US INVESTMENT COMPANY

CORPORATE GOVERNANCE OUTLINE

Stuart E. Fross, Senior Partner

Wilmer Cutler Pickering Hale and Dorr, LLP

Stuart Fross
WilmerHale
60 State Street
Boston, MA 02109 USA
+1 617 526 6792 (t)
+1 617 526 5000 (f)
stuart.fross@wilmerhale.com

US Investment Company

Corporate Governance Outline

Stuart E. Fross, Senior Partner[1]

Wilmer Cutler Pickering Hale and Dorr, LLP

I. Current Expectations for Corporate Governance of US Mutual Funds

US Investment Companies – The Highest Standard of Corporate Governance. It is the author's view that US publicly offered investment companies[2] are subject to the most comprehensive (and mandatory) corporate governance regime applicable to public companies in the US, and in all probability, in the world. For example, listed investment companies are subject to all of the corporate governance requirements of operating companies (such as the Sarbanes-Oxley Act), the listing requirements of the listing exchange and the additional requirements of the Investment Company Act of 1940, as amended (the "1940 Act"). This outline will focus on those *additional* and unique requirements applicable to "registered management investment companies.".

Management Companies. Only managed funds (called "management companies") are subjected to the 1940 Act's statutory corporate governance regime.[3] Management companies are subject to a corporate governance regime because management companies face conflicts of interest typical of agent-principal relationships. Management companies have agents of one of two kinds: internal management who are employed by the fund; or, the funds are "externally managed" (and this is the overwhelming preference of industry) by a separate investment adviser.

Management companies present the potential for agency conflicts of interest with fund shareholders, and therefore are obliged to have a board of directors, composed so as to achieve (for all practical purposes) a very substantial representation by independent directors (see Section (V), "The Legal Structure of Investment Company Boards," below.). The board as a whole is responsible for a highly detailed agenda (see Section III "The Board Meeting Agenda" below), mandated by regulations and legal responsibilities imposed upon the directors in a level of detail

[1] Kasey Lindsey, a summer associate of Wilmer Hale, and a third year law student at the Georgetown University School of Law assisted substantially in the preparation of this outline. The author expresses his deep gratitude to Ms. Lindsay for her excellent work.

[2] US collective investment schemes are referred to as "investment companies" under the 1940 Act. Suffice it to say that an investment company that conducts an offering of its securities to the "public" must "register" with the SEC under the 1940 Act. (See, 1940 Act, Section 8).

[3] Not all investment companies are subject to corporate governance requirements. Hedge funds are excluded from the definition of investment companies by operation of Sections 3(c)(1) or 3(c)(7) of the 1940 Act. US registered investment companies are divided into three types – unit investment trusts (that hold a fixed portfolio of securities), face amount certificate companies (that issue certificates that pay a stated return) and management investment companies - - those that actively manage their assets. Only this last category are subject to corporate governance requirements. The concept of "management companies" does not correspond well to the modern concept of "actively managed funds" as contrasted with "index funds". Most index funds simulate their index, rather than replicate it, and so are organized as "management" companies. However the most famous S&P 500 Index tracker – the Sypdr Exchange Traded Fund (or ETF) is organized as a unit investment trust, and thus has no corporate governance regime associated with it.

unique (in the author's opinion) in American company law, and unique world-wide, with respect to collective investment schemes.

The Shareholders' Watch Dog. US regulation of registered management investment companies is highly dependent upon corporate governance[4], particularly on the concept and role of directors who have come to be known as "independent directors."

- The Investment Company Act establishes a system of "checks and balances," and relies on independent directors to "oversee the fund's operations so as to prevent abuses of investors." James M. Storey & Thomas M. Clyde, The Uneasy Chaperone 34 (2000).

- Directors also have broad responsibilities to monitor compliance with securities, corporate and other laws. Robert A. Robertson, *Board Oversight of Mutual Fund Compliance Operations*, Rev. Sec. & Comm. Reg., Oct. 24, 2000, at 1.

In short, fund directors are viewed by the Supreme Court as the "watch dogs" for investors in the fund. *See* Burks v. Lasker, 441 U.S. 471, 484 (1979) (quoting Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977)).

II. Best Practices.

Synopsis. At present, the consensus standard for "best practices" would hold that the board of directors of an investment company should be comprised of at least 75% independent directors, and should have an independent chairman. The independent directors should have the ability to engage a staff that is at their direction and control. They must – as a practical matter - have separate counsel independent from counsel to the investment adviser or sponsor of the fund. Their independent counsel is expected to attend all board meetings. The independent directors should be self-selecting and should nominate their successors. They should be well insured. The independent directors should meet separately from management. The agenda for fund board meetings should be set by the independent directors, or should be reviewed by them in advance. The fund's chief compliance and chief legal officer should report to the fund board. The fund board should adopt compliance policies and procedures to address all legal and regulatory requirements and the resolution of compliance breaches. It probably needs to be stated that fund boards remain "non-executive" in nature, and that they do not manage the fund. They do, however, supervise its management extensively.

Best Practice Sources. Current best practices can be sourced to November of 2003 when then SEC Chairman Donaldson wrote to the Mutual Fund Directors Forum asking that they, comprising effectively a committee of wise persons who were either independent directors, counsel to independent directors or persons of high standing in the investment company industry, prepare best

[4] Many of the original objectives of the 1940 Act were addressed by designating fund directors as the solution to the perceived problem. A comparative table of the original purposes of the 1940 Act and the directors' role in providing a solution is attached as Appendix 1 to this outline.

practices recommendations.[5] The Chairman noted that the impetus for his request was the fact that the SEC was then "scheduled to consider a package of rulemaking reforms designed to combat late trading and market timing abuse involving a number of mutual funds." The Chairman charged the MDF with giving guidance on:

- Management fees;
- Soft dollars;
- Distribution costs paid by fund shareholders (so called Rule 12b-1 fees);
- Brokerage arrangements;
- Revenue sharing arrangements between advisers and distributing brokers;
- Valuation and pricing of fund shares; and,
- Conflicts of interest between funds and their managers.

The MDF responded with a 58 page report in July of 2004 that made 33 best practices recommendations designed to educate and guide independent directors in particular, as set out below.

IDF Recommendation	**Author's Explanatory Comment**
1. A fund's board should adopt a statement of fundamental ethical principles to the effect that all actions taken on behalf of the fund must be in the best interests of its shareholders;	This recommendation supplements a requirement that the fund have a code of ethics governing personal investing (Section 17(j) of the 1940 Act), and insider trading (or market abuse) under Section 204A of the Investment Advisers Act.
2. The chairman of a fund's board of directors should be a person who is independent of the investment adviser and of entities affiliated with the adviser;	There is no statutory requirement as to whether or not the Chair is independent. Traditionally the Chair was a management board member, often its CEO. The 1999 ICI Study relied on the concept of a "lead independent director".
3. At least 75 percent of a fund's directors should be persons who are independent of the investment adviser and of entities	The 1940 Act typically mandates a simple majority for open-end funds – so-called "mutual funds" - because a majority is

[5] While these "best practices" are not universally employed – and are even rejected in party by prominent members of industry (such as Fidelity Investments and Vanguard Funds) – they have gained wide adherence since their dissemination in 2004. U.S. best practices for fund directors were also the subject of another prominent White Paper in 1999, before the "market timing scandals". See, "*Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness", Investment Company Institute*, June 24 1999 ("The ICI 1999 White Paper").

IDF Recommendation	Author's Explanatory Comment
affiliated with the adviser;	required if the fund engages its adviser to sell its shares to the public (a practical necessity for funds that offer redemption daily). The 1999 ICI Study recommended a two-thirds independence standard.
4. The definition of "independent of the investment adviser" should be broader than the definition of "interested person" in the Investment Company Act, adding a requirement that such "independent director" should not have been affiliated with the fund's adviser or its affiliates for at least 5 years;	The 1940 Act does not require "independence", but a lesser standard of not being an "interested person" of the adviser. Some interested persons, such as former adviser employees, can become not interested once their status changes, although some must wait 2 years. The IDF proposes a higher standard to assure greater independence. This implies that the 1940 Act standard is inadequate. The 1999 ICI Study recommended that persons never "switch hats".
5. A fund's independent directors should retain knowledgeable independent legal counsel to advise them on an ongoing basis and should have express authority to employ staff, other independent consultants and advisors to assist them in carrying out their fiduciary duties to the fund's shareholders;	The concept of "independent counsel" had its birth as a result of a case – Moses vs. Bergen – in which management fund directors were unable to defend their conduct in the board room based upon reliance on advice of external law firm counsel to the adviser who also served as sole counsel to the fund. The utility of independent counsel is now well established, as courts have taken note of independent counsel's role in upholding board decisions (see Schuyet v. Rowe Price Prime Reserve Fund, 663 F. Supp. 962 (S.D.N.Y.), aff'd., 835 F.2d 45 (2d Cir. 1987). The 1999 ICI Study made a similar recommendation.

[6] The rules under the Investment Company Act of 1940 (the "1940 Act") are: Rule 10f-3 (permitting investment companies to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of investment company assets to pay distribution expenses); Rule 15a-4 (permitting investment company boards to approve interim advisory contracts without shareholder approval); Rule 17a-7 (permitting securities transactions between an investment company and another client of the investment company's adviser); Rule 17a-8 (permitting mergers between certain affiliated investment companies); Rule 17d-1(d)(7) (permitting investment companies and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying conditions under which investment companies may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting investment companies to maintain joint insured bonds); Rule 18f-3 (permitting investment companies to issue multiple classes of voting stock); and Rule 23c-3 (permitting the operation of interval investment companies by enabling closed-end investment companies to repurchase their shares from investors).

IDF Recommendation	Author's Explanatory Comment
	The concept has evolved into a regulatory requirement – as a practical matter – as the SEC has conditioned ten of its exemptive rules on having any counsel to the independent directors be independent counsel.[6]
6. A fund's independent directors should be solely responsible for determining the level of their compensation;	This presents a potential conflict of interest, but is thought better than leaving the decision to fund management. The 1999 ICI Study also advocates this view.
7. A fund's board should require the fund's adviser to develop written policies on execution of portfolio transactions, which should be designed to help ensure that the adviser seeks best execution on all brokerage transactions; 8. A fund's board should request and review regular reports from the fund's adviser on execution of portfolio transactions; 9. A fund's board should not permit the fund's adviser to consider a broker-dealer's sale of the fund's shares or shares of other funds in the complex as a factor in allocating trades to broker-dealers;	Portfolio brokerage has long been a source of "capital" for the adviser to use to either obtain soft dollar services that benefit the adviser, or to reward brokers who also sell fund shares. While the latter practice is now illegal (1940 Act Rule 12b-1(h)), fund boards believe that the independent directors should closely review brokerage allocations, commissions and execution quality. Fund boards have been particularly sensitized to concerns that brokerage has been allegedly allocated by adviser employees in exchange for gifts and entertainment.
10. The fund's board should request and review reports on the quality of the execution a fund receives on transactions in its portfolio securities that are placed with broker-dealers in arrangements involving expense reducing directed brokerage;	US funds routinely seek to "recapture" brokerage commissions that might otherwise be used to purchase soft dollar services for the purpose of paying fund expenses, such as custody fees. While this is all fine – and even arguably a duty of the fund board – execution quality should come first.
11. Independent directors should not permit the fund's adviser to participate in soft dollar arrangements in trades for the fund;	Soft dollars are expressly permitted by law (Section 28(e) of the Securities and Exchange Act of 1934, as amended). But, soft dollars have fallen into disfavor with fund boards, who feel obliged to monitor the value of the services obtained and to identify

IDF Recommendation	Author's Explanatory Comment
	the additional value as compensation to the investment adviser. As US fund boards have to evaluate all fees paid to advisers annually, soft dollar valuations present a significant potential for compensation to the adviser that is often difficult to value, and therefore, potentially inconsistent with the board's duty to monitor the use of fund assets.
12. Independent directors should require that any trades placed with an affiliated broker-dealer receive the most favorable commission rates that the broker-dealer gives to comparable clients;	When the adviser is also a broker, the fund's trading offers a potential for exploiting the fund. Assuming that the broker charges the fund its lowest commission rate, however, the potential for abuse can be eliminated. This "most favored nation" policy requires that the fund board learn the brokerage terms for all brokerage clients of the adviser-broker, and review the adviser-broker's brokerage clients to determine their "comparability" to the fund.
13. Independent directors should review the quality of the execution a fund receives on any transactions placed with an affiliated broker-dealer;	Use of the adviser for fund brokerage should be accompanied by detailed review of trades to compare execution quality achieved by the adviser-broker in comparison to third parties. This requires measurement of execution quality by broker, and reporting to the independent directors, and their approval of the reporting methodology.
14. Independent directors should require that fund management disclose revenue sharing arrangements to the board, should review any revenue sharing arrangements annually, and should consider revenue sharing arrangements to be part of the contract renewal process, where applicable;	Revenue sharing is the term in use in the US to describe any form of compensation paid to a distributor of fund shares by the adviser (other than commissions paid by shareholders). The IDF recommends review of all payments to distributors because there is a concern that the adviser's payments to a broker may unduly influence the broker to sell fund shares over other funds, and that expenses of this type may be indirectly financed by fund advisory fees. Accordingly, fund boards involve themselves in the negotiations between distributors and fund managers.

IDF Recommendation	Author's Explanatory Comment
15. Independent directors should require that pertinent revenue sharing information be disclosed to shareholders;	It is believed that revenue sharing creates a conflict "at the point of sale" inside of the broker, and that the fund board should make sure that fund documents adequately disclose the broker's potential conflict of interest in recommending the fund shares. In this regard, it should be noted that American fund prospectuses are delivered after sale, and that the brokers are independent contractors, responsible for their own conduct.
16. The fund's board should designate a committee, consisting of some or all of the fund's independent directors, to oversee the contract review process and the committee should have a written charter; 17. Independent directors and the contract review committee should consult with independent legal counsel as needed; 18. Independent directors and the contract review committee should consider retaining unaffiliated third party consultants; 19. The contract review committee should establish a structured process for the consideration of the advisory agreement; 20. A fund's board should require the investment adviser to commit by contract to provide the independent directors with all relevant information and the contract review committee should prepare a formal written 15(c) request to obtain that information; 21. Independent directors should ask counsel for a memorandum describing their legal obligations in reviewing an investment advisory agreement; 22. The contract review committee, and	US mutual fund advisers operate under an advisory contract that – for all practical purposes – has a one year term, and must be reviewed annually by the fund's directors, with the independent directors voting separately. As a practical matter, fund boards do not put advisory services out to bid. Instead, they seek to discern whether the advisory fee approximates a fee that would have been produced through arm's length bargaining. Increasingly, the independent directors see themselves as negotiating fee reductions for the benefit of fund shareholders. The fee discussion process typically becomes an analysis of the so-called Gartenberg factors, named for the case in which the board's role was described by the US Second Circuit Court of Appeals. In addition to performance, the board considers competitiveness of the fee and the adviser's profit margins. Naturally, profitability analysis depends on a revenue and expense allocation methodology. Therefore the fund directors must approve of the allocation of revenue and expense within the adviser, at least for analytical purposes, if not in fact. Competitor data needs to be collected on performance and fees. Legal advice is needed as directors have a statutory duty to ask for sufficient information for the directors to take an informed decision.

IDF Recommendation	Author's Explanatory Comment
preferably all independent directors, should meet in person at least once, with no representatives of the adviser, including adviser affiliated directors, in attendance, to review the advisory fee report and to formulate a recommendation for the board regarding adoption or continuation of the advisory contract;	US Mutual funds advisory fees are, accordingly, reviewed annually, as are all other forms of business (e.g., brokerage) and fees (including distribution fees under Rule 12b-1).
23. A fund's board should establish a standing valuation and pricing committee to provide objectivity and the committee should have a written charter; 24. A fund's board should assure that factors and decisions it used in determining any fair valuations are documented in detail; 25. A fund's board should request that the adviser identify new situations that may require fair valuations; 26. A fund family's valuation and pricing procedures should assure that, in general, the same valuation is used consistently for a security throughout the fund family, including its public and private funds; 27. A fund's board, or the board valuation and pricing committee, should establish valuation and pricing procedures that are consistent with current regulatory guidance and the fund's public disclosures;	Fund directors have a statutory duty to determine the value of the fund's assets. While directors can and do delegate valuation to agents of the fund, the directors have a duty to set policy and supervise valuation. Therefore it is not unusual for directors to approve valuation policies, to amend them as new investments are introduced to the fund, and to meet on as needed basis to deal with unanticipated circumstances. As the need for speed is paramount in a daily priced fund, the board typically delegates its powers to one or more committees.

IDF Recommendation	Author's Explanatory Comment
28. A fund's board should establish a process for identifying and reviewing conflicts of interest;	The board may rely on the fund's chief compliance officer to assist in monitoring known conflicts. As new conflicts are inevitable, as circumstances change, conflicts must be addressed with each new proposal.
29. A fund's independent directors should establish guidelines for ownership of fund shares by directors;	Ownership of the fund by directors is believed to align their interests with shareholders', but can give rise to suitability concerns for the directors as investors. The 1999 ICI study also recommended ownership by directors.
30. The IDF recommends that the independent fund directors seek to identify conflicts of interest that may arise from "the adviser's other business activities". The fund directors should require information for their review concerning the non-investment businesses of the adviser, whenever the adviser engages in a new business, or makes a new product or service available, or alters its operation of the adviser significantly;	The independent fund director, therefore, is charged with a comprehensive understanding of the financial services company that the adviser is a part of and of developments across the entire enterprise, all with a view to identify potential conflicts of interest with the fund's shareholders.
31. Independent directors should make disclosure of their fund share ownership easily accessible;	Note that fund share ownership is disclosed in SEC filings, posted on the SEC website, and available upon request, as a matter of law. This is not available enough, however, in the IDF's view.

IDF Recommendation	Author's Explanatory Comment
32. A fund's board should conduct an annual self-evaluation review;	This has become an important aspect of the year in a life of a fund board, and is a widely adopted practice, and was also recommended by the 1999 ICI Study.
33. Each independent director of a fund should participate in ongoing educational and informational programs designed to enhance knowledge of issues relating to fund oversight.	This too is now quite common and was also a recommendation of the 1999 ICI Study. Continuing education of fund directors by counsel and by one another and by industry associations, is quite common place. Various publications serve the independent mutual fund director community as well.

The 32 best practices describe a "way" of working, but not "what" the directors should do. With that in mind, it is worth reviewing the "work" assigned to US independent fund directors.

III. The Board Meeting Agenda - Responsibilities of Independent Fund Directors.

Agenda Set By Independent Directors. The agenda of US investment company board meetings is filled with significant detail. The mandatory agenda, as set out below, is extensive. It is also considered a "best practice" for the independent directors (aided by their counsel) to be responsible for the annual agenda, and the introduction of items as may be appropriate during the year, to control the time allotted for discussion items, and to assure that the independent directors in particular, are satisfied with of the conduct of fund board meetings.

The 1940 Act Responsibilities of Directors. The 1940 Act – together with the exemptive rules - charge independent directors of a typical mutual fund with the responsibility to do (by the author's count) 25 specific tasks, as follows:

1. Determine the fair value of portfolio securities (Section 2(a)(41)(Rule 2a4(a)(1)).

2. Approve, continue or terminate investment advisory contracts (Section 15(a) and 15(c)).

    a. This includes review of performance of the adviser's performance, the nature and quality of the services provided, the competitiveness of the fees charged, and **the adviser's profitability**.

    b. As an adviser has a duty to seek best execution of securities transactions, the independent directors must review the discharge of that duty.

    c. The independent directors should supervise the use of brokerage commissions, particularly with regard to the acquisition of research and other services.

3. Approve agreements with the principal underwriter (Section 15(b)) and annually review its continuation (Section 15(c)).

4. Call a shareholder meeting if less than a majority of directors were elected by shareholders (Section 16(a)).

5. Select the accountants and auditors (Section 32(a)).

6. Select the principal accounting officer (Section 32(b))(unless selected by shareholder vote).

7. Monitor money market funds $1 net asset value based on board approved procedures to measure and – if necessary – act upon the variance between market value and $1. (Rule 2a-7).

8. Adopt procedures supervising the fund's participation in any underwriting in which the adviser (or its affiliate) acts as an underwriter. (Rule 10f-3).

9. Adopt a plan of distribution if the fund's assets will be used to pay distribution costs (directly or indirectly). (Rule 12b-1).

10. Adopt procedures to govern the transactions in portfolio securities between funds at no commission based on market prices. (Rule 17a-7).

11. Supervise the fairness of proposed mergers of the fund with other funds (Rule 17a-8).

12. Determine whether joint liability insurance policies are in the best interest of the fund (Rule 17d-1(d)(7).

13. Supervise brokerage transactions between the fund and the adviser (or its affiliates) to assure they are comparable to third party transactions (Rule 17e-1).

14. Supervise the contractual arrangements for custody of assets held by a broker acting as custodian (Rule 17f-1), self-custody arrangements (Rule 17f-2), holding of up to $500 of free cash (Rule 17f-3), and the use of securities depositories (Rule 17f-4).

15. Appoint a foreign custody manager to report on the prudence of foreign custody arrangements (Rule 17f-5).

16. Review the fund's custody arrangements, particularly with respect to foreign sub-custodians and securities depositories (Rule 17f-7).

17. Approve mandatory fidelity bonds and their form (Rule 17g-1).

18. Approve a Code of Ethics for the fund relating to personal securities transactions (Rule 17j-1).

19. Approve a written plan if the fund offers multiple share classes – such as deferred sales charge shares (Rule 18f-3).

20. Fix the time for determining the net asset value calculation (Rule 22c-1).

21. Review arrangements with respect to sales loads, and sales load schedules. In the US, sales loads are not negotiable, but can be reduced under a published schedule that discounts the loads for larger transactions charges. (Section 22(d) and Rule 22d-1).

22. Determine whether or not a redemption fee is appropriate (Rule 22c-2).

23. Adopt policies and procedures designed to assure legal compliance (Rule 38a-1).

24. Review the compensation of the fund's chief compliance officer (Rule 38a-1).

25. Approve shareholder annual report disclosure of the basis for the directors' approval and renewal of the advisory contract (Form N-1A).

The SEC's Delegation of Responsibilities to Directors. The role of investment company directors can be fairly said to that of assisting the SEC in its regulatory role. The remarks of Brian Cartright, the SEC's General Counsel in November of 2006 are both insightful, and a window into the American point of view. In his conclusion, General Counsel Cartright stated[7]:

> In many ways, we at the SEC have the same task you do: investor protection. So it's no surprise that, just like you, we at the SEC also need to be committed, vigilant and independent. Like you, America's investors have entrusted us with a tough, challenging job. Because we share the same goal, **your effective oversight complements our work at the SEC. We at the SEC benefit directly from the good work you perform as independent fund directors.** When you succeed in your role as effective independent directors, America's investors benefit. I therefore pledge my continued support and thank you from the bottom of my heart for your critical contribution to the protection of America's investors.

In addition to the statutory and rule-related responsibilities, the SEC has added to the agenda of the typical fund director ten broad responsibilities to make findings and determinations concerning:

1. Contracts with service providers (especially if affiliated with the adviser).

2. The payment of fees to fund supermarkets.

3. Review of letters of credit used to facilitate payment of redemptions if the fund participates with more than one fund.

4. Repurchase agreements and the procedures the fund will adopt to assure that it is fully collateralized.

5. Leverage – the board should review instruments that tend to have imbedded leverage to be sure that the instruments are appropriate for the fund.

[7] SEC Counsel's speech is located at: www.sec.gov/news/speech/2006/spch111506bgc.htm

6. Securities lending, and the procedures to assure collateralization and voting rights.

7. Liquidity of private placements purchased by the fund.

8. The risks and appropriate use of derivative investments.

9. Policies with respect to market timing, including the sale of fund securities through intermediaries.

10. Policies with respect to the disclosure of fund portfolio holdings, particularly selective disclosure of holdings exclusively for valid corporate purposes pursuant to confidentiality agreements.

IV. Management Directors: Their Roles and Responsibilities.

If the 1940 Act looks to the board of directors of the fund to assist in implementing the structure of these provisions and to supplement the supervision of the fund by the SEC, the 1940 Act recognizes that directors of the fund often are also directors of the fund's sponsor. These "management" directors are conflicted, and have tended to act in the bests interests of the fund sponsor, rather than the best interest of fund shareholders, as noted in Section 1 of the 1940 Act.[8]

Management directors are therefore considered "interested persons" of the fund.[9] Yet, they must discharge each of the responsibilities set out above, equally with the independent (non-interested) directors.

In addition, the management directors have been found by the courts to have a unique duty to the independent directors to provide the independents with "sufficient information so as to enable [the independent directors] to participate effectively in the management of the investment company". Fogel v. Chestnutt, 553 F2d, 731, 743 fn 13 (2nd Cir. 1975). The court in Fogel developed guidelines for management which the author takes to mean the following:

---

[8] The text of Section 1 identifies the following problems that Investment Company Act is intended to address, as follows:

"Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935 [15 USCS § 79z-4], and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

1. when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies, without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

2. when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;….."

[9] See Section 2(a)(19).

1. Communication of information by management directors must be "effective;"
2. Management must bear in mind that independent directors are not full time employees, and that they may be unfamiliar with fund operations;
3. Management must keep directors informed so that they are in a position to discharge their responsibilities; and
4. The test for whether or not management should inform the independent directors is whether the matter is one that could be thought to be of possible significance.

V The Legal Structure of Investment Company Boards.

While the Investment Company Act relies on corporate governance, and while it does so by mandating a species of "independent" director, the 1940 Act imposes different levels of "independence" on different kinds of management investment companies.

Despite the heavy emphasis on corporate governance in the 1940 Act, the 1940 Act mandates corporate governance only when Congress deemed it necessary. Even some "registered management" investment companies need only on independent director, under the 1940 Act. If an open-end, management, investment company that has no load, no redemption or purchase fee, pays no distribution costs, has one share class and one adviser, it need have only one "independent" director (see, Section 10(d), 1940 Act).

Section 10(d) gives us a good road map for the circumstances that may require added shareholder protections that can be afforded by corporate governance. An investment company needs to have *more than one* independent director if:

- Shareholders pay a commission on their investment – referred to as a sales load. Presumably funds that are not paying sales commissions can be expected to present a lesser potential for a conflict of interest between shareholder and the fund.

- Shareholders pay a purchase or redemption fee that exceeds 2%. The concern is with an excess fee.

- The fund pays – directly or indirectly – any distribution costs. Presumably when a fund does so, there is a conflict of interest.

- The fund has more than one share class. Presumably the issuance of preferred shares – with preferences with respect to dividends, or earnings afford the opportunity to treat common stock holders unfairly. Hence the need for additional independent directors.

- The fund has only one investment adviser, and its fee does not exceed 1%, and it pays all executive compensation. Presumably supervision of multiple advisers adds to complexity, calling for more independent directors, and fees less than 1% were not thought to present a high risk of conflict with fund shareholders. (This view is no longer held and 1% fees – or less – have been the subject of fairly extensive litigation under Section 36(b) of the 1940 Act.)

These "10(d) funds" are rare, but are used by advisers – to this day – to pool client accounts. If a fund fails to qualify as a Section 10(d) Company, it will fall under either Section 10(a) or Section 10(b). Section 10(a) requires that the fund have 40% non-interested directors, at a minimum. But if an "affiliated person" or an affiliated person of an affiliated person plays one of two important roles, the board must have a majority of independent directors.

- The two key roles are having an affiliate as the fund's "regular broker" or "principal underwriter". As the names suggest, a "regular broker" trades regularly as the fund's agent in portfolio transactions. 1940 Act Rule 10b-1. Apparently, brokerage is an area with the potential for self-dealing, and we should expect to see the fund's independent directors to have a special role in this regard.

- A "principal underwriter" has a contract with the fund to sell its shares to the public. One might think that all underwriters will be affiliated, but in fact, closed end funds – listed on exchanges - typically engage underwriters who are not affiliated, and the Act recognizes this. See, 1940 Act, Section 29.

- There is one other circumstance that requires a majority of independent directors, and that is the presence of an investment banker on the board, an affiliate of an investment banker, or any employee of an investment banker (See, Section 10(b)). Apparently, investment banking too, is a cause of special concern.

While the statute calls for a majority of independent trustees only under limited (but highly common) circumstances, the SEC has come to have the view that independent directors should be in the majority, if not in a super majority. The SEC can not, under US law, amend the 1940 Act, but it can use its authority to strongly encourage board composition.

- The SEC has the power, and has exercised the power, to authorize exemptions from the Act's many prohibitions, if it finds that a potential conflict of interest can be addressed by procedures, typically including board supervision of the conflict.[10]
  - These exemptions range from the profound to the modest.
  - For example, Rule 12b-1 famously authorizes the use of fund assets to pay for distribution costs, provided amongst other things, that the independent directors are in the majority.

VI. Company Law and Corporate Governance.

The Investment Company Act introduces a detailed set of tasks to be carried out in the board room by investment company directors. But that legislation does not altogether replace state law. It only does so to a limited degree, and only to the amount specifically set out in the 1940 Act. (Burks v. Lasker, 441 U.S. 471 (1975)) (State law is the source of authority for managerial power and is not displaced by the 1940 Act unless state law is inconsistent with the policy upon which the 1940 Act is based.)

[10] For a list of the rules, see footnote 6, above.

Importantly, the rights of shareholders of "investment companies" is first a question of state law, and secondarily a question of Federal law, in which Federal law sets a minimum standard for investor protection (e.g., a majority of directors must be elected by shareholders) and rights in excess of the minimum that might be provided for under state law or might not be (e.g., an annual meeting requirement).

State law establishes the basic framework for corporate governance of US companies – as there is no federal company law in the United States. Investment companies are – companies – organized under the law of a state – typically one of three major jurisdictions: Massachusetts (business trusts), Delaware (typically also as a business trust) and Maryland (corporation).

State law typically governs shareholder voting rights, indemnification and/or liability of directors, the process for authorizing share capital, capital structure of the company, the conduct of board and shareholder meetings, etc. Industry has periodically sought out forms of "companies" that can be adopted to impose no requirements not found in the 1940 Act. Today, business trusts are the vehicle of choice for this purpose. The big push in modern times away from corporate mutual funds to those of the business trust type started in Massachusetts and got is impetus with the advent of money market funds.[11]

With the passage of time, Massachusetts came to be eclipsed by Delaware as the venue of choice for mutual funds. The Delaware Statutory Trust Act allows fund sponsors to choose a form of organization that effectively imposes no requirements additional to those found in the 1940 Act.[12] In effect, the trust instrument governs the duties of directors at state law and may even alter the law of fiduciary duty.[13] For this reason, the 1940 Act as supplemented by director best practices form the detailed code of conduct for fund governance. However, directors' fiduciary duties

[11] Sheldon A. Jones, Laura M. Moret, and James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies,* 13 Del. J. Corp. L. 421 (1988). After passage of the 1940 Act, which recognized many different organizational forms as eligible for investment companies, the appearance of new business trusts declined even though a significant percentage (almost 20%) of all open-end investment funds were organized as business trusts in 1940. After 1972 the business trust form became popular for money market funds. Fund managers preferred the business trust form because it did not require a shareholders' meeting to authorize new shares, and also avoided the large fee a Massachusetts corporation once paid when it registers a large number of shares in an attempt to avoid the expense of a shareholders' meeting to authorize new shares. In fact, the SEC declared the registration statement of Fidelity Daily Income Trust effective despite the fact that it did not provide for annual election of trustees at an annual meeting in 1974. Secondly, managers believed that the business trust allowed a reverse stock split to maintain a net asset value of $1 per share. Since it is unclear whether corporate officers could effect the same reverse split, a business trust organization is preferable. The absence of a need for an annual shareholders' meeting solidified the preference for the business trust organization in mutual funds and investment companies. Mutual funds have also taken advantage of the exception afforded open-end investment companies under the 1940 Act that allows them to issue a new series of shares without having to register as a new investment company, and the 1933 Act allows such a series to be registered by amendment to the effective registration statement of the "parent." In 1984 and in subsequent private letter rulings, the IRS stated that each series of a business trust (but not a corporation) could qualify as a separate taxpayer in certain circumstances. However, in 1986 the Tax Code was reformed to provide such an advantage to investment companies regardless of whether they were organized as a corporation or a trust.

[12] Tamar Frankel, *The Delaware Business Trust Act: Failure as the New Corporate Law*, 23 Cardozo L. Rev. 325 (2001-2002). ("Business trusts could be viewed as the epitome of promoters' freedom. Trusts allow promoters to design their organizations any way they wish subject only to the pressures and judgments of the markets.")

[13] See, *Elizabeth Miller and Thomas Rutledge, The Duty of Finest Loyalty and Reasonable Decisions: the Business Judgment Rule in Unincorporated Business Organizations?,* 30 Del. J. Corp. L. 343 (2005). (Author's thesis is that when parties are allowed to bargain for the fiduciary duties that will be applied to the management of an unincorporated business organization, the business judgment rule should not be applied unless specifically bargained-for and incorporated into the organizing documents of the business.)

fundamentally arise from state law and it is those fiduciary duties that provide principles - the duty of loyalty and the duty of care - which inform the best behavior of all directors.

Appendix 1

The following table offers an illustration of how the purposes of the Investment Company Act are implemented by tasking the directors of the fund with specific responsibilities.

Problem	Corporate Governance Solution	Source
Investors purchase, pay for, exchange, receive dividends upon,	**Board role in determining fair value of fund assets and shares**. Disclosure statements must accompany dividends paid by investment companies	1940 Act Section 2(a)(xx) definition of "value" 1940 Act Section 19
vote, refrain from voting,	Solicitation of votes ("proxies") requires a proxy statement that discloses all material fact, and omits no necessary statements to avoid misleading shareholders. **Board must approve proxy statement**	1940 Act Section 20 and 1934 Act Proxy Rules
sell, or surrender securities issued by investment companies,	**Board role in determining fair value of fund assets and shares**	1940 Act Section 2(a)(xx) definition of "value"
without adequate, accurate, and explicit information, fairly presented, concerning,	**Directors must sign "registration statement" that contains the fund's prospectus**.	1933 Act Regulation C
the character of such securities,	Degree of leverage restricted by statute and must be disclosed. **Board has duty to supervised use of leverage**	1940 Act Section 18(f) and Form N1-A.
the circumstances, policies,	Certain policies must be disclosed, and may only be changed by shareholder vote. **Board has duty to supervise compliance with fund policies**	1940 Act Sections 8 and 13 1940 Act Rule 38a-1 (Fund compliance policies and procedures)
financial responsibility of such companies,	**Directors and shareholders appointment of auditors;**	1940 Act Section 32

	Role of Audit Committee Audit Committee Financial Expert	Sarbanes Oxley Act of 200[3], Section xx.
and their management.	**Investment advisory contracts must be approved by fund** shareholders, and **directors**, and may not be "assigned"	1940 Act Section 15
2. when investment companies are organized, operated, managed, or their portfolio securities are selected,	**Board duty to supervise investment adviser and/or management**	State law duty to supervise
in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers,	Affiliated persons precluded from transactions with the investment company.	Section 17(a)
in the interest of special classes of their security holders, or	Share classes prohibited from allocations that are preferential. **Board must declare and pay dividends that comply with fund policies**	Section 18
in the interest of other investment companies, or	Investments in investment companies by other investment companies restricted **Board must approve compliance policies and procedures applicable to sale of shares to other investment companies**.	Section 12(d)
persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders.	**Board's policies concerning dealing with market timers must be disclosed.**	Form N-1A