

ENHANCED CORPORATE GOVERNANCE FOR MUTUAL FUNDS: A FLAWED CONCEPT THAT DESERVES SERIOUS RECONSIDERATION

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INTRODUCTION

Mutual funds¹ are the most popular retail investment in America,² a testament to the simplicity and transparency of the mutual fund concept. A mutual fund investor owns a share of common stock issued by a company that invests in debt or equity securities issued by other operating companies.³ Like operating companies, a mutual fund distinguishes itself by its business objective—for example, to exceed the Standard & Poor's 500 Index (an equity fund), to match the Lehman Brothers Aggregate Bond Index (a bond fund), or to maintain a current net asset value of \$1.00

1. Technically, a mutual fund is an open-end management company registered with the Securities and Exchange Commission ("SEC" or "Commission") under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (2000) (the "Investment Company Act"). An "open-end company" is a management company that issues a redeemable security. 15 U.S.C. § 80a-5(a)(1). The term "redeemable security" is defined in section 2(a)(32) of the Investment Company Act to mean a security the terms of which entitle the holder, upon presentation, "to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." 15 U.S.C. § 80a-2(a)(32). Management companies are divided into two categories: "diversified companies" and "non-diversified companies." 15 U.S.C. § 80a-5(b). A "diversified company" has at least seventy-five percent of the value of its total assets invested in "cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities," but no more than five percent of the value of the total assets of the management company can be invested in any one issuer and such investment cannot exceed ten percent of the issuer's outstanding voting securities. 15 U.S.C. § 80a-5(b)(1). A "non-diversified company" is "any management company other than a diversified company." 15 U.S.C. § 80a-5(b)(2). A closed-end fund is any management investment company other than an open-end fund. 15 U.S.C. § 80a-5(a)(2). After the initial public offering, shares of a closed-end fund trade like shares of an operating company: they can be listed on an exchange, traded in the over-the-counter markets, or bought and sold in direct transactions between individuals or institutional investors. DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 423 (1992). The corporate governance issues facing the boards of directors of closed-end funds are beyond the scope of this Article, as is the general topic of corporate governance for operating companies.

2. See INV. CO. INST., 2004 MUTUAL FUND FACT BOOK 79–83 (2004).

3. A mutual fund that invests in shares issued by other investment companies is known as a "fund of funds." See Martin E. Lybecker, *Fund of Funds: The 1996 Act and Related Industry Developments*, INVESTMENT LAW., Jan. 1997, at 33.

per share (a money market fund).⁴ Unlike an operating company that is managed by its officers and employees, most mutual funds are managed by an external investment adviser, pursuant to a contract. In recognition of the obvious conflict of interest between a mutual fund and its investment adviser because of or resulting from that contract, the Investment Company Act of 1940 (“Investment Company Act”)⁵ has always required that at least forty percent of the members of the mutual fund’s board of directors be independent.⁶ In July 2004, the Securities and Exchange Commission (“SEC” or “Commission”), in a three-to-two vote,⁷ amended certain existing exemptive rules (the “Corporate Governance Amendments”) to require that no less than seventy-five percent of the members of a mutual fund’s board of directors be independent, that the chairman of the board of directors be an independent director, and that the board of directors engage in certain specific corporate governance practices.⁸ This Article will argue that the Commission’s decision to adopt

4. An investment company that wishes to hold itself out as a money market fund must comply with Rule 2a-7 under the Investment Company Act. 17 C.F.R. § 270.2a-7 (2005). *See generally* Martin E. Lybecker, *Money Market Funds*, in THE INVESTMENT COMPANY REGULATION DESKBOOK 15–1 (Amy L. Goodman ed., 1997, rev. 1998).

5. 15 U.S.C. §§ 80a-1 to -52. For the legislative history of the adoption of the Investment Company Act, see Richard H. Farina et al., Survey, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 794–808 (1969); Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677 (1969).

6. *See* Investment Company Act of 1940, Pub. L. No. 76-768, § 10(G), 54 Stat. 789, 806 (codified as amended at 15 U.S.C. § 80a-10(a)). Technically, the requirement is phrased in terms of no more than sixty percent of the members of a mutual fund’s board of directors being “interested.” The term “interested person” is defined in section 2(a)(19) of the Investment Company Act. 15 U.S.C. § 80a-2(a)(19). Thus, a person who is not “interested” is “disinterested.” It is far more common for such persons to be referred to as “independent,” as they will be throughout this Article.

7. In the sixty-five-year history of the SEC’s administration of the Investment Company Act, very few decisions have been made by a three-to-two vote. *See* Vanguard Special Tax-Advantaged Retirement Fund, Inc., Investment Company Act Release No. 14,361, 32 SEC Docket 1867 (Feb. 7, 1985) (the only such prior 3–2 split on a regulatory matter).

8. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004) [hereinafter Release No. 26,520] (adopting release); Investment Company Governance, Investment Company Act Release No. 26,323, 81 SEC Docket 3415 (Jan. 15, 2004) (proposing release). The Corporate Governance Amendments became effective on September 7, 2004, but compliance is not required until January 16, 2006, giving the mutual fund industry about sixteen months to prepare to be compliant. Release No. 26,520, *supra*, at 1395–96.

The Corporate Governance Amendments were attached to Rules 17 C.F.R. § 270.10f-3 (purchase of securities from an affiliated underwriter during an underwriting or selling syndicate), 17 C.F.R. § 270.12b-1(c) (use of mutual fund assets for distribution), 17 C.F.R. § 270.15a-4(b)(2) (assignment of the investment advisory contract), 17 C.F.R. § 270.17a-7(f) (purchase and sale of portfolio securities between affiliated persons), 17 C.F.R. § 270.17a-8(a)(4) (mergers between affiliated persons), 17 C.F.R. § 270.17d-1(d)(7) (joint transactions with affiliated person), 17 C.F.R. § 270.17e-1(c) (brokerage transactions with affiliated person), 17 C.F.R. § 270.17g-1(j)(3) (joint fidelity bond with affiliated person), 17 C.F.R. § 270.18f-3(e) (multiple classes of stock), and 17 C.F.R. § 270.23c-3(b)(8) (interval fund tender offers). Release No. 26,520, *supra*, at 1400–02. The Commission chose to

amend these particular rules under the Investment Company Act because they address business situations commonly confronted by mutual funds. *Id.* at 1385–86. However, a mutual fund not doing transactions with affiliated persons, without a Rule 12b-1 Plan, with one class of stock, and with a dedicated fidelity bond could engage in business and not be subject to the Corporate Governance Amendments, rendering them elective and not mandatory for that subset of mutual funds that can operate successfully in that restrictive environment.

The Chamber of Commerce sued the SEC in the U.S. Court of Appeals for the District of Columbia Circuit requesting a stay of the Corporate Governance Amendments on an emergency basis, or, alternatively, for expedited briefing. Emergency Motion at 1, Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133 (D.C. Cir. 2005). Before filing its appeal, the Chamber of Commerce asked the SEC to stay the effectiveness of the Corporate Governance Amendments pending the outcome of the litigation, but the Commission refused on September 9, 2004, by a three-to-two vote; the Chamber of Commerce had previously sued the Commission on September 2, 2004, in U.S. District Court for the District of Columbia, No. 1:04-cv-01522-RMC; the U.S. District Court stayed that case pending action by the Court of Appeals. The Court of Appeals denied the Chamber of Commerce's request for a stay but granted the Chamber of Commerce's motion for expedited consideration. Judith Burns, *Court Refuses to Delay Fund Rules*, WALL ST. J., Oct. 19, 2004, at C19. For news accounts of arguments in the parties' briefs, see Judith Burns, *SEC Wants Chamber to Back off*, WALL ST. J., Jan. 17, 2005, at C13; *Fund Governance Rules Lawful, Rational, SEC Argues to D.C. Circuit*, 37 Sec. Reg. & L. Rep. (BNA) 130 (Jan. 24, 2005); *SEC Acted Beyond Its Powers, U.S. Chamber Urges in Fund Rule Challenge*, 37 Sec. Reg. & L. Rep. (BNA) 176 (Jan. 31, 2005); see also Editorial, *Mutual Displeasure*, WALL ST. J., Jan. 19, 2005, at A14 (criticizing the Corporate Governance Amendments and recommending a reassessment). Oral argument was held on April 15, 2005. See Judith Burns, *Board Chairman Rule Is Challenged*, WALL ST. J., Apr. 18, 2005, at C15; Carrie Johnson, *Appeals Court Considers Mutual Fund Rules*, WASH. POST, Apr. 16, 2005, at E1; *U.S. Chamber Argues in Appeals Court SEC Fund Governance Action Was Arbitrary*, 37 Sec. Reg. & L. Rep. (BNA) 723 (Apr. 25, 2005).

On June 21, 2005, the Circuit Court decided that the SEC did have the authority to adopt the Corporate Governance Amendments but granted the petition because the SEC had violated the Administrative Procedure Act by failing to consider the costs to mutual funds and at least one alternative approach. *Chamber of Commerce*, 412 F.3d at 136. See also Jenny Anderson, *Appeals Court Tells S.E.C. Director Rule Needs Review*, N.Y. TIMES, June 22, 2005, at C3; *Court Remands Fund Governance Rule to SEC Based on Procedural Violations*, 37 Sec. Reg. & L. Rep. (BNA) 1097 (June 27, 2005); Michael Schroeder et al., *Court Orders SEC to Review Mutual-Fund Governance Rule*, WALL ST. J., June 22, 2005, at A2. The Commission then promptly scheduled reconsideration of the Corporate Governance Amendments for June 29, 2005, the next-to-last day in Chairman Donaldson's tenure at the SEC. See Jenny Anderson, *S.E.C. Chief Defends Timing of Fund Vote*, N.Y. TIMES, June 28, 2005, at C3; Riva D. Atlas, *Ex-Officials Urge S.E.C. to Postpone a Vote*, N.Y. TIMES, June 25, 2005, at B12; Editorial, *A Lawless SEC*, WALL ST. J., June 29, 2005, at A14 (criticizing the SEC's decision to reconsider the Corporate Governance Amendments as "hardly the way to build trust with the public, Congress or the courts"); *Eight Republicans on Senate Banking Panel Ask SEC to Defer Action on Mutual Fund Rule*, 37 Sec. Reg. & L. Rep. (BNA) 1099 (June 27, 2005); *Republican Senators Urge SEC to Defer Action on Fund Rule*, WALL ST. J., June 24, 2005, at C13; *SEC Reconsideration of Fund Rule Should Wait, Scalia, Grundfest Urge*, 37 Sec. Reg. & L. Rep. (BNA) 1100 (June 27, 2005); Deborah Solomon, *Donaldson's Finale Draws Uproar*, WALL ST. J., June 28, 2005, at C3.

The SEC did reconsider the Corporate Governance Rules on June 29, 2005. Investment Company Governance, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (June 30, 2005). See Jenny Anderson, *Strife Aplenty at S.E.C. Chief's Farewell Session*, N.Y. TIMES, June 30, 2005, at C3; Ronald A. Cass & Henry G. Manne, Op-Ed, *SEC à la Donaldson*, WALL ST. J., July 1, 2005, at A8 (criticizing the SEC's reconsideration of the Corporate Governance Amendments); Karen Damato & Arden Dale, *Independents May Be Here to Stay*, WALL ST. J., July 1, 2005, at C17 (speculating that mutual fund boards that have already selected an independent chairman will not switch back); Carrie

Johnson, *Records and Rancor*, WASH. POST, June 30, 2005, at D1; *Over Strenuous Dissents, SEC Acts to Re-Adopt Controversial Fund Rule*, 37 Sec. Reg. & L. Rep. (BNA) 1141 (July 4, 2005); Michael Schroeder, *SEC Adopts Mutual Fund Rule, Risks New Court Challenge*, WALL ST. J., June 30, 2005, at C1.

On July 7, 2005, the Chamber of Commerce again petitioned the Court of Appeals for a permanent injunction. See Judith Burns, *Independence Rule for Mutual Funds Faces New Protest*, WALL ST. J., July 8, 2005, at C3; *Business Group Renews Challenge to S.E.C. Rule*, N.Y. TIMES, July 8, 2005, at C3; Carrie Johnson, *Chamber Again Sues SEC over Fund Rule*, WASH. POST, July 8, 2005, at D2; *U.S. Chamber Sues SEC Second Time over Mutual Fund Rule*, 37 Sec. Reg. & L. Rep. (BNA) 1170 (July 11, 2005). Simultaneously, the Chamber of Commerce sought reconsideration of that part of the Court of Appeals's June 21st ruling that the Commission had adequately justified the need for the independent chair and seventy-five percent independence requirement, but that petition was denied. *Court Denies Chamber's Petition for Rehearing in Fund Governance Case*, 37 Sec. Reg. & L. Rep. (BNA) 1521 (Sept. 19, 2005). On August 10th, the Court of Appeals granted the Chamber of Commerce's motion for a stay. See *Appeals Court Stays Requirements of SEC Mutual Fund Governance Rule*, 37 Sec. Reg. & L. Rep. (BNA) 1357 (Aug. 15, 2005); Judith Burns, *Fund-Board Rule Is Dealt Setback*, WALL ST. J., Aug. 11, 2005, at C11; Judith Burns, *SEC Response*, WALL ST. J., Aug. 9, 2005, at C13; *By 2-2 Vote, SEC Refuses to Stay Fund Governance Rules Pending Decision*, 37 Sec. Reg. & L. Rep. (BNA) 1249 (July 25, 2005); *Chamber Seeks Court Stay of SEC Fund Rules Pending Decision*, 37 Sec. Reg. & L. Rep. (BNA) 1279 (Aug. 1, 2005); Editorial, *Donaldson's Dead Hand*, WALL ST. J., Aug. 11, 2005, at A12 (criticizing delegation of authority to defend lawsuit to SEC General Counsel, thereby avoiding further involvement by individual SEC Commissioners); *U.S. Chamber Asks SEC to Stay Rule on Fund Governance Pending Court Decision*, 37 Sec. Reg. & L. Rep. (BNA) 1213 (July 18, 2005). For news accounts of the briefs, see Judith Burns, *SEC's Fund-Rule Fight Continues*, WALL ST. J., Nov. 9, 2005, at C13; *Mutual Fund Rules Consistent with '40 Act, APA, SEC Tells D.C. Cir.*, 37 SEC Reg. & L. Rep. (BNA) 1797 (Oct. 31, 2005); *U.S. Chamber Says SEC Violated Law in Re-Adopting Two Mutual Fund Provisions*, 37 Sec. Reg. & L. Rep. (BNA) 1580 (Sept. 26, 2005). On November 11, 2005, SEC Commissioner Paul Atkins spoke to the American Bar Association's Committee on Banking Law and criticized the process by which the Corporate Governance Amendments were re-approved and the manner in which the Commission's Office of General Counsel was handling the appeal. Paul S. Atkins, SEC Commissioner, Remarks Before the American Bar Association Legislative and Regulatory Subcommittee of the Committee on Banking Law, <http://www.sec.gov/news/speech/spch111105psa.htm>; Judith Burns, *Fight over an SEC Rule Intensifies*, WALL ST. J., Nov. 17, 2005, at C13.

Additionally, Congress required the SEC to submit a report by May 1, 2005, to the Committee on Appropriations of the Senate that provided a justification for the independent chairman requirement of the Corporate Governance Amendments, including an analysis of "whether mutual funds chaired by independent directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors." Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, 2004 U.S.C.A.N. (118 Stat. 2809, 2910). See STAFF OF THE SEC, EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION (2004), <http://www.sec.gov/news/studies/indchair.pdf> (the required report); see also Judith Burns, *SEC Fumbles on Defense of Ruling*, WALL ST. J., May 2, 2005, at C17 (describing disagreement among the five Commissioners about whether the report did what Congress asked the SEC to do); *Glassman, Atkins Dissent on SEC Study of Independent Chair Rule for Mutual Funds*, 37 Sec. Reg. & L. Rep. (BNA) 813 (May 9, 2005) (describing letter sent to Senator Cochran, Chairman of the Senate Appropriations Committee, by the dissenters, stating that the report "fails to respond constructively to your inquiry and offers no evidence to support its premises"). The Commission is directed to act upon the recommendations of the report not later than January 1, 2006, fifteen days before the Corporate Governance Amendments were to have become effective. 118 Stat. at 2910.

Finally, some have pragmatically proceeded to take steps to implement the Corporate Governance Amendments in light of the compliance deadline of January 16, 2006. See INDEP. DIRS. COUNCIL, BOARD SELF-ASSESSMENTS: SEEKING TO IMPROVE MUTUAL FUND BOARD EFFECTIVENESS 4-16

the Corporate Governance Amendments was without statutory authority and usurped the proper legislative role of Congress, was not adequately justified, and will be of questionable efficacy.⁹

I. THE EVOLVING CORPORATE GOVERNANCE REGULATORY FRAMEWORK FOR MUTUAL FUNDS

A. *The Investment Company Act as a Baseline for Comparison*

The original Senate bill that would ultimately become the Investment Company Act would have required that a majority of the members of a mutual fund's board of directors be independent.¹⁰ However, Congress ultimately provided that forty percent of the members of a mutual fund's board of directors be independent.¹¹ Congress believed that investors

(2005), <http://memos.ici.org.intradoe/groups/attachments/documents/attachment/18543.pdf> (identifying the process for self-assessment as embracing: composition of the board; board committees; board meetings; meeting materials; oversight of multiple funds; director compensation; overall assessment of the board; and self-assessment of individual directors); INDEP. DIRS. COUNCIL, IMPLEMENTING THE INDEPENDENT CHAIRPERSON REQUIREMENT 4–7 (2005), <http://memos.ici.org/getPDF.do?file=18424> (identifying the duties and responsibilities of an independent chair as including: managing the board meeting and setting the agenda; coordinating communication with the investment adviser and others; managing board operations; guiding the investment advisory contract renewal process; and managing the board's self-assessment process); Arden Dale, *Fund Boards Get Set for Self-Reviews*, WALL ST. J., Feb. 14, 2005, at C15 (describing practical considerations being considered by the Independent Directors Council in evaluating methodologies for self-assessments); Arden Dale, *Independent Chairmen Move into Place*, WALL ST. J., May 2, 2005, at R1 (describing decisions by different boards of trustees to proceed or to wait in selecting independent chairpersons); SEC *Mutual Fund Governance Rule Not Costly, Directors Group Reports*, Sec. Reg. & L. Rep. (BNA) 1483 (Sept. 5, 2005).

9. The Commission has been criticized for the lack of empirical data supporting rules that it has recently adopted. PETER WALLISON, AM. ENTER. INST., SHOOTING FROM THE HIP: THE SEC HAS STOPPED DOING ITS HOMEWORK 1, Oct. 1, 2004, [http://www.aei.org/docLib/20040922_Financial ServicesCCG.pdf](http://www.aei.org/docLib/20040922_FinancialServicesCCG.pdf).

Throughout its seventy-year history, the Securities and Exchange Commission has always distinguished itself among regulatory agencies by the care and thoroughness with which it approached the issues within its jurisdiction. Major initiatives and even relatively modest reform measures were often preceded by extensive staff studies or reports from advisory committees of distinguished members of the securities industry or the securities bar. . . . Thus, it has been surprising and disappointing that in the last year, for reasons that are not yet clear, the SEC has abandoned its customary mode of operation and begun to propose major changes in its rules and regulations that are not apparently based on any empirical work by the [C]ommission's staff or any significant reliance on academic or other outside studies. As a result, the [C]ommission's recent initiatives have seemed ad hoc and superficial—indeed, almost ideologically driven—and as a result have drawn far more opposition from inside and outside the securities industry and within the [C]ommission itself than has historically been true of SEC rulemaking.

Id.

10. S. 3580, 76th Cong. § 10(a) (1940).

11. See *supra* note 6.

would prefer to choose mutual funds that they knew would be guided principally by individuals affiliated with the mutual fund's investment adviser:

The bill as originally introduced . . . required that a majority of the board be independent of the management. However, the argument was made that it is difficult for a person or firm to undertake the management of an investment company, [and] give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice.

. . . [T]hat is why the provision for 40 percent of independents was inserted.¹²

Importantly, Congress also simultaneously provided different formulas regarding membership on a mutual fund's board of directors to address different situations:

- A majority of the members may not be affiliated persons of a regular broker, underwriter, or investment banker employed by the mutual fund, or persons with which such regular broker, underwriter, or investment banker is an affiliated person;¹³
- A majority of the members may not be persons who are officers, directors, or employees of any bank;¹⁴ and
- Only one independent director is necessary if, among other requirements, the mutual fund is no-load, its investment adviser's fee does not exceed one percent of assets under management, and the mutual fund has only one class of securities outstanding.¹⁵

12. *Investment Trusts and Investment Companies: Hearing on H.R. 10065 Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce, 76th Cong.* 109–110 (1940) [hereinafter *Hearings on H.R. 10065*] (statement of David Schenker, Chief Counsel of the Commission's Investment Trust Study).

13. Investment Company Act of 1940, Pub. L. No. 76-768, § 10(b), 54 Stat. 789, 806 (codified as amended at 15 U.S.C. § 80a-10(b)). See *Hearings on H.R. 10065*, *supra* note 12, at 110 (testimony of David Schenker) (need for majority of independent directors where there is a pecuniary interest more direct than that of an investment adviser earning a fee).

14. Investment Company Act § 10(c).

15. Investment Company Act § 10(d).

The point is that even in 1940 Congress had definite, nuanced ideas about the composition of a mutual fund's board of directors. It also bears emphasis that Congress did not in 1940 elect to legislate about any other matter of corporate governance, with the result that mutual funds have always looked to corporate law in the jurisdiction in which they are organized to determine all kinds of routine corporate matters.¹⁶

B. The 1970 Amendments Act

In 1970, new section 2(a)(19) was added to the Investment Company Act and section 15(c) was amended by the Investment Company Amendments Act of 1970 ("1970 Amendments Act").¹⁷ Section 15(c) provides that:

[(1)] [I]t shall be unlawful for any [mutual fund] having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such [mutual fund], unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. [(2)] It shall be the duty of the directors of a [mutual fund] to request and evaluate, and the duty of an investment adviser to such [mutual fund] to furnish, such information as may reasonably be necessary to

16. *Burks v. Lasker*, 441 U.S. 471, 478–79 (1979) (holding that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the Investment Company Act; the Investment Company Act does not purport to be the source of authority for managerial power—rather, it functions primarily to impose controls and restrictions on the internal management of mutual funds).

It should be noted that section 16(a) of the Investment Company Act prohibits a person from serving as a director of a mutual fund unless he has been elected to that office by the shareholders of the mutual fund. Section 16(a) goes on to provide that vacancies "may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office" by the shareholders of the mutual fund at an annual or special meeting. Properly viewed, section 16(a) merely indicates when an election of directors must take place—indeed, the two-thirds requirement is agnostic as to whether the remaining directors are interested or independent. *See* John Nuveen & Co., Inc., SEC No-Action Letter [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,383, at 77,201–02 (Nov. 18, 1986) (stating that section 16(a) does not require mutual funds to hold shareholders' meetings annually to elect directors).

17. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, §§ 2(a)(3), 8(c), 84 Stat. 1413, 1413–14, 1420 (codified at 15 U.S.C. §§ 80a-2(a)(19), -15(c)). Section 2(a)(19) was subsequently amended by the Gramm-Leach-Bliley Act in 1999. *See infra* note 23.

evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such [mutual fund].¹⁸

The purpose of section 15(c) was to empower the independent members of the board of directors of a mutual fund (1) by requiring that the investment advisory contract be approved by a majority of independent directors at an in-person meeting, and (2) by giving them the statutory authority to demand information and to impose on the investment adviser the obligation to provide it.¹⁹ It is notable that the congressional draftsmen of section 15(c) chose to empower *all* of the directors of a mutual fund, not just those who are independent, suggesting that an interested director of a mutual fund has the same fiduciary obligations as an independent director of a mutual fund with respect to review and approval of the mutual fund's investment advisory contract.²⁰

Section (2)(a)(19) was inserted by the 1970 Amendments Act to provide that:

“Interested person” of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

18. 15 U.S.C. § 80a-15(c) (2000).

19. H.R. REP. NO. 91-1382, at 26 (1970). See William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179 (1971) (discussing the sources and scope of independent directors responsibilities). For a pre-1970 Amendments Act discussion of the factors that independent directors ought to consider to fulfill properly their role, see Robert H. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058 (1967).

20. It should be noted that section 36(a)(1), which imposes a federal fiduciary duty upon the “directors” of a mutual fund, also does not distinguish between an interested and independent director in imposing that duty. 15 U.S.C. § 80a-35(a)(1) (2000).

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

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso”²¹

Section 2(a)(19) casts a very wide net, precluding virtually anyone with a business or professional relationship with the mutual fund or its investment adviser²² from serving as an independent director of the mutual fund.

Section 2(a)(19) was amended in 1999 by the Gramm-Leach-Bliley Act by striking old clause (v), adding new clauses (v) and (vi), and renumbering old clause (vi) to become clause (vii).²³ New clauses (v) and (vi) add to the term “interested person” a person who at any time within the six-month period preceding the date of the determination “has executed portfolio transactions for, engaged in any principal transactions with, or distributed shares for” the investment company, and a person who at any time within the six-month period preceding the date of the determination has loaned money or other property to the investment company.²⁴ The purpose of the Gramm-Leach-Bliley Act amendments was to reflect the fact that a broker-dealer or bank could serve as an investment adviser to a mutual fund and disallow persons who were affiliated with a broker-dealer or bank otherwise doing business with a mutual fund from serving as an independent director of that mutual fund.²⁵

21. § 2(a)(3).

22. Section 2(a)(19)(B) defines the term “interested person” with respect to an investment adviser or principal underwriter of a mutual fund in a manner that is almost identical to subparagraph (A), adding any person who has any direct or indirect beneficial interest in “any security issued either by such investment adviser or principal underwriter, or by controlling person o[f] such investment adviser or principal underwriter.” *Id.*

23. Pub. L. No. 106-102, § 213, 113 Stat. 1338, 1397–98 (1999) (codified at 15 U.S.C. § 80a-2(a)(19)).

24. *Id.*

25. *Id.*

C. The 1975 Amendments Act

In 1975, new section 15(f) was added to the Investment Company Act by the Securities Acts Amendments Act of 1975 (“1975 Amendments Act”).²⁶ Section 15(f)(1) provides:

An investment adviser . . . of a [mutual fund] or an affiliated person of such investment adviser . . . may receive any amount or benefit in connection with a sale of securities of, or a sale of any other interest in, such investment adviser . . . which results in an assignment of an investment advisory contract with such [mutual fund] . . . if—

(A) for a period of three years after the time of such action, at least 75 per centum of the members of the board of directors of such [mutual fund] . . . are not (i) interested persons of the investment adviser of such [mutual fund] . . . , or (ii) interested persons of the predecessor investment adviser . . . ; and

(B) There is not imposed an unfair unburden on such [mutual fund] as a result of such transaction or any express or implied terms, conditions, or understand applicable thereto.”²⁷

Section 15(f) was adopted by Congress in response to the decision of the U.S. Court of Appeals for the Second Circuit in *Rosenfeld v. Black*.²⁸ In *Rosenfeld*, the court ruled that an investment adviser to a closed-end fund that sold its investment advisory contract to a third-party—which would succeed it as investment adviser to the closed-end fund—had breached its fiduciary duty to the closed-end fund. Specifically, the investment advisory contract with the closed-end fund was an asset of the closed-end fund (and not of the investment adviser) that the investment adviser could not lawfully sell.²⁹ There was a strong reaction to the *Rosenfeld* decision for, if applied literally to investment advisers to mutual funds, it would deprive them of one traditional avenue of capturing the value of the business that had been built up over the years by selling the stock of the investment adviser to a successor investment adviser. Section 15(f) resolved the uncertainty caused by the *Rosenfeld* decision by allowing the sale of the investment advisory contract while adding two

26. Securities Acts Amendments Act of 1975, Pub. L. No. 94-29, § 28(1), 89 Stat. 97, 164.

27. 15 U.S.C. § 80a-15(f)(1) (2000). Subparagraphs (2), (3), and (4) of § 15(f) provide definitions of interested person and unfair burden, and descriptions of transactions to which § 15(f)(1) should not apply. 15 U.S.C. § 20a-15(f)(2)-(4).

28. 445 F.2d 1337 (2d Cir. 1971). See S. REP. NO. 94-75, at 71 (1975).

29. *Rosenfeld*, 445 F.2d at 1342–44.

principal safeguards to protect a mutual fund and its shareholders—the requirement that seventy-five percent of the members of the board of directors be independent for at least three years, and the requirement that the transaction not impose any unfair burden on the investment company.

D. Rule 12b-1 in 1980

Rule 12b-1³⁰ was adopted in 1980 after a long period of consideration by the Commission regarding whether assets of mutual funds should be used to make payments to selling dealers to supplement the process of distributing shares of mutual funds.³¹ Before the mid-1970s, most mutual funds were sold with a sales load or were “no-load,” and the sponsor and/or principal underwriter and/or investment adviser to the mutual fund bore the cost of distributing shares of the no-load mutual fund.³² It was the advent of money market funds and the introduction of broker-dealer-sponsored “cash management accounts” in the mid-1970s that caused concern regarding the process of distribution.³³ Shares of a money market fund, offering a stable net asset value of \$1.00 with a return based on its portfolio of high-quality, short-term debt securities, could scarcely be sold with a sales load (although the very earliest versions were sold with a low-load); a brokerage account with “sweep” capability, daily redemptions, wire transfers, and check-writing privileges (providing the functionality of a bank time deposit offering an interest rate that varies daily with the money markets), could not bear the costs of sales loads on daily transactions.³⁴

After strongly resisting the idea of allowing a mutual fund’s assets to be used to pay for the distribution of its shares,³⁵ the SEC ultimately

30. 17 C.F.R. § 270.12b-1 (2005).

31. Section 12(b) of the Investment Company Act provides that it is unlawful for a mutual fund “to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe.” 15 U.S.C. § 80a-12(b). The permissive aspect of § 12(b) was not self-executing, so it required the adoption of something like Rule 12b-1 for mutual funds to act as their own underwriters and use fund assets for distribution. The SEC took the position that the prohibition in § 12(b), however, proscribed any payments that a mutual fund might make, even indirectly through an investment advisory fee, for example, that would have the effect of paying for the costs of distribution. *Bearing of Distribution Expenses by Mutual Funds*, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 21 SEC Docket 324 (Oct. 28, 1980).

32. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 51–52 (1966).

33. See *infra* notes 35–36.

34. Lybecker, *supra* note 4, at 15-3 to 15-4.

35. See *Future Structure of the Securities Markets*, [Extra Edition] Fed. Sec. L. Rep. (CCH) No. 409, 35–49 (Feb. 4, 1972) (SEC policy statement that any use of a mutual fund’s assets for the purpose

decided to adopt Rule 12b-1 to allow such payments when subject to annual review and approval by the mutual fund's board of directors.³⁶ For this purpose, paragraph (c) of Rule 12b-1 as adopted in 1980 allowed a mutual fund to rely on Rule 12b-1 only if a majority of the members of the mutual fund's board of directors were independent and they selected and nominated all new independent members of the mutual fund's board of directors.³⁷ Interestingly, much of the adopting release is devoted to arguments that the Commission had the statutory authority in section 12(b) to regulate the use of fund assets to pay for distribution, and that it was proper to include indirect distribution expenses within Rule 12b-1 so that all distribution expenses knowingly financed by a mutual fund's board of

of financing the distribution of mutual fund shares would be improper); *see also* National Aviation & Technology Corp., SEC No-Action Letter, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,414, at 82,729 (Feb. 16, 1979) (permitting a fund to bear distribution costs temporarily where it was in the process of converting from a closed-end fund to an open-end fund under pressure of heavy redemptions from arbitrageurs); *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 9915, 12 SEC Docket 1657, 1657 (Sept. 1, 1977) (order reiterating the Commission's 1972 position, establishing a hearing for all pending exemptive applications seeking to use fund assets to pay for distribution, and instructing the SEC staff not to issue any no-action letters with respect to any "new" proposed distribution arrangements); Mutual Liquid Assets, Inc., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,667, at 86,730 (July 15, 1976) (permitting a proposed arrangement where the money market fund would allocate fifty percent of its investment advisory fees to the distributor, subsequently withdrawn at the Commission's direction in October 1976); Pegasus Fund, Inc., SEC No-Action Letter, 1975 SEC No-Act LEXIS 1117, at *1 (May 22, 1975) (permitting an internally-managed mutual fund to bear distribution expenses where the members of the board of directors and legal counsel were serving pursuant to a court order); Broad Street Investing Corp., Investment Company Act Release No. 7114, 1972 SEC LEXIS 534 (Apr. 14, 1972) (exemptive order permitting a mutual fund complex with a captive underwriter to share the costs of distribution expenses); Broad Street Investing Corp., Investment Company Act Release No. 7072, 972 LEXIS 1251 (Mar. 16, 1972) (notice). For the complete history of the quest by the Vanguard Group to bear its own distribution expenses, *see* Vanguard Group, Inc., Investment Company Act Release No. 11,761, 22 SEC Docket 988 (May 4, 1981) (order); Vanguard Group, Inc., Investment Company Act Release No. 11,718, 22 SEC Docket 728 (Apr. 6, 1981) (notice of filing of application for an exemptive order permitting proposed transactions); Vanguard Group, Inc., Investment Company Act Release No. 11,645, 22 SEC Docket 238, 238 (Feb. 25, 1981) (decision of the Commission approving plan and granting exemption); Vanguard Group, Inc., 1979 SEC LEXIS 2452 (Oct. 4, 1979) (supplemental initial decision of the administrative law judge); Vanguard Group, Inc., 1978 SEC LEXIS 2550 (Nov. 29, 1978) (initial decision of administrative law judge); Vanguard Group, Inc., Investment Company Act Release No. 10,016, 13 SEC Docket 903 (Nov. 18, 1977) (order setting the matter down for an administrative hearing); Vanguard Group Inc., Investment Company Act Release No. 9927, 13 SEC Docket 92 (Sept. 13, 1977); Vanguard Group, Inc., Investment Company Act Release No. 9850, 12 SEC Docket 1301 (July 15, 1977) (notice of filing of application for exemption permitting mutual fund complex to bear distribution expenses).

36. *Bearing of Distribution Expenses by Mutual Funds*, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 21 SEC Docket 324 (Oct. 23, 1980) (adoption of Rules 12b-1 and 17d-3); *Bearing of Distribution Expenses by Mutual Funds*, Securities Act Release No. 6119, Investment Company Act Release No. 10,862, 18 SEC Docket 271 (Sept. 7, 1979) (proposed Rules 12b-1 and 17d-3).

37. 21 SEC Docket at 337.

directors would fall within the ambit of Rule 12b-1.³⁸ The SEC's final position was that where an investment adviser bears distribution expenses out of its own resources, the investment advisory fee must not be a conduit for the indirect use of fund assets. In other words, if the investment advisory fee is not "excessive" within the meaning of Section 36(b) (i.e., they are "legitimate profits"), the distribution expenses may be borne by the investment adviser because they are not an indirect use of a mutual fund's assets.³⁹

E. "*Protecting Investors*"—*The Special Study in 1992*

In 1992, the SEC's Division of Investment Management issued its important study, *Protecting Investors: A Half Century of Investment Company Regulation*.⁴⁰ Regarding investment company governance, the Division concluded:

the governance model embodied in the [Investment Company] Act is sound and should be retained, with limited modifications. The oversight function performed by [mutual fund] boards of directors, especially the "watchdog" function performed by the independent directors, has served investors well, at minimal cost. In our view, however, the increasingly significant responsibilities placed on independent directors warrant a few changes to further strengthen their independence. Accordingly, the Division recommends that the Commission recommend legislation that would increase the minimum proportion of independent directors on [mutual fund] boards from forty percent to more than fifty percent. In addition, the Division recommends that independent director vacancies be filled by persons chosen by remaining independent directors. Finally, the Division proposes that independent directors be given the express authority to terminate advisory contracts.

At the same time, however, the Division recommends eliminating provisions in certain rules under the [Investment Company] Act that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance. Elimination of such formalistic

38. *Id.* at 331–35.

39. *Id.* at 333.

40. DIV. OF INV. MGMT., SEC, *PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION* (1992).

requirements will increase the effectiveness of boards of directors by allowing them to focus to a greater extent on what they do best—exercising business judgment in their review of interested party transactions and in their oversight of operational matters where the interests of a[] [mutual fund] and its adviser may diverge.⁴¹

The recommendations from this important study are striking in at least two respects: (i) the Division expected Congress (and not the Commission through rulemaking) to effect any change in the minimum percent of members on a mutual fund's board of directors who must be independent;⁴² and (ii) the Division believed that the highest and best use of independent directors was to review interested party transactions and other matters where the interests of the mutual fund and its adviser might diverge.⁴³

F. The 2001 Amendments

In 1999, the Commission convened a two-day public Roundtable on the Role of Independent Investment Company Directors to discuss the role of independent directors and the steps that could be taken to improve their effectiveness.⁴⁴ Based on this discussion, the Commission proposed that independent directors constitute a majority of the board of directors of a mutual fund relying on certain exemptive rules,⁴⁵ that legal counsel to independent directors be independent,⁴⁶ and that independent directors

41. *Id.* at 253–54.

42. *Id.* at 266–67 (recommending legislation to increase the forty percent independent director requirement).

43. *Id.* at 266.

44. See SEC, THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS (1999), <http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm>; <http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm> (transcripts from roundtable of independent directors, investor advocates, executives of mutual fund advisers, academicians, corporate governance experts, and legal counsel).

45. Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 70 SEC Docket 1867 (Oct. 14, 1999) (proposing release).

46. It seems gratuitous and self-serving to criticize rules that require lawyers to be “independent.” In this rulemaking, however, the Commission did not link any specific abuses or abusive situations involving lawyers who were not independent to the need to adopt the proposal. Instead, the SEC based its proposal on its perception of the dynamics of the boardroom and its assumptions about the need for independent directors to have independent legal counsel, presumably to offset the undue influence of the investment adviser and its legal counsel in the boardroom. Role of Independent Directors of Investment Companies, *id.* at 1878–79 (proposing release). It is at least ironic that the Commission is confident that independent directors will make good decisions when faced with a conflict of interest, but cannot be trusted to (i) select their own legal counsel or (ii) select and appoint the chairman of the board of directors on which they sit.

nominate and select new independent directors.⁴⁷ With respect to the requirement that independent directors have “independent legal counsel,” if they have any counsel at all, Rule 0-1(a)(6)(i) under the Investment Company Act provides that a person is “independent legal counsel” with respect to the independent directors of a mutual fund if:

(A) A majority of the [independent] directors reasonably determine in the exercise of their judgment (and record the basis for that determination in the minutes of their meeting) that any representation by the person of the [mutual fund]’s investment adviser, principal underwriter, administrator (“management organizations”), or any of their control persons, since the beginning of the fund’s last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the [independent] directors; and

(B) The [independent] directors have obtained an undertaking from such person to provide them with information necessary to make their determination and to update promptly that information when the person begins to represent, or materially increases his representation of, a management organization or control person.⁴⁸

In January 2001, the Commission adopted the 2001 Amendments.⁴⁹ The 2001 Amendments were just as extralegal as the Corporate Governance Amendments are, but were neither as controversial nor as intrusive because (a) many mutual funds had adopted Plans pursuant to Rule 12b-1 and thus at least fifty percent of the members of the board of directors were already independent, and (b) most independent directors

47. *Id.* at 1871–72.

48. 17 C.F.R. § 270.0-1(a)(6)(i) (2005). Subparagraph (ii) of Rule 0-1(a)(6) permits the independent directors “to rely on the information obtained from the person, unless they know or have reason to believe that the information is materially false or incomplete. The disinterested directors must re-evaluate their determination no less frequently than annually (and record the basis accordingly). . . .” 17 C.F.R. § 270.0-1(a)(6)(ii) (2005). Subparagraphs (iii) and (iv) provide a transition period if independent legal counsel loses his “independence” and define terms for purposes of paragraph (a). 17 C.F.R. § 270.0-1(a)(6)(iii), (iv) (2005).

49. Role of Independent Directors of Investment Companies; Correction, Securities Act Release No. 7932 Exchange Act Release No. 43,786A, Investment Company Act Release No. 24,816A, 74 SEC Docket 473 (Feb. 27, 2001); Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24, 816, 74 SEC Docket 3 (Jan. 2, 2001) (adopting release).

were already represented by legal counsel who were independent in that they did not also represent the mutual fund's investment adviser.⁵⁰

II. THE SCANDALS FROM 2003–2004

A. *Market-Timing*⁵¹

On September 3, 2003, the New York Attorney General announced a civil injunctive action against Canary Capital Partners LLC (“Canary Capital”) in which Canary Capital agreed to pay \$40 million to settle claims against it under the Martin Act.⁵² The Canary Capital complaint described four mutual fund groups that had cooperated with Canary Capital by, *inter alia*, allegedly allowing it to effect market-timing and “late-trading” transactions in shares of certain mutual funds in return for “sticky assets” (usually invested in a private hedge fund also managed by the investment adviser); allegedly, one of the investment advisers effectively functioned as Canary Capital's prime broker, lent it money, allowed a terminal to be installed in Canary Capital's offices to facilitate late trading in shares of mutual funds, and disclosed portfolio holdings to,

50. Cf. INV. CO. INST., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS 18–20 (1999).

51. See generally GOV. ACCOUNTABILITY OFFICE, MUTUAL FUND TRADING ABUSES: LESSONS CAN BE LEARNED FROM SEC NOT HAVING DETECTED VIOLATIONS AT AN EARLIER STAGE (2005) (report to the Committee on the Judiciary, House of Representatives discussing the SEC's immediate and subsequent response to the market timing abuses). Cf. GOV. ACCOUNTABILITY OFFICE, MUTUAL FUND TRADING ABUSES: SEC CONSISTENTLY APPLIED PROCEDURES IN SETTING PENALTIES, BUT COULD STRENGTHEN CERTAIN INTERNAL CONTROLS (2005); *Enforcement Chief Says Big Board to Complete Fund Probe by Year's End*, 84 Banking Rep. (BNA) 1125 (June 27, 2005) (regulatory bodies plan to conclude current investigations into market-timing and late-trading of mutual funds by the end of 2005).

52. Press Release, N.Y. Att'y General, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html (reporting a disgorgement penalty of \$30 million and civil money penalty of \$10 million). It is remarkable that neither the New York Attorney General nor the Department of Justice have yet brought criminal charges against Canary Capital or any of its principals under state or federal laws. Cf. State *ex rel.* McGraw v. Bear Stearns & Co., 618 S.E.2d 582, 584 (W. Va. 2005) (decision on a certified question from the Circuit Court of Marshall County that the West Virginia consumer protection statutes do not provide a basis for an action against securities underwriters for manipulating the product of associated research analysts). It is also remarkable that so many investment advisers and broker-dealers have acceded to the New York Attorney General's assertion of jurisdiction of the Martin Act to activities that are clearly regulated in detail by the SEC. *But see* Complaint, J. & W. Seligman & Co. v. Spitzer, No. 05 CV 7781 (S.D.N.Y. Sept. 6, 2005) (asserting lack of jurisdiction of the state to address advisory fees); Riva D. Atlas, *Firm Sues to Block Mutual Fund Fee Inquiry*, N.Y. TIMES, Sept. 7, 2005, at C8 (reporting suit); Erica Copulsky, *Money Manager Sues Eliot Spitzer*, WALL ST. J., Sept. 7, 2005, at C13; Erica Copulsky, *Seligman Again Draws Spitzer's Fire*, WALL ST. J., Sept. 29, 2005, at C13; Editorial, *Spitzer in Court*, WALL ST. J., Sept. 23, 2005, at A16 (giving kudos to J & W. Seligman & Co. for challenging the New York Attorney General for exceeding his powers).

and designed derivative instruments for, Canary Capital to permit it to consummate more efficient hedging transactions based on the non-public information about the mutual fund's investment portfolio.⁵³

53. Administrative Proceedings Instituted Against Theodore Charles Sihpol, III, a Former Broker at Banc of America Securities LLC, for Enabling Certain Hedge Fund Customers to "Late-Trade" Mutual Funds, Securities Act Release No. 8288, Exchange Act Release No. 48,493, Investment Company Act Release No. 26,179, 81 SEC Docket 17 (Sept. 16, 2003). The New York Attorney General simultaneously brought criminal charges against Mr. Sihpol in New York State Court. Riva D. Atlas, *Spitzer's Office Prepares for Rare Trial*, N.Y. TIMES, Apr. 19, 2005, at C1; *Broker's Trial Hears Testimony on Late Trading*, N.Y. TIMES, May 14, 2005, at B2; Judith Burns, *Charges Stand*, WALL ST. J., Mar. 15, 2005, at C15 (trial court refused to dismiss the charges); Arden Dale, *Fund Trustees Testify in Sihpol Case*, WALL ST. J., May 19, 2005, at C15; Arden Dale, *Jury Hears About Timestamp Deceit*, WALL ST. J., May 5, 2005, at C15; Arden Dale, *Late-Trade Case Prosecution Rests*, WALL ST. J., May 24, 2005, at C13; Arden Dale, *Sihpol Never Talked About Trades*, WALL ST. J., May 12, 2005, at C17; Arden Dale, *Sihpol's Attorneys Rest Their Case*, WALL ST. J., May 26, 2005, at C15; Arden Dale, *Witness Bolsters Sihpol's Defense*, WALL ST. J., May 16, 2005, at C15; Arden Dale, *Witness Calls Fund Trades No Secret*, WALL ST. J., May 9, 2005, at C13; Arden Dale, *Witness Details Sihpol Arrangement*, WALL ST. J., May 17, 2005, at C13; Arden Dale, *Witness Testifies at Sihpol's Trial*, WALL ST. J., May 10, 2005, at C15; Jonathan D. Glater, *For Some, "Just Following Orders" Is a Good Defense*, N.Y. TIMES, June 24, 2005, at C6 (commentary that prosecuting low-level employees can be difficult); *Jurors in Sihpol Case Divided on 13 Counts*, WALL ST. J., June 8, 2005, at C15; Brooke A. Masters, *Spitzer's Charges Face a Challenge*, WASH. POST, Apr. 26, 2005, at E1; Op-Ed, *The Sihpol Verdict*, WALL ST. J., June 10, 2005, at A8 (criticizing Spitzer for bringing case); Angelo Pruitt, *Sihpol's Supervisor Testifies at Trial*, WALL ST. J., May 18, 2005, at C19; Kara Scannell & Arden Dale, *After-Hours Trading Goes on Trial*, WALL ST. J., May 3, 2005, at C17; Kara Scannell & Arden Dale, *Sihpol Verdict Raises Questions on Spitzer Style*, WALL ST. J., June 10, 2005, at A1; *Sihpol Absolved of Most Charges in N.Y. Suit over Mutual Fund Trading*, 37 Sec. Reg. & L. Rep. (BNA) 1039 (June 13, 2005); *Sihpol Jury to Begin Deliberations Today*, WALL ST. J., June 2, 2005, at C13; *Trial Will Proceed for Former Broker*, N.Y. TIMES, Mar. 15, 2005, at C6; *Verdict on Some Counts in Broker's Trial*, N.Y. TIMES, June 8, 2005, at C2.

The New York Attorney General initially decided to retry Mr. Sihpol on the four counts on which the jury could not agree. See Arden Dale, *Spitzer Plans to Retry Sihpol on 4 Counts in Fund-Trade Case*, WALL ST. J., July 8, 2005, at C3; Editorial, *Cruel and Unusual*, WALL ST. J., July 11, 2005, at A12 (criticizing the decision to retry Mr. Sihpol as "vindictive and petty"); Jonathan D. Glater, *Case Isn't Closed as Spitzer's Office Plans to Retry Broker on 4 Counts*, N.Y. TIMES, July 8, 2005, at C3; *Sihpol Retrial Postponed Until October*, IGNITES, Aug. 12, 2005, <http://www.ignites.com/ome/members/article.html?id=974227046>; *Spitzer Offers Ex-Broker Alternative to Retrial*, WASH. POST, July 8, 2005, at D2. See also *Possible Sihpol Retrial Talks to Start Oct. 20*, IGNITES, Oct. 10, 2005, http://www.ignites.com/articles/20051010/possible_sihpol_retrial_talks_start; *Sources: Sihpol About to Settle with SEC*, IGNITES, Oct. 12, 2005, http://www.ignites.com/articles/20051012/sources_sihpol_about_settle_with; Riva D. Atlas & Andrew Ross Sorkin, *Ex-Broker Is Said to be Close to Deal with the S.E.C.*, N.Y. TIMES, Oct. 12, 2005, at C3; SEC Press Release No. 2005-146, SEC Settles Securities Fraud Charges Against Theodore Sihpol, Oct. 12, 2005; Arden Dale & Chad Bray, *Spitzer Won't Retry Sihpol on Trading Charges*, WALL ST. J., Oct. 13, 2005, at C5; N.Y. Criminal Charges Against Sihpol Dismissed, as Broker Settles with SEC, 37 Sec. Reg. & L. Rep. (BNA) 1729 (Oct. 17, 2005). In the matter of Theodore Charles Sihpol III, Investment Advisers Act Release No. 2440 (Oct. 12, 2005) (order barring association with any broker, dealer, or investment adviser for five years, and announcing payment of \$200,000 as a civil money penalty to resolve the SEC's civil action in the U.S. District Court for the Southern District of New York).

For other criminal cases against individuals at brokerage firms who facilitated market-timing activities, see Chad Bray, *Guilty Pleas*, WALL ST. J., Aug. 31, 2005, at C13 (senior executives of Security Trust); *Broker Pleads Guilty*, WALL ST. J., Aug. 10, 2005, at C13; *Former Trader Pleads*

Mutual funds are required by Rule 22c-1 under the Investment Company Act to effect transactions in their shares at the current net asset value per share (“NAV”) next determined after receipt of the request for redemption or order to purchase.⁵⁴ Most mutual funds calculate their NAV at 4:00 p.m. Eastern Time, so orders received after 4:00 p.m. Eastern Time today should be effected at the price next determined, i.e., the NAV calculated at 4:00 p.m. tomorrow.⁵⁵ Section 2(a)(41)(B) of the Investment Company Act defines the term “value” to mean “(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.”⁵⁶ Among

Guilty, IGNITES, Aug. 10, 2005, <http://www.ignites.com/home/members/article.html?id=974227018>; *Guilty Pleas from Security Trust Execs*, IGNITES, Aug. 31, 2005, <http://www.ignites.com/home/members/article.html?id=974227262>; John Hechinger, *Ex-Broker at Prudential Is Charged*, WALL ST. J., Aug. 3, 2005, at C13; *In Rarity, Spitzer Drops Case*, N.Y. TIMES, Nov. 22, 2005, at C1; Tom Lauricella & Paul Davies, *Spitzer Retreats from Another Fund Prosecution*, WALL ST. J., Nov. 22, 2005, at C1; *Second Former Prudential Broker Charged with Fraud, Intends to Plead Guilty*, 37 Sec. Reg. & L. Rep. (BNA) 1481 (Sept. 5, 2005); *Security Trust Guilty Pleas*, N.Y. TIMES, Aug. 31, 2005, at C15.

For civil enforcement cases against brokerage firms that effected market-timing trades, see *SEC Sues Broker, Alleging He Made Abusive Mutual Fund Trades*, 37 Sec. Reg. & L. Rep. (BNA) (July 8, 2005) (reporting injunctive proceeding against registered representative for executing late trades for hedge fund clients, then falsifying records to conceal them); Deborah Solomon, *CIBC Agrees to Settle Fraud Case*, WALL ST. J., July 20, 2005, at C13 (\$100 million civil money penalty for bank that financed Canary Capital Partners LLC).

54. 17 C.F.R. § 270.22c-1(a) (2005). Rule 2a-4(a) under the Investment Company Act defines the term “current net asset value” for purposes of making that calculation. 17 C.F.R. § 270.2a-4(a) (2005). For SEC interpretive positions on pricing a mutual fund’s assets, see Guide 28 to Form N-1A, 6 Fed. Sec. L. Rep. (CCH) ¶ 51,208 at 39,261-62; Statement Regarding “Restricted Securities,” Investment Company Act Release No. 5847, [Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,135, at 62,284-86 (Oct. 21, 1969); Guidelines for the Preparation of Form N-8B-1, 6 Fed. Sec. L. Rep. (CCH) ¶ 51,301, at 39,583-84 (June 9, 1972); Accounting for Investment Securities by Registered Investment Companies, Securities Act Release No. 5120, Exchange Act Release No. 9049, Investment Company Act Release No. 6295, [Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,140 (Dec. 23, 1970); Investment Company Institute, SEC No-Action Letter, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,658, at 76,385-86 (Dec. 9, 1999); Investment Company Institute, SEC No-Action Letter, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,113 (Apr. 30, 2001).

55. See Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 81 SEC Docket 2553, 2554 (Dec. 11, 2003).

56. 15 U.S.C. § 80a-2(a)(41)(B) (2000). The SEC was sued in the U.S. Court of Appeals for the Seventh Circuit in July 2004 on allegations that statements made by the SEC about “fair value” pricing in the context of the adoption of compliance program rules under the Investment Company Act were improper in that they had the effect of a legislative rule without following the Administrative Procedure Act’s requirements of notice and opportunity for comment. *DH2, Inc. v. SEC*, 422 F.3d 591, 594 (7th Cir. 2005). In September 2005, the Court of Appeals for the Seventh Circuit dismissed the petition on the ground that DH2 had no standing to challenge the SEC’s rules because it is merely an investor, not a registered investment company. *Id.* at 596-97.

other things, Canary Capital was exploiting anomalies in the price of securities held by global funds where a significant event had occurred after the market had closed in London or the Far East (i.e., there was a market quotation that was readily available from earlier in the day but it had become “stale” as a result of events that occurred after the market had closed), or was effecting trades after 4:00 p.m. Eastern Time (“late-trading”) when a significant event had occurred in the U.S. markets after the U.S. markets had closed.⁵⁷ Arguably, the former problem could be “cured” if the board of directors of a mutual fund were to “fair value” the portfolio securities held by global or international funds before the NAV is calculated at 4:00 p.m. Eastern Time in the event that their prices have become “stale”; however, there is no “cure” for trades illegally entered after 4:00 p.m. without the knowledge of the mutual fund (and/or its service providers) other than the pursuit of civil and criminal actions against the lawbreakers after the fact.

Since the announcement of the Canary Capital settlement, a number of enforcement actions have been brought by the SEC, NASD, and the attorneys general of a number of states against mutual fund advisers and broker-dealers under the Investment Company Act, the Securities Act of 1933 (“1933 Act”),⁵⁸ the Securities Exchange Act of 1934 (“Exchange

It is beyond the scope of this Article to discuss Rule 2a-4 and § 2(a)(41)(B) in depth. It should be noted, however, that (i) pricing an equity security in reliance on the last “round lot” traded on the New York Stock Exchange may not be appropriate where a mutual fund holds a large position, (ii) pricing a bond that has never been traded using a “matrix” that attempts to estimate what the sale price for that bond would be based on the characteristics of bonds that have traded is necessarily merely an educated estimate, and (iii) “small cap” and “micro cap” stocks have very thin trading markets. Richard D. Marshall, *Pricing and Liquidity*, in THE INVESTMENT COMPANY REGULATION DESKBOOK, 5-4 to 5-8 (Amy L. Goodman ed., 1997, rev. 1998). Because there are differing elements of subjectivity in pricing virtually every type or class of asset held by mutual funds—not just foreign securities trading in markets that close prior to 4:00 p.m. in non-Eastern time-zones—regulatory policy should recognize that elements of subjectivity necessarily exist in calculating a mutual fund’s NAV. See Arden Dale, *Mutual Funds Consider ‘Fair Value’*, WALL ST. J., Mar. 14, 2005, at C15 (account of survey by Deloitte & Touche finding that more mutual funds are hiring outside firms to help value stocks and bonds held in their investment portfolios).

57. Marshall, *supra* note 56, at 5-11, 5-12. The mutual fund industry has, for years, authorized third parties to serve as sub-transfer agents for the purpose of determining the time that a purchase order or request for redemption was received. See Charles Schwab & Co., Inc., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,353, at 77,768 (July 7, 1997). Other traders routinely interface with the mutual fund’s transfer agent through a broker-dealer, a bank, or a third-party pension administrator, each of which takes orders from its clients up to 4:00 p.m. Eastern Time, then transmits a “batched” net order to the mutual fund transfer agent after 4:00 p.m. of the orders that it represents that it processed in fact before the 4:00 p.m. cut-off. If the person transmitting orders to the mutual fund’s transfer agent disrespects the sanctity of the 4:00 p.m. cut-off, the mutual fund’s transfer agent may well be unable to detect the cheating if the third party placed its orders on an omnibus basis.

58. 15 U.S.C. § 77a–(aa) (2000 & Supp. 2005).

Act”),⁵⁹ the Investment Advisers Act of 1940 (“Advisers Act”),⁶⁰ NASD rules, and state securities laws.⁶¹ To date, most of the settled cases involve

59. 15 U.S.C. § 78a–(nn) (2000 & Supp. 2005).

60. 15 U.S.C. § 80b-1 to -27 (2000 & Supp. 2005). Sections 206(1) and 206(2) of the Advisers Act (15 U.S.C. §§ 80b-6(1),(2)) impose federal fiduciary duties on registered investment advisers in that they prohibit employing “any device, scheme, or artifice to defraud any client or prospective client,” or engaging “in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194–201 (1963) (failure to disclose “scalping” justified imposition of an injunction requiring disclosure). Section 206(4) prohibits “any act, practice, or course of business which is fraudulent, deceptive, or manipulative” and gives the Commission rulemaking authority to define such acts, practices, and courses of business. 15 U.S.C. § 80b-6(4). The Commission has adopted rules regarding advertising, custody and possession of client funds and securities, cash referral fees, and disclosure of financial and disciplinary information. 17 C.F.R. §§ 275.206(4)-1 to -4 (2005).

61. Putnam Inv. Mgmt., LLC, Investment Company Act Release No. 26,255, 81 SEC Docket 1913 (Nov. 13, 2003) (partial settlement alleging violations of sections 203(e)(6), 204A, 206(1), and 206(2) of the Advisers Act and sections 17(j) and Rule 17j-1 under the Investment Company Act); *see also* Brean Murray & Co., Exchange Act Release No. 51,219, Investment Company Act Release No. 26,761, 84 SEC Docket 3014 (Feb. 17, 2005) (alleging aiding and abetting violations of Rule 22c-1 under the Investment Company Act—civil money penalty of \$150,000); Fremont Inv. Advisors, Inc., Investment Company Act Release No. 26,650, 84 SEC Docket 231 (Nov. 4, 2004) (alleging violations of sections 206(1) and 206(2) of the Advisers Act and sections 17(d), 34(b), Rules 17d-1, and 22c-1 of the Investment Company Act—disgorgement of \$2.146 million, civil money penalty of \$2 million); Invesco Funds Group, Inc., Exchange Act Release No. 50,506, Investment Company Act Release No. 26,629, 83 SEC Docket 2872 (Oct. 8, 2004) (alleging violations of sections 206(1) and 206(2) of the Advisers Act and sections 17(d), 34(b), and Rule 17-3-1 of the Investment Company Act—disgorgement of \$225 million, penalty of \$140 million); RS Inv Mgmt., Inc., Investment Company Act 26,627, 83 SEC Docket 2828 (Oct. 6, 2004) (alleging violations of sections 206(1) and 206(2) of the Advisers Act and sections 17(d), 34(b), and Rule 17d-1 of the Investment Company Act—disgorgement of \$11.5 million, civil money penalty of \$13.5 million); Charles Schwab & Co., Exchange Act Release No. 50,360, Investment Company Act Release No. 26,595, 83 SEC Docket 2252 (Sept. 14, 2005) (alleging violation of Rule 22c-1 of the Investment Company Act—civil money penalty of \$350,000); PA Fund Mgmt. LLC, Exchange Act Release No. 50,354, Investment Company Act Release No. 26,594, 83 SEC Docket 2228 (Sept. 13, 2004) (alleging violations of sections 204A, 206(1), and 206(2) of the Advisers Act and sections 17(d), 34(b), and Rule 17(d)-1 of the Investment Company Act—disgorgement of \$10 million and civil money penalty of \$40 million); Janus Capital Mgmt. LLC, Investment Company Act Release No. 26,532, 83 SEC Docket 1766 (Aug. 18, 2004) (alleging violations of sections 206(1) and 206(2) of the Advisers Act and sections 17(d), 34(b), and Rule 17d-1 of the Investment Company Act—disgorgement of \$50 million, civil money penalty of \$50 million); Inviva, Inc., Securities Act Release No. 8456, Exchange Act Release No. 50,166, Investment Company Act Release No. 26,527, 83 SEC Docket 1567 (Aug. 9, 2004) (alleging violations of section 10(b) and Rule 10b-5 of the Exchange Act and section 34(b) of the Investment Company Act—disgorgement of \$3.5 million, civil money penalty of \$1.5 million); CIHC, Inc., Securities Act Release No. 8455, Exchange Act Release No. 50,165, Investment Company Act Release No. 26,526, 83 SEC Docket 1558 (Aug. 9, 2004) (alleging violations of section 10(b) and Rule 10b-5 under the Exchange Act, section 17(a) of the Securities Act, and section 34(b) of the Investment Company Act—disgorgement of \$7.5 million, civil money penalty of \$7.5 million); Franklin Advisers, Inc., Investment Company Act Release No. 26,523, 83 SEC Docket 1530 (Aug. 2, 2004) (alleging violations of sections 206(1) and 206(2) of the Advisers Act and section 34(b) of the Investment Company Act—disgorgement of \$30 million, civil money penalty of \$20 million); Banc One Inv. Advisors Corp., Investment Company Act Release No. 26,490, 83 SEC Docket 695 (June 29, 2004) (alleging violations of sections 204A, 206(1), and 206(2) of the Advisers Act and sections 17(d), 34(b), and Rule 17d-1 of the Investment Company Act—disgorgement of \$10 million, civil money

penalty of \$40 million); Pilgrim Baxter & Assoc., Investment Company Act Release No. 26,470, 83 SEC Docket 363 (June 21, 2004) (alleging violations of sections 204A, 206(1), and 206(2) of the Advisers Act and section 34(b) of the Investment Company Act—disgorgement of \$40 million, civil money penalty of \$50 million); Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 82 SEC Docket 3178 (May 20, 2004) (alleging violations of sections 204A, 206(1) and 206(2) of the Advisers Act and section 34(b) of the Investment Company Act—disgorgement of \$40 million, civil money penalty of \$40 million); Mass. Fin. Serv. Co., Investment Company Act Release No. 26,347, 82 SEC Docket 341 (Feb. 5, 2004) (alleging violations of section 206(1) and 206(2) of the Advisers Act and section 34(b) of the Investment Company Act—disgorgement of \$175 million, civil money penalties of \$50 million); Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, 81 SEC Docket 2800 (Dec. 18, 2003) (alleging violations of sections 204A, 206(1), and 206(2) of the Advisers Act and sections 17(d), 20(a), 24(b) and Rules 17d-1 and 20a-1 under the Investment Company Act—disgorgement of \$150 million, civil money penalty of \$100 million); Franklin Advisers, Inc., Consent Order, Docket No. E-2004-007 (Mass. Sec. Div., Sept. 20, 2004), <http://www.sec.state.ma.us/sct/sctpdf/ftconsentorder.pdf> (alleging violations of MASS. GEN. LAWS. ch. 110A, § 101—penalty of \$5 million); Press Release, Mass. Att’y Gen., Putnam Investment Admits Wrong Doing; Fined \$50 million in Market Timing Case (Apr. 8, 2004), <http://www.sec.state.ma.us/sct/sctpdf/putnampressrelease.pdf> (disgorgement of \$5 million, civil penalty of \$50 million); Press Release, N.J. Att’y Gen., Attorney General Harvey Announces \$18 Million Settlement with Allianz Dresdner Asset Management of America, PA Distributors and PEA Capital (June 1, 2004), <http://www.state.nj.us/lps/newsreleases04/pr20040601a.html> (alleging violations of N.J. STAT. ANN. § 49:3-52 (West)—disgorgement of \$3 million, penalty of \$15 million); Press Release, NASD, Jefferson Pilot to Pay Over \$500,000 in First VUL Market Timing Action; NASD Also fines Affiliate \$125,000 for Email Retention Violations (Mar. 16, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013566 (alleging failure to prevent holders of variable universal life insurance policies from engaging in market-timing transactions in sub-accounts of the separate account—disgorgement of \$238,697, fine of \$325,000); Press Release, NASD, NASD Fines Davenport & Co. in First Case of Deceptive Market Timing in Variable Annuities (June 1, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002824 (alleging deceptive market timing in variable annuity contracts and a failure to prevent late trading—disgorgement of \$288,000, fine of \$450,000); Press Release, NASD, NASD Fines H&R Block Financial Advisors \$500,000 for Enabling Deceptive Market Timing, Orders Payment of \$325,000 in Restitution (Dec. 21, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012819 (announcing disgorgement of \$325,000 and penalty of \$500,000); Press Release, NASD, NASD Fines Sentinel Financial Services \$700,000 for Failing to Prevent Market timing (Oct. 7, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_011624 (announcing disgorgement of \$659,674 and penalty of \$40,326); Press Release, NASD, NASD Fines State Street Research Investment Services \$1 Million for Market Timing Supervision Violations; Firm Ordered to Pay More Than \$500,000 in Restitution (Feb. 19, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002852 (alleging failure to prevent market timing due to inadequate supervisory systems—disgorgement of \$500,000, fine of \$1 million); Press Release, NASD, NASD Orders First-Ever Suspension of Mutual Fund Business and \$600,000 in Sanctions Against National Securities Corp. for Deceptive Market Timing Practices (Aug. 19, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_010888 (announcing disgorgement of \$300,000 and penalty of \$300,000); Press Release, New York Stock Exchange, NYSE Regulation Fines Merrill Lynch, Pierce, Fenner & Smith Incorporated \$13.5 million (Mar. 8, 2005), <http://www.nyse.com/press/1110282618687.html> (alleging failure to supervise registered representatives who engaged in market timing, opening accounts at mutual funds outside Merrill Lynch to execute trades—fine of \$13.5 million, \$10 million payable to New Jersey, \$3.5 million payable to Connecticut); Press Release, SEC, SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading (Mar. 15, 2004), <http://www.sec.gov/news/press/2004-33.htm> (announcing a settlement in principle—disgorgement of

alleged charges that the investment adviser breached its fiduciary duty under the Advisers Act by allowing market-timing transactions to occur contrary to statements in the affected mutual fund's prospectus that market-timing transactions were prohibited or severely restricted.⁶² None of the settled cases involve alleged charges against members of the mutual fund's board of directors who were independent—instead, there is usually an allegation that the investment adviser failed to inform the mutual fund's board of directors of the precise nature of the market-timing activities that it was allowing to occur.⁶³

To address these issues, the Commission has adopted amendments to Form N-1A that require enhanced disclosure of a mutual fund's risks, policies, and procedures concerning market-timing, selective disclosure of portfolio holdings, and the use of "fair value" pricing.⁶⁴ The Commission also proposed amendments to Rule 22c-1 that would provide that, for an order to purchase or redeem shares to receive the NAV calculated by the mutual fund for today, the designated transfer agent or registered clearing agency must receive the order by the time the mutual fund establishes for calculating its NAV.⁶⁵ To bring previously unregulated hedge fund

\$250 million, civil penalty of \$125 million); Press Release, SEC, SEC's Division of Enforcement Announces Agreement to Settle Civil Fraud Charges Against Fleet's Columbia Mutual Fund Adviser and Distributor for Undisclosed Market Timing (Mar. 15, 2004), <http://www.sec.gov/news/press/2004-34.htm> (announcing a settlement in principle—disgorgement of \$70 million, civil money penalty of \$70 million).

62. See, e.g., Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312A, 81 SEC Docket 3401 (Dec. 18, 2005).

63. *Id.*

64. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 82 SEC Docket 2357, 2357 (Apr. 16, 2004) (adopting release); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8343, Investment Company Act Release No. 26,287, 81 SEC Docket 2425, 2425–26 (Dec. 11, 2003) (proposing release).

65. Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 81 SEC Docket 2553, 2553–54 (Dec. 11, 2003) (proposing release). This proposal, often referred to as the "hard 4:00 p.m. close," would disadvantage every investor who accesses a mutual fund through a third-party—a broker-dealer, bank, or third-party pension administrator—which would be required, as a practical matter, to cease taking orders by around 1:30 p.m. Eastern Time (for example), to be able to submit its "batched" net order to the mutual fund's transfer agent by 4:00 p.m. Eastern Time. See *GAO: Proposed SEC Rules Could Affect Pension Plan Participants More Than Others*, 36 Sec. Reg. & L. Rep. (BNA) 1483 (Aug. 16, 2004) (relating GAO report that the proposal would create new costs for all long-term mutual fund shareholders, especially defined-contribution-plan participants); *Lawmakers Warn 'Hard 4' Proposal May Have Unintended Consequences*, 36 Sec. Reg. & L. Rep. (BNA) 614 (Apr. 5, 2004) (reporting that the chairs of the House Committee on Financial Services and its Subcommittee on Capital Markets have expressed concern that the proposal will harm innocent investors); *Senators Ask SEC to Consider Effect of Reform on Plan Participants*, 36 Sec. Reg. & L. Rep. (BNA) 613 (Apr. 5, 2004) (reporting request from the chairman and ranking member of the Senate Committee on Finance that the SEC consider the effect of the proposed rule on retirement plan participants).

advisers into its regulatory fold, the Commission adopted Rule 203(b)(3)-2 under the Advisers Act.⁶⁶ The rule redefines the term “client” in order to require certain investment advisers to hedge funds and other private investment companies to register under section 203(c) of the Advisers Act,⁶⁷ notwithstanding the exception to registration in section 203(b)(3) thereof⁶⁸ for an investment adviser with fewer than fifteen clients that is not holding itself out to the public.⁶⁹ Finally, the SEC proposed that mutual funds be required to impose a mandatory redemption fee of two percent, payable to the mutual fund if an investor engages in rapid trading,⁷⁰ but in March 2005 adopted new Rule 22c-2 authorizing (but not

66. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 84 SEC Docket 1032, 1032 (Dec. 2, 2004) (adopting release) (codified at 17 C.F.R. § 275.203(b)(3)-(2)).

67. 15 U.S.C. § 80b-3(c) (2000).

68. 15 U.S.C. § 80b-3(b)(3) (2000).

69. 17 C.F.R. § 275.203(b)(3)-2 (2005). The critical term is the word “client,” which, since 1940, has consistently been treated as the person or entity receiving advice from the investment adviser, not the individual members or owners of the entity, unless the investment adviser also advises them individually. The practical effect of Rule 203(b)(3)-2 is to treat every investor in a hedge fund as a separate client of the hedge fund’s adviser, even when the adviser has no actual client relationship with the investor. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 66, at 1033–58.

The Commission was sued over the adoption of Rule 203(b)(3)-2 in December 2004. Petition, *Goldstein v. SEC*, No. 04-1434 (D.C. Cir. Dec. 21, 2004). Like the Chamber of Commerce, Mr. Goldstein also sued the Commission simultaneously in the District Court for the District of Columbia. Oral argument occurred on December 9, 2005. For press reports of the oral argument, see Judith Burns, *Court Questions SEC Regulation for Hedge Funds*, WALL ST. J., Dec. 10, 2005, at A4; Carrie Johnson, *Appeals Judges Question SEC’s Hedge Fund Rule*, WASH. POST, Dec. 10, 2005, at D1; Stephen Labaton, *Judges Weigh Hedge Funds vs. the S.E.C.*, N.Y. TIMES, Dec. 10, 2005, at B1. For two editorials regarding Rule 203(b)(3)-2, see Jenny Anderson, *Should Hedge Funds Be Exempt From an Exemption?*, N.Y. TIMES, Dec. 9, 2005, at C5 (arguing that requiring hedge fund advisers to become registered investment advisers will exempt them from the short-swing profits prohibition in section 16(b) of the Exchange Act, a perverse incentive for registering); John Berlan, *Who Is Watching the Watchdog?*, WALL ST. J., Dec. 9, 2005, at A14 (arguing that the rule also applies to most venture capital and private equity funds, a danger Congress has repeatedly tried to avoid).

70. Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A, 82 SEC Docket 1419, 1419 (Mar. 5, 2004) (proposed rule requiring mandatory redemption fees). Sections 22(e) and 22(f) of the Investment Company Act prohibit a mutual fund from suspending the right of redemption, postponing the date of payment, or restricting the transferability of any security of which it is the issuer; thus, for years mutual funds were not able to impose any kind of redemption fees to deter rapid trading. 15 U.S.C. § 80a-22(e)–(f) (2000). *Cf.* *United States v. NASD*, 422 U.S. 694, 729–30 (1975) (the restrictions in section 22(f) on distribution that would otherwise be per se violations of the Sherman Act are immune from antitrust liability).

In 1989, in the context of adopting rules regarding exchanges under section 11 of the Investment Company Act, 15 U.S.C. § 80a-11, the Commission first permitted the imposition of redemption fees. 17 C.F.R. § 270.11a-3(b)(2) (2005) (a security holder may be charged a redemption fee that is applied uniformly, and any scheduled variation must be reasonably related to the costs to the mutual fund of processing that type of redemption). Because of (i) the clear prohibitions in Sections 22(e) and 22(f) and the notion that every shareholder (even a market-timer) had the statutory right to redeem without the imposition of a penalty and (ii) the fact that the redemption fees authorized by Rule 11a-3 must

requiring) a mutual fund to impose a redemption fee of up to two percent on shares that are redeemed within seven days of purchase.⁷¹

B. Revenue-Sharing

In November 2003, the SEC and NASD settled cases against Morgan Stanley DW Inc. (“Morgan Stanley”) for allegedly failing to disclose to its brokerage customers that it had had a Preferred Partners Program since 2002 in which its registered representatives were paid higher commissions and received other extra compensation from Morgan Stanley and from the mutual fund advisers in the Preferred Partners Program for selling shares

relate to administrative and processing costs associated with a redemption request and not the actual “damage” that a redemption might cause a mutual fund, the SEC staff was reluctant to sanction redemption fees of more than two percent *Compare* Chase Fund of Boston, SEC No-Action Letter, [1989–1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,332 (Sept. 9, 1989) (withdrawing previous no-action letter limiting redemption fees to five dollars), *with* Newberger & Berman Genesis Fund, Inc., SEC No-Action Letter, 1988 WL 235038, at *13 (Sept. 27, 1988) (a redemption fee would not create a senior security for purposes of Section 18(f)(1) of the Investment Company Act), *and* John P. Reilly & Assocs., SEC No-Action Letter, 1979 WL 14677, at *1 (July 12, 1979) (redemption fee in excess of two percent may cause the shares not to be considered “redeemable securities”). If redemption fees are going to act as a brake on rapid trading, the higher the redemption fee is, the more likely that it will act as a brake. Accordingly, some mutual funds determined as a matter of business judgment to impose redemption fees of two percent for some funds—for example, S&P 500 Index funds that seemed to be inviting targets for investors who wanted to “long” a mutual fund with very predictable portfolio holdings and “short” a derivative or S&P 500 futures contract to create a hedge. Where the investor has inside information about the exact nature of the mutual fund’s portfolio holdings, it is possible to create a better hedge and even a two percent redemption fee appeared to have little deterrent effect on a determined market-timer or late-trader. *See infra* note 123.

71. Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 84 SEC Docket 3664 (Mar. 11, 2005) (adopting release). *See SEC Gives Funds Redemption Fee Option, but Requires Contract with Intermediaries*, 37 Sec. Reg. & L. Rep. (BNA) 393 (Mar. 7, 2005); Deborah Solomon, *Mutual Fund Boards Get Break over Penalizing Rapid Traders*, WALL ST. J., Mar. 4, 2005, at C3. New Rule 22c-2 under the Investment Company Act will require information-sharing between mutual funds and intermediaries, such as broker-dealers, banks, and third-party administrators, to allow the mutual fund’s transfer agent to surveil for market-timers and late-traders behind omnibus accounts. Mutual Fund Redemption Fees, *supra*, at 3669. The intermediaries will have to agree to implement a mutual fund’s instructions and impose trading restrictions on their customers. *Id.* New Rule 22c-2 will not apply to money market funds or exchange-traded funds, or mutual funds that encourage active trading and disclose in their prospectuses that active trading will impose costs on the fund. *Id.* at 3668 n.26. There is also no restriction on how long the embargo period on rapid trading can be, leaving that also to the business judgment of individual mutual funds. *Id.* at 3669. The Commission decided to seek additional comment on whether it should set uniform standards for redemption fees, whether exceptions should be standardized, and whether the embargo period should be calculated on a first-in/first-out basis or some other assumption. *Id.* at 3672–75. New Rule 22c-2 will have a compliance date in October 2006, giving the mutual fund industry eighteen months to come into compliance. *Id.* at 3676. *Cf.* Arden Dale, *Van Kampen Plans to Levy New Fees*, WALL ST. J., Aug. 4, 2005, at C11; Tom Leswing, *ICI Readies New Attack on Timers*, IGNITES, Aug. 24, 2005, <http://www.ignites.com/home/members/article.html?id=974227179>; Tom Leswing, *Redemption Fee Rule May Carry \$1B Price Tag*, IGNITES, Aug. 16, 2005, <http://www.ignites.com/home/members/article.html?id=974227078>.

of the mutual funds in the Preferred Partners Program.⁷² Specifically, it was alleged that fourteen third-party mutual fund complexes paid Morgan Stanley fifteen or twenty basis points on gross sales of mutual fund shares, and five basis points on “aged assets,” i.e., mutual fund shares held for more than one year. The five basis point component of the Preferred Partners Program was paid to the participating registered representatives, who also received a higher commission payout for selling mutual funds in the Preferred Partners Program than for other mutual funds.⁷³ “Revenue-sharing” payments made by an investment adviser out of its own pocket are not subject to Rule 12b-1 under the Investment Company Act.⁷⁴

Rule 10b-10 under the Exchange Act requires the disclosure of certain information to a broker-dealer’s customer on the confirmation statement, including “[t]he source and amount of any other remuneration received or to be received by the broker in connection with the transaction.”⁷⁵ In 1977,

72. Morgan Stanley DW Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 81 SEC Docket 1993, 1996, 2001 (Nov. 17, 2003) (alleging violations of section 17(a)(2) of the Securities Act, Rule 10b-10 under the Exchange Act, and NASD Rule 2830(k)—disgorgement of \$25 million, civil penalties of \$25 million). As part of the settlement, Morgan Stanley agreed to an undertaking to provide customers with a disclosure statement concerning compensation received by the firm and its registered representatives in connection with the sale of shares of mutual funds through the Preferred Partners Program. *Id.* at 1999. See Kathy Chu, “Preferred” Funds Get More Money, WALL ST. J., Jan. 25, 2005, at C19 (describing use of “preferred” groups of investments).

73. *Id.* at 1994–95.

74. As a matter of law, nothing prohibits an investment adviser from using its “legitimate profits,” see *supra* text accompanying note 35, in any way that it sees fit, including compensating selling broker-dealers for providing “shelf space,” for allowing the investment adviser access to the selling broker-dealer’s registered representatives, and for providing opportunities to educate the selling broker-dealer’s sales force about the mutual funds served by the investment adviser. See *supra* note 31.

75. 17 C.F.R. § 240.10b-10(a)(2)(i)(D) (2005). The NASD has its own disclosure requirements related to receipt of cash compensation. NASD Rule 2830(l)(4) prohibits a member from accepting any cash compensation that is not described in a current prospectus for the investment company, and prohibits the receipt of “special cash compensation” that is not made available on the same terms to all members unless the name of the member and details of the arrangements are disclosed in the prospectus. The NASD has taken the position that these requirements may be met by disclosure in the mutual fund’s Statement of Additional Information rather than in the prospectus. Questions and Answers Relating to Non-Cash Compensation Rules, NASD Notice to Members 99-55, at 357–58 (1999), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004217.pdf. The NASD did not, however, resolve during the 1990s how Rule 2830(l)(4)—either the cash compensation or special cash compensation clauses—applied to revenue-sharing arrangements. See Salesperson Compensation Practices, NASD Notice to Members 99-81 (1999), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004080.pdf; NASD Regulation Requests Comment on Regulation of Payment and Receipt of Cash Compensation Incentives, http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004655.pdf; NASD Solicits Member Comment on Proposed Rules Relating to Prospectus Disclosure of Cash and Non-Cash Compensation, NASD Notice to Members 96-68, 1996 WL 1771346. NASD Notice to Members 97-50 (1997), NASD Rule 2820(g) does not impose any disclosure obligations on members regarding compensation arrangements related to variable contracts. NASD Regulation Requests Comment on Regulation of Payment and Receipt of Cash Compensation Incentives, *supra*, at 407 (“NASD Rules

when adopting Rule 10b-10, the Commission stated that if the required information is set forth in a final prospectus delivered to the customer at the time of the transaction, then a broker-dealer need not provide the information separately on the confirmation.⁷⁶ Nonetheless, to address this aspect of the Morgan Stanley case, the Commission has proposed to amend the requirements of Form N-1A (the form for registering mutual funds under the 1933 Act and the Investment Company Act) to require increased disclosure of the investment adviser's "revenue-sharing" payments,⁷⁷ and has proposed new Rules 15c2-2 and 15c2-3 under the Exchange Act, as well as amendments to Rule 10b-10, to require improved confirmation disclosure for transactions in mutual fund shares and point-of-sale disclosure prior to effecting transactions in mutual fund shares.⁷⁸

for variable products do not contain any requirements regarding prospectus disclosure of cash compensation arrangements.”).

Courts have concluded that disclosure of an individual registered representative's compensation is not required. *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987); *Benzon v. Morgan Stanley*, No. 3:03-0159, 2004 WL 62747, at *4 (M.D. Tenn. Jan. 8, 2004); *United States v. Alvarado*, No. 01 CR. 156(RPP), 2001 WL 1631396, at *8 (S.D.N.Y. Dec. 19, 2001) (Rule 10b-10 focuses on the total compensation to the firm, not the internal allocation of compensation); *Castillo v. Dean Witter Discover & Co.*, [1998 Supplement Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,249, at 91,099 (S.D.N.Y. 1998). See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION*, § 14.14[1] (4th ed. 2002).

76. Securities Confirmations, Exchange Act Release No. 13,508, Investment Company Act Release No. 9753, 12 SEC Docket 299, 305 (May 5, 1977). Investment Company Institute, SEC No-Action Letter (Apr. 18, 1979), [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,041, at 81,655 (permitting the use of confirmations that omitted information about remuneration received by the selling broker provided that the prospectus for the mutual fund contained disclosure of sales charges, breakpoints, and maximum dealer discounts). *But see* Investment Company Institute, SEC No-Action Letter, 1994 SEC No-Act LEXIS 435 (Mar. 16, 1994) (stating that commissions for investment company transactions should be disclosed on confirmations and announcing its intent to withdraw the 1979 no-action letter, but no further action to withdraw the letter was taken).

77. Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 82 SEC Docket 5, 6, 10 n.20 (Jan. 29, 2004). See also Compensation for the Sale of Investment Company Securities, NASD Notice to Members 03-54 (2003), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003152.pdf (proposed change to NASD Rule 2830 requiring disclosure of revenue sharing). The SEC has reopened the comment period on these rules for an additional thirty days and made a supplemental request for comment. Point of Sale Disclosure Requirements and Confirmation Requirements, Securities Act Release No. 8544, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 84 SEC Docket 3182 (Feb. 28, 2005); *Atkins Says Internet Could Be Key to Crafting Mutual Fund Disclosure Rule*, 85 Banking Rep. (BNA) 20 (July 4, 2005) (discussing reactions to the re-issue of the proposal).

78. Point of Sale Disclosure Requirements and Confirmation Requirements, *supra* note 77. Specifically, Rule 15c2-2 would require specific confirmation disclosure of information about front-end loads and deferred sales loads and other distribution-related costs that directly impact the returns earned by investors in mutual fund shares, brokers would be required to disclose their compensation for selling those securities, including "revenue-sharing" and directed-brokerage arrangements, and brokers would have to disclose whether they are receiving extra compensation for selling certain fund

Since the announcement of the Morgan Stanley settlement, the SEC and NASD have brought several enforcement actions against mutual fund advisers and broker-dealers regarding “revenue-sharing.”⁷⁹ To date, virtually all of the settled cases involve allegations either that the investment adviser breached its fiduciary duty by using fund assets to pay for distribution of mutual fund shares outside of a properly adopted Rule 12b-1 plan, notwithstanding general disclosure in the affected mutual fund’s prospectus that “revenue-sharing” payments were being made by the mutual fund’s investment adviser,⁸⁰ or that the broker-dealer failed adequately to disclose its conflicts of interest with sufficient specificity to the brokerage customer at the point of sale.⁸¹ None of the settled cases involves charges against members of the mutual fund’s board of directors who were independent—instead, there is usually an allegation that the

shares. *Id.* at 3199–200. The Commission intends to withdraw the no-action letter issued in 1979 to the Investment Company Institute by the Division of Market Regulation. Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341 (Jan. 29, 2004).

Rule 15c2-3 would require broker-dealers to provide point-of-sale disclosure of transaction-specific information about distribution-related costs, and of remuneration arrangements that lead to conflicts of interest for broker-dealers prior to effecting transactions in mutual fund shares. Point of Sale Disclosure Requirements and Confirmation Requirements, *supra* note 77, at 3186.

79. Edward D. Jones & Co., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1799, 1801–10 (Dec. 22, 2004) (alleging violations of section 17(a)(2) of the Securities Act, section 15(B)(c)(1) and Rule 10b-10 under the Exchange Act, and Rule G-15 of the Municipal Securities Rulemaking Board—disgorgement of \$37.5 million, civil money penalty of \$37.5 million); Franklin Advisers, Exchange Act Release No. 50,841, Investment Company Act Release No. 26,692, 84 SEC Docket 1357, 1360–62 (Dec. 13, 2004) (alleging violations of section 206(2) of the Advisers Act, section 17(d) and Rule 17d-1 under the Investment Company Act and aiding and abetting such violations, and section 34(b) of the Investment Company Act—disgorgement of \$1, civil money penalty of \$20 million); PA Fund Mgmt. LLC, Exchange Act Release No. 50, 384, Investment Company Act Release No. 26,598, 83 SEC Docket 2287, 2292–99 (Sept. 15, 2004) (alleging violations of section 206(2) of the Advisers Act, sections 15(c), 17(d), 34(b) and Rules 12b-1(d) and 17d-1 under the Investment Company Act, and aiding and abetting violations of Section 12(b) and Rule 12b-1(b)—disgorgement of \$6.6 million, civil money penalties of \$5 million); Mass. Fin. Servs. Co., Investment Company Act Release No. 26,409, 82 SEC Docket 2036, 2039–40, 2042 (Mar. 31, 2004) (alleging violations of section 206(2) of the Advisers Act, and section 34(b) of the Investment Company Act—disgorgement of \$1, civil penalty of \$50 million); Press Release, NASD, NASD Charges 15 Firms with Directed Brokerage Violations, Imposes Fines Totaling More Than \$34 Million (June 8, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GETPAGE&ssDocName=NASDW_014340 (alleging violations of NASD Rule 2830(k); Press Release, NASD, NASD Fines Quick & Reilly, Piper Jaffray \$845,000 for Directed Brokerage Violations (Feb. 22, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GETPAGE&ssDocName=NASDW_013402 (alleging violations of NASD Rule 2830(k)—fine of \$570,000).

80. *See, e.g.*, PA Fund Mgmt. LLC, Exchange Act Release No. 50,384, Investment Company Act Release No. 26,598, 83 SEC Docket 2287, 2292–93 (Sept. 15, 2004).

81. *See, e.g.*, Edward D. Jones & Co., L.P., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1798, 1801 (Dec. 22, 2004).

investment adviser failed to inform the mutual fund's board of directors of the precise nature of the "revenue-sharing" activities in which it was engaging.⁸²

C. Directed Brokerage

Some investment advisers used brokerage commissions incurred in effecting securities transactions for the mutual fund to make "revenue-sharing" payments to Morgan Stanley.⁸³ With respect to the receipt of payments by a broker-dealer in the form of brokerage commissions, before the Morgan Stanley case NASD Rule 2830(k) had provided:

(1) No member shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by the member from any source, including such investment company or any covered account.

82. See, e.g., *supra* note 81.

83. Mutual funds in the Preferred Partners Program using directed brokerage allegedly paid a negotiated multiple of the amount they would have paid in hard dollars. The Morgan Stanley trading desk retained one-third of the brokerage commissions to cover its expenses. In some instances, the credit for distribution was identified by the investment adviser after the securities transaction was executed solely for Morgan Stanley's internal recording-keeping purposes. In some instances, Morgan Stanley was asked to "step-out" part of the securities transaction after it was effected to a clearing broker who would complete settlement of the transaction in part for the benefit of a broker-dealer that was selling shares of the mutual fund but was unable to effect or execute a securities transaction for its own account. Morgan Stanley DW Inc., *supra* note 72. See also *American Beats Back Calif. AG*, IGNITES, Nov. 16, 2005, http://www.ignites.com/articles/20051116/american_beats_back_calif. (noting that adoption of 1996 Amendments to Advisers Act preempts the State of California regarding directed-brokerage disclosure); Riva D. Atlas, *NASD Says Fund Family Paid Improper Fees*, N.Y. TIMES, Feb. 17, 2005, at C1; *California Court Rules U.S. Law Preempts Bid by AG to Regulate Fund Disclosure Statement*, Sec. L. Daily (BNA), Nov. 30, 2005. Tom Lauricella, *American Funds Sues Regulator*, WALL ST. J., Mar. 25, 2005, at C13 (reporting lawsuit by Capital Research & Management against the Attorney General of the State of California seeking an injunction and a declaration that the disclosure regarding directed brokerage in its American Funds prospectuses was accurate and the state's fraud jurisdiction is preempted by the SEC's comprehensive regulation of mutual fund prospectuses); Ian McDonald, *NASD Takes Aim at American Funds*, WALL ST. J., Feb. 17, 2005, at C17; Press Release, NASD, *NASD Charges American Fund Distributors, Inc. with Arranging \$100 Million in Directed Brokerage Commissions for Top Sellers of American Funds* (Feb. 16, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GETPAGE&ssDocName=NASDW_013358 (announcing filing of an administrative complaint alleging violations of NASD Rule 2830(k) in that the investment adviser to American Funds directed brokerage to selling broker-dealers in an amount equal to ten to fifteen percent of last year's sales). Cf. *Court Finds No Private Remedies for Claims over Fund Marketing Practices*, 37 Sec. Reg. & L. Rep. (BNA) 1322 (Aug. 4, 2005) (reporting decision by the Southern District of New York regarding Eaton Vance Mutual Funds concluding that there are no private rights of action under the Investment Company Act).

(2) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

(3) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

(4) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are required, in the overall management of the member's business, to have access to such information.

(5) No member shall, with respect to such member's activities as underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment which incentive or sales effort is . . . to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

(6) No member shall, with respect to such member's retail sales or distribution of investment company shares: (A) provide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. . . . ; (B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or incentives to favor or disfavor the shares of such company or companies in sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers or other sales personnel any participation in brokerage commissions received by such

member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account⁸⁴

If all of these conditions could be met, then it was permissible for a member to:

(A) . . . execut[e] portfolio transactions of any investment company or covered account by members who also sell shares of the investment company;

(B) . . . sell[] shares of, or act[] as an underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution; [or]

(C) . . . compensat[e] its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use of overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this paragraph (k).⁸⁵

84. NASD Rule 2830(k)(1)-(6).

85. NASD Rule 2830(k)(7). As originally adopted in 1973, this position was characterized by the NASD as an interpretation and prohibited member firms from seeking portfolio brokerage based on their sale of shares of a mutual fund. *See* NASD Notice of Members 73-42 (May 1973) (“Anti-Reciprocal Rule”). After the adoption of Rule 12b-1 in 1980, the NASD revised its Anti-Reciprocal Rule to allow mutual funds to consider sales of their shares as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution. NASD Notice to Members 80-7 (Mar. 6, 1980) (initial discussion); NASD, Exchange Act Release No. 17,599, Investment Company Act Release No. 11,662, 22 SEC Docket 329, 331 (Mar. 4, 1981) (approval of NASD rule, stating “it is not inappropriate for [mutual funds] to seek to promote the sale of their shares through the placement of brokerage *without* the incurring any additional expense”). In 1984, the NASD issued guidance on the Anti-Reciprocal Rule emphasizing that that the rule continued to prohibit a number of practices, whether or not disclosed, and offered examples of practices that were prohibited. Compensation Arrangements with Respect to Sale of Mutual Fund Shares, NASD Notice to Members 84-40 (1984), http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159005009.

To address this aspect of the Morgan Stanley case, the Commission has amended Rule 12b-1 by adding new paragraph (h), which prohibits a mutual fund from making “revenue-sharing” payments with brokerage commissions unless the mutual fund has implemented policies and procedures designed to ensure that the mutual fund adviser’s selection of selling brokers to execute portfolio securities transactions is not influenced by considerations about the sale of fund shares.⁸⁶ The NASD also amended Rule 2830(k) to prohibit a broker-dealer from selling a mutual fund’s shares if the broker-dealer has any agreement or understanding with any party that portfolio transactions will be directed to the member in exchange for the promotion or sale of fund shares,⁸⁷ which the Commission promptly approved.⁸⁸

86. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 83 SEC Docket 2106, 2106 n.3, 2109–10 (Sept. 2, 2004) (adopting release); Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,356, 82 SEC Docket 892 (Feb. 4, 2004) [hereinafter Investment Company Act Release No. 26,356] (proposing release). The proposing release observes:

[The SEC’s] review of current practices . . . suggests that many arrangements that direct brokerage to reward selling brokers for distribution constitute more than mere allocation of brokerage, and are not consistent with our 1981 rationale for approving the exception to the NASD’s Anti-Reciprocal Rule. The use of multiple broker-dealers for execution, step-outs, and other arrangements . . . explicitly quantif[ies] the value of the distribution component of fund brokerage commission and belie the notion that fund advisers are merely ‘considering’ the selling efforts of the broker(s) involved.

Id. at 896.

87. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change Relating to Investment Company Transactions, Exchange Act Release No. 50,609, 84 SEC Docket 157 (Oct. 29, 2004) (notice of proposed rule being filed with the SEC); Investment Company Directed Brokerage Arrangements, NASD Notice to Members 05-04 (Jan. 2005), http://nasd.complinet.com/file_store/pdf/rulebooks/nasd_0504.pdf (announcement of SEC approval). In May 2004, the NASD formed a Mutual Fund Task Force to consider ways to improve the transparency of mutual fund portfolio transactions costs and distribution arrangements, and to provide guidance to the Commission. *NASD Names 20 to Task Force on Mutual Fund Transparency*, 36 Sec. Reg. & L. Rep. (BNA) 1032 (May 28, 2004). Its first report was issued on November 11, 2004, and focused on “soft dollar” services and mutual fund transactions costs. MUTUAL FUND TASK FORCE, NASD, SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS 2004, http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf. In its second phase, the Mutual Fund Task Force will focus on distribution arrangements, including Rule 12b-1 Plans and “revenue-sharing.” Press Release, NASD, NASD Endorses Concise, Web-Based Point of Sale Mutual Fund Disclosure (Apr. 4, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013727 (announcing “Profile Plus,” “a two-page document providing basic information about a mutual fund,” the principal recommendation of the Mutual Fund Task Force’s report MUTUAL FUND DISTRIBUTION).

The Investment Company Institute, Securities Industry Association, and Mutual Fund Directors Forum have supported eliminating directed brokerage arrangements. *See Mutual Fund Directors Forum Advises End to Soft Dollars at Funds*, 31 Sec. Reg. & L. Rep. (BNA) 1384 (July 29, 2004); *SEC Proposes Directed-Brokerage Ban, Adopts New Fee-Disclosure Requirements*, 36 Sec. Reg. & L. Rep. (BNA) 293 (Feb. 16, 2004) (noting petition from the Investment Company Institute to the SEC to adopt rules prohibiting directed brokerage arrangements).

88. Self Regulatory Organizations; Order Approving Proposed Rule Change by NASD, Inc.,

D. Some Thoughts on the Scandals

The facts described in the Canary Capital complaint were both astonishing and appalling.⁸⁹ The settlements, uniformly harsh, reflect the Commission's deep disappointment with those in the securities industry who violated or facilitated violation of the letter and spirit of Rule 22c-1 for personal gain and to the disadvantage of mutual fund shareholders.⁹⁰ The terms of the SEC market-timing settlements involving mutual fund advisers usually require, *inter alia*, that the board of directors of the affected mutual fund adopt a number of corporate governance changes that substantially mirror the Corporate Governance Amendments.⁹¹ The settlements also uniformly invoke the Fair Fund provisions in section 308(a) of the Sarbanes-Oxley Act⁹² to provide for an independent

Relating to Investment Company Portfolio Transactions, Exchange Act Release No. 50,883, 84 SEC Docket 1835 (Dec. 20, 2004).

89. *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Government Affairs*, 108th Cong. 1 (2003) (statement of Matthew P. Fink, President, Investment Company Institute).

90. *See supra* note 61. It is understood that the SEC staff will not enter into serious settlement negotiations with the investment adviser unless the most senior person(s) who knew or should have known about the market-timing activities has been dismissed. To date, there have been very few settlements with individuals. *Cf.* Baxter, Securities Act Release No. 8506, Exchange Act Release No. 50,681, Investment Company Act Release No. 26,656, 84 SEC Docket 340, 344 (Nov. 17, 2004) (senior executive barred from the securities industry—disgorgement of \$60 million, civil penalty of \$20 million); Pilgrim, Securities Act Release No. 8505, Exchange Act Release No. 50,680, Investment Company Act Release No. 26,655, 84 SEC Docket 335, 339–40 (Nov. 17, 2004) (same); Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 82 SEC Docket 3178, 3189–90 (May 20, 2004) (barring senior executives from association with broker-dealers and investment advisers). It is expected that, when time allows, the SEC staff will return to deal with those senior persons, and will also be interested in those who prepared and/or supervised the preparation of market-timing disclosure for the mutual fund's prospectus and/or Statement of Additional Information that did not fully reflect the market-timing activities that were actually taking place. *See* SEC v. Treadway, 354 F. Supp. 2d 311, 312–13 (S.D.N.Y. 2005) (denial of motion to reconsider motion to dismiss by CEO and CIO of PIMCO Advisers Fund Management); *see also* Julie Creswall, *S.E.C. Accuses Former Citigroup Executives of Securities Fraud*, N.Y. TIMES, Aug. 9, 2005, at C3; Siobhan Hughes, *SEC Wraps Up Probe of Amvescap Arm*, WALL ST. J., July 20, 2005, at C13 (two senior executives of AIM Distributors fined \$225,000 and suspended for six- and nine-month periods from employment in the investment company industry); Mitchell Pacelle, *Citigroup Ex-Officials Face Charges*, WALL ST. J., Aug. 9, 2005, at C13 (reporting civil complaint filed alleging senior executives were principally responsible for fraud related to affiliated transfer agent contract). *Cf.* Arden Dale, *Spitzer Effect: Not Quite Devastating*, WALL ST. J., Sept. 21, 2005, at C13 (noting that number of funds liquidated or merged has not increased appreciably and that increased costs of regulation has disproportionately affected small funds); Laura Johannes, *Strong Performers Suffer Less in Mutual-Fund Scandals*, WALL ST. J., Jan. 24, 2005, at C1 (reporting that investors have remained with mutual fund groups that have continued to achieve good performance notwithstanding regulatory issues, but not the converse).

91. *See supra* note 80.

92. 15 U.S.C. § 7246(a) (Supp. II 2002). Judith Burns, *Cox Says Size Lags in Returning "Fair*

distribution consultant to administer and dispense the funds deposited in the Fair Fund, consisting of both the amount to be disgorged and the civil money penalty.⁹³ Finally, the settlements usually require the investment adviser to employ an independent compliance consultant to review its compliance with the federal securities laws and render reports to the Commission on specified dates.⁹⁴

With respect to revenue-sharing, it was generally believed that the Commission was well aware of mutual fund marketplaces⁹⁵ and concepts like “shelf space” through inspections of investment advisers and broker-dealers, processing mutual fund registration statements,⁹⁶ and its

Funds,” WALL ST. J., Nov. 22, 2005, at C3; *SEC Put \$4.8b Into Fair Fund for Return to Investors; Little Distributed, GAO Says*, Securities L. Daily (BNA), Oct. 4, 2005 (discussing GAO report). Cf. Lynn Cowan, *PBS Financial-Education Series Is Funded by Street’s Settlement*, WALL ST. J., Mar. 16, 2005, at B2 (reporting Investor Protection Trust funded with \$27.5 million from the \$1.4 billion global research analysts settlement with Wall Street brokerage firms in 2003); Randall Smith & Ian McDonald, *Frustrating Venture: SEC Education Fund to Lose Top Figures*, WALL ST. J., Mar. 23, 2005, at C1 (reporting resignations of the chairman and several directors of the investor education fund); Deborah Solomon, *What’s the Best Way to Invest in Teaching the U.S. to Invest?*, WALL ST. J., May 26, 2005, at C1 (reporting SEC motion to allow the NASD to take control of the Federal education money); Robert Tomsho, *Putnam Ex-Employee Wants His Cut*, WALL ST. J., July 6, 2005, at C13 (reporting lawsuit against the Massachusetts Attorney General for \$15 million under the state’s whistleblower statute for providing information about market-timing activities).

93. See *supra* note 80. The settlements usually provide that, regardless of whether any Fair Fund distribution is made, amounts ordered to be paid as civil money penalties are to be treated as penalties payable to the U.S. government for all purposes, including Federal income tax purposes. To preserve the deterrent effect of the civil money penalty, the mutual fund adviser agrees that it shall not benefit from any offset or reduction in any related civil action. The market-timing settlements usually require the independent distribution consultant of the Fair Fund to make payments directly to the shareholders of the affected mutual funds. *Id.* See John Hechinger, *Putnam May Owe \$100 Million*, WALL ST. J., Feb. 2, 2005, at C1 (reporting apparent decision of the independent distribution consultant of the Fair Fund for Putnam finding that improper trading by Putnam employees cost between \$3 million and \$6 million, improper trading in retirement and college plans cost \$46 million, and the massive redemptions in the aftermath of the settlement cost \$53 million in transaction costs); John Hechinger, *Putnam to Pay \$83.5 Million More in Restitution*, WALL ST. J., Mar. 4, 2005, at C3; *Putnam to Pay Additional \$43M for Employees’ Questionable Fund Trades*, 37 Sec. Reg. & L. Rep. (BNA) 399 (Mar. 7, 2005). Cf. Arden Dale, *Janus Argues Lawsuit Is Superfluous*, WALL ST. J., July 26, 2005, at C13 (reporting motion arguing class action should be dismissed because fund investors’ losses will be more than covered by SEC action); *Janus Scores Big Victory in Scandal Suit*, IGNITES, Aug. 29, 2005, <http://ignites.com/home/members/article.html?id=97422728> (reporting that Janus committed to paying \$100 million through SEC action, while independent distribution consultant concluded that investors in Janus-advised mutual funds lost only about \$22 million as a result of late trading).

94. See *supra* note 80.

95. See Investment Company Institute, SEC No-Action Letter, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,477, at 78,437–38, Oct. 30, 1998 (discussing mutual fund marketplaces).

96. Form N-1A requires disclosure of the full panoply of compensation alternatives, including Items 3 and 8 (sales load), 15(f) (dealer reallowances and special cash compensation), 15(g) (distribution and service fees), 20 (underwriting commissions), 27 (compensation on redemptions and repurchases), 16 and 27 (brokerage commissions), and 20 (any other compensation made during the preceding year to underwriters and dealers). 6 Fed. Sec. L. Rep. (CCH) ¶ 51,201 (2004).

involvement in private appellate litigation regarding these activities.⁹⁷ Accordingly, the Morgan Stanley enforcement case appears to represent a significant change of position on the Commission's part.⁹⁸ Unlike the market-timing settlements, several of the "revenue-sharing" settlements by investment advisers require disgorgement of only \$1, with a substantial civil money penalty, solely to invoke the use of a Fair Fund to administer receipt and disbursement of the civil money penalty.⁹⁹

III. ADOPTION OF THE CORPORATE GOVERNANCE AMENDMENTS IN 2004

A. *The SEC's Preliminary Thoughts*

In adopting the Corporate Governance Amendments, the Commission made several preliminary observations about the role of independent directors. First, the Commission focused on the central role that independent directors play in policing the conflicts of interest that advisers inevitably have with the mutual funds that they advise, asserting that to be

For additional indications of the Commission's awareness of revenue-sharing, see GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 40 (2000), <http://www.gao.gov/new.items/gg00126.pdf> (report to the Chairman, Subcommittee on Finance and Hazardous Materials, and the Ranking Member, Committee on Commerce, House of Representatives describing revenue-sharing practices of investment advisers); SEC, THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS, *supra* note 44 (questions about revenue-sharing asked by the SEC Chairman and the Director of the SEC's Office of Compliance Inspections and Examinations); Debra Cope, *Funds Slumping, but Conference Stronger Than Ever*, AM. BANKER, Mar. 28, 1995, at 6 (reporting on remarks about revenue-sharing made at a conference by the Director of the Division of Investment Management).

The NASD was also aware of revenue-sharing. In 1994, the NASD solicited comments on a proposed rule addressing the receipt of compensation. Self-Regulatory Organizations, Notice of Filing of Proposed Rule Change Relating to the Regulation of Cash and Non-Cash Compensation in Connection with the Sale of Investment Company Securities and Variable Contracts, NASD Solicits Member Comment on Cash and Non-Cash Compensation for Selling Investment Company and Variable Contract Securities, NASD Notice to Members 94-67 (1994), http://nasd.complinet.com/nasd/display/display_display.html?rbid=1189&element_id=115900. See Self-Regulatory Organization; Notice of Filing of Proposed Rule Change Relating to the Regulation of Non-Cash Compensation in Connection with the Sale of Investment Company Securities and Variable Contracts, Exchange Act Release No. 38,993, 65 SEC Docket 664 (Aug. 29, 1997) (discussing proposed changes to NASD Rules 2820 and 2830); Exchange Act Release No. 37,374, 62 SEC Docket 590, 609-24 (June 26, 1996) (describing the comment letters submitted in response to NASD Notice to Members 94-67, and a letter dated November 22, 1994, from the Division of Investment Management to the NASD asking whether revenue-sharing was covered by the NASD's Rules).

97. See Brief of the SEC, Amicus Curiae, in Response to the Court's Request, *Press v. Quick & Reilly*, 218 F.3d 121 (2d Cir. 2000) (Nos. 97-9153, 97-9159), 2000 WL 34447852.

98. See Tom Lauricella & Deborah Solomon, *SEC Defended Fund-Broker Compacts in Past*, WALL ST. J., Jan. 22, 2004, at C1.

99. The independent distribution consultant of the Fair Fund in these cases is expected to make payments to the adviser's mutual funds on the basis of their relative net assets. Mass. Fin. Services, *supra* note 79, ¶ 27.

truly effective, a mutual fund's board of directors must be an independent force in the mutual fund's affairs.¹⁰⁰ Second, the Commission described the operation of section 15(c) and stated that the best way to ensure that mutual fund shareholders obtain fair and reasonable fees is through a marketplace of vigorous, independent, and diligent mutual fund boards of directors coupled with fully-informed investors.¹⁰¹ Finally, the Commission discussed the process of selecting and nominating new independent directors and encouraged the selection of persons with the background, experience, and independent judgment to represent the interests of mutual fund investors.¹⁰²

B. Seventy-five Percent Independence Requirement

The Corporate Governance Amendments require that at least three-fourths of the members of a mutual fund's board of directors be independent.¹⁰³ The Commission asserts that a principal purpose is to strengthen the independent directors' control of the mutual fund's board of directors and its agenda, citing the seventy-five percent requirement in section 15(f) as appropriate to ensure that the independent directors can carry out their fiduciary requirements.¹⁰⁴ The Commission also asserts that the investment adviser controls the day-to-day activities of the mutual fund and has significantly greater access to information about the mutual fund than do the independent directors, and the seventy-five percent independence requirement seeks to remedy this imbalance.¹⁰⁵

C. Independent Chairman Requirement

The Corporate Governance Amendments require that the chairman of the board of directors be an independent director.¹⁰⁶ Citing the scandals discussed above, the Commission asserted that a mutual fund's board of directors is in a better position to protect the interests of the mutual fund and to fulfill the board's obligations under the Investment Company Act, "when its chairman does not have the conflicts of interest inherent in the

100. Release No. 26,520, *supra* note 8, at 1387–88.

101. *Id.* at 1388–89.

102. *Id.* at 1389.

103. *Id.* at 1389–90.

104. *Id.* at 1390.

105. *Id.*

106. *Id.* at 1391.

role of an executive of the fund adviser.”¹⁰⁷ The Commission commented that a board chairman can: (i) “play an important role in setting the agenda of the board and in establishing a boardroom culture that can foster the type of meaningful dialogue between fund management and the independent directors that is critical for healthy fund governance”; (ii) “play an important role in providing a check on the adviser” and providing leadership; and (iii) best “fulfill these responsibilities when his loyalty is not divided between the fund and its investment adviser.”¹⁰⁸

D. Other Requirements

The Corporate Governance Amendments require: (i) the board of directors of the mutual fund to evaluate the performance of the board and its committees at least annually; (ii) the independent directors to meet in a separate session at least once every quarter; and (iii) the independent directors to be authorized “to hire employees and to retain advisers and experts necessary to carry out their duties.”¹⁰⁹ The Commission asserts that: (i) the annual self-assessment is intended to strengthen directors’ understanding of their role and foster better communications and greater cohesiveness while identifying potential weaknesses and deficiencies; (ii) the separate session will “give independent directors the opportunity for a frank and candid discussion among themselves”; and (iii) the ability to hire employees and others will help independent directors to deal with matters beyond their expertise.¹¹⁰

IV. CRITICISMS OF THE CORPORATE GOVERNANCE AMENDMENTS

A. The SEC Does Not Have the Statutory Authority to Adopt the Corporate Governance Amendments and Usurped the Proper Legislative Role of Congress

From 1940 through 1992, the Commission showed appropriate and commendable deference to Congress when it perceived that there were fundamental problems in the mutual fund industry that needed correcting. The 1970 Amendments Act was preceded by an important study

107. *Id.*

108. *Id.* at 1391–92.

109. *Id.* at 1394–95.

110. *Id.*

conducted by the SEC staff,¹¹¹ and the 1970 and the 1975 Amendments Acts were each preceded by four years of lengthy hearings.¹¹² As it relates to corporate governance, the *Protecting Investors* report¹¹³ is of a piece with that precedent. It is the 2001 Amendments in which the Commission first strayed into inappropriate activity. But by requiring that all mutual funds have at least a majority of independent directors on their boards and that the independent directors nominate and select the new independent directors, the 2001 Amendments were at least borrowing from the requirements of Rule 12b-1 that had been in place for over twenty years.

In contrast, the Corporate Governance Amendments are cut from whole cloth, except to the limited extent that section 15(f) has a super-majority independence requirement for three years in the unusual situation where the investment adviser has assigned its contract to a third party. Historically, Congress has not differentiated between those directors who are interested and those who are independent for purposes of sections 15(c) and 36(a) and has seen fit to impose unusual requirements regarding voting by independent directors or the number of independent directors who must serve on a board only where the issue was related to approval of the investment adviser's contract.¹¹⁴ The requirement in Rule 12b-1 that a majority of the board of directors be independent can be rationalized and justified on the ground that approval of a Rule 12b-1 Plan would allow the investment adviser to avoid spending its own assets, the opposite side of the coin from approving its investment advisory contract.¹¹⁵ The Corporate Governance Amendments go well beyond that precedent by imposing those requirements on a mutual fund's routine business affairs, not just variations of the conflict of interest with the investment adviser's contract. Whether the Corporate Governance Amendments were supported by the comment letters or were a "good idea" or "best practices" is beside the point: such a significant change should have been submitted by the Commission to Congress with the recommendation that Congress amend section 10(a) of the Investment Company Act to provide that seventy-five

111. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966).

112. The Commission's adoption of Rule 12b-1 in 1980 could be characterized as an exception to this general rule, but section 12(b) itself gives the Commission express rulemaking authority and the obvious analogies to the requirements of sections 15(a) and 15(c) make the requirement that at least fifty percent of the mutual fund's board of directors be independent seem like a proper exercise of the Commission's implementing authority where the mutual fund's assets will be used in a manner that obviates the need for the investment adviser to bear distribution expenses out of its own resources.

113. DIV. OF INV. MGMT., SEC, *supra* note 40.

114. *See id.*

115. *See supra* notes 26–29.

percent of the members of a mutual fund's board of directors be independent for all purposes and under all circumstances.

Congress was very respectful of state law when it passed and subsequently amended the Investment Company Act. Corporations that are listed on the stock exchanges voluntarily submit to various corporate governance practices that go well beyond the minimum requirements of state corporate law,¹¹⁶ and entities like the New York Stock Exchange ("NYSE") laud the high corporate governance standards that companies whose shares are traded on the NYSE must adhere to as an inducement to attract investors from around the world.¹¹⁷ However desirable those corporate governance requirements may be, they are imposed by a self-regulatory organization and accepted by a company as one of the costs to be borne in exchange for ready access to the capital markets. The requirements in the Corporate Governance Amendments that the chairman of the mutual fund's board be an independent director, that the independent directors meet separately at least annually, that the mutual fund's directors conduct an annual self-assessment, and that the independent directors have access to experts may also be a "good idea" or "best practices," but they are in the first instance matters for corporate law in the state where the mutual fund is organized.¹¹⁸ The fact that the Corporate Governance Amendments were adopted as amendments¹¹⁹ to

116. See NYSE, LISTED COMPANY MANUAL § 303A (2004), http://www.nysc.com/lcm/subsection_3_303A_00.shtml?printable=ye?. The Corporate Governance Standards set out in Section 303A were initially approved by the SEC on November 4, 2003. Self-Regulatory Organizations; Order Approving Proposed Rule Changes, Exchange Act Release No. 48,745, 81 SEC Docket 1586 (Nov. 4, 2003). On November 3, 2004, the SEC approved cleanup and other amendments to Section 303A.

117. Approval of Proposed Rule Change Relating to Corporate Governance, Exchange Act Release No. 50,625, 84 SEC Docket 179 (Nov. 3, 2004). See NYSE, Listed Companies, <http://www.nyse.com/about/listed/1089312755443.html> (last visited Oct. 27, 2005) ("NYSE-listed companies are among the world's best. They range from 'blue-chip' companies, to world-leaders in technology, to young, high-growth enterprises. They meet and adhere to the most stringent listing and governance requirements.").

118. The Sarbanes-Oxley Act imposes significant prohibitions and requirements on reporting companies. The response to the Sarbanes-Oxley Act from the legal and business communities reflects the degree to which the Sarbanes-Oxley Act prohibits decisions that had previously just been a matter of reasonable business judgment for the boards of directors of reporting companies under state law.

119. There has only been one other instance of which the author is aware where an existing rule under the Investment Company Act has been amended to make it more difficult to comply with, and that is Rule 2a-7 regarding money market funds. See Technical Revisions to the Rules and Forms Regulating Money Market Funds, Securities Act Release No. 7479, Investment Company Act Release No. 22,921, 65 SEC Docket 2226 (Dec. 2, 1997); Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 7275, Investment Company Act Release No. 21,837, 61 SEC Docket 1244 (Mar. 21, 1996); Amendment to Rule 2a-7 Under the Investment Company Act, Investment Company Act Release No. 18,177, 48 SEC Docket 1741 (May 31, 1991); Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 6882, Investment Company Act Release No. 18,005, 48 SEC Docket 346 (Feb. 20, 1991); Acquisition and Valuing of Certain Portfolio Instruments by

ten existing exemptive rules that have nothing to do with corporate governance is mute witness to the Commission's lack of statutory authority to adopt them—they are not even an interpretation of corporate governance requirements already extant in the Investment Company Act.¹²⁰ And it is no less anomalous that statutory authority intended to give the Commission the ability to *relax* statutory prohibitions in deserving circumstances has been used to *impose* additional regulatory requirements not otherwise extant in the statute.

B. The Corporate Governance Amendments Were Not Adequately Justified

It is hornbook law that, in adopting a rule, an administrative agency must explain why it is adopting the rule.¹²¹ In proposing and adopting the Corporate Governance Amendments, the Commission routinely cited the scandals from 2003–2004 as the reason why the Corporate Governance Amendments should be enacted.¹²² Accordingly, one would have expected to find a one-to-one relationship between the justifications for the Corporate Governance Amendments and the principal features of the scandals in 2003–2004. One feature of the scandals was exploitation of anomalies in mutual fund pricing that caused “stale” prices. Another feature was the willingness of intermediaries—banks, broker-dealers, and third-party administrators to violate the federal securities laws (including Rule 22c-1) and their contractual commitment to comply with the law in the selling agreement with the mutual fund's distributor. Yet another feature is the offering of preferred partners programs where the method of payment is “revenue-sharing,” something that was not illegal in 2003–2004 and is not illegal today when paid by the investment adviser out of its own resources. The Commission made no attempt, however, to provide such one-to-one justifications.

Registered Investment Companies, Investment Company Act Release No. 14,983, 35 SEC Docket 324 (Mar. 12, 1986); Withdrawal of Quarterly Reporting Forms and Filing Obligations of Certain Registered Investment Companies; Related Rule Amendments, Securities Act Release No. 6591, Exchange Act Release No. 22,194, Investment Company Act Release No. 14,606, 33 SEC Docket 700 (July 1, 1985).

120. It could be speculated that the Commission may have chosen this route to avoid proposed legislative changes to the Investment Company Act that it did not support. *See* S. 2059, 108th Cong. (2004); S. 1971, 108th Cong. (2003); H.R. 2420, 108th Cong. (2003). The fact that Congress has not seen fit to pass that legislation does not make the Corporate Governance Amendments any less inappropriate.

121. Administrative Procedure Act § 4(b), 5 U.S.C. § 553(c) (2000).

122. Release No. 26,520, *supra* note 8, at 1385–86 & n.6.

With respect, it is very hard indeed to understand how a mutual fund's board of directors with seventy-five percent independent directors, with an independent chair, meeting separately once a year, conducting an annual self-assessment, and having access to experts can bring the necessary skill set, surveillance tools, and adequate time to do due diligence to the tasks of (i) rooting out a determined late-trader,¹²³ (ii) understanding the nuances of stock prices in a country facing a natural disaster that has imposed restrictions on repatriating profits, or (iii) anticipating a change in the Commission's position on the payment of brokerage commissions for executing portfolio transactions to a broker-dealer to which it is also selling shares of that mutual fund.¹²⁴ These tasks are more efficiently performed by trained professionals, like lawyers and accountants on the Commission's staff with unfettered access to a mutual fund's books and records, which is why Congress gave the SEC its authority to inspect mutual funds¹²⁵ and to require that certain books and records be kept¹²⁶ to facilitate those inspections.

C. The Corporate Governance Amendments Will Be of Questionable Efficacy

The scandals (and the harsh settlements) have surely caused independent directors to become even more conscious of their responsibilities. The fact remains that, for many, serving as an independent director is a less-than-full-time job, largely involving preparing for and attending in-person board meetings and telephone conference calls for which they receive an appropriate level of remuneration. While some independent directors may qualify as an "audit committee financial expert,"¹²⁷ others bring to the boardroom varying backgrounds in

123. SEC v. Calugar Litigation Release No. 18,524, 81 SEC Docket 3044, 3044-45 (Dec. 24, 2003) (reporting civil injunctive complaint alleging violations of section 17(a) of the Securities Act and section 10(b) and Rule 10b-5 of the Exchange Act for participation in a scheme to defraud mutual fund shareholders through improper late-trading and market-timing—seeking permanent injunction, disgorgement, and monetary penalties). For news accounts of Mr. Calugar's late-trading activities with various mutual fund groups, see Riva D. Atlas, *Alliance Settles Fund Trading Complaints*, N.Y. TIMES, Dec. 19, 2003, at C2; Riva D. Atlas, *Allied Ousts 2 Executives, Seeing a Failure to Police Trades*, N.Y. TIMES, Nov. 11, 2003, at C1; Riva D. Atlas, *Another Fund Under Scrutiny for Trading*, N.Y. TIMES, Nov. 5, 2003, at C1; Riva D. Atlas, *Market Timer's Quick Rise and Sharp Fall*, N.Y. TIMES, Mar. 9, 2004, at C1; *Broker Accused of Illegal Trades in Funds*, N.Y. TIMES, Dec. 24, 2003, at C4; *Mutual Fund Manager Accused of Fraud*, N.Y. TIMES, Feb. 5, 2004, at C8.

124. See *supra* notes 84, 85.

125. Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b) (2000).

126. Investment Company Act § 31(a), 15 U.S.C. § 80a-30(a) (2000).

127. Section 407 of the Sarbanes-Oxley Act required the Commission to adopt rules to require an

marketing, finance, and business. Very few independent directors have a personal background that would equip them to manage a mutual fund or its investment adviser, transfer agent, fund accountant, custodian, or distributor. Of necessity, independent directors depend upon the investment adviser, the mutual fund's independent public accountants, and their own legal counsel to bring important matters to their attention.¹²⁸ The Commission seems intent upon changing the dynamics of board meetings and board discussions and seems persuaded that changing who (or how many) sit at what seat around the boardroom table will accomplish that goal. Even if one accepts *arguendo* the Commission's assumptions and goal, it strains credulity to believe that adding more independent directors, selecting an independent chair, conducting an annual self-evaluation, convening separate meetings, and/or having access to experts¹²⁹ can

issuer, including a mutual fund, to disclose whether or not its audit committee has at least one member who is a financial expert. 15 U.S.C. § 7265(a) (Supp. II 2002).

128. Section 307 of the Sarbanes-Oxley Act required the Commission to adopt rules setting forth the minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers. 15 U.S.C. § 7245 (Supp. II 2002). The implementing rules can be found at 17 C.F.R. § 205.1–205.7 (2005).

129. The Commission made clear in its release adopting the Corporate Governance Amendments that it is relying on the mutual fund's chief compliance officer, reporting directly to the board, to provide the board with the information necessary to fulfill the duties that have been imposed on independent directors. Release No. 26,520, *supra* note 8, at 1393 (footnote omitted) (“A key element of that larger package [of regulatory reforms] is our rule requiring each [mutual] fund to designate a chief compliance officer who reports directly to the [mutual] fund[’s] board. With the information about fund compliance matters now required by our rule 38a-1, and the information about advisory contract renewal required by section 15(c) of the [Investment Company] Act, fund boards are better able to fulfill their responsibilities.”).

Rule 38a-1 under the Investment Company Act requires an investment company to appoint a chief compliance officer reporting solely to the board of directors of the mutual fund. 17 C.F.R. § 270.38a-1 (2005). The chief compliance officer is expected to prepare written policies and procedures addressing, at a minimum: portfolio management processes; trading practices; personal and proprietary trading; custody; recordkeeping; marketing and advertising; privacy; disaster recovery; portfolio valuation; pricing of portfolio securities and fund shares; processing fund shares; affiliated transactions; protection of non-public information; fund governance requirements; and market-timing. Compliance Program of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 81 SEC Docket 2775 (Dec. 17, 2003). These policies must be reviewed annually, compliance risk areas must be identified, and the effectiveness of existing policies and procedures must be evaluated. 17 C.F.R. § 270.38a-1(a)(4)(iii).

It is beyond argument that these tasks ought to be performed—what is quite arguable is whether the independent directors of a mutual fund are the right group of persons to be closely supervising a critical and important compliance function, or whether it should be the senior executive officers of the mutual fund's investment adviser. It is too early to tell whether a chief compliance officer will be able to assemble a compliance program for a mutual fund that is as comprehensive and granular as the Commission's own compliance program, particularly where the chief compliance officer will necessarily be more constrained in her ability to surveil activities being performed by third-parties that are not likely to provide as much access to the chief compliance officer as they must provide to the Commission's inspection staff. *Cf. Fidelity Official Describes Overlap in “Reporting Up” Rules and CCO Rule,* 37 Sec. Reg. & L. Rep. (BNA) 1115 (June 27, 2005). *See generally* William H.

produce an effective compliance program that is more than a shadowy substitute for and incomplete accessory to the Commission's own robust Office of Compliance Inspections and Examinations and its experienced staff.

V. THE LONG VIEW

A. *Mutual Fund Corporate Governance*

The scandals of 2003–2004 are unique in the history of the SEC's administration of the Investment Company Act but appear to validate the concern that the Commission still has insufficient resources adequately to surveil the securities industry and to catch wrongdoers among those that it is responsible for regulating¹³⁰ before serious harm has been done. As a

Donaldson, Chairman, SEC, Remarks Before the Mutual Fund and Investment Management Conference (Mar. 14, 2005), <http://www.sec.gov/news/speech/spch031405whd.htm> (discussing of proposed CCO outreach program intended to enable the Commission to better communicate and coordinate with CCOs: "The CCO guides, leads, and implements the firm's overall compliance program. Most importantly, fund CCOs are the eyes and ears of the board on matters of compliance. We view CCOs as our allies in our parallel mission to protect investors, so we want to assist CCOs to fulfill their function. . . . Let me say a word, however, about what the CCO Outreach program is *not*. It is not an effort by the Commission to re-write the fund's reporting structure—fund CCOs continue to report to the fund's board. It also is not an effort to 'deputize' CCOs as agents of the SEC.").

130. The SEC is not responsible for regulating every wrongdoer that contributed to the scandals of 2003–2004. For example, banks and third-party administrators are not currently subject to the Commission's jurisdiction as broker-dealers or transfer agents. Indeed, one of the key elements of the Gramm-Leach-Bliley Act was the provisions in Title II thereof that would give the Commission jurisdiction over retail bank brokerage activities while excluding certain brokerage activities traditionally engaged in by banks. § 231, 15 U.S.C. 78q(i)-(j) (2000). See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 47,364, 79 SEC Docket 1839 (Feb. 13, 2003) (adoption of final "dealer" rules); Regulation B, Exchange Act Release No. 49,879, 83 SEC Docket 75 (June 17, 2004) (proposed "broker" rules). The Commission's "push-out" rules have been very controversial and have been criticized by the Federal bank regulatory agencies and others. See Judith Burns, *SEC Will Take Additional Time to Ponder Bank Brokerage Rules*, WALL ST. J., Nov. 3, 2004, at C6; *Banking Regulators Blast SEC Proposal, Urge Delay for Rule on Securities Activities*, 36 Sec. Reg. & L. Rep. (BNA) 1859 (Oct. 18, 2004); *Federal Bank Regulators Find Ample Room for Improvement in Broker-Dealer Proposal*, 36 Sec. Reg. & L. Rep. (BNA) 1159 (June 28, 2004); *Institutions Hopeful of Longer Time Frame to Comply with Rule on Securities Activities*, 85 Banking Rep. (BNA) 6 (July 4, 2005); Damian Paletta, *Latest SEC Spat Renews Old One over "Push-Outs"*, AM. BANKER, Oct. 18, 2004, at 1 (describing letter from top members of the House Financial Services Committee urging that Regulation B be abandoned and the SEC instead work with Federal bank and thrift regulatory agencies on a compromise); Damian Paletta, *Reg B: Ripe for Litigation*, AM. BANKER, Apr. 18, 2005, at 1; *SEC Delays Compliance on Push-Out Rule; Fourteen From Senate Banking Urge Rewrite*, 84 Banking Rep. (BNA) 480 (Mar. 14, 2005) (reporting a letter signed by 14 Senators advising the SEC to rewrite Regulation B and inviting public comment—the current proposal is "burdensome and wholly unjustifiable"); Press Release, SEC, SEC Extends Time for Banks to Comply with Gramm-Leach-Bliley Act Broker Registration Requirements (Sept. 9, 2005), <http://www.sec.gov/news/press/2005-130.htm> (extending the exemption until September 30,

practical matter, the Commission appears to be attempting to enlist mutual fund independent directors into its compliance program, deputizing them with new day-to-day responsibilities. To the extent that the Commission is “outsourcing” its compliance responsibilities to independent directors (and not just to the mutual fund’s chief compliance officer), it is asking them to do and be responsible for tasks that they are structurally and personally ill-equipped to perform, individually and collectively. The day-to-day management of the compliance function belongs with the mutual fund’s investment adviser: no one knows the “ins-and-outs” of a mutual fund’s operations better than the adviser’s experienced senior executives.

The Commission dismissed the many thoughtful suggestions that were submitted in comment letters in response to the Corporate Governance Amendments.¹³¹ These suggestions included the designation of a lead independent director, increased reliance on board committees chaired by independent directors, and disclosure by a mutual fund of whether or not it has an interested or independent director as the chairman of its board of directors. It would have been preferable if the Commission had followed its usual approach of cautious gradualism—it declared the 2001 Amendments to have been unsuccessful¹³² a scant two years after they had first been imposed, hardly a sufficient period of time to determine the results of most scientific experiments. Law is not a science, but a better decision might well have been to let the experiment begun with the 2001 Amendments have more time to run its course while strongly encouraging the boards of directors of mutual funds to pursue the alternatives that were rejected by the Commission.

B. The Regulatory Problems Behind the Scandals

The core regulatory problems underlying the scandals of 2003-2004 were abuse of Rule 22c-1, aggravated by “stale” prices in the NAV and aggressive use of a mutual fund’s brokerage transactions to provide an

2006); Press Release, SEC, SEC Extends Time for Banks to Comply with Gramm-Leach-Bliley Act Broker Registration Requirements, (Nov. 2, 2004), <http://www.sec.gov/news/press/2004-151.htm> (announcing extension of temporary exemption until March 31, 2005).

131. The release adopting the Corporate Governance Amendments explicitly addressed just three suggestions, and it dismissed them in a single paragraph. Release No. 26,520, *supra* note 8, at 1393-94 (“We carefully considered alternatives suggested to us by commenters, including designation of a lead independent director and increased reliance on board committees chaired by independent directors. . . . Commenters recommended a variety of other alternatives, including having the audit committee chair set the agenda.”).

132. *Id.* at 1384 (“[W]e now believe that the 2001 [A]mendments do not go far enough in addressing the need for independent fund boards.”).

impetus to selling activities by broker-dealers and their registered representatives. With respect to “revenue-sharing,” the Commission has now prohibited the use of directed-brokerage and has proposed new rules and rule amendments that would significantly enhance the point-of-sale and confirmation disclosures that would be made by broker-dealers to investors.

The Commission has not yet adopted its proposed amendments to Rule 22c-1. The late-trading that was exposed in 2003-2004 has been, and should continue to be, a matter of civil and criminal enforcement with respect to wrongdoers or illegal activities. If every investment adviser or broker-dealer involved in the scandals had been screening for market-timing transactions in compliance with prospectuses and/or had actively discouraged abusive market-timing activities, and if each of the intermediaries providing “batched” net orders to the mutual fund’s transfer agent had been in compliance with Rule 22c-1 and their contract with the mutual fund’s principal underwriter, there would not have been any need for the Commission to consider proposing a “hard close” at 4:00 p.m. Eastern Time. There is no serious question that a “hard 4:00 p.m. close” will be disadvantageous to numerous classes of investors in mutual funds.¹³³ It is poor public policy to adopt a rule that will disadvantage so many investors. The Commission’s ongoing insistence that mutual fund directors “fair value” securities is similarly misguided—that is a subjective task that will not ever squeeze every last opportunity for arbitrage out of a mutual fund’s NAV.

A far better solution to both problems is to allow mutual funds whose investment objective permits them to purchase and hold portfolio securities where a market quotation is not readily obtainable to use the next day’s price, i.e. Trade Date plus one (T+1) when the investment adviser doubts that the prices being obtained are the prices that would be received if the security were to be sold. It is one thing to attempt arbitrage on an overnight basis and another thing entirely to make a bet that will take two days to unfold. To the extent that the Commission believes that it is transcendentally important to mutual fund investors to be able to read yesterday’s closing prices in this morning’s *Wall Street Journal* so that trading information is instantly available, it should be noted that every investor whose trade is executed on the NYSE other than at the closing price must get that information from his broker or wait for receipt of her confirmation. It seems a much better public policy to adopt a T+1 trading

133. See *supra* note 65.

requirement in Rule 22c-1 and ask all of the mutual fund's shareholders to live with the slightly delayed receipt of information than to impose a "hard 4:00 p.m. close" to the acute disadvantage of so many.

With respect to redemption fees, the Commission should rest now that it has adopted new Rule 22c-2. It was important to empower a mutual fund's board of directors to tailor its redemption policy, size of redemption fee, and duration of its "stand-still" period to the circumstances that the board of directors believes that it is facing; however, standardization among mutual funds on any one of those points is, at best, a decidedly ancillary policy or investor-protection goal and should be abandoned, at least for the time being. With the full authority of the Commission behind them and the example of the scandals from 2003–2004 so fresh in their minds, there is every reason to believe that boards of directors of mutual funds can identify and implement redemption fee policies and procedures that will be in a mutual fund's best interests.

C. The Costs Imposed by the Commission's Rulemaking

We have all been told that there is no such thing as a free lunch. The Commission has just engaged in a vigorous period of rulemaking, and continues to engage in numerous "sweeps"¹³⁴ and inspections.¹³⁵ Much of

134. The SEC staff describes a "sweep" as a simultaneous inspection of numerous mutual funds focusing on a specific issue. Some "sweeps" are conducted pursuant to a formal order of investigation with a generic title like, "In re Certain Mutual Fund Trading Practices" so that the SEC staff can exercise its subpoena enforcement authority in a federal district court if necessary. *See generally* Stephen M. Cutler, Dir., Div. of Enforcement, SEC, Address before the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), <http://www.sec.gov/news/speech/spch042904smc.htm> (discussing recent enforcement actions); *SEC's Mutual Fund Exam Strategy Has Significant Weakness*, *GAO Finds*, 37 Sec. Reg. & L. Rep. (BNA) 1579 (Sept. 26, 2005).

135. The limits of the SEC's statutory authority has been tested here, too. The Commission has the authority to require that regulated entities like mutual funds, investment advisers, and broker-dealers keep books and records. *See, e.g.*, Investment Company Act § 31(a), 17 U.S.C. § 80a-30(a). As a technical matter, that is all that the SEC has the statutory right to inspect. *See, e.g.*, Investment Company Act § 31(b)(1), 17 U.S.C. § 80a-30(b)(1) ("[a]ll records required to be maintained and referred in accordance with subsection (a) shall be subject at any time and from time to time to such reasonable periodic, special, and other examinations by the Commission . . ."). Yet, especially since Fall 2003, the SEC staff has "requested" or issued subpoenas demanding the creation of information, in computer-readable formats, that is not required to be kept by an existing rule or regulation. The most obvious example is email, where the "requests" that have been made have been extremely expensive to respond to. It is the unusual regulated entity that wants to pick a fight with its regulator, so investment advisers and broker-dealers have largely cooperated with these "requests," for good business reasons. *See* Banc of America Inv. Serv's., Inc., Exchange Act Release No. 51,852, Investment Advisers Act Release No. 2396, 85 SEC Docket 1975 (June 15, 2005) (alleging violations of section 17(a) of the Exchange Act and Rule 17a-4 thereunder and section 204 of the Advisers Act and Rule 204-2 thereunder for failure to maintain adequate systems and procedures for the preservation of email communications—civil money penalties of \$1.5 million); J. P. Morgan Securities

the cost of the rulemaking, such as the salary for a chief compliance officer and the increased compensation that will inevitably flow from the expanded duties and responsibilities of boards of directors, will be borne directly by mutual fund shareholders. Other costs, such as those associated with the “sweeps” and inspections, are less obvious but just as harmful—it is the rare mutual fund group that has not been asked to respond to one “sweep” or another, generally on a very expedited schedule and with the attendant devotion of scarce resources to accomplish the task. The last two years have imposed an enormous time burden and significant financial toll on investment advisers’ management and compliance personnel. While the mutual fund industry has endured severe pressure from the Commission’s extensive rulemakings and expansive “sweeps,” it does not take a Nostradamus to predict that the result will be further consolidation within the securities industry. And it would be a fearless entrepreneur who would now seek to enter the mutual fund industry and bear the skyrocketing costs of creating and maintaining a vibrant and robust compliance infrastructure without serious prospects for having at least \$20–\$30 billion in assets under management in very short order.

The Commission is charged by law with assessing the costs and benefits of its rulemaking.¹³⁶ Because that is an event-by-event responsibility associated with each individual rulemaking, the Commission now needs to reexamine and reassess what it has wrought cumulatively in the cold light of day¹³⁷ and determine whether the new

Inc., Exchange Act Release No. 51,200, 84 SEC Docket 2989 (Feb. 14, 2005) (alleging violations of section 17(a) of the Exchange Act and Rule 17a-4 thereunder for failure to preserve email for two years in an easily accessible place—civil money penalties of \$2.1 million, payable one-third each to the SEC, NYSE, and NASD); *J.P. Morgan Securities Settles Charges over E-Mail for \$2.1M Total to SEC, SROs*, 37 Sec. Reg. & L. Rep. (BNA) 310 (Feb. 21, 2005); “Prompt” Response to E-Mail Request Poses Retention, Other Issues for Advisers, 37 Sec. Reg. & L. Rep. (BNA) 400 (Mar. 1, 2005) (reporting discussion at IA Compliance Best Practices Summit of current email requests from the SEC staff and proposed methods of complying with those requests); *UBS Agrees to Pay \$2.1 Million After SEC, SROs Investigate E-Mail Retention*, 37 Sec. Reg. & L. Rep. (BNA) 1224 (July 18, 2005).

Now that the crisis atmosphere has abated somewhat, it would be an appropriate time for the Commission to reconsider the inspection practices that have been engaged in, and review and revise its record-keeping regulations. An inspection program at or beyond the limits of its statutory authority may be a necessary evil in a crisis, but does not engender respect for anything other than the exercise of raw power and is not an attractive feature of a governmental agency that is itself charged with enforcing laws.

136. 15 U.S.C. § 80a-2(c) (consideration of promotion of efficiency, competition, and capital formation); Paperwork Reduction Act, 44 U.S.C. §§ 3501–3520 (2000); Investment Company Act § 2(c). Interestingly, staff from the SEC’s Office of Economic Analysis estimated that implementing Rule 22c-2 with respect to redemption fees would cost the mutual fund industry \$630 million in its first three years, including one-time start-up costs. *SEC Gives Funds Redemption Fee Option, but Requires Contracts with Intermediaries*, 37 Sec. Reg. & L. Rep. (BNA) 393, 394 (Mar. 7, 2005).

137. To identify an obvious example, consider the harm that has been done to the concept of a

regulatory framework that will emerge from this experience will support a mutual fund industry that can effectively and efficiently perform its vital business function for the benefit of investors in a cost-effective manner. It would be wrong for the crisis of the moment, and the immediate reaction to it, to drive decisions that will, in the long run, not be in the best interests of investors. This surely counsels that the Commission let developments have a reasonable opportunity to play out before any additional costs or requirements are considered or imposed.

VI. CONCLUSION

For the reasons set forth above, the Commission should suspend the effective date of the Corporate Governance Amendments and seriously reconsider whether there are not better, more effective methods for

clear, simple, consumer-friendly prospectus in "plain English." See Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7398, Exchange Act Release No. 38,346, Investment Company Act Release No. 22,528, 63 SEC Docket 2293 (Feb. 27, 1997) (prospectus simplification and profile prospectus); Improving Descriptions of Risk by Mutual Funds and Other Investment Companies, Securities Act Release No. 7153, Exchange Act Release No. 35,546, Investment Company Act Release No. 20,974, 58 SEC Docket 2740 (Mar. 29, 1995). There is now mandatory disclosure of many regulatory matters in a mutual fund's prospectus that were previously considered worthy of mention (if at all) only in a Statement of Additional Information; similarly, mutual fund annual reports must now discuss in numbing detail exactly what was considered by a board of directors in approving the investment advisory contract. Some disclosure adjustments were clearly necessary, but the pendulum seems to have swung a long way away from simple, consumer-friendly prospectuses, surely at the cost of readability and thus of actual transparency. Cf. Judith Burns, *Prospectuses May Get a Makeover*, WALL ST. J., Feb. 22, 2005, at C19 (reporting comments of Paul Roye, Director of the SEC's Division of Investment Management before the Mutual Fund Directors Forum: "SEC will consider changes that could pare down prospectuses to two to four pages containing key information," with all additional information in the Statement of Additional Information). See also William H. Donaldson, *supra* note 129:

The final agenda item I'd like to mention is mutual fund disclosure reform. As part of the Commission's ongoing point of sale initiative, we have received helpful input from commenters, including investor focus groups. They have delivered one unmistakable message: investors want straightforward, simple disclosure about their mutual fund investments. We continue to search for the best method of informing investors about broker conflicts and compensation. Ideally, we'd like to minimize the costs to the broker-dealer and fund industries, and at the same time not force the delivery of so much information to investors that they end up ignoring the most important parts of it. These should not be irreconcilable goals. . . . From a broader perspective, I have asked the staff to carry out a top-to-bottom review of the mutual fund disclosure regime and how we can maximize its effectiveness on behalf of fund investors. Few would disagree that many mutual fund disclosure documents are too long and complicated. Investors need disclosure that is clear, understandable, and in a usable format in order to make informed investment decisions.

See also *SEC Mulling Voluntary Redemption Fee*, IGNITES, Feb. 17, 2005 ("Also at the [Mutual Fund Directors Forum this week], [SEC Chairman William] Donaldson said he has asked [C]ommission staff to study how to make fund disclosure simpler to understand. Investors need clear disclosure in a usable format, he said, but too many disclosure documents are too long and complicated.").

achieving the compliance goals that it endorses. Similarly, the proposed amendments to Rule 22c-1 should be abandoned. Finally, the Commission should, consistent with its responsibility for administering the Investment Company Act in the best interest of investors, continue its laudable efforts to provide leadership in restoring the confidence of America's investors in the mutual fund industry.