

DUTIES OF DIRECTORS AND TRUSTEES **OF REGISTERED INVESTMENT COMPANIES**

I. GENERAL FIDUCIARY RESPONSIBILITIES OF INDEPENDENT FUND DIRECTORS

A. Introduction

The independent directors and trustees (“directors”) of registered management investment companies are fiduciaries and, as such, owe each fund on whose board they serve and its shareholders special responsibilities that come into play whenever business decisions of significance to the fund and its shareholders are made that call for a determination or review by the independent directors. These responsibilities are derived from state law (common law and statute) and from various provisions of the Investment Company Act of 1940 (“1940 Act”).

B. Responsibilities Under State Law

Mutual funds, like other corporations and business trusts, are organized pursuant to state, not federal, law. Accordingly, mutual fund directors, like the directors of any corporation or business trust, owe the fund and its shareholders the fiduciary duties of loyalty and care. Existing judicial and statutory formulations of these duties are widely accepted and vary only slightly in their effect from state to state.

1. Duty of Loyalty

The duty of loyalty mandates that directors avoid using their positions of trust and confidence to further their private interests. Fundamental to the duty of loyalty is the avoidance of self-dealing and conflicts of interest.

2. Duty of Care

The duty of care imposed by section 2-405 of the Maryland Corporations and Associations Code (“Maryland Code”) is typical. The Maryland Code imposes a general duty on directors (including independent fund directors) to perform their duties in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with that degree of care which an ordinarily prudent person in a like position would exercise under similar circumstances.

- a. If the director has greater skill than an ordinary person (if, for example, he or she is a professional investment adviser or attorney), the law requires that this greater skill be applied.

- b. The duty of care requires that directors inform themselves adequately on matters within their purview, apply their business judgment to matters on which action by the directors is appropriate, and reach reasonable decisions. Reasonable reliance on others, including officers and employees of the corporation, counsel, accountants and other experts, or committees of the board of directors, generally is permissible.

C. **Effect of the Business Judgment Rule**

While the rhetorical formulation of the due care standard would appear to subject directors to liability for acts of ordinary negligence (i.e., a lack of due care), courts in practice are disinclined to substitute their judgment for that of the corporate directors in the absence of bad faith, fraud, conflict of interest, illegality, or gross negligence in the process by which their decisions are reached. This judicial reluctance finds its expression in the "business judgment rule."¹

1. **Presumption Favoring Directors**

The business judgment rule provides a rebuttable presumption that, in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company -- that is, a presumption that the directors have not breached their duty of care.

2. **Elements of Defense**

The presumption of the business judgment rule is invoked only if certain threshold requirements are met.

- a. The rule has no applicability where directors have violated their duty of loyalty, have abdicated their functions or, absent a conscious decision, have simply failed to act. In other words, a business judgment must actively have been reached.

¹ In a number of important respects, trustees of business trusts are treated like directors of corporations. In particular, trustees of business trusts are entitled to rely on and will be protected by the "business judgment rule." See Evangelist v. Fidelity Management & Research, 554 F. Supp. 87 (D. Mass. 1982); Hasan v. Clevetrust Realty Investors, 548 F. Supp. 1146 (N.D. Ohio 1982). In these two cases, the first involving a mutual fund and the second a real estate investment trust, federal courts applying the law of Massachusetts indicated that the business judgment rule is applicable to decisions of trustees of a Massachusetts business trust.

- b. In addition, the courts in recent years have begun to articulate more explicitly another threshold requirement: that the directors' decision must result from the exercise of their informed business judgment. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

3. The importance of "process"

The effect of the foregoing formulation, in practical terms, is to render the duty of care a duty to use appropriate care in the process of reaching a business judgment. If procedures evidencing careful, fully informed decision making by directors are followed, then liability will not attach even if the business judgment itself proves to be incorrect.

D. Responsibilities and Duties Under the 1940 Act

In addition to the due care and loyalty responsibilities under state law, independent directors of funds have further fiduciary responsibilities under the 1940 Act.

1. Requirement of Independent Directors

Section 10 of the 1940 Act specifically requires that 40% of the directors of an investment company be independent of the adviser and underwriter precisely because, in the case of mutual funds, Congress was unwilling to rely only on the fiduciary duties that all corporate directors have under state law.²

² Where the fund is affiliated with its principal underwriter – a very common situation – a majority of the board must be independent of the principal underwriter.

2. Independence Requirements

In 2001, the Securities and Exchange Commission (“SEC”) amended certain commonly-used exemptive rules³ to include additional requirements for director independence. Under those amendments, funds that wish to rely on any of the rules must (1) have a majority of independent directors; (2) provide that candidates for the post of independent director will be selected and nominated by the independent directors; and (3) take steps to assure that any counsel to the independent directors is “independent counsel.”⁴

In 2004, the SEC adopted a rule that required (1) boards to perform a self-assessment at least once annually; (2) independent directors to meet in separate sessions at least once quarterly; and (3) independent directors to be affirmatively authorized to hire their own staff.⁵ In 2006, a federal appeals court suspended two other provisions of the rule—requiring that boards have no less than 75% independent directors and an independent chair—and sent it back to the SEC for further consideration of the potential benefits of such a requirement.⁶ Although the SEC did conduct some additional studies, the rule never reemerged.

³ Rule 10f-3 (permitting the purchase of securities during the existence of an underwriting syndicate of which a fund affiliate is a member); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4 (permitting the approval of interim advisory contracts without shareholder approval); Rule 17a-7 (permitting securities transactions between a fund and certain affiliated persons of the fund); Rule 17a-8 (permitting mergers of certain affiliated funds); Rule 17d-1(d)(7) (permitting funds to purchase joint liability insurance policies with affiliates); Rule 17e-1 (addressing when funds may pay commissions to affiliated brokers); Rule 17g-1(j) (permitting joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of shares); and Rule 23c-3 (permitting closed-end funds to repurchase shares periodically from investors and thereby operate as interval funds). The Commission said that it selected these rules because they involve inherent conflicts of interests between funds and their affiliates and, therefore, require the independent scrutiny of independent directors.

⁴ Counsel is independent if the independent directors reasonably determine that any representation of the fund’s adviser, principal underwriter, or administrator, or their control affiliates, by counsel or counsel’s firm during the last two fiscal years of the fund is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation. In adopting the rule, the SEC stressed that it was not requiring independent directors to obtain separate counsel, nor was it imposing these independence requirements on counsel to the fund.

⁵ Inv. Co. Act Rel. No. 26520 (Aug. 2, 2004).

⁶ U.S. Chamber of Commerce v. SEC (U.S. Ct. App. D.C. April 7, 2006).

In February 2010, new governance rules took effect.⁷ These rules require disclosure of the board's leadership structure, including:

- whether the same person serves as both principal executive officer and board chair;
- whether the board chair is an “interested person” of the fund as defined in Section 2(a)(19) of the 1940 Act;
- if one person serves in both roles, or if the board chair is an interested person, whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board; and
- why the registrant has determined that its leadership structure is appropriate, given the specific characteristics or circumstances of the registrant.

The new governance disclosure requirements have seemingly replaced efforts to require an independent chair or the requirement for 75% independent directors. Indeed, the Adopting Release, in discussing companies in general, notes that “different leadership structures may be suitable for different companies depending on factors such as the size of a company, the nature of a company's business, or internal control considerations, among other things” – a statement seemingly inconsistent with any attempt to impose a single governance structure on all companies, even those within a single industry, such as investment companies.

Separately, the Investment Company Institute (“ICI”) recommends that independent directors constitute at least two-thirds of a board as a best practice. In addition, the majority of investment companies have voluntarily composed their boards with an independent chair and 75% independent directors.

3. Exemption from Board Composition Requirements

Rule 10e-1 temporarily suspends the board composition requirements of the 1940 Act and the exemptive rules cited in note 3 if a fund fails to meet those requirements because of the death, disqualification, or resignation of a director. The requirements are suspended for 90 days if the vacancy can

⁷ SEC Rel. 33-9089 (Dec. 16, 2009).

be filled by the remaining directors and for 150 days if the fund must obtain a shareholder vote to fill the vacancy.

4. Independent Watchdog Function

The Supreme Court observed in Burks v. Lasker, 441 U.S. 471, 486 (1979): "[T]he structure and purpose of [the 1940 Act] indicate that Congress entrusted to the independent directors of investment companies ... the primary responsibility for looking after the interests of the funds' shareholders."⁸ In recognition of this responsibility, court decisions often refer to the independent directors as "independent watchdogs" for the funds and their shareholders. See, e.g., Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).

5. Section 36(a) - Breach of Fiduciary Duty Involving Personal Misconduct

- a. Section 36(a) authorizes the SEC to seek an injunction against any person who serves as an "officer, director, member of any advisory board, investment adviser, or depositor" or any underwriter, for breaches of "fiduciary duty involving personal misconduct."
- b. The legislative history for this provision states that "your committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." Senate Report No. 91-184 (91st Cong., 1st Sess. (1970) at 36.3 [1970] U.S. Code Cong. 9 Admin. News, 4894 at 4931.
- c. The SEC has rarely used this provision to initiate action against the directors of mutual funds. Moreover, case law indicates that a well-qualified board of directors, which is not under the domination of the fund's investment adviser, can be an effective defense for an adviser in an action under section 36(a). See

⁸ In enacting Section 10, Congress concluded that mutual funds require greater independent oversight than other corporations in light of the control exercised by the external adviser, the use of affiliated underwriters and broker-dealers, and the conflicts of interest inherent in mutual fund organizations.

Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), cert. denied, 98 S. Ct. 421 (1977).

6. Overall Responsibility

The Report of the Advisory Group on Best Practices for Fund Directors, prepared under the auspices of the Investment Company Institute in early 1999, characterized fund directors' responsibilities as follows:

Ultimately, the Advisory Group believes that the fundamental responsibility of fund directors is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law (e.g., resulting from the investment adviser's fiduciary duties to the fund and specific requirements under the Act) and in accordance with investor expectations reasonably created by the fund's prospectus and other disclosure documents. Within this context, it is the responsibility of the fund's board to evaluate the performance of the fund's investment adviser and that of its other service providers on the basis of what is best for shareholders and to apply that same standard in evaluating any proposals for change in fund operations or expenses. On those occasions where the interests of the adviser and fund shareholders diverge, the fund's directors and, in particular, the independent directors, must effectively represent the interests of the fund and its shareholders.

7. Specific Responsibilities

Central to the role of independent trustees as "watchdogs" are their specific statutory obligations, which focus on oversight of issues that are most likely to create conflicts between a fund and its managing organizations? The obligations include:

- a. Annual approval of the advisory contract (Section 15(c)), discussed below.
- b. Annual approval of the principal underwriting contract (Section 15(c)).
- c. Annual selection of the independent accountant (Section 32(a)(1)).

- d. Selection and nomination of persons to fill independent director vacancies under certain circumstances (Section 16(b)).
- e. Determination of the “fair value” of certain portfolio securities (Section 2(a)(41)).

In addition to these statutory obligations, the SEC has, through regulation, imposed additional responsibilities on independent directors (acting with the full board), including:

- a. Approval of any 12b-1 plan of distribution (Rule 12b-1(b)(2)).
- b. Adoption of policies and procedures relating to purchases from affiliated underwriter (Rule 10f-3(b)(1), purchases and sales to affiliated funds (Rule 17a-7(e)) and brokerage transactions with affiliates (Rule 17e-1(b)).
- c. Oversight of mergers with affiliated funds (Rule 17a-8(a)).
- d. Review of joint fund insurance policies (Rule 17d-1(d)(iii) and adequacy of fidelity bond for fund officers and employees (Rule 17g-1(d)).
- e. Oversight of multi-class agreements (Rule 18f-3(c)(1)(v)).
- f. Approval of compliance policies and procedures of the funds and of the adviser, underwriter, administrator and transfer agent, as well as approval of the designation and compensation of the chief compliance officer of the funds (Rule 38a-1).

In addition to the foregoing statutory and regulatory obligations, the SEC frequently requires independent directors to take certain actions periodically as a condition to individual exemptions issued to fund groups.

II. FIDUCIARY RESPONSIBILITIES OF INDEPENDENT DIRECTORS IN THE CONTEXT OF ADVISORY CONTRACT REVIEWS

A. Requirement to Review the Advisory Contract

Section 15(c) of the 1940 Act requires the independent directors to review the advisory contract at least annually. The directors are to request and evaluate, and the adviser to provide, “such information as may reasonably be necessary to evaluate the terms of” the advisory contract.

B. The Gartenberg Case

Many actions brought against funds for excessive advisory fees have been settled with relatively modest reductions in the fees payable by the funds. One case, however, involving a large money market fund, was tried on the merits and dismissed. See Gartenberg v. Merrill Lynch Asset Management, Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), aff’d 694 F.2d 823 (2d Cir. 1982). Both the District Court and the Court of Appeals decisions in Gartenberg are significant to the mutual fund industry. Although the cases were brought under Section 36(b)⁹ of the 1940 Act, the court opinions focus considerable attention on the role of independent directors in reviewing and renewing the advisory contract, and are therefore taken as authoritative guidance for the role of independent directors under Section 15(c).

1. In Gartenberg and the cases that followed, the courts have hesitated to disturb a fund’s fee structure where:
 - a. the directors were individuals whose education and experience in business affairs enabled them to address the issues at hand;
 - b. the directors were fully informed of all facts and circumstances relevant to their consideration;
 - c. the directors were careful and conscientious in carrying out their duties; and
 - d. the directors were independent of management.

⁹ Section 36(b) imposes a fiduciary duty on a fund’s investment adviser as to receipt of compensation.

2. The following observations of the Court of Appeals in Gartenberg are worth noting:
- a. The court concluded that to be guilty of a violation of section 36(b) of the 1940 Act, an adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. To make this determination, all pertinent factors must be weighed.
 - b. The court held that factors which may be important in fixing advisory fees are the adviser's cost in providing the service, the nature and quality of the services furnished by the adviser, and the extent to which the adviser realizes economies of scale as the fund grows larger.
 - c. The court was not prepared to regard competitiveness in setting advisory fees as the principal factor in determining the appropriateness of advisory fees, although it did recognize that "best industry practice," particularly with respect to reductions of fees as a fund grows in size, is a factor to be taken into account.
 - d. The court said that fall-out financial benefits to an adviser and its affiliates must be considered.
 - e. The court said that consideration should be given to any "float" earnings realized by a distributor in connection with sales and redemptions.
 - f. In their arm's-length negotiations with investment advisers, independent directors should, among other matters, consider the reasonableness of investment advisory fees in relation to the adviser's profits derived from its investment and administrative services. With regard to the profit questions, there are no specific legal benchmarks established by case law or SEC Rules, nor is there adequate comparative data. In Gartenberg, however, the court said that profit margins ranging from a loss to a profit of 38.4% on an after-tax basis (depending on the methodology used) "could hardly be labeled so excessive as to constitute a breach of fiduciary duty." The matter is, therefore, one to be decided by the exercise of reasonable business judgment in the interests of fund shareholders and in the context of arm's-length negotiation with the adviser.

C. The Gartenberg Factors and Subsequent Litigation

1. Following Gartenberg, other courts and the SEC have amplified on the legal standards governing the so-called “Gartenberg factors” that boards should consider. The factors typically include:
 - a. The nature and quality of the services provided.
 - b. The extent to which economies of scale are reflected in the fee schedule. *Krinsk v. Fund Asset Management, Inc.* 715 F. Supp. 472 (S.D.N.Y. 1988), *aff’d*, 875 F.2d 404 (2d Cir.), *cert. denied*, 493 U.S. 919 (1989).
 - c. The evidence of any “fall-out” benefits to the adviser, i.e. indirect profits to the adviser attributable in some way to the existence of the fund. *Krinsk*, *supra*.
 - d. A comparison of advisory fees and performance to those of similar funds.
 - e. The adviser’s costs incurred and profits realized for providing services to the funds. *Schuyt v. T. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y.), *aff’d*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988).
 - f. The volume of transaction orders that must be processed by the adviser.
2. The U.S. Court of Appeals for the Ninth Circuit has broadly endorsed the power of independent fund directors to terminate the investment advisory contract, provided they satisfy their fiduciary duties, notably the duties to inform themselves and to exercise their judgment for the benefit of the fund. *Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001). The Ninth Circuit affirmed the district court’s judgment, which held that directors who had terminated an advisory contract and sought the services of a new adviser had no liability to the fund, its shareholders, or the old adviser.

D. Jones V. Harris Associates and Gallus v. Ameriprise Financial, Inc.—Lower Court Decisions

1. While the courts had repeatedly reaffirmed the Gartenberg standard for reviewing claims under Section 36(b), in May 2008, the U.S. Court of

Appeals for the Seventh Circuit, in Jones, et al. v. Harris Assoc. L.P.,¹⁰ sowed considerable uncertainty in the industry when it diverged from Gartenberg and adopted a differing fiduciary duty standard in upholding the dismissal of a Section 36(b) claim.

2. In Jones, the Seventh Circuit noted that an adviser's compensation may be so high that a court could infer that deceit must have occurred, or that the persons responsible for determining the level of the fee (i.e., the trustees) abdicated their responsibility. The court then concluded that, other than those (and presumably similar procedural) questions, there is no role for the judiciary in the review of fees. The court focused on the market for mutual funds and cited several recent studies showing that the market structure is such that robust competition exists among funds so that investors can seek out those investment companies with low fees. Finally, the court rejected the notion that fees charged by investment advisers to other institutional accounts are appropriate benchmarks for evaluating mutual fund fees.
3. In Gallus v. Ameriprise Financial, Inc., Case No. 07-2945, 2009 U.S. App. LEXIS 7382 (8th Cir. 2009), the U.S. Court of Appeals for the Eighth Circuit further deepened the circuit split in a decision that reversed a district court decision that had granted an investment adviser's motion for summary judgment based on the Gartenberg factors. The appeals court ruled that the district court erroneously rejected a comparison between the fees the adviser charged to its institutional and mutual fund clients. It also noted that, while the court in Gartenberg dismissed such fee comparisons as unnecessary due to the dissimilarity of the money market mutual funds and equity pension funds discussed in that case, it does not follow that such a comparison is irrelevant where there is greater similarity between the funds and other client accounts being compared. The Gallus court stated that the district court should have determined whether the adviser "purposefully omitted, disguised, or obfuscated information that it presented to the Board about the fee discrepancy between different types of clients."
4. The Gallus court's decision specifically noted the Seventh Circuit's ruling in Jones. It stated that, while Gartenberg "demonstrates one way in which a fund adviser can breach its fiduciary duty, it is not the only way" and "Jones highlights a flaw in the way many courts have applied Gartenberg."

¹⁰ 2008 U.S. App. LEXIS 10804 (7th Cir. 2008).

The Gallus court concluded that “the proper approach to Section 36(b) is one that looks to both the adviser’s conduct during negotiation and the end result. . . . Unscrupulous behavior with respect to either can constitute a breach of fiduciary duty.”

D. Jones v. Harris Associates—Supreme Court Decision

2. The uncertainty was resolved by the Supreme Court in Jones v. Harris Associates L.P., 559 U.S. 335 (2010). The Court held in Jones that the approach established by Gartenberg is “correct in its basic formulation: to face liability under Section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.”
3. Adviser’s fiduciary duty in the context of Section 36(b) claims. Citing its 1939 decision in Pepper v. Litton, the Supreme Court stated that “the essence of [whether a fiduciary duty has been violated] is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain.” The Court also stated that the 1940 Act “shifts the burden of proof from the fiduciary to the party claiming breach,” thus emphasizing that plaintiffs (and not advisers) continue to have the burden of proof when asserting a Section 36(b) claim, as acknowledged in Gartenberg.
4. Role of comparative fees in reviewing Section 36(b) claims. The Court reasoned that “[s]ince the [1940] Act requires consideration of all relevant factors . . . we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require.” The Court warned against “inapt comparisons,” noting that:

[T]here may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and the higher marketing costs. If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and the fees charged to an independent fund are

relevant, courts should be mindful that the [1940] Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to petitioners' [plaintiffs'] contentions.

5. Comparison of fees. The Court warned, as did the Gartenberg court, against placing too much emphasis on a comparison of one fund's advisory fees against fees charged to other mutual funds by other advisers. "These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length." Moreover, the Court cited Gartenberg for the proposition that "competition between . . . funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent."
6. Affirmation of the crucial role of informed and diligent fund directors in overseeing fees and monitoring conflicts of interest. Citing its 1979 decision in Burks v. Lasker, the Court observed that "[u]nder the [1940] Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the 'cornerstone of the . . . effort to control conflicts of interest within mutual funds.'" The Court explained that a court's evaluation must take into account both procedure and substance, writing, "Where a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process. Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently. . . . In contrast, where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome." The Court noted that "an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve advisory fees."

E. Ongoing Litigation Based on Subadvisory Fees

On December 17, 2012, the United States District Court for the District of New Jersey granted in part and denied in part a motion to dismiss an excessive fee suit brought under Section 36(b) of the 1940 Act against Hartford Investment Financial Services, LLC ("Hartford"). Accordingly, this case may proceed to discovery and trial because of the District Court's partial dismissal. The

plaintiffs' complaint contained two claims for excessive fees, one pertaining to investment management fees and one pertaining to distribution fees. The District Court began its analysis with a discussion about the Supreme Court's decision in *Jones v. Harris Associates L.P.* In applying this standard, the District Court in the Hartford case employed the multi-factor *Gartenberg* test.

The plaintiffs focused on the nature and quality of services provided to each fund and its shareholders by detailing the investment management services Hartford provides, the services the subadvisers provide to the funds, the overlap between the two, and the differences between their fees for what the plaintiffs allege to be for substantially the same services. To support their complaint, the plaintiffs used information readily available from public sources, such as shareholder reports, prospectuses, and investment advisory and sub-advisory contracts. The plaintiffs alleged that the management fees Hartford charges six mutual funds are, on average, three times the amount Hartford pays its subadvisers for similar services. With regard to this *Gartenberg* factor, the District Court found that the plaintiffs raised a plausible inference that Hartford's fees are excessive under Section 36(b).

The plaintiffs also provided a comparison of Hartford's management fees to those of a similar Vanguard fund, noting that both advisers use the same subadviser to manage their respective funds' investments. The complaint alleges that, after the subadviser's fees are removed from total fees for both advisers, Hartford's management fees are on average three times Vanguard's management fees. In their comparison, the plaintiffs argue that the fees Vanguard actually charges for oversight and administrative services are minimal, either nothing or one basis point; whereas Hartford charges between 50 and 55 basis points for such services. Hartford urged the District Court to reject this comparison, noting that Vanguard is a not-for-profit entity that markets itself as a low-cost mutual fund provider. The plaintiffs countered that argument by noting that both Hartford and Vanguard use the same for-profit subadviser and that the "gross disparity in the fees suggests a lack of arm's length bargaining." The District Court found that "since Vanguard and [Hartford] employ the same subadviser, this comparison is more apt than in the typical case ... while certainly not decisive, the Court gives some, limited weight to this comparison."

The District Court denied Hartford's motion to dismiss the excessive management fee claim and found "[i]n sum,...that while the standard under *Jones* and *Gartenberg* is onerous, Plaintiffs' 80-page Complaint alleges sufficient facts to satisfy their burden at this early stage of the proceedings. Construing all of the facts set forth above in Plaintiffs' favor, a plausible inference arises that [Hartford's] management fees are so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The District Court granted Hartford's

motion to dismiss the excessive distribution fee claim. The opinion notes that the plaintiffs' arguments with regard to the distribution fees were sparse and conclusory. Similar litigation is pending against other fund groups based on disparities in the adviser's management fee and that of subadvisers.

F. Disclosure Requirements Mandated by SEC

On June 23, 2004, the SEC adopted amendments that require funds to disclose to investors the manner in which their boards of directors evaluate, approve and recommend shareholder approval of investment advisory contracts. As a result of these disclosure requirements, the board of directors must include the following factors in its review of the investment advisory contracts: (1) the nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors. These specific factors largely mirror the factors cited in Gartenberg.

III. FIDUCIARY RESPONSIBILITIES OF INDEPENDENT DIRECTORS IN THE SPECIFIC CONTEXT OF A CHANGE OF CONTROL

A. Introduction

Where there is a change in control of a fund's investment adviser, it is the responsibility of the fund's independent directors to reach a business judgment as to whether the new arrangement contemplated by the transaction, including the proposed advisory contract, in the context of all the facts and circumstances, is in the best interests of the fund and its shareholders.

B. Active Involvement of Independent Counsel

The courts and the SEC both place heavy reliance on this factor. Independent counsel should play an active, ongoing role in advising the independent directors, which would include helping them to formulate requests for information, communicating with counsel for other parties to the transaction and attending meetings.

C. Due Diligence -- Understanding the Transaction and Its Impact on Funds and Their Shareholders

The overriding obligation of independent directors is to review and evaluate the terms of new advisory agreements and, in connection therewith, the effects of any

change of control on each fund and its shareholders. To this end, the independent directors should become fully informed respecting the underlying change of control transaction, carefully assess the benefits, costs, and risks of the transaction for the funds and other participants, and satisfy themselves that the change of control will be consistent with the interests of the funds' shareholders.

D. The Processes Independent Directors Should Follow

The critical matter in assessing whether independent mutual fund directors satisfactorily discharge their fiduciary responsibilities to the funds is whether they exercise due care in reaching their decisions. The processes they follow should be adequate to permit reasonable business judgments to be reached.

E. Considerations of Alternative Management Arrangements

An issue that often arises in change of control situations is whether independent directors have any duty to seek out or consider other management arrangements. Based upon the legal authorities, the independent directors typically would have no such responsibility so long as they are satisfied with the quality of the proposed advisory services, find the terms of the new advisory agreements acceptable, and conclude that the funds and their shareholders will continue to be adequately served under the new arrangements. See Krieger v. Anderson, 182 A.2d 907 (Del. 1962).

IV. LIMITATIONS ON LIABILITY OF DIRECTORS AND TRUSTEES

A. Massachusetts Business Trusts

Massachusetts courts recognize that a trustee's liability generally may be limited if a statement to that effect is included in the declaration of trust. The declaration of trust of Massachusetts business trusts typically is written to protect its trustees against liability to the fullest extent permitted by federal and state law. The following provisions are standard:

1. No trustee is liable for the act or omission of any other trustee or for any neglect or wrongdoing of any officer, agent, employee, consultant, or service provider of the trust.
2. No trustee is liable for any act or omission in accordance with the advice of counsel or other experts with respect to (i) his or her duties as a trustee and (ii) the meaning and operation of the trust's declaration of trust.
3. No trustee will be liable simply for failing to follow advice of counsel.

4. In discharging their duties, the trustees, when acting in good faith, are entitled to rely on certain written information (e.g., the trust's books of account and any written reports made to the trustees by any officer appointed by them or any independent certified public accountant).

B. Maryland Corporations

A corporation's articles of incorporation also are typically written to protect the directors against liability to the fullest extent permitted by federal and state law at the time the articles were drafted.

1. Under the Maryland Code, a director will have no liability by reason of being or having been a director of the corporation if the director performs his or her duties in accordance with the standard of care set forth above. "No liability" means liability for money damages as well as equitable relief and includes liability to third parties as well as to the corporation and its shareholders.
2. Maryland permits a corporation to include in its charter a provision limiting or eliminating a director's personal liability to the corporation or its shareholders for money damages for certain breaches of the director's duty of care, subject to specific exceptions. It is important to note, however, that Maryland's limitation of liability provision appears to have no protective effect unless a corporation's charter (either originally or by an amendment thereto validly approved by the corporation's shareholders) contains such a provision limiting or eliminating personal liability of directors.
3. The Maryland Code does not permit a corporation to limit or eliminate its directors' personal liability (i) to any person or entity other than the corporation or its shareholders, (ii) for claims for nonmonetary or equitable relief such as rescission or injunction, or (iii) for violations of the federal securities laws.

C. Delaware Statutory Trusts

1. Delaware law provides that a trustee, when acting in such capacity, shall not be personally liable to any person other than the trust or its shareholders for any act, omission or obligation of the trust. Delaware law also provides that the trustee's liabilities may be expanded or restricted by the trust's governing instrument.

2. The declaration of trust of a Delaware statutory trust typically is written to provide that absent willful misfeasance, bad faith, gross negligence or reckless disregard of the trustee's duties, a trustee shall not be personally liable to any person contracting with or having any claim against the trust or a particular series. In addition, the declaration of trust typically provides that a trustee shall not be liable to the trust or its shareholders so long as the trustee has exercised reasonable care and acted under the reasonable belief that his actions are in the best interest of the trust.

D. 1940 Act Limitations

1. Section 17(h) of the 1940 Act in effect establishes a minimum standard of conduct for investment company directors. Section 17(h) requires that an investment company's organizational documents and agreements not contain any provision that "protects or purports to protect" any director against liability to the investment company or its shareholders for "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his [or her] office."
2. As discussed below, the SEC staff has interpreted section 17(h) as a substantive restriction on an investment company's ability to indemnify, as well as to advance expenses to, its directors.

V. INDEMNIFICATION, ADVANCES AND INSURANCE

A. Indemnification

1. Massachusetts Business Trusts

- a. The indemnification and advancement provisions of the typical Massachusetts business trust's declaration of trust are more detailed than those provisions of the typical corporation's articles of incorporation. This is because Massachusetts has not adopted statutes that govern indemnification or advances by Massachusetts business trusts.
- b. Under a typical declaration of trust, a trustee is generally required to be indemnified in connection with any action, suit, or other proceeding, in which the trustee was or is involved as a party, or to which the trustee was or is threatened to be made a party, while in office or thereafter, by reason of the fact that he or she was or is a trustee. This obligation extends to all liabilities (e.g., amounts paid in satisfaction of judgments, in compromise, or as fines and

penalties) and expenses (e.g., reasonable accountants' and attorneys' fees) incurred by the trustee.

- c. A Massachusetts business trust's organizational documents typically will contain various exceptions. A trustee will not be indemnified --
 - (1) When a court has made a final decision on the merits that the director is liable by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of duties.
 - (2) When either (a) a majority of a quorum of the directors who are not defendants or (b) an independent legal counsel in a written opinion has reasonably determined, based on a review of the facts, that the director engaged in willful misfeasance, bad faith, gross negligence, or reckless disregard of duties.
 - (3) When a court has made a final decision on the merits that the director did not act in good faith in the reasonable belief that his or her action was in, or at least was not opposed to, the best interests of the trust.

2. Maryland Corporations

- a. Under a typical corporation's by-laws, any director who becomes involved as a party in, or was or is threatened to be made a party to, any claim, action, suit or proceeding, while in office or thereafter, by reason of the fact that he or she was or is a director, is required to be indemnified "to the fullest extent permitted by law" against all expenses (e.g., attorneys' fees, costs, fines, penalties, and amounts paid in satisfaction of judgments) reasonably incurred by the director in connection with such a proceeding and amounts incurred by the director in settlement of such a proceeding.
- b. Under the Maryland Code, unless limited by its charter, a Maryland corporation is required to indemnify a director who has been successful, on the merits or otherwise, in the defense of any proceeding to which the director is made a party by reason of his or her service as a director. A corporation is required to indemnify a director against all reasonable expenses (including attorneys' fees) incurred by the director in connection with the proceeding.

- c. In the event of a settlement, a director may not be indemnified unless there has been a determination that the director did not act with willful misfeasance, bad faith, gross negligence, or reckless disregard of his or her duties. The determination must be made by either (a) the court or other body approving the settlement; or (b) a majority of the nonparty directors, or an independent legal counsel in a written opinion, based on a review of readily available facts.
- d. The Maryland Code also provides that, unless ordered by a court, a Maryland corporation may not indemnify a director against
 - (1) Any judgment against the director in a shareholder derivative suit or an action initiated by the corporation itself, in which suit or action the director is adjudged to be liable to the corporation; or
 - (2) The expenses of any proceeding charging improper personal benefit to the director, whether or not the proceeding involves action in the director's official capacity, in which proceeding the director is adjudged to be liable on the basis that the director improperly received a personal benefit.

3. Delaware Statutory Trusts

- a. Under Delaware law, a trust has the power to indemnify and hold harmless any trustee from and against any and all claims and demands. Such indemnification may be expanded or restricted by the trust's governing instrument. The absence of a provision of indemnity in the trust's governing instrument, however, shall not be construed to deprive any trustee of any right to indemnity which is otherwise available under the laws.
- b. The declaration of trust of a Delaware statutory trust typically provides that a trustee shall be indemnified by the trust or the appropriate series to the fullest extent permitted by law against liability and against all expenses reasonably incurred or paid by him in connection with the defense of any proceeding in which he becomes involved by virtue of his being or having been a trustee and against amounts paid or incurred by him in a settlement. Such liability and expenses shall include, without limitation, attorney fees, costs, judgments, amounts paid in settlement, fines, penalties and other liabilities.

- c. The declaration of trust typically provides that a trustee shall not be indemnified if the court decides that the trustee is liable by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of his duties, or that the trustee has not acted in good faith in the reasonable belief that his action was in the best interest of the trust.
- d. In the event of a settlement, a trustee shall not be indemnified if there has been a determination by any of the following that the trustee engaged in willful misfeasance, bad faith, gross negligence or reckless disregard of his duties:
 - (1) The court or other body approving the settlement;
 - (2) At least a majority of the trustees who are neither interested persons of the trust nor parties to the matter; or
 - (3) Written opinion of independent legal counsel based on a review of readily available facts.

4. 1940 Act Limitations

The SEC considers indemnification of directors in certain contexts to be contrary to the provisions of the 1940 Act and the policy of the federal securities laws. The SEC staff has interpreted section 17(h) of the 1940 Act as a substantive restriction on an investment company's ability to indemnify its directors. The SEC staff has taken the position that an indemnification provision is generally acceptable under section 17(h), provided that

- a. It precludes indemnification for any liability arising from a director's willful misfeasance, bad faith, gross negligence, or reckless disregard of his or her duties; and
- b. It sets forth reasonable and fair means for determining whether indemnification is permissible.

Such means would include a reasonable determination, based on a review of the facts, that a director is entitled to indemnification by (i) a vote of a majority of a quorum of nonparty directors or (ii) independent legal counsel in a written opinion.

B. Advancement of Expenses

1. Corporation and Business Trust

An important issue for directors and trustees is whether a fund must pay a director's legal and other expenses prior to a settlement or judgment. In many cases, a director will not be able to carry on an adequate defense unless expenses are advanced.

- a. Because no judicial determination has been made, state law does not provide for mandatory advancement. However, investment companies can and generally do advance expenses. Advancement can also be a major benefit of insurance coverage.
- b. A fund's organizational documents typically will provide that the fund may advance a director his or her expenses to defend against an action, suit, or other proceeding. A director's or trustee's ability to obtain advancements is subject to board discretion. Prior to making an advance to a director or trustee, a fund must receive a written undertaking by or on behalf of the director or trustee to repay the amount if it is ultimately determined that the director or trustee is not entitled to indemnification.

2. 1940 Act Limitations

- a. The SEC staff has interpreted section 17(h) of the 1940 Act as a substantive restriction on an investment company's ability to advance expenses to its directors.
- b. The SEC staff has taken the position that an advancement provision is generally acceptable under section 17(h), provided that
 - (1) the director undertakes to repay the amount unless it is ultimately determined that he or she is entitled to indemnification (compare B.1.b. above; note that the presumption has been reversed); and
 - (2) at least one of the following additional conditions is satisfied:
 - (a) the director provides security for the undertaking;
 - (b) the investment company is insured against loss arising from unlawful advances; or

- (c) a majority of a quorum of nonparty directors, or an independent legal counsel in a written opinion, determines, based on a review of the readily available facts, that there is reason to believe that the director ultimately will be found entitled to indemnification.

C. Directors and Officers/Errors and Omissions Insurance

1. Description of Insurance

A fund may protect itself and its directors, officers and employees from certain liabilities and expenses arising from their acts or omissions in the conduct of their duties.

2. Provisions of Typical Policies

A typical policy includes the following provisions:

- a. Coverage for losses that a director becomes legally obligated to pay by reason of any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, or other act or omission committed in his capacity as director. The policies generally also insure against costs and expenses incurred by a director in the defense of any claim for which coverage is provided under the policy.
- b. Exclusions from coverage for any director whose personal dishonesty, fraudulent breach of trust, lack of good faith, or intention to deceive or defraud has finally been adjudicated and who fails to act prudently. The policies may also exclude losses incurred from (a) claims arising out of acts committed prior to the effective date of a fund; and (b) claims alleging that investments made or recommended by an insured are improper by reason of the fact that the insured (or an affiliate) is a market maker, sponsor, issuer, or underwriter.
- c. Provisions in the policy may also exclude losses incurred from claims (a) for personal injury, emotional distress, sickness, disease, or death, for physical damage to property, or arising out of libel or slander; (b) for obligations or responsibilities assumed by an insured under certain contracts; (c) for fines, penalties, or punitive or exemplary damages, except in jurisdictions where damages are

insurable; (d) caused by or contributed to by suspensions of payment by banks, brokers, or dealers, or based upon the insolvency of the fund; and (e) for an accounting of profits allegedly made by a director.

- d. These policies have typically excluded coverage for lawsuits between two insured parties, as a way of protecting the insurers against collusive lawsuits. In response to cases in which an investment adviser to a fund sued the fund's independent directors, the SEC amended Rule 17d-1(d)(7) to permit joint policies only where they provide coverage for such suits (see below). Even before the new rule, several major insurers had modified their policies to cover good faith suits between insured parties.

3. Rule 17d-1(d)(7) - Exemption from Prohibition Against Joint Transactions

Rule 17d-1(a) of the 1940 Act requires the filing of an application for exemption for any joint enterprise or arrangement between an investment company and any affiliated persons. Rule 17d-1(d)(7), which applies to directors and officers/errors and omissions insurance, exempts from this requirement any arrangement regarding liability insurance other than the fidelity bond required by Rule 17g-1, if:

- a. The investment company's participation in the joint liability insurance policy is in the best interests of the investment company;
- b. The proposed premium to be allocated to the investment company, based upon its proportionate share of the sum of premiums that would have been paid if such insurance coverage had been purchased separately by the parties, is fair and reasonable;
- c. The board of directors of the fund, including a majority of the disinterested directors, determines no less frequently than annually that the foregoing standards have been met; and
- d. The policy does not exclude coverage for good faith suits between the investment adviser and the fund's independent directors.
- e. The board of a fund must meet the independence requirements described in Section I.D.2. of this chapter if the fund intends to rely on this rule.

4. Limits on Insurance Coverage

Claims involving bad faith, willful misfeasance, gross negligence, or reckless disregard of duties of a director or officer generally are uninsurable as a matter of law and policy.

VI. CHANGING ROLE OF DIRECTORS

- A. **Limiting Responsibilities of Directors for Operational Matters.** In its 1992 Report on the 1940 Act, the SEC Staff concluded that:

“To the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.” Division of Investment Management, SEC, *Investment Company Governance, Protecting Investors: A Half Century of Investment Company Regulation* (1992), at 266.

B. **SEC Actions Against Independent Directors**

1. Background

- a. A review of federal administrative and case law has revealed that, since the SEC was established in 1934, the SEC apparently has taken formal action against independent directors in only a few public cases. Although plaintiffs in civil litigation routinely name independent directors, court decisions where independent directors were found by a judge or jury to have violated their fiduciary duties under the federal securities laws are extremely rare.
- b. There are three common elements present in the three earliest cases. First, the independent directors did not appear to be advised by independent counsel. Second, there were serious violations of the 1940 Act by an affiliated adviser or underwriter. Third, although the independent directors were aware of the violations, they neglected to take appropriate steps to protect shareholders or correct the violations.

2. SEC Actions Involving Independent Directors

- a. **Parnassus**
 - (1) In an administrative proceeding against independent trustees of an investment company, the SEC staff charged that they

failed to value a security in good faith. In re Parnassus Investments, Admin. Pro. File No. 3-9317 (1997).

- (2) The trustees of the fund, based on recommendations of its adviser, had valued a particular security at 34.4 cents per share for about two years. The valuation was lowered to 20 cents a share and later to 15 cents. Ultimately, it was sold for 27 cents per share.
- (3) In September 1998, an Administrative Law Judge (“ALJ”) held that the fund had overstated its NAV in violation of Rule 22c-1 under the Investment Company Act, and that the fund’s adviser and non-interested trustees aided and abetted the fund’s violation. He found that the adviser and the trustees did not use the appropriate “current sale” methodology to fair value the fund’s holdings in the issuer because they initially valued restricted securities at the same price as unrestricted securities and then later applied a 10 percent premium with no written documentation. As a result, the ALJ determined that they did not fair value the holdings in good faith within the meaning of Accounting Series Releases (“ASRs”) 113 and 118.
- (4) The ALJ refused to impose civil penalties against the fund’s adviser or the trustees. He held that their actions involved only violations of technical provisions, there was no harm to others or unjust enrichment and the respondents had never before been the subject of enforcement proceedings.

b. Monetta

- (1) In 2000, an SEC administrative law judge (“ALJ”) ruled that Russo, an independent Fund director, willfully violated the anti-fraud provisions of the 1933 and 1934 Acts when he knowingly accepted IPO allocations from the Funds’ investment adviser without disclosing this fact to the Funds and their investors. According to the ALJ, the existence of favorable treatment from the adviser in the director’s personal account and the failure to disclose created a serious conflict of interest. In the Matter of

Monetta Financial Services, Initial Decisions Release No. 162 (Mar. 27, 2000).

- (2) On further appeal, the Commission dismissed the charges against the independent director for evidentiary reasons. The Commission found insufficient evidence to support that the adviser had accorded any special treatment to the director. Since the director had participated in the transaction on the same terms as any person not affiliated with the Fund could have obtained in an arm's-length transaction, the director's failure to disclose the IPO allocations was not actionable. In the Matter of Monetta Financial Services, Securities Act Release No. 8239 (June 9, 2003).

c. Heartland

- (1) The SEC sought a cease-and-desist proceeding against four independent directors of Heartland Funds, alleging that they failed to adequately assure that portfolio bonds were priced at fair value, or to monitor and assure the bonds' liquidity. The SEC also alleged that the directors were a cause of the investment adviser's violation of Rule 22c-1(a) of the 1940 Act by permitting the adviser to sell, redeem and repurchase fund shares at a price not based on the Funds' current NAVs. In the Matter of Jon D. Hammes, Securities Act Release No. 8346 (Dec. 11, 2003).
- (2) The SEC held it appropriate to institute cease-and-desist proceedings against the directors. The SEC found that the directors had expressly undertaken the duties to adequately monitor the bonds' liquidity and that they had failed to discharge their responsibilities to participate meaningfully in the valuation of the funds. Specifically, the SEC stated that while mutual fund directors are permitted to delegate some responsibility for pricing a fund's securities to a separate pricing committee, each director retains responsibility in the valuation process and may not passively rely on securities valuation provided by such a committee. The directors thus failed in their obligation to take adequate steps to detect inaccuracies in the bonds' valuation provided by a third party pricing service and to follow up on such matter, when they were on notice of the problems with the valuation.
- (3) In addition, the SEC determined that the directors had failed to expressly instruct the adviser to correct the prices of the Funds' bonds, when they knew or should have known that those prices did

not reflect the bonds' fair value, and consequently knew or should have known that the adviser was violating Rule 22c-1(a).

d. **Settlement of SEC Administrative Action Against, Among Others, Trustees of Northern Lights Trusts Regarding Advisory Contract Approvals**

On May 2, 2013, the SEC issued an order initiating and settling an administrative action against: the board members of two Northern Lights registered investment companies (the "Trusts"), including the four independent board members; Gemini Fund Services, LLC ("GFS"), the Trusts' administrator; and Northern Lights Compliance Services, LLC, a GFS affiliate that provided chief compliance officer services to the Trusts. The SEC order noted that Northern Lights is a "turn-key" fund operation, in which a single five-member board was serving funds run by numerous separate advisers, and that the board had approved or renewed 113 advisory and 32 sub-advisory contracts over a two year period.

Among other findings, the Commission determined that these parties caused the Trusts to make untrue or misleading disclosures in public shareholder reports and in the minutes of board meetings relating to the factors considered and the conclusions reached by the board when approving or renewing investment advisory contracts. Examples of disclosures that the Commission found materially misleading included the following:

Example 1: Certain disclosures stated that the board had received and considered comparisons of advisory fees charged by comparable mutual funds, whereas, in fact, such peer group data was not provided to or considered by the board.

Example 2: Certain disclosures stated that the board, regarding a decision to renew an advisory contract, "reviewed the Fund's advisory fees and overall expenses compared to a peer group of similarly managed funds" and "concluded that the Fund's advisory fee and expense ratio were 'acceptable in light of the quality of the services the Fund expected to receive from the Adviser, and the level of fees paid by funds in the peer group.'" [Emphasis added.] The SEC concluded that these statements "were materially misleading since they implied that the fund was paying fees that were not materially higher than the middle of its peer group range when, in fact, the adviser's approved

fee was materially higher than all of the fees of the adviser's selected peer group of 17 funds and nearly double the peer group's mean fees."

The SEC appeared to go out of its way to hold board members responsible for this disclosure. The SEC found that the minutes of the meeting at which the foregoing actions occurred were materially misleading because they contained statements similar to those made in public disclosures. The SEC noted that these minutes were initially drafted by a paralegal, then reviewed by the Trusts' outside counsel, and finally approved by the board. The board members were thus considered to have caused the disclosure violations (and the record-keeping violations related to the underlying board minutes) because they were aware that the minutes, as the official record of the meetings, would form the basis for the public disclosures.

The SEC also determined that GFS, on ten occasions, failed to ensure that certain shareholder reports included any of the required disclosures relating to the Board's advisory contract evaluation process.

Finally, the SEC determined that the board members caused the Trusts to fail to abide by compliance policies and procedures adopted by the Trusts with respect to the approvals and renewals. Specifically, the SEC found that the board had relied on the chief compliance officer's representations that advisers' compliance programs were adequate instead of personally reviewing required materials or a summary of the program. As a result, the Commission concluded that the trustees had caused the funds to violate Rule 38a-1, which requires funds to adopt and implement policies and procedures reasonably designed to prevent violations of the federal securities laws.

As sanctions, the SEC (1) issued cease and desist orders against each respondent, (2) assessed a \$50,000 fine against GFS, and (3) accepted respondents' undertakings to retain a compliance consultant to review the relevant compliance activities, and to implement the consultants' recommendations, subject to limited exceptions.

e. **Settlement of SEC Administrative Proceeding Against Former Directors of the Morgan Keegan Funds Regarding Valuation Issues**

On June 13, 2013, the SEC issued its Order in the case captioned *In re J. Kenneth Alderman*, the administrative proceeding against the former

directors of certain investment companies managed and administered by Morgan Keegan & Co. Inc. and its affiliates. The respondents in *Alderman* settled the proceeding without admitting or denying any of the allegations or the statements in the Order, other than the Commission's jurisdiction. While the Order is directed toward the responsibilities of directors in connection with "fair valuation" of securities in fund portfolios, it contains a number of points that are significant for director liability and for fund governance generally. When read in tandem with the recent *Northern Lights* case (discussed above), it may also signal a new approach to enforcement using Rule 38a-1, the 1940 Act rule requiring funds to have policies and procedures "reasonably designed to prevent violation of the Federal Securities Laws," as a means to take action against independent directors in areas in which the 1940 Act has not historically imposed direct liability.

Alderman arises from events during a five-month period in 2007. The funds involved were both open- and closed-end fixed income funds holding significant numbers of mortgage- and asset-backed securities that had to be fair valued. While the Order does not mention it, this was a period of unprecedented turmoil in the market for these securities, and the pricing of mortgage-backed securities in general and subprime mortgage-backed securities in particular was exceptionally difficult.

The SEC found that during this period, the Funds did not have adequate written policies and procedures as to valuation, which the Commission found constituted a violation of Rule 38a-1. The Board did not perform the valuation process itself, but delegated responsibility to a valuation committee established by the adviser. The procedures directed the committee to perform valuations using factors identified in the Commission's seminal guidance on valuation. The board received reports from management and auditors, and reviewed a "back testing report" comparing actual sales, when they occurred, to the values previously used for the securities. The Order finds that these measures were not adequate.

Apparently building off the Investment Company Act section providing that "fair value" is to be determined "in good faith" by a fund's board of directors, the Commission appears to have adopted the staff's view that where a board delegates valuation authority, it must be pursuant to detailed and prescriptive valuation procedures setting out methodologies as part of the package of required fund compliance

procedures. (Note, however that the Order, coupled with other pronouncements from the Commission staff, certainly leaves open the ability of a board to approve the specific methodologies after the fact.)

Moreover, merely setting proper “methodologies” to be implemented by a valuation committee still may not be enough. The Order quotes an earlier case stating “[e]ach director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a [valuation] committee.” This statement, coupled with the Order’s seeming dismissal of the significance of input from outside experts and management, and the absence of any reference to the role of the chief compliance officer, suggests that even after setting “methodologies,” directors themselves must engage directly to some degree in a thoughtful review of the results, at least where a material portion of the portfolio is fair valued. The Order offers little guidance on what would be appropriate “methodologies,” other than stating that the general valuation factors identified by the Commission itself in prior pronouncements are not detailed or proscriptive enough. Nor does the Order provide specific guidance on the degree of involvement or oversight to be required of directors.

Given the attention and resources devoted to the case by the staff, the findings concerning the actual violations are quite limited. The directors were not found to have directly violated any provision of the federal securities laws. There is no finding that they breached their fiduciary duties to the Funds or acted intentionally, willfully or recklessly. There is also no finding that the directors did not act “in good faith.” Nor did the SEC find that the Funds’ net asset values were at any time materially misstated or that there were any false and misleading statements in any filings made by the Funds covering this period. The SEC found instead that the Funds’ NAVs were “inaccurate” during the period. The remedies did not include any bar or monetary sanctions. The only remedy is an order that the former independent directors, who have not been in the industry for over four years, cease and desist from committing or causing any future violations of Rule 38a-1, an otherwise unlikely occurrence under the circumstances.

These factors, and the Order’s omission of a number of facts tending to show the directors’ diligence during this difficult period, strongly suggest that this case was a “message” case, a vehicle for the Commission and its staff to put forth their views on valuation in a

manner that is otherwise free from the notice and comment provisions of standard rulemaking.

Given the open questions, it remains to be seen what effect the statements in *Alderman* may have on the Commission's repeatedly promised SEC valuation guidance, or indeed whether this will supersede further work on that release. The staff has been meeting with industry participants for the stated purpose of informing itself about valuation practices and the issues faced by boards in performing their responsibilities, but the Order seems to enshrine a view of director responsibility long held by certain staff members, and it may be difficult for any future guidance to differ from this view.

Alderman may be more significant for what it reveals about the Commission's view of director responsibilities generally, and its ability to pursue directors for a wide variety of regulatory failures. The Order reveals the SEC's willingness to use Rule 38a-1, which imposes obligations on *funds* to establish compliance programs, as a tool to hold *directors* responsible for what the Commission perceives as flaws in a fund's compliance with at least some aspects of the Investment Company Act. It should be noted, however, that the compliance matters at issue in *Alderman* touched rather directly on the substantive responsibilities of fund directors.

Perhaps more troubling, some in the industry are suggesting that a board's ability to have certain of its determinations protected by the exercise of its informed business judgment may now be in question. Decisions about the adequacy of compliance policies and procedures made in good faith in accordance with a board's duties of care and loyalty may not be enough to protect directors from liability if the Commission, with the benefit of hindsight, subsequently determines those procedures are defective, or even could be improved.

C. **Lawsuits Questioning the Independence of Non-Interested Directors**

1. Most corporations treat as "independent" any director who is not currently an officer, director or employee of that corporation.
2. The 1940 Act contains a stricter standard for who may be considered non-"interested," a defined term.
 - a. Securities of the Adviser. An individual with direct or beneficial interest in even one share of a security issued by the adviser

(including designations as trustee, executor or guardian of any estate holding such securities, ownership by a spouse or member of the trustee's household, or ownership as a beneficiary of a trust which owns the security) would be an interested director.

- b. Relationship with the Fund, Adviser or Distributor. An individual who is also an officer of the fund or an officer, director or employee of the adviser or distributor will be an interested director of the fund.
 - c. Family Members. An individual will be deemed to be an interested director if he or she is a member of the immediate family of an officer, director or employee of the adviser, the distributor, their affiliates or the fund. This covers a parent, child, spouse of a child, spouse, brother or sister, including step and adoptive relationships.
 - d. Broker-Dealer. An individual who is a director, officer or employee of any broker-dealer or who owns directly or indirectly 5 percent or more of the outstanding voting securities of any broker-dealer would be an interested director; provided, however, that such a director is independent if, for the previous six months, no fund in the complex, and no other account managed by the fund's adviser, has made use of that broker-dealer to execute trades, to effect principal transactions, or to sell fund shares. This may mean that a person affiliated with a rarely-used broker-dealer is interested at some times and independent at other times. Indirect affiliations, such as may occur when an individual is an officer of a company that has established a broker-dealer subsidiary, also may cause interested status and should be considered very carefully.
 - e. Business Relationships with the Adviser or Distributor. The SEC may deem a director to be interested if it finds that, during the fund's past two fiscal years, he or she has had a material business or professional relationship with the fund's adviser or distributor or any of their affiliates or has had such a relationship with the principal executive officers of the adviser, the distributor or the fund. Any such determination is forward-looking only; its effect is not retroactive.
3. A 1997 decision of a federal District Court for the Southern District of New York raised a serious issue with respect to the 1940 Act framework for independent directors. Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997) ("Strougo").

- a. The judge held that only one of the “non-interested” directors was independent for purposes of whether the plaintiff in a shareholder derivative suit was required to first make a demand to the fund’s board of directors before filing a complaint. The judge reached this conclusion because all of the directors but one also served on the boards of other related funds. Because of their relationships with the other funds in the complex, the judge held that demand would be futile.
 - b. The fund in this case added a new director who is not on any other Scudder fund board. The fund’s board then established a committee of the two “independent” directors not on any other board to consider a demand by the plaintiff. The committee issued a report recommending that the case be dismissed, and it was.
4. Since Strougo, no claim attacking director independence has been successful in fund litigation. Moreover, in 1998 and 1999, the state laws of Massachusetts, Maryland and Delaware were amended to specify that a fund director who was “disinterested” for purposes of the 1940 Act also would be considered as independent and disinterested for state corporate law purposes.

D. Best Practices for Fund Directors

1. Report of the ICI Advisory Group on Best Practices

- a. In March 1999, the Investment Company Institute established an Advisory Group to review and recommend best practices for maintaining and enhancing the independence and effectiveness of fund directors. The Advisory Group consisted of three independent directors and three interested directors. They met with more than 30 experts in corporate governance of mutual funds, including fund directors, attorneys, auditors, former SEC officials and independent consultants.
- b. The Advisory Group’s 1999 report contained 15 recommendations. Principal among these are:
 - (1) that at least two-thirds of the directors of each fund be independent of management;
 - (2) that former officers and directors of a fund’s investment adviser and principal underwriter not serve as independent

directors of a fund. (Under current law, they could be considered independent two years after terminating their association with the adviser and underwriter);

- (3) that independent directors be selected and nominated by the incumbent independent directors;
 - (4) that independent directors be the ones to establish the level of compensation for board service;
 - (5) that independent directors have access to independent counsel and other experts. (The Advisory Group believes that counsel to the directors can also serve as fund counsel without compromising its independence. However, any work that counsel does for the adviser or its affiliates should be considered carefully by the independent directors for its possible bearing on the question of counsel's independence);
 - (6) that boards establish Audit Committees composed entirely of independent directors, operating under a written charter; and
 - (7) that independent directors meet separately from management in connection with their consideration of the advisory and underwriting contracts, and otherwise as they deem appropriate.
- c. In 2003, the Advisory Group recommended two additional best practices:
- (1) Prohibiting "close family members" of employees of the fund, its adviser or principal underwriter from serving as independent directors; and
 - (2) Implementing audit committee requirements similar to those applicable to operating companies under Section 301 of the Sarbanes-Oxley Act.
- d. The Advisory Group's recommendations are not mandatory. However, it is recommended that the board of every fund, and especially the independent directors, consider the applicability of each of the 17 recommendations to its own situation, and document that it has done so. Some of the recommendations have been subsumed in

the SEC's rules on director independence, discussed in Section I.D., above.

2. Mutual Fund Directors Forum

The Mutual Fund Directors Forum ("MFDF"), launched in 2002, generally provides educational and outreach programs to independent directors. In 2004, the MFDF prepared a report titled "Best Practices and Practical Guidance for Mutual Fund Directors" in response to a request from then SEC Chairman William H. Donaldson. The report contains 32 recommendations covering five areas of mutual fund governance and operation.

3. Independent Directors Council

The Independent Directors Council ("IDC"), launched in 2004, is an ICI initiative that serves the mutual fund independent director community and consists of a group of independent fund directors from a wide spectrum of funds. The IDC has written various reports on topics, such as fair valuation, director oversight of multiple funds, board self-assessments, the independent chair requirements and soft dollars.

VII. THE NEW REGULATORY LANDSCAPE

A. Dodd-Frank Wall Street Reform and Consumer Protection Act

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act") is widely viewed as the most sweeping reform of financial regulation since the Great Depression. Because the mutual fund industry was not widely implicated in the recent financial crisis, little in the Act's 2,300 plus pages applies directly to registered investment companies, although several of its provisions have implications for the investment management industry generally. The Act also directs an unprecedented number of studies and reports to be performed by the SEC, the GAO and other federal agencies, certain of which will have direct impact on investment companies. In particular, the Act contains provisions for two special studies to be conducted on investors' financial literacy and mutual fund advertising. The Act directs the SEC to conduct a study of the financial literacy of retail investors, including to determine what information investors need and methods to increase transparency for expenses and conflicts of interest. The GAO is also directed to conduct a study on current marketing practices for the sale of open-end investment company shares, the impact of such advertising on consumers and recommendations (i) to improve investor protection in mutual fund advertising and (ii) as to additional information that could assist investors to make informed financial decisions when purchasing mutual funds shares.

B. SEC Emphasis on Enforcement

It now appears clear that SEC Chair Mary Jo White intends to place primary emphasis on the SEC's enforcement role as opposed to its regulatory mission, consistent with her background as a federal criminal prosecutor. Recently, she announced the SEC's intention, in certain enforcement cases, to make companies and individuals admit wrongdoing as a condition of settling civil charges, or be forced to go to trial. This is a departure from the SEC's longstanding policy of allowing companies and individuals to settle enforcement charges "without admitting or denying" liability. Chair White said that the new policy will be applied in "cases where . . . it's very important to have that public acknowledgment [of wrongdoing] and accountability." She further noted that decisions will be made on a case-by-case basis, but that the agency intends to target cases of egregious intentional conduct or widespread harm to investors.

In one of the SEC's first applications of this policy, an advisory firm and its principal agreed to a settlement with the SEC that includes an admission of wrongdoing. In the settlement papers, the principal admitted to multiple facts that the SEC characterized as having "harmed investors and interfered with the normal functioning of the securities markets," including improperly borrowing over \$113 million in fund assets to pay personal tax obligations at a time when the principal had barred fund investors from making redemptions. The defendants also admitted to providing favorable redemption and liquidity terms to certain fund investors at the expense of other investors and engineering a "short squeeze" to retaliate against a brokerage firm that had sold short a security in which his funds held a significant position.

On September 26, 2013, at the Council of Institutional Investors fall conference, Chair White also discussed the SEC's intention of pursuing responsible individuals, noting that there will be a shift from holding entities responsible first to holding individuals responsible first and then working out to the entity level. One possible remedy sought against individuals may be a bar from future employment in the securities industry. She added that "[r]edress for wrongdoing must never be seen as a 'cost of doing business' made good by cutting a corporate check."

Finally, in a speech on October 9, Chair White announced an enforcement philosophy for the SEC based on the "broken windows" policing approach developed in New York City. Under this approach, she suggested that the SEC may bring an increasing number of enforcement actions based on technical and even inadvertent violations of SEC rules as a means to deter more substantial

securities law violations and foster more stringent compliance cultures at regulated firms.