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A NATIONAL ASSOCIATION FOR INDEPENDENT DIRECTORS
OF INVESTMENT COMPANIES: A SUPPLEMENT TO
CURRENT SEC PROPOSALS

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Independent directors of investment companies have been an important focal point of Securities and Exchange Commission (the "SEC") scrutiny since 1990, when the SEC undertook a review of the Investment Company Act of 1940,¹ following fifty years of tremendous growth and structural changes in the investment company industry.² In its thorough, detailed report to the SEC, the Division of Investment Management made three recommendations concerning independent directors: 1) the minimum proportion of independent directors on investment company boards should be increased from 40% to a majority; 2) independent director vacancies should be filled by the remaining independent directors; and 3) independent directors should be given the authority to terminate advisory contracts.³ On October 14, 1999, the SEC proposed regulations⁴ to adopt two of the three recommendations which at the time of this writing are pending SEC approval.⁵ As the Division of Investment Management stated in *Protecting Investors*, "[W]e believe that the investment company governance system works best when the functions required of independent directors are performed by individuals who are truly independent. Measures that enhance the independence of independent directors, if they can be taken without undue expense, are consequently desirable."⁶ This arti-

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1. See 15 U.S.C. § 80a.

2. See *Protecting Investors: A Half-Century of Investment Company Regulation*, SEC Staff Report, Fed. Sec. L. Rep. (CCH), Report 1504, Extra Edition, May 29, 1992, at xvii, 251-289 (May 1, 1992) [hereinafter "Protecting Investors"].

3. See *id.* at xxix, 266-269.

4. See *Role of Independent Directors of Investment Companies*, Exchange Act Release No. 33-7754, 70 SEC Docket 1867, at 1868 (Oct. 14, 1999).

5. Since the SEC proposal to give independent directors authority to terminate advisory contracts requires an amendment to Section 15 of the Investment Company Act of 1940, the proposed regulations cited *supra* at note 2 do not address this proposal.

6. *Protecting Investors*, *supra* note 2, at 266.

cle sets forth a proposal to supplement the current pending SEC proposals to enhance the independence of directors without undue expense.

Over the last 20 years the SEC has increasingly come to rely upon independent directors of investment companies to monitor fund operations and exercise their judgment in conflict of interest situations.⁷ Since the number of SEC field auditors responsible for auditing investment companies and investment advisers is less than 400,⁸ and the number of investment companies and investment advisers is currently greater than 16,000,⁹ there is no practical alternative to relying upon, and enhancing the independence of independent directors in order to protect investors in investment companies.¹⁰ The SEC¹¹ and critics of current investment company governance¹² share the concern that independent directors may not be able to assert "genuine independence in addressing conflict of interest situations because of direct or indirect influence by the adviser."¹³

7. See Protecting Investors, *supra* note 2, at 267.

8. This calculation is based upon a telephone conversation with Gene Gohlke, SEC Office of Inspections and Examinations, on January 12, 2000 and data supplied by the SEC. It includes SEC field auditors in all regional branches, as well as the Washington, D.C. headquarters.

9. See INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 2000 i, at <http://www.ici.com>. This source lists 8,034 mutual funds and 496 closed-end funds as members of the Investment Company Institute. The SEC lists 7,792 registered investment advisers. Telephone Interview with Linda Schneider, Senior Counsel, Division of Investment Management of the SEC (Nov. 27, 2000).

10. The SEC could, of course, hire additional field auditors. However, the author of this article has been told that there are no present intentions at the SEC to hire additional auditors. See Protecting Investors, *supra* note 2, at 267, 285. A suggestion that the Division of Investment Management has carefully reviewed and rejected is the abolition of boards of directors for investment companies. The SEC also reviewed several other proposals, including the "unitary investment fund proposal," which would abolish fund boards of directors and substitute custodians or trustees. See *id.* at 282-288.

11. See *id.* at 267 n.65.

12. See *id.* nn.59-62 (citing Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2nd Sess. 491-95 (1962)); Tamar Frankel, *Money Market Funds*, 14 REV. SEC. REG. 913 (May 20, 1981); Victor Brudney, *The Independent Director - Heavenly City on Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Werner Renberg, *Sixth Men or Fifth Wheels; Do Mutual Fund Directors Earn Their Paychecks?*, BARRONS, Aug. 12, 1991, at M14. See also *Strougo v. Bassini*, 112 F. Supp. 2d 355 (S.D.N.Y. 2000); *Strougo v. Padegs*, 27 F. Supp. 2d 442 (S.D.N.Y. 1998); and *McLachlan v. Simon*, 31 F. Supp. 2d 731 (N.D. Cal 1998).

13. Protecting Investors, *supra* note 2, at 267 n.65.

An observer of the present dilemma facing the SEC and independent directors may gain a broader understanding of it by considering that there are currently an estimated 17,000 independent directors of registered investment companies in the U.S. and yet there is no professional or industry organization to protect independent directors' interests.¹⁴ Clearly, organizations are routinely formed to protect and enhance the interests of their group or constituency.¹⁵ Why, then, is there no such organization for independent directors or a national association for independent directors of investment companies? If a shared objective of the SEC and critics of current fund governance alike is to protect and enhance the "genuine independence" of independent directors, then a national association for independent directors of investment companies (the "NAID") should be dedicated to protecting independent directors so that they can better protect fund investors' interests.

Having suggested the need and purpose for a NAID, it may be worthwhile to consider how that organization could work, who would be its members and governing board, what its responsibilities would be, and how it could be established. A NAID could be established along the lines of current self-regulatory organizations, like the National Association of Securities Dealers.¹⁶ The NAID would have a charter setting forth its purpose to protect and enhance the independence of independent directors of investment companies. The charter would describe the internal organization of the NAID, including its governing board and standing committees. The NAID's membership would be comprised of all current independent directors of investment companies who elect to participate and attest in writing to their independence. A membership committee would be formed to review and decide challenges to attestations of independence. Over time, the materiality standards for determining "independence" would become clearer than they are today.¹⁷ All membership committee decisions would, of course, be subject to judicial review in accordance with standard administrative law procedures.

14. This estimate is based upon the approximate number of mutual funds, 8,500, times an average of two independent directors per fund.

15. See Group Theorists such as E.E. SCHATTSCHNEIDER, *The Semisovereign People: A Realist's View of Democracy in America* (Dryden Press 1975) and others.

16. See R.J. TEWELES & E.S. BRADLEY, *THE STOCK MARKET 195-99* (5th ed. 1987).

17. See 1 THOMAS P. LEMKE ET AL., *REGULATION OF INVESTMENT COMPANIES* § 6.03[1][6] (2000).

The NAID may also consider adopting a written qualifying examination for independent directors, administered every two years. The exam would assist the NAID membership in keeping informed about recent regulatory, statutory and case law developments concerning investment companies and their advisers.

The NAID could develop guidelines for independent directors on controversial topics, such as director compensation, retirement benefits and payments to directors for resigning from boards to accommodate fund mergers.

Not least of its functions would be the ongoing educative role the NAID would play both for independent directors and the investing public. This would include the preparation and dissemination of periodic information bulletins for independent directors, as well as the staffing of an "information bank" to provide the public with general information and to assist independent directors and their counsel with issues that require an informed understanding of conflict situations.¹⁸

The NAID could be authorized to litigate in those circumstances in which the independence of its members is challenged, or in instances where fund management ignores the authority of independent directors.

The NAID could maintain current lists of prospective new independent directors to assist those boards of directors who are searching for new members to fill vacancies. Prospective independent directors could be required to take written qualifying examinations that demonstrate a certain level of requisite knowledge about funds and financial markets, as well as a bona fide interest in funds as evidenced by preparing for and taking the qualifying examination. In addition, the NAID could provide boards seeking broader diversity of their current memberships with information about individual prospective independent directors' geographic location, prior business and professional affiliations, sex and ethnicity.

Initially, the governing board of the NAID could be appointed by the Chairman of the SEC. The initial governing board would serve its term through the drafting of the charter, the establishment of by-laws and standing committees, and the certification of its membership. After completion of these organizational responsibilities, the governing board would be charged with implementing procedures for the stag-

18. David Ruder, former chairman of the SEC, organized the mutual fund director's education council in 2000, which in part addresses this concern.

gered elections of new governing board members from the NAID's total membership, so that after a reasonable period of time the entire governing board of the NAID would be elected by its membership.

Financing for the NAID ideally should come from the U.S. Government, not the investment companies or their advisers. If financing came from advisers, the NAID could be held directly or indirectly accountable to the advisers, and thus impugn the independence of independent directors and the NAID. If legislation from Congress is not forthcoming, it is possible that the NAID could obtain financing directly from participating investment companies whose boards of directors decide to join the NAID's membership without obtaining review or approval from the investment advisers. This method of financing could then be scaled to the size of each investment companies' assets under management, as is the case with the Investment Company Institute, the national trade association for U.S. investment companies registered with the SEC. Regardless of how it is financed, the annual costs of operating the NAID would be an infinitesimal fraction of the current \$7 trillion of assets under management by investment companies.¹⁹

In the final analysis, this proposal for the formation of a national organization dedicated exclusively to the protection and enhancement of the independence of independent directors of investment companies is entirely consistent with the stated purposes of the SEC as set forth in its seminal analysis, *Protecting Investors*, and is consistent with the objectives of industry participants who have criticized the current governance of investment companies. Only if the foundation is laid for an increased measure of independence can we reasonably expect independent directors of investment companies to perform their important responsibilities to fund investors wisely and fairly.

19. See INVESTMENT COMPANY INSTITUTE, *supra* note 9, at i.

