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Comments on Martin Lybecker's Enhanced Corporate Governance

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COMMENTS ON MARTIN LYBECKER'S *ENHANCED CORPORATE GOVERNANCE*

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Martin Lybecker's article, *Enhanced Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*,[1] raises significant issues regarding the Securities and Exchange Commission's ("Commission" or "SEC") exercise of its exemptive authority. Under that authority, the Commission amended a number of exemptive rules under the Investment Company Act of 1940 ("'40 Act") to require that mutual funds relying on those rules conform to enumerated governance practices ("fund governance reforms").[2] Lybecker argues that the fund governance reforms deserve serious reconsideration primarily because, in his opinion, they (1) were unauthorized, (2) were not adequately justified, and (3) will be of "questionable efficacy."[3]

To the contrary, the Commission has ample authority to adopt the fund governance reforms, and the recent mutual fund scandal provided more than adequate justification for them. The Commission has broad exemptive authority under the '40 Act, and the incorporation of

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∗ Assistant Professor of Law, University of Mississippi School of Law. This author has interests in the issues discussed in this article in a variety of current and former capacities. Neither these comments nor Lybecker's article have been updated to reflect developments in litigation concerning the independent governance rules discussed herein. In June 2005, the D.C. Circuit found that the SEC had acted within its authority to adopt the rules but had violated the Administrative Procedures Act by not adequately considering (1) the costs of complying with the governance rules and (2) disclosure requirements as an alternative to the rules, Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005). The SEC reconsidered the proposal in light of these concerns and decided not to amend the rules. *See* Investment Company Governance, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (July 7, 2005). The court subsequently denied a petition for rehearing on its finding that the SEC had acted within its authority, 2005 U.S. App. Lexis 19602 (Sep. 9, 2005), but granted a stay of the January 2006 compliance date. On April 7, 2006, the court vacated the governance rules on the ground that the Commission had not adequately considered their cost, but withheld the issuance of the mandate for ninety days to afford the Commission an opportunity to reopen the record for comment. The Commission had not acted on the court's decision as of this writing.

1. Martin Lybecker, *Enhanced Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045 (2005).

2. The amendments generally require the following: (1) an independent chairman; (2) a seventy-five percent independent board; (3) an annual self-assessment by the board; (4) quarterly meetings of independent directors; and (5) authority for the independent directors to hire their own staff. *See* Investment Company Governance, Investment Company Act Release No. 26,323, 69 Fed. Reg. 3472 (proposed Jan. 23, 2004) [hereinafter Governance Proposing Release]. *See also* Investment Company Governance, Investment Company Act Release No. 26,250, 69 Fed. Reg. 46,378 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270) [hereinafter Governance Adopting Release].

3. Lybecker, *supra* note 1, at 1081, 1084, 1085.

governance conditions into rules adopted under that authority mirrors the way in which Congress has used governance requirements in the Act.[4] Both Congress and the Commission have long used governance requirements to protect investors, generally for the purpose of monitoring and managing conflicts of interest between funds and their sponsors. The recent mutual fund scandal confirmed the risks to shareholders presented by these conflicts of interest and accordingly provided more than adequate justification for strengthening the governance conditions in the exemptive rules.

Whereas Lybecker is unpersuasive regarding the lack of authority and justification for the fund governance reforms, he may be correct that their efficacy is questionable. He essentially argues that the reforms will fail because independent directors lack the ability to serve in the watchdog capacity that the exemptive rules assign to them. It is hard to know the answer to the efficacy question, however, not only because it is inherently predictive, but also because the Commission has never explained exactly what it expects independent directors to do in the context of the exemptive rules.

Indeed, Lybecker's argument is partly that the Commission has failed to make the case as to its authority or the justification or efficacy of the reforms. The relevant proposing and adopting releases appear to base the fund governance reforms more on a general disagreement with Congress's decisions—for example, not to require an independent fund chairman and to require only a forty percent independent board—than on the view that the reforms are necessary to protect investors specifically in the context of the exemptive rules into which the reforms have been incorporated.[5] There is no evidence that the Commission knows whether the independent directors have been effective in the context of the operation of the exemptive rules in the past, or that it has any way of measuring their effectiveness in the future. The problem may be more serious, as there also is no evidence that the Commission knows if the exemptive rules themselves have been effective in protecting investors. Perhaps it is not the fund governance reforms alone that deserve serious reconsideration, but also the authority, justification and efficacy of the exemptive rules themselves.

4. *See* discussion *infra* notes 6–15.

5. *See* 17 C.F.R. §§ 270.10f-3, 270.12b-1, 270.15a-4, 270.17a-7, 270.17a-8, 270.17d-1, 270.17e-1, 270.17g-1, 270.18f-3, 270.23c-3.

ENHANCED CORPORATE GOVERNANCE: AUTHORITY?

The Commission based its authority to enact the reforms on its authority to grant exemptions from and adopt rules under the '40 Act.[6] These exemptions permit funds and their affiliates to engage in practices that would otherwise be prohibited under the Act. With the power to grant exemptions goes the power to impose conditions (such as the reforms) on the exemptions. Lybecker argues that the fund governance reforms are extralegal because the Commission used its exemptive authority as a convenient vehicle to accomplish unrelated goals.[7]

The SEC's authority to impose governance conditions in exemptive rules has a strong foundation. From its inception, the federal regulation of mutual funds has intruded upon state control over corporate governance matters, in many cases specifically with respect to the role of fund boards and independent directors. Lybecker asserts that "Congress was very respectful of state law when it passed and subsequently amended the Investment Company Act,"[8] but Professor Langevoort's comment that "much of the '40 Act rests on a repudiation of the traditional protections of state law" is more accurate.[9] That fund governance is a federal interest is well established.

In a number of provisions of the '40 Act, Congress has carefully tailored governance requirements to the particular circumstances. The Act's default rule is that at least forty percent of a fund's board must be independent,[10] but this minimum is raised or lowered depending on the situation. Congress raised the minimum to seventy-five percent for three years following the assignment of the advisory contract, when it believed investor protection concerns were heightened.[11] It deemed only one independent director to be sufficient, however, for no-load funds with an advisory fee of less than one percent and, among other things, only one class of securities outstanding.[12] Congress required approval by independent directors in certain circumstances, such as for the approval of the advisory contract.[13]

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6. *See*, *e.g.*, 15 U.S.C. §§ 80a-6(c), 80a-12(b) (2000).
7. Lybecker, *supra* note 1, at 1060.
8. *Id.* at 1083.
9. Donald Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005).
10. *See* 15 U.S.C. § 80a-10(a) (2005).
11. *Id.* § 80a-15(f)(1)(A).
12. *Id.* § 80a-10(d).
13. *Id.* § 80a-15(c).

Congress also provided a mechanism whereby the '40 Act's prohibitions could be relaxed as circumstances warranted. It granted the Commission broad authority to exempt any person or transaction from the Act "consistent with the protection of investors and the purposes fairly intended by . . . [the Act],"[14] and granted the Commission rulemaking authority in a number of substantive provisions of the Act.[15]

The Commission has adopted dozens of rules and granted thousands of individual exemptions under these grants of authority, many of which include fund governance conditions.[16] Each rule and exemption permits an activity that the '40 Act otherwise would prohibit; each governance condition is accordingly designed (justifiably or not) to ensure that the exemption is "consistent with the protection of investors and the purposes fairly intended . . . [by the Act]."[17] The SEC's use of the governance conditions in these rules and exemptions mirrors Congress's tailoring of the Act's governance provisions to the particular circumstances. Lybecker argues, in effect, that the Commission lacks the authority to include governance conditions in exemptions for the protection of investors, notwithstanding that Congress itself used governance conditions for precisely the same reason.

Congress's grant of broad authority to the Commission to repeal statutory prohibitions logically must include similarly broad authority to decide when additional governance measures are necessary to protect investors. This is precisely the kind of determination Congress made repeatedly in the Act. If there is a genuine issue as to the SEC's authority, it is whether the Commission has the authority to grant an exemption without requiring, for example, that the fund's chairman be independent if it believed that an independent chairman was necessary for the protection of investors.

ENHANCED CORPORATE GOVERNANCE: JUSTIFICATION?

The fact that the Commission has the authority to adopt the fund governance reforms does not tell us whether the conditions are justified. Lybecker generally argues that the reforms were not justified because there was not "a one-to-one relationship between the justifications for the [fund governance reforms] and the principal features of the scandals in

14. *Id.* § 80a-6(c).
15. *See, e.g.*, *id.* §§ 80a-10(f), 80a-12(b), 80a-17(d).
16. *See, e.g.*, 17 C.F.R. §§ 270.10f-3, 270.12b-1(b), 270.17d-1 (2005).
17. 15 U.S.C. § 80a-6(c) (2005).

2003–2004."[18] There are actually other circumstances, in addition to the mutual fund scandal, that justified fund governance reforms,[19] but only the scandal needs to be addressed here because it, by itself, provided sufficient justification for the reforms.

There was, in fact, a "one-to-one relationship" between the reforms and the scandal. The abuses underlying the mutual fund scandal resulted from conduct for which fund directors, and particularly independent fund directors and non-independent chairmen, had direct or indirect responsibility. In some cases, non-independent fund chairmen directly participated in or facilitated the abuses.[20] The governance reforms are a direct response to demonstrated boardroom failures that involve the very conflicts of interest that Congress and the Commission have long looked to independent directors to monitor and manage.

One abuse underlying the mutual fund scandal was pricing arbitrage, which occurs when a fund undervalues its portfolio and attentive arbitrageurs purchase fund shares at a discount to their market value.[21] Pricing arbitrage harms non-arbitrageur shareholders because it dilutes their interests in the fund, with the amount of their losses providing the arbitrageurs' profits. The undervaluing of fund portfolio securities often occurs when market quotations for the securities are not readily available, in which case the securities must be fair-valued in good faith "by the board of directors."[22] The failure of fund directors to ensure that their funds' securities were properly fair-valued was directly responsible for pricing arbitrage opportunities.[23]

Lybecker argues that directors' fair valuation responsibilities are too complex, requiring an "understanding [of] the nuances of stock prices in a

18. Lybecker, *supra* note 1, at 1084.

19. For example, Lybecker discusses two other circumstances: revenue sharing and directed brokerage. *Id*. at 1084–85.

20. *See, e.g.*, Strong Capital Mgmt., Inc., Admin. Proc. File No. 3-11498 ¶ 3 (May 20, 2004), http://www.sec.gov/litigation/admin/34-49741.htm (settlement with non-independent chairman of mutual fund complex); *see generally* Letter from Michael Oxley, Chairman, Committee on Financial Services, House of Representatives, to William Donaldson, Chairman, Securities and Exchange Commission (May 20, 2004), http://financialservices.house.gov/media/pdf/ic.pdf.

21. For a detailed discussion of the mutual fund scandal and the mechanics of fund arbitrage, see Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271 (2006).

22. 15 U.S.C. § 80a-2(a)(41)(B)(ii) (2005).

23. *See* Bullard, *supra* note 21, at 1285–87, 1288. Although the scandal involved another form of arbitrage known as late trading, this author generally would agree that fund directors' failure to detect and prevent late trading probably would not alone justify the fund governance reforms. Late trading, unlike pricing arbitrage, was not a problem that had been well-known in the industry, *see generally id.* Lybecker is correct that it generally would be unreasonable to hold fund directors directly responsible for "rooting out a determined late trader." Lybecker, *supra* note 1, at 1085.

country facing a natural disaster that has imposed restrictions on repatriating profits."[24] Admittedly, such a situation may pose a challenging task for a board (although it is not clear why this should excuse a violation of a legal duty), but it has nothing to do with the scandal. Arbitrageurs did not exploit stale prices resulting from "natural disasters" or "restrictions on repatriating profits," which occur infrequently and could not sustain a profitable, systematic arbitrage strategy. Rather, pricing arbitrage was based on knowledge of commonplace events, such as a rise in the value of the S&P 500 index.[25] Arbitrage opportunities had been well-documented in the academic literature and financial media for years,[26] and directors of funds in fund complexes that were untouched by the scandal, such as Vanguard, Fidelity and T. Rowe Price, were able to implement fair value procedures with success.

A second scandal-related justification for the fund governance reforms is the funds' violations of their own frequent trading policies.[27] Funds often permitted pricing arbitrageurs to trade fund shares more frequently than permitted by the funds' prospectuses. Fund directors, like directors of other entities that sell their securities publicly, are responsible for the accuracy of the prospectus. One should reasonably expect that fund directors will take steps to ensure that the fund manager is operating the fund consistent with the terms of the prospectus, including the pricing of the fund's portfolio securities and trading of fund shares. If a fund limits frequent trading, the board should have procedures designed to determine whether frequent trading is occurring in violation of the fund's policy.

Lybecker argues that limiting frequent trading was not possible because only intermediaries—such as 401(k) plan administrators, broker-dealers, and variable annuity providers—had access to records of many shareholder transactions; therefore, fund directors "could not" obtain information about shareholders' transactions.[28] If this were true, it would still beg the question of why directors authorized disclosures containing false statements of the funds' frequent trading policies. But funds could, in fact, obtain information about shareholders' transactions simply by limiting the sale of fund shares to those intermediaries who agreed to provide such information to the funds. Granted, funds may choose not to

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24. Lybecker, *supra* note 1, at 1085.
25. *See* Bullard, *supra* note 21, at 1285–90.
26. *See id.* at 1288–89.
27. *See generally* Bullard, *supra* note 21.
28. Lybecker, *supra* note 1, at 1089.

take this action because they lack the market power to do so,[29] but market exigencies do not excuse knowing prospectus violations.

In addition to the mutual fund scandal of 2003–2004, the contemporaneous breakpoint scandal also justified the fund governance reforms.[30] Mutual funds frequently offer discounts on sales commissions that are based on volume or other factors, which are known as "breakpoints." Joint SEC/NYSE/NASD inspections conducted between November 2002 and January 2003 of forty-three broker-dealers found that they overcharged investors on commissions in thirty-two percent of transactions that were eligible for a discount.[31] Breakpoint schedules, like frequent trading policies, are disclosed in fund prospectuses, and fund directors accordingly are obligated to take reasonable steps to ensure that shareholders receive breakpoints as promised in the prospectus.

Fund directors' lapses involving pricing arbitrage, frequent trading and breakpoints provided more than adequate justification for the fund governance reforms, especially with respect to the role of independent directors. The primary role of independent directors is to provide a check on conflicts of interest between funds and their sponsors, and the conduct underlying the scandal arose largely as a result of this conflict of interest. Fund managers permitted, and even encouraged, arbitrageurs and frequent trading because the managers received side payments, such as fees paid on additional investments by arbitrageurs in the managers' hedge funds. Breakpoint overcharges inured to the benefit of fund distributors. The fund governance reforms are intended to counteract the demonstrated willingness of conflicted fund affiliates to exploit fund shareholders.

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29. *See generally* Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328, at 13,328 (Mar. 18, 2005) (to be codified 17 C.F.R. pt. 270) ("The competitive pressure of marketing funds, especially smaller funds, coupled with the costs of imposing redemption fees in omnibus accounts, may deter some funds from imposing redemption fees. Intermediaries may use their market power to prevent funds from applying the fees, or to provide incentives for fund groups to waive fees.").

30. Alternatively, this author disagrees with Lybecker's contention that conduct involving revenue sharing and directed brokerage were part of the scandal or part of the asserted justification for the governance reforms. Lybecker, *supra* note 1, at 1084–85.

31. Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (Mar. 2003), http://www.sec.gov/news/studies/breakpointrep.htm.

ENHANCED CORPORATE GOVERNANCE: EFFICACY?

Lybecker argues that, even if the fund governance reforms were authorized and justified, it "strains credulity to believe that [the governance reforms] can produce an effective compliance program that is more than a shadowy substitute for and incomplete accessory to [the SEC's staff]."[32] He describes fund directors as superficially competent part-timers who rely heavily on their legal counsel and the fund manager "to bring important matters to their attention."[33] Accordingly, the fund governance reforms reflect an ill-advised attempt to change the "dynamics" of the boardroom by strengthening the hand of the independent directors.[34]

It is not clear how Lybecker's argument is different from the argument that independent fund directors serve no purpose at all. Either they can provide an effective check on conflicts between the fund and its affiliates or they cannot. If they can, it is reasonable to assume that the more authority they have, the more effectively they can play this role. Lybecker's efficacy argument assumes that independent directors simply cannot serve in this capacity, without explaining why.

A more interesting question is whether independent directors *do*, in fact, serve effectively as watchdogs. One might argue that while independent directors can be effective watchdogs, the mutual fund scandal was the best evidence that in practice they are not effective watchdogs. If the justification for the fund governance reforms is that recent abuses reflect independent directors' failure to fulfill existing responsibilities, why will requiring more of them and/or granting them more authority improve fund oversight?[35] Or more specifically, why will these reforms provide better protection to shareholders in the context of the exemptive rules?

Lybecker does not answer these questions, but he probably would agree that, assuming that independent directors had the capacity to be effective watchdogs, they need more guidance to do so. The administrative history of the exemptive rules provides little guidance as to exactly what

32. Lybecker, *supra* note 1, at 1086.
33. *Id.*
34. *Id*.
35. *See* U.S. SEC. & EXCHANGE COMMISSION, EXEMPTIVE RULE AMENDMENT OF 2004*:* THE INDEPENDENT CHAIR COMMISSION, at 51 (Apr. 2005), http://www.sec.gov/news/studies/indchair.pdf [hereinafter INDEPENDENT CHAIR REPORT] ("The Commission determined that the breakdowns in fund management and compliance controls raised troubling questions about the ability of many fund boards more generally to effectively oversee the management of funds.").

the Commission expects directors to do to protect shareholders. For that matter, the Commission has provided no guidance as to what it expected independent directors to have done to prevent the abuses underlying the mutual fund scandal. Nor has any independent director been charged with violating the securities laws in connection with the scandal. In many discussions with fund directors, the most frequent complaint that this author hears is that the Commission does not give them sufficient guidance.

One way to provide more guidance for fund directors would be to create a self-regulatory organization for mutual funds, as discussed in Professor Seligman's article in this issue.[36] The lack of guidance for directors was also the primary impetus for this author's proposal to create a Mutual Fund Oversight Board that would be responsible for (and only for) establishing uniform minimum standards for fund governance.[37] The Commission could perform this function, but recent events support the view that it lacks the flexibility to ensure that such standards are kept current.[38] Despite widespread and longstanding evidence of stale pricing by mutual funds,[39] the Commission allowed the problem to grow unchecked until the office of the New York Attorney General initiated its investigation.

Surprisingly, Lybecker does not address the most vociferous attack on the efficacy of the fund governance reforms. Members of Congress, SEC Commissioners and certain industry representatives have asserted that the reforms would cause reduced investment performance and increased expenses.[40] That the Commission ignored empirical evidence supporting this contention has been a centerpiece of the Chamber of Commerce's

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36. *See* Joel Seligman, *Should Investment Companies Be Subject To A New Statutory Self-Regulatory Organization?* 83 WASH. U. L.Q. 1115 (2005).

37. *See Review of Mutual Fund Industry Investigations: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 2 (2004) (statement of Mercer Bullard, President and Founder, Fund Democracy, Inc.); *see generally* Patrick McGeehan, *With Critics at the Door, Funds Propose Cleaning Own House*, N.Y. TIMES, Oct. 31, 2003, at C1. A bill proposed by Senator John Kerry would have created a Mutual Oversight Board, *see* Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201 (2003). Two other Senate bills would have required that the Commission study the proposal. *See* Mutual Fund Investor Confidence Restoration Act of 2003, S. 1971, 108th Cong. § 401 (2003); Mutual Fund Transparency Act of 2003, S. 1822, 108th Cong. § 3(e) (2003).

38. U.S. GOV'T ACCOUNTABILITY OFFICE, MUTUAL FUND TRADING ABUSES: LESSONS CAN BE LEARNED FROM SEC NOT HAVING DETECTED VIOLATIONS AT AN EARLIER STAGE, GAO-05-313 (Apr. 2005).

39. *See id*. at 16; Bullard, *supra* note 21, at 1288–90.

40. *See, e.g.*, Governance Adopting Release, *supra* note 2 (Commissioners Cynthia A. Glassman & Paul S. Atkins dissenting); *see also* Edward Johnson, '*Interested'—and Proud of It!*, WALL ST. J., Feb. 17, 2004, at A20.

challenge to the reforms.[41] After the Commission rejected an industry study that purported to prove this effect,[42] Congress required that the Commission revisit this question,[43] and the Commission again found that there was no evidence that such a causal relationship existed.[44]

The problem with the debate about the effect of the reforms on fund performance and fees is that the efficacy of the reforms is not primarily a function of their effect on performance or fees, but rather on fund directors' effectiveness in protecting investors in the context of the exemptive rules. The question of whether the reforms will cause higher fees and/or lower performance is thus a secondary factor. Even if such a causal relationship could be proved, one would still have to determine whether the cost in fees/performance outweighed the benefit of enhanced investor protection.

THE SEC'S RECORD ON AUTHORITY, JUSTIFICATION AND EFFICACY

The foregoing discusses the authority, justification and efficacy issues as an objective matter, but Lybecker's argument is as much that the SEC failed to make its case on these issues as it is about each issue's intrinsic merits. Indeed, there is a real possibility that the U.S. Court of Appeals may agree and vacate the rule amendments on this basis.

One would expect the relevant proposing and adopting releases to discuss the role of independent directors in the operation of the exemptive rules, but they do not. Rather, the releases present a general policy justification for the reforms. The background section of the proposing release discusses the Act's general reliance on "fund boards of directors to manage conflicts of interest that the fund adviser inevitably has with the fund."[45] The adopting release includes a lengthy discussion of directors' responsibilities in approving advisory agreements under Section 15(c) of the Act,[46] although the reforms do not apply to such approvals. Congress

41. *See* U.S. Chamber of Commerce, Case Alert: U.S. Chamber of Commerce v. SEC Mutual Fund "Governance" Litigation (Apr. 8, 2005), http://www.uschamber.com/nclc/news/casealerts/ca050408.htm.

42. *See* Governance Adopting Release, *supra* note 2, at n.52.

43. *See* Consolidated Appropriations Act, 2005, Pub. L. No. 108-447, § 2, 118 Stat. 2809, 2910 (2004); *see generally* Letter from Michael Oxley, Chairman, and Barney Frank, Ranking Member, Committee on Financial Services, House of Representatives, to William Donaldson, Chairman, Securities and Exchange Commission (Nov. 19, 2004), *available at* http://financialservices.house.gov/media/pdf/1119ltr.pdf.

44. *See* Independent Chair Report, *supra* note 35, at 73.

45. Governance Proposing Release, *supra* note 2, Part I.

46. *See* Governance Adopting Release, *supra* note 2, Part II.B.

specifically determined that a forty percent independent board with a nonindependent chairman was sufficient for purposes of approving the advisory agreement; the Commission has no authority to overturn that determination. The Commission published a lengthy justification of the independent chairman requirement after the reforms were adopted, but the report's discussion of the exemptive rules describes only in general terms the role played by the independent directors and how the reforms will affect this role.[47]

The proposing release also does not explain exactly why the scandal justified the reforms. The release states that, "[i]n some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers; in other cases, boards may have lacked the information or organizational structure necessary to play their proper role."[48] The Commission offers no specific examples, however, of such board lapses in connection with the abuses underlying the scandal.[49]

The proposing release separately discusses the requirements for an independent chairman, seventy-five percent independent board, annual self-assessments, separate sessions and the authority to hire independent staff; yet nowhere in these discussions does the Commission tie a particular governance reform to any of the exemptive rules.[50] Is it so self-evident, for example, that a fund board with an independent chairman will be in a better position to determine whether the fund's 12b-1 plan is reasonably likely to benefit the fund, as required by rule 12b-1? Perhaps, but this argument is left unstated.

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47. *See* Independent Chair Report, *supra* note 35, at 14–31, 74–77. In the discussion of the rules, the Report states, for example, that if a

> fund relies on rule 10f-3 (one of the Exemptive Rules) to purchase securities from an affiliated underwriting syndicate, the board has the responsibility to be "vigilant" not only in reviewing the fund's compliance with the procedures required by rule 10f-3, but also "in conducting any additional reviews that it determines are needed to protect the interests of investors."

Id. at 53–54. The Report also makes three general arguments about how an independent chair will enhance compliance: (1) the fund's chief compliance officer, who was recently required to report directly to the board, will report to an independent person, rather than a representative of management; (2) up-the-ladder reporting requirements for attorneys under § 307 of the Sarbanes-Oxley Act similarly will result in an independent person receiving compliance information; and (3) an independent chair will enhance the "boardroom culture" by, for example, promoting "frank discussion of what is in the best interests of the fund." *Id*. at 74–77.

48. Governance Proposing Release, *supra* note 2, Part I (footnotes omitted).

49. *See* Independent Chair Report, *supra* note 35, at 31–50. The Independent Chair Report does provide three specific examples, implying that compliance reports about the harm caused by arbitrage and frequent trading would have been provided directly to the independent chairman under new rules requiring that the chief compliance officer report directly to the board. *Id*. at 74–76.

50. *See* Governance Proposing Release, *supra* note 2, Parts II.A–II.D.

The Commission seems to base the reforms on its general view that the ’40 Act’s fund governance provisions simply are no longer adequate to protect investors. For example, in noting the “many important responsibilities assigned” to independent fund directors, the Commission cites four specific statutory responsibilities under the ’40 Act.[51] But with respect to these responsibilities, Congress deemed a forty percent independent board with a non-independent chairman to be sufficient. The Commission has no authority to overturn these Congressional determinations, regardless of how misguided the mutual fund scandal may reveal them to be.

As noted above, much has been made of the lack of empirical support for the fund governance reforms, but the true empirical void here is quite different from the one commonly cited by critics. The empirical void is not the absence of evidence that the reforms will not adversely affect fund performance or fees, but rather the absence of any evidence of a relationship between enhanced governance and the operation of the exemptive rules. Each exemptive rule raises investor protection issues that the independent directors are expected to address, but there is no evidence that the Commission has any idea how well independent directors have served in that role, or more broadly, whether *any* of the conditions imposed in the rules have been successful in protecting investors against the potential harms presented by the exempted transactions or products.

The real empirical void is the nonexistent empirical support for the continuation of the exemptive rules themselves, the actual operation of which the Commission has effectively disregarded for decades.[52] Perhaps the reason that the Commission did not adequately explain how the reforms were justified by the mutual fund scandal, or were relevant to the exemptive rules, is that the Commission simply lacks a clear conception of exactly what it is independent fund directors are supposed to do or whether or how the exemptive rules are actually working. What truly deserves serious reconsideration is the SEC’s exercise of its exemptive authority.

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51. Governance Proposing Release, *supra* note 2, Part I n.10 (citing board responsibilities set forth at 15 U.S.C. §§ 80a-2a41, 80a-15(a), 80a-15(b), 80a-15(c) (2005)).

52. Fund Democracy has twice based challenges to exemptions on empirical evidence that the exempted transactions were not operating consistent with the grant of exemptive relief. *See* Memorandum in Support of Hearing Request, Fund Democracy (May 4, 2000) (analysis of trading of exchange-traded funds at discounts and premiums to their net asset values), http://www.fund democracy.com/Supporting%20Memo.pdf; Memorandum in Support of Hearing Request, Fund Democracy (Mar. 5, 2001) (analysis of use of multiple managers under multi-manage exemptions), http://www.funddemocracy.com/Supporting%20 Memorandum.pdf.