepts) of the institution as mechanisms that in the long run facilitate, rather than undermine, the functioning of society. If this perspective is useful for understanding the institution, the doctrines and concepts of law will ultimately embody the requisites for effective group operation. Accordingly, an emphasis on interpersonal trust in the obligation of good faith may be attributable to, and a means of rectifying, an erosion or abandonment of such an emphasis in the duty of loyalty,[114] and it may not be coincidence that the Supreme Court of Delaware has subsumed good faith under the duty of loyalty.[115]

Specifically, the Supreme Court of Delaware has taken the position that bad faith is necessary, though not sufficient, to render directors liable for losses resulting from action or inaction by them as directors and that, because liability for bad faith stems from a

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[111] *The Roots of Law*, *supra* note 9, at 615–26, 677–80.

[112] 5 OXFORD ENGLISH DICTIONARY 679 (2d ed. 1989) (definitions 10 and 11.a. of "faith"). *Accord*, RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 822 (2d ed. unabr. 1987) (definition of "good faith").

[113] Stephen Knack, *Social Capital and the Quality of Government: Evidence from the States*, 46 AM. J. POL. SCI. 772, 779 (2002) (finding that the performance of state government rises with the level of trust characterizing state populations); Daniel Lederman et al., *Violent Crime: Does Social Capital Matter?*, 50 ECON. DEV. & CULTURAL CHANGE 509, 529 (2002); additional supporting empirical studies are summarized and cited in *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, *supra* note 10, at 827.

[114] Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993).

[115] Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006). In so ruling, the court regarded good faith not as a fiduciary duty but, rather, as an *element* of a fiduciary duty, viz., the duty of loyalty.

breach of the duty of loyalty, good faith is inherent in loyalty.[116] Thus, the court, in endorsing the fiduciary duty of loyalty, reinforced for directors an obligation (albeit not a fiduciary duty) of good faith. Notably, by placing good faith within the duty of loyalty, the court directed attention to the ties that individuals have to one another and, hence, to pertinent groups, and it implicitly acknowledged that the ability of groups to operate successfully depends in part on the degree to which their members are committed to the groups. The position adopted by the court, in short, manifested a principle of group dynamics.[117]

If the preservation or augmentation of interpersonal trust is an underlying concern of good faith, what substantive components might good faith contain as a fiduciary duty or as a component of a fiduciary duty? One scholar has suggested that the foundation of good faith as a fiduciary duty in a business setting should be comprised of four elements: (i) the personal integrity needed to sustain social life, (ii) adherence to societal norms of decency in business operations, (iii) conformity to important standards and mandates that have been established for business entities, and (iv) commitment to fulfilling the particular office held in a business entity.[118]

With these elements, good faith prohibits a director of an entity from making decisions for the entity based on a personal *non*-financial motive when the shareholders will be financially injured.[119] Since apart from good faith the duty of loyalty mandates that directors not approve action or inaction by the entity that financially harms its shareholders when the directors have a personal financial reason for approving the action or inaction,[120] an essential aspect of the director role is the protection of shareholders from financial abuse. Notably, the Supreme Court of Delaware, in an en banc opinion, has indicated that a commitment to preventing avoidable economic harm to shareholders, as well as promoting

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[116] *Id.*

[117] *See The Roots of Law*, *supra* note 9, at 615 & nn.4–5.

[118] Eisenberg, *supra* note 109, at 5, 22–25.

[119] *Id.* at 57–58. *See Stone*, 911 A.2d at 370 (Del. 2006); Blake v. Smith, No. 03-0003-B, 2006 Mass. Super. LEXIS 668, at *21 (Mass. Super. Ct. 2006).

[120] *E.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 298–99 (1999).

economic gain for shareholders, is encompassed by the obligation of good faith applicable to directors of a corporation.[121] Because the expectations that are embodied in law for directors are essentially the same in every type of investment company having a board,[122] a director of an investment company must have a commitment to the financial concerns of the company's shareholders even if the investment company is a limited partnership or a business trust.

C. *Summary*

Parts III.A and III.B of this article advanced several key points. First, the members of an investment company board are subject to three obligations—care, loyalty, and good faith—and at least the first two of these obligations are fiduciary in nature, i.e., expressions of a societal demand for ethical conduct in business (and other) relationships rather than contractual provisions for specified conduct in relationships.[123] Second, the three obligations, which are embedded in state law and derive from the social setting in which the law of a state exists, cover *all* directors of all investment companies. The three obligations thus apply to the interested directors of investment companies. The third point, which parallels the second, is that the test determining whether a fiduciary duty has been breached is the same for all directors. State law, that is, offers no safe haven for investment company directors of a particular stripe, and directors who are interested, as well as directors who are not interested, under section 2(a)(19) of the Investment Company Act are treated alike by state law. Under state law, then, interested directors should not differ from independent directors in the degree to which they protect investment company shareholders from financial abuse.

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121 *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66–67 (Del. 2006) (en banc).

122 See notes 84 to 88 *supra* and accompanying text.

123 *See* Robert W. Hillman, *Closely-Held Firms and the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio?*, 41 TULSA L. REV. 441, 442, 448–49 (2006).

D. In re *Nuveen Fund Litigation*

In a case that illustrates the duties of investment company directors, the directors of two closed-end funds[124] were alleged to have breached their duty of care in approving the issuance and sale of additional shares by each fund after the initial blocks of shares offered by the funds had been purchased by investors.[125] As a presumably conventional closed-end investment company, each fund would have sold its shares to the public but would not have redeemed these shares at the request of their owners.[126] Investors who, after purchasing shares of either fund, wanted to dispose of the shares would have sold them to other persons who desired to acquire the shares as an investment. Following the initial sale of shares by the fund, then, transactions in fund shares would have occurred between investors. However, the market price of the shares in such transactions frequently differs from the net asset value of the shares,[127] although the market price and the net asset

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[124] Under the Act, a closed-end fund is a management investment company that issues securities that are not redeemable by the company. 15 U.S.C. §§ 80a-2(a)(32), -5(a)(2) (2000).

[125] *In re* Nuveen Fund Litigation, No. 94 C 360, slip op., 1995 U.S. Dist. LEXIS 19482 (N.D. Ill., Dec. 21, 1995) (report of magistrate judge) [hereinafter *Report of Magistrate Judge*]; *In re* Nuveen Fund Litigation, No. 94 C 360, slip op., 1996 U.S. Dist. LEXIS 8077 (N.D. Ill., May 17, 1996) (district court opinion) [hereinafter *District Court Opinion*].

[126] *See Report of Magistrate Judge*, *supra* note 125, at *7; *District Court Opinion*, *supra* note 125, at *4. Closed-end funds that satisfy specified conditions can periodically redeem shares they have issued. 17 C.F.R. § 270.23c-3 (2006). *See generally* Sec. & Exch. Comm'n, Exemptive Rule Amendments of 2004: The Independent Chair Condition, A Report in Accordance with the Consolidated Appropriations Act, 2005, 2005 SEC LEXIS 1031 (April 2005), at *65–67 (discussing Rule 23c-3). I assume that the two funds did not take advantage of Rule 23c-3 and regularly redeem their shares, because neither the *Report of the Magistrate Judge* nor the *District Court Opinion* mentions the Rule.

[127] *See* DOWNES & GOODMAN, *supra* note 14, at 233 (defining "closed-end fund" and "closed-end management company"). The "net asset value" of a share is computed by subtracting the total liabilities of a fund from the total market value of the assets of the fund, including the securities in its portfolio, and dividing the result by the number of outstanding shares of the fund. *Id.* at 449–50 (defining "net asset value").

value of shares of closed-end funds tend to move in the same direction and movements in the former are on average smaller than movements in the latter.[128]

In the instant litigation, the complaint alleged that, because each fund invested only in bonds and the additional shares of the fund were sold when interest rates were low, the directors breached their duty of care in failing to anticipate that the bonds acquired by the funds with the proceeds from the sale of the additional shares would unavoidably damage the long-term investment performance of each fund.[129] The reason for this damage, the plaintiffs claimed, was that the market price of the newly acquired bonds would decline in the future when interest rates increased and the decline would reduce the net asset value of fund shares.[130] The complaint also alleged that the directors did not fulfill their duty of care because they failed to understand that, in violation of the funds' articles of incorporation, the additional shares were priced to sell at less than the net asset value of shares presently outstanding, which caused investors who owned shares just prior to the sale of the additional shares to suffer a financial loss.[131] Finally, the complaint alleged that at least two of the directors approving the sale of the additional shares were motivated by self-interest stemming from ties they had to the investment adviser and the parent of the adviser.[132] The self-interest existed, according to the complaint, because the proceeds from the sale of the additional shares would increase the assets of the funds and thereby result in the payment by the funds of larger advisory fees to the adviser.[133] In effect, therefore, the plaintiffs contended that the two directors had also

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[128] Peter Klibanoff et al., *Investor Reaction to Salient News in Closed-End Country Funds*, 53 J. FIN. 673, 678, 681 (1998) (finding that, for 39 single-country closed-end funds during the period January 1986 through March 1994, weekly changes in share price were 36% less than weekly changes in net asset value).

[129] *Report of Magistrate Judge*, *supra* note 125, at *13–14.

[130] *Id.*

[131] *Id.* at *10–11, *13; *District Court Opinion*, *supra* note 125, at *6–7.

[132] *Report of Magistrate Judge*, *supra* note 125, at *16.

[133] *Id.* at *2, *4, *9–10.

breached their duty of loyalty to the funds.[134]

With regard to the fund boards, each fund had seven directors, and the individuals who were the directors of one fund were also the directors of the other fund.[135] All seven directors of each fund were named as defendants, and two of the seven had the status of interested directors under section 2(a)(19) of the Act.[136]

The decision of the federal district court resulted from a motion to dismiss filed by the five directors who were designated by the funds as independent.[137] Employing the business judgment rule,[138] the court focused on whether the independent directors, by relying entirely on materials supplied by the funds' investment adviser and its parent, had utilized a reasonable procedure in evaluating the effect that the additional shares would have on the future investment performance of the funds.[139] In doing so, the court followed the view of the business judgment rule presented in Part III.A *supra.* However, this view may not have been followed in considering the allegation that the articles of incorporation of the funds were breached by the price that the board set for the additional shares. On this issue, the court's opinion is not altogether clear, and even

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[134] *See* Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783, 800 (S.D.N.Y. 1997) (concluding on facts similar to those of *Nuveen* that plaintiffs had alleged a violation by fund directors of their duty of loyalty to the fund because plaintiffs claimed the directors had a financial incentive to favor the investment adviser to the fund).

[135] *Report of Magistrate Judge, supra* note 125, at *3–4.

[136] *Id.* at *4. The two directors were interested directors of the funds because they were interested persons of the investment adviser to the funds. 15 U.S.C. § 80a-2(a)(19)(A)(iii) (2000). Two factors made these directors interested persons of the adviser, although either factor by itself would have sufficed. First, each of the two directors was a director of the adviser. *Report of Magistrate Judge, supra* note 125, at *3. As directors of the adviser, they were affiliated with the adviser, and this affiliation caused them to be interested in the adviser. 15 U.S.C. §§ 80a-2(a)(3)(D), -2(a)(19)(B)(i) (2000). Second, both directors owned stock issued by the corporation that was the parent of the adviser and that controlled the adviser. *Report of Magistrate Judge, supra* note 125, at *3–4. An owner of a security issued by an entity in control of an investment adviser is interested in the adviser. 15 U.S.C. § 80a-2(a)(19)(B)(iii) (2000).

[137] *District Court Opinion, supra* note 125, at *1.

[138] *Id.* at *12.

[139] *Id.* at *13–22.

though the directors claimed they had relied on counsel from an outside law firm, the court may have believed that the merits of the board's decision were pertinent.[140]

Two matters that were not discussed in the opinion of the court are noteworthy. First, all seven directors of the funds had evidently voted to approve the issuance and sale of the additional shares, and the plaintiffs had alleged that two of the directors were interested persons under section 2(a)(19) due to their ties to the investment adviser and its controlling parent.[141] However, the motion to dismiss had been filed by the five directors who were independent under section 2(a)(19), not by the two directors who were interested, and the court opinion thus does not analyze the law applicable to the two interested directors and their votes. Such an analysis would have been instructive.

A second and equally important question omitted by the court was whether any of the fund directors who were denominated as independent had a conflict of interest pertinent to the business judgment rule. Such a conflict of interest would have raised the issue of whether the affected director fulfilled his/her obligations under state law. In particular, one director who was evidently classified by the funds as independent pursuant to section 2(a)(19)[142] could have been incorrectly classified due to subsection (B)(vii).[143]

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[140] *See id.* at *24 (concluding that the plaintiffs adequately alleged that the directors, in relying on counsel, had not fulfilled their duty of care).

[141] *See supra* note 136.

[142] The district court described the fund director in question as independent, and the plaintiffs evidently did not contest this designation. *District Court Opinion*, *supra* note 125, at *1, *8.

The fund director in question had been chairman of the investment adviser to the funds. *Report of Magistrate Judge*, *supra* note 125, at *4. The position of chairperson is not described. If, as chairman, the fund director was a director and/or officer of the adviser, he would have been affiliated with the adviser, and hence interested in the adviser and the funds, but only while he was a director/officer of the adviser. 15 U.S.C. §§ 80a-2(a)(3)(D), 80a-2(a)(19)(A)(iii), 80a-2(a)(19)(B)(i) (2000).

[143] Subsection (B)(vii) provides that interest in the investment adviser or principal underwriter for an investment company exists on the part of "any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last

At some point in the past, the fund director in question had been chairman of the parent (and hence the entity in control) of the funds' investment adviser,[144] and if he had held this position at any time since the start of the most recent two completed fiscal years of the funds, he might have been found under subsection (B)(vii) to be currently involved in a "material business or professional relationship" with the parent.[145] Such a relationship would be deemed to exist in the present even though the fund director was no longer chairman of the parent, and it would make the director interested in the investment adviser because subsection (B)(vii) covers a person (e.g., a parent) that controls the adviser. If the director was still interested in the adviser, he would be an interested director of the funds.[146]

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two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter." 15 U.S.C. § 80a-2(a)(19)(B)(vii) (Supp. V 2005). *See generally When is a Mutual Fund Director Independent?*, *supra* note 39, at 165–78 (distinguishing "professional" relationships from "business" relationships and discussing the former under subsections (A)(vii) and (B)(vii) of section 2(a)(19)). A ruling by the Commission that a director is interested in the investment adviser or principal underwriter for an investment company under subsection (B)(vii), or is interested in the investment company under subsection (A)(vii) (*infra* note 151), does not operate retroactively; the director is deemed to be interested only after the ruling. S. COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 33 (1st Sess. 1969); H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. REP. NO. 91-1382, at 14 (2d Sess. 1970).

[144] *Report of Magistrate Judge*, *supra* note 125, at *3, *4.

[145] A seven-member board can have a maximum of four interested directors under section 10(a) of the Act (7 x 0.60 = 4.2). 15 U.S.C. § 80a-10(a) (2000). Even though two of the seven directors of the Nuveen funds were interested (see *supra* note 136 and accompanying text), an additional board member of each Nuveen fund could have been an interested director without placing the boards in violation of section 10(a). Compliance with section 10(a), however, has no bearing on whether a director has breached a fiduciary duty under state law.

[146] 15 U.S.C. §§ 80a-2(a)(19)(A)(iii), 80a-2(a)(19)(B)(vii) (2000 & Supp. V 2005). Subsection (A)(iii) deems a member of the board of directors of an investment company to be interested in the company if the director is "any interested person of any investment adviser of or principal underwriter for such com-

When does a position that is no longer held create an ongoing material business or professional relationship? If the position was occupied during the time period covered by subsection (B)(vii), a material business or professional relationship will exist if the position could

> impair a director's independence by providing incentives for the director to place his or her own interests over the interests of fund shareholders. The key factors in evaluating whether a director's position with [an entity specified by the subsection] would tend to impair his or her independence include the level of the director's responsibility in the position and the level of compensation or other benefits that the director receives or received from the position.[147]

Given the above test for whether a relationship is material, in what situations would a director of the funds who was formerly chairperson of the parent of the investment adviser to the funds have a current material business relationship with the parent and, hence, a current conflict of interest? Otherwise expressed, what circumstances would provide the director, as former chairperson of the parent, with a continuing incentive to place the welfare of the parent and adviser ahead of the welfare of the funds? A number of possibilities can be imagined. For example, a current material business relationship would presumably exist if there was more than a negligible possibility that, at the time the board authorized the funds to issue and sell additional shares, the parent would award its former chairperson a lucrative consulting contract or would steer clients to a business managed by its former chairperson.[148] These examples, although hypothetical, are plausible because the parent in the instant case was not a small entity but a "multi-million dollar" firm supplying financial services as an investment banker and investment adviser.[149]

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pany." 15 U.S.C. § 80a-2(a)(19)(A)(iii) (2000).

[147] Release No. IC-24083, *supra* note 20, at 59,879.

[148] *Id.* at 59,880–81. If an individual chaired the parent of the investment adviser at the time he or she voted as a fund director to approve an action by the fund, the position as chair of the parent could by itself have produced a material business relationship with the investment adviser. *Id.* at 59,880.

[149] *District Court Opinion*, *supra* note 125, at *3–4.

E. Director Status under Section 2(a)(19) and Director Liability for Board Decisions

The test quoted above[150] for whether a business or professional relationship is material was articulated by the staff of the Securities and Exchange Commission for two provisions of section 2(a)(19) of the Act—namely, subsections (A)(vii) and (B)(vii)[151]—but it has an important feature in common with the business judgment rule: Under the subsections and under the rule, evaluations of investment company directors are based on specifics.[152] Generalities such as category labels, accordingly, do not determine the outcome of these evaluations. In terms of the business judgment rule, an investment company director who participated in a particular decision and who had a conflict of interest or was acting in bad faith with regard to the matter that was decided would be liable under state law for a loss resulting from the decision unless the decision was fair.[153] The status of the director under section 2(a)(19)—whether the director is interested or not interested—is not relevant

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[150] *Supra* note 147 and its accompanying text.

[151] Subsection (A)(vii) provides that interest in an investment company exists on the part of

> any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company.

15 U.S.C. § 80a-2(a)(19)(A)(vii) (Supp. V 2005). Subsection (B)(vii) is reproduced in note 143 *supra*.

[152] Release No. IC-24083, *supra* note 20, at 59,879 (stating the view of the Commission staff that, under subsections (A)(vii) and (B)(vii), whether the independence of a director might be impaired by a business or professional relationship depends on "the particular facts of each case"); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) (asserting that the business judgment rule applies to "the business transaction at hand" and "a particular transaction").

[153] See *supra* notes 107–08 and accompanying text.

to liability. However, a conflict of interest that was created for the director by the matter decided is relevant, whether or not the conflict affected the status of the director under the Act.

To illustrate, section 2(a)(19) provides that a director of an investment company is not interested in the company if, inter alia, the director has not served as an attorney for the company or its investment adviser at any time since the start of the previous two completed fiscal years of the company and is not a member of a law firm any of whose partners or employees have done so.[154] Nonetheless, a director who is not interested under this provision would be unable to impartially assess a given matter if the director's spouse would obtain a significant financial benefit from the decision on the matter by the board of the company. Within the scope of state law, then, a fund director would have a conflict of interest regarding a board decision if a current or former position or relationship leads the director to anticipate personal gain from board approval or disapproval of an action by the fund and thus "tend[ed] to impair"[155] the director's judgment on behalf of the fund with respect to the matter. In this situation, the director could not rely on the business judgment rule as a defense because the rule does not shield from liability a director who promotes a board decision with knowledge that he or she will obtain a unique finan-

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[154] 15 U.S.C. §§ 80a-2(a)(19)(A)(iv), 80a-2(a)(19)(B)(iv) (2000).

[155] According to the reports of the Senate and House committees that drafted section 2(a)(19), Congress wanted a director of an investment company to be deemed interested under subsections (A)(vii) and (B)(vii) when the director had a material business or professional relationship with specified parties, i.e., a relationship that "might tend to impair" the director's ability to represent shareholders. S. COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 33 (1st Sess. 1969); H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. REP. NO. 91-1382, at 14 (2d Sess. 1970). The "might tend to impair" standard, however, arguably should not be confined to subsections (A)(vii) and (B)(vii). Rather, *all* of the subsections of section 2(a)(19) may reflect a concern with situations and arrangements that "might tend to impair" the ability of a director to advance the welfare of shareholders. Furthermore, a plausible argument can be made that the phrase "tend to impair" is appreciably broadened by the use of the word "might" and that Congress believed that interest should exist when a situation or arrangement produced even a low probability of swaying a director.

cial benefit from the decision.[156]

For a fund director then, the fiduciary duties found in state law are unaffected by section 2(a)(19) because the Act does not preempt state law on the fiduciary duties of fund directors.[157] Indeed, the Commission has expressly acknowledged that the fiduciary duties of investment company directors embodied in state law are separate from, and in addition to, the mandates of the Act.[158] Within the Act, nonetheless, section 2(a)(19) is important, and its role is significant. In particular, the status of an individual established by the section can affect the eligibility of the individual for a seat on an investment company board,[159] and this status is the basis for assigning certain board tasks to the individuals who are directors.[160]

Because under state law the liability of an investment company director for a decision made as a director is determined by whether the director directly or indirectly could or did benefit personally from the decision in question, the test for interest under state law differs from and is much broader than the activities and relationships listed in section 2(a)(19) of the Act. Specifically, interest is present under state law if *any* factor renders a director of an entity incapable of making for the entity a decision that is grounded solely on the advantages or disadvantages of the decision to the entity.[161] In the words of the Supreme Court of Delaware, interest exists in a particular matter whenever a connection of a director to an individual or an entity

> is so close that the director's independence may *reasonably*

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[156] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See* Allen et al., *supra* note 104 and accompanying text.

[157] Clarke Randall, *Fiduciary Duties of Investment Company Directors and Management Companies Under the Investment Company Act of 1940*, 31 OKLA. L. REV. 635, 644 (1978).

[158] Release No. IC-26520, *supra* note 8, at 46,380, 46,392 n.32 (statement of commissioners); Release No. IC-24083, *supra* note 20, at 59,878 (statement of staff).

[159] 15 U.S.C. § 80a-10(a) (2000).

[160] These tasks are reviewed in Palmiter, *supra* note 66, at 171–76.

[161] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 920 (Del. Ch.), *appeal denied*, 829 A.2d 141 (Del. 2003).

> be doubted. This doubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis a vis an interested director.[162]

For investment company directors, the implication of the preceding points is of major practical significance, and it is central to the instant article. Two investment company directors who are similarly situated with regard to a given matter will be subject to the same standard of review under state law for ascertaining whether, in their action on the matter, they breached a fiduciary duty even though one director qualifies as interested under section 2(a)(19) of the Act and the other does not. When adjudicating an allegation of a breach of duty by a director, state law focuses on the character of the matter being decided by the board and on whether the director directly or indirectly gained, or was in a position to gain, a personal advantage from the decision reached.

If the status of a director under section 2(a)(19) of the Act is irrelevant to the director's risk of liability under state law for decisions as a director, then directors designated as interested by the section may be no more likely than directors designated as independent to use their board seats to benefit themselves at the expense of shareholders. Notably, social science research has often found that regulatory law fails to achieve its goal(s). This research, which I discuss next, buttresses the argument that directors of an investment company make decisions for the company unaffected by their status under section 2(a)(19).

In illustrating social science research on the impact of regulatory law, I begin with studies of government regulation directed at economic activity. As to such activity, state statutes prohibiting employment policies that either mandate union membership or mandate abstention from union membership have been found not to influence appreciably the proportion of nonagricultural workers

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[162] Beam v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (emphasis in original). *Accord*, McCabe v. Foley, 424 F. Supp. 2d 1315, 1324–25 (M.D. Fla. 2006).

who are union members.[163] In addition, statutes and executive-branch actions directed at controlling hospital costs have not consistently and substantially done so.[164] As an example of government regulation directed at activity that is largely social in nature, state statutes requiring minors to attend school until they reach a specified age have generally not had a material impact on the school enrollment rates of minors.[165] Moreover, statutes permitting divorce only when fault exists seem to have had little effect on the divorce rate because the adoption of statutes allowing divorce without fault evidently has had no more than a short-term impact on the probability of marriage dissolution[166] (even though critics of

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[163] Keith Lumsden & Craig Petersen, *The Effect of Right-to-Work Laws on Unionization in the United States*, 83 J. POL. ECON. 1237 (1975).

[164] John J. Antel et al., *State Regulation and Hospital Costs*, 77 REV. ECON. & STAT. 416, 421–22 (1995).

[165] JOHN K. FOLGER & CHARLES B. NAM, EDUCATION OF THE AMERICAN POPULATION 24–27 (1967); William M. Landes & Lewis C. Solman, *Compulsory Schooling Legislation: An Economic Analysis of Law and Social Change in the Nineteenth Century*, 32 J. ECON. HIST. 54, 86 (1972); Linda Nasif Edwards, *An Empirical Analysis of Compulsory Schooling Legislation, 1940–1960*, 21 J.L. & ECON. 203, 221–22 (1978).

[166] The most persuasive study supporting this conclusion is by Frans van Poppel & Joop de Beer, *Measuring the Effect of Changing Legislation on the Frequency of Divorce: The Netherlands, 1830-1990*, 30 DEMOGRAPHY 425 (1993). In the van Poppel and de Beer study, which was confined to The Netherlands, the divorce rate was measured by the annual number of divorces per 10,000 married males during a 160-year period (viz., 1830-1990). *Id.* at 430. A no-fault divorce statute was adopted in The Netherlands in 1971. *Id.* at 430. None of three major changes that occurred in divorce law during the 160 years covered by the study, including the introduction of no-fault divorce in 1971, had a long-term, appreciable effect on the divorce rate. *Id.* at 438–39.

Of the research done to date on the impact of no-fault divorce law on the incidence of divorce, the study by van Poppel and de Beer is the most convincing for several reasons. First, the study covered a long time span during which three important changes in divorce law occurred, and it found that the response of the divorce rate to all three changes was the same. The impact of divorce law, then, was consistent and exhibited a pattern. Second, the changes in law were assessed with a statistical technique whose estimates of relationships between variables are unaffected by serial dependency in data. *Id.* at 427. Divorce rates for multiple time points can be expected to exhibit serial dependency because the rate at any one time point is likely to be affected by the rate at the preceding

no-fault statutes have believed the statutes substantially increase the incidence of divorce[167]).

The preceding studies are not alone. An impressive body of well-designed quantitative research on a variety of social problems has found that law intended to regulate behavior, including law that criminalizes behavior, does not have a large, enduring impact on the frequency of the behavior.[168] The reason for the lack of a

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time point. Third, the denominator of the divorce rate calculated by van Poppel and de Beer was the number of married males, not the total population. *Id.* at 430. As a result, their measure of the likelihood of divorce was limited to persons who were exposed to the possibility of divorce.

Research on the impact of divorce law in the United States has yielded disputed findings. *E.g.*, *compare* Norval D. Glenn, *Further Discussion of the Effects of No-Fault Divorce on Divorce Rates*, 61 J. MARRIAGE & FAM. 800 (1999), *with* Joseph Lee Rodgers et al., *The Effect of No-Fault Divorce Legislation on Divorce Rates: A Response to a Reconsideration*, 59 J. MARRIAGE & FAM. 1026 (1997) *and* Joseph Lee Rodgers et al., *Did No-Fault Divorce Legislation Matter? Definitely Yes and Sometimes No*, 61 J. MARRIAGE & FAM. 803 (1999). In this research, the denominator for the divorce rate seems to have uniformly been the total number of people in a jurisdiction, and the dependent variable was, therefore, the crude divorce rate. The denominator of the crude divorce rate includes not only unmarried adults but also individuals too young to marry, and the percentage of these persons in a population can differ at one point in time across jurisdictions and across time in a single jurisdiction. Accordingly, the crude divorce rate can vary between jurisdictions and over time within a jurisdiction even though the risk of divorce is the same. Not surprisingly, therefore, when differences and changes in statutes governing divorce are statistically related to the crude divorce rate, jurisdiction-level differences and changes in demographic, economic, and social attributes of the population appear to have a considerably stronger relationship to the divorce rate. Thomas B. Marvell, *Divorce Rates and the Fault Requirement*, 23 LAW & SOC'Y REV. 544, 551, 557 (1989).

[167] Robert M. Gordon, Note, *The Limits of Limits on Divorce*, 107 YALE L.J. 1435, 1436, 1439–40 (1998).

[168] *E.g.*, *Law as Symbol*, *supra* note 9, at 300–01 nn.65–67; Anne H. Gauthier, *The Impact of Family Policies on Fertility in Industrialized Countries: A Review of the Literature*, 26 POPULATION RES. & POL'Y REV. 323, 339, 342 (2007); Ann E. Horvath-Rose et al., *Capping Kids: The Family Cap and Nonmarital Childbearing*, 27 POPULATION RES. & POL'Y REV. 119, 134 (2008); Marc Poitras & Daniel Sutter, *Policy Ineffectiveness or Offsetting Behavior? An Analysis of Vehicle Safety Inspections*, 68 S. ECON. J. 922, 932 (2002). Law can also have inconsistent effects on a targeted problem; that is, law may improve

substantial, permanent impact probably lies in societal complexity. The studies cited were conducted in relatively complex social systems, i.e., social systems whose populations and institutions are heterogeneous. However, a complex system is characterized by multiple causal pathways and feedback loops. As a result, complexity in a social system is likely to hamper regulation and render law incapable of having an appreciable, sustained influence on conditions in the system. Accordingly, if the law that was examined in these studies was making or had made a positive contribution to society, it did so mainly in other ways, e.g., by acting as a symbol that contributed to societal cohesion.[169]

It should not be surprising, then, that social science research on operating companies has failed to uncover uniform, material inter-company differences in economic performance attributable to the proportion of board seats held by "outside" directors (i.e., directors who are not employees of the firm on whose board they serve) or independent directors generally.[170] Of course, operating companies are not investment companies, but as discussed *supra* in Part II.B, social science studies completed to date do not permit a firm conclusion to be drawn regarding whether the economic returns of investment companies are affected to a meaningful degree by the

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one dimension of a problem and have no impact on, or worsen, another dimension of the problem. *E.g.*, David Neumark & Wendy A. Stock, *The Labor Market Effects of Sex and Race Discrimination Laws*, 44 ECON. INQUIRY 385, 411–14 (2006) (finding with census data on individuals that state statutes prohibiting sex-based differentials in pay increased the earnings of employed white women and of employed black women but reduced the level of employment among both, and finding that state statutes prohibiting race-based employment discrimination raised the earnings, but did not affect the level of employment, of black men relative to white men).

[169] *Law as Symbol*, *supra* note 9, at 299–301.

[170] Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 271, 278–80 (1998). The same conclusion is reached by Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 75 (2007). *Cf.* James D. Westphal, *Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management*, 43 ADMIN. SCI. Q. 511, 512, 529 (1998) (finding that changes in board composition may not have their anticipated effects because chief executive officers adapt to the changes by personally influencing directors).

composition of their boards under section 2(a)(19).[171] Future research, however, will probably find that the number and proportion of seats on fund boards occupied by independent directors as defined by section 2(a)(19) have, in general, little or no long-term impact on the funds' investment performance. If board composition is a distinct and major influence on investment performance, existing studies would have uniformly uncovered the effect, and their findings would be unambiguous. Performance differences between funds seem instead to be attributable to other fund-related factors.[172]

The concepts and doctrines of law exist for a reason, however, and as a result, investment performance should not be the sole criterion for judging the composition of mutual fund boards under section 2(a)(19) even though investments are made in mutual funds for the purpose of economic gain.[173] An additional, but equally important, criterion should be whether the number and proportion of interested directors and independent directors influence the functioning of the social system by, for example, affecting the frequency of scandals involving funds. Unlike the criterion of investment performance—which is economic—the second criterion is sociological, and while investment performance is widely accepted

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[171] See text accompanying *supra* notes 65–68.

[172] *Cf.* Christine Parker & Vibeke Lehmann Nielsen, *Do Corporate Compliance Programs Influence Compliance?* 47 (Univ. of Melbourne Legal Studies Research Paper No. 189, Sept. 2006), *available at* http://ssrn.com/abstract=930238 (finding that compliance by business firms with the requirements of law governing competition and consumer protection was most clearly influenced by the level of general competence of the managers of the businesses, not by the presence or absence of formal compliance programs, and suggesting that managerial competence and commitment to compliance, together with the depth of organizational resources, "are likely to be much more important" than compliance programs themselves).

[173] Indeed, a profit motive on the part of investors is essential if the instruments issued by mutual funds are to qualify as securities. Fund investors typically seem to hold investment contracts. *See generally* Sec. & Exch. Comm'n v. Edwards, 540 U.S. 389, 393, 395 (2004) (identifying, from prior cases, the elements of an investment contract). An investment contract is deemed by the Act to be a security. 15 U.S.C § 80a-2(a)(36) (2000). A profit motive is an element of an investment contract. United Housing Found. v. Forman, 421 U.S. 837, 852–53 (1975).

as a criterion for evaluating funds, the sociological criterion is largely ignored.

The importance of the sociological criterion, however, cannot be overstated. The social products of an organization such as an investment company include reputation and trust, and although these products have yet to be explored fully by social science, they seem to be critical in the long run to the organization and to society in general.[174] For instance, the negative publicity involved in a scandal damages not just the reputation of and trust in the particular organization(s) in which a socially accepted rule of behavior was violated, but it can also harm the reputation of and trust in the societal segment in which the violation occurred.[175] The damaged segment may be all of the organizations comprising a particular industry in the economy (e.g., all mutual funds), and under some conditions, it may encompass the entire institution or sub-institution in which the industry operates (e.g., the financial sector). Even if the damage is limited to a particular industry, however, the operation of society is impaired to some extent.[176] Consequently, a sociological criterion, and not just an economic criterion, is needed to evaluate investment company boards. Unfortunately, a sociological criterion raises questions that rigorous social science studies have yet to answer.

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[174] *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, *supra* note 10.

[175] Ari Adut, *A Theory of Scandal: Victorians, Homosexuality, and the Fall of Oscar Wilde*, 111 AM. J. SOC. 213, 219–21 (2005).

[176] Public misstatements of material facts, or omissions of material facts from public communications, by officers of mutual funds are also pertinent to the sociological criterion. Such misstatements and omissions can reduce trust in and the reputation of the funds and thereby hamper the funds in raising capital for economic activity. Congress has recognized that the federal securities statutes, including the Investment Company Act, were adopted to preserve trust in securities markets. *When is a Mutual Fund Director Independent?*, *supra* note 39, at 158–59. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("The [federal] securities statutes seek to maintain public confidence in the marketplace.").

IV. THE MACROSOCIOLOGICAL NATURE OF INVESTMENT COMPANY REGULATION

By way of review, federal law governing mutual funds is grounded on skepticism regarding the willingness or ability of interested directors to safeguard fund investors from financial abuse. This skepticism exists in spite of the explicit recognition that state law contains fiduciary duties for directors and that interested directors are subject to the same duties as independent directors. Under state law, the care and loyalty with which interested directors perform their tasks as directors must match that of independent directors. Given this parity, the skepticism directed at interested directors is illogical.

In addition to involving a logical inconsistency, law on the interested directors of mutual funds is accompanied by the belief that the prevalence of interested directors on fund boards substantially affects the investment returns of the funds. The accuracy of this belief, however, seems dubious in light of existing social science studies.[177] These studies are buttressed by a substantial body of social science research that has found regulation to be relatively ineffective in altering societal patterns.[178] Consequently, it is at least plausible, and may indeed be probable, that the relationship between board composition and fund performance is weak or nonexistent.

If we postulate that the status of directors under section 2(a)(19) does not appreciably influence the financial performance of mutual funds as a whole—i.e., if interested directors do not pose the economic threat to the funds and their shareholders that is commonly assumed—two questions must be answered. First, what advantages accrue to society from the congressionally established maximum percentage of interested directors on fund boards and from the actions of the Securities and Exchange Commission to reduce this percentage? Second, can regulatory approaches that do

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[177] *See* Ding & Wermers, *supra* note 65; Meschke, *supra* note 68. Also see *supra* note 67.

[178] *See* sources cited *supra* notes 163–66, 168.

not impose a maximum on the percentage of board seats held by interested directors benefit society as much as, or more than, regulatory approaches that do? The answer to the first question will inform the answer to the second.

The first question implicates the macrosociological proposition that (i) the concepts and doctrines dominant in the institution of law facilitate the operation of the society in which they exist and (ii) when these concepts and doctrines hinder the social system, they are abandoned and replaced by concepts and doctrines that strengthen the social order.[179] This two-part proposition leads to the conclusion that, if interested directors have no appreciable effect on the profitability of investments in fund shares, existing law on the percentage of interested directors on fund boards arose because it benefits the social system in some other way(s). The functioning of a social system is improved by the creation and preservation of trust,[180] and the legislative history of the Act discloses that it was adopted to promote trust in entities that are vehicles for collective investments in securities so that the entities would contribute to the growth of the United States economy.[181] Thus, even though a concern with trust is rarely made explicit (let alone stressed) in court opinions and Commission releases, Congress evidently had an underlying sociological purpose in limiting the percentage of investment company board seats held by interested fund directors.

Trust, however, is not the only dimension of society affected by the regulation of investment company boards. Through this regulation, Congress and the Commission have probably also protected the reputation of investment companies and created symbols of governmental concern with the welfare of investors.[182] Symbols

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[179] United States v. Trottier, 9 M.J. 337, 344 (C.M.A. 1980) ("The law is not an end in itself; more properly it is a means to accomplish the ends of an ordered society. When change occurs in the conditions of that society upon which the law is based, the law, in turn, must respond thereto.").

[180] Knack, *supra* note 113, at 779; Lederman et al., *supra* note 113, at 529; *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, *supra* note 10, at 825–27.

[181] *When is a Mutual Fund Director Independent?*, *supra* note 39, at 159.

[182] *Social Productivity, Law, and the Regulation of Conflicts of Interest in*

are important for maintaining and improving the operation of groups,[183] and in regulating investment company boards of directors, federal legislation seems to be inescapably symbolic. The macrosociological concept of social productivity encompasses these outputs (viz., symbols, trust, and reputation) of societal institutions and other organized groups, including business firms.[184] Because the concept of social productivity deals with an important aspect of the institution of law, it can aid in understanding the emergence and role of the doctrines and concepts of law in a society.[185]

In sum, the success of legislation, agency rules, and agency enforcement efforts should be judged at least as much by a sociological yardstick as by one that is economic. This will not happen, however, until the macrosociological character of law is acknowledged, because an important contribution of a macrosociological perspective is recognition that law can benefit society in ways

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the Investment Industry, *supra* note 10, at 832.

183 *Id.* at 821–25; *Law as Symbol*, *supra* note 9, at 290–91.

184 *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, *supra* note 10. The concept of social productivity is more useful than the concept of social capital when considering law and its consequences. Social capital is concerned with the resources of a group (including an institution) and the advantages and disadvantages furnished by these resources to the participants in the group. Social productivity, on the other hand, focuses on the social outputs of a group and the effects of these outputs. Law, as a social output of a group (i.e., society), has consequences, and these consequences are central to social productivity.

185 The macrosociological framework for law that I am proposing considers the political process, as the forerunner of legislation and agency rules, to be an indicator of societal conditions. This point is implicit in the remark that "[p]olitics is the art of the possible." Otto von Bismarck, *quoted in* The Quotations Page, Otto von Bismarck Quotes—The Quotations Page, http://www.quotationspage.com/quotes/Otto_von_Bismarck/ (last visited Feb. 3, 2008). In my framework, therefore, criticisms that are directed at the current content of section 2(a)(19) of the Act, and at Commission rules pertinent to the section, should prompt a study of the social system in which the Act exists and the Commission operates.

The political process is involved in choosing judges, too, and is an indicator of the societal conditions that shape judicial rulings and opinions. *See The Roots of Law*, *supra* note 9, at 636–37.

other than by altering the incidence of targeted behavior. The effects of law are broad, subtle and elusive, and there must be an awareness of *all* of the effects in order to understand the role of law in a social system.

V. SANCTIONS FOR SHAREHOLDER EXPLOITATION

I turn now to the second question raised in Part IV *supra*. If law regulating investment company boards primarily involves social productivity and is primarily concerned with reinforcing the social system, can law strengthen society without focusing on the number or percentage of board seats held by interested directors? I believe that the question has an affirmative answer, and I suggest below an approach that has not heretofore been applied to investment companies. I emphasize, however, that well-designed social science research does not exist at the present time to evaluate my suggestion. Barring an emergency, novel law and policies should be adopted, and actions to enforce them should be undertaken, only *after* exacting research indicates that their goals will be achieved without major, undesired side effects.

A. A Proposal

The starting point for my proposal is the remarkable growth that has occurred in the number of mutual funds in the United States during the last quarter of a century. This growth is visible in Figure 1, which uses data from the Investment Company Institute and covers the period from 1940 through 2006.[186] Mutual funds

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[186] INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 97. For the period from 1940 until 1970, the Investment Company Institute reports the number of funds for each fifth year, but starting in 1970, the number is reported for every year. Through 1973, furthermore, the data of the Institute combine money market funds with other types of mutual funds (viz., funds investing in longer-term debt securities and funds investing in equity securities), and a separate count of money market funds is furnished beginning only with 1974. Based on these numbers, the figure contains one time series (denoted by hollow triangles) that represents all mutual funds, including money market funds; the data in this time series are for each fifth year from 1940 to 1970 and then for every year through 2006. The second time series in the figure represents funds that are *not* money

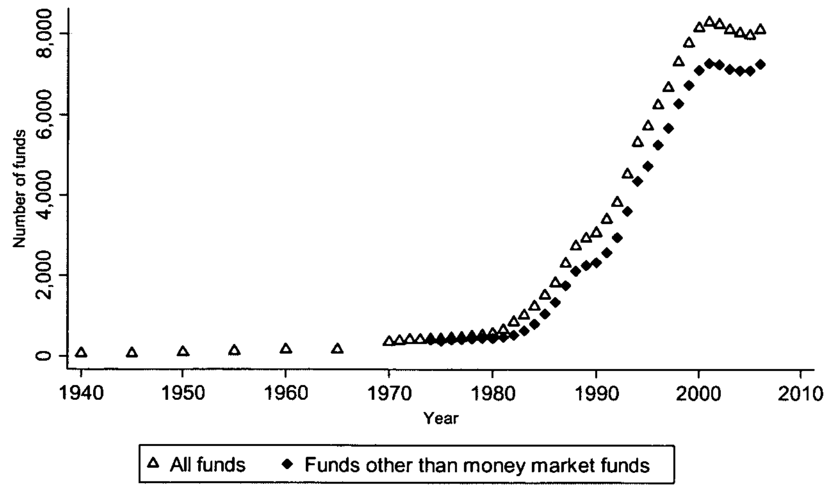
today operate in a buyer's market and must actively pursue investors,[187] and an important reason for the intense competition is the enlarged number of funds.[188] The numerical growth in funds has also created a greater potential for incidents of shareholder exploitation because, all else being equal, more funds present more opportunities for such exploitation.

market funds, i.e., funds that invest in stocks and/or in debt securities having maturities exceeding those of money market instruments. The second time series (denoted by solid diamonds) includes every year from 1974 through 2006. *Id.*

[187] *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. IC-26356, 69 Fed. Reg. 9726, 9729 (Mar. 1, 2004) (characterizing as "intense" the degree of competition for investors when funds distribute their shares through brokers).

[188] Since the mid-1980s, a noticeable decline has occurred in the percentage of all mutual fund assets held by the largest fund families. For instance, the twenty-five largest fund families managed 78% of the assets of all mutual funds in 1985 and 71% in 2006. INVESTMENT COMPANY INSTITUTE, *supra* note 2, at 17. The change probably stemmed from an increase in the number of fund families; such an increase is a logical accompaniment of growth in the number of funds. Change in the number of fund families is likely to be a better indicator of the trend in competition for investors because marketing efforts seem to be undertaken typically by fund families, not by individual funds. However, the Investment Company Institute does not report the number of fund families and the change that occurred in this number over time.

Figure 1. Number of Mutual Funds in the United States - 1940 to 2006



Both of the time series in the figure reveal a rapid rise in the number of mutual funds starting in the first half of the 1980s. Given the current number of funds and the level of competition between them, the prospect of adverse publicity is presumably a concern of directors and officers of the funds and their investment advisers. A recent study reveals the damage that funds can suffer from unfavorable publicity. The study estimated the asset outflows from mutual funds following disclosure in the *Wall Street Journal* that the entities managing the funds were being investigated or had been sanctioned by the Securities and Exchange Commission during the period from 1994 through 2004.[189] For the particular funds that were the focus of the Commission and that were managed by an entity that was sanctioned, outflows were found to average 22% of the assets of the funds in the twelve months after the Commission action was reported in the *Wall Street Journal*.[190] At the same time, average outflows of 7% of assets were experienced by funds that were not involved in an investigation or sanction but that be-

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[189] Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1026 (2007).

[190] *Id.* at 1029, 1042.

longed to a fund family having a fund that was involved.[191] Because substantial outflows occurred not only from the particular funds that were subjects of Commission attention but also from other funds in the same family, it is clear that shareholders react when they learn that the entity managing their fund may have disregarded, or in fact did disregard, the welfare of fund investors, and the reaction generalizes to other funds in the same family.[192]

Unfortunately, the study could not ascertain whether board composition under section 2(a)(19) of the Act affected the likelihood that a fund would become the focus of a Commission investigation or the subject of a Commission sanction,[193] but the central finding of the study is nonetheless important—shareholders financially punish a fund and its fund family when they learn that the fund manager is even suspected of unlawful conduct. Because the shareholders' reactions remove substantial assets from the funds, they reduce the fees that the funds pay their investment advisers since the fees are calculated as a percentage of fund assets.[194] The possibility of such reactions is presumably an incentive for directors and other affiliates of funds, including the investment advisers of funds, to be wary of any action or inaction that is or might be legally unacceptable and that can generate adverse publicity. The incentive, moreover, is likely to be as strong for the interested directors as for the independent directors.

What means are available to the Commission that will publicize instances in which affiliated persons of funds have exploited

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[191] *Id.* at 1050. Outflows from funds that were not involved in a Commission investigation or sanction, but that were in the same family as a fund that was involved, were larger in total number of dollars than outflows from the fund involved because the former funds collectively had more assets than the latter fund. *Id.* at 1051.

[192] The negative reaction of investors to funds that were not involved in a Commission investigation or sanction, but that were part of a fund family having a fund that was investigated or sanctioned, is attributable to the psychological process of stimulus generalization. *See Law as Symbol*, *supra* note 9, at 297–98 (explaining stimulus generalization).

[193] Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals* 25, 27 (New York Univ. Ctr. for Law & Econ., Working Paper No. 06-07, 2006).

[194] 15 U.S.C. § 80b-5 (2000).

shareholders? In a number of cases, the Commission has required investment advisers that breached the antifraud section of the Investment Advisers Act ("Advisers Act")[195] to furnish a copy of the Commission's order identifying the breach and sanction(s) both to current clients by certified or registered mail[196] and also, for the twelve months following the order, to prospective clients.[197] The same requirement could be imposed on funds when their directors have exploited shareholders or have failed to prevent other fund affiliates from doing so. The requirement as to funds is evidently authorized by section 9(f)(1) of the Investment Company Act.[198] By its terms, the section applies when any provision of the Act, or any rule or regulation promulgated by the Commission under the Act, has been breached in the past, is being breached currently, or can be expected to be breached in the future.[199] In such a situation, the Commission can order an end to the violation by both the person(s) committing the violation and "any other person" that was involved in, and that had actual or constructive knowledge of, the violation.[200] Notably, the order may further

> require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the

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[195] 15 U.S.C. § 80b-6 (2000).

[196] For certified and registered mail, the U.S. Postal Services supplies proof of mailing as well as proof of the date and time of attempted or actual delivery. As a means of confirming delivery, a return receipt can be obtained for a certified letter and a registered letter. Registered mail differs from certified mail in that insurance is available for registered mail to a maximum of $25,000. U.S. Postal Service, A Customer's Guide to Mailing, Adding Extra Services, http://pe.usps.com/text/dmm100/adding.htm (last visited Feb. 3, 2008). For investment companies that send a copy of a Commission order to shareholders, there would seem to be no need for insurance, and certified mail would suffice.

[197] *E.g.*, In the Matter of Account Mgmt. Corp., Admin. Proc. File No. 3-8857, Investment Advisors Act Release No. 1529, 1995 SEC LEXIS 2554, at *18, *19 (Sept. 29, 1995); In the Matter of CapitalWorks Inv. Partners, LLC, Admin. Proc. File No. 3-12324, Investment Advisers Act Release No. 2520, 2006 SEC LEXIS 1306, at *9, *10 (June 6, 2006).

[198] 15 U.S.C. § 80a-9(f)(1) (2000).

[199] *Id.*

[200] *Id.*

Commission may specify in such order.[201]

Because a "person" can be an entity,[202] section 9(f)(1) applies to investment companies of all types.

Instances in which investors in a mutual fund are exploited by an affiliate of the fund threaten a tenet that permeates the entire Act,[203] and such a fund will probably fail to make adequate disclosure of incidents of investor exploitation in the periodic reports it must file with the Commission[204] pursuant to section 30 of the Act,[205] at least until after the Commission has learned of the exploitation. Under section 34(b), disclosure in these reports must be complete, and the content of the reports cannot imply, let alone explicitly assert, that there has been no exploitation of fund shareholders when there has been.[206] However, the likelihood does not seem high that a fund will voluntarily and fully disclose such exploitation until after at least one inaccurate report that could have disclosed the exploitation has been submitted to the Commission. If the exploitation is due to conduct by a director (or other affiliate) of the fund and involves the purchase of property (e.g., securities) from the fund, or the sale of property to the fund, without prior Commission approval, section 17(a) of the Act will have been violated.[207] If the director (or other affiliate) benefited financially

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[201] *Id.*

[202] 15 U.S.C. § 80a-2(a)(28) (2000).

[203] The objectives of the Act include protecting investors from intentional injuries such as those that occur when funds are operated for the benefit of, inter alia, their directors, officers, or investment advisers. 15 U.S.C. § 80a-1(b)(2) (2000).

[204] 17 C.F.R. §§ 270.30b1-1, 270.30b1-5 (2006).

[205] Section 30 applies to investment companies registered with the Commission. 15 U.S.C. §§ 80a-29(a), 80a-29(b) (2000). Mutual funds, as the term is used in the instant article, are by definition registered.

[206] Section 34(b) of the Act requires the inclusion in reports of truthful statements and prohibits omissions that cause the included statements to be "materially misleading." 15 U.S.C. § 80a-33(b) (2000). Under federal securities law, a statement that is literally accurate can be materially misleading if, by context or wording, it prevents a reasonable person from comprehending the facts. McMahan & Co. v. Wherehouse Entertainment, Inc., 900 F.2d 576, 579 (2d Cir. 1990), *cert. denied*, 501 U.S. 1249 (1991).

[207] 15 U.S.C. §§ 80a-17(a), 80a-17(b) (2000). Section 17(a) covers both

from the transaction while acting as an agent of the fund or another person, section 17(e)(1) may have been violated too.[208]

In short, a breach of section 34(b) by a fund, or a breach of section 17[209] by a director of a fund that can be imputed to the fund, is a basis for sanctioning the fund. For a breach of either section, the Commission could require that the fund supply to current and prospective investors a salient notice of the manner in which its investors were exploited. The sanction might also prohibit the fund from seeking new investors for a specified period of time.[210]

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first-tier and second-tier affiliated persons of a registered investment company. *Id.* Directors of a fund are first-tier affiliates of the fund under section 2(a)(3)(D). 15 U.S.C. § 80a-2(a)(3)(D) (2000).

[208] 15 U.S.C. § 80a-17(e)(1) (2000). Section 17(e)(1) applies to first-tier and second-tier affiliated persons of an investment company that is registered with the Commission. Directors of a fund are first-tier affiliates of their fund through section 2(a)(19)(3)(D) of the Act. 15 U.S.C. § 80a-2(a)(3)(D) (2000). Under section 17(e)(1), the affiliated persons must be serving as an agent of either their fund or another person. Investors Research Corp. v. Sec. & Exch. Comm'n, 628 F.2d 168, 176 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980). Section 17(e)(1) prohibits the acceptance of "compensation" by such agents, but compensation does not include either (i) profits earned from transactions in securities in the course of an underwriting or brokerage business or (ii) acceptance of "a regular salary or wages from" the investment company. 15 U.S.C. § 80a-17(e)(1) (2000). Outside of these exclusions, the term "compensation" is construed broadly and includes anything that the recipient views as a benefit. United States v. Ostrander, 999 F.2d 27, 31 (2d Cir. 1993). This expansive definition of compensation is not confined to the Act but seems to be found generally in law. *E.g.*, United States v. Rosenthal, 9 F.3d 1016, 1023 (2d Cir. 1993).

[209] A breach of section 17 could also include a violation of section 17(d), which prohibits a first-tier and second-tier affiliated person of a registered investment company from engaging in a joint transaction with the company in which the affiliated person is acting as a principal unless the transaction complies with Rule 17d-1. 15 U.S.C. § 80a-17(d) (2000); 17 C.F.R. § 270.17d-1 (2006).

[210] *See In re* Gintel Asset Mgmt., Inc., Admin. Proc. File No. 3-10930, Investment Advisors Act Release No. 2079, 2002 SEC LEXIS 2868, at *33, *41 (Nov. 8, 2002). In *Gintel Asset Management*, an investment adviser that violated the antifraud section of the Investment Advisers Act and the prohibition imposed by the Investment Company Act on trading in securities with an affiliated registered investment company was (i) required to mail a copy of the Commission order to existing clients and (ii) barred for one year from "soliciting, marketing, or advertising" to recruit new clients. *Id.*

If the proposal outlined above is implemented, funds would face not only the prospect of adverse publicity in the mass media for an instance of investor exploitation but also the possibility that they would be compelled to call the attention of current and potential investors to the exploitation and the resulting sanction(s). Since investment advisers that have run afoul of the antifraud section of the Advisers Act have been required to inform their clients of the violation(s) in this manner,[211] the proposal is not without some precedent. Certified mail is unlikely to be disregarded by a recipient, and the notification to shareholders can be expected both to enhance the symbolism of the sanction and, by suggesting regulatory vigilance on the part of the Commission, to assist in restoring trust in mutual funds. My proposal, in short, has the potential to improve the social productivity of investment company regulation.

A final point merits brief mention. Section 17(h) of the Investment Company Act prevents a registered investment company from immunizing its directors from liability to the company or to its shareholders for conduct amounting to "willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties" of a director.[212] These types of conduct, of course, constitute violations of the obligations of a director that are recognized by state law and that are discussed *supra* in Part III of the instant article. Investment company directors may thus be exposed to the possibility that they will need to pay damages from their personal assets if the exploitation of a fund is attributable to a breach of any of the directors' obligations to the fund. The Commission staff has taken the position that section 17(h) prevents an investment company from paying the premiums for an insurance policy that covers the types of conduct listed in the section unless the policy allows the insurance provider, after compensating the investment company for damages incurred by the company for such director misconduct, to collect the damages from the director.[213] While a director is not prevented from purchasing on her or his own a policy covering the listed

[211] See *supra* note 197 and its accompanying text.

[212] 15 U.S.C. § 80a-17(h) (2000).

[213] Exemption of Certain Joint Purchases of Liability Insurance Policies, Investment Company Act Release No. 10700, 1979 SEC LEXIS 1544, at *6 n.8 (May 16, 1979).

types of conduct and paying the policy premiums,[214] section 17(h) at least symbolically underscores the need for interested directors (as well as for independent directors) to perform capably the duties of their office.[215]

B. Discussion

The proposal made in Part V.A, if adopted, would join other approaches used by the Securities and Exchange Commission to respond to instances of financial abuse of mutual fund investors. As the mutual fund scandal that emerged in 2003 demonstrates, the Commission already sanctions exploiters. My proposal would not displace such sanctions but would add to them. In protecting the integrity of the social system, however, prevention of conduct that has not occurred is likely to be preferable to penalties for conduct that has already occurred, and my proposal, like the sanctions now used by the Commission, employs penalties.

A common assumption in the United States is that penalties reduce the future occurrence of the behavior targeted by the penalties, i.e., that penalties contribute to deterring unwanted conduct,[216] and thus penalties for an activity that has happened are employed with the expectation that the penalties will contribute to preventing future activity of the same type. Unfortunately, this assumption is just that—an assumption. Notably, social science research strongly suggests that penalties for criminal conduct, and the possibility of penalties for such conduct, have generally no more than a minimal deterrent effect.[217] Because civil sanctions are less severe than

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[214] *Id.*

[215] *See* Release No. IC-24083, *supra* note 20, at 59,882–59,883.

[216] Ctr. for Survey Research, Univ. of Virginia, Jan. 27–April 14, 1996, Public Opinion Online, accession no. 280345, *available at* LEXIS, RPOLL File (finding in a survey of U.S. adults that, to reduce crime, "tougher laws and penalties" were believed by 59% of respondents to "help a lot" and by 28% to "help somewhat"); Princeton Survey Research Assoc., Aug. 23–25, 1994, Public Opinion Online, accession no. 226723, *available at* LEXIS, RPOLL File (finding in a survey of U.S. adults that "tougher laws and penalties" were believed by 68% of respondents to "help a lot," and by 22% of respondents to help "somewhat," as a deterrent to "crime, including white collar crime").

[217] Supporting research is found in *Law as Symbol*, *supra* note 9, at 300

criminal sanctions, there is no reason to anticipate that civil penalties in any form—whether the mandatory notifications that are included in my proposal or the disgorgement and fines that the Commission already imposes[218]—will be effective in averting substantial amounts of socially harmful conduct by directors, regardless of their status under section 2(a)(19) of the Act.[219]

Nonetheless, penalties can benefit a society. While penalties qua penalties may not appreciably curb the frequency of an activity, penalties can symbolize a societal commitment to established social values and thereby serve "not so much to guide society, as to comfort it."[220] In doing so, penalties are likely to help in cementing a social system.[221] Moreover, through as well as apart from their symbolism, penalties may reinforce trust in the social system and promote the reputation of organizations. There is a possibility, of course, that such consequences will reduce the incidence of some types of socially undesirable behavior, but the deterrence is unlikely to be large in magnitude and, if it occurs, would be indirect—the penalties would strengthen the social system, and the strengthened social system would prevent socially damaging conduct.

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n.65. *See* Chester Britt et al., *A Reassessment of the D.C. Gun Law: Some Cautionary Notes on the Use of Interrupted Time Series Designs for Policy Impact Assessment*, 30 LAW & SOC'Y REV. 361 (1996) (discussing important features of social science research design for assessing the impact of law and finding with time-series data and an appropriate control group that the law of a local government regulating the possession of handguns did not affect the homicide rate).

[218] *E.g.*, *In re* Banc of Am. Capital Mgmt, LLC, Investment Company Act Release No. 26756, 2005 SEC LEXIS 291 (Feb. 9, 2005).

[219] The fiduciary duties of directors under state law are a form of regulation. Because regulatory law generally seems to have little measurable impact on the occurrence of the conduct with which such law is concerned, the fiduciary duties of directors probably do not often stop either interested directors or noninterested directors from financially exploiting shareholders. Whether directors financially exploit shareholders seems attributable, instead, to factors other than the fiduciary duties of directors and the status of directors under section 2(a)(19).

[220] THURMAN W. ARNOLD, THE SYMBOLS OF GOVERNMENT 34 (1935).

[221] Unfortunately, sociologists have yet to identify with rigorous quantitative research the degree to which, and the paths by which, the symbolism of penalties benefits a society.

While penalties seem to help in maintaining a social system, penalties may contribute less than prevention to reinforcing the fabric of a society.[222] If so, approaches that prevent shareholder exploitation but that do not involve penalties are advisable in efforts to preserve the attractiveness to investors of entities for collective investments in securities. Effective non-penalty approaches will be difficult to identify, but one possibility is suggested by a recent study. The study found that, all things being equal, the investment return of mutual funds whose portfolios were dedicated to equity securities generally rose with the amount of money that the directors of the funds had personally invested in their funds.[223] If the relationship between director investments and fund performance reflected a greater personal commitment to funds by directors who were investors, a requirement that an individual commit a specified minimum sum to a fund in order to be a director of that fund may prevent shareholder exploitation because directors of a fund who are also investors in the fund are likely to take actions to avert such exploitation. However, while prevention is prudent, none of the current provisions of the Investment Company Act explicitly authorizes the Securities and Exchange Commission to compel investments by directors in their funds, let alone compel specified minimum investments, and Congress would need to amend the Act to provide the Commission with this authority. Whether Congress would adopt such an amendment is an open

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[222] *Cf.* Ezzat A. Fattah, *Some Reflections on Crime Prevention Strategies in Large Metropolitan Centres of the 21st Century*, 7 EUR. J. CRIME, CRIM. L. & CRIM. JUST. 130, 131, 135, 141, 146–48 (1999) (concluding that the incidence of crime cannot be reduced by law-imposed penalties but may be reduced by certain prevention strategies).

[223] Martijn Cremers et al., *Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry* 14, 18, 23 (Yale Int'l Ctr. for Fin., Working Paper No. 06-34, 2006), *available at* http://ssrn.com/abstract=686167. Another study, which included funds with portfolios consisting of debt securities as well as funds with portfolios consisting of equity securities, found a relationship between the amounts that independent directors personally invested in their funds and the financial performance of the funds. However, the causal direction of the relationship was unclear; i.e., the performance of the funds may have been the antecedent, rather than the effect, of the amount that the directors put into their funds. Meschke, *supra* note 68, at 17–18.

question.

Finally, regardless of the form it takes and the activity it targets, regulation should be informed by the findings of rigorous social science research. Because well-designed studies support the conclusion that deterrence of conduct injurious to mutual funds and their investors is unlikely to be achievable through law, the mailed notification that I proposed would probably not prevent substantial amounts of future misconduct, at least partly because the notification would reach current shareholders only after many if not most of them had learned of the misconduct through other means (e.g., newspaper articles) and had reacted to the disclosure. If the mailed notification would be unlikely to generate appreciable additional redemptions of shares from the fund involved in the scandal and from other funds in the same family, fund directors and officers may be minimally concerned by the notification requirement.

However, every approach to regulating mutual fund boards should be assessed with a sociological criterion, not just an economic criterion, because each approach requires an examination of the influences and reactions of society, elusive and subtle as these influences and reactions may be. Government regulation stems from and affects society in ways that can be understood with the tools of sociology, and studies of the regulation of investment companies can be enriched by, and can enrich, the sociology of law.[224] For example, the statute establishing the maximum percent-

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[224] Serious problems of quality in sociology became obvious during the 1980s in the United States. The problems, which were largely caused by sociologists themselves, had developed over the course of the two or three preceding decades. Hubert M. Blalock, Jr., *The Real and Unrealized Contributions of Quantitative Sociology*, 54 AM. SOC. REV. 447, 457–58 (1989); *see* IRVING LOUIS HOROWITZ, THE DECOMPOSITION OF SOCIOLOGY 12–13, 24 (1993). The problems have not been cured; rather, they are continuing and evident today. Alan Wolfe, *Social Skills*, NEW REPUBLIC, April 23, 2007, at 56 (estimating that half of all sociologists are currently advancing a political agenda, not science); HOROWITZ, *supra*, at 9, 16–17 (concluding that sociology is in danger of becoming "a pseudoscience" due to the large proportion of sociologists who are political ideologues). For empirical sociologists, however, major improvements in data sets and statistical techniques since the 1980s have dramatically increased the sophistication of their research. Unfortunately, the higher quality of socio-

age of interested directors on an investment company board, as well as the sanctions imposed by the Commission for instances of shareholder exploitation, are likely to furnish symbols supporting the social order as well as promote trust in the financial sector. In doing so, these regulatory measures would enhance the credibility of, and hence commitment to, the social system among participants in the system, and the benefit to the social system would occur even if, as seems probable, the measures do not directly or indirectly curb the frequency with which shareholders are financially exploited.[225] By its very nature, a social system requires its participants' commitment, and the extent of this commitment is presumably a determinant of the degree to which the system operates effectively. Thus, in efforts to understand government regulation of investment companies, research employing a macrosociological perspective is essential, and the exclusive use of an economic perspective is a mistake.

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logical research has probably not markedly enhanced the reputation of sociology as a discipline. *Cf.* Bruce Keith & Nicholas Babchuk, *The Quest for Institutional Recognition: A Longitudinal Analysis of Scholarly Productivity and Academic Prestige among Sociology Departments*, 76 SOC. FORCES 1495 (1998) (finding that scholarly articles and books published by faculty members in Ph.D.-granting departments of sociology had just a limited impact on the reputation within sociology of their departments). Nonetheless, the improved data sets and statistical techniques in sociology permit studies of the sociological aspects of law with a degree of rigor that was not possible a quarter of a century ago. Such studies will be essential to understanding the manner in which law functions in a social system.

[225] Palmiter, *supra* note 66, at 200, 207; Meschke, *supra* note 68, at 18–19, 38 (finding that the percentage of board seats held by independent directors is not related to the incidence of suits against mutual funds filed by shareholders and the Securities and Exchange Commission).