

STATEMENTS OF FUND DEMOCRACY, LLC
ON SENATE BILL 264
INVESTMENT COMPANIES -- DIRECTORS

COMMITTEE ON ECONOMIC MATTERS
HOUSE OF DELEGATES

MARCH 28, 2001

TESTIMONY

Fund Democracy greatly appreciates this opportunity to testify on Senate Bill 264 before this Committee.

I am Mercer Bullard, founder and CEO of Fund Democracy. I left the SEC, where I was an Assistant Chief Counsel, in January 2000 to form Fund Democracy, which acts as an advocate and information resource for mutual fund shareholders. Fund Democracy is completely independent, has no connection to either the fund industry or the securities plaintiffs' bar, and currently receives all of its income from publishing articles.¹

More than 88 million Americans, representing more than half of U.S. households, own mutual fund shares today. As the Committee is aware, a large percentage of mutual funds are incorporated in Maryland and therefore subject to Maryland law.

This Committee should oppose Senate Bill 264 because it is bad for America's – and Maryland's – mutual fund shareholders.

Senate Bill 264 provides that mutual fund directors who are independent under federal law must be treated as independent under state law.

This means that courts will be required to treat as independent, directors who have substantial conflicts of interests, and defer to these directors' decisions even when they have a personal financial interest in the matter.

This perverse result is due to the narrowness of the federal definition of independence. This definition does not cover transactional relationships between a fund director and the fund or its affiliates. It covers only a limited set of business relationships between a fund director and the fund or its affiliates.

Indeed, the Investment Company Act of 1940 and SEC rules identify numerous situations in which a director who is independent under federal law is not sufficiently

¹ For more information about Fund Democracy, see www.funddemocracy.com.

independent in certain circumstances. Yet Senate Bill 264 would treat these directors as independent regardless of the circumstances.

In October 1999, the SEC published a laundry list of situations in which directors who qualify as independent under federal law nonetheless have significant conflicts of interest.

Just two months ago, the SEC adopted rules requiring funds to publish information about independent directors' conflicts of interest, so that shareholders can better evaluate their "independent" directors' independence.

Ironically, this Committee is considering a bill that would require that courts ignore this information when they evaluate "independent" directors' independence.

Even the Investment Company Institute, the lobbying arm for the fund management industry, has recommended that funds not treat certain directors as independent – even though they are independent under federal law. The ICI has taken the opposite position before this Committee, arguing that the Committee should treat as independent the same directors that the ICI believes should not serve as independent directors.

Thus, Senate Bill 264 directly conflicts with Congress's, the SEC's, and even the fund industry's positions that federally independent directors often have substantial conflicts of interest. This is a bad law that has no reasonable basis.

As often is the case with unreasonable laws, this law is destined, I believe, to have a short life. One reason is that courts will simply nullify the law. If a court finds itself having to treat a director who embezzled money from a fund as independent, as it would be required to do under Senate Bill 264, it will ignore the law and find a way to treat the director as independent.

Another reason the law's survival is doubtful is its questionable legality. At least one commentator, a prominent Boston University securities law professor, has suggested that the law's conflict with federal law and policy presents a strong case for federal preemption. Additionally, a convincing argument can be made that it is unconscionable and void as a matter of public policy.

These arguments will be vigorously and relentlessly pressed both by well-funded plaintiffs lawyers and dedicated shareholder advocates, both in the courts and in the halls of this building. Indeed, this law already has been voided as unconstitutional once, and I have no doubt that its reenactment will result in this Committee revisiting it again in the near future.

The law's most remarkable failing is that it does not even accomplish its primary purpose: to reverse the *Strougo* court's decision that a director could be found not to be independent based on his or her compensation. In fact, at least one court, applying the

law being considered here today, has found that fund directors were not independent because of the level of their compensation.

Thus, Senate Bill 264 fails to reverse the court decision that is the bill's sole impetus, and the fund industry will return to this Committee, very soon, arguing that more legislation is needed.

Fund Democracy has drafted an alternative bill that would avoid all of the shortcomings of Senate Bill 264, and effectively reverse *Strougo*. Fund Democracy does not believe that any legislation is needed, but if legislation is inevitable, this alternative is an approach – unlike Senate Bill 264 -- that one could reasonably support. I have included the text of the alternative bill in Fund Democracy's written submission.

In conclusion, Senate Bill 264 is bad law that abolishes centuries-old legal principles of independence, is destined to be the subject of unrelenting lobbying and legal challenges leading to its repeal, and fails to accomplish what parties on both sides of the bill agree is its primary purpose.

And most importantly, it will harm the interests of millions of Americans who rely on mutual funds for their financial security.

WRITTEN SUBMISSION

I. BACKGROUND

Over the last ten years, mutual funds have become the investment vehicle of choice for America's investors. Since 1990, assets in mutual funds have increased from \$1 trillion to more than \$7 trillion. More than 88 million Americans, representing more than half of U.S. households, own mutual fund shares today.

More than 65% of assets in defined contribution retirement plans, which include 401k and 403b plans, are invested in mutual funds. More than 49% of assets in Individual Retirement Accounts, or IRAs, are invested in mutual funds. Thus, tens of millions of Americans have entrusted mutual funds with a substantial part of their retirement assets and rely on mutual funds for their financial security.

As the Committee is aware, Maryland is one of the three most popular states of incorporation for mutual funds.² A fund's state of incorporation is important because the law of the state of incorporation substantially defines shareholders' legal rights in respect of their funds – regardless of the location of the courts in which their claims are brought, and regardless of whether the claims are brought in federal or state court.

² The other two states are Massachusetts and Delaware.

Indeed, a decision of a federal district court in the Southern District of New York is the impetus of the legislation now before the Committee.³

In 1997, the court in *Strougo v. Scudder* applied Maryland law in finding that three fund directors could be deemed not independent because of the amount of compensation they received for service on multiple fund boards in the same fund complex. On this basis, the court found that the directors did not have the independence necessary to reject a claim brought by shareholders on behalf of a fund, and that shareholders accordingly could bring the suit on their own.⁴

The fund industry was rightfully concerned about the *Strougo* decision. The three directors' annual compensation and the number of fund boards on which they served were as follows: \$132,000 (service on 15 fund boards), \$55,000 (service on 4 fund boards), and \$30,000 (service on 8 fund boards).⁵

The compensation paid to the directors, and the number of fund boards on which they served, were quite unremarkable in an industry where many fund directors earn over \$300,000 each year and serve on boards of well over 100 funds. The court's decision, if applied by other courts, would have meant that in many cases not a single director of a mutual fund could qualify as independent.

The fund industry opined, and Fund Democracy agrees, that the *Strougo* court's decision was wrong.

Normally, the appellate process is the best method to correct trial court error because courts – not legislators -- are in the best position to make fact-specific evaluations. The determination of whether a fund director's compensation is so grossly excessive as to impair the director's independence is exactly the kind of fact-specific determination best left to courts.

The fund industry, however, sought to reverse *Strougo* by statute. Here, Fund Democracy disagrees. Courts are usually more proficient at making fact-specific judgments than legislatures, and there is nothing about the *Strougo* decision, such as its widespread adoption by other courts, that warrants a legislative fix.

Nonetheless, Fund Democracy recognizes that there is nothing inherently unreasonable about seeking legislation to correct a judicial decision. Indeed, Fund Democracy would agree that a bill that provided, for example, that courts could not

³ *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F.Supp. 783 (S.D.N.Y. 1997).

⁴ Under state law, claims alleging injury to a corporation often can be brought only by the corporation. Shareholders who wish to bring such a claim must first make a demand on the directors to bring the claim. This "demand requirement" is excused if it would be futile, such as when the director has a personal interest in the outcome of the claim or some other material conflict of interest.

⁵ The third director had earned a total of \$366,000 in deferred compensation during his 8-year tenure as a director of the funds.

consider a fund director's compensation when evaluating the director's independence, unless the compensation was grossly excessive, was a reasonable – if not optimal -- solution to the *Strougo* problem.

The fund industry chose a different solution, however. It lobbied for a bill that bears no reasonable relationship to *Strougo* and constitutes an indefensible abridgment of shareholders' rights.

II. SENATE BILL 264

Rather than address the issue of fund directors' compensation, Senate Bill 264 requires courts to treat as independent any director who is independent under federal law.

This off-the-shelf solution to the problem of deciding when a person can exercise independent judgment has superficial appeal. It carries the imprimatur of federal authority, the advantages of an "objective" standard, and the foundation of an established body of regulatory and judicial interpretation.

But there are no easy solutions when it comes to judgments about a person's state of mind. As expressly recognized by Congress, the U.S. Securities and Exchange Commission, and the fund industry itself, directors who satisfy the federal definition of independence often have conflicts that compromise their independence.

Yet Senate Bill 264 would require courts to treat these conflicted directors as independent for state law purposes.

A. The Federal Definition Of Independence

A federally independent fund director: (1) cannot be an executive of the fund's manager or principal underwriter, or an immediate family member of such an executive; (2) have acted as legal counsel for the fund or the fund's manager or principal underwriter since the beginning of the fund's last two completed fiscal years; (3) be an executive of a registered broker-dealer; or (4) be an affiliated person of the fund or the fund's manager or principal underwriter. Investment Company Act § 2(a)(19) (copy at Attachment B).

An affiliated person of a fund includes: (1) an executive or majority shareholder of a company if the fund owns 5% or more of the company's stock; (2) a 5% or more owner of the fund's shares; or (3) a person under the control of the fund's manager or principal underwriter. Investment Company Act § 2(a)(3).

The definition of a federally independent fund director is most relevant here, however, for the broad scope of conflicts of interest that it does not cover.⁶

⁶ See generally Mercer Bullard, Pretty Please, Can We Sue You? TheStreet.com (Mar. 22, 2001)(copy at Attachment C).

A former executive or owner of the fund's manager or principal underwriter would be federally independent, as would the grandparent or uncle of the current CEO or owner of the fund's manager or principal underwriter. Such a person would be considered federally independent even for purposes of considering whether the fund should sue the fund's manager or principal underwriter for intentionally overcharging the fund for services rendered.

An executive or owner of a business providing services to the fund, such as the fund's administrator, shareholder servicing agent, proxy solicitor, custodian or accountant, would be federally independent. Such a person would be considered federally independent even for purposes of deciding whether the fund should sue the director's company for intentionally overcharging the fund for services.

An executive or owner of a company in which a fund invests would be federally independent. Such a person would be considered federally independent even for purposes of deciding whether the fund should sue the fund's manager for investing in the director's company in violation of the fund's investment restrictions.

An executive or owner of a company that engaged in transactions with a fund or the fund's manager or principal underwriter, such as a real estate firm that leased office space to the fund or the fund's manager or principal underwriter, would be federally independent. Such a person would be considered federally independent even for purposes of deciding whether the fund should sue the director's real estate firm for overcharging the fund for rent.

As noted by a prominent securities law professor, fund directors under Senate Bill 264 "will be deemed disinterested even when they are sued for embezzlement or breach of fiduciary duties under the Act. Their status as disinterested directors will not disqualify them from voting to dismiss a suit against them, even though with respect to the suit they are surely very interested."⁷

Senate Bill 264 would require that courts treat all of these persons as independent under state law.

Congress, the SEC, and even the fund industry all have expressly acknowledged the limited scope of the federal definition of independence. In contrast, Senate Bill 264 would treat this definition as the beginning and end of any inquiry into a director's independence.

**B. When Independent Directors Are Not Independent:
Investment Company Act of 1940**

⁷ Tamar Frankel, The Different Design of Corporate Governance under State Law and Federal Law and the Aftermath of the *Strougo* Case, 7 The Investment Lawyer 3, 5 (Feb. 2000)(copy at Attachment D).

In recognition of the narrow scope of the federal definition of independence, Congress imposed additional standards for independent fund directors in certain contexts.

When a fund manager sells his company to another fund manager, and the new fund manager assumes the contracts to manage the selling manager's funds, Congress required that at least 75 per cent of the funds' directors be independent of the selling manager. Investment Company Act § 15(f)(1)(A). Although a director who is independent of the selling manager would be federally independent, Congress decided that stronger measures were needed to ensure the independence of the funds' federally independent directors in the context of this transaction.

When a fund's directors approve the contract with its manager, Congress required that the contract be approved by the independent directors who were not parties to the contract. Again, such directors would be federally independent, but Congress decided that this fact alone would not be sufficient to ensure they would be independent when dealing with the fund's manager. Investment Company Act § 15(c).

Congress also authorized the SEC to issue orders prohibiting persons from acting as fund directors who had violated the federal securities laws, or had been found by a foreign regulator or court to have violated foreign securities laws. Investment Company Act § 9(b). Congress recognized the self-evident proposition that such a person should be precluded from serving as a fund director.

Nonetheless, such a person would qualify as a federally independent fund director, and, if the SEC has not issued an order banning that person from serving as a director, nothing would prevent him or her from serving as a federally independent fund director. Yet Senate Bill 264 would require courts to treat a fund director who had admitted to violating the federal securities laws, for example, as independent because that person would be federally independent.

Congress also authorized the SEC to issue an order finding that a person was not independent under federal law by reason of having had a material business or professional relationship with the fund or the fund's manager or principal underwriter since the beginning of the last two completed fiscal years. Investment Company Act §§ 2(a)(19)(A)(vi) & (B)(vi).

Congress granted this broad authority because it recognized that many kinds of relationships could compromise a director's independence, and it would be impossible to draft a definition of federal independence that covered them all. In contrast, Senate Bill 264 assumes the opposite, and would treat such persons as independent regardless of the person's business and professional relationships with fund affiliates.

The Maryland legislature cannot rely on the SEC to issue an order in every case in which a fund director has a blatant conflict of interest. In fact, the SEC has never issued such an order, because it has not needed to. In practice, the SEC staff has found it

sufficient to informally warn a fund that it would seek an order from the SEC if the fund attempted to treat such a person as independent for federal law purposes.⁸

As discussed above, Congress expressly recognized numerous situations in which a federally independent director was not sufficiently independent in certain contexts. It also recognized the inherent limitations of the federal definition of independence, and accordingly granted the SEC broad authority to issue orders deeming persons as not independent directors, or precluding them from serving as directors at all.

In contrast, Senate Bill 264 requires that directors who meet the narrow definition of independence under federal law always be treated as independent, even when they have the kinds of relationships that Congress deemed to create a significant conflict of interest.

C. When Independent Directors Are Not Independent: SEC Rules and Positions

Senate Bill 264's blind adherence to the federal definition of independence conflicts not only with Congress's intent, but also with SEC rules and positions.

For example, members of this Committee may be familiar with so-called "12b-1 fees" charged by funds. These fees, which use fund assets to pay for fund marketing and shareholder services, take their name from SEC Rule 12b-1.

Under Rule 12b-1, a fund's a 12b-1 plan must be approved not only by the fund's federally independent directors, but also by the directors "who have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan." SEC Rule 12b-1(b)(2). The Commission added the latter requirement because it believed that, "in order for [the independent directors] to make such a decision, it is not enough for them merely not to be interested persons of the fund within the meaning of the Act."⁹

Concerned that, "in many cases disinterested directors may not be able to act with genuine independence in deciding whether to use fund assets for distribution because of the control investment advisers typically exercise over the funds they advise," the Commission further required that funds charging 12b-1 fees commit the selection and nomination of the independent directors to the fund's independent directors.¹⁰

⁸ Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083, Section 2A (Oct. 14, 1999)("Independent Directors Release")(copy of excerpt at Attachment E).

⁹ Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862 (Sep. 7, 1979).

¹⁰ Id.

The approval of 12b-1 plans is only one of many circumstances in which the SEC has determined that being independent under federal law was insufficient to ensure that independent directors would be effective advocates on behalf of shareholders. The SEC recently provided a laundry list of situations in which it might issue an order finding that a federally independent director nonetheless should not be treated as independent.

On October 14, 1999, the SEC staff provided guidance to the fund industry regarding the kinds of relationships that “might tend to impair the independence of a director.”¹¹ Specifically, the staff looked for relationships that would tend to impair a director’s independence “by providing incentives for the director to place his or her own interests over the interests of fund shareholders.”¹²

The staff would consider, for example, the former portfolio manager of a fund, and other former executives of the fund’s manager or principal underwriter not to be independent.¹³ The staff reasoned that:

a fund's former portfolio manager must be viewed as having had a material business or professional relationship with the fund and its adviser because he or she would have had significant responsibilities with the fund and the adviser, and likely would have received substantial compensation and other benefits from the adviser and/or the fund. Indeed, the staff would view the former portfolio manager's position as material due to the manager's responsibility in the position even if the manager had not received substantial compensation from adviser or the fund. Similarly, the staff believes that former directors, officers, and employees of the fund's investment adviser or principal underwriter could be viewed as having had a material business or professional relationship with [fund affiliates], depending on the facts and circumstances.

The staff also considered the independence of a director who engaged or proposed to engage in material transactions with the fund or its affiliates to be compromised. These transactions “may be structured as service arrangements, including legal, investment banking, and consulting services, or other business transactions, such as business and personal loans, and real estate purchases.”

A director’s independence also could be compromised to the extent that he or she received special treatment from the fund or its affiliates. For example, the staff believes that a director would not be independent “if the fund's investment adviser manages or

¹¹ Independent Directors Release, Section 2A (quoting legislative history of the federal definition of independence, R. Rep. No. 1382, 91st Cong., 2d Sess. 14 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 33 (1969)).

¹² Id.

¹³ Id. Each of the following examples is taken from Section 2A of the Independent Directors Release.

managed for the director, at any time during the two-year period, an advisory or brokerage account, and the adviser favors, or creates the expectation that it will favor, the account over the other accounts that it manages.”

A director who was the CEO of a company on the board of which the fund manager’s CEO served as a director, the staff concluded, also would not be independent. “The relationship between the fund director and the adviser's chief executive officer may tend to impair the director's independence because the adviser's chief executive officer has the power to vote on matters that affect the director's compensation and status as chief executive officer of the company.”

The staff believes that a director who has an interest in a company that does business with the fund or its affiliates would not be independent because “a fund director who had a controlling interest in a company that conducted material business with a fund would likely receive significant economic benefits, either directly or indirectly, as a result.”

In every situation described immediately above, Senate Bill 264 would require courts to treat the director as independent.

Concurrent with the issuance of Independent Directors Release, the SEC adopted rules requiring funds to disclose information about independent fund directors’ conflicts of interest.¹⁴

The new disclosure requirements further illustrate the nature and extent of conflicts of interest that fund directors may have, notwithstanding that they satisfy the definition of independence under federal law.

For each independent director, funds will be required to disclose their positions held with the fund’s manager, principal underwriter, and administrator; any material interests in these entities; and any material transactions with these entities. The requirements also extend to positions, interests and transactions with respect to entities in the same control group; and to positions, interests and transactions of the director’s immediate family members.

The SEC imposed these and other disclosure requirements to “bring to the attention of shareholders circumstances that may affect the directors' allegiance to shareholders.”¹⁵ It recognized that “a director who is involved in a transaction or

¹⁴ Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082, Section II.E.3 (Jan. 2, 2001)(adopting new disclosure requirements).

¹⁵ Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082, Section II.E.3.b (Oct. 14, 1999)(proposing new disclosure requirements).

relationship with the fund or related persons may have financial or other interests that compete with those of fund shareholders.”¹⁶

Accordingly, the SEC hoped that, “with this information, shareholders may decide for themselves whether an independent director has any potential conflicts of interest that could affect the director's ability to protect the interests of shareholders.”¹⁷

Thus, 2001 marks a watershed year for the independence of fund directors. The SEC has taken major steps to apprise shareholders of ostensibly independent directors’ conflicts of interest. As stated by the SEC, hopefully the “resulting public dissemination [of information about directors’ conflicts of interest] may discourage the selection of independent directors who have relationships or engage in activities that raise questions about their independence.”¹⁸

How ironic, that the same year the SEC decided to make more information available to shareholders to evaluate fund directors’ independence, this Committee is considering a bill that would require that courts ignore this information when evaluating fund directors’ independence.

The only audience for the disclosure that will not be able to make good use of this information is the courts, which will be bound by Senate Bill 264 to ignore federally independent directors’ conflicts of interest and find them to be independent – no matter how blatant their personal interest in the transaction at issue.

**D. When Independent Directors Are Not Independent:
Investment Company Institute**

Even the fund industry itself concedes that certain federally independent fund directors have conflicts of interest that compromise their independence.

In 1999, the Investment Company Institute, the trade association for fund management companies, issued a report that recommended that “former officers or directors of a fund’s investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.”¹⁹

The report’s recommendation was based on the belief that “prior service as an officer or director of the adviser or principal underwriter may affect the director’s

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

¹⁹ Report of the Advisory Group on Best Practices for Fund Directors at 12 (June 24, 1999).

independence, both in fact and in appearance. In particular, it may call into question whether the former officer or director would be able to effectively ‘switch hats.’²⁰

Thus, to its members, the ICI recommends that former executives of a fund’s manager not be treated as independent. To this Committee, however, the fund industry argues that these same executives should be treated as independent.

III. SENATE BILL 264: A PRECARIOUS FUTURE

As often is the case with unreasonable laws, Senate Bill 264 is destined to have a short life. Courts will nullify the bill at every opportunity, its opponents will not rest until it has been repealed, and the fund industry will soon return to this Committee, hat in hand, begging for more protection for directors.

A. Judicial Nullification of Senate Bill 264

Senate Bill 264 will confront courts with a difficult dilemma. When shareholders ask fund directors to bring a suit in which the directors have a personal financial interest, and the directors reject that request, Senate Bill 264 will require the courts to treat the directors’ decision as having been independently made.

Some judges, particularly strict constructionists, probably will apply Senate Bill 264 as written and treat the directors’ decision as independent.

Many other judges, however, will find a way to reach the right result. They will apply narrow solutions, such as twisting the federal definition of independence to find that the directors are not federally independent, or finding a procedural flaw in the directors’ decision that renders it void.

More activist judges will declare that Senate Bill 264 is preempted by federal law, or is unconscionable and void as a matter of public policy. Tamar Frankel, a prominent Boston University securities law professor, has questioned whether Senate Bill 264 conflicts with Congressional intent as evidenced by the structure and provisions of the Investment Company Act.²¹

As many members of this Committee are aware, when the law requires a wrong decision, as will Senate Bill 264, courts will find a way to ignore the law to reach a just result.

B. Opposition to Senate Bill 264

²⁰ Id.

²¹ Frankel, *supra* note 7.

Just as courts will find a way to nullify Senate Bill 264, opponents will find a way to obtain its repeal.

The bill's extraordinary breadth ensures that well-funded plaintiffs' lawyers will not rest until the Maryland legislature repeals the bill or the courts reverse it on public policy or federal preemption grounds. Their efforts will be joined by fund shareholder advocates such as Fund Democracy and the Consumer Federation of America.

In this respect, Senate Bill 264's future is foreshadowed by its past. Soon after a similar bill was passed by both houses and signed into law by the Governor in 1998, plaintiffs' lawyers attacked its constitutionality. Last year, the Maryland Court of Appeals struck down the law, and so this Committee is again spending valuable time considering its merits.

C. Senate Bill 264 Does Not Reverse Strougo

Perhaps the most remarkable failing of Senate Bill 264 is that it does not accomplish its primary purpose. This failing ensures that the fund industry will soon be asking this Committee for more protection for fund directors.

As discussed above, Senate Bill 264 is a response to the *Strougo* decision.²² That decision found that three fund directors could be deemed not independent because of the amount of compensation they received for service on multiple fund boards in the same fund complex.

Under Senate Bill 264, courts will continue to be able to consider compensation when evaluating fund directors' independence.

The federal definition of independence requires that a person not be under the control of the fund's manager. Under federal law, a natural person enjoys a presumption that he or she is not controlled by the manager, but that presumption can be rebutted by an SEC or court order.²³

A person therefore could be deemed to be controlled by a fund's manager and not federally independent, if the amount of compensation received by the director was sufficient to rebut the presumption that the director was not controlled by the fund's manager.

At least one federal court already has reached exactly this conclusion. On December 9, 1999, a court applying the same Maryland law being considered here today,

²² See discussion *supra* accompanying notes 3 - 4.

²³ *Olesh v. Dreyfus Corp.*, 1995 Westlaw 500491 (E.D.N.Y.).

found that the fund directors were not federally independent because of the level of their compensation.²⁴ The court's analysis was as follows:

Maryland law governs whether demand is required and the conditions that excuse demand. . . . Demand is futile when the directors are interested persons. [The plaintiff] must allege facts to show that the directors are interested under the [Investment Company Act]. See MD Corp & Assn's sec. 2-405.3 (1998) ("A director of a corporation who with respect to the corporation is not an interested person, as defined by the Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as director.") At this juncture, [the plaintiff] has alleged enough in his complaint to demonstrate that demand was futile.²⁵

Thus, Senate Bill 264 fails to reverse *Strougo* -- the decision that is the bill's sole impetus.

In fact, Senate Bill 264 will increase the likelihood that courts will consider compensation when evaluating fund directors' independence. Because the federal definition will prevent them from considering other, more blatant conflicts of interest, they will be more inclined to find that directors are not federally independent based on their compensation.

Senate Bill 264 also will have the effect of expanding the reach of the *Strougo* analysis to federal law. Any interpretation of Senate Bill 264 will require an interpretation of the federal definition of independence. Every finding that a fund's directors' are not independent under Senate Bill 264 will mean that the fund is also violating the federal requirement that at least 40 per cent of the board be federally independent.

This very claim recently was asserted in the case cited immediately above. The plaintiffs filed motions earlier this year claiming that the funds were violating the federal 40 per cent requirement because the directors' compensation rendered them under the control of the fund's manager. According the court clerk, this claim will be argued in May.

D. A Reasonable Alternative to Senate Bill 264

Had the fund industry genuinely intended to reverse *Strougo*, it would have lobbied for a bill that prohibited courts from considering a fund director's compensation when evaluating the director's independence, unless the compensation was grossly excessive.

²⁴ *Roumell v. Templeton Asset Management*, 98-6059-CIV-Hurley (Dec. 9, 1999).

²⁵ *Id.*

Toward that end, Fund Democracy recommends that the Committee consider the following alternative to Senate Bill 264:

(a) This section applies to a corporation that is an investment company, as defined by the Investment Company Act of 1940.

(b) Service as a director or trustee, or the receipt of fees or other compensation for service as a director or trustee, of one or more series or funds of an investment company or companies that are part of the same group of investment companies, shall not be considered in determining whether a director or trustee is independent and disinterested when making any determination or taking any action as a director, unless the fees and other compensation are grossly excessive.

Although Fund Democracy does not believe that such legislation is needed, as such fact-specific judgments are generally best left to courts, Fund Democracy recognizes that its alternative bill, unlike Senate Bill 264, is a reasonable response to the *Strougo* decision.

This alternative bill, unlike Senate Bill 264: effectively reverses *Strougo*; permits courts to consider blatant conflicts of interest when evaluating fund directors' independence; avoids conflict with federal law; is consistent with public policy; may help reduce frivolous litigation; and is not offensive to fund shareholder advocates.

IV. CONCLUSION

Fund Democracy strongly encourages the Committee to reject Senate Bill 264. The bill will require courts to treat fund directors who have blatant conflicts of interest as independent under Maryland law, and thereby directly conflicts with positions taken by Congress, the SEC and the fund industry itself.

The bill will harm the millions of mutual fund shareholders whose funds are incorporated in Maryland by requiring them to obtain approval of legal claims from fund directors who may have a personal interest in the outcome of the claims.

Courts will find ways to circumvent the bill's requirements, plaintiffs' lawyers and shareholder advocates will relentlessly seek its repeal, and the fund industry, upon recognizing that the bill fails to accomplish its primary purpose, will again ask this Committee to spend valuable time on a problem that the industry could have solved years ago by proposing the alternative presented by Fund Democracy.

The alternative bill proposed by Fund Democracy would both reverse the *Strougo* decision and protect the interests of fund shareholders. Senate Bill 264 accomplishes neither goal, and accordingly should be rejected by this Committee.

* * * * *

ATTACHMENTS

- A. Proposed Alternative to Senate Bill 264
- B. Federal Definition of Independence
- C. Mercer Bullard, Pretty Please, Can We Sue You? TheStreet.com (Mar. 22, 2001).
- D. Tamar Frankel, The Different Design of Corporate Governance under State Law and Federal Law and the Aftermath of the *Strougo* Case, 7 The Investment Lawyer 3 (Feb. 2000).
- E. Excerpt from Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999).
- F. Excerpt from the Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999).

* * * * *

ATTACHMENT A

PROPOSED ALTERNATIVE TO SENATE BILL 264

(a) This section applies to a corporation that is an investment company, as defined by the Investment Company Act of 1940.

(b) Service as a director or trustee, or the receipt of fees or other compensation for service as a director or trustee, of one or more series or funds of an investment company or companies that are part of the same group of investment companies, shall not be considered in determining whether a director or trustee is independent and disinterested when making any determination or taking any action as a director, unless the fees and other compensation are grossly excessive.

ATTACHMENT B

FEDERAL DEFINITION OF INDEPENDENCE

Investment Company Act sec. 2(a)(19):

"Interested person" of another person means -

A. when used with respect to an investment company -

- i. any affiliated person of such company,
- ii. any member of the immediate family of any natural person who is an affiliated person of such company,
- iii. any interested person of any investment adviser of or principal underwriter for such company,
- iv. any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,
- v. any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and
- vi. any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company: Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

B. when used with respect to an investment adviser of or principal underwriter for any investment company -

- i. any affiliated person of such investment adviser or principal underwriter,
- ii. any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

- iii. any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person or such investment adviser or principal underwriter,
- iv. any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,
- v. any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and
- vi. any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this subparagraph 19, "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph A or B of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this Title or for any other purpose for any period prior to the effective date of such order.

ATTACHMENT C

**MERCER BULLARD, PRETTY PLEASE, CAN WE SUE YOU?
THESTREET.COM (MAR. 22, 2001)**

(see <http://www.thestreet.com/funds/mercerbullard/1331674.html>)

* * * * *

ATTACHMENT D

**TAMAR FRANKEL, THE DIFFERENT DESIGN OF CORPORATE
GOVERNANCE UNDER STATE LAW AND FEDERAL LAW AND THE
AFTERMATH OF THE *STROUGO* CASE,
7 THE INVESTMENT LAWYER 3 (FEB. 2000).**

(text available only to Investment Lawyer subscribers)

* * * * *

ATTACHMENT E

EXCERPT FROM:

**MATTERS CONCERNING INDEPENDENT DIRECTORS
OF INVESTMENT COMPANIES,
INVESTMENT COMPANY ACT RELEASE NO. 24083 (OCT. 14, 1999)**

(see <http://www.sec.gov/rules/interp/ic-24083.htm>)

* * * * *

ATTACHMENT F

EXCERPT FROM:

**THE REPORT OF THE ADVISORY GROUP
ON BEST PRACTICES FOR FUND DIRECTORS**

(see http://www.ici.org/pdf/rpt_best_practices.pdf)