

**EXEMPTIVE RULE AMENDMENTS OF 2004:  
THE INDEPENDENT CHAIR CONDITION**

**A REPORT IN ACCORDANCE WITH THE  
CONSOLIDATED APPROPRIATIONS ACT, 2005**

**Staff Report to the  
United States Securities and Exchange Commission**

**April 2005**

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Letter from Seven Living Former Chairmen of the U.S. Securities and Exchange Commission to Chairman William H. Donaldson (June 15, 2004)

***EXEMPTIVE RULE AMENDMENTS OF 2004:  
THE INDEPENDENT CHAIR CONDITION***

**I. INTRODUCTION AND EXECUTIVE SUMMARY**

The staff of the Securities and Exchange Commission (“Commission”) has prepared this Report to the Commission pursuant to the Consolidated Appropriations Act, 2005 (“Appropriations Act”). The Appropriations Act requires the Commission to submit a report to the Senate Appropriations Committee that:

- (i) provides a justification for the final rules issued by the Commission requiring, as a condition for reliance on ten exemptive rules (“Exemptive Rules”) adopted by the Commission, that a mutual fund’s board of directors be chaired by an independent director; and
- (ii) analyzes whether mutual funds chaired by independent directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors.<sup>1</sup>

When Congress enacted the Investment Company Act (“Act”) in 1940, it determined that investment companies (“mutual funds” or “funds”) should be prohibited from engaging in certain transactions because of serious conflicts of interest.<sup>2</sup> Congress also resolved that a fund’s board of directors, particularly its independent members, should serve as “watchdogs” that protect fund shareholders’ interests and provide an independent check on management. Simultaneously,

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<sup>1</sup> Section 2, Division B, Title V of the Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, 118 Stat. 2809, 2910 (2004) provides in relevant part:

Not later than May 1, 2005, the Securities and Exchange Commission shall submit a report to the Committee on Appropriations of the Senate that provides a justification for final rules issued by the Commission on June 30, 2004 (amending title 17, Code of Federal Regulations, Parts 239, 240, and 274), requiring that the chair of the board of directors of a mutual fund be an independent director: *Provided*, That such report shall analyze whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors: *Provided further*, That the Securities and Exchange Commission shall act upon the recommendations of such report not later than January 1, 2006.

<sup>2</sup> The Investment Company Act is codified at 15 U.S.C. 80a. In this Report, references to sections 1 through 28 of the Act are to 15 U.S.C. 80a-1 through 80a-28. Because section 29 of the Act (dealing with bankruptcy) was codified in a different part of the U.S. Code, references to sections 30 through 65 are to 15 U.S.C. 80a-29 through 80a-64.

Congress granted broad authority to the Commission to provide exemptions, conditionally or unconditionally, from the Act, when the exemptions are in the public interest and consistent with the protection of investors and the purposes of the Act.<sup>3</sup> Since 1940, the Commission has adopted a variety of exemptive rules that permit otherwise prohibited transactions, but only under certain conditions – including active oversight by fund independent directors – that help to deter overreaching by fund managers and protect the interests of fund investors.

In 2003, a series of mutual fund scandals first came to light. These scandals revealed systemic breakdowns in compliance systems at funds and their advisers, weaknesses in fund governance structures, and a significant betrayal of mutual fund investors’ trust. This betrayal of trust undermined investor confidence in the mutual fund industry.

The Commission responded to the scandals in a comprehensive manner, including enforcement and regulatory actions. Since late 2003, the Commission has brought numerous enforcement cases related to mutual funds, and the cases have involved some of the most well-known names in the industry. The Commission obtained over \$2.2 billion in disgorgements and civil penalties, which will be used to compensate harmed investors. These numbers demonstrate the extent of the harm to investors and show how mutual fund managers violated investors’ trust by resolving conflicts of interest in their own favor. In addition, the Commission adopted a number of rules and rule amendments designed to ensure better compliance by funds and advisers with the federal securities laws, promote the accountability of fund officers and directors to the investors they serve, and enhance disclosure by funds and advisers to investors.

The scandals also underscored, among other things, the need for greater board independence. The Commission determined that it was necessary to further strengthen independent director oversight under the Exemptive Rules. The Commission amended the Exemptive Rules to add, among other conditions, a condition that requires funds relying on the Exemptive Rules to have independent board chairs.<sup>4</sup>

The Commission adopted the independent chair condition as a means of enhancing independent oversight of the conflicts of interest inherent in the transactions permitted by the Exemptive Rules. As the recent scandals demonstrated, active independent oversight of fund advisers and other affiliates was sorely missing in many of the leading fund complexes.

The Commission did not adopt the independent chair provision as a means of enhancing fund financial performance or reducing fund expenses. The staff, including the staff of the Division of Investment Management and the Office of Economic Analysis, examined this issue, however, and found that the empirical data regarding the relationship between an independent

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<sup>3</sup> See section 6(c) of the Act.

<sup>4</sup> See rule 0-1(a)(7)(iv). See also Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004) (“2004 Proposing Release”); Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) (“2004 Adopting Release”) (Commissioners Glassman and Atkins dissented).

chairman and fund performance and fees are inconclusive.

With respect to improved compliance, as the Commission explained when it amended the Exemptive Rules, an independent chair can improve fund compliance by helping to ensure that independent directors are in a position to provide a meaningful check on the adviser and by helping to ensure that the fund board focuses on the long-term interests of the fund's investors, rather than the often competing interests of the adviser. The independent chair also is the logical person to whom the chief compliance officer reports.

The staff recommends that the Commission and its staff continue to monitor how fund boards operate with an independent chair, especially in the context of the other regulatory changes that the Commission has recently adopted.

## **II. FUND GOVERNANCE AND CONFLICTS OF INTEREST**

### **A. CONFLICTS OF INTEREST OF FUND ADVISERS AND SERVICE PROVIDERS**

Independent director oversight of conflicts of interest has always been a critical aspect of the extensive corporate governance provisions of the Act, and has long been a cornerstone of the Exemptive Rules. Funds are organized and operated by people whose pecuniary interests lie outside the enterprise, and this structure presents the types of inherent conflicts of interest that led to the fund scandals of the 1930s, as well as the most recent scandals of the past few years. This section discusses how these conflicts of interest arise and describes independent directors' responsibilities in overseeing and monitoring these conflicts and their role in representing shareholders' interests.

A fund is a pooled investment vehicle.<sup>5</sup> Investors provide money to the fund by purchasing securities that the fund issues. The fund then invests the money in assets, including securities and cash instruments, that comprise its portfolio. The investment adviser, or "manager" of the fund, determines which assets the fund will own, based on various considerations such as the fund's investment policy and investment restrictions, the price and value of available assets, and the fund's need for liquid investments. Investors hope to profit by the professional management of those portfolio assets when they redeem or otherwise dispose of their shares.

Unlike other types of commercial companies, a fund consists mostly of a pool of securities. With few exceptions, funds typically have no employees of their own. The fund is

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<sup>5</sup> A fund is usually formed as a corporation or business trust under state law, which requires that the fund be operated for the benefit of its shareholders. Directors of funds and other business corporations owe duties of loyalty and care. The duty of loyalty prohibits directors from using their positions to benefit themselves at the expense of the fund and its shareholders. The duty of care requires that a director use the degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances or in the management of his own affairs.

organized and operated by a sponsor that intends to serve as the investment manager of the fund's assets and the affiliated principal underwriter (initial distributor) of the fund's shares.<sup>6</sup> A fund therefore begins its life at the initiative of a future business partner – an investment advisory firm, broker-dealer, insurance company, or bank.<sup>7</sup> A fund contracts with an investment adviser, underwriter (distributor), and other service providers to perform principal functions for the fund on a fee basis. The officers of the fund typically are employed and compensated by those outside organizations.<sup>8</sup>

As illustrated in the diagram below, a fund is owned by the investors who purchase the shares issued by the fund. The fund also is typically dominated by an investment adviser that provides investment management and administrative services to the fund. The diagram also illustrates the fact that the fund's investment adviser generally has its own shareholders, to whom it owes a duty to seek favorable returns.

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<sup>6</sup> For purposes of this Report, we will refer to a fund's sponsor interchangeably as the fund's investment adviser or management company. Under the Investment Company Act, management of a fund generally refers to the active selection of investments. *See, e.g.*, section 5 of the Act (subclassification of *management* investment companies). *See also Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 251 (1940) ("S. 3580 Hearings")* (statement of David Schenker, Chief Counsel of the Investment Trust Study) (referring to a fund's "management contract," *i.e.*, an advisory contract, as a contract in which "individuals are given the power to give investment advice and in many instances *manage* the portfolio") (emphasis added).

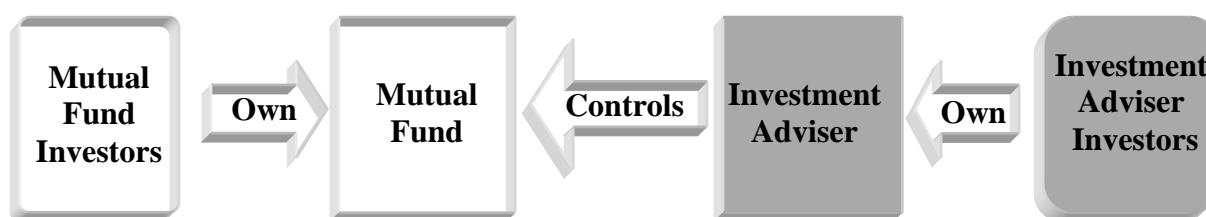
<sup>7</sup> Until 1999, banks were prohibited by the Glass-Steagall Act from engaging in the mutual fund business. During the mid-1980s and through much of the 1990s, those restrictions were incrementally relaxed by the Federal Reserve and the Comptroller of the Currency through the exercise of rulemaking and interpretive authority. The prohibitions were finally removed by provisions of the Gramm-Leach-Bliley Act in 1999.

<sup>8</sup> *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999) ("1999 Interpretive Release") at Section I.A. *See also* 1 T. Frankel, THE REGULATION OF MONEY MANAGERS § 1.01[B] and § 12.01 (2001). Some funds, however, (*e.g.*, the Vanguard funds) are managed by a company that the funds in the same complex jointly own. These "internally" managed funds are not subject to many of the conflicts of interest that are inherent in externally managed funds.

### Common Ownership Structure of a Corporation



### Common Ownership Structure of a Mutual Fund



The external management structure of funds that pervades the industry exposes funds to the risk of harm at the hands of their outside managers and service providers. Conflicts of interest arise because fund shareholders and the advisers that manage the fund have overlapping, but not identical, interests. The legal structure under which funds operate is designed to place an independent check on the fund managers and guide the resolution of conflict issues.<sup>9</sup>

***Alignment of Interest.*** In some important areas, the interests of fund shareholders and investment advisers are aligned. For example, shareholders of the fund and of the fund's investment adviser usually have a mutual interest in maximizing the fund's performance.

***Conflicts of Interest.*** In other areas, however, the interests of fund shareholders and investment advisers diverge. Investment advisers typically manage the fund in exchange for a fee based on a percentage of the assets under management. It is therefore in the investment adviser's interest to maximize the assets under management so that it can maximize its compensation. By contrast, it is in the fund investors' interest to increase assets under management to the extent that the increase achieves the economies of scale that should reasonably accompany fund growth. Fund advisers may have means of attracting assets that are not in the best interests of long-term shareholders. In a number of recent Commission enforcement actions, for example, investment advisers were found to have entered into transactions that sought to gain new assets from large private investors who were given undisclosed rapid trading and market timing privileges to the disadvantage of investors seeking

<sup>9</sup> See Section II.B below.

long-term returns.<sup>10</sup>

The interests of fund shareholders and the interests of the fund's investment adviser also may be at odds in other circumstances. For example, rule 12b-1 permits the use of fund assets to pay for the distribution of fund shares, a practice commonly known as charging "12b-1 fees." An investment adviser's compensation generally increases with an increase in fund assets under management. Thus, the adviser has a financial interest in encouraging the fund to charge higher 12b-1 fees to be spent on the sale and promotion of fund shares in order to maximize fund assets. The fund adviser also has little incentive to curb 12b-1 fees because the fund, rather than the adviser, pays 12b-1 fees.<sup>11</sup> Another example of a potential conflict of interest might occur when a fund adviser sells its business, including the fund's investment advisory contract. The investment adviser may be able to profit significantly from the sale of the advisory contract to another adviser while the funds' shareholders may be harmed if there is a lapse in services or the new adviser provides inferior service or charges higher fees. Rule 15a-4 addresses the conflict by limiting the circumstances under which a successor investment adviser may provide services under an interim advisory contract without shareholder consent. Rules 12b-1 and 15a-4 (as well as the other Exemptive Rules) control these types of conflicts through, among other things, the use of independent director oversight.<sup>12</sup>

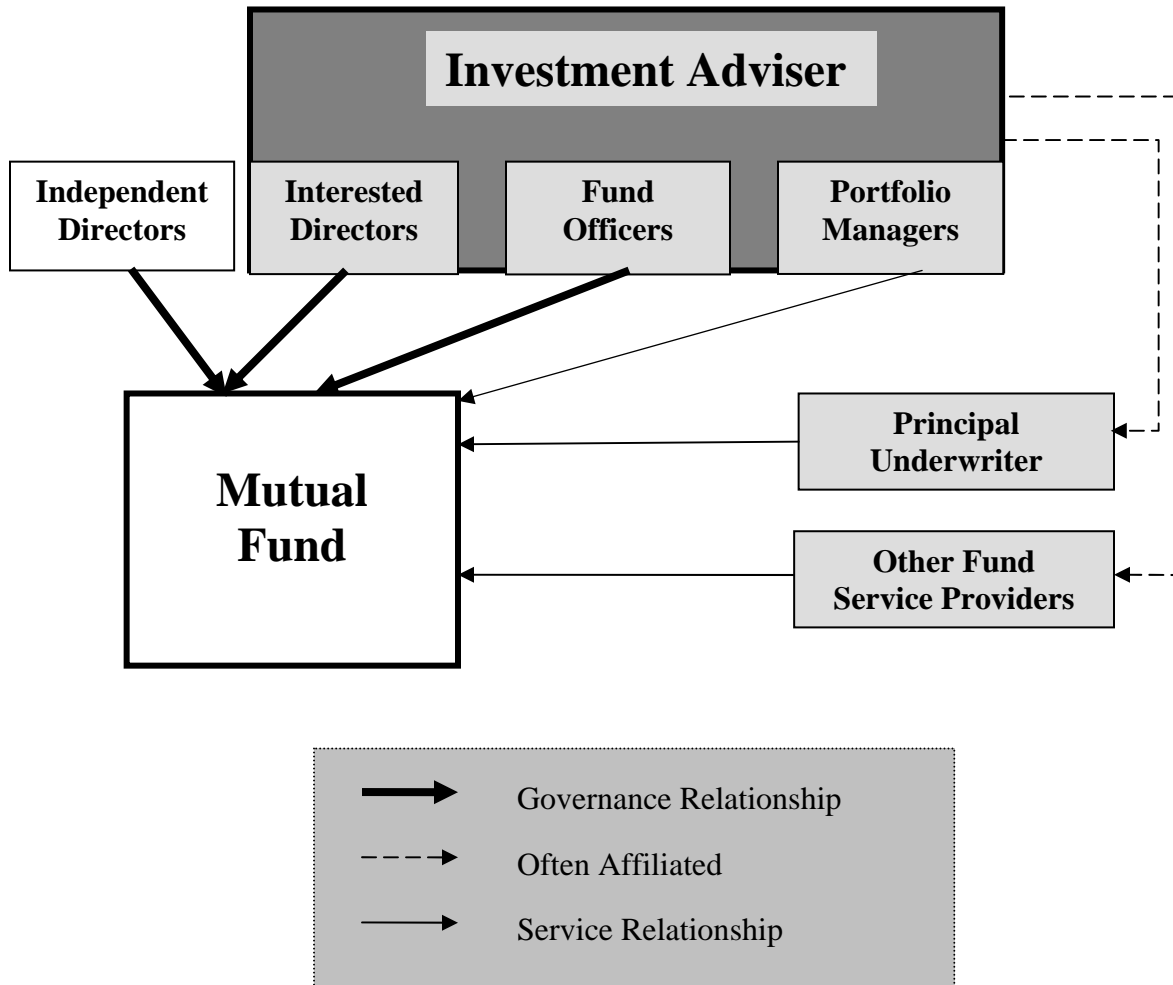
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<sup>10</sup> See, e.g., *In the Matter of Banc of America Capital Management, LLC*, Investment Company Act Release No. 26756 (Feb. 9, 2005) ("*Banc of America Order*"); *In the Matter of Fremont Investment Advisors, Inc.*, Investment Company Act Release No. 26650 (Nov. 4, 2004) ("*Fremont Order*"); *In the Matter of Invesco Funds Group, Inc.*, Investment Company Act Release No. 26629 (Oct. 8, 2004) ("*Invesco Order*"); *In the Matter of Massachusetts Financial Services Co.*, Investment Company Act Release No. 26347 (Feb. 5, 2004) ("*MFS Order*"); *In the Matter of Strong Capital Management, Inc.*, Investment Company Act Release No. 26448 (May 20, 2004) ("*Strong Order*").

<sup>11</sup> See rule 12b-1 under the Act; see also *Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies*, Investment Company Act Release No. 16431 (June 13, 1988) ("*12b-1 1988 Proposed Amendments*"), at text accompanying nn.6-7.

<sup>12</sup> See Section II.E below.

## Common Fund Relationships



### B. HOW THE INVESTMENT COMPANY ACT PROTECTS FUNDS FROM CONFLICTS OF INTEREST

In the 1920s and 1930s, investors in funds suffered grievous losses caused to a great extent by the operation of funds in the interest of investment advisers and other affiliates, rather than the interest of fund shareholders.<sup>13</sup> In examining those harms, Congress determined to

<sup>13</sup> The Senate Committee on Banking and Currency's report on the bill (which later became the Act) concluded that:

[C]ontrol of [the liquid assets of investment companies] offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have

address the potential harm to fund investors by prohibiting certain activities rather than relying solely on the disclosure approach of the earlier federal securities laws.<sup>14</sup>

To address the unique types of harm to investors that fund structures can pose, the Investment Company Act sets out a detailed and substantive regulatory framework for funds. Among other things, the Act:

- restricts activities that pose a significant risk of harm to shareholders, such as affiliated transactions;
- imposes extensive requirements for fund structure, operations, and governance; and
- requires all funds to register and file reports with the Commission if they publicly offer their securities.

The restrictions in the first category – affiliated transactions – are especially important for fund operations. Section 17 of the Act, for example, prohibits or restricts a wide range of affiliated

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been employed to foster their personal interests rather than the interests of public security holders.

S. REP. NO. 76-1775, at 6, 3d Sess. (1940) (“S. REP. NO. 1775”). *See also* section 1(b) of the Act (finding that “the national public interest and the interest of investors are adversely affected – ... (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, [or] investment advisers ... rather than in the interest of all classes of such companies’ security holders”).

<sup>14</sup> *See, e.g.*, section 17 of the Act. *See also Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 67th Cong., 3d Sess. 64 (1940) (“H.R. 10065 Hearings”)* (statement of Robert E. Healy, Commissioner, Securities and Exchange Commission) (“[D]uring the period that the Securities Act has been in effect, since 1933, some of the worst abuses have occurred. The Securities Act and the Securities and [sic] Exchange Act provide no regulation whatever of these investment trusts. They are simply required to make disclosure. The pending measure is a regulatory measure. It undertakes to regulate certain practices and to stop certain things. And, the Securities Act undertakes no such results. Under the Securities Act if a man makes a complete disclosure, he can do anything, almost, that he pleases; but there are certain practices that have happened in connection with investment companies that I think everybody agrees – I think certainly everybody in the industry I have talked with agrees – ought to be stopped, and they cannot be stopped by mere disclosure.”); Pacific Scholarship Trust Sponsored by Pacific Scholarship Fund, Investment Company Act Release No. 8065 (Oct. 31, 1973), at n.11 and accompanying text (“The Investment Company Act, passed in 1940 ... is a recognition by Congress that the disclosure requirements of the pre existing legislation did not meet the special problems presented by investment companies and that regulatory measures were needed to control those companies and to prohibit certain practices by them.”).

transactions that, as history has shown, pose risks of harm from self-dealing by fund affiliates.<sup>15</sup> Similarly, section 10(f) of the Act prohibits a fund from acquiring securities from an affiliated underwriting syndicate, which poses a risk that the fund will be used as a “dumping ground” for the syndicate’s unmarketable securities.<sup>16</sup>

**C. RESPONSIBILITY OF FUND DIRECTORS TO ADDRESS CONFLICTS OF INTEREST**

**1. Independent Directors Oversee and Monitor Conflicts of Interest**

Congress recognized and directly addressed the conflicts of interest that exist on the part of fund advisers and other fund affiliates. It provided fund boards with specific responsibilities designed to help protect the fund from overreaching by these affiliates. In the words of the U.S. Supreme Court, Congress intended that a fund’s board of directors, and particularly the board’s independent members, should serve as “watchdogs” that protect shareholders’ interests and furnish an “independent check upon management.”<sup>17</sup>

The Investment Company Act therefore provides, among other requirements, that:

- at least 40 percent of a fund’s board must be independent directors;<sup>18</sup>
- if a fund uses an affiliate as a broker or as an underwriter of its securities, at least a majority of the fund’s board must be independent directors;<sup>19</sup>
- if a fund is a business development company, at least a majority of its board must be independent directors; and<sup>20</sup>

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<sup>15</sup> Section 17 is a core provision of the Act. *See S. 3580 Hearings*, note 6 above, at 779 (statement of Prof. E. Merrick Dodd, Jr.) (“Section 17 of the bill ... is designed to prevent so far as possible what experience proves to have been one of the principal abuses in the investment trust industry.”). *See also* DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 500 (1992) (“1992 REPORT”) (“The [Investment Company] Act’s restrictions on transactions with affiliates are among its core provisions.”).

<sup>16</sup> One of the major abuses noted in the period preceding the Act was the use of investment companies as a “dumping ground” for otherwise unmarketable securities. *See S. 3580 Hearings*, note 6 above, at 35 (statement of Commissioner Healy).

<sup>17</sup> *See Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977); *H.R. 10065 Hearings*, note 14 above, at 109).

<sup>18</sup> Section 10(a) of the Act.

<sup>19</sup> Section 10(b)(1) - (2) of the Act.

<sup>20</sup> Section 56(a) of the Act.

- in order for an adviser to receive a benefit in connection with the sale of an advisory business in reliance on the statutory safe harbor, at least 75 percent of the fund’s directors must be independent for the three years following the assignment of the advisory contract.<sup>21</sup>

The Act also requires that the board of directors, and separately its independent directors, evaluate and approve the fund’s contract with its adviser and the fee arrangements under the contract.<sup>22</sup> Similar authority is given to the board and its independent directors with respect to a fund’s underwriting contracts.<sup>23</sup> The board’s independent directors are also responsible for selecting the fund’s independent public accountant.<sup>24</sup>

## 2. Commission Exemptive Orders and Rules Also Rely on Independent Directors to Monitor Conflicts of Interest

The Act gives the Commission significant discretion to regulate funds. In at least 33 separate provisions, it authorizes the Commission to issue orders for different types of exemptive relief from specific statutory requirements. The broadest of these exemptive provisions is section 6(c),<sup>25</sup> which authorizes the Commission, by rule or by order, to:

conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions of [the Act] or of any rule or regulation thereunder, *if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions [of the Act].*<sup>26</sup> (Emphasis added.)

Congress included this section to provide the Commission a wide degree of administrative flexibility<sup>27</sup> and allow it to deal with developments and circumstances in the markets and funds

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<sup>21</sup> Section 15(f) of the Act.

<sup>22</sup> See sections 15(a) and 15(c) of the Act.

<sup>23</sup> Sections 15(b) and 15(c) of the Act.

<sup>24</sup> Section 32(a)(1) of the Act.

<sup>25</sup> Other provisions of the Act similarly authorize the Commission to provide exemptive relief, conditionally or unconditionally. For example, section 10(f), which prohibits funds from purchasing securities in an affiliated underwriting, also expressly authorizes the Commission to exempt transactions or classes of transactions conditionally or unconditionally, by rule or by order.

<sup>26</sup> The policy provisions of the Act are contained in section 1(b). See note 13 above and accompanying text.

<sup>27</sup> In 1996, Congress reiterated the benefits of providing exemptive relief when it added exemptive authority – nearly identical to that provided in section 6(c) of the Act – to the Securities Act of 1933 and the Securities Exchange Act of 1934 when it passed the National Securities Markets

that Congress could not foresee.

Since 1940, the Commission has periodically reviewed the fund governance framework and undertaken a number of initiatives to enhance the independence and effectiveness of independent directors. For example, in the 1960s the Commission conducted a study on the adequacy of the independence standard applicable to independent directors under the Act. At that time, any person who was not an officer, employee, or the investment adviser of a fund was eligible to serve as an independent director of the fund. The Commission found that the Act's standard of independence for non-affiliated directors was inadequate.<sup>28</sup> After the issuance of this report, Congress in 1970 amended the Act to require that independent fund directors not be "interested persons" of the fund. These amendments tightened the standards of independence required of independent directors.<sup>29</sup>

The timeline on the next page illustrates some of the Commission's efforts to enhance the effectiveness of independent directors in overseeing fund operations and fund management's conflicts of interest in recent decades.

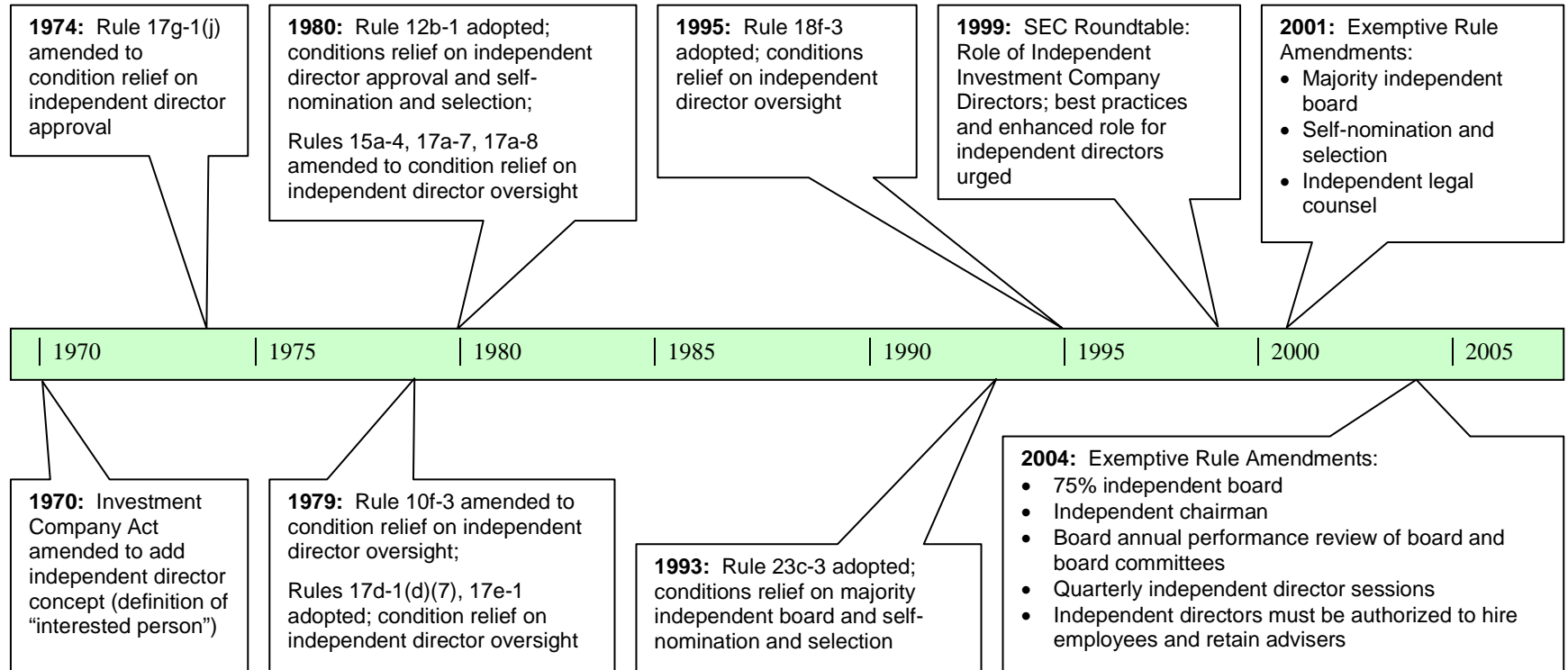
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Improvement Act. The Senate Committee Report stated that "[t]he Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the Commission general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues related to the securities markets more generally." S. REP NO. 104-293, at 15 (1996). *See* Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 344 (1941) ("The most important and far reaching of these [other] grants of power [to the Commission] is that of § 6(c) .... Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive, and would cause unnecessary hardships.").

<sup>28</sup> *See* SECURITIES AND EXCHANGE COMMISSION REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 30 (1966) ("PPI REPORT") (finding, among other things, that non-affiliated directors could be close to the adviser through business or family relationships).

<sup>29</sup> *See* section 2(a)(19) of the Act (defining "interested person"). *See also* note 37 below (discussing definition).

## Fund Governance Timeline



Funds have grown from \$40 billion in assets in the 1960s to \$8.1 trillion today.<sup>30</sup> The complexities of the market have opened new opportunities to use fund assets to pay for services that present conflicts of interest. While these opportunities can benefit fund investors, they also can benefit fund managers. As a result, the need for exemptive relief has grown to keep pace with changes in business practices and to accommodate financial innovation. Accordingly, the Commission has adopted rules that permit funds and their affiliates to operate in certain ways that would otherwise be prohibited under the Act. Many benefits have flowed to investors and funds as a result of the Commission's exercise of its conditional exemptive authority, including the development of money market funds, exchange traded funds, and multiple classes of fund shares.<sup>31</sup> The exemptive rules permit certain activities only under conditions that are designed to help ensure that funds and their investors are adequately protected from the risks posed by the conflicts of interest. Some of the conditions that the Commission has included as a part of its exemptive orders and rules include:

***Independent Legal Counsel.*** If a fund hires subadvisers without holding a shareholder vote and does not separately disclose the advisory fee of the subadvisers and adviser, the independent directors must have independent legal counsel.<sup>32</sup>

***Independent Bidding Process.*** If a "principal protected fund" decides to enter into an arrangement with an affiliate, the fund must use a bidding process that the independent directors approve and oversee.<sup>33</sup>

***Separate Advisory and Broker-Dealer Operations.*** If a fund buys or sells tax-exempt money market instruments through an affiliated broker, the fund must maintain information barriers, reporting lines, and compensation structures.<sup>34</sup>

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<sup>30</sup> As of December 31, 2004, there were 8,046 mutual funds with assets of \$8.1 trillion, 620 closed-end funds with assets of \$254.4 billion, and 6,485 unit investment trusts with a value of \$36.8 billion. See Investment Company Institute, *Trends in Mutual Fund Investing* (Jan. 28, 2005) available at [http://www.ici.org/stats/mf/trends\\_12\\_04.html](http://www.ici.org/stats/mf/trends_12_04.html); Investment Company Institute, *Closed-End Fund Assets: Fourth Quarter 2004* (Feb. 23, 2005) available at [http://www.ici.org/stats/ce/cef\\_12\\_04.html](http://www.ici.org/stats/ce/cef_12_04.html); Investment Company Institute, *Unit Investment Trust Data: February 2005* (Mar. 21, 2005) available at [http://www.ici.org/stats/uit/uits\\_02\\_05.html](http://www.ici.org/stats/uit/uits_02_05.html).

<sup>31</sup> See 1992 REPORT, note 15 above, at 506-07.

<sup>32</sup> See, e.g., Frank Russell Investment Company, Investment Company Act Release Nos. 21108 (June 2, 1995) (notice) and 21169 (June 28, 1995) (order). A subadviser generally is an investment adviser under contract to the fund or the fund's adviser to manage a portion of the fund's portfolio.

<sup>33</sup> See, e.g., Merrill Lynch Principal Protected Trust, Investment Company Act Release Nos. 26164 (Aug. 20, 2003) (notice) and 26180 (Sept. 16, 2003) (order). In a "principal protected fund," a shareholder who holds fund shares for a specified period of time can redeem the shares at the end of the time and recoup the initial investment (less expenses).

<sup>34</sup> See, e.g., Goldman Sachs Trust, Investment Company Act Release Nos. 24834 (Jan. 23, 2001)

**Limits on Control.** If a fund engages in securities transactions with an affiliated broker-dealer or bank, the fund must not be controlled by the affiliated broker-dealer or bank and must be primarily controlled by a separate entity.<sup>35</sup>

**Audit Reports.** If a fund engages in cash lending transactions with affiliated funds, the fund must prepare an initial report describing the procedures to be implemented that will ensure that the fund is treated fairly, and have an independent public accountant prepare a report evaluating those procedures for the subsequent two years.<sup>36</sup>

#### **D. EXEMPTIVE RULES**

On July 27, 2004, the Commission adopted the independent chair provision as one of several amendments that added conditions to the use by a fund of any of the Exemptive Rules. The Exemptive Rules have long been conditioned upon the judgment and scrutiny of the funds' independent directors to oversee these conflicts of interest.<sup>37</sup>

Each of the Exemptive Rules that the Commission amended in 2004 (and had earlier amended in 2001) is a rule that:

- conditionally exempts funds or their affiliates from certain provisions of the Act that prohibit transactions that involve serious conflicts of interest; and
- relies on the approval or oversight of independent directors in overseeing the permitted transaction or activity.

The table below lists the Exemptive Rules. The next section discusses those rules in greater depth, including the important role of independent directors in monitoring the activities of funds and their affiliates under the rules.

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(notice) and 24877 (Feb. 21, 2001) (order).

<sup>35</sup> See, e.g., American Century Companies, Inc., Investment Company Act Release Nos. 25449 (Mar. 1, 2002) (notice) and 25501 (Mar. 27, 2002) (order).

<sup>36</sup> See, e.g., SEI Institutional Managed Trust, Investment Company Act Release Nos. 26762 (Feb. 17, 2005) (notice) and 26783 (Mar. 15, 2005) (order); Dreyfus Founders Funds, Inc., Investment Company Act Release Nos. 26487 (June 24, 2004) (notice) and 26499 (July 20, 2004) (order).

<sup>37</sup> The term "independent," as used in the Commission's 2004 Adopting Release, note 4 above, describes a director who is not an "interested person" of the fund, as defined by section 2(a)(19) of the Act. Interested persons of a fund include, among others, the fund's investment adviser and its affiliated persons, such as its officers, directors, and employees, and members of their immediate families.

### Exemptive Rules

1.	Rule 10f-3	Permitting funds to purchase securities when an affiliated broker-dealer is a member of the underwriting syndicate
2.	Rule 12b-1	Permitting use of fund assets to pay distribution expenses
3.	Rule 15a-4	Permitting fund boards to approve temporary advisory contracts without shareholder approval
4.	Rule 17a-7	Permitting securities transactions between a fund and another client of the fund's adviser
5.	Rule 17a-8	Permitting mergers between affiliated funds
6.	Rule 17d-1(d)(7)	Permitting funds and their affiliates to purchase joint liability insurance policies
7.	Rule 17e-1	Specifying circumstances in which funds may pay commissions to affiliated brokers
8.	Rule 17g-1(j)	Permitting funds to maintain joint insured bonds
9.	Rule 18f-3	Permitting funds to issue multiple classes of voting stock
10.	Rule 23c-3	Permitting closed-end funds to repurchase their shares from investors

Congress viewed the conflicts of interest inherent in the transactions covered by the Exemptive Rules as being so serious that it imposed a complete prohibition on those transactions. At the same time, however, Congress gave the Commission broad authority in Section 6(c) of the Act to grant exemptions by order or rule, “conditionally or unconditionally,” from these prohibitions.<sup>38</sup> In his remarks to Congress recommending the bill that later became the Act, David Schenker, Chief Counsel of the Commission’s Investment Trust Study and a principal author of the Act, explained that “the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities ... is precisely [the

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<sup>38</sup> Typically, a fund seeking an exemption must file an application for an exemptive order explaining the purpose of the requested exemption and any conditions to be imposed on the fund in connection with the exemption. When the Commission determines it appropriate, it may adopt an exemptive rule upon which any fund may rely without the need for applying to the Commission. *See generally* 1992 REPORT, note 15 above, at 503-22.

reason that section 6(c)] is inserted.”<sup>39</sup> The Commission has relied extensively on oversight by independent directors in rules that exempt funds from various prohibitions under the Act. Long before the Exemptive Rules were amended in 2001 to provide for a majority independent board, reliance by a fund and its affiliates on any of the Exemptive Rules was expressly conditioned upon the oversight of the independent directors.

As the Exemptive Rules were adopted or amended at various times over a period of five decades, each rule provided for independent director oversight. The Commission explained that, because the adviser may have a “significant self-interest” in a transaction, an exemption pertaining to the transaction should be conditioned upon approval of the independent directors “to ensure that the interests of the investment companies and their shareholders ... are not compromised.”<sup>40</sup> The Commission has pointed out that oversight by independent directors is particularly important in the case of an exemptive *rule* because, unlike in the case of an individual application for an exemption, the Commission staff would no longer individually review the transactions exempted under the rule.<sup>41</sup> When it adopted Rule 12b-1 in 1980, the Commission discussed the connection between greater oversight by independent directors and reduced oversight by Commission staff. Citing a study then being conducted, the Commission said:

Two central goals of the Study are to permit investment companies to exercise wider latitude in making business judgments without Commission approval and to enhance the role of directors, particularly the disinterested directors, in scrutinizing investment company affairs. These goals are interdependent in that the more capable the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce regulatory restrictions.<sup>42</sup>

Under the Exemptive Rules, then, reliance is placed on the independent directors, rather than the Commission, to oversee any conflicts of interest in the transactions permitted by the rules and to protect the interests of fund investors.<sup>43</sup>

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<sup>39</sup> *S. 3580 Hearings*, note 6 above, at 197.

<sup>40</sup> Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 10886 (Oct. 2, 1979) (“17a-8 Proposing Release”), at text following n.11.

<sup>41</sup> Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, Investment Company Act Release No. 11676 (Mar. 10, 1981), at nn.6-7 and accompanying text (adopting an amendment to Rule 17a-7).

<sup>42</sup> Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) (“12b-1 Adopting Release”), at text preceding n.50 (paragraph following “Independence of Directors” heading).

<sup>43</sup> Congress took the same tack when it enacted the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980), which exempted certain funds defined as “business development companies” from various provisions of the Act. In requiring that their

**Amendments in 2001.** In the late 1990s, industry developments and enforcement actions called into question the effectiveness of fund independent directors.<sup>44</sup> In response to these concerns, the Commission conducted a two-day public roundtable discussion on fund governance in 1999.<sup>45</sup> Later that year, the Commission proposed to amend the Exemptive Rules to include conditions designed to enhance the independence and effectiveness of independent directors of funds that rely on any of those rules. The rule amendments were designed “to reaffirm the important role that independent directors play in protecting fund investors, strengthen their hand in dealing with fund management, reinforce their independence, and provide investors with better information to assess the independence of directors.”<sup>46</sup> The Commission received 142 comment letters on its proposal, including 86 letters from independent

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boards be majority independent, the House Committee on Interstate and Foreign Commerce explained:

The special [*i.e.*, exempt] status of such companies under the Act places particular responsibility on their boards of directors to assure compliance with the Act’s provisions, *particularly where board approval is made expressly a substitute for Commission review or for a per se restriction.* The Committee believes that the protection afforded by the board of directors in these instances – and in the governance of the company generally – is best assured to the extent that directors are not otherwise affiliated with the company, and hence are able to exercise their business judgment without the conflicts of interest inherent in service in multiple capacities.

H.R. REP. NO. 96-1341, at 25 (1980) (emphasis added).

<sup>44</sup> The Commission instituted three enforcement actions against independent directors of funds who failed to meet their legal responsibilities. *See In the Matter of Parnassus Investments*, Initial Decision Release No. 131 (Sept. 3, 1998), *initial dec. final* (Oct. 8, 1998); *In the Matter of the Rockies Fund, Inc.*, Investment Company Act Release No. 26202 (Oct. 2, 2003) (proceedings instituted on June 1, 1998), Order Denying Motions for Reconsideration (June 1, 2004); *In the Matter of Monetta Financial Services, Inc.*, Investment Company Act Release No. 26070 (June 9, 2003) (proceedings instituted on Feb. 26, 1998). Private legal actions at that time also challenged the independence of independent directors. *See Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997), *rearg. den.*, 1997 WL 473566, Fed. Sec. L. Rep. 99,533 (S.D.N.Y. 1997); *Strougo v. Bassini*, 1 F. Supp.2d 268 (S.D.N.Y. 1998), *settlement approved*, 258 F. Supp.2d 254 (S.D.N.Y., 2003); *Strougo v. BEA Associates*, 98 Civ. 3725 (S.D.N.Y. 1999), *dismissed*, 188 F. Supp.2d 373 (S.D.N.Y. 2002); *Verkouteren v. Blackrock Financial Management, Inc.*, 37 F. Supp.2d 256 (S.D.N.Y. 1999), *dismissal upheld*, 208 F.3d 204 (2d Cir. 2000). *See also* Edward Wyatt, *Empty Suits in the Board Room; Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung*, N.Y. TIMES, June 7, 1998, at C1.

<sup>45</sup> The roundtable discussion included independent directors, fund executives, investor advocates, legal counsel, and academics who offered a range of views and recommendations. *See* SEC, Notice of Sunshine Act Meetings (Feb. 18, 1999). *See also* Transcripts from the Roundtable on the Role of Independent Investment Company Directors, February 23-24, 1999 (<http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm>).

<sup>46</sup> *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082 (Oct. 14, 1999), at text following n.1.

directors.<sup>47</sup> Commenters, including funds, their advisers, and investors, largely supported the proposed amendments.

The Commission adopted the amendments in 2001, which added fund governance conditions to enhance the independence and effectiveness of independent directors of funds that rely on the rules.<sup>48</sup> The amendments required that, for funds relying on any of the Exemptive Rules:

- independent directors constitute at least a majority of the fund’s board of directors (rather than the minimum 40 percent required by the Investment Company Act);<sup>49</sup>
- independent directors select and nominate other independent directors; and
- any legal counsel for the fund’s independent directors be *independent* legal counsel.

The 2001 amendments also made important changes to Commission disclosure requirements by requiring funds to provide better information about the fund’s board and its directors, including: (i) basic information about the identity and experience of directors; (ii) fund shares owned by directors; (iii) information about directors that may raise conflict of interest concerns; and (iv) information about the board’s role in governing the fund.<sup>50</sup>

#### **E. THE EXEMPTIVE RULES REQUIRE INDEPENDENT DIRECTORS TO MONITOR CLOSELY FUND ACTIVITIES UNDER THE RULES**

We discuss the Exemptive Rules below in more detail – the relief provided by the rules, the risks to funds and investors presented by the activities covered by the rules, and the need for

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<sup>47</sup> The comment letters and a summary of the comments prepared by the Commission staff are available on the Commission’s Internet web site: [www.sec.gov/rules/proposed/s72399.shtml](http://www.sec.gov/rules/proposed/s72399.shtml) (comment letters); [www.sec.gov/rules/extra/brownin1.htm](http://www.sec.gov/rules/extra/brownin1.htm) (comment summary).

<sup>48</sup> Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001).

<sup>49</sup> As discussed above, other provisions of the Act require a super-majority of fund directors to be independent in certain circumstances. *See, e.g.*, note 21 above and accompanying text.

<sup>50</sup> In addition, the new rules and rule amendments: (i) prevented qualified individuals from being disqualified from serving as independent directors because they invest in index funds that hold shares of the fund’s adviser or other affiliates; (ii) protected the independence of independent directors by requiring that joint “errors and omissions” insurance policies not exclude coverage for lawsuits against them brought by investment advisers; (iii) encouraged the development of independent audit committees by exempting funds with these committees from seeking shareholder approval of the funds’ auditors; and (iv) required funds to keep any records they rely on to assess the independence of independent directors and independent directors’ counsel.

independent directors to oversee fund activities under the rules.

### 1. Rule 10f-3 – Purchase of Securities in Affiliated Underwritings

*The rule permits funds to purchase securities if an affiliated broker-dealer is a member of the underwriting syndicate.*

**Why Congress generally prohibited activities in this area.** Section 10(f) of the Act prohibits a fund from purchasing securities if an affiliated underwriter is acting as a principal underwriter of those securities. This section was designed to prevent funds from being used as a “dumping ground” for unmarketable securities.<sup>51</sup> This was one of the major abuses prevalent in the period before enactment of the Investment Company Act.<sup>52</sup> There is an inherent conflict of interest when underwriting participants have business relationships with a fund or its adviser that purchases securities in an offering.<sup>53</sup>

**How the Exemptive Rule protects investors.** The conditions for relying on rule 10f-3 include: (i) registration of certain types of securities purchased in reliance on the rule; (ii) prohibition of purchasing securities directly from the underwriter that is affiliated with the fund; (iii) percentage limits on purchases under the rule; and (iv) close oversight by the fund’s board of directors, including independent directors.<sup>54</sup>

**Why board involvement is important under this Exemptive Rule.** If a fund relies on the rule, the board (including a majority of independent directors) must, among other things: (i) approve fund procedures regarding purchases; and (ii) determine at least quarterly that the fund’s purchases complied with the procedures. The Commission has emphasized that directors should be “vigilant” in reviewing the fund’s compliance with the procedures under rule 10f-3, and also “in conducting any additional reviews that it determines are needed to protect the interests of investors.”<sup>55</sup> The independent directors’ involvement helps to ensure that the shareholders’ representatives continually monitor securities transactions in which the fund adviser may have a financial interest in purchasing from a syndicate that includes an affiliate.

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<sup>51</sup> See Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 22775 (July 31, 1997) (“10f-3 1997 Release”), at text following n.1.

<sup>52</sup> See SECURITIES AND EXCHANGE COMMISSION, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-279, pt. 3, at 2581, 2589 (1940) (“INVESTMENT TRUST STUDY”).

<sup>53</sup> See Transactions of Investment Companies with Portfolio and Subadviser Affiliates, Investment Company Act Release No. 25888 (Jan. 14, 2003), at text following n.44.

<sup>54</sup> See Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10592 (Feb. 13, 1979) (stating that the conditions of the rule provided “appropriate safeguards” and “necessary investor protections”).

<sup>55</sup> 10f-3 1997 Release, note 51 above, at n.52 and accompanying text.

## 2. Rule 12b-1 – Paying for Distribution out of Fund Assets

*The rule permits funds to use their own assets to pay distribution expenses.*

**Why Congress generally prohibited activities in this area.** Section 12(b) of the Act authorizes the Commission to adopt rules governing the distribution of fund securities. It protects funds from bearing excessive sales and promotion expenses.<sup>56</sup> Using fund assets to pay for sales and promotion can benefit fund advisers by increasing the size of fund assets (and therefore advisory fees, which are based on a percentage of assets under management).<sup>57</sup> When advisory fees are directly affected by the sale of fund securities, the interests of the adviser and the fund shareholders are not necessarily aligned. Given that advisers are rewarded primarily for the size of the fund they manage and not the investment performance, the duty to handle fund assets responsibly may conflict with the strong incentive to increase fund assets.<sup>58</sup> The adviser may be inclined to spend excessive amounts on the distribution of fund shares in an effort to increase fund assets and its own compensation.<sup>59</sup> Thus, there is an inherent conflict of interest when fund assets are used to finance the distribution of fund securities.

**How the Exemptive Rule protects investors.** In 1980, the Commission adopted rule 12b-1, which allows the use of fund assets to pay for the distribution of fund shares. The rule requires a fund relying on the rule to meet certain conditions, including: (i) formulating a written plan describing all material aspects of the proposed financing; (ii) having the plan approved by a majority of the fund’s outstanding securities and board, including a majority of independent directors; and (iii) not using directed brokerage to pay for fund distribution.<sup>60</sup> The independent

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<sup>56</sup> See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252 (May 23, 1978), at text following n.5; see also *S. 3580 Hearings*, note 6 above, at 37 (statement of Commissioner Healy) (“To increase their distribution profits and management fees, these [fund] insiders engaged in distribution practices which resulted in substantial dilution of the investors’ interests.”).

<sup>57</sup> The term “fund assets” includes both direct payments to fund distributors as well as fund brokerage.

<sup>58</sup> See, e.g., Letter from Warren E. Buffet, Chairman of the Board, Berkshire Hathaway, Inc., to Shareholders of Berkshire Hathaway, Inc. 3 (Feb. 27, 2004) *available at* <<http://www.berkshirehathaway.com/letters/2003ltr.pdf>> (“Investment managers often profit far more from piling up assets than from handling those assets well. So when one tells you that increased funds won’t hurt his investment performance, step back: His nose is about to grow.”). See also Statement of Robert Turner, chairman and chief investment officer of Turner Investment Partners, <http://www.turner-invest.com/index.cfm/fuseaction/news.detail/ID/1279> (“While enormous cash inflows certainly enrich the companies that manage the funds, the benefits are less certain for the investors. Research has demonstrated that once assets in a particular fund reach a certain mass, on average, performance tends to deteriorate. A fund can indeed become too popular for its – and its investors’ – own good.”).

<sup>59</sup> See 12b-1 1988 Proposed Amendments, note 11 above, at text accompanying nn.6-7.

<sup>60</sup> See 12b-1 Adopting Release, note 42 above. Last year, the Commission amended rule 12b-1 to

directors' involvement means that the shareholders' representatives evaluate whether the 12b-1 plan has resulted in or appears likely to result in benefits to fund shareholders.

***Why board involvement is important under this Exemptive Rule.*** If a fund relies on the rule, its board (including a majority of independent directors) must: (i) approve the 12b-1 plan initially and annually; (ii) request and evaluate information necessary to evaluate the plan; (iii) conclude that the plan will likely benefit the fund and its shareholders; (iv) approve fees paid under the plan; and (v) approve procedures to prevent direction of portfolio transactions to brokers in exchange for the distribution of the fund's shares. The Commission also has emphasized that it permits funds to pay distribution expenses under rule 12b-1 in reliance on the active oversight of independent directors.<sup>61</sup>

### **3. Rule 15a-4 – Interim Advisory Contracts**

*The rule permits fund boards to approve interim advisory contracts for up to 150 days without shareholder approval.*

***Why Congress generally prohibited activities in this area.*** Section 15(a) of the Act prohibits a person from acting as an investment adviser to a fund, except under an investment advisory contract that shareholders have approved. It was designed to inhibit “trafficking” in investment advisory contracts, *i.e.*, the sale of investment advisory relationships.<sup>62</sup> Without this prohibition, an adviser would be able to profit by selling its advisory contract to another adviser that may provide inferior services to the fund. Permitting these sales could harm the fund, as well as compromise the quality and nature of advisory services due to the adviser's conflict of interest.

***How the Exemptive Rule protects investors.*** To prevent harm to funds caused by the short-term loss of advisory services in circumstances when an advisory contract terminates

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prohibit funds from paying for the distribution of their shares with brokerage commissions, a practice that the Commission determined presented unmanageable conflicts of interest. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sept. 2, 2004) (“12b-1 2004 Release”), at text accompanying nn.11-12.

<sup>61</sup> In its adopting release, the Commission stated that the use of its exemptive authority to alleviate regulatory burdens directly correlated to the enhanced role of independent directors. 12b-1 Adopting Release, note 42 above, at text preceding n.50 (paragraph following “Independence of Directors” heading) (“[T]he more capable the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce regulatory restrictions.”).

<sup>62</sup> *See S. 3580 Hearings*, note 6 above, at 252-53 (statement of David Schenker, Chief Counsel, Investment Trust Study); (“[A]fter investors have invested substantial sums in companies on their faith in the reputation and standing of the existing managements, the insiders have frequently transferred control ... to other persons, without the prior knowledge or consent of these security holders. Trafficking in control of [funds] has reached surprising proportions.”). *Id.* at 38 (statement of Commissioner Healy).

unexpectedly, the Commission adopted rule 15a-4 in 1980. Rule 15a-4 permits a successor investment adviser to serve up to 150 days before receiving shareholder consent, following the termination of an investment advisory contract. The rule includes conditions that a fund must meet in order to rely on the rule, including: (i) the compensation to be received by the interim adviser is not greater than the prior adviser's compensation; (ii) approval of the interim contract by the fund's board, including a majority of the independent directors; and (iii) a determination that the interim contract generally contains the same terms and conditions as the former contract.

***Why board involvement is important under this Exemptive Rule.*** If a fund relies on the rule, its board (including a majority of independent directors), must: (i) approve the interim contract; and (ii) determine that the scope and quality of services under the interim contract will be at least equivalent to the scope and quality of services under the former contract. The directors therefore must scrutinize the contract and determine whether it is in the best interest of shareholders. The board therefore stands in the position of shareholders in reviewing and approving the temporary advisory contract.

#### **4. Rule 17a-7 – Affiliated Cross-Transactions**

*The rule permits securities transactions between a fund and an affiliate of the fund's adviser.*

***Why Congress generally prohibited activities in this area.*** Section 17(a) of the Act prohibits an affiliated person of a fund, or an affiliate of the fund's affiliate, from engaging in most securities transactions with the fund, or with another fund under common control. Congress enacted section 17(a) to protect shareholders by prohibiting transactions in which a party has both the ability and financial incentive to deplete the assets of the fund.<sup>63</sup> In those transactions, conflicts of interest may arise if, for example, the adviser profits at the expense of certain fund investors by shifting profitable securities to affiliated clients, or "dumping" undesirable securities on less profitable funds.

***How the Exemptive Rule protects investors.*** Rule 17a-7, which the Commission adopted in 1966, includes conditions that are designed to limit the rule to those circumstances in which the likelihood of overreaching by the fund's affiliate involved in the affiliated transaction is small.<sup>64</sup> To qualify for the rule 17a-7 exemption:

- the affiliated transaction must be a cash purchase or sale of a security that has a readily available market quotation, at the independent current market price of the security;

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<sup>63</sup> S. 3580 Hearings, note 6 above, at 256-59 (statement of David Schenker, Chief Counsel, Investment Trust Study).

<sup>64</sup> Adoption of Rule 17a-7 to Provide an Exemption from the Provisions of Section 17(a) of the Investment Company Act of 1940, Investment Company Act Release No. 4697 (Sept. 8, 1966) ("17a-7 1966 Adopting Release").

- the transaction must be consistent with the stated policy of each fund participating in the transaction;
- no brokerage commission or fee other than customary transfer fees may be paid in connection with the transaction; and
- the board, including a majority of independent directors, must adopt procedures designed to ensure that the rule 17a-7 requirements are complied with, make necessary changes to those procedures, and determine at least quarterly that all the transactions complied with the procedures.

***Why board involvement is important under this Exemptive Rule.*** Rule 17a-7 transactions may pose the possibility of conflicts of interest if, for example, the investment adviser “dumps” undesirable securities on a fund, or shifts desirable securities to favored advisory clients within a fund complex.<sup>65</sup> The Commission noted that the heightened role of independent directors under rule 17a-7 accords “with the Commission’s general objective of enhancing, insofar as feasible, the role of investment company directors and particularly [independent] directors as watchdogs of shareholder interests.”<sup>66</sup>

## 5. Rule 17a-8 – Affiliated Fund Mergers

*The rule permits mergers between certain affiliated funds.*

***Why Congress generally prohibited activities in this area.*** As noted above, section 17(a) of the Act prohibits most securities transactions between a fund and its affiliates in order to protect shareholders by prohibiting transactions in which a party has both the ability and financial incentive to deplete the assets of the fund.<sup>67</sup> The affiliated transaction provisions of section 17(a) prohibit mergers of affiliated funds. A conflict of interest may arise in these circumstances if, for example, an investment adviser could benefit by causing one fund to pay too much for another fund’s assets or causing a fund to sell its assets too cheaply, in either case diluting the interests of one fund’s shareholders. A conflict also may arise if an adviser experiences certain economies in advising a single merged fund rather than two separate funds. By merging two separate funds into a single fund, an investment adviser may be able to achieve substantial savings for itself at the expense of fund shareholders. As a means of attracting investors to new funds, advisers will often agree to limit, or even refund a portion of their fees and expenses. If a fund with such a fee limitation agreement merges with an affiliated fund, the

<sup>65</sup> Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, Investment Company Act Release No. 11136 (Apr. 21, 1980), at text preceding n.10.

<sup>66</sup> *Id.* at text accompanying n.18.

<sup>67</sup> See note 63 above and accompanying and preceding text.

resulting economies of scale may allow the adviser to shift the economic consequences of that fee limitation agreement from the adviser on to the shareholders of the newly merged fund.<sup>68</sup>

***How the Exemptive Rule protects investors.*** The Commission adopted rule 17a-8 in 1980 to exempt mergers and transactions between affiliated funds from the section 17(a) prohibition.<sup>69</sup> To ensure that shareholders are protected, funds relying on the rule must comply with a variety of conditions, including: (i) shareholder approval of the transaction in most circumstances; and (ii) review, evaluation, and approval of the transaction by the board of directors, including a majority of the independent directors.<sup>70</sup>

***Why board involvement is important under this Exemptive Rule.*** If a fund relies on the rule, its board (including a majority of independent directors), must: (i) determine that the merger is in the best interests of the fund and will not dilute the interests of the shareholders; (ii) evaluate all information necessary to make that determination; and (iii) approve procedures for the valuation of the assets to be conveyed.

The Commission emphasized that the approval of mergers by independent directors is critical, “particularly when the merger involves significant conflicts of interest.”<sup>71</sup> Rule 17a-8 assigns a special role to independent directors, with the Commission relying on them to influence the terms of mergers and to prevent abuses that may arise because of the conflicts of interest of the parties initiating the merger.<sup>72</sup>

## **6. Rule 17d-1(d)(7) – Joint Liability Insurance**

*The rule permits funds and their affiliates to purchase joint liability insurance policies.*

***Why Congress generally prohibited activities in this area.*** Section 17(d) of the Act and rule 17d-1 thereunder prohibit any joint transactions between a fund and any of its affiliated persons. Congress enacted section 17(d) to limit or prevent participation by the fund, or a company it controls, on a basis different from or less advantageous than that of the affiliated participant. This was another of the major abuses prevalent in the period before enactment of the Investment Company Act.<sup>73</sup> A conflict of interest may arise when fund advisers, who make the investment decisions for the fund, have both a pecuniary incentive and the ability to cause the

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<sup>68</sup> See 17a-8 Proposing Release, note 40 above, at n.10 and accompanying text.

<sup>69</sup> See Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 11053 (Feb. 19, 1980).

<sup>70</sup> See Investment Company Mergers, Investment Company Act Release No. 25666 (July 18, 2002).

<sup>71</sup> *Id.* at text accompanying n.13.

<sup>72</sup> Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001), at text following n.23.

<sup>73</sup> See *H.R. 10065 Hearings*, note 14 above, at 120 (statement of David Schenker, Chief Counsel, Investment Trust Study).

fund's participation in a joint transaction or arrangement with an affiliate. These situations are fraught with the danger that the fund or its controlled company may be abused for financial gain by such persons.<sup>74</sup> Section 17d-1 therefore prohibits, among other types of joint transactions, an arrangement in which a fund jointly purchases an insurance policy with its affiliated persons.<sup>75</sup>

***How the Exemptive Rule protects investors.*** Section 17 does not list specific prohibited transactions, but rather provides the Commission with rulemaking authority to enact rules it deems necessary to prevent the conflicts of interest that may arise in joint transactions between funds and their advisers. In 1979, the Commission adopted rule 17d-1(d)(7), which provides relief from the statutory prohibition by allowing a fund and its adviser to purchase joint liability insurance without first obtaining a Commission exemptive order as required by section 17(d) of the Act and rule 17d-1 thereunder.<sup>76</sup> Before such joint liability insurance may be purchased, and on an annual basis thereafter, a majority of the independent directors must determine that the policy is in the best interest of the fund, does not exclude independent directors, and that the policy's premium is allocated fairly.

***Why board involvement is important under this Exemptive Rule.*** Conditions for relying on rule 17d-1(d)(7) include a requirement that the board, including a majority of its independent directors, must:

- determine that the insurance policy is in the fund's best interests;
- determine that the proportion of the policy's premium allocated to the fund is fair and reasonable;
- determine that the policy's coverage does not exclude independent directors; and
- determine at least annually that the conditions of the rule have been satisfied.

In a 1999 interpretive release, the Commission noted that “[i]ndependent directors play a critical role in policing the potential conflicts of interest between a fund and its investment adviser” and that their duty to determine whether participation in joint insurance contracts is in

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<sup>74</sup> See *S. 3580 Hearings*, note 6 above, at 256 (statement of David Schenker, Chief Counsel, Investment Trust Study) (indicating that the purpose of Commission rules to be promulgated under section 17(d) (originally drafted as section 17(a)(4)) is to “insure fair dealing and no overreaching”).

<sup>75</sup> Such insurance policies, known as “errors and omissions” policies, are purchased by funds, in large part, to attract the services of qualified directors and officers. They are jointly maintained to secure greater insurance coverage, at more favorable rates.

<sup>76</sup> Exemption of Certain Joint Purchases of Liability Insurance Policies, Investment Company Act Release No. 10891 (Oct. 4, 1979).

the best interest of the fund (among other duties) “is vital to the proper functioning of fund operations and, ultimately, the protection of fund shareholders.”<sup>77</sup>

## 7. Rule 17e-1 – Affiliated Brokerage Expenses

*The rule specifies conditions under which funds may pay commissions to affiliated brokers in connection with the purchase or sale of securities on an exchange.*

**Why Congress generally prohibited activities in this area.** Section 17(e)(2)(A) of the Act prohibits brokers that are affiliated with a fund from accepting compensation from the fund exceeding the “usual and customary” stock exchange brokerage commission. This provision prevents affiliated brokers from exploiting the fund’s portfolio transactions by using the fund’s purchases and sales for their own profit. Otherwise, a fund manager with a financial incentive to direct portfolio transactions to an affiliated broker could choose an affiliated broker that will charge excessive commissions to the fund.

**How the Exemptive Rule protects investors.** The advent of negotiated commission rates in the 1970s made it impracticable for funds to determine whether commissions paid to their affiliated brokers satisfied the statutory standard of “usual and customary” brokerage commissions.<sup>78</sup> In 1979, the Commission adopted rule 17e-1, which established a safe harbor for commissions paid to affiliated brokers, subject to certain conditions.<sup>79</sup>

Conditions for relying on rule 17e-1 include:

- the brokerage commission must be reasonable and fair compared to the compensation received by other brokers in connection with comparable transactions;
- the fund’s directors (including the independent directors) must (i) adopt procedures designed to provide that the affiliated broker’s commissions are reasonable and fair, (ii) make and approve changes to these procedures as the board deems necessary, and (iii) determine at least quarterly that all transactions under the rule comply with the procedures adopted by the board; and
- the fund must maintain records on the procedures and transactions under the rule.

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<sup>77</sup> 1999 Interpretive Release, note 8 above, at text accompanying nn.5, 11-12 (statement of views of the Commission and its staff).

<sup>78</sup> Agency Transactions by Affiliated Persons on a Securities Exchange, Investment Company Act Release No. 10605 (Feb. 27, 1979) (“17e-1 Proposing Release”), at text following n.4.

<sup>79</sup> Agency Transactions by Affiliated Persons on a Securities Exchange, Investment Company Act Release No. 10741 (June 20, 1979).

***Why board involvement is important under this Exemptive Rule.*** As discussed above, a fund that relies on the rule must closely involve the board of directors, including the independent directors. This reliance on the board is intended to prevent overreaching by fund affiliates. As the Commission has explained, the “difficulties inherent in monitoring continuously the reasonableness and fairness of ... unfixed commission rates” mean that “the first line of responsibility for determining compliance with [rule 17e-1] must be with each investment company’s directors.”<sup>80</sup> This is even more true today than it was when the rule was adopted in 1979, given the proliferation of trading platforms and the availability of discounted rates of commission from both traditional “full service” brokers and alternative trading platforms.

## **8. Rule 17g-1(j) – Joint Fidelity Insured Bonds**

*The rule permits funds to maintain joint insured bonds.*

***Why Congress enacted the underlying provision.*** Congress enacted section 17(g) of the Act to authorize the Commission to adopt rules requiring that funds be bonded against larceny and embezzlement by their officers and employees, including officers and employees of fund advisers, that have direct or indirect access to fund assets. Section 17(g) helps protect funds from the risk of harm by persons who have access to fund assets.

***How the Exemptive Rule protects investors.*** In 1947, the Commission adopted rule 17g-1, which requires every fund to provide and maintain a fidelity bond.<sup>81</sup> In 1974, the Commission amended the rule to permit “joint insured bonds.”<sup>82</sup> These types of bonds name as insured parties not only the fund, but also the fund’s managers and distributors, other funds managed or distributed by these persons, and certain other related persons. A fund manager may have an interest in having a joint insured bond provide better coverage for one fund as compared with another, or having a fund bear a disproportionate share of the insurance premium. In view of the possibility that joint insured bonds may constitute joint arrangements prohibited by section 17(d) of the Act and rule 17d-1 thereunder, the Commission added paragraph (j) to exempt from the provisions of section 17(d) and the rules thereunder any joint insured bonding arrangements that comply with rule 17g-1.<sup>83</sup>

Rule 17g-1 includes conditions that a fund must meet in order to rely on the rule, including: (i) determination at least annually by the board, including a majority of the

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<sup>80</sup> See 17e-1 Proposing Release, note 78 above, at text following n.9.

<sup>81</sup> See Revision of Rule N-17F-2; Adoption of Rule N-17G-1, Investment Company Act Release No. 1112 (Oct. 2, 1947) (“17g-1 Adopting Release”).

<sup>82</sup> See Adoption of Amendments to Rule 17g-1 under the Investment Company Act of 1940 to Provide that Fidelity Bonds Required Pursuant to the Rule Shall Comply with Certain New and Revised Provisions, Investment Company Act Release No. 8267 (Mar. 14, 1974) (“1974 17g-1 Release”) (allowing joint insured bonds).

<sup>83</sup> *Id.*

independent directors, that the bond is reasonable in amount and form; (ii) provision of specified notices to affected parties and the Commission before a bond is cancelled, terminated or modified; (iii) execution of an agreement between the fund and the other named insureds, providing that in the event recovery is received, the fund will receive its equitable share; and (iv) filing of the bond and related materials with the Commission.

***Why board involvement is important under this Exemptive Rule.*** The Commission has required the review and approval by the board’s independent directors since it adopted rule 17g-1 in 1947.<sup>84</sup> In order for a fund to rely on rule 17g-1(j), its board, including a majority of its independent directors must:

- approve at least annually the amount and form of the joint insured bond; and
- approve the portion of the premium to be paid by the fund covered under the joint insured bond.

In 1978, the Commission highlighted the importance of the independent directors’ review when it emphasized “their specific statutory obligations under the provisions of the rule and their fiduciary responsibilities under the Act to assure that the funds they serve have fidelity bond coverage that both satisfies the requirements of the rule and offers adequate protection to shareholders.”<sup>85</sup>

## **9. Rule 18f-3 – Multi-Class Funds**

*The rule permits funds to issue multiple classes of voting stock.*

***Why Congress generally prohibited activities in this area.*** Section 18(f)(1) of the Act makes it unlawful for a mutual fund to issue any class of “senior security.” A senior security includes any stock of a class having priority over any other class as to the distribution of assets or

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<sup>84</sup> As initially adopted, the rule referred to the “board of directors who are not such officers and employees thereof.” *See* 17g-1 Adopting Release, note 81 above. In 1951, the Commission amended rule 17g-1 to clarify that investment advisory personnel are considered employees or officers of the fund, given that the fund contracts with third parties to provide these functions. Amendment of Rule N-17G-1, Investment Company Act Release No. 1563 (Jan. 12, 1951) (defining the terms “officer” and “employee”). Although the Commission amended this phrase further in 1974 to specifically refer to independent directors, the Commission had previously viewed the reviewing directors as separate from management. *See* Adoption of Amended Rule 17g-1 to Provide that Certain Bonds Required Pursuant to the Rule shall be Reported to the Commission, Investment Company Act Release No. 4020 (July 24, 1964) (referencing independent directors); 1974 17g-1 Release, note 82 above (amending the rule to, among other things, include factors to be considered by independent directors).

<sup>85</sup> Fidelity Bonding of Registered Management Investment Companies, Investment Company Act Release No. 10393 (Sept. 8, 1978), at text contained in the last paragraph.

payment of dividends. Section 18(f)(1) was enacted in response to the operation of funds with different classes of shares that paid unequal dividends and had varying liquidation and voting rights. The investor abuses associated with these complex capital structures included excessive leverage, conflicts of interest among classes, investor confusion, and inequitable and discriminatory voting provisions.<sup>86</sup> Section 18 therefore prohibits material differences among the rights of shareholders in a fund.<sup>87</sup>

***How the Exemptive Rule protects investors.*** Conditions for relying on rule 18f-3 include:

- each class must (i) pay for an equal share of the fund’s expenses (except to the extent that a class receives unique services), (ii) have appropriate voting rights, and (iii) have in other respects the same rights and obligations as other classes;
- the fund’s gains and losses must be allocated to the classes appropriately; and
- close oversight by the fund’s board, including its independent directors.

***Why board involvement is important under this Exemptive Rule.*** When the Commission proposed rule 18f-3 in 1993, it emphasized that the Act “places a great deal of responsibility on boards to evaluate fees paid to advisers and their affiliated persons.”<sup>88</sup> When the Commission adopted the rule in 1995, it emphasized that the rule gives “boards of directors, particularly the independent directors, significant responsibility to approve a fund’s plan and oversee its operation.”<sup>89</sup> If a fund relies on the rule, its board (including a majority of independent directors) must approve the fund’s written plan setting out the separate arrangement and expense allocation for each class, determining that the plan and the expense allocation is in the best interest of each class individually and the fund as a whole.<sup>90</sup>

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<sup>86</sup> See *S. 3580 Hearings*, note 6 above, at 38, 46, 58, 122; INVESTMENT TRUST STUDY, note 52 above, at ch. 1-6.

<sup>87</sup> See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds, Investment Company Act Release No. 19955 (Dec. 15, 1993), at text after n.18.

<sup>88</sup> See *id.* at n.48 (noting that because “[m]ultiple class arrangements involve potential conflicts over fees ... board review of multiple class arrangements is appropriate”).

<sup>89</sup> Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Investment Company Act Release No. 20915 (Feb. 23, 1995), at text preceding n.44.

<sup>90</sup> *Id.* at text accompanying n.44.

## 10. Rule 23c-3 – Repurchases of Shares by Closed-End Funds

*The rule permits the operation of “interval funds” by enabling closed-end funds to repurchase their shares from investors.*

***Why Congress generally prohibited activities in this area.*** Section 23 of the Act imposes requirements on the pricing, sale, and repurchase of shares issued by closed-end funds. It was enacted in response to abuses such as fund repurchases of shares at a discount, repurchases from insiders at a premium, and manipulative repurchases from certain shareholders to remove opposition to management.<sup>91</sup>

***How the Exemptive Rule protects investors.*** In 1993, the Commission adopted rule 23c-3, which provides an exemption from section 23 by permitting closed-end funds to offer to repurchase shares from shareholders at the net asset value calculated for fund shares.<sup>92</sup> Closed-end funds traditionally had difficulties attracting investors, and rule 23c-3 gave flexibility to funds and investors by providing a new method for closed-end funds to repurchase and redeem their shares.<sup>93</sup> Rule 23c-3 gives shareholders intermediate degrees of liquidity for closed-end funds.

To ensure that the goal of shareholder protection is met, funds must comply with a variety of conditions in order to rely on the rule, including:

- limiting repurchases to set periodic intervals specified in a fundamental policy of the fund, or on a limited discretionary basis;
- complying with limits on the amount of shares the fund must offer to repurchase; and
- suspending or postponing a repurchase offer only with approval by the board, including a majority of independent directors.

***Why board involvement is important under this Exemptive Rule.*** The board plays an important role in overseeing the conflicts that are inherent when a closed-end fund repurchases its shares. For this reason, rule 23c-3 has required a majority independent board since the rule was adopted in 1993. Determining the size of the repurchase offer, for example, may present a

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<sup>91</sup> INVESTMENT TRUST STUDY, note 52 above, pt. 3 at 954, 966-67.

<sup>92</sup> Rule 23c-3 has required a majority independent board since 1993. *See* Repurchase Offers by Closed-End Management Investment Companies, Investment Company Act Release No. 19399 (Apr. 7, 1993) (“23c-3 Adopting Release”).

<sup>93</sup> Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or with Extended Payment, Investment Company Act Release No. 18869 (July 28, 1992), at text following n.46.

conflict of interest between the adviser and the shareholders because the adviser may prefer a small repurchase offer so that the retention of assets under management is maximized, while shareholders may prefer a large offer so that all shares that are tendered may be redeemed.<sup>94</sup> The Commission has emphasized that the fund’s independent directors play an important role in overseeing these conflicts of interest under rule 23c-3.<sup>95</sup>

### **III. RECENT MUTUAL FUND SCANDALS AND THE COMMISSION’S ENFORCEMENT RESPONSE**

#### **A. ABUSIVE PRACTICES IN LARGE FUND COMPLEXES**

The Commission’s independent chair provision, together with the other recent reform initiatives, was adopted against the backdrop of egregious industry scandals that first came to public attention in the fall of 2003. These scandals revealed breakdowns in compliance systems at funds and their advisers, weaknesses in fund governance structures, a significant betrayal of many mutual fund investors and fundamental breaches of fiduciary obligations.

Serious misconduct by prominent mutual fund managers, their sales affiliates, and the financial intermediaries with which they do business, was initially made public when New York Attorney General Eliot Spitzer brought an action involving improper mutual fund trading practices by Canary Capital Partners, LLC (“Canary”), a hedge fund operated by Edward J. Stern. The Canary action identified two abusive practices involving mutual funds – “late trading” and “market timing.” Following the announcement of the Canary case on September 3, 2003, the Commission promptly acted to fully investigate these matters, assess the scope of the problem, and hold any wrongdoers accountable. It was revealed that Canary had engaged in late trading and market timing schemes involving some of the largest mutual fund complexes, including Invesco, PIMCO, and Alliance Capital, as well as subsidiaries of Bank of America, FleetBoston Financial Corporation, and Banc One.

As the Commission continued its investigations, it uncovered additional wrongdoing. The Commission found that fund managers engaged in market timing for their own accounts, allowed certain investors to market time funds contrary to disclosed policies and in return for assets invested in other funds managed by the adviser (“sticky assets”), and selectively disclosed fund portfolio securities to market timers to facilitate their abusive trading. The investigations also revealed abuses in fund sales practices related to so-called “revenue sharing” and “directed brokerage” arrangements. The Commission has aggressively and successfully worked, and continues to work, to pursue unlawful activity in the mutual fund industry in coordination with state regulators.

Since late 2003, the Commission has instituted numerous cases related to the mutual fund scandals. These enforcement actions have involved some of the most well-known names in the

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<sup>94</sup> 23c-3 Adopting Release, note 92 above, at text following n.87.

<sup>95</sup> *Id.* at text following n.87.

mutual fund industry, including Putnam Investments, Invesco Funds Group, Alliance Capital Management, Massachusetts Financial Services Co. (“MFS”), FleetBoston Financial, and Bank of America. Indeed, these enforcement actions have involved advisers in at least eight of the twenty-five largest fund complexes. The Commission has obtained over \$2.2 billion in disgorgements and civil penalties, which will be used to compensate harmed investors. These numbers give some indication of the extent of these abusive practices and their detrimental impact on investors. The cases show how mutual fund managers violated the trust of fund investors by resolving the conflicts of interests in favor of the managers and retail fund brokers, rather than the funds they were supposed to serve.

## **1. Market Timing**

“Market timing” refers to (i) frequent buying and selling of shares in the same mutual fund and (ii) buying and selling mutual fund shares to exploit pricing inefficiencies (so-called “arbitrage market timing”). “Arbitrage market timers” buy and sell shares of funds if they believe that the fund’s calculation of net asset value significantly lags behind the current value of a fund’s portfolio securities. Mutual funds that invest in overseas securities markets are particularly vulnerable to market timers who take advantage of time-zone differences between the foreign markets on which the funds’ portfolio securities trade and the U.S. markets which generally determine the time that net asset value (“NAV”) is calculated. Thus, market timers frequently purchase or redeem shares of mutual funds that invest internationally based on events occurring after foreign market closing prices are established (and may be used in calculating the fund’s NAV that day), but before the fund determines its NAV (typically at 4:00 p.m. Eastern Time). Market timers generally then redeem or purchase the fund’s shares the next day, when the events are reflected in the NAV, for a quick profit at the expense of long-term fund shareholders. Funds that invest in small cap securities and other types of specialty investments, including high yield funds, also can be the targets of market timers.

Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly and that one group of shareholders (*i.e.*, market timers) is not favored over another group of shareholders (*i.e.*, long-term investors). Moreover, when a fund represents in its prospectus that it will act to discourage market timing, it cannot knowingly permit such activities. In some cases, fund managers allowed market timing despite representations in the fund’s prospectus that the fund did not permit market timing or other excessive trading practices. In addition, fund procedures designed to discourage market timing, such as charging a redemption fee for frequent trading, were ignored in the case of market timers with whom the fund managers had an arrangement.

Over time, the long-term shareholders in a fund will, in effect, pay the costs of the market timers’ transactions and have the value of their fund shares diluted. Dilution can occur through the sale of a fund’s securities at a price below the fund’s NAV or the redemption of fund shares at a price above NAV. Short-term trading can raise transaction costs for a fund, disrupt the fund’s stated portfolio management strategy, require a fund to maintain an elevated cash position, and result in lost opportunity costs and forced liquidations. Short-term trading can also result in unwanted taxable capital gains for fund shareholders and reduce the fund’s long-term

performance. Therefore, while market timers may profit from engaging in short-term trading of mutual fund shares, the costs associated with such trading are borne by the fund's long-term shareholders.

In spite of the costs to the fund of short-term trading and the detriment to long-term shareholders, some fund managers allowed market timing arrangements because these arrangements could significantly increase the fund managers' advisory fees and the fund distributors' distribution fees. Market timers make large, albeit short-term, additions to a fund's assets – assets on which the adviser's fees are based. Frequent trading also means increased distribution fees for brokers selling the fund shares. Often the market timer would agree to commit so-called “sticky assets” – long-term investments in other funds managed by the adviser – thus increasing the advisory fees received by the adviser from those funds as well. Affiliates of the fund managers also have benefited from the market timing arrangement, such as banking affiliates that were able to enter into loan agreements with the market timers to finance the timing activities. By placing their own interests in generating fees for themselves and their affiliated entities above those of the fund shareholders, and by failing to disclose these arrangements and resulting conflicts of interest to fund boards and shareholders, fund managers breached their fiduciary duties to shareholders.

## 2. Late Trading

“Late trading” refers to the practice of placing orders to buy or sell mutual fund shares *after* the fund's pricing time (most funds price daily at 4:00 p.m. Eastern Time) and receiving a share price calculated as of 4:00 p.m. A variation of the practice involves placing conditional trades prior to 4:00 p.m. with the option of withdrawing or confirming the trades after 4:00 p.m. Thus, late trading enables the trader to profit from market events that occur after 4:00 p.m. but that are not reflected in that day's price. In particular, the late trader obtains an opportunity for a virtually risk-free profit when he learns of market-moving information and can purchase mutual fund shares at prices established *before* the market-moving information was released.

Current Commission rules prohibit late trading by requiring funds, their principal underwriters, dealers and others authorized to consummate transactions in fund shares, to assign the NAV calculated as of the fund's next pricing time to any order to purchase or redeem a fund's shares, a process known as “forward pricing.” The forward pricing requirement typically is reflected in dealer or selling agreements between funds and the financial intermediaries – brokers, banks, retirement plan administrators and transfer agents – that sell their shares. Financial intermediaries accept investor trades throughout the business day, bundle the trades together, and pass the net trade amount to fund companies at the end of the day after 4:00 p.m. This netting allows intermediaries to realize cost savings in the delivery of trade orders to funds. Although intermediaries are supposed to segregate the orders they receive before 4:00 p.m. (for same-day pricing) from trades they receive after 4:00 p.m. (for next-day pricing), the recent scandals have demonstrated that this was not always the case. In order to help favored customers, certain intermediaries “bundled” late (post-4:00 p.m.) orders with legitimate (pre-4:00 p.m.) orders for same-day pricing. In some cases, fund affiliates participated in the scheme. Potentially enormous profits were gained by late trading, and those profits came out of the

pockets of mutual fund investors.

### **3. Selective Disclosure of Fund Portfolio Holdings**

In several cases, fund managers also selectively disclosed their funds' investment portfolios in order to curry favor with large investors who could take advantage of this non-public information at the expense of other fund investors. Selective disclosure can enable an investor to sell short the fund's holdings in the same or similar proportions to the fund's established security positions. It also can enable shareholders who receive the information to make advantageous decisions to place orders for fund shares. Thus, selective disclosure of a fund's portfolio can facilitate fraud and have a significant adverse effect on a fund's investors when that portfolio information is used to trade against the fund.

### **4. Undisclosed Revenue Sharing and Directed Brokerage**

The significant increase in the number of mutual funds together with the limited number of distribution channels has provided brokers who sell fund shares with significant leverage over funds. This leverage permitted selling brokers to demand additional payments from fund advisers from their own assets ("revenue sharing") or from commissions (paid by the fund) for fund portfolio securities transactions the adviser directs to brokers who sell the fund's shares. These payments were used to purchase greater prominence (or better "shelf space") in an increasingly crowded fund marketplace. Shelf space refers to a select group of fund families that a broker-dealer and its representatives promote from among the funds the broker-dealer may sell. Revenue sharing has been inappropriately characterized by brokers, fund advisers and distributors as service fees, recordkeeping and transfer fees, seminar sponsorships or other types of payments that ostensibly compensate the selling broker for costs it incurs in fund distribution activities. When payments reached NASD limits on sales loads and distribution fees,<sup>96</sup> some fund advisers used brokerage commissions to make payments to finance distribution.

The Commission, the NASD and state regulators found that prospective mutual fund investors were not provided with adequate disclosure concerning revenue sharing and directed brokerage arrangements. Fund investors often were not told that their broker-dealer was being paid incentive fees to promote certain funds over others in the broker-dealer's array of offerings. Moreover, these undisclosed fees in many cases increased costs to investors. These cases included prominent fund groups such as Franklin Templeton and MFS as well as prominent retail broker-dealers such as Edward Jones and Morgan Stanley Dean Witter.

## **B. LATE TRADING, MARKET TIMING AND SELECTIVE DISCLOSURE OF FUND PORTFOLIO HOLDINGS**

### **1. Banc of America**

The first, and one of the largest, Commission actions touched off by the Canary

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<sup>96</sup> See NASD Conduct Rule 2830.

revelations involved three subsidiaries of Bank of America Corporation: Banc of America Capital Management, LLC (“BACAP”), the investment adviser to the Nations Funds; BACAP Distributors, LLC (“BACAP Distributors”), the distributor and administrator for the Nations Funds; and Banc of America Securities, LLC (“BAS”), a registered broker-dealer.<sup>97</sup> Bank of America operates one of the nation’s largest fund groups.<sup>98</sup> The Commission settled its enforcement action against BACAP, BACAP Distributors, and BAS on February 9, 2005. The Commission ordered the three entities to pay \$375 million in disgorgement and penalties. The Commission also censured BACAP, BACAP Distributors and BAS, ordered them to undertake certain remedial actions to strengthen their oversight of compliance with the federal securities laws, and ordered that they cease and desist from further violations.

From as early as July 2000 and continuing through July 2003, BACAP and BACAP Distributors had arrangements with Canary and another market timing customer, TranSierra Capital, LLC, that allowed them to engage in short-term or excessive trading in at least 13 Nations Funds mutual funds, including international funds. The arrangements increased the advisory fees earned by BACAP and the distribution fees earned by BACAP Distributors. Moreover, in connection with one of these arrangements, BACAP received sticky assets.

BACAP and BACAP Distributors did not disclose to Nations Funds’ shareholders the special arrangements made with these short-term traders and the potential harm these arrangements posed to the relevant Nations Funds. They also did not disclose the resulting conflicts of interest the arrangements created between BACAP and BACAP Distributors, on the one hand, and the Nations Funds’ shareholders, on the other. The trades made pursuant to these relationships were also contrary to representations made in a letter to a clearing broker by BACAP that Nations Funds would not allow more than eight exchanges per fund account per

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<sup>97</sup> *Banc of America Order*, note 10 above.

<sup>98</sup> In addition to the actions discussed below, the Commission has also settled market timing actions against other fund advisers. *See, e.g., In the Matter of Franklin Advisers, Inc.*, Investment Company Act Release No. 26523 (Aug. 2, 2004); *In the Matter of RS Investment Management, Inc.*, Investment Company Act Release No. 26627 (Oct. 6, 2004); *Fremont Order*, note 10 above. The Commission has also instituted actions against other market participants. *See, e.g., In the Matter of Steven B. Markovitz*, Investment Company Act Release No. 26201 (Oct. 2, 2003) (late trading); *In the Matter of James Patrick Connelly, Jr.*, Investment Company Act Release No. 26209 (Oct. 16, 2003) (market timing); *In the Matter of Southwest Securities, Inc.*, Investment Company Act Release No. 26721 (Jan. 10, 2005), and *SEC v. Scott B. Gann*, Litigation Release No. 19027 (Jan. 10, 2005) (market timing, late trading); *SEC v. Mutuals.com, Inc.*, Litigation Release No. 18489 (Dec. 4, 2003) (late trading, market timing); *SEC v. Martin J. Druffner*, Litigation Release No. 18444 (Nov. 4, 2003) (market timing); *In the Matter of CIHC, Inc.*, Investment Company Act Release No. 26526 (Aug. 9, 2004) (market timing of variable annuities); *In the Matter of Paul A. Flynn*, Investment Company Act Release No. 26345 (Feb. 3, 2004) (providing financing for Canary Capital and others to engage in market timing and late trading); *SEC v. JB Oxford Holdings, Inc.*, Litigation Release No. 18850 (Aug. 25, 2004) (late trading, market timing); *SEC v. Geek Securities, Inc.*, Litigation Release No. 18738 (June 4, 2004) (late trading, market timing).

year because of the harmful effect of short-term trading on Nations Funds.

Indeed, BACAP had internal policies designed to identify and prevent market timing. Nations Funds reserved the right to “limit the number of exchanges that [an investor] can make within a specified period of time.” In order to effectuate this policy, BACAP’s “timing police” monitored transaction reports. When a transaction was identified as a possible “market timing” trade, the “timing police” would instruct the transfer agent to block the transaction and would alert the clearing broker of the block.

Shortly after securing approval to time certain Nations Funds, Canary began to ask for more timing capacity. Between May 2001 and July 2003, Canary had as much as \$70 million in approved timing space in ten Nations Funds mutual funds. Canary executed more than \$3 billion of purchases and sales in these funds, and ultimately reaped nearly \$16.7 million of profits through this trading.<sup>99</sup>

Bank of America affiliates also profited from the Canary relationship. BAS received more than \$4.1 million from a 1% “wrap” fee on Canary’s timing assets and broker fee revenue for Canary-related accounts. BAS also earned more than \$7 million in revenue from executing the derivative transactions that were part of Canary’s market timing strategy. Canary, through an affiliate, also received a loan from Bank of America’s private banking entity to finance trading in mutual funds through brokerage accounts maintained at BAS. The private banking entity received more than \$1 million in revenue from its lending relationship with Canary. BACAP received \$267,000 in additional advisory fees on Canary’s assets invested in Nations Funds, and BACAP Distributors received \$113,000 in additional distribution fees on Canary’s assets invested in Nations Funds.

BACAP knew that market timing could and did harm Nations Funds’ shareholders. As one of Nation Funds’ sub-advisers explained in an e-mail received by senior BACAP officers, market timing harms the funds and its shareholders in at least three ways: (i) market timing harms fund performance;<sup>100</sup> (ii) market timing has negative tax consequences for long-term investors;<sup>101</sup> and (iii) market timers profit at the expense of existing shareholders.<sup>102</sup>

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<sup>99</sup> BACAP also had an arrangement with TranSierra Capital, LLC that allowed market timing. TranSierra executed 524 transactions in three Nations Funds, reaping almost \$2 million in profits.

<sup>100</sup> *See Banc of America Order*, note 10 above (quoting a subadviser’s e-mail, “Given that market timers are trying to exploit an arbitrage which occurs because of increased global correlations and the closed nature of some of the International markets they tend always for performance purposes to be in the wrong direction. So that when U.S. markets, particularly Nasdaq, are sharply lower Timers are sellers of International [funds] thereby either taking cash away in a down market or more usually forcing the manager to sell into weak markets and vice-versa.”).

<sup>101</sup> *Id.* (quoting a subadviser’s e-mail, “As these are taxed funds the vastly increased turnover may result in a deterioration of the net of tax return.”).

<sup>102</sup> *Id.* (quoting a subadviser’s e-mail, “And most importantly Who is paying for the arbitrage? As I understand it is the other mutual fund holders who are being disadvantaged by the activities of the

In 2002 BACAP instituted a redemption fee on short-term trades in certain Nations Funds in order to combat market timing, but decided to exempt Canary from the fee even though an analysis done by one of the funds' sub-advisers demonstrated that market timers were responsible for the inferior performance of one of Nations Funds' international equity funds. When BACAP recommended to the Nations Funds' board of trustees that it adopt a redemption fee on some Nations Funds with various exemptions, it did not disclose that Canary would be exempt from the redemption fee and the board did not ask any questions regarding the exemptions to the redemption fee.

BAS also facilitated late trading by some introducing broker-dealers and by Canary. These entities effected their late trading through the mutual fund order system. After they were granted access to the system, these introducing broker-dealers and Canary could and did enter mutual fund trade orders as late as 7:00 p.m. Eastern Time. At least some of the introducing broker-dealers who had access to the system used this system to engage in late trading. BAS either knew or recklessly disregarded that at least some of these entities were engaged in late trading through this system. BAS also provided its introducing broker-dealer customers with account management tools and other assistance that enabled the introducing broker-dealers to conceal the market timing activities of their customers from unsuspecting mutual funds. BAS facilitated the submission of hundreds of market timing trades by these broker-dealers after the mutual funds in question had acted to block these entities from further trading.

Prior to Spring 2001, BAS provided the system only to registered broker-dealers. In Spring 2001, BAS provided Canary with access to the system. From October 2001 until July 2003, the system was the preferred route for Canary's late trading, and Canary executed approximately 8,300 fund exchanges through the system. The system not only facilitated Canary's late trading in the Nations Funds, it also enabled Canary to trade late in the many other mutual fund families with which BAS had selling agreements.

## 2. Invesco

On October 8, 2004, the Commission instituted and settled a cease-and-desist proceeding against Invesco Funds Group, Inc. ("IFG"), AIM Advisors, Inc. ("AIM Advisors"), and AIM Distributors, Inc. ("ADI"), based on market timing agreements that allowed certain individuals and entities, including Canary, to make frequent trades in the Invesco Funds advised by IFG and in the AIM Mutual Funds advised by AIM Advisors.<sup>103</sup> The settlements required IFG to pay

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'market timers.' Aside from the fact that the vastly increased turnover of the fund is likely to hurt performance as is discussed above, the arbitrage exists because market timers are effectively dealing at 'stale prices' as Asian markets have closed. They are therefore selling stocks at historic prices when they are likely to open lower or buying them when they are likely to open higher, this at the expense of the existing mutual fund holders as the 'gain' made by market timers must be a transfer or 'loss' for the existing holders.").

<sup>103</sup> *Invesco Order*, note 10 above.

\$325 million in disgorgement and penalties, and required AIM Advisors and ADI to pay, jointly and severally, \$20 million in disgorgement and an aggregate \$30 million in civil penalties.

The Commission also settled an enforcement action against Raymond R. Cunningham, the former president and chief executive officer of IFG and a former member of the Invesco funds' board of directors, for his role in IFG's market timing program. That settlement required Cunningham to pay \$1 in disgorgement and \$500,000 in civil penalties.<sup>104</sup> Cunningham was also barred, with a right to reapply in two years, from association with any investment adviser or broker-dealer and was subject to a mutual fund industry prohibition.<sup>105</sup>

From at least 2001 through July 2003, IFG entered into undisclosed market timing agreements with over 40 individuals and entities, which allowed them to market time certain Invesco funds. Some of the timing agreements were entered into with the understanding that the market timer would maintain "sticky assets" in certain non-timed Invesco funds. At their height, the market timers held over \$1 billion of the assets invested in the Invesco funds and made excessive exchanges and redemptions totaling approximately \$58 billion. During this same time period, the Invesco funds' prospectuses represented that shareholders could make only four exchanges out of each fund per twelve-month period. Although he was responsible for informing the funds' board of directors about IFG's operations, Cunningham never disclosed the existence of the market timing agreements to the board.

Like IFG, AIM Advisors also entered into undisclosed market timing agreements with individuals and entities, allowing the timers to exceed AIM Mutual Funds' ten-exchange-per-year limit, and to make trades, valued collectively at tens of millions of dollars, within AIM Mutual Funds.<sup>106</sup> One of the timing agreements was entered into with the understanding that the market timer would invest sticky assets in certain AIM Mutual Funds.

### **3. Alliance Capital Management**

On December 18, 2003, the Commission settled an enforcement action against Alliance Capital Management, L.P. for defrauding mutual fund investors by allowing market timing in certain of its mutual funds.<sup>107</sup> The Commission ordered Alliance Capital to pay \$250 million in

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<sup>104</sup> *In the Matter of Raymond R. Cunningham*, Investment Company Act Release No. 26630 (Oct. 8, 2004) ("*Cunningham Order*").

<sup>105</sup> Section 9(b) of the Act authorizes the Commission to prohibit, conditionally or unconditionally, either permanently or for a specified period of time, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser, or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter. In this Report we refer to a sanction imposed under this authority as a "mutual fund industry prohibition."

<sup>106</sup> AIM Advisors entered into 10 market timing agreements.

<sup>107</sup> *In the Matter of Alliance Capital Management, L.P.*, Investment Company Act Release No. 26312A (Jan. 15, 2004).

disgorgement and penalties. The Commission also ordered Alliance Capital to undertake certain compliance and fund governance reforms designed to prevent a recurrence of the kind of conduct described in the Commission's Order.

The Commission found that Alliance Capital entered into undisclosed arrangements permitting market timing in certain of its mutual funds in exchange for sticky assets invested in its hedge funds and mutual funds. By virtue of these arrangements, Alliance Capital reaped additional management fees, but exposed its mutual funds to the potential adverse effects of market timing, of which it was aware.

At the height of the activity in 2003, Alliance Capital had arranged over \$600 million in approved market timing in its mutual funds. Its single biggest timer, Daniel Calugar, owner of Security Brokerage, Inc. in Las Vegas, Nevada, at one time had \$220 million of timing capacity in certain mutual funds. In exchange, Mr. Calugar invested in hedge funds managed by some of the same portfolio managers overseeing the mutual funds. For example, Alliance Capital granted Calugar \$150 million timing capacity (the right to make multiple roundtrip trades up to \$150 million each) in the AllianceBernstein Technology Fund in return for a \$30 million investment – a 5 to 1 ratio – in a hedge fund managed by the same portfolio managers.<sup>108</sup>

Alliance Capital also solicited shareholder approval to lift a restriction on futures trading in one of the funds by means of a misleading proxy. Alliance Capital failed to disclose that one reason for seeking to lift the restriction was to enable the portfolio manager to manage better the cash flows resulting from market timers.

In addition, Alliance Capital provided confidential information about the portfolio holdings of certain mutual funds to Canary Investment Management. The disclosure enabled Canary to profit from market timing in declining markets.

#### **4. Massachusetts Financial Services**

On February 5, 2004, the Commission settled an enforcement action against MFS, its chief executive officer John W. Ballen, and its president and chief investment officer Kevin R. Parke, for violating federal securities laws by allowing widespread market timing trading in certain MFS mutual funds in contravention of those funds' public disclosures.<sup>109</sup> The Commission censured MFS and ordered it to pay \$225 million in disgorgement and penalties. The Commission's order also requires MFS to undertake certain compliance and mutual fund

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<sup>108</sup> The Commission filed civil fraud charges against Security Brokerage and Calugar for their participation in a scheme to defraud mutual fund shareholders through improper late trading and market timing. The Commission alleged that from at least 2001 to 2003, Calugar, trading through Security Brokerage, reaped profits of approximately \$175 million from improper late trading and market timing, principally through mutual funds managed by Alliance Capital and MFS. The case is pending. See *SEC v. Daniel Calugar*, Litigation Release No. 18524 (Dec. 24, 2003).

<sup>109</sup> *MFS Order*, note 10 above.

governance reforms designed to enhance the independence of mutual fund boards of trustees and strengthen oversight of MFS's compliance with the federal securities laws.

For their roles in the misconduct, the Commission prohibited Ballen and Parke from serving as an officer, chairman, or director of any investment adviser and from serving as an employee, officer, or trustee of any registered investment company for three years. In addition, the Commission's order, among other things, places restrictions on the duties Ballen and Parke can perform during that period. For nine months and six months, Ballen and Parke, respectively, were suspended from association with any investment adviser and were subject to a mutual fund industry prohibition, and were each ordered to pay a penalty of \$250,000 and disgorge over \$55,000 in ill-gotten gains derived from MFS's market timing practices.

The Commission found that beginning in late 1999, MFS began including disclosures in its retail mutual fund prospectuses that it prohibited market timing trading in those funds. Contrary to those disclosures, MFS internally categorized certain of its retail funds as "Unrestricted Funds" with respect to market timing, and knowingly permitted widespread market timing in these funds. Ballen and Parke implemented MFS's undisclosed policy permitting market timing trading in its Unrestricted Funds during the same period that they signed registration statements for certain funds that stated they prohibited market timing.

## **5. Columbia Management Advisors (FleetBoston)**

On February 9, 2005, the Commission announced the settlement of an enforcement action against two subsidiaries of FleetBoston Financial Corporation, Columbia Management Advisors, Inc. ("Columbia Advisors") and Columbia Funds Distributor, Inc. ("Columbia Distributor"), and against three former Columbia executives in connection with undisclosed market timing arrangements in the Columbia Funds. In settling the matter, the Columbia entities agreed to pay \$140 million in disgorgement and penalties.<sup>110</sup>

In separate orders, the Commission found that Peter Martin, a former national sales manager, entered into several undisclosed timing arrangements that were inconsistent with the funds' prospectus disclosures, and that Erik Gustafson, formerly a Columbia portfolio manager, breached his fiduciary duty to the funds by approving four such arrangements. In addition, the Commission found that Joseph Palombo, formerly the chief operating officer of Columbia Advisors and chairman of the board of several Columbia funds, ignored indications of improper trading and failed to take appropriate action. Martin, Gustafson and Palombo agreed to the entry of settled orders requiring them to cease and desist from future violations. The Commission's order required Martin to pay \$60,000 in disgorgement and penalties and suspended him from association with any broker-dealer or investment adviser and imposed a mutual fund industry prohibition.<sup>111</sup> Gustafson will pay a \$100,000 penalty and serve a twelve-month suspension from

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<sup>110</sup> *In the Matter of Columbia Management Advisors, Inc.*, Investment Company Act Release No. 26752 (Feb. 9, 2005).

<sup>111</sup> *In the Matter of Peter Martin*, Investment Company Act Release No. 26754 (Feb. 9, 2005).

association with any investment adviser and be subject to a mutual fund industry prohibition for twelve months.<sup>112</sup> The Commission's order requires Palombo to be suspended from association with any investment adviser and imposes a mutual fund industry prohibition for six months, followed by a twelve-month suspension from serving as an officer or director of any investment adviser. The Commission's order also bars Palombo from serving as a trustee, officer or director of any registered investment company and requires him to pay \$100,000.<sup>113</sup>

The Commission also brought fraud charges against two additional former Columbia executives in federal district court. In its complaint, the Commission alleged that co-president James Tambone and senior sales executive Robert Hussey entered into or approved undisclosed timing arrangements with multiple investors that benefited the executives but were detrimental to long-term fund shareholders. The Commission's civil fraud complaint against Tambone and Hussey is pending.<sup>114</sup>

The Commission's order against Columbia Advisors and Columbia Distributor found that, from at least 1998 through 2003, Columbia Distributor secretly entered into arrangements with at least nine companies and individuals allowing them to engage in frequent short-term trading in at least seven Columbia funds. In connection with certain of the arrangements, Columbia Distributor and Columbia Advisors accepted sticky assets in certain funds. Columbia Advisors knew and approved of all but one of the arrangements and allowed them to continue despite knowing such short-term trading could be detrimental to long-term shareholders in the funds. The special arrangements were never disclosed to long-term shareholders or to the independent trustees of the Columbia funds. In addition to trading made pursuant to specific arrangements, Columbia allowed or failed to prevent hundreds of other accounts from engaging in a practice of short-term or excessive trading. Many of the arrangements and trades were directly contrary to representations made in fund prospectuses that the funds did not permit short-term or excessive trading.

## **6. Janus Capital Management**

On August 18, 2004, the Commission announced a settled enforcement action against Janus Capital Management LLC for entering into undisclosed market timing agreements with certain investors. The Commission ordered Janus to pay disgorgement and penalties of \$100 million. Janus also consented to a cease-and-desist order and a censure, and agreed to undertake certain compliance and mutual-fund governance reforms.<sup>115</sup>

The Commission found that Janus negotiated, but did not disclose, market timing

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<sup>112</sup> *In the Matter of Erik Gustafson*, Investment Company Act Release No. 26755 (Feb. 9, 2005).

<sup>113</sup> *In the Matter of Joseph Palombo*, Investment Company Act Release No. 26753 (Feb. 9, 2005).

<sup>114</sup> *SEC v. James Tambone*, Litigation Release No. 19269 (Feb. 9, 2005).

<sup>115</sup> *In the Matter of Janus Capital Management LLC*, Investment Company Act Release No. 26532 (Aug. 18, 2004).

agreements with 12 entities that allowed these entities to market time certain Janus mutual funds. At the time Janus entered into these agreements, the prospectuses for the funds being timed stated, or at least strongly implied, that Janus did not permit frequent trading or market timing in these funds. Some of Janus's market timing agreements were entered into with the understanding that the market timer would invest sticky assets in certain Janus mutual funds. In addition, Janus waived all redemption fees that would have otherwise been assessed against the market timers for their frequent trading activity.

## **7. Banc One**

On June 29 2004, the Commission settled an enforcement action against Banc One Investment Advisors Corporation ("BOIA"), a registered investment adviser and subsidiary of Bank One Corporation, and Mark A. Beeson, former President and CEO of One Group Mutual Funds ("One Group") and Senior Managing Director of BOIA. The Commission ordered BOIA to pay disgorgement and a penalty of \$50 million and ordered Beeson to pay a civil penalty of \$100,000. BOIA also consented to a cease-and-desist order and a censure, and agreed to undertake certain compliance and mutual fund governance reforms. In addition, Beeson consented to a bar from association with any investment adviser and a mutual fund industry prohibition (with a right to reapply in two years) and a three-year prohibition on serving as an employee, officer or director of a registered investment company, or a chairman, director, or officer of an investment adviser.<sup>116</sup>

The Commission found that BOIA violated, and Beeson aided and abetted violations of, the federal securities laws by: (i) allowing excessive short-term trading in One Group funds by hedge-fund manager Edward J. Stern (Canary) in the hope of attracting additional business; (ii) failing to charge Stern redemption fees as required by One Group's international-fund prospectuses; (iii) having no written procedures in place to prevent the disclosure of nonpublic portfolio holdings and improperly providing confidential portfolio holdings to Stern; and (iv) causing One Group funds to participate in joint transactions (a BOIA affiliate loaned money to Stern for the purpose of market timing), raising a conflict of interest. The Commission also found, among other things, that BOIA allowed excessive short-term trading in One Group funds by a market timer in Michigan in violation of fund prospectuses and failed to collect required redemption fees from a Texas hedge fund that engaged in short-term trading.

## **8. PIMCO**

In May 2004, the Commission filed civil fraud charges in federal court against PIMCO Advisors Fund Management LLC ("PA Fund Management"), two affiliated entities, Stephen J. Treadway, the chief executive officer of PA Fund Management, as well as the chairman of the board of trustees for the PIMCO Equity Funds: Multi-Manager Series ("PIMCO Funds"), and Kenneth W. Corba, for defrauding of PIMCO Funds investors in connection with an undisclosed

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<sup>116</sup> *In the Matter of Banc One Investment Advisors Corporation*, Investment Company Act Release No. 26940 (June 29, 2004).

market timing arrangement with Canary.<sup>117</sup>

On September 13, 2004, the Commission announced that the PIMCO entities agreed to a settlement of charges that they defrauded investors. The Commission found that from February 2002 to April 2003, PIMCO Funds' advisers provided "timing capacity" in their mutual funds to Canary in return for sticky assets in a mutual fund and a hedge fund from which the advisers earned management fees. The prospectuses for the mutual funds failed to disclose that an agreement had been made to permit timing in the funds in exchange for sticky assets. In addition, the prospectuses gave the misleading impression that the PIMCO Funds discouraged market timing. At the height of the agreement, Canary used over \$60 million in timing capacity in several different mutual funds and invested \$27 million in sticky assets into a mutual fund and a hedge fund. Treadway approved the market timing arrangement sometime around January 2002 but did not disclose his knowledge of the arrangement to the board of trustees until approximately September 2003. Under the settlement, the PIMCO entities have been ordered to pay \$50 million in disgorgement and penalties.<sup>118</sup> The Commission's litigation in federal court continues against Treadway and Corba.

### **C. ENFORCEMENT ACTIONS INVOLVING MARKET TIMING BY FUND MANAGERS**

In some cases, fund managers not only allowed undisclosed market timing, but engaged in market timing of funds under their management for their own accounts. These self-dealing transactions illustrate the extent to which some fund managers abused their fiduciary responsibilities to fund investors.

#### **1. Pilgrim Baxter & Associates**

On November 20, 2003, the Commission filed an injunctive action in the United States District Court against Gary L. Pilgrim, Harold J. Baxter, and Pilgrim Baxter & Associates, Ltd. ("Pilgrim Baxter"), a registered investment adviser, charging them with fraud and breach of fiduciary duty in connection with market timing of the PBHG funds.<sup>119</sup> Pilgrim was the President, Chief Investment Officer and Director of Pilgrim Baxter, and the President of the PBHG funds. Baxter was the CEO and Chairman of Pilgrim Baxter, and the Chairman and a trustee of the PBHG funds and the PBHG Insurance Series Fund. Pilgrim and Baxter each resigned from their positions on November 13, 2003, and the Commission subsequently settled charges against Pilgrim, Baxter and the investment adviser.

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<sup>117</sup> *SEC v. PIMCO Advisors Fund Management LLC*, Litigation Release No. 18697 (May 6, 2004). See also PIMCO Equity Mutual Funds' Adviser, Sub-Adviser, and Distributor to Pay \$50 Million to Settle Fraud Charges for Undisclosed Market Timing, Press Release No. 2004-127 (Sept. 13, 2004).

<sup>118</sup> *In the Matter of the PA Fund Management LLC*, Investment Company Act Release No. 26594 (Sept. 13, 2004).

<sup>119</sup> *SEC v. Gary L. Pilgrim*, Litigation Release No. 18474 (Nov. 20, 2003).

The Commission found that the respondents permitted a hedge fund in which Pilgrim and his wife had a substantial interest to engage in market timing of the PBHG Growth Fund, which Pilgrim himself managed.<sup>120</sup> The Commission also found that Baxter provided non-public PBHG fund portfolio information to a close friend who headed a New York brokerage firm. The friend then passed this information to brokerage customers to assist their market timing efforts in the PBHG funds and exercise hedging strategies through other financial and brokerage institutions.

In June 2004, the Commission settled charges against Pilgrim Baxter, and entered a Commission Order instituting settled administrative and cease-and-desist proceedings. The Commission found that Pilgrim Baxter recognized that market timing was detrimental to funds. PBHG funds' prospectuses in effect at the time limited shareholder exchanges into the PBHG Cash Reserves Fund from any other PBHG fund to four times a year. Notwithstanding this published limitation, more than two dozen investors, including the hedge fund in which Pilgrim invested and the brokerage firm headed by Baxter's friend conducted short-term trading in the PBHG funds with the respondents' knowledge and consent. At its peak, approximately 28 accountholders of PGBH funds, whose accounts contained total assets of approximately \$600 million, exceeded the four exchange policy.

In the summer of 2001, the respondents suspended trading by all of the timers except the hedge fund in which Pilgrim invested and the brokerage firm headed by Baxter's friend, which were permitted to continue their short-term trading through the end of 2001. Neither Pilgrim nor Baxter informed the board of trustees of the funds or fund shareholders that Pilgrim had an extensive financial interest in the hedge fund that employed a short-term trading strategy and had been permitted to trade in the fund that Pilgrim was managing. In 2000 and 2001, the Commission found that the hedge fund profited by at least \$9 million from its trading activity in the PBHG funds, while the PBHG Growth Fund, in which the hedge fund primarily conducted its short-term trading and which Pilgrim managed, reported losses of nearly 23 percent and 34 percent in 2000 and 2001, respectively.

Based on the findings in that Order, the Commission ordered Pilgrim Baxter to pay \$90 million in disgorgement and penalties. Pilgrim Baxter also consented to a censure and an order to cease and desist from committing or causing any violations and future violations of the antifraud provisions of the Investment Advisers Act and its requirement to establish, enforce, and maintain policies and procedures to prevent the misuse of material nonpublic information by the investment adviser, and section 34(b) of the Investment Company Act. Pilgrim Baxter also further agreed to undertake a series of compliance and mutual fund governance reforms.

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<sup>120</sup> See *In the Matter of Gary L. Pilgrim*, Investment Company Act Release No. 26655 (Nov. 17, 2004) ("*Pilgrim Order*"); *In the Matter of Harold J. Baxter*, Investment Company Act Release No. 26656 (Nov. 17, 2004); *In the Matter of Pilgrim Baxter & Associates, LTD*, Investment Company Act Release No. 26470 (June 21, 2004).

On November 17, 2004, the Commission settled the charges against Gary L. Pilgrim and Harold J. Baxter under a settled administrative and cease-and-desist proceeding. Baxter and Pilgrim each agreed to pay \$80 million in disgorgement and penalties. Baxter also consented to a bar from association with any broker, dealer, transfer agent, or investment adviser, and agreed to a mutual fund industry prohibition. Pilgrim consented to a bar from association with any transfer agent or investment adviser and agreed to a mutual fund industry prohibition.

## **2. Strong Capital Management**

In May 2004, the Commission settled an enforcement action against Strong Capital Management, Inc. (“SCM”), its founder and majority owner, Richard S. Strong for allowing and, in the case of Strong, engaging in undisclosed frequent trading in Strong mutual funds in violation of their fiduciary duties to the Strong funds and their investors. The Commission ordered SCM to pay \$80 million in disgorgement and penalties; ordered Strong to pay \$60 million in disgorgement and penalties; and barred Strong from association with any investment adviser, broker, dealer, municipal securities dealer or transfer agent and imposed a mutual fund industry prohibition. The Commission also imposed sanctions on two other officers of SCM and two affiliated entities.<sup>121</sup>

The Commission found that SCM entered into an express agreement with Edward J. Stern allowing Canary hedge funds to trade frequently in four Strong funds and discussed the possibility of other non-mutual fund investments from Stern and his family. The agreement enabled the Canary hedge funds to realize gross profits of \$2.7 million and net profits of \$1.6 million from December 2002 to May 2003. The Strong funds’ prospectuses and SCM’s policies and practices created the misleading impression that frequent trading of the kind practiced by Strong and the Canary hedge funds would not be allowed. Moreover, during the time Canary was market timing certain Strong funds, other shareholders who attempted to engage in frequent trading were prohibited from such trading. During the period in which it was frequently trading Strong funds, Canary invested \$500,000 in one of Strong’s hedge funds.

Richard Strong engaged in frequent trading in ten Strong funds, including one fund that he managed. Between 1998 and 2003, he engaged in several hundred of these trades, making gross profits of \$4.1 million and net profits of \$1.6 million. SCM failed to disclose Strong’s personal trading, to the Strong funds’ boards of directors or shareholders.

## **3. Putnam Investment Management**

On April 8, 2004, the Commission settled an enforcement action against Putnam Investment Management, LLC, under which the Commission ordered Putnam to pay \$55 million in disgorgement and penalties for violating the federal securities laws by failing to disclose improper market timing trading by Putnam portfolio managers.<sup>122</sup> Putnam also consented to

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<sup>121</sup> *Strong Order*, note 10 above.

<sup>122</sup> *In the Matter of Putnam Investment Management, LLC*, Investment Company Act Release No. 26412 (Apr. 8, 2004).

adopt certain restrictions on employee transactions in Putnam funds and implement employee trading compliance review and oversight measures.

Beginning as early as 1998, at least six Putnam investment management professionals engaged in excessive short-term trading of Putnam funds in their personal accounts. Four of those employees engaged in such trading in funds over which they had investment decision-making responsibility. Although Putnam became aware in 2000 that several investment management professionals were engaging in potentially self-dealing short-term trading of mutual fund shares, Putnam failed to disclose this trading to the boards of directors of the mutual funds it managed and to the funds' shareholders.

The Commission also filed an injunctive action charging two Putnam employees, portfolio managers Justin M. Scott and Omid Kamshad, with securities fraud for engaging in excessive short-term trading of Putnam funds in their personal accounts.<sup>123</sup> That action is pending.

#### **D. ENFORCEMENT ACTIONS INVOLVING REVENUE SHARING AND DIRECTED BROKERAGE ARRANGEMENTS**

##### **1. Morgan Stanley**

On November 17, 2003, the Commission settled an enforcement action with Morgan Stanley DW Inc., a broker-dealer, for failing to provide its customers with important information relating to their purchases of mutual fund shares. As part of the settlement, Morgan Stanley paid \$50 million in disgorgement and penalties, which will be distributed to Morgan Stanley customers. This matter involved two distinct, firm-wide disclosure failures by Morgan Stanley. The first related to Morgan Stanley's "Partners Program" and its predecessor, in which a select group of mutual fund complexes paid Morgan Stanley substantial fees for preferred marketing of their funds. To encourage its sales force to recommend the purchase of shares in these "preferred" funds, Morgan Stanley paid increased compensation to individual registered representatives and branch managers on sales of those funds' shares. The fund complexes paid these fees in cash or in the form of portfolio brokerage commissions.<sup>124</sup> Morgan Stanley did not require its registered representatives to disclose that they received higher compensation for selling these funds over other funds offered by Morgan Stanley.

Morgan Stanley also failed to adequately disclose at the point of sale the higher fees associated with large (\$100,000 or greater) purchases of Class B shares of certain Morgan Stanley funds. In connection with its recommendation to customers to purchase certain Class B shares, Morgan Stanley did not adequately inform customers at the point of sale that large purchases of those shares were subject to higher fees than large purchases of Class A shares. Significantly, Morgan Stanley also failed to explain to customers that those fees could have a

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<sup>123</sup> *SEC v. Justin M. Scott*, Litigation Release No. 18428 (Oct. 28, 2003).

<sup>124</sup> *In the Matter of Morgan Stanley DW Inc.*, Securities Act Release No. 8339 (Nov. 17, 2003).

negative impact on customers' investment returns. As with the sales of funds in the "preferred" programs, Morgan Stanley's sales force stood to earn more on sales of Class B shares of Morgan Stanley funds than on sales of Class A shares.<sup>125</sup>

## 2. Massachusetts Financial Services

On March 31, 2004, the Commission settled an enforcement action against MFS, related to the company's use of mutual fund assets – namely, brokerage commissions on mutual fund transactions – to pay for the marketing and distribution of mutual funds in the MFS fund complex ("MFS Funds"). The Commission issued an order finding that MFS failed adequately to disclose to the boards of trustees and to shareholders of the MFS Funds the specifics of its "shelf-space" arrangements with brokerage firms and the conflicts created by those arrangements. As part of the settlement, MFS agreed to a series of compliance reforms and to pay a penalty of \$50 million, which will be distributed to the MFS Funds.<sup>126</sup>

The Commission found that from at least January 1, 2000, through November 7, 2003, MFS negotiated bilateral arrangements, known as "Strategic Alliances," with approximately 100 broker-dealers. Under these arrangements, MFS paid cash and directed brokerage commissions on fund portfolio transactions to the brokerage firms in exchange for heightened visibility within the brokerage firms' distribution networks. Based upon negotiated formulas, MFS paid brokerage firms anywhere from 15 to 25 basis points on mutual fund gross sales and/or 3 to 20 basis points on assets held over one year. MFS satisfied the Strategic Alliances in two ways: by paying cash, or by "allocating" brokerage commissions to selling brokers. When MFS satisfied the Strategic Alliances with brokerage commissions, it paid 1.5 times (or some other negotiated multiple) the amount broker-dealers requested to satisfy the same Strategic Alliances in hard dollars. MFS did not adequately disclose to the funds' boards and shareholders the quid pro quo nature of these arrangements and the attendant conflicts of interest they created.

## 3. PIMCO

On September 15, 2004, the Commission settled an enforcement action against the investment adviser, sub-adviser, and principal underwriter and distributor for the PIMCO Funds. The Commission found that certain entities had failed to disclose to the funds' board of directors and shareholders material facts and conflicts of interest that arose from their use of directed brokerage on the funds' portfolio transactions to pay for shelf space arrangements with selected

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<sup>125</sup> The Commission's order found that this conduct violated section 17(a)(2) of the Securities Act of 1933 and rule 10b-10 under the Securities Exchange Act of 1934. Section 17(a)(2) prohibits the making of materially misleading statements or omissions in the offer and sale of securities. Rule 10b-10 requires broker-dealers to disclose the source and amount of any remuneration received from third parties in connection with a securities transaction. The order also found that the conduct violated NASD Rule 2830(k), which prohibits NASD members from favoring the sale of mutual fund shares based on the receipt of brokerage commissions. *Id.*

<sup>126</sup> *In the Matter of Massachusetts Financial Services Company*, Investment Company Act Release No. 26409 (Mar. 31, 2004).

broker-dealers. In addition, the Commission found that PA Distributors caused the funds to violate rule 12b-1(b) by financing the funds' distribution through the direction of brokerage, although that financing was not described in the funds' 12b-1 distribution plans. The entities agreed to pay over \$11.6 million in disgorgement and penalties and to undertake significant disclosure and compliance reforms.<sup>127</sup>

Between 2000 and 2003, PA Distributors LLC, the principal underwriter and distributor for the PIMCO Funds, with the knowledge and approval of PA Fund Management, entered into shelf space arrangements with nine broker-dealers. Under those arrangements, PA Distributors agreed to pay the broker-dealers, based upon individually negotiated formulas relating to gross fund sales and the retention of fund assets, for heightened visibility for PIMCO funds within the broker-dealers' distribution systems. Most of the payments for shelf space arrangements were made in cash out of the assets of PA Distributors. Nevertheless, PA Fund Management and PA Distributors requested that PEA Capital LLC, a subadviser to certain PIMCO Funds, direct brokerage on PIMCO Funds' portfolio transactions to certain broker-dealers who accepted brokerage commissions in lieu of cash.

The use of fund assets to defray PA Distributors' shelf space expenses should have been disclosed to the funds' board of directors and shareholders. This arrangement created a conflict of interest that PA Fund Management, as a fiduciary, was obliged to disclose. PEA Capital, a fiduciary responsible for investing fund assets and directing brokerage, also had an obligation to alert the PIMCO Fund boards to the fact that PA Fund Management and PA Distributors had asked that fund assets be used for PA Distributors' benefit. In addition, PA Fund Management, PEA Capital and PA Distributors failed to ensure that each fund's brokerage commissions were used to support only the distribution of that fund, and instead allowed the brokerage commissions paid by some PIMCO Funds to subsidize the distribution of the shares of other funds in the PIMCO complex.

#### **4. Edward D. Jones & Co.**

The Commission settled an enforcement proceeding against Edward D. Jones & Co., L.P., a registered broker-dealer, on December 22, 2004. Edward Jones failed to disclose adequately revenue sharing payments that it received from a select group of mutual fund families that Edward Jones recommended to its customers. As part of the settlement, Edward Jones has agreed to pay \$75 million in disgorgement and civil penalties. Edward Jones also agreed to disclose on its public Internet web site information regarding revenue sharing payments and hire an independent consultant to review and make recommendations about the adequacy of Edward Jones' disclosures.<sup>128</sup>

The Commission found that Edward Jones had entered into revenue sharing arrangements

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<sup>127</sup> *In the Matter of PA Fund Management LLC et al.*, Investment Company Act Release No. 26598 (Sept. 15, 2004).

<sup>128</sup> *In the Matter of Edward D. Jones & Co., L.P.*, Securities Act Release No. 8520 (Dec. 22, 2004).

with seven mutual fund families, which Edward Jones designated as “Preferred Mutual Fund Families.” Edward Jones told the public and its clients that it was promoting the sale of the Preferred Families’ mutual funds because of the funds’ long-term investment objectives and performance. At the same time, Edward Jones failed to disclose that it received tens of millions of dollars from the Preferred Families each year, on top of commissions and other fees, for selling their mutual funds. Edward Jones also failed to disclose that such payments were a material factor, among others, in becoming and remaining an Edward Jones Preferred Family fund. Edward Jones provided the Preferred Families with certain benefits not otherwise available to non-preferred families including, among other things, exclusive shelf space for the sale and marketing of their funds and exclusive access to Edward Jones’ investment representatives and customer base. Edward Jones also exclusively promoted the 529 college savings plans offered by its Preferred Families over all other 529 plans that it had available to sell.

## **5. Franklin Advisers Inc.**

On December 13, 2004 the Commission settled an enforcement action against Franklin Advisers Inc. (“FA”), and Franklin Templeton Distributors, Inc. (“FTD”) (collectively “Franklin”) the investment adviser and principal underwriter respectively for the Franklin Templeton Investments Complex.<sup>129</sup> Without proper disclosure, Franklin used assets of the funds that it managed to compensate certain brokerage firms that recommended Franklin Templeton mutual funds to their clients over other funds. As part of the settlement, Franklin agreed to pay \$20 million in civil penalties, which will be distributed to the Franklin funds whose assets were used to pay for the marketing. Franklin undertook to retain an independent consultant to develop a plan for distributing the penalty and to institute compliance measures designed to prevent future violations, including, appointing an employee to design and implement policies and procedures regarding marketing arrangements with broker-dealers.

Between 2001 and 2003, FTD had agreements with 39 broker-dealers under which the brokers promoted Franklin Templeton funds. In exchange for preferential marketing of the funds, Franklin allocated \$52 million from brokerage commissions related to trades of the portfolios of Franklin Templeton funds, (such brokerage commissions are fund assets) to those 39 broker-dealers. The use of brokerage commissions to compensate brokerage firms for promotion created a conflict of interest. FA benefited from the increased management fees resulting from the increased fund assets that resulted from the marketing arrangements. However, instead of paying for this benefit from Franklin’s own assets, it used assets of the mutual funds it advised (the brokerage commissions it directed to the 39 broker-dealers). Because of these arrangements, FA had an incentive to direct its fund portfolio trading to brokerage firms that might not have been the best choice for fund shareholders. Franklin was required, but failed, to disclose adequately these arrangements to the funds’ boards so they could approve this use of fund assets, and to fund shareholders so they could be informed when making

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<sup>129</sup> *In the Matter of Franklin Advisers, Inc.*, Investment Company Act Release No. 26692 (Dec. 13, 2004).

investment decisions.

The funds' boards were not specifically advised of the practice of paying for shelf space with directed brokerage and were never made aware of several potential conflicts of interest, including that FTD had a choice about whether to pay for the shelf space from its own assets or the funds' assets and that FA stood to profit from higher fees resulting from increased assets under management. As a result, the boards were unable to adequately evaluate the funds' overall marketing expenses in approving the funds' marketing plans as required by the Commission pursuant to rule 12b-1. Because they were not given the opportunity to approve the practice of using fund assets to pay for shelf space, the boards could not adequately evaluate whether this use of fund assets was in accordance with the best interests of the funds' shareholders. Nor could they evaluate the funds' overall marketing expenses.

#### **IV. THE INDEPENDENT CHAIR CONDITION OF THE 2004 EXEMPTIVE RULE AMENDMENTS**

In assessing the significance of the compliance breakdowns that came to light in 2003 and 2004, the Commission, after careful analysis, discussions, and review of comments from the public and the industry, determined that boards and independent directors were not adequately monitoring the conflicts of interest that are inherent in the mutual fund industry. The Commission also concluded that strengthening the role and the ability of independent directors to actively discharge their oversight responsibilities under the Exemptive Rules would provide additional needed protections for fund investors and would be in the public interest.

##### **A. THE COMMISSION'S RULES THAT ADDRESS FUND COMPLIANCE ISSUES RELY ON BOARDS OF DIRECTORS**

As discussed in Section III above, the Commission and other law enforcement agencies in 2003 and 2004 uncovered an array of compliance problems related to mutual funds. In response to the breakdown in compliance controls evident at some of the largest and most widely held mutual funds, their affiliates, and related business entities, the Commission took a series of steps designed to address the abuses.<sup>130</sup>

- ***Compliance Procedures.*** The Commission adopted rules requiring that all

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<sup>130</sup> In addition to the rules described below, the Commission took other steps to address the compliance breakdowns, including rule and disclosure form amendments (i) to prevent late trading in mutual fund shares, (ii) to require funds to provide better disclosure of their policies to address market timing transactions, and (iii) to require that registered investment advisers adopt codes of ethics and implement other procedures to address conflicts of interest that arise from personal trading by investment advisory personnel. *See* Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26418 (Apr. 16, 2004); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26492 (July 2, 2004).

funds and their advisers adopt and implement compliance policies and procedures. These rules require the appointment of a chief compliance officer who reports directly to the fund's board of directors.<sup>131</sup>

- ***Board Consideration of Fund Redemption Fees.*** In response to evidence of market timing abuses at mutual fund complexes, the Commission adopted a new rule that requires mutual fund boards to adopt a redemption fee or determine that a redemption fee is not appropriate for the fund.<sup>132</sup>
- ***Board Approval of Advisory Contracts.*** The Commission amended its rules and forms to improve the disclosure that funds provide to shareholders regarding the reasons for the fund board's approval of an investment advisory contract.<sup>133</sup>
- ***Board Monitoring of Directed Brokerage.*** In response to evidence of funds directing their portfolio transactions to broker-dealers as a way to compensate them for distributing fund shares, the Commission adopted a rule amendment to prohibit that practice.<sup>134</sup> Directors have an important role in overseeing management compliance with the rule and more closely monitoring the allocation of brokerage, including the commission rates charged and the quality of the services rendered.

**B. IN 2004, THE COMMISSION REVISED THE FUND GOVERNANCE CONDITIONS OF THE EXEMPTIVE RULES TO ADDRESS FURTHER THE COMPLIANCE BREAKDOWNS**

The Commission determined that the breakdowns in fund management and compliance controls raised troubling questions about the ability of many fund boards more generally to effectively oversee the management of funds. In many respects, the enforcement cases bore a striking resemblance to the abuses that originally led to the enactment of the Investment Company Act.<sup>135</sup>

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<sup>131</sup> Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (“Compliance Release”).

<sup>132</sup> Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005).

<sup>133</sup> Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26486 (June 23, 2004).

<sup>134</sup> 12b-1 2004 Release, note 60 above.

<sup>135</sup> See S. REP. NO. 1775, note 13 above, at 6 (“[C]ontrol of [investment companies] offers manifold opportunities for exploitation by the unscrupulous managements of some companies. [Investment company] assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of the public security holders.”). See also section 1(b)(2) of the Act (finding that the interests of investors are adversely affected when funds are organized, operated and managed in the interests

In response, in January 2004 the Commission proposed to amend the Exemptive Rules that it had amended in 2001. The Commission proposed to require that any fund that relies on any of those rules meet certain fund governance standards. The Commission sought comment on the need and justification for amending the rules to include those governance standards. The Commission also sought comment on the costs and benefits of the proposed amendments,<sup>136</sup> the effect of the amendments on small entities,<sup>137</sup> and whether those amendments would promote efficiency, competition, and capital formation.<sup>138</sup>

The Commission's proposal engendered a substantial amount of interest. The Commission received nearly 200 comment letters from fund investors, management companies, independent directors to mutual funds, and members of Congress. The Commission also received several comments from organizations that had a more general interest in corporate governance issues. Most commenters supported the Commission's efforts to strengthen fund governance, but many were divided on some of the proposals. Some commenters believed the proposed amendments did not go far enough. Others recommended modifications.

After carefully considering the comments it received on the proposed amendments, in June 2004 the Commission adopted the following amendments to the Exemptive Rules, to enhance the independence and effectiveness of the fund's independent directors in overseeing or approving these transactions under the Exemptive Rules:

- ***Independent Composition of the Board.*** Independent directors are required to constitute at least 75 percent of the fund's board if the fund relies on an Exemptive Rule. (An exception to this 75 percent requirement allows fund boards with three directors to have all but one director be independent.) This requirement is designed to strengthen the hand of independent directors when dealing with fund management and may assure that independent directors maintain control of the board and its agenda.
- ***Independent Chairman.*** The chairman of the fund's board must be an independent director if the fund relies on an Exemptive Rule. This provision is discussed in detail below.

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of fund insiders).

<sup>136</sup> See 2004 Proposing Release, note 4 above, at Section V (cost-benefit analysis). In addition, the Office of Management and Budget determined, pursuant to 5 U.S.C. 804(2), that the 2004 Exemptive Rule Amendments did not constitute a major rule.

<sup>137</sup> See *id.* at Section VI (initial analysis under the Regulatory Flexibility Act, 5 U.S.C. § 603).

<sup>138</sup> See *id.* at Section VII (requesting comment on efficiency, competition and capital formation, which the Commission is required to consider pursuant to section 2(c) of the Act).

- **Annual Self-Assessment.** The board must assess its own effectiveness at least once a year if the fund relies on an Exemptive Rule. Its assessment would have to include consideration of the board’s committee structure and the number of funds on whose boards the directors serve.
- **Separate Meetings of Independent Directors.** The independent directors must meet in separate sessions at least once a quarter if the fund relies on an Exemptive Rule. This requirement is designed to provide independent directors the opportunity for candid discussions about management’s performance.
- **Independent Director Staff.** The fund must authorize the independent directors to hire their own staff if the fund relies on an Exemptive Rule. The rule does not require the hiring of a permanent staff, but allows independent directors to retain experts or other assistance when the need arises.

## C. THE INDEPENDENT CHAIR CONDITION

### 1. Boards Protect Fund Investors by Overseeing Operations and Addressing Conflicts of Interest

As discussed above in Section II, the board of directors of a fund has the responsibility to oversee the fund’s operations. Oversight of the investment adviser’s conflicts of interest as well as the conflicts of other affiliates and service providers of the fund, is a critical part of the board’s duties.<sup>139</sup>

A fund’s board of directors also is charged with the responsibility of overseeing the fund’s activities under any Exemptive Rule on which the fund may rely.<sup>140</sup> For example, if a fund relies on rule 10f-3 (one of the Exemptive Rules) to purchase securities from an affiliated underwriting syndicate, the board has the responsibility to be “vigilant” not only in reviewing the fund’s compliance with the procedures required by rule 10f-3, but also “in conducting any

<sup>139</sup> See American Bar Association, Committee on Federal Regulation of Securities, *FUND DIRECTOR’S GUIDEBOOK*, in 59 Bus. Law. 201, 240 (2003) (“The task of monitoring compliance involving the adviser or other affiliated persons of the fund falls primarily on the independent directors with guidance from their independent legal counsel.”). See also C. Meyrick Payne, *Hear My Voice: What a Fund Customer Wants From a Fund Director* (available from <www.mfgovern.com>) (stating that a fund investor wants its board to monitor conflicts of interest: “I really do want you to monitor ‘conflicts of interest.’ Anyone can see that if I give you my hard earned money, conflicts can arise. Please look out for my interests. Be loyal to me!”) (last visited Apr. 26, 2005).

<sup>140</sup> As discussed above, each of the Exemptive Rules (i) exempts funds or their affiliates from provisions of the Act that can involve serious conflicts of interest and (ii) conditions the exemptive relief on the approval or oversight of independent directors.

additional reviews that it determines are needed to protect the interests of investors.”<sup>141</sup>

The recent compliance breakdowns at mutual funds and investment advisers described above underscore the need for fund boards of directors to be vigilant in overseeing the operations of funds and their advisers. As discussed above in Section III, the past two years have revealed extensive compliance problems at mutual funds.

## **2. Independently Chaired Boards Are Better Able to Oversee Fund Operations and Monitor Conflicts of Interest**

### *a. The Chairman of a Board Exercises Leadership*

The chairman of a board exercises important leadership on the board. Model corporate bylaws provide that the “Chairman of the Board shall preside at all meetings of the shareholders and the Board of Directors.”<sup>142</sup> As one commenter on the 2004 Exemptive Rule amendments stated,

With the chairmanship comes the power to set the agenda, primary responsibility for determining what information is provided to the board by the fund adviser and other service providers, and the ability to guide board discussion of key issues.<sup>143</sup>

The Government Accountability Office came to a similar conclusion in testimony before the Senate Committee on Banking, Housing and Urban Affairs:

Our prior work also recognized that independent leadership of the [fund’s] board is preferable to ensure some degree of control over the flow of information from management to the board, scheduling of meetings, setting of board agendas, and holding top management accountable.<sup>144</sup>

Among the comment letters on the 2004 Exemptive Rule amendments, one director described his experience as a member of a fund board that made a difficult decision to change investment advisers. He stated that the decision would not have been possible without the leadership

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<sup>141</sup> Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate, Investment Company Act Release No. 22775 (July 31, 1997), at n.52 and accompanying text.

<sup>142</sup> See Marvin Hyman, Corporation Forms, Section 3:4 (Checklist for Drafting Corporate Bylaws – Model Bylaws), Article 4 (Officers), Section 5 (Duties) (2004 update).

<sup>143</sup> Comment Letter of Consumer Federation of America, et al., (Mar. 10, 2004) (“Consumer Federation Letter”), File No. S7-03-04.

<sup>144</sup> GAO, MUTUAL FUNDS: ASSESSMENT OF REGULATORY REFORMS TO IMPROVE THE MANAGEMENT AND SALE OF MUTUAL FUNDS (testimony of David M. Walker, Comptroller General, before the Senate Committee on Banking, Housing and Urban Affairs) (Mar. 10, 2004) at 16.

exercised by the independent chairman of the board.<sup>145</sup>

*b. Independent Chairmen Promote the Effectiveness of the Board.*

A fund board's primary responsibility is to protect the interests of the fund and its shareholders. These interests may be adversely affected by the substantial ongoing conflicts of interest of the fund management company. A fund board is in a better position to protect the interests of the fund, and to fulfill the board's obligations under the Act and the Exemptive Rules, when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund adviser.

Leadership by an independent chairman is likely to help the board be more effective in overseeing fund operations and monitoring conflicts of interest. As the Commission stated when it proposed and adopted the 2004 Exemptive Rule amendments, the chairman of a fund board can play an important role in setting the agenda of the board, and in establishing a boardroom culture that can foster meaningful dialogue between fund management and independent directors.<sup>146</sup> The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long-term interests of investors. A fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.

A range of commenters on the 2004 Exemptive Rule amendments agreed with the Commission's assessment that an independent chairman is more effective than an inside chairman.<sup>147</sup> As one investor stated, "current practice of allowing the same person to be chairman of a mutual fund board and a chairman or part owner of the mutual fund's outside investment adviser firm is – at best – a blatant conflict of interest and – at worst – an invitation to betray the interests of shareholders of the fund or the investment adviser firm."<sup>148</sup>

The independent chairman of the Goldman Sachs Trust and Goldman Sachs Variable Insurance Trust, for example, supported the independent chairman amendment and added that,

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<sup>145</sup> Letter from James J. McMonagle to William H. Donaldson, Chairman, SEC (Jan. 14, 2004), File No. S7-03-04 ("Your recommendation that all funds have an independent chairman is based in common sense, and is in the best interest of shareholders. If the Chairman of the Selected Funds Board in 1993 had not been independent, I am satisfied that we would not have moved the advisory contract.").

<sup>146</sup> See 2004 Proposing Release, note 4 above, at Section II.B.

<sup>147</sup> Other commenters disagreed with the independent chair provision the Commission proposed in 2004. As discussed below, however, those commenters largely viewed the provision as unnecessary (because independent directors can choose for themselves who should chair the board) or disadvantageous (because an independent chairman would not have as much expertise as an inside chairman).

<sup>148</sup> Comment Letter of Patricia Rizzolo (Feb. 24, 2004), File No. S7-03-04.

based on the funds' ten years of experience with an independent chairman, a chairman who is independent "can provide an important and meaningful role in the preparation of board agenda and in fostering the dialogue between fund management and the independent directors on fund-related matters."<sup>149</sup>

A fund board chairman can be more effective in overseeing fund conflicts of interest if the chairman is not subject to those conflicts. In testimony before the Senate Banking Committee, the managing director of a nationally prominent fund analyst firm stated,

While in U.S. operating companies the chairman and the CEO are often the same person, such an arrangement presents a conflict of interest in funds that does not exist in operating companies. In an operating company there is only one party to which directors, be they independent or not, owe their loyalty – the firm's stockholders. In a mutual fund there are two parties to which the non-independent directors owe their allegiance – one is the fund shareholder, the other is the stockholder in the fund management company. Only independent fund directors have a singular fiduciary responsibility to fund shareholders. Accordingly, we believe that fund shareholders may be better served when an independent chairman oversees their fund.<sup>150</sup>

The Mutual Fund Directors Forum, a nonprofit organization of U.S. fund directors including some of the largest fund groups, similarly concluded, in recommending as a best practice that all fund boards have independent chairs:

A fund's board can address potential conflicts of interest between the fund and its adviser, and between the fund and entities affiliated with the adviser, by limiting the adviser's control over the affairs of the fund. This goal can best be achieved if the fund's board is chaired by a person who is not affiliated with the fund's adviser or affiliates of the adviser.<sup>151</sup>

All seven of the living former chairmen of the Commission stated in their comment letter

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<sup>149</sup> Comment Letter of Ashok N. Bakhru, Chairman of the Board and Independent Trustee, Goldman Sachs Trust and Goldman Sachs Variable Insurance Trust (Mar. 9, 2004), File No. S7-03-04 ("Bakhru Letter").

<sup>150</sup> Don Phillips, Managing Director of Morningstar Inc., testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, pp. 7-8 (Feb. 25, 2004). *See also* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 814 (2001) ("[T]here are industries where the case for independence is compelling. The best example here is the mutual fund industry, where conflicts of interests are commonplace and traditional checks on managerial overreaching, such as vigorous shareholder voting and hostile tender offers, do not exist.").

<sup>151</sup> Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Mutual Fund Directors (July 2004) ("Forum Report"), at 6.

on the 2004 Exemptive Rule amendments,

An independent mutual fund board chairman would provide necessary support and direction for independent fund directors in fulfilling their duties by setting the board's agenda, controlling the conduct of meetings, and enhancing meaningful dialogue with the adviser.<sup>152</sup>

Several members of Congress also agreed with the benefits of having a fund's board be chaired by an independent director. Chairmen Oxley and Baker, and Senators Fitzgerald, Akaka, and Levin stated in a letter to the Commission,

We believe that an independent chairman would set the proper 'tone at the top' among those charged with overseeing the fund's internal controls and compliance by making it clear that the interests of fund shareholders, rather than that of management, are paramount. An independent chairman can foster the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance.<sup>153</sup>

A letter to the Wall Street Journal signed by several independent chairs at mutual funds also expressed support for the new provision: "By empowering fund independent directors to manage the board's agenda and control the boardroom dynamics, the [C]ommission has taken an important step forward in making the regulatory structure work as Congress intended."<sup>154</sup>

After the Commission adopted the 2004 Amendments, noted securities law expert Professor John Coffee of Columbia Law School noted that "There is something fundamentally wrong about a watchdog being an employee of the party being watched."<sup>155</sup>

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<sup>152</sup> Comment Letter of Richard C. Breeden, G. Bradford Cook, Roderick M. Hills, Arthur Levitt, Harvey L. Pitt, David S. Ruder, and Harold M. Williams (June 15, 2004), File No. S7-03-04.

<sup>153</sup> Letter from U.S. Representative Michael G. Oxley, Chairman, House Committee on Financial Services; U.S. Representative Richard H. Baker, Chairman, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises; U.S. Senator Peter G. Fitzgerald, Chairman, Senate Governmental Affairs, Subcommittee on Financial Management, the Budget, and International Security; U.S. Senator Daniel K. Akaka, Ranking Member, Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security; and U.S. Senator Carl Levin, Ranking Member, Senate Governmental Affairs Permanent Subcommittee on Investigations (Mar. 11, 2004), File No. S7-03-04.

<sup>154</sup> John A. Hill, Independent Chairman, Putnam Mutual Funds, *In Support of the SEC's New Mutual Fund Rules*, The Wall St. J., July 16, 2004, at A13. The letter was also signed by the following mutual fund independent chairs: Fergus Reid III, J.P. Morgan Funds; Arne H. Carlson, American Express Funds; Virginia Stringer, First American Funds; Leigh A. Wilson, the Victory Portfolios; Michael Scofield, Evergreen Funds; Clayton Yeutter, Oppenheimer Funds New York Board.

<sup>155</sup> Todd Mason, *SEC Vote Heralds Sweeping Fund-Industry Change*, The Philadelphia Inquirer, June 24, 2004, at C1 (quoting John Coffee, the Adolf A. Berle Professor of Law at Columbia Law School and the Director of Columbia Law School's Center on Corporate Governance).

c. *Independent Chairs Have Substantial Expertise*

Not all commenters on the 2004 Exemptive Rule amendments agreed with the Commission's assessment that independent chairmen will most often be more effective at leading fund boards and representing the interest of fund investors. Most of those who disagreed, however, stated that independent directors might not have the expertise in fund management needed to lead the board effectively.<sup>156</sup>

As the Commission noted when it adopted the 2004 Exemptive Rule amendments, boards are able to draw on the expertise of advisory personnel who may be available as either inside fund directors or as outside advisers to the board. The Commission stated,

[R]epresentatives of management would still be responsible for the day-to-day operations of the fund, [and] would continue to be able to serve as fund directors .... We do not believe that this amendment will deprive the board of management's knowledge and judgment. .... We fully expect that these executives ... will have every opportunity to engage the board on issues important to the fund investors as well as the management company.<sup>157</sup>

Other commenters argued that their experience had shown that independent chairmen did have the expertise necessary to effectively lead fund boards. As one independent chairman stated,

With regards to your specific question whether an independent director is able to lead effectively the board through a discussion of a detailed and complex agenda, our response is "yes." Independent directors are fully capable in this regard.<sup>158</sup>

Fund boards are also able to use the expertise that independent directors already possess. For example, some funds have recently appointed independent chairmen who are both expert in financial matters and closely aware of the fund's affairs. The American Century (Mountain View) board, for example, recently appointed Professor Ronald Gilson as independent chairman. Professor Gilson served for ten years as an independent director of the funds, and is also a professor of business law at both Columbia Law School and Stanford Law School.<sup>159</sup>

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<sup>156</sup> See 2004 Adopting Release, note 4 above, at n.49 and accompanying text (citing, *e.g.*, Comment Letter of F. Pierce Linaweaver, Chairman of the Committee of Independent Directors, T. Rowe Price Mutual Funds (Feb. 25, 2004), File No. S7-03-04).

<sup>157</sup> *Id.* at text following n.50 and at text accompanying n.60.

<sup>158</sup> Bakhru Letter, note 149 above.

<sup>159</sup> Professor Gilson is the Marc and Eva Stern Professor of Law and Business at Columbia Law School, and the Charles J. Meyers Professor of Law and Business at Stanford Law School. See Press Release, American Century Investments, "American Century Fund Boards Appoint Independent Chairmen a Year in Advance of SEC Compliance Deadline" (Dec. 15, 2004),

The Mutual Fund Directors Forum, described further in the next section, reflected this view as well: “We believe that a management director will be no less valuable because his or her title has changed from ‘chair’ to ‘director.’” In a February 2005 letter to Chairman Donaldson, the Forum’s board of directors predicted that “with the chair’s duties devolved onto another director, the management director – already carrying obligations to the management company’s shareholders – will be better able to play a more significant, more clarified and less conflicted role at the board table.”<sup>160</sup>

Some commenters were concerned that boards should be allowed to select their own chair, regardless of whether the person considered most qualified by the directors is independent. According to this argument, the directors should be permitted to exercise their judgment – consistent with their fiduciary duties – to select the most qualified and capable candidate to serve as chairman without restriction.

In adopting the 2004 Exemptive Rule amendments, the Commission explained that the amendments “do not prevent the independent directors from choosing the most qualified and capable candidate. That candidate, however, cannot serve two masters.”<sup>161</sup> The Forum has pointed out that a fund’s investment adviser, which may have sponsored and initially organized the fund, may have such presence on the board of directors that even a majority of independent directors would be reluctant to recommend that an independent director chair the board: “[I]n many situations fund directors do not feel sufficiently empowered to appoint an independent chair over the objection of existing fund management.”<sup>162</sup> Therefore, to the extent that the CEO or another senior employee of the management company exerts control and influence over a board, it seems unlikely that the independent directors – even if they compose 75 percent of the board – would be willing to propose the election of any other person as chair. The rule overcomes that reluctance to act.

#### *d. Alternatives Were Considered*

As discussed in the 2004 Proposing and Adopting Releases, a number of alternatives for achieving the Commission’s objectives were considered. The Commission did not believe that these alternatives were sufficient to address the problems highlighted by the mutual fund scandals.

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available at  
[http://www.americancentury.com/welcome/news\\_release2\\_2004.jsp?press\\_release=20041215](http://www.americancentury.com/welcome/news_release2_2004.jsp?press_release=20041215)  
(last visited Apr. 11, 2005).

<sup>160</sup> Letter from Mutual Fund Directors Forum Board of Directors to William H. Donaldson, Chairman, SEC (Feb. 17, 2005) (“Forum Letter”).

<sup>161</sup> 2004 Adopting Release, note 4 above, at text following n.48.

<sup>162</sup> Forum Letter, note 160 above.

These alternatives included designation of a lead independent director and increased reliance on board committees chaired by independent directors. As the Commission stated in the 2004 Adopting Release, “Neither of these arrangements, however, would create a position that is likely to be filled by a person with sufficient stature within the fund complex to serve as an effective counterweight to a fund chairman who may also be the chief executive officer of the management company.”<sup>163</sup> An independent director who had direct experience in this area concluded that, although appointing a lead independent director had improved the involvement of independent directors generally, “it is still difficult to influence the Board meeting agenda to assure full discussion of the more important items. Having an independent chair will significantly change the dynamics of the board meetings.”<sup>164</sup>

*e. Costs and Benefits Were Considered*

As discussed in the 2004 Proposing and Adopting Releases, while the benefits of the independent chair provision are significant, the Commission found that the costs associated with the provision were minimal. Some commenters suggested that the independent chair simply could be selected from among the fund’s existing independent directors.<sup>165</sup> When it proposed the independent chair provision, the Commission acknowledged that the provision could impose some additional costs on funds that rely on an Exemptive Rule. Although some commenters were concerned about the cost of hiring staff to assist the independent chair, the Commission said that it was not aware of any costs associated with the hiring of staff because “boards typically have this authority under state law, and the rule would not require them to hire employees.”<sup>166</sup> Although the amendments added a provision to authorize the independent directors to hire employees and to retain advisers and experts necessary to carry out their duties, the amendments did not require that they do so. The cost, if any, would be wholly within their discretion. Presumably any additional cost would be incurred because the independent directors decided that it was in the interest of the fund and its investors for them to retain staff to help them better carry out their duties. In any event, the additional costs, if any, are speculative at this point, and the Commission has no reliable basis for estimating those costs.

Even before the 2004 Exemptive Rule amendments, many funds had independent chairs. After the amendments were adopted, other funds have voluntarily instituted an independent chair even though the new conditions do not take effect until January 2006. None of these funds has indicated to the Commission staff that there were particular costs, much less burdensome costs,

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<sup>163</sup> 2004 Adopting Release, note 4 above, at text accompanying n.58. Further, as commenters pointed out, “[a]ppointing a lead director does nothing to ensure that independent directors control the agenda, information requests, and terms of board debate.” Consumer Federation Letter, note 143 above.

<sup>164</sup> Comment Letter of Anne J. Mills, Trustee of The Aquila Group of Funds (Feb. 2, 2004), File No. S7-03-04.

<sup>165</sup> See, e.g., Comment Letter of John A. Hill, Chairman of the Board, The Putnam Funds (May 12, 2004), File No. S7-03-04.

<sup>166</sup> 2004 Adopting Release, note 4 above, at Section VI.B.

associated with an independent chair. Indeed, although the Commission indicated that it would consider requests for relief from the independent chair provision if it proved burdensome, it has received no such requests. Therefore, we do not believe that the independent chair provision will result in a major increase in costs or prices for funds or their investors.

### **3. The Independent Chair Provision Has Received Continuing Substantial Support**

**Industry Groups.** The Forum, a prominent national industry group for fund directors expressed support for the independent chair provision. The Forum was organized in 2002 as a nonprofit organization that focuses on the needs of independent directors by providing educational and outreach programs.<sup>167</sup> It provides a forum for independent directors to discuss critical issues confronting fund investors, the funds and their directors. The Forum seeks to promote vigilant, dedicated, and well-informed independent directors.<sup>168</sup> The Forum is chaired by David S. Ruder, Chairman of the Securities and Exchange Commission from 1987 to 1989.

The Forum Letter expressed support for the independent chair provision, stating that “the best way to assure that mutual funds are operated in the best interests of their shareholders is to strengthen the ability of fund independent directors, through an independent chair, to fulfill their oversight responsibilities.”<sup>169</sup> The Forum Letter supported the Commission’s reasoning for adopting the amendments. First, like the Commission, the Forum identified controlling “the flow of information from management to the board and to shareholders” as important in “discovering, identifying, analyzing and managing conflicts of interest.”<sup>170</sup> The Forum Letter noted that by controlling this flow of information, “[a]n independent board chair can control the fund’s ‘corporate machinery’ by calling meetings, setting board agendas, and taking other actions without the adviser’s consent.”<sup>171</sup>

The Forum Letter also agreed with the Commission’s assessment of the critical importance and value of an independent fund chair. In adopting the 2004 Exemptive Rule amendments, the Commission explained, “The chairman can play an important role in providing a check on the adviser, in negotiating the best deal for shareholders when considering the advisory contract, and in providing leadership to the board that focuses on the long-term interests

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<sup>167</sup> The predecessor to the Forum was the Mutual Fund Directors Education Council, a group convened in 1999 in response to the call for improved fund governance by then-SEC Chairman Arthur Levitt. For information about the Forum, see [www.mfdf.com](http://www.mfdf.com).

<sup>168</sup> Forum membership is limited to independent directors of registered investment companies. The Forum has an Advisory Board comprised of mutual fund independent directors and individuals from organizations supporting the mutual fund industry.

<sup>169</sup> Forum Letter, note 160 above.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

of investors.”<sup>172</sup> According to the Commission, “a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.”<sup>173</sup> The Forum Letter similarly observed, “When the chair is affiliated with the adviser, the chair’s duties run naturally toward the adviser. Management directors cannot help but bring the adviser’s answers to the full board, instead of penetrating questions. They cannot unlearn what they have absorbed while serving the management company.”<sup>174</sup> The Forum supported the idea that with an independent chairman, “the board is better able to pose questions to which the adviser must respond.”<sup>175</sup>

The other industry group representing fund directors, the Independent Directors Council (“IDC”), was established by the Investment Company Institute to advance the education of, communication with, and development of policy positions by, independent fund directors. In January 2005, the IDC published a report, prepared by a task force consisting of 17 independent directors from a broad array of fund groups, chaired by Cynthia Hargadon of Wilshire Funds Allmerica Securities Trust.<sup>176</sup> According to the IDC’s task force report, “The Task Force agrees that an independent chairperson ... can play an important role ‘in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and independent directors that is crucial for healthy fund governance.’”<sup>177</sup>

In addition to support expressed by industry groups, well-respected individual fund industry participants also supported the amendments. For example, John C. Bogle, founder of Vanguard Group Inc., praised the amendments when they were first proposed, and he continues to be a strong supporter.<sup>178</sup> Shortly after the Commission adopted the amendments, Mr. Bogle

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<sup>172</sup> 2004 Adopting Release, note 4 above, at text following n.46.

<sup>173</sup> *Id.* at text following n.47.

<sup>174</sup> Forum Letter, note 160 above.

<sup>175</sup> *Id.*

<sup>176</sup> The IDC Independent Chair Task Force consisted of: William Altman (FPA Funds); John Benning (Liberty All-Star Funds); Kathy Cuocolo (Select Sector SPDR Trust); Dawn-Marie Driscoll (Scudder Funds); William Foulk (AllianceBernstein Funds); Gary Gerst (Harris Insight Funds); Rainer Greeven (Smith Barney Funds); Cynthia Hargadon, Chairperson (Wilshire Funds Allmerica Securities Trust); Sidney Koch (ING Funds); John Murphy (Smith Barney Funds); Frank Nesvet (StreetTRACKS Series Trust); Jock Patton (ING Funds); Michael Scofield (Evergreen Funds); Ed Smeds (Thrivent Funds); Robert Smith (Guardian Group of Funds); Susan Sterne (Sentinel Funds); and Frederick Vogel (Waddell & Reed Funds).

<sup>177</sup> Independent Directors Council, IMPLEMENTING THE INDEPENDENT CHAIRPERSON REQUIREMENT (Jan. 2005), at 1 (footnotes omitted) (*quoting* 2004 Adopting Release, note 4 above).

<sup>178</sup> See John C. Bogle, *Mutual Funds in the Coming Century ... While We're At It, Let's Build a Better World*, remarks before the Institutional Investor Magazine Mutual Fund Regulation and Compliance Conference, Washington, DC, May 5, 2005 (“[W]hen there are two clearly distinct corporate ships – the management company and the fund, each with its set of owners – there ought to be two captains.”) (“Bogle Speech”).

wrote in the Wall Street Journal that “the Act failed to establish a structure that would facilitate the realization of its noble purpose: Put the fund investor first.” According to Mr. Bogle, the Commission took “a courageous ... first major step in accomplishing that goal” when it adopted the independent chair condition.<sup>179</sup> Herbert Allison, chief executive of the teacher’s retirement system TIAA-CREF, called the amendments a “major victory” for fund investors and described the Commission’s action as affirming “the basic principle that the people who buy fund shares own the funds.”<sup>180</sup>

**State Regulators.** A number of state regulators have expressed their strong support of the independent chair provision of the amendments. State regulators from New York, California, and North Carolina came together and proposed a set of landmark “Mutual Fund Protection Principles” designed to shape the mutual fund industry to protect investors.<sup>181</sup> While proposing these mutual fund principles, the state regulators noted that they supported the amendments, and urged that they be strengthened.<sup>182</sup>

The Mutual Fund Protection Principles include recommending independent chairs for mutual funds, as well as other governance reforms that go beyond the requirements of the Commission’s 2004 Exemptive Rule amendments.<sup>183</sup> CalPERS, CalSTRS, and other influential public pension funds have adopted the Mutual Fund Protection Principles.<sup>184</sup> For states and public pension funds (or any other entities) that have adopted the Mutual Fund Protection Principles, a fund’s compliance with those principles will be considered when deciding whether a mutual fund may do business with that state or public pension fund (or other entity).

**Mutual Funds.** Years before the approval of the 2004 Exemptive Rule amendments, a number of major mutual fund complexes such as Thrivent, One Group, and Goldman Sachs, had independent chairs for their funds. Since the approval of the rule, a number of other funds have

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<sup>179</sup> John C. Bogle, *Fair Shake or Shakedown?*, The Wall St. J., July 8, 2004, at A14.

<sup>180</sup> Matt Ackermann, *SEC Independent Chairman Rule Hits Fund Giants*, American Banker, June 24, 2004, at 10 (*quoting* Herbert Allison).

<sup>181</sup> North Carolina Treasurer Moore, New York State Comptroller Hevesi, California Treasurer Angelides, Joined by New York AG Spitzer, Announce Landmark Mutual Fund Principles to Protect Investors and Pensioners (“Principles Press Release”) (Jan. 15, 2004) available at [http://www.oag.state.ny.us/press/2004/jan/1\\_15\\_04\\_mutual\\_fund\\_principles\\_release.pdf](http://www.oag.state.ny.us/press/2004/jan/1_15_04_mutual_fund_principles_release.pdf). (last visited Apr. 14, 2005).

<sup>182</sup> *Id.*

<sup>183</sup> *Id.* The principles include: “At least three-quarters of the mutual fund board and the chairman shall be independent directors and shall not have had any material business or employment relationships with the fund company, advisor or any service provider and shall not have had such a relationship for a period of five years prior to the appointment.”

<sup>184</sup> Treasurer Angelides Wins CalPERS Approval of Tough, New Mutual Fund Protection Principles, (Mar. 15, 2004) available at [http://www.treasurer.ca.gov/news/releases/2004/031504\\_pers.pdf](http://www.treasurer.ca.gov/news/releases/2004/031504_pers.pdf) (last visited Apr. 14, 2005).

taken the initiative and elected an independent chair far before the compliance date of the rule.<sup>185</sup> Funds such as Scudder, ING, UBS Brinson, American Century, and others all elected an independent chair more than a year in advance of the compliance deadline. American Century Funds stated that they “embrace the SEC’s new independent chairperson requirement” and were “in compliance with the new standard a full year in advance of the SEC deadline.”<sup>186</sup>

## V. ANALYSIS OF RELATION BETWEEN INDEPENDENT CHAIRS AND FUND PERFORMANCE, EXPENSES AND COMPLIANCE

As discussed above, the independent chair provision was designed to enhance independent oversight of conflict of interest transactions, not as a means of enhancing fund financial performance or lowering expenses. The Commission noted when it adopted the 2004 Exemptive Rule amendments that “having independent chairmen can provide benefits and serve other purposes apart from achieving high performance of the fund.”<sup>187</sup>

Nevertheless, the staff considered the relation of independent chairs to fund performance and expenses. As discussed below, the staff continues to believe that the analyses based on data currently available on performance and expenses are inconclusive – there is insufficient evidence to conclude that management-chaired funds have better performance or lower fees.

Below is a summary of the staff’s analysis of the evidence, methods, and data available on the relation of independent chairs to fund performance and expenses. In performing its analysis, the staff evaluated a report that was submitted in conjunction with a fund adviser’s comment letter on the 2004 Proposing Release (“Bobroff-Mack Report”).<sup>188</sup>

The staff’s empirical findings identify a high degree of sensitivity (that is, the choice of method and data samples can determine whether fund chair independence appears to have an effect on performance or expenses). We have concluded that certain choices of design and method in empirical analysis in this area can lead to inappropriate conclusions.

Finally, we discuss in the following section how an independent chair can improve a fund’s compliance with the federal securities laws.

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<sup>185</sup> *Boards Designate Independent Chairs ahead of Deadline*, Board IQ, Feb. 8, 2005, at 3.

<sup>186</sup> Putting Investors First, available at [http://www.americancentury.com/welcome/putting\\_investors\\_first.jsp](http://www.americancentury.com/welcome/putting_investors_first.jsp) (last visited Apr. 1, 2005).

<sup>187</sup> 2004 Adopting Release, note 4 above, at text following n.52.

<sup>188</sup> See GEOFFREY H. BOBROFF AND THOMAS H. MACK, ASSESSING THE SIGNIFICANCE OF MUTUAL FUND BOARD INDEPENDENT CHAIRS, A STUDY FOR FIDELITY INVESTMENTS (Mar. 10, 2004) (attached to Comment Letter of Fidelity Investments (Mar. 18, 2004), File No. S7-03-04).

## A. PERFORMANCE AND EXPENSES

### 1. Methodological Framework and Limitations

#### a. *Methods*

This section discusses the methods used to analyze the relation between the independence of mutual fund chairs and the performance and expenses of funds, and the methodological limitations inherent in such an analysis.

In analyzing whether funds with independent chairs “perform better” or “have lower expenses” compared to funds with inside (*i.e.*, management) chairs, there are a number of methodological decisions that could be made, any of which could affect the results. These include assumptions about how performance is measured, which expenses should be included, what time period should be examined, and which funds should be examined (or excluded from the analysis). Without careful design, empirical research is unlikely to reliably identify a relationship between governance and performance, even if such a relationship were to exist. Empirical research is potentially further hampered if one uses improper methods.

With these caveats in mind, this section examines the sensitivity of such analyses of the relations between chair type (*i.e.*, independent- or management-chaired funds) and excess returns and expenses. In light of the potential sensitivity of results to the choices of assumptions, the staff used an analytical framework consistent with the existing literature in order to analyze the differences between independent-chaired and management-chaired funds.

As is common in empirical analyses, we examined the “robustness” of the results. That is, are the results consistent in direction and magnitude across a range of similar approaches? Robustness is considered a key check of the validity of a conclusion that one draws from data. Results that are highly sensitive to methodological choices may be invalid. Our approach was to posit a range of alternate methodological approaches based on existing studies, in order to examine the robustness of existing studies regarding the relation between fund chair independence, and performance and fees. Our range of alternate methodological specifications includes various samples, performance and expense measurements, and an accounting for fund characteristics, such as distribution channel, which may affect performance and expenses.<sup>189</sup>

Specifically, the staff conducted sensitivity analyses to determine the degree to which the results reported in studies of this relation are dependent on particular methodological and study design choices. The staff (i) employed alternative approaches to measuring performance and expenses, (ii) used a larger sample of funds than used in other studies of which we are aware, and (iii) compiled data about fund governance characteristics to ensure proper identification of independent- and management-chaired funds.

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<sup>189</sup> While many of these alternatives are discussed in the Bobroff-Mack Report, they are not directly addressed in the Bobroff-Mack Report.

The staff also analyzed the Bobroff-Mack Report. The staff examined the sensitivity of the Bobroff-Mack Report’s findings by using alternative methods to estimate fund financial performance and fund expenses, and by expanding the amount of data analyzed.

*b. Performance and expense measures*

To illustrate the sensitivity of the relation between chair independence and the performance measures used, we estimated excess returns – returns in excess of market benchmarks – using three separate models. Two of these models (factor models) are standard methods in the academic literature.<sup>190</sup> The third model is a close approximation of the style-based methodology described in the Bobroff-Mack Report to measure excess returns. This excess returns methodology is based on a different design – it used a returns-based style analysis to construct factors from specific indices.<sup>191</sup>

With respect to performance, the staff used the same indices and groupings as the Bobroff-Mack Report to estimate excess returns. The staff estimated monthly excess returns for the three models and then aggregated at the fund level to calculate annual fund-family excess returns.<sup>192</sup> In order to assess the sensitivity of results to how funds are aggregated to the family level, we then calculated equally weighted and asset-weighted excess returns at the family level.

With respect to expenses, the Bobroff-Mack Report used measures of mutual funds’ category-adjusted expense ratio both including and excluding 12b-1 fees. That method of category-adjustment involves assigning each fund to a style-based category – equity, international, taxable fixed income, and tax-free fixed income – based on a combination of Lipper and Strategic Insight categories. The Bobroff-Mack Report then calculated average expenses across all funds within each category, and defined as the category-adjusted expense measure the difference between a fund’s expense measure and its category average. The authors then compared average category-adjusted expense measures across their sample of independent-

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<sup>190</sup> See Eugene F. Fama and Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. of Fin. Econ. 3 (1993). For additional background, see Eugene F. Fama and Kenneth R. French, *Multifactor Explanations of Asset-Pricing Anomalies*, 51 J. of Fin. 55 (1996); Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. of Fin. 57 (1997). For an overview of multifactor models, see chapter 20 of JOHN H. COCHRANE, *ASSET PRICING*, ch. 20, at 434 (2001).

<sup>191</sup> The Bobroff-Mack Report excess returns methodology is based on a different design than the factor models. The Bobroff-Mack Report assigns each fund to an investment style. It then uses different sets of indices for each style to determine the appropriate benchmark for each fund. The Bobroff-Mack Report stated that it uses “standard quadratic programming tools” to assign funds to one of three sets of portfolios. We assigned funds to their style portfolio using Strategic Insight Mutual Fund Research and Consulting, LLC’s (“Strategic Insight”) fund category code. We excluded prime funds and gold commodities funds.

<sup>192</sup> We calculate excess returns based on a rolling window of 60 months.

and management-chaired funds, and concluded that independent-chaired funds charge higher fees.

The staff designed its analysis to examine the robustness of the results of the Bobroff-Mack Report relative to the existing empirical evidence on the relation between chair independence and expenses. As in our performance analysis, we used the Bobroff-Mack analysis as a benchmark, and examined the results under alternative methodological choices. We calculated category-adjusted expense measures similar to those used in the Bobroff-Mack Report. We then compared both category-adjusted expenses and raw expenses across independent- and management-chaired funds for each of the samples described above. In addition, we attempted to correct for differences across load and no-load funds by comparing expense measures separately for load and no-load funds. Finally, we considered that there may be structural differences in the costs of fund operation across different distribution channels, and so we performed the analysis separately for bank proprietary funds, direct distribution funds, and all others.

### *c. Limitations*

In support of its study of the relation between mutual fund chair independence and performance, the staff conducted additional analyses. The first considers the ability of standard methodologies to identify small but potentially economically meaningful relations in mutual fund returns. The second considers evidence available to the staff concerning the relation between governance and performance. We note that the state of research in the area of governance and mutual fund performance, broadly defined, is still in its nascent stage. The nature of the experiments, the amount of data available, and the lack of well-established theory limit the ability to draw definitive conclusions from the literature. The nature of the relation between governance and performance is complex, due in part to the complex nature of the conflicts of interest that may arise between fund managers and investors. Without careful design, empirical research is unlikely to reliably identify a relation between governance and performance, even if such a relation were to exist.

The staff performed an analysis of the “power” of statistical data in analyzing the effect of governance changes on performance and expenses (“Power Analysis”). Existing empirical studies of the effects of mutual fund governance have failed to consistently document a significant relation between fund governance and performance, including with respect to independent mutual fund chairs. The Power Analysis suggests that this may be the result of the limits of standard statistical methods in identifying such a relation and is not necessarily indicative of a failure of such a relation to exist.

In particular, analyses attempting to identify significant differences in financial performance associated with differences in governance attributes across a large sample of mutual funds will suffer from a low probability of identifying such a relation (“low power”). Several factors, including the degree of “noise” in mutual fund returns, the existence of many other factors that lead to predictable differences in returns across funds, and data limitations all contribute to the low power. Given the lower probability of identifying a relation between chair

independence and returns, it is difficult to draw strong inference from the lack of extant academic evidence on this topic.

Our expense analyses, discussed below, suggest that the results are highly sensitive to both the specification of sample and the method used to measure expenses. Mutual fund expenses are commonly measured by the fund's expense ratio, i.e., the dollar amount of a fund's total expenses as a percentage of its average net assets. The expense ratio includes management fees (investment advisory fees and administrative or other fees paid to the investment adviser or its affiliates for services); rule 12b-1 fees (payments for distribution or other expenses incurred under a plan adopted pursuant to rule 12b-1) and other expenses (all other expenses incurred by the fund, including payments to transfer agents, securities custodians, providers of shareholder accounting services, attorneys, auditors, and fund independent directors).<sup>193</sup> The expense ratio does not include sales charges (loads) paid upon purchase or redemption of shares (including redemption fees that some funds charge to deter (and recoup costs associated with) frequent trading). The expense ratio also does not include transaction costs that funds incur when trading portfolio securities. These transaction costs are netted out of returns and are not disclosed separately.

It is difficult to compare the costs paid by investors in different mutual funds because the distribution and financial advisory services provided and methods of payment vary. Some funds include in the expense ratio the cost of all services provided to the fund and its shareholders. Other funds exclude from the expense ratio the cost of some services, such as marketing or financial advice provided to individual investors by those who sell fund shares, because those costs are not paid for with fund assets; instead they are paid by the individual shareholder. For example, assume that Fund A is a no-load, direct marketed fund. With respect to self-directed investors, Fund A's marketing costs may be low, and costs associated with providing financial advice to those investors may be zero. Other investors may purchase Fund A's shares after consulting a fee-only financial planner. Marketing and financial advisory costs for those investors may be higher, and a large portion of these costs may be paid by the investor and therefore excluded from Fund A's expense ratio. Assume that Fund B is distributed by a broker-dealer, bank, or insurance company. An investor in Fund B is likely to receive advice from an employee or agent of an investment firm, bank, or insurance company. The cost of providing the advice and the cost of marketing Fund B's shares may be paid by (i) the investor (through a sales load that is not included in the fund's expense ratio); (ii) the fund (through a 12b-1 fee that is included in the expense ratio); or (iii) a combination of the two methods.

The fact that that some investors pay for marketing and distribution costs through sales loads (or direct payments to financial professionals), other investors pay for these costs through 12b-1 fees, and still others through a combination of the two, makes it difficult to compute expenses in an equivalent manner for funds that use varying distribution arrangements. Investors

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<sup>193</sup> For a more complete discussion of mutual fund fees, see *Division of Investment Management: Report on Mutual Fund Fees and Expenses (2000)*, available at <[www.sec.gov/news/studies/feestudy.htm](http://www.sec.gov/news/studies/feestudy.htm)>

pay expenses and rule 12b-1 fees as a percentage of assets invested. Front-end loads, however, are charged at the time of purchase. Annualizing this expense is impossible in the absence of knowledge about the investors' holding periods. A back-end load, paid on redemption, is equally difficult to estimate, given that the magnitude of the load decreases with the holding period. Existing studies have typically taken one of two approaches to accounting for this difficulty in estimating actual costs incurred by mutual fund investors. One approach is to separate the annual expenses (rule 12b-1 fees and other expenses) from the one-time fees (front-end loads and contingent deferred sales loads), while the other is to amortize the load over a certain amount of time. Neither approach is particularly satisfying, nor are they empirically successful. This difficulty both in combining annualized and discrete expenses and in comparing stated expense ratios across funds is consistent with our finding that empirical analyses of such measures are not robust to methodological choices.

Finally, one must be careful when drawing conclusions from any results. The failure to identify a relation does not necessarily mean that no relation exists. Rather, the failure may imply that the empirical design or statistical methods are not powerful enough to identify such a relation. Conversely, evidence of a relation between governance and performance in a particular context may not necessarily imply that it exists in all contexts.

## **2. Data Samples**

In conducting our analysis, we compiled a range of information, including financial data and fund governance characteristics. We used financial data that we purchased from Strategic Insight, both because it provided critical data for the analysis and because it is the data set used in the Bobroff-Mack Report. Information about certain fund governance characteristics was not available from a third party. Commission staff therefore compiled that information through a fund-by-fund, class-by-class analysis of Commission filings on EDGAR for the years 2002 and 2004 for over 17,000 fund classes.

We constructed three samples based on different methods of identifying independent- and management-chaired funds. The methods used for inclusion in each sample are:

- independent- and management-chaired funds as identified in the Bobroff-Mack Report;
- a broader sample based on the CRSP®<sup>194</sup> survivorship-bias free mutual fund database where independent-chaired families were verified by the staff; and
- a sample based on the entire universe of the CRSP® survivorship-bias free mutual fund database for which chair independence was reported in

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<sup>194</sup> The Center for Research in Security Prices (CRSP®) is a financial research center at the University of Chicago Graduate School of Business.

EDGAR<sup>195</sup> filings for 2002 and 2004.

This universe consisted of 17,124 funds in 571 fund families.<sup>196</sup> These are the funds for which we are able to match the Simfund® database<sup>197</sup> to the latest CRSP® and EDGAR data.

To identify a relation between chair independence and performance or expenses over a long horizon, funds must be appropriately categorized by chair independence (or “type”) within each period. We used the CRSP® survivorship-bias free mutual fund database to construct annual cross-sections of funds.<sup>198</sup> In addition, we tracked when chairs changed from management-affiliated to independent, to help ensure that funds with independent chairs were appropriately captured. As a result, we were able to characterize fund chair type within each year, instead of using a single cross-section of chair types to generate excess return comparisons over an extended period.

Using the CRSP® survivorship-bias free mutual fund data to construct our universe of funds also allowed us to track funds through management company mergers. Several academic studies have suggested that changes to governance structure may be related to management company mergers.<sup>199</sup> For each year, we were able to track individual funds through changes in the management company and thus in changes of chair type.<sup>200</sup>

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<sup>195</sup> EDGAR, the Commission’s Electronic Data Gathering, Analysis, and Retrieval system, performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the Commission. Its primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the Commission. *See* <[www.sec.gov/edgar/aboutedgar.htm](http://www.sec.gov/edgar/aboutedgar.htm)>.

<sup>196</sup> We started with 17,893 individual mutual fund classes and excluded prime funds and commodities funds from the analysis. We define a “family” as those funds with a unique management number in the CRSP® database. In the 2004 data, the samples consist of: The Bobroff-Mack Report – 14 independent chaired families and 41 management chaired families; the staff-verified sample – 44 independent chaired families and 527 management chaired families; and the EDGAR sample – 130 independent chaired families and 254 management chaired families.

<sup>197</sup> Simfund® MF is a database supplied by Strategic Insight. The analysis and commentary in this Report that rely on this data are the product of the staff only.

<sup>198</sup> Several studies have examined the impact of survivorship-bias on performance measures.

<sup>199</sup> The impact of mergers on chair type has been discussed in the literature.

<sup>200</sup> In addition, we avoided survivorship-bias by using the CRSP mutual fund data to generate our EDGAR data universe.

### 3. Results

#### a. Main results

The staff calculated the annual excess returns for each sample, using the three models of excess returns discussed above from 1994 to 2004. Excess returns measures are what we compare across independent- and management-chaired funds to determine if a relation between performance and governance is suggested by the data. Thus, systematic differences across alternative excess returns measures may lead to contrasting results. The method used in the Bobroff-Mack Report to estimate excess returns has been shown to produce estimates that differ in terms of size and magnitude from those estimated by factor models.<sup>201</sup> Because excess returns measures are model dependent, direct comparisons across excess returns methods are not valid. This result holds in our data for all three samples.

We find that the relation between independent chair and performance is sensitive to both the choice of sample and the measure of excess returns consistent with the literature.<sup>202</sup> Generally we found no statistically significant relation between chair type and excess returns. The only statistically significant differences in means for independent- and management-chaired funds occur for the Bobroff-Mack Report returns-based analysis in the Bobroff-Mack Report sample.<sup>203</sup>

We conducted the same analysis at the equally weighted and asset-weighted fund level. Excess returns patterns and magnitudes were similar for the three models. However, we find no evidence of any statistically significant differences between performance based on chair types for any sample or any measure of excess returns.

With respect to expenses, our family-level results suggest that independent-chaired fund families charge lower fees than management-chaired families (20 out of 24 cases). However, the difference in mean expenses is not statistically significant in all cases, and we hesitate to make inference based on such evidence.<sup>204</sup>

The fund level results were mixed, though largely statistically significant. This fact may be due to the larger sample size in the fund level analyses, but it also highlights the sensitivity of the approach to specification.

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<sup>201</sup> See, e.g., Edwin J. Elton, Martin J. Gruber and Christopher R. Blake, *The Persistence of Risk-Adjusted Mutual Fund Performance*, 69 J. of Bus. 133 (1996).

<sup>202</sup> Bruce N. Lehmann and David M. Modest, *Mutual Fund Performance Evaluation: A Comparison of Benchmarks and Benchmark Comparisons*, 42 J. of Fin. 233 (1987).

<sup>203</sup> The significance level for the difference in means test was  $\alpha=5\%$ . Note that  $\alpha$  is the significance level of the test statistic, not excess returns.

<sup>204</sup> There are difficulties inherent in statistical identification of small differences between small samples.

We also attempted to address issues related to fund loads. The results highlight the first consistent patterns across samples in our expense analysis. Using raw expense measures, we see that management-chaired funds charge statistically significant higher expenses for no-load funds, while the opposite holds true for load funds. However, using the category-adjusted expense measures, the results are again mixed across samples. Different statistically significant results using different expense measures suggest that the results are sensitive to the expense measures used in the analysis.

*b. Sensitivity of Results to Fund Characteristics*

Different funds have different cost structures. A study of fund performance (in terms of expenses or excess returns) that does not account for unmeasured fund characteristics with different cost structures may result in the wrong inferences. We provide an example in this section. In particular, different distribution channels may be subject to different relative costs.<sup>205</sup> To account for the impact of the distribution channel on performance and expenses, we replicate the excess returns analysis after controlling for distribution channels.

In particular, we control for primary distribution channel (as reported in the Simfund® database) by constructing a simple categorical variable for different types of distribution channels. The variable distinguishes bank funds and direct-marketed funds from funds with all other distribution channels. We choose to control for bank funds because some have noted the preponderance of bank funds in the independent-chaired sample. Although our breakdown of distribution channel is crude, this is intended to suggest that the results are sensitive to unmeasured fund characteristics. This may have an effect on inferences that may be drawn even after carefully structuring the analysis in terms of performance measures and for a much larger sample of funds.

We replicated the performance analysis for each distribution channel type. The staff found no significant difference in performance between independent- and management-chaired funds for bank funds or funds with other (non-direct-marketed and non-bank) distribution channels.

Alternatively, we find evidence consistent with the hypothesis that direct-marketed funds with independent chairs outperform funds with management chairs. In this case, the result exists in one of the factor models and the Bobroff-Mack Report excess returns, both equally-weighted

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<sup>205</sup> One reason to control for distribution channel is that it can be viewed as a proxy for internally managed funds. One commenter noted that once one distinguishes among management chaired funds, independent-chaired funds, bank-managed funds, and mutualized funds, the management-chaired and bank-managed funds “ranked at the bottom” in terms of performances and expenses. In particular, the Bobroff-Mack Report identified the Vanguard funds as management-chaired funds. However, the Vanguard funds own their adviser and therefore many of the conflicts inherent for advisers to externally managed funds do not exist. See Bogle Speech, note 178 above.

and asset-weighted. We note, however, that for some years in the Bobroff-Mack Report sample, there are no direct-marketed funds with independent chairs.

However, in the substantially larger EDGAR sample, Bobroff-Mack Report excess returns suggest that management-chaired direct-marketed funds outperform independent-chaired direct-marketed funds over the period. The contrasting result for the same excess return measure applied to different samples is an illustration of the sensitivity of performance measures to the sample. This suggests that distribution channel may have some effect on the relation of chair type to performance, but the nature of the relation is not adequately described in this framework.

Thus, a study using a single sample or excess returns methodology might have produced a statistically significant result without adequately considering the underlying complexity of the interaction between chair type and distribution channel. The inferences drawn from a study using a single sample and a single measure of excess returns might result in an inference that depends directly upon the method and the sample. This particular finding suggests that controlling for distribution channel may be important, but the nature of its effect on the relation between fund chair type and performance is not clear.

#### **4. Conclusion**

This study examined the sensitivity of existing empirical studies of the relations between fund chair independence and performance and fees. In particular, we benchmarked our analyses to the approach taken in the Bobroff-Mack Report. We implemented a series of alternative methodological choices, including broader samples, different performance and fee measures, and correcting for fund characteristics such as assigning funds to the independent chair sample in appropriate years, and distribution channel, which is thought to be related to performance and fees.

Our findings suggest that the inferences drawn about the relation of fund type to various measures of performance and expenses are sensitive both to the sample and performance measures used in the study. In addition, inferences drawn from the expense analysis are sensitive to the expense measure used and the category definition in the case of expenses net of category. We found contradictory results in our study of excess returns when controlling for distribution channel.

We found evidence that the performance results of the Bobroff-Mack Report are highly sensitive to the sample used and the excess returns measure, and conclude that the authors' conclusion that management-chaired funds both perform better than and charge lower fees than independent-chaired funds is due to their sample selection and choice of empirical method.

Our results support the conclusions that one must take care interpreting the results of any analysis pertaining to the relations between governance and performance broadly defined. Without careful design and methods, researchers may come to inappropriate conclusions. Finding no relation in the data does not confirm that no economically significant relation exists between fund governance and performance. Likewise, without careful sensitivity analysis, it

may be imprudent to conclude such a relation necessarily exists in the presence of a statistically significant estimate.

## **B. COMPLIANCE**

Fund shareholders rely upon the judgment and scrutiny of independent directors to assure that a fund and its adviser comply with the federal securities laws. It is difficult, if not impossible, however, to analyze past compliance because there is no clear method for measuring the quality of compliance by funds and their advisers. Although individual funds or advisers may be subject to Commission enforcement actions in the event of serious compliance problems, enforcement actions are only one indication of compliance. The Commission's periodic examination of funds have uncovered areas of compliance concerns affecting large numbers of funds, but the examination process is not designed to provide a statistical basis for comparing categories of funds.

The Commission did not adopt the independent chair provision in isolation. This requirement was adopted as part of a larger package of regulatory reforms in the wake of the Commission's enforcement actions involving mutual fund trading that demonstrated a serious compliance breakdown.<sup>206</sup> As discussed below, the Commission believes that this package of regulatory reforms will, in the future, lead to enhanced compliance by funds with independent chairs. A robust compliance program will reduce the risk that fund investors will be harmed by violations of law.<sup>207</sup>

**Interrelationship of Independent Chair and Chief Compliance Officer.** An independent chair can improve fund compliance. The independent chair will be an individual, independent of management, who will receive reports from the fund's compliance personnel.<sup>208</sup> Under rules adopted by the Commission in December 2003, each fund is required to have a chief compliance officer who is responsible for, among other things, keeping the fund's board of directors apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program.<sup>209</sup> In several of the Commission's enforcement actions, senior personnel of advisers to funds overruled their compliance personnel in favor of business considerations that benefited the fund's managers rather than the fund's investors.<sup>210</sup>

While there is no way to determine in hindsight whether unethical and unlawful conduct would have been prevented if the fund boards had been led by an independent chair, the funds

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<sup>206</sup> See 2004 Adopting Release, note 4 above, at text accompanying nn.5-6, and Section III above.

<sup>207</sup> See Compliance Release, note 131 above, at text following n.4.

<sup>208</sup> *Id.* at text accompanying n.80.

<sup>209</sup> *Id.* at Section II.C.2.

<sup>210</sup> *Id.*

may well have benefited from the zealous oversight of an independent chair.<sup>211</sup> For example, in the Commission's action against IFG, the company's chief compliance officer prepared a detailed memorandum for Raymond C. Cunningham, the funds' president and chief executive officer, explaining why IFG's deals with market timers might not be in the best interests of the Invesco funds and their shareholders.<sup>212</sup> The compliance officer specifically addressed how IFG's practices with respect to market timers were inconsistent with the funds' prospectus disclosures.<sup>213</sup> Mr. Cunningham, however, ignored the recommendations in the memo and did not circulate the memo to the funds' board of directors.<sup>214</sup>

In other cases, senior managers acted to directly benefit themselves. For example, in an enforcement action the Commission found that SCM allowed and Richard S. Strong, its founder and majority owner, engaged in, frequent trading in SCM managed mutual funds, each in violation of their fiduciary duties to the Strong mutual fund shareholders.<sup>215</sup> SCM and Strong failed to disclose to the Strong funds' boards or to fund shareholders Strong's frequent trading in a Strong mutual fund for which he was the portfolio manager and the conflicts of interest inherent in such trading. When Strong's frequent trading in Strong mutual funds came to the attention of SCM's compliance department, Strong was advised by in-house counsel that his frequent trading was taking profits from other investors and cautioned him that he should stop trading in this manner. Despite his agreement to stop, Strong continued his frequent trading, which ultimately generated profits of over \$4 million.<sup>216</sup>

Similarly, in its action against Gary Pilgrim, the Commission found that Pilgrim permitted Appalachian Trails, a hedge fund in which he was a substantial investor, to engage in

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<sup>211</sup> See generally 2004 Adopting Release, note 4 above, at Section III.B. This is particularly likely when the role of the independent chair and the other elements of the Commission's fund initiatives are taken into account, such as the 75 percent board independence condition of the Exemptive Rules, independent legal counsel condition, independent selection and nomination of independent directors condition, and the requirement that the chief compliance officer report to the board.

<sup>212</sup> *Cunningham Order*, note 104 above. Further discussion of this action is included above at Section III.B.2.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Strong Order*, note 10 above. A complete discussion of this action is included above at Section III.C.2.

<sup>216</sup> The Commission noted in its order that this action was not the first brought by the Commission against Strong in which he placed his interests before the interests of SCM mutual fund investors. In 1994, the Commission settled an action against Strong in which the Commission found that he engaged in a pattern of improper affiliated securities transactions between some of the Strong funds and a hedge fund in which Strong had a substantial personal interest. *In the Matter of Strong/Corneliuson Capital Management, Inc.*, Investment Company Act Release No. 20394 (July 12, 1994).

market timing in the PBHG Growth Fund for which Pilgrim himself served as portfolio manager.<sup>217</sup> Pilgrim did not disclose to the PBHG mutual funds' board of trustees that he had an extensive financial interest in Appalachian and that Appalachian had been permitted to market time PBHG mutual funds.

The role of the fund chief compliance officer is designed to address these types of situations by strengthening the hand of compliance personnel with a direct line of reporting to fund boards that is not controlled by management.<sup>218</sup> For the new chief compliance officers to be truly effective, the boards to which they report must themselves be sufficiently independent, particularly if they are to appropriately resolve the significant conflicts of interest presented by the transactions allowed by the Exemptive Rules.<sup>219</sup> Accordingly, the Commission determined that funds engaging in these conflict of interest transactions should be led by a board whose chair does not share the conflicts of interest that burden a management-affiliated chair.

**Interrelationship with Attorney Conduct Rules.** Under recently adopted standards of conduct for attorneys under section 307 of the Sarbanes-Oxley Act, an attorney providing legal advice to a fund, who becomes aware of evidence of a material violation, has a duty to report such evidence “up-the-ladder” within the investment company.<sup>220</sup> As a practical matter, since most funds do not have their own employees, evidence of a material violation would need to be reported to the fund board. An attorney employed by an investment adviser who provides legal advice to a mutual fund pursuant to an advisory contract is a legal representative of the fund and therefore required by the rules to report evidence of a material violation to the fund's board.<sup>221</sup> The independent chair is the logical person to receive these reports, even if the fund's audit committee or similar independent body receives it initially. The independent chair will not only be in a position to receive reports from compliance officers and attorneys when problems arise, but will, in consultation with independent counsel, be able to act in the best interests of fund investors, even when it means opposing or modifying positions taken by fund managers.

**Enhanced Boardroom Culture.** In adopting the independent chair provision, the Commission determined that a fund board would be in a better position to protect the interests of the fund, and to fulfill the board's obligations under the Act and the Exemptive Rules, if its chair did not have the conflicts of interest inherent in the role of an executive of the fund's adviser.<sup>222</sup> The Commission observed that the chair can play an important role in establishing a boardroom culture that can “foster the type of meaningful dialogue between fund management and

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<sup>217</sup> *Pilgrim Order*, note 120 above. A complete discussion of this action is included above at Section III.C.1.

<sup>218</sup> Compliance Release, note 131 above, at n.87 and accompanying text.

<sup>219</sup> *See* FORUM REPORT, note 151 above.

<sup>220</sup> *See* Implementation of Standards of Professional Conduct for Attorneys, Investment Company Act Release No. 25919 (Jan. 29, 2003).

<sup>221</sup> *Id.* at n.55 and accompanying text.

<sup>222</sup> 2004 Adopting Release, note 4 above, at text preceding n.46.

independent directors that is critical for healthy fund governance.”<sup>223</sup> Meaningful dialogue is particularly important where the board is evaluating the types of transactions permitted by the Exemptive Rules. A board can most effectively manage the conflicts of interest inherent in these transactions where the board culture encourages rather than stifles open and frank discussion of what is in the best interest of the fund. This is especially true in connection with the conflicts of interest presented by these transactions because the best interest of the fund frequently is different from the best interest of the fund’s management company.

Similarly, the Commission stated that the chair of a fund board “is in a unique position to set the tone of meetings and to encourage open dialogue and healthy skepticism.”<sup>224</sup> An independent chair is better equipped to serve in this role. An independent chair also can play an important role in serving as a counterbalance to the fund’s management company by providing board leadership that focuses on the long-term interests of investors.<sup>225</sup> The Commission concluded “that a fund chairman is in the best position to fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.”<sup>226</sup>

## VI. RECOMMENDATIONS

The Commission adopted the independent chair provision in July 2004 as part of the 2004 Exemptive Rule amendments. The compliance date for those amendments is January 16, 2006. As discussed above, many funds have chosen voluntarily to appoint independent chairs on their boards of directors well in advance of that compliance date.

The feedback that the staff has received about the independent chair provision has been largely favorable. We have heard that fund boards are able to appoint educated, informed, qualified chairs who are independent of fund management. We are not aware that fund boards have encountered problems finding qualified candidates to serve as independent chairs. We also have been informed that independent chairs have been able to effectively carry out their responsibilities.

The Commission and staff should continue to monitor how the presence of an independent chair on the board changes the independence and effectiveness of the board. This information can be useful in determining whether the rule is having its intended effect and, if not, whether the Commission should consider revising the rule. At this time we do not recommend that the Commission rescind or modify the rule.

Similarly, as discussed above, the 2004 Exemptive Rule amendments were part of a larger set of regulatory changes designed to improve the compliance of funds and address serious

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<sup>223</sup> *Id.* at text preceding n.47.

<sup>224</sup> *Id.* at text following n.50.

<sup>225</sup> *Id.* at text preceding n.47.

<sup>226</sup> *Id.* at text following n.47.

compliance problems that have come to light in recent years.<sup>227</sup> Because the phase-in dates for these rules will be occurring during the next year or so, it remains to be seen how funds will implement all of the organizational and systemic changes required by the new rules. The Commission and staff should continue to monitor how funds are able to implement these changes, in order to determine whether any revisions to the rules are needed.

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<sup>227</sup> See Section III above.