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Fund Governance: A Successful, Evolving Model

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IDC *Foundations for Fund Directors* Orientation Program
Dinner Remarks

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As prepared for delivery.

Good evening.

I hope you're all enjoying your dinner, and that you had a great day here. It's truly a pleasure for me to join you on this red-letter day for IDC—marking the inaugural session of its Foundations for Fund Directors orientation program. We hope there will be many more sessions to come.

For all those participating in this program, you can be certain you're building the knowledge and skills that make an effective independent fund director, and strengthening your commitment to your funds' shareholders. Thank you sincerely for that.

I want to quickly recognize some of the people who've had a hand in making this terrific program a reality. Big thanks:

- To the IDC, ICI, and KPMG staff who worked tirelessly over nearly a year to design the curriculum, build out the website and online modules, and handle the many associated administrative tasks.
- To our outside facilitators, John Capone of KPMG and JoAnn Strasser of ThompsonHine,

who are with us here tonight, and Chris Palmer of Goodwin Procter, who could not join us. These experts have so generously put aside their other professional obligations to help us with today's and tomorrow's activities.
- To the IDC working group of independent directors, which includes our in-house facilitators, Erik Sirri, Jon Zeschin, and Ralph Verni, the group's chair. We are especially grateful for Ralph's invaluable advice and expertise, countless volunteer hours, and belief in the program's benefits to the industry and millions of fund shareholders—all of which improved the program immeasurably.

Please join me in thanking everyone for their contributions.

You know, when Amy asked me to speak at this dinner tonight, I readily agreed.

The regulated fund industry's great success over more than three-quarters of a century is well known. So too are many of the contributing factors—like its robust regulatory framework, its constant innovation, and its wide range of inexpensive, highly diversified, professionally managed products.

But an equally crucial factor in the industry's success—its unique system of governance—is too often overlooked. So tonight, I thought I'd share a few thoughts about the complex history of fund governance and about where the role of fund directors stands today. This history was the subject of an article that Amy and I, with independent counsel Paulita Pike, published last year in the *Virginia Law & Business Review*.

As I see it, fund governance has evolved in three distinct stages—from inception, to growth, and into maturity. I will briefly describe each in turn.

The first stage began nearly a century ago—in the Roaring Twenties. You know that era for its post–World War I prosperity, but you might not know how big a role investment funds played in it.

Thanks largely to the soaring stock market, funds experienced tremendous growth, especially in the latter part of the decade. At the peak of their 1920s expansion, new funds were forming nearly every business day.

But though the young industry appeared to be thriving, the growth masked a litany of underlying abuses. It took the 1929 market crash and the ensuing Great Depression—disasters of epic proportions—to expose the industry's very troubled state.

Congress responded by directing the newly established SEC to study the industry. What the SEC found—including gross conflicts of interest and woeful governance—was shocking.

The study inspired Congress, the SEC, and the industry to work together on a detailed new statutory regime for funds. Ultimately, this collaboration produced the last pieces of New Deal legislation and what remains today the cornerstone of the modern fund industry—the Investment Company Act of 1940.

The '40 Act, as it came to be known, established an extraordinarily strict and highly detailed regulatory framework to protect fund shareholders. On the governance side, this framework included a requirement that at least 40 percent of directors on a fund board be independent—that is, unaffiliated with the fund's adviser or principal underwriter. The concept of "independent" directors who would act as a "check" on fund management was a remarkable innovation that would prove critically important to the industry's future

success.

With this new regulatory framework in place, the industry took off, launching a second stage in the evolution of fund governance. The next three decades would see explosive growth, which in turn would prompt close examination of the industry's economics and, ultimately, revisions to the '40 Act of great consequence for fund directors.

From 1940 to 1957, the industry grew from about $450 million in assets under management to about $8.7 billion, and from fewer than 300,000 shareholder accounts to more than 3 million.

This stunning expansion caught the attention of regulators and lawmakers, who would spend much of the next decade studying the industry, including the cost of fund investing and the state of industry competition. All this work pointed up the need to improve independent directors' ability to protect shareholder interests, especially with respect to the fees that funds pay to their advisers.

On the strength of these studies—and the wide-ranging public policy debate to which they gave rise—Congress in 1970 significantly amended the '40 Act. In three respects, these amendments would prove most influential in the further evolution of fund governance.

First, Congress narrowed the definition of "independence" for directors. Henceforward, independent directors had to be "disinterested" persons—a term that proscribed a much wider range of personal, business, or financial connections with the fund's adviser or the fund itself in order better to ensure the director's independence.

Second, the Act now required a fund's disinterested directors to request and evaluate—and the adviser to provide—the information that directors would need to assess the terms of the fund's contract with its adviser. This was intended to help position the directors to make an informed decision on whether to approve the contract, including the fees and expenses of the fund.

Finally, the Act established that fund advisers have a "fiduciary duty" with respect to the receipt of compensation from a fund. Congress authorized fund shareholders, in addition to the SEC, to sue advisers for breach of this duty through receipt of excessive compensation.

The 1970 amendments were landmark events for the fund industry and fund governance. The full implication of the amendments has taken many years to become clear—especially what constitutes a manager's fulfilling its fiduciary duty with respect to the receipt of compensation, and how fund boards can best fulfill their oversight role in this regard.

It was more than a decade later that the Second Circuit, in *Gartenberg v. Merrill Lynch Asset Management*, established an authoritative framework for assessing whether management fees, and a board's approval process, passed muster under the terms of the 1970 amendments. And it was 40 years before the US Supreme Court, in its 2010 decision in *Jones v. Harris*, affirmed the famous *Gartenberg* factors as the appropriate measure for evaluating excessive fee cases.

In sum, over decades now the federal judiciary has decided that the key area of inquiry in excessive fee cases would be the rigor and diligence exhibited by independent fund directors in fulfilling their statutory role. Courts have recognized that—where that kind of governance process is apparent—judges can and should defer to the decisions reached in good faith by a fund board.

Advisers have generally supported the added scrutiny from boards, recognizing that an informed, thorough, and conscientious board—led by its independent directors—is not only likely to be a good steward for fund shareholders, but also the best defense against an assault on management fees.

In the years following the 1970 amendments, the economics of fund investing have changed significantly because of many factors, not least board oversight of fund fees under the framework of the 1970 amendments. Equity and bond fund investors, for example, pay almost 40 percent less today than they did just two decades ago.

Years of further tremendous growth followed, cementing funds as major players in the capital markets and major vehicles for retirement savings. By the mid-1990s, US registered open-end fund assets had reached $2.8 trillion—more than 60 times the assets when the 1970 amendments were passed. The industry was evolving, too—developing new types of funds, entering new distribution channels, and reaching new segments of the investing public.

Against this backdrop of a maturing industry, a third stage of fund governance unfolded, with controversy and then major scandals prompting still further substantive reforms.

In the late 1990s, disputes between independent directors and advisers at several fund complexes led to unprecedented proxy battles that unseated independent directors and sparked large-scale shareholder redemptions. To me, a key lesson of the proxy battles was that when an adviser and a board fail to collaborate in advancing the interests of fund shareholders, everyone stands to lose.

In January 2001, the SEC moved to strengthen the hand of independent fund directors. Among other things, it mandated that:

- a majority of a fund’s board must consist of independent directors;
- independent directors must select and nominate new independent directors; and
- lawyers counseling independent directors must themselves be independent, as defined in SEC regulations.

Less than three years later, allegations of late-trading and market-timing abuses, first brought to light by Eliot Spitzer as New York’s attorney general, triggered an enforcement and regulatory response—and a degree of public concern—unlike anything the fund industry had seen in its history.

There followed a series of high-profile enforcement actions against a number of fund advisers, as well as brokers and hedge funds. Congress also held a series of hearings looking at ways to prevent the abuses from recurring. By the time the hearings had ended, two perceptions had hardened:

- first, that the SEC should have been aware of the abuses, and
- second, that independent directors might have caught the abuses earlier had they been more alert.

To address these perceptions, the SEC implemented landmark new rules for funds and their advisers at the end of 2003.

According to the Commission, “compliance failures [had] occurred when a fund service provider [had] denied information to the fund’s board, or [had] been less than forthright,

because the service provider viewed full disclosure as detrimental to its own interests."

The new rules therefore required funds to establish formal compliance programs and to appoint a chief compliance officer—or CCO—who would be responsible for regulatory compliance throughout the fund, and who would answer directly to the board. Boards were to oversee the adoption of the compliance programs, and to approve the appointment, compensation, and removal of the CCO. The SEC intended the CCO to be the "eyes and ears" of the board, to ensure that directors were no longer kept in the dark.

As for the funds implicated in the market-timing and late-trading scandals, independent directors on their boards by and large neither approved, nor were even aware, of any wrongdoing. Even so, many people, including some members of Congress, concluded that these funds' independent directors had failed their shareholders. And statements from the Commission left a distinct impression—one keenly felt by independent directors themselves—that boards should have done more to prevent the abuses.

As a result, in the following year, the SEC sought to ratchet up fund governance standards yet further, adopting rules that would require a supermajority of fund directors to be independent and that would specify that a fund board chair be an independent director. A federal court of appeals ultimately invalidated these new requirements, citing the SEC's failure to perform adequate cost-benefit analysis.

It is interesting that in the years since, most fund boards have gravitated to these very same practices. Today, more than eight in 10 fund boards have a supermajority of independent directors. Nine in 10 have designated independent director leadership, whether as board chair or lead director.

Together, the 2001 and 2004 reforms and evolving industry practices have promoted the independence, objectivity, and professionalism of the board as a mechanism for oversight of fund operations. They've also helped ensure that fund boards themselves devote sustained, ongoing attention to their performance.

You might be sensing a pattern here. In each of these three stages of fund governance, fund investing has grown more central to the financial system and the economy, and the regulatory focus on the industry and its independent directors has intensified.

So, with US regulated fund assets now exceeding $20 trillion—and with the growth showing no signs of abating—today's intense regulatory scrutiny should come as no surprise. Nor should the high expectations for independent directors, from policymakers and the investing public.

While those expectations are understandable, it is important not to lose sight of the sharp distinction between directors' oversight role, on the one hand, and advisers' day-to-day management responsibilities, on the other.

In theory, no one disputes that independent directors' proper role—the role where they are best-positioned to represent shareholder interests—is to oversee the work of fund management. But in practice, how regulators have interpreted that role in recent years strays from how directors view their job.

Nowhere is this more evident than in a pair of recent SEC rulemaking initiatives—one that reforms how funds manage liquidity risk, and another that redefines how funds can use derivatives. Both rulemakings call for strict oversight from fund boards, yet both assign

directors responsibilities that seem far better suited to fund management.

ICI is working closely with the new SEC leadership to reform major pieces of these rulemakings. But the unusual governance responsibilities that they impose tell me that we must broaden our efforts.

I know that the leadership of the IDC agrees that it's time for the SEC to reassess the types of responsibilities that fit with independent directors' conventional oversight role, and those that should be reserved for fund management. It's time for the Commission to reexamine all the responsibilities that have been imposed on fund boards over the years—to ensure that directors can focus on those areas where they add value.

For each responsibility imposed on boards, this review should include at least three questions:

- First, is the board responsibility meant to address issues that fall outside of boards' core oversight function of dealing with potential conflicts between the interests of the fund and those of the adviser?
- Second, are fund compliance programs already required to address the issue that the board responsibility was meant to address?
- And finally, does handling the responsibility require deep subject-matter expertise—expertise that is inconsistent with the common understanding of what an oversight role entails?

If the answer to any of these questions is "yes," then the responsibility should probably be imposed on fund management, not on fund boards.

The Commission should also use these criteria for evaluating possible board responsibilities in future rulemakings. Lest we forget, there's a lot at stake here.

Failure to draw the line between oversight and management correctly could set directors up for failure and expose them to greater liability. It could alter the composition and dynamic of fund boards in a way that would make them less effective, cohesive, and collegial. And it risks diverting their focus from the areas where they add the most value to shareholders.

This is all a lot to think about, I know. But the fact of the matter is, the industry is more complex—and serving on a fund board is more challenging—than it once was.

That's why it's so important for funds to continue attracting directors with resolve and conviction about the vital role they play on behalf of fund shareholders. That's why it's so important for boards to find and keep smart, talented directors who can dedicate the time and attention required of that role. And that's why it's critical that directors avail themselves of opportunities to learn about and discuss their role with their peers—as you all have.

Thank you for your time and attention—and, once again, thank you for participating in the *Foundations for Fund Directors* orientation program.

should not be considered a substitute for, legal advice.