Regulation of Adviser Compensation Under the Investment Company Act: Who Is Responsible?

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INTRODUCTION

A “mutual fund” is the common title given to an open-end investment company.1 Mutual funds accumulate the capital of shareholders and invest it in a wide variety of securities.2 These companies are structured differently than the typical business corporation because a mutual fund relies on the services of an outside investment adviser.3 As a result, conflicts of interest


may arise between the fund shareholders and their investment advisers.4

The Investment Company Act of 1940 ("the Act") regulates the investment company industry.5 In the forty years following the inception of the Act, there has been a dramatic increase in the

REPORT]. In a typical corporation, management and shareholders share similar interests. The officers of the corporation usually have an equity interest in the corporation and will consequently do everything within their power to maximize its profits. In contrast, the control of a mutual fund is typically left to an investment adviser,

(a) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to a contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property. . . .

15 U.S.C. § 80-2(20) (1976). The primary interest of the adviser, as an external business entity, is the maximization of self profit. The almost complete dependence of a fund on its investment adviser results in a lack of arm's length bargaining in business relations between fund and adviser. PPI, supra note 1, at 88.


The Act's provisions are highly complex. See Levitt v. Johnson, 334 F.2d 815 (1st Cir.
assets of mutual funds. One serious problem which accompanied the growth of the industry had been that adviser fees fixed at a percentage of the fund's assets became excessive as mutual fund assets multiplied. The regulatory provisions of the Act were inadequate to protect the investing public from this situation.

In an effort to remedy the problem, Congress amended two
sections of the Act in 1970.\textsuperscript{8} Section 10 of the Act was altered to impose a more stringent standard for determining adviser "independence."\textsuperscript{9} Section 36(a)\textsuperscript{10} was amended to impose a fiduciary duty on the directors, and a new provision in section 36(b) prohibits outside management from accepting excessive compensation.\textsuperscript{11}

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10. 15 U.S.C. § 80a-35(a). The complete text of section 36(a) reads as follows:

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or
(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-l(b) of this title.

Until 1970, Section 36(a) was the only paragraph in Section 36. Therefore, references to Section 36 are to Section 36(a). S. Rep. No. 91-184, 91st Cong., 2d Sess. 35-36, U.S. Code Cong. and Admin. (1970), Vol. 3, p. 4931.
11. \textit{Id.}, § 80a-35(b). The complete text of section 36(b) reads as follows:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment advisor or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a
The proper application of the remedial provisions of section 36(b) has created judicial conflict over whether a shareholder action under section 36(b) is a derivative suit.\textsuperscript{12} If viewed as a derivative suit, the regulatory provisions of Federal Rule of Civil security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

A derivative suit is an action brought by a stockholder to enforce a corporate claim. In a derivative suit, the plaintiff is the stockholder, but the potential benefit runs to the corporation. See W. Cary. Corporations: Cases and Materials 733-37 (4th ed. abr. 1970); H. Henn. Law of Corporations 360 (3d ed. 1970). See also Ross v. Bernhard, 396 U.S. 531, 534-35 (1970); Swanson v. Traer, 354 U.S. 114, 116-17 (1957). Only shareholders or the Securities and Exchange Commission (SEC) are specifically authorized to bring suits against an investment adviser. See supra note 11. Nonetheless, some courts have concluded that an action brought by a shareholder under section 36(b) is impliedly one
Procedure 23.1 apply to such shareholder action. Before a shareholder may institute a derivative suit, rule 23.1 requires him to either demand that the corporation’s directors instigate action or allege with particularity the reasons for his failure to which the corporation itself could have brought, and is therefore derivative. See infra notes 60-75 and accompanying text.

13. To ensure that the derivative suit is used fairly, rules were developed to regulate it. In the early case of Hawes v. Oakland, 104 U.S. 450 (1881), the Supreme Court laid the foundation for what later became Federal Rule of Civil Procedure 23.1. The Court recognized that although the derivative suit was an essential protection for shareholders, a shareholder should be required to show that “he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances....” Id. at 460. “He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, ... [and he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.” Id. at 461. See also Huntington v. Palmer, 104 U.S. 482 (1882); Nussbacher v. Continental Ill. Bank & Trust, 518 F.2d 873 (7th Cir. 1975); Smith v. Chase & Baker Piano Mfg. Co., 197 F.2d 466 (D.C. Mich. 1912).

Statutory efforts to regulate the institution of derivative suits culminated in Federal Rule of Civil Procedure 23.1 3B J. MOORE, MOORE’S FEDERAL PRACTICE 23.1.9 (2d ed. 1980). Rule 23.1 provides:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not the collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority, and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

FED. R. CIV. P. 23.1.

14. Rule 23.1 normally requires a shareholder bringing a derivative suit to exhaust intracorporate remedies. The directors of a corporation are legally charged with the conduct of the corporation’s affairs and should have the first opportunity to instigate action on behalf of the corporation. Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361 (N.D. Ill. 1974). One of the primary purposes for requiring demand is to allow the corporation to take action which would make the shareholder suit superfluous. Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977); Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975). The derivative suit is an extraordinary remedy which a shareholder should be entitled to use only when there is “no other road to redress.” Caldwell v. Eubanks, 326 Mo. 185, 191, 30 S.W.2d 976, 978 (1930). For an excellent general discussion of the demand requirements, see Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. CHI. L. REV. 168 (1976); Note, Demand on Directors and Shareholders as a
Prerequisite to a Derivative Suit, 73 HARV. L. REV. 729, 746-62 (1960).

Practical reasons which support the demand rule include (1) the corporate officers and directors are normally in possession of information necessary to properly frame the complaint, (2) the corporation generally has greater financial ability to prosecute the suit, and (3) the directors and officers have a fiduciary duty to the corporation which shareholders do not have. Abrahms v. Mayflower Investors, Inc., 62 F.R.D. 361, 369 (N.D. Ill. 1974). Note, supra, at 748. Once a demand is made, the corporation's directors ordinarily have some discretion in dealing with the alleged wrongdoing. The "business judgment" rule entitles the directors, in good faith, to instigate a lawsuit or, alternatively, to pursue internal remedies and avoid litigation. Id. There is an unresolved question, however, as to whether the independent directors of a mutual fund may ever terminate a section 36(b) lawsuit. See infra notes 78-89 and accompanying text.


Generally, if a shareholder can demonstrate that demand would be "futile," "useless," or "unavailing," demand will be excused. If the court perceives that the directors are antagonistic, adversely interested, or involved in the transaction attacked, futility of demand is presumed. Tasner v. Billera, 379 F. Supp. 815, 826 (N.D. Ill. 1974); DePinto v. Provident Sec. Life Ins. Co., 323 F.2d 826, cert. denied, 376 U.S. 950, reh'g denied, 383 U.S. 973 (1963); Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2d Cir. 1955).


16. Fox v. Reich & Tang, Inc., 692 F.2d 250, 261-62 (2d Cir. 1982), cert. filed sub nom.,
The First, Second and Third Circuits have conflicted in their interpretations of this problem. In their interpretations they have focused on different issues and the varying language in the statutes and their legislative histories. The conclusions are conflicting. The need to resolve this problem is evidenced by the fact that the Supreme Court has docketed one of the cases for review. To resolve this problem, the Court must consider the legislative history behind section 36(b) to determine congressional intent. In addition, the Court should analyze the provision in the context of the other provisions of the Act.\(^{17}\)

This note will discuss the propriety of applying the demand requirement of rule 23.1 to suits brought under section 36(b). First, the article will survey the history of the investment company industry and the conflicts of interest which precipitated adoption of the Act and the 1970 amendments. It will then analyze the existing judicial controversy, discussing the rationales supporting and opposing application of the demand provision to section 36(b) shareholder suits. Finally, premised on these theories, the note will formulate a viable solution to the conflict among the circuits that is consistent with congressional intent. The note proposes a two-tier method of regulation which not only strengthens the role of the independent directors, but places the ultimate remedy for the payment of excessive compensation in the courts.

**MUTUAL FUNDS**

The first mutual fund was created in 1924.\(^{18}\) Since that date mutual funds have become increasingly popular with small investors.\(^{19}\) The internal structure of a mutual fund differs substantially from the structures of most other corporate organizations.\(^{20}\) A mutual fund typically is established by an investment

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\(^{18}\) WHARTON REPORT, supra note 3, at 4.

\(^{19}\) See supra note 7.

\(^{20}\) See supra note 3.

Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships.
adviser who provides most necessary management services.\textsuperscript{21} The investment adviser typically selects directors for the fund, and the individuals chosen for management positions are often directors of the advising corporation.\textsuperscript{22} These interrelations between the mutual fund and its adviser give the adviser significant influence over the operation of the fund.\textsuperscript{23} The arm's length bargaining which typifies traditional business relationships is therefore non-existent in the mutual fund industry, leaving mutual funds highly vulnerable to management abuse.\textsuperscript{24}

Recognizing that investment company shareholders needed special protection, Congress enacted the Investment Company Act in 1940.\textsuperscript{25} Although this legislation was initially effective in regulating the industry, the industry's subsequent growth caused


\textsuperscript{23} As a result of this influence, the mutual funds have built-in conflicts of interest. \textit{See Statement of the SEC Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, Oct. 10, 1967, 1967 House Hearings 26, 33-34; Lobell, Rights and Responsibilities in the Mutual Fund, 70 Yale L.J. 1258, 1263-65 (1961); Rottenberg, Developing Limits on Compensation of Mutual Fund Advisers, 7 Harv. J. Legis. 309, 312 (1970); Note, Business Incest, supra note 4, at 142 n.23.}

\textsuperscript{24} \textit{See supra notes 3-4.}

unforeseen problems which the Act's original provisions could not control. Consequently, the Act was amended in 1970. The amended Act provides a detailed and comprehensive system of regulations which touch most aspects of the operation of investment companies.

The Excessive Fees Problem

One particularly troublesome issue which emerged in the mutual fund industry involved the setting and payment of advisory fees. As a result of the phenomenal increase in mutual fund assets and the manner in which adviser fees were calculated, adviser compensation grew. Specifically, problems arose when advisers failed to share the economies of scale attributable to the growth of the industry with the funds.

Neither the 1940 Act nor existing state corporate law remedies effectively regulated this problem. Consequently, in 1970 Congress amended the Act to provide specific remedies for excessive enactment. The preamble of the Act indicates Congress' primary intention: "to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors." 15 U.S.C. § 80a-1 (1940).

26. In 1940, Congress recognized that unforeseeable circumstances were likely to occur in the industry and therefore enacted § 14(b) which authorizes the SEC to "make a study and investigation *** and from time to time to report the results *** and its recommendations to the Congress" whenever the Commission determines that changes in the industry have created new problems for investors. S. Rep., supra note 20, at 4899. Pursuant to the authority granted by § 14(b), the Commission authorized the Wharton Study, supra note 3. The detailed study identified significant problems in the industry but did not make any legislative recommendations. See supra note 10. A final comprehensive study was made by the SEC in 1966. PPI, supra note 1.

27. See supra note 5.

28. See supra note 7. See, e.g., Fox v. Reich & Tang, Inc., 692 F.2d 250, 253 (2d Cir. 1982), where the plaintiff alleged that the adviser continued to provide the same services it had always provided while the fees grew to exorbitant amounts.

29. See supra note 7.

30. Prior to 1940, Investment advisers were not subject to federal regulation although several states had brought them under supervision. SECURITIES & EXCH. COMM., REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, "INVESTMENT COUNSEL, MANAGEMENT, INVESTMENT SUPERVISORY AND INVESTMENT ADVISORY SERVICES" ch.7 (1939) [hereinafter cited as SEC REPORT]. Although there was some shareholder litigation to reduce fee rates, it was relatively ineffective. In each case, fund shareholders brought derivative suits, a procedural device designed to permit minority shareholders to enforce a corporation's claim against officers and directors. WHARTON REPORT, supra note 3, at 431.

State law placed difficult burdens of proof on a plaintiff bringing a derivative suit, requiring a showing of corporate waste. To recover damages, fees were required to be so high that "no person of ordinary, sound business judgment would be expected to enter-
Section 36(b) of the ICA: Demand Requirements

compensation.\textsuperscript{31} Section 10 was amended to create a greater distance between an investment company's advisers and its directors.\textsuperscript{32} Section 36 was amended to impose fiduciary duties on both the directors of mutual funds in the performance of their responsibilities\textsuperscript{33} and on mutual fund advisers with regard to compensation.\textsuperscript{34} All three of these amendments were aimed at the problem of excessive adviser compensation. An analysis of whether the demand requirement of rule 23.1 should be applied to shareholder suits under section 36(b) of the Act therefore requires that the amendments be considered in tandem.

\textit{The Role of the Unaffiliated Director}

Prior to the enactment of the 1970 amendments, section 10 required at least forty percent\textsuperscript{35} of the board of directors of an investment company to be "unaffiliated"\textsuperscript{36} with the company's investment adviser. This disaffiliation requirement was the sole shareholder protection from management abuse.\textsuperscript{37} Because of
the intimate ties between mutual fund directors and advisers, however, the unaffiliated directors did not always protect the shareholder's best interests. Consequently, a primary goal of the 1970 amendments was to create a greater distance between the interests of the directors and advisers. Toward this end, section 10(a) was amended to require that at least forty percent of the board of directors be persons “uninterested” in the investment company. The replacement of the adjective “interested” for the adjective “affiliated” created a more stringent standard for director disaffiliation. Congress thus intended directors to better fulfill their role as “watchdogs” for the fund.

Prior to the amendment of section 36 a showing of “gross misconduct” or “gross abuse of trust” was required before an action could be brought against directors of an investment company. Amended section 36(a), however, grants the Securities and Exchange Commission (SEC) an absolute right to sue a director in federal court for breach of fiduciary duty involving personal misconduct. Section 36(a) liberalizes the requirements for bringing suit on behalf of a mutual fund by requiring 40 percent of the board to be unaffiliated. See supra notes 35-68 and accompanying text; Eisenberg & Phillips, Mutual Funds Litigation—New Frontiers for the Investment Company Act, 62 COLUM. L. REV. 72, 76 (1962).

38. “Interested person” is defined in § 2(a)(19) of the Investment Company Act, and includes persons who have close family ties or substantial financial or professional relationships with the investment company or its advisers, or who have beneficial or legal interests in securities issued by the adviser or underwriter.

39. As amended, section 10(a) of the Act states: “(a) No registered investment company shall have a board of directors more than 60 percentum of the members of which are interested persons of such registered company.” 15 U.S.C. § 80a-10 (1970).

40. The definitions emphasize that greater distance must be placed between the interests of the directors and the advisers. The amendments “place[d] the unaffiliated directors in the role of ‘independent watchdogs’ who would assure . . . that mutual funds would operate in the interest of all classes of their security holders, rather than for the benefit of investment advisers, directors, or other special groups.” Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.) cert. denied, 434 U.S. 934 (1977); Conference on Mutual Funds, 115 U. PA. L. REV. 669, 739 (1967) (comment by A. Pomerantz). See also Burks v. Lasker, 441 U.S. 471, 484-85 (1979), where Justice Brennan embellished on congressional intent to create strong standards for independent directors. See generally Note, supra note 21.


42. For a complete discussion of which parties are entitled to sue or to be sued under section 36(a), see Crane & Walker, Who Can Sue and Be Sued Under Section 36(a) of the Investment Company Act of 1940, 32 BUS. LAW. 417 (1977).
Section 36(b) of the ICA: Demand Requirements

The Role of the Adviser

The most significant change in the Act was section 36(b)'s imposition of fiduciary responsibilities upon a fund's investment adviser with regard to compensation received for services provided to the fund. Recognizing that even independent directors were unable to deal at arm's length with investment advisers, the House of Representatives originally proposed an express standard of statutory "reasonableness" for management compensation which was criticized by industry representatives for focusing too much attention on the director's behavior rather than on the adviser's behavior. The Senate ultimately replaced


44. See supra note 11 and accompanying text.

45. Various studies concluded that negotiations between unaffiliated directors and fund advisers over advisory fees lacked an essential element of arm's length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services.

In view of the fund's dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser's reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry.

PPI, supra note 1, at 131.

46. "Reasonableness" was to be determined without consideration of prior ratification of adviser contacts by either shareholders or directors, but rather, by referring to fees paid for similar services by like institutions, the nature and quality of the services rendered, and any other factors considered to affect the public interest. PPI, supra note 1, at 143. The purpose behind the proposed legislation was to make clear to "those who derive benefits from their fiduciary relationships with investment companies" that they "cannot charge them more for services than if they were dealing with them on an arm's length basis." Id. at 144.

47. "Although they [the industry] did not object to the proposition that management fees should be reasonable, they wanted to change the standard because "reasonableness" focused on the directors and they wanted court actions to focus on the conduct of the investment advisors." Memorandum of the Commission in Response to Query by Chairman Moss Regarding the Differences Between the Reasonableness in S. 34 and the "Breach of Fiduciary Duty" Standard of S. 2224 and H.R. 11,995 with Respect to Management Fees, p. 188, Hearings Before the Subcomm. on Commerce & Finance of the Comm. on Interstate & Foreign Commerce, H.R. REP. No. 91st Cong., 1st Sess. (1969).
the "reasonableness" standard with a statutory fiduciary duty for an adviser accepting compensation from a mutual fund and created a judicial remedy for breach of that duty.\textsuperscript{48}

An action brought under section 36(b) does not require a showing of personal misconduct by the defendant. The plaintiff must simply establish a breach of fiduciary duty in the acceptance of excessive compensation. The emphasis of this statute is on the regulation of fees.\textsuperscript{49}

\textbf{Split Among the Circuits}

Three circuits have considered this problem and their analyses and conclusions differ. The facts of three circuit court cases,\textsuperscript{50} all presenting the issue of whether the demand provisions of rule 23.1 of the Federal Rules of Civil Procedure apply to a shareholder's suit under section 36(b) of the Act, are strikingly similar. In each, the plaintiff was a shareholder of an open-end investment company who sued its investment adviser alleging that the adviser had breached its fiduciary duty to the fund.\textsuperscript{51} Although each plaintiff acknowledged that no prior demand had been made on fund directors to pursue the action,\textsuperscript{52} they argued that the demand provision of rule 23.1 should not be a prerequisite to suits brought under section 36(b).\textsuperscript{53} The First, Second and Third Circuits were unable to reach uniform answers to the question.

Each opinion initially sought to determine whether a section 36(b) suit brought by a shareholder was derivative.\textsuperscript{54} Employing a two-tiered analysis, the courts first examined the issue of

\begin{enumerate}
\item \textsuperscript{48} "In the case of management fees the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees. Therefore . . . in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where the mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." S. Rep., supra note 20, at 4 (emphasis added).
\item \textsuperscript{49} See Note, supra note 30, at 640-50; Note, Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control, 83 YALE L.J. 1475, 1478 (1971).
\item \textsuperscript{51} Grossman, 674 F.2d at 118. Fox, 692 F.2d at 253; Weiss, 692 F.2d at 931. In Grossman, the plaintiff also alleged breach of fiduciary duty for failure to recapture excessive underwriting commissions. 674 F.2d at 124. That issue is beyond the scope of this article.
\item \textsuperscript{52} Grossman, 674 F.2d at 118; Fox, 692 F.2d at 253; Weiss, 692 F.2d at 931.
\item \textsuperscript{53} Grossman, 674 F.2d at 118; Fox, 692 F.2d at 253; Weiss, 692 F.2d at 931.
\item \textsuperscript{54} Grossman, 674 F.2d at 118-20; Fox, 692 F.2d at 255-61; Weiss, 692 F.2d at 933-36.
\end{enumerate}
whether a section 36(b) action could be terminated by a director exercising business judgment.\textsuperscript{55} If not, then one of the most important justifications for requiring demand does not exist.\textsuperscript{56} Second, assuming that director termination is permissible, the courts considered the applicability of the various reasons traditionally excusing demand.\textsuperscript{57}

The First and Third Circuits concluded that the demand requirements of rule 23.1 could play a significant role in a section 36(b) shareholder suit, regardless of whether directors could terminate suits, and therefore held that compliance with rule 23.1 was mandatory.\textsuperscript{58} The Second Circuit reached the opposite conclusion and held that bringing demand on directors would not result in the practical resolution of excessive compensation disputes and was therefore not required.\textsuperscript{59}

\section*{The Issues}

\textbf{Section 36(b) Suits: Derivative?}

The First and Third Circuits both held that section 36(b) shareholder suits were derivative.\textsuperscript{60} Although the statute does not explicitly give the fund authority to sue, the courts both argued that language in the statute allowing shareholders or the SEC to bring complaints "on behalf of such company" implied that the suits were derivative.\textsuperscript{61} In \textit{Weiss v. Temporary Investment Fund, Inc.},\textsuperscript{62} the Third Circuit advanced several additional arguments. The court cited dicta in the Supreme Court opinion of

\begin{itemize}
  \item \textit{Grossman}, 674 F.2d at 121-23; Fox, 692 F.2d at 261; Weiss, 692 F.2d at 936-39.
  \item See \textit{supra} note 21 and accompanying text.
  \item \textit{Grossman}, 674 F.2d at 123-25; \textit{Weiss}, 692 F.2d at 943.
  \item \textit{Grossman}, 674 F.2d at 123; \textit{Weiss}, 692 F.2d at 943.
  \item Fox, 692 F.2d at 260.
  \item In \textit{Grossman}, the court stated: "A suit 'on behalf of such company' (a phrase which is more than merely one 'for the benefit of the company') is normally a derivative action that the company could itself bring." 674 F.2d at 120, \textit{cited in Weiss}, 692 F.2d at 934. Further, the First Circuit stated: "Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), it was unnecessary to say with particularity that the company also did." 674 F.2d at 120, \textit{cited in Weiss}, 692 F.2d at 934.
  \item 692 F.2d 928 (3d Cir. 1982).
\end{itemize}
**Burks v. Lasker**⁶³ that suggested that a section 36(b) shareholder suit is derivative.⁶⁴ The **Weiss** court also held that the fund has an implied right of action under section 36(b).⁶⁵

The Second Circuit analyzed the same issues but held that a section 36(b) suit is not a derivative suit. **Fox v. Reich & Tang, Inc.**⁶⁶ rejected the argument that the words “on behalf of” in section 36(b) were in themselves sufficient to give mutual fund independent directors the right to bring a suit for the fund. The court refused to assume an unexpressed congressional intention to create additional parties under the statute.⁶⁷ **Fox** held that the words “on behalf of” were imposed by Congress to ensure that fees recovered by a shareholder in a successful section 36(b) suit would be returned to the fund.⁶⁸ The **Fox** court interpreted the words to mean that shareholders should act as “private attorney

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⁶³. *Id.* at 934 (citing **Burks v. Lasker**, 441 U.S. 471, at 477 (1979), where the Court referred to a section 36(b) suit as derivative).

⁶⁴. *But see* **Blatt v. Dean Witter Reynolds Intercapital, Inc.**, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982) (where the court held in part that the lack of specific language giving the fund the right to bring an action for violation of section 36(b) meant that the fund had no right to sue and consequently, that there was no basis for a section 36(b) suit to be derivative).

⁶⁵. **Weiss**, 692 F.2d at 934. The Court implemented the four-part test of implied rights of action which originated in *Cort v. Ash*, 442 U.S. 66 (1975). Although the **Weiss** court noted that the facts of its case were atypical, 692 F.2d at 934 n.8, it nevertheless applied the *Cort* test.

The first requirement of the *Cort* analysis is that the proposed plaintiff be the intended beneficiary of the statute. Analyzing the legislative history of 36(b) and noting that any recovery of fees went directly to the fund, the **Weiss** court found that investment company shareholders were the intended beneficiaries of section 36(b). *Cort* then requires ascertainment of congressional intent. Although noting the lack of any express intent to give the fund the right to bring suit, the court also found nothing in the legislative history which “suggested an intent to deprive the companies of a direct remedy.” **Weiss**, 692 F.2d at 936. Weiss analyzed laws regulating investment companies prior to the Amendment and discerned a congressional intent to preserve the existing legal remedy, a derivative suit by a shareholder who could make a showing of corporate waste. **Weiss**, 692 F.2d at 935.

The third prong of the *Cort* test inquires whether an implied action would be consistent with the legislative purpose behind the statute. Because section 36(b)'s purpose was to provide a means for recovering excessive advisory fees, allowing the investment company a cause of action furthered the legislative purpose. Finally, the court held that the implication of a “companion remedy” for the investment company did not intrude on state law because the express cause of action conferred on shareholders by Congress ipso facto federalizes the litigation. Thus all four factors of the *Cort* tests were met.

See also **Markowitz v. Brody**, 90 F.R.D. 542, 557 n.12 (S.D.N.Y. 1981), where the court applied the *Cort* test and held that the idea that a section 36(b) suit was derivative was "doctrinally sound." *Id.*

⁶⁶. 692 F.2d 250 (2d Cir. 1982).

⁶⁷. *Id.* at 255-56.

⁶⁸. *Id.* at 256.
generals” to assist the enforcement of remedies for breach of fiduciary duty by an investment adviser.69

Fox criticized the First Circuit’s opinion in Grossman v. Johnson70 for the “scant support” of its conclusion that a fund could sue its investment adviser under section 36(b).71 Fox specifically rejected the Grossman logic which argued that Congress might not have considered it necessary to specify that a fund had its own cause of action under section 36(b), and highlighted the fact that had Congress given a right of action to the fund, the shareholder’s right to bring a derivative suit would have followed automatically.72 Considering the exhaustive nature of the study which led to this amendment, the Second Circuit found it unlikely that Congress would have failed to recognize this situation. The court therefore concluded that the failure to grant a right of action to the fund was intentional.73 Finally, Fox noted that the source of the adviser fee problem, which section 36(b) was created to correct, was the unique structure of the investment company industry where effective arm’s length bargaining was virtually nonexistent.74 Because the troublesome relationship between advisers and directors was at the root of the adviser fee problem, directors could not be relied on to solve the problem.75 Consequently, Congress did not give them the right to bring a section 36(b) suit. Although the role of the independent director was admittedly strengthened by other amendments, Fox determined that these new provisions did not extend to section 36(b) suits which Congress left solely in the hands of the SEC or shareholders.

69. Id. at 255.
70. 674 F.2d 115 (1st Cir. 1982).
71. Fox, 692 F.2d at 256.
72. Id.
73. Id.
74. Id. at 258-59. “[T]he root of the excessive advisor fee problem is basically incompatible with a corporate right of action as an effective solution.” Id. “It defies logic to conclude” that Congress intended for the independent directors to sue their advisors. Id. at 260.
75. Although independent directors do serve a function in the investment company scheme, their usefulness is severely limited. The independent directors usually consider their responsibilities to be only part-time obligations, they do not usually retain the assistance of outside help to fulfill their responsibilities, and most of the information they use in their decision making comes from the investment adviser. As a result, the SEC found that “in general the unaffiliated directors have not been in a position to make changes in the level of advisory fee rates in the mutual fund industry.” WHARTON REPORT, supra note 3.
The Demand Requirements

Even assuming that a section 36(b) action brought by a shareholder is derivative, the conflict between the circuits regarding the applicability of the demand provisions of rule 23.1 remains unsettled. The issue involves two considerations. The first is whether or not independent directors may terminate a derivative suit brought under section 36(b), and the second, whether the traditional excuses for not bringing demand apply to section 36(b) suits brought by shareholders.

The Rights of Directors to Terminate Suit

A major obstacle faced by the courts upholding the demand requirement is the contention that independent directors of a mutual fund can never exercise good faith business judgment to terminate a section 36(b) shareholder suit. If they cannot, then one of the primary rationales for requiring demand is lost, and the demand requirement must be justified on another basis.

To resolve this issue, Grossman, Fox and Weiss cited dicta in the Supreme Court decision of Burks v. Lasker, where the Court referred to section 36(b) as manifesting specific congressional intent to prevent independent directors from terminating lawsuits. The First and Third Circuits interpreted the Burks dicta to mean that directors may not terminate section 36(b) suits. The courts nevertheless held that demand should be required, because Congress' overriding interest in adopting the amendments was to strengthen the role of the independent director. Requiring demand best achieved this congressional goal.

In Weiss, the Third Circuit expanded on this issue. For the sake of argument the court accepted the plaintiff's proposition that independent directors could not terminate section 36(b)

76. See infra notes 90-92 and accompanying text.
77. Grossman, 674 F.2d at 123; Fox, 692 F.2d at 261-62; Weiss, 692 F.2d at 939.
78. 441 U.S. 471 (1979).
79. "[W]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees." Id. at 484. The Act does not specifically note whether an independent director should have a right to terminate a suit which is brought under it. See Note, supra note 5, at 426.
80. Grossman, 674 F.2d at 121; Weiss, 692 F.2d at 940.
81. Grossman, 674 F.2d at 121; Weiss, 692 F.2d at 941-42. In Grossman, the court also emphasized that bringing demand would serve the practical function of preventing "strike" suits.
suits, and considered the plaintiff's argument that if independent directors are too self-interested to terminate lawsuits, they are also too self-interested to respond objectively to shareholder demand. To support this argument, the plaintiff cited *Cramer v. General Telephone & Electronics Corp.* where the Third Circuit held that the business judgment rule and the demand requirement were "inextricably linked." In other words, the same considerations which characterize a director as too interested to terminate a lawsuit also determine whether directors are too interested ever to act in the corporation's best interest. If mutual fund directors are too self-interested to be permitted to terminate section 36(b) lawsuits, then bringing demand on them will serve no purpose and therefore should be excused.

The Third Circuit rejected this argument, denying the full force and power of *Cramer*, and deferring instead to the district court opinion in *Weiss* which distinguished between the policies supporting the business judgment rule and those justifying the demand requirement. The court held that, regardless of whether directors could terminate section 36(b) shareholder suits, the demand requirements of rule 23.1 should be upheld.

In *Fox*, the Second Circuit analyzed the identical situation but reached the opposite conclusion, accepting the *Burks* dicta as conclusively establishing that directors cannot terminate section 36(b) suits. This was consistent with the court's belief that Congress intended to take control of the adviser fee problem out

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82. *Weiss*, 692 F.2d at 939.
84. Id. at 274.
85. *Weiss* made this argument before the Third Circuit. The court acknowledged some basis in the argument as a result of the holding in *Lewis v. Curtis*, 671 F.2d 779 (3rd Cir. 1982). In *Lewis* the Court held that the futility of bringing demand depended on the disinterestedness of the directors. To determine disinterestedness a court should use the same standard that they used to determine whether a court should defer to the board's business judgment not to pursue a lawsuit on behalf of the corporation. *Weiss*, 692 F.2d at 940-41.
86. *Weiss*, 692 F.2d at 940-41.
87. *Fox*, 692 F.2d at 259.
of the hands of the directors. The court therefore concluded that because directors may not bring suit under section 36(b) and may not terminate section 36(b) shareholder suits, there is no valid purpose in requiring demand.

Excuses for Demand

Finally, assuming that the demand requirements of rule 23.1 are generally applicable to section 36(b) shareholder suits, the courts considered whether any of the traditional excuses for failing to bring demand were applicable to the facts of their cases. In Grossman and in Weiss, the courts held that the plaintiffs failed to allege with sufficient particularity the reasons why demand would be futile. Relying on In re Kauffman Mutual Fund Actions, the courts held that the pleadings failed to

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88. This notion is well-supported in the legislative history behind section 36(b):

This bill would make clear that as a matter of federal law, the investment advisor or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees. Therefore in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where the mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.

S. REP., supra note 20, at 2 (emphasis added).

89. Two other arguments which Grossman and Weiss found to be untenable were: (1) an analogy to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(p)(b) (1976) ("profits from purchase and sale of security within six months") to section 36(b). Although § 16(b) actions have been excluded from some of the 23.1 provisions, the demand requirement issue is wholly inapplicable because § 16(b) embodies its own demand requirements; Grossman, 674 F.2d at 120-21; Weiss, 692 F.2d at 938-39; and (2) that giving "security holders" the right to sue under § 36(b) gives debenture holders or creditors the right to sue. Weiss dismissed the argument that these parties would be unable to comply with the requirements of rule 23.1 requiring suit to be brought by security holders. Id.

90. The general rule ... is that demand will be excused when the plaintiff shows that a majority of the company's directors have an interest in the subject matter of the lawsuit such that the court concludes that it would have been futile to ask the board to act. Galef v. Alexander, 613 F.2d 51 (2d Cir. 1980). See also Papilsky v. Berndt, 59 F.R.D. 95 (S.D.N.Y. 1973), appeal dismissed, 503 F.2d 554 (2d Cir.), cert. denied, 419 U.S. 1048 (1974).

91. Grossman, 674 F.2d at 124-25; Weiss, 692 F.2d at 943.

92. 479 F.2d 257 (1st Cir. 1972), cert. denied, 414 U.S. 857 (1973). In Kauffman the court was confronted with the issue of whether the mutual fund industry should have a different set of standards for determining the necessity of demand than those established for more traditional organizations. The court held that demand on independent directors was still required unless particular facts were introduced that would render demand
establish any firm basis for excusing demand, and consequently, the shareholder's failure to make demand was inexcusable.93

ANALYSIS

In Grossman and Weiss, the First and Third Circuits emphasized congressional intent to strengthen the role of independent directors and concluded that requiring demand helped achieve that goal. In Fox, the Second Circuit focused more attention on the co-existing congressional intent to fashion a remedy for the excessive adviser fee problem which did not rely solely on the judgment of the independent directors for its success. When this goal was considered the court concluded that demand would serve no valid purpose.

Whether the demand provisions of rule 23.1 should apply to a suit brought by a shareholder under section 36(b) of the Investment Company Act is not susceptible to a simple answer.94 Section 36(b) was enacted to combat the payment of excessive adviser compensation.95 To understand the mechanics of this
remedial provision, an examination of the problem which the provision was intended to address is necessary.

Congressional records describe a situation, prior to the enactment of the 1970 amendments, in which excessive compensation was typically paid to outside advisers of mutual funds.\footnote{See supra note 7; S. REP., supra note 20, at 6. See also Barnard, Reciprocal Business, Sales Charges and Management Fees, in 1966 Fed. B.A. CONFERENCE ON MUTUAL FUNDS 127-29.} This accelerating trend, combined with the inability of mutual fund directors to deal at arm’s length when regulating the fees paid to outside advisers, created a situation which required prompt legislative attention.\footnote{See supra notes 1-7 and accompanying text.}

Congress responded to the dilemma by creating two levels of shareholder protection which both strengthened the role of the independent director and afforded enhanced investor protection from the payment of excessive adviser compensation.\footnote{The proposition that Congress intended to strengthen the role of the independent director while at the same time imposing a fiduciary duty on investment advisers is grounded in legislative history: “This section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal Courts can effectively enforce the federally created fiduciary duty with respect to management compensation.” S. REP., supra note 20, at 7-8 (emphasis added). The two goals are not mutually exclusive, but together provide extra protection for mutual fund investors. None of the circuit courts saw the two steps as compatible. Rather, the opinions viewed the legislative history either as indicative of congressional intent to strengthen the role of the independent adviser, or as taking all discretion from these advisers in the determination of fees. For example, in Weiss, 692 F.2d at 937, the court recognized that the management was installed as the “first line” of defense for the individual investor. This logic is not faulty, but is incomplete under this two-tier model because it fails to recognize that the courts were installed as the “second line” of defense. See supra note 11.} Under this model, the demand requirement of rule 23.1 serves no valid purpose.

In the 1970 amendments to the Act, Congress created a system in which the independent directors of an investment fund have primary responsibility for establishing reasonable fees and a continuing obligation to regulate payment of such fees.\footnote{See supra note 11.} Congress therefore narrowed the definition of an interested direc-
tor to create the greatest possible separation between the directors and the adviser and loosened the requirements for bringing suit against a director. Section 36(a) reinforces the duties imposed on directors in other parts of the Act. Under section 36(a) an action may be brought against a director whose personal misconduct results in a breach of fiduciary duty to the fund.

However, even this enhanced protective mechanism does not sufficiently protect investors. Consequently, section 36(b) was enacted to provide final assurance that the shareholder's best interests are protected. Under section 36(b) an investment adviser may be sued by either a shareholder or the SEC for breach of fiduciary duty with regard to the receipt of excessive compensation.

Specifically, two tiers of protection are provided. The independent directors of a fund have a fiduciary obligation to enter into contracts providing for reasonable advisory compensation and to regulate the compensation rate during the pendency of

100. See supra text accompanying notes 34-40.
101. See supra text accompanying notes 40-45.
102. See supra note 10; Crane & Walker, Who Can Sue and Be Sued Under Section 36(a) of the Investment Company Act of 1940, 32 BUS. LAW. 417, 421-22 (1977). Also, under 15 U.S.C. § 80a-41(c) (1976), the SEC is given authority to bring suit whenever it appears that a violation of the Act has been or is about to be committed. Thus, directors are always required to fulfill their statutory obligations regarding adviser fees. See supra note 11. Since it has been implied that shareholders can sue independent directors under section 36(a), the provisions of the section provide a significant deterrent to the independent director who hesitates to act as a careful "watchdog." Moses v. Burgin, 445 F.2d 369, 373 (1st Cir.), cert. denied, 404 U.S. 994 (1971); Herpich v. Wallace, 430 F.2d 792, 815 (5th Cir. 1970).
103. See Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 942 (3d Cir. 1982), which recognized that directors have been given extra responsibility under the Act but concluded for this reason that demand should be required. Under the two-tier analysis, the same statutory provisions would suggest that no demand should be required because the directors already had an opportunity to act in regard to the regulation of fees. Contrary to Weiss' conclusion, the shareholders should, at this level, be able to by-pass the directors. See infra note 119 and accompanying text.
104. "Strengthening the voice of disinterested directors is important for the protection of public shareholder. But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's advisor-underwriter would not be an effective check on advisory fees and other forms of management compensation." PPI, supra note 1, at 148.
105. 15 U.S.C. §80a-35(b) (1976). See supra note 15. The purpose of section 36(b) is "to make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge them more for services than if they were dealing with them on an arm's length basis. PPI, supra note 1, at 144.
the contract. The advisers are also given the fiduciary responsibility to accept only reasonable compensation.\textsuperscript{106} Under this two-tier approach, requiring a shareholder to bring a demand on directors before bringing a section 36(b) suit would be superfluous.\textsuperscript{107} Allowing independent directors to bring a suit challenging an act for which they could be personally liable would defy common sense.\textsuperscript{108} A section 36(b) action, left in the hands of the directors, gives an appearance of impropriety, and is ludicrous because directors would rarely bring a suit which would be self-threatening.\textsuperscript{109}

Assuming, then, that a section 36(b) suit is one which the directors of the fund may instigate, the policies underlying the demand requirements of rule 23.1 would not be served by requiring demand to be made by shareholders in a suit to recover excessive advisory compensation.\textsuperscript{110} Generally, demand is required in a shareholder’s derivative suit to provide a corporation with the opportunity to analyze the complaint and discern whether bringing a lawsuit would serve the best interests of the corporation.\textsuperscript{111} In a section 36(b) shareholder suit, allowing the directors to determine whether a lawsuit is in the corporation’s best interest would be inefficient because section 36(b) was created to limit director discretion in controlling the payment of adviser fees.\textsuperscript{112} Allowing the directors of a mutual fund to exercise their business judgment to terminate a section 36(b) lawsuit thus would circumvent the protection offered by section 36(b) and would defeat the purpose for which section 36(b) was created.\textsuperscript{113}

Finally, even assuming that demand generally should be required, the exceptions which excuse demand would often apply

\textsuperscript{106} \textit{Id.}

\textsuperscript{107} \textit{See supra} note 102.

\textsuperscript{108} Under the two-tier system, both directors and advisers have an obligation to the fund in regard to the regulation of adviser compensation. Although the directors would be sued for the payment of excessive compensation and the advisers for receipt of such excessive compensation, the two are intimately connected. In any situation where the adviser could be sued under § 36(b), the director could be sued under § 36(a).

\textsuperscript{109} \textit{Id.}

\textsuperscript{110} \textit{See supra} note 13 and accompanying text.

\textsuperscript{111} \textit{See supra} notes 13-15 and accompanying text.

\textsuperscript{112} \textit{See supra} notes 87-89 and accompanying text.

\textsuperscript{113} Under the two-tier analysis the dicta in \textit{Burks} should be treated as conclusive because it is in accordance with the logic that provides that directors should not be able to terminate the §36(b) suit, as they are too self-interested in the transaction to look at it objectively.
to a section 36(b) suit. The circumstances which typically excuse shareholder failure to bring demand in a derivative suit are inherent in the investment company-investment adviser relationships. When it is unlikely that directors will take affirmative steps to remedy a shareholder's complaint, failure to make demand is excused.

One excuse recognizes that the directors of a corporation are often controlled by the alleged wrongdoers. Indeed, the Investment Company Act was created and amended specifically to combat this problem. A second situation in which a shareholder's demand will be excused is when there are allegations that a conflict of interest exists which forecloses the likelihood of a director vigorously prosecuting a shareholder's claim.

A third excuse commonly accepted in lieu of demand is that the directors, upon whom demand is to be made, participated in the wrongful transaction and therefore would always terminate shareholder suits. This excuse is also appropriate in a section 36(b) shareholder suit. Because independent directors establish fee schedules and have a continuing obligation to ensure their reasonableness, they are intimately involved in the controversy giving rise to a section 36(b) suit. To expect these same directors to sue the fund's advisers would, in effect, be asking them to

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114. See supra note 15; Comment, supra note 14, at 173-83.
116. See supra note 4; S. Rep., supra note 20, at 2. "In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult . . . to apply traditional fiduciary standards in considering questions concerning management fees."
117. Comment, supra note 14, at 174-75.
118. See supra note 35 and accompanying text.
119. See supra notes 4, 7.
120. Comment, supra note 14, at 176-80. In In re Kauffman Mutual fund Actions, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973), the First Circuit held that allegations of mere approval of injurious corporate transactions by directors are not enough to excuse demand. Id. at 265-66. Even though the applicability of this holding is questionable to cases which arose after the 1970 amendments, if it is applicable it will not be an obstacle in this situation, because under the two-tier analysis the directors have an affirmative duty to the corporation in regard to adviser compensation. See supra notes 102-113 and accompanying text.
implicate themselves.\(^{121}\)

In short, the traditional situations excusing demand in a shareholder's derivative suit involve antagonism between the interests of shareholders and directors. This troublesome relationship is, in the context of mutual funds, the rule, rather than the exception. Once the directors have had an opportunity to regulate the compensation paid to the advisers, and have failed to do so effectively, the structure of the industry mandates that the ultimate solution to the problem be placed in the hands of a neutral party. Congress interposed the courts as this neutral body to ensure that the public’s best interests would not be jeopardized by the payment of excessive compensation to mutual fund advisers.\(^{122}\)

This interpretation of the legislative history of the 1970 amendments does not contradict the argument of the First and Third Circuits that the amendments were intended to strengthen the authority of independent directors.\(^{123}\) Nor does it accept the Second Circuit's contention that independent directors should be bypassed on issues concerning regulation of advisory fees. The "two-tier" approach reconciles these arguments. By strengthening the role independent directors play in establishing rates of adviser compensation, while placing ultimate responsibility for reviewing such fees in the courts, Congress developed compatible means by which to attain one end. When viewed in this light, requiring shareholders to bring demand under rule 23.1 would be both inefficient and meaningless because it would serve none of the functions for which rule 23.1 was created and would defeat the intentions of section 36(b).

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121. See supra note 107.

122. 15 U.S.C. § 80a-35(b)(2) (1976); S. Rep. supra note 20, at 5. "[T]here should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." Id.

123. As the Third Circuit noted in Weiss, 692 F.2d at 937, "legislative history is replete with references to Congress' intent to preserve, not preempt, the role of management in negotiating advisory fees." See S. Rep. supra note 20, at 5-6. Nonetheless, if Congress intended the independent directors to serve as the sole protection for the investment company it would have required a majority rather than 40 percent of the directors to have the "independent" qualifications. See Goldberg, supra note 36, at 568-70.
CONCLUSION

Unlike the typical business corporation, mutual funds are managed by outside investment advisers. Accordingly, conflicts of interest exist in mutual funds which do not exist in traditional corporations. Due to the close relationship between a fund's director and its adviser, the director often fails to effectively regulate the compensation paid to the advisers, and, in many cases, the fees paid to investment advisers have been excessive. In an effort to remedy this problem, Congress amended the Act in 1970 to establish that independent directors of a fund have a fiduciary duty to the fund, and that fund advisers have a fiduciary duty not to accept excessive compensation from the fund.

Three circuit courts found provisions of section 36(b) of the Act confusing. In particular, the issue of whether the demand provisions of rule 23.1 should apply to section 36(b) shareholder suits has been problematic. Given the conflicts which the courts have uncovered in their discussion of this issue, the Supreme Court has docketed the petition for certiorari which was filed by the defendant in Fox. Should the Court accept the case for review, it is essential that it consider the legislative history of section 36(b) to discern congressional intent. Section 36(b) cannot properly be applied without an understanding of the other related provisions of the Act.

The two-tier scheme of regulation proposed by this article recognizes the expressed legislative intent to strengthen the role of the independent director, while placing the ultimate remedy for the payment of excessive compensation in the courts. Seen in light of the problem section 36(b) was created to correct, it is apparent that Congress did not intend the demand provisions of rule 23.1 to be applied to shareholder suits brought under section 36(b) of the Act. To do so would effectively return responsibility for solving the problem back to those who helped create it. The Supreme Court should therefore accept the two-tier analysis and recognize that demand should not be required in a section 36(b) shareholder suit.

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