FUND BOARD VIEWS

Viewpoints

The role of independent fund directors: 60 years ago and today

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Congress enacted the Investment Company Act of 1940 to address perceived abuses in the mutual fund industry, primarily resulting from overreaching by investment advisers and sponsors to the detriment of fund shareholders. At the time, the fund industry was tiny by today's standards: In 1941, there were some 141 registered mutual funds with assets of $440 million (about $89 billion in today's dollars); by the end of 1961—just after the 20th anniversary of the 1940 Act and a critical historical junction—those numbers had grown to 344 mutual funds, with assets of about $24.4 billion (about $250 billion in today's dollars).


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Relatively speaking, mutual fund assets in 1961 were still tiny compared to modern-day asset levels: As of Dec. 31, 2021, some 8,887 mutual funds had total net assets of $27 trillion, plus another $7.2 trillion in 2,690 exchange-traded funds. But in 1961, the Securities and Exchange Commission considered this "tremendous growth in the number and size of the mutual funds" that warranted the debut exercise of its investigative and reporting authority under Section 14(b) of the 1940 Act, an easily overlooked provision that authorizes the agency:

> … at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress.

What followed was a 595-page report, modestly called “A Study of Mutual Funds” and undertaken at the SEC’s direction by the Wharton School of Finance and Commerce.

The Wharton Report, as it became known upon its submission to Congress a year later in 1962, painted a dismal picture of fund governance. In dry but explosive language, the Wharton Report concluded that the independent director requirements for mutual funds “may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its adviser.”

Why did the Wharton Report reach this conclusion? Among other reasons, it found the definition of an “affiliated director” too narrow and referred to “accumulated evidence concerning … the typically minor role of the board of directors and independent directors in mutual fund affairs.” The Wharton Report also criticized the levels of investment advisory fees and asserted that advisers often did not share economies of scale with fund shareholders.

These findings led directly to important changes in the 1940 Act and, ultimately, helped reshape boardroom practices in ways big and small. Perhaps most significantly, these and other changes to the legal and regulatory landscape for funds drew in more qualified fund directors, who today exercise dramatically more robust and professional oversight of funds and their advisers.

Let us briefly explain how this happened.

The Wharton Report was followed by the SEC’s 1963 “Report of the Special Study of Securities Markets,” and another report, “The Implications of Investment Company Growth.” Collectively these three reports emphasized the themes we’ve highlighted: Advisers were not sharing economies of scale associated with industry growth at levels that the authors of the studies expected, and fund directors could have been more effective in the interests of shareholders. These findings were to lead Congress to amend the 1940 Act in 1970 in three important ways.

Director independence. The 1940 Act’s original independence standards allowed independent fund directors to own shares of the adviser’s stock or be related to an adviser’s executives. The 1970 amendments responded with clear limits on each of those kinds of affiliations; to be considered independent today, a fund director can no longer beneficially own even one share of the stock of a fund’s adviser or principal underwriter, nor can the director be an immediate family member of an affiliated person of the adviser.

Advisory agreement approval. To more fully engage the independent directors, Congress amended Section 15 to require fund directors to “request and evaluate” information “as may reasonably be necessary to evaluate the terms” of advisory contracts. It also added a requirement for advisers to provide this information to the directors. At the same time, Congress required that a majority of the independent directors annually approve the agreements at an in-person meeting called for that purpose. Thus, the Wharton Report led in a straight line to both the adoption of Section 15(c) and the development of the “Section 15(c) process”—among the most important statutory responsibilities of fund directors—and the addition of the in-person annual review requirement.

Fiduciary duty of advisers. Perhaps the most controversial change to the 1940 Act was the addition of Section 36(b), which deems investment advisers to have a fiduciary duty with respect to compensation that the fund pays to the adviser or its affiliates and provides for enforcement of that fiduciary duty by both the SEC and private plaintiffs. Prior to 1970, the SEC had the power only to sue an adviser for “gross misconduct or gross abuse of trust” with respect to the compensation a fund or its shareholders paid to the adviser and to seek only injunctive (“cease and desist”) relief, while fund shareholders could sue only under state law and only under a theory of “corporate waste,” a high bar.

The 1970 amendments created a private right of action under Section 36(b), giving rise to today’s “excessive fee” cases. And a dozen years later, in 1982, the Second Circuit Court of Appeals decided *Gartenberg v. Merrill Lynch Asset Management*. This seminal case, known to every investment company director, established the “*Gartenberg*” benchmark used to determine whether an adviser has breached its fiduciary duty under Section 36(b) with respect to receipt of fees. That is, for an adviser to violate its Section 36(b) fiduciary duty, the fee must be “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.”

So, we fast forward to present day.

For more than half a century, funds and their shareholders have benefitted from enhanced protections of the 1940 Act, including tighter director independence standards and specific process requirements for the annual review and approval of advisory agreements. Meanwhile, fund advisers have endured decades of private litigation alleging that funds paid them excessive fees. During the 40-plus years since the Second Circuit Court of Appeals decision, the litigation has proceeded under the *Gartenberg* standard, which the U.S. Supreme Court made the law of the land when it decided the seminal case of *Jones v. Harris*.

In the 60 years that followed the Wharton Report, fund boardroom culture has evolved dramatically. Fund directors have become more educated, informed and inquisitive, they are better advised and supported by independent counsel and, yes, they are more independent in both name and fact. This evolution is attributable, at least in part, to the collective impact of the Wharton Report, the SEC reports that quickly followed, the 1970 amendments, and enduring shifts in the broader corporate governance landscape.

Bottom line: The 1940 Act and today’s robust boardroom culture owe much to what is now a mostly forgotten academic study undertaken 60 years ago pursuant to an obscure provision in the statute—indeed, a reminder that history is always an important guide to understanding the present.

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