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The Role of the Independent Counsel to Fund Boards

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Welcoming Remarks by
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Independent Counsel Roundtable
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Good morning. Isn't it great to be in Washington in July!

On behalf of the Investment Company Institute and the Independent Directors Council, I am pleased to welcome you to this second annual Independent Counsel Roundtable. When I suggested early last year that we organize a conference designed specifically for the lawyers who serve fund boards, we thought of it as one-time event. The success of the 2006 Roundtable made it clear, however, that we should make this a regular part of our calendar. We intend to do just that, and we are very grateful for your support and interest.

I want to express my gratitude to those distinguished members of the '40 Act Bar who serve on the Advisory Committee for this Roundtable; you'll see them listed in your program. And I extend my thanks to all the many members of the ICI and IDC staff who have worked on the conference, especially Lisa Hamman.

While this Roundtable primarily is intended for counsel to fund boards, I am pleased that we also have with us today numerous fund directors and management company representatives. That's important, because it helps assure a broad perspective on the issues we will be considering. As was the case last year, we hope the Roundtable will involve a lively give-and-take, and we encourage each of you to take an active part in the discussion.

As I was working on my remarks for today, a Google search produced an article published at the University of Chicago back in 1997. It was a profile of a Chicago law professor who was an expert in family law. The professor described a moment familiar to those in her field: A bewildered child, placed in foster care, meets an imposing adult. The adult says, "Hello, I'm your attorney" – and the child blurts out, "You're my what?"

Not a bad question – for either the lawyer or the client. Even clients with the sophistication of mutual fund directors may be tempted to ask you – “You’re my what?” What is an “independent counsel”? What can I expect of you – and what do you expect of me?

I want to address those questions briefly today – from three perspectives: first, the nature of your job as counsel to the independent directors on fund boards; second, the burgeoning responsibilities of your clients as fund directors; and third, the sensitive and complicated relationship that you bear to the mutual fund as an enterprise.

First, the nature of your role.

If a director bluntly asked, “You’re my what?” you probably would explain your duties in terms of advising members of the board on matters of law and regulation.

That is a very large part of the picture, of course, and especially so in an industry like ours. It is a truism – but nonetheless quite true – that no financial product is more comprehensively regulated than a mutual fund. Your work involves all the major federal securities laws, state corporate law, provisions of the Internal Revenue Code, ERISA, and much more – in short, a corpus juris of daunting range and complexity, one that grows larger each year.

But there is more to advising independent fund directors than this. In discussing the role of a lawyer as a counselor or advisor, the ABA Model Rules of Professional Conduct state that “[i]n rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client’s situation.”

What makes a being a counselor so professionally rewarding, and a good counselor so valued, is precisely this: there is more to it than the law, there are myriad additional considerations that may be relevant and even compelling, and sorting all these out is the very essence of good advice.

In this context, your client after all is a fiduciary – and therefore is held, as Justice Cardozo famously opined almost 80 years ago in Meinhard v. Salmon, “to something stricter than the morals of the marketplace” and “to a level higher than that trodden by the crowd.” The standard of behavior in this realm, he wrote, is “[n]ot honesty alone, but the punctilio of honor the most sensitive” and an “undivided loyalty.”

In our contemporary business culture, in the aftermath of the business scandals of recent years, a term like “honor” seems quaint. And let’s be candid, it is a term that may make many lawyers uncomfortable, when merely knowing what the law requires can be so difficult and the consequences of error so serious. But I tip my hat to Justice Cardozo – I think “honor” remains precisely the right word.

“Honor” comes down to us from the Latin noun honos, from which sprung honestas – a term denoting not mere “honesty” but “integrity” and “rectitude.” A deeper root yet may be the Latin onus or “burden” – as in the burden or weight of a moral obligation. It seems to me that is what Cardozo intended to convey – and it is the essence of the fiduciary relationship that both fund directors and fund advisers have to the shareholders they serve.

This understanding of what the law expects of your clients brings us back, inescapably, to the broadest dimension of the independent counsel’s role as adviser to the board. Yes, you must render independent, candid, and expert advice about matters of law. But that is not

the full story. As the commentary on the Model Rules notes, “advice couched in narrow legal terms may be of little value”; “moral and ethical considerations impinge on most legal questions and may decisively influence how the law is applied.” You must therefore be mindful of a wide range of other concerns as well – with a conscience disposed not to what is most expedient, but rather to what is fitting, fair, just and proper. You are expected to give advice on those questions, as well.

To be sure, that is not always an easy or welcome task. At times it may entail personal or professional costs. But I believe it is all a part of your position description as independent counsel.

Second, a word about your clients.

Those clients – the independent directors – need your counsel now more than ever, for their own jobs have grown immensely more difficult in recent years.

In its 1999 Report on Best Practices for Fund Directors, an ICI advisory group recommended that independent directors engage qualified investment company counsel who has no connection to the investment adviser or the fund’s other service providers. (As an aside, let me note that we were the first to formally advance this as a governance principle – and I predict it someday will migrate to corporate governance as well.)

In the ensuing years, directors have increasingly recognized that such representation is crucial to effective fund governance. As of the end of 2006, about 92 percent of fund complexes surveyed by ICI reported that their independent directors had the benefit of legal counsel separate from the fund adviser’s. More than half of those complexes reported that their independent directors had retained their own independent counsel.

Those percentages have grown over the years and likely will continue growing, because independent fund directors have a demanding job – and the demands on them only seem to increase. I do not need to recount the many new laws and regulations that confront today’s mutual funds. We can all agree that the predicted shelf life of an ABA Fund Directors Guidebook is short indeed! Nor need I dwell on the high expectations that the investing public has of fund boards and of our industry. The degree of regulatory accountability and the close scrutiny of our industry are not likely to change – nor should they.

But if directors are to perform their critically important role most effectively, they deserve not only expert counsel but also strong regulatory support. That is why I am pleased to see the SEC taking on a review of Rule 12b-1. I hope that, based on the input it received at its recent Roundtable, the Commission will review and update its guidance to fund boards. It should reconsider the standards applicable to 12b-1 plans, including such specific requirements as the need for quarterly review of 12b-1 fees.

I also am pleased that Investment Management Division Director Buddy Donohue and his staff are reaching out attentively to fund boards. Hopefully this process will identify other areas where the board’s role can be rationalized or streamlined to help assure that fund independent directors are as effective as possible, and able to apply their time and energy to the very best advantage of funds and their shareholders.

A third and final point, about the mutual fund enterprise itself.

Although the term is not used in the Investment Company Act, it seems the concept of “independence” has become the talisman of fund governance. This reflects a conventional wisdom that at the core of the mutual fund enterprise is a unique and debilitating conflict of

interest. For example, although every lawyer is held to “exercise independent professional judgment” under the canons of legal ethics, it was this conventional wisdom that gave birth in 2001 to unique regulatory requirements concerning the independence of lawyers that advise fund boards.

Is the conventional wisdom correct? Are mutual funds really so very different from other forms of economic activity? I doubt it.

Fund advisers have strong legal and economic incentives to uphold their fiduciary offices by delivering good investment results, providing a high level of service to their shareholders, and fulfilling their compliance obligations. Those who do not will soon find that the rigors of the marketplace are as great as those of the legal system – and often a lot swifter!

In principle, the conflict over fees – which fund boards work hard to moderate – is no different than that which exists in any other agency or trust relationship (between lawyers and their clients, for example). Indeed, this same conflict pervades our economic life. Sellers want to charge more; buyers want to pay less.

I have long thought that the conventional wisdom’s exclusive focus on conflicts of interest obscures an essential feature of mutual funds – the collaboration and shared purpose they necessarily involve. A successful fund enterprise critically depends upon two sets of fiduciaries – the adviser and the independent directors – communicating well and working closely together both to advance and safeguard the interests of the fund’s shareholders.

Let’s face it – the board alone, no matter what its composition, cannot by itself achieve the shareholders’ objective, which is to increase their wealth. Nor under our legal structure can the adviser, working alone, meet that goal. It takes two. In this model, “independence” may be a sensible rule of engagement, but surely it is not an end in itself.

As independent counsel for the board, you are a linchpin in this relationship. Facilitating an appropriate fiduciary partnership, advancing the purposes of the mutual fund enterprise – in my view, this too is a proper, indeed an essential role, of the independent counsel.

Thank you for your time and attention, and I hope you enjoy the conference.
