Commoditized Governance: The Curious Case of Investment Company Shared Series Trusts

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I. INTRODUCTION 233
II. THE EMERGENCE OF SERIES TRUSTS IN THE INVESTMENT COMPANY INDUSTRY 238
  A. *The Origins of Registered Investment Company Use of Series Trusts* 240
  B. *The Regulatory Response to Series Funds in the Registered Fund Industry* 243
III. THE ROLE OF GOVERNANCE IN THE REGISTERED INVESTMENT COMPANY CONTEXT 246
  A. *The Typography of RIC Governance* 246
    1. The Push for Independence on Fund Boards 248
    2. Affirmative Delegated Regulatory Role of Independent Trustees 250
  B. *The Theory of What Fund Boards "Should be Doing"* 255
    1. Current Appraisals of Fund Governance: The Good, the Bad and the Ugly 255
    2. A Process-Oriented Perspective on Fund Governance 258
IV. SHARED SERIES TRUSTS: PROMISES AND PITFALLS 262
  A. *The Shared Series Trust Business Model* 263
  B. Pitfalls in Practice 265
  C. Implications for Commoditized Governance 266
V. THE LESSONS AND LIMITS OF COMMODITIZED GOVERNANCE 268
  A. *Situating the Issue of Commoditized Governance in Corporate Theory* 269
  B. *A General Theory of Commoditized Governance* 275
VI. CONCLUSION 278
VII. APPENDICES 279
  Appendix A 279
  Appendix B 291

I. INTRODUCTION

Use of series structures for multiple registered investment company funds (such as mutual funds or exchange-traded funds (ETFs)) is well-established both in practice and, as

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a regulatory matter, under the Investment Company Act of 1940 (ICA).[1] Essentially, in a series trust, multiple distinct funds reside in a single entity, most commonly a trust, as separate series of the trust.[2] Because registered funds are publicly offered, each fund series will invariably be owned by shareholders that differ from shareholders in other funds in the same trust. The assets and liabilities of each fund within the trust are legally segregated from its sibling funds. More recently the use of series structures in business entities has spread to other forms of business and types of business entities (most notably, LLCs[3]). But there should be no mistake about the significance and dominance of series structures among registered investment companies. Together, mutual funds and ETFs oversee $22 trillion in assets under management (AUM)[4] in roughly 10,000 funds,[5] and 91% of these funds reside in entities organized as Massachusetts common law business trusts, Delaware statutory

1. This Article focuses on two kinds of registered investment companies—open-end investment companies (i.e., mutual funds) and exchange traded funds. ETF is not a defined term in the ICA, but rather, as vehicles for investing in securities, ETFs are a hybrid form of registered investment company. Their operation is authorized pursuant to exemptive relief from the Securities and Exchange Commission. Exchange-Trade Funds, Investment Company Act Release No. 33,140, 83 Fed. Reg. 37,332, 37,333 (July 31, 2018) [hereinafter 2018 ETF Release]. "Historically ETFs have been organized as [mutual funds] or *UITs* [unit investment trusts]." *Id.* at 37,334. The first ETF, State Street's SPY ETF, was organized as a UIT. *See* Exchange-Trades Funds, Investment Company Act Release No. 28,193, 73 Fed. Reg. 14,618, 14,619 & n.10 (March 18, 2008) [hereinafter 2008 ETF Release]. This organizational approach gave way to the more common practice of organizing ETFs as open-end funds (i.e., mutual funds). *See* Stacy L. Fuller, *The Evolution of Actively Managed Exchange-Traded Funds*, 41 REV. SEC. & COMMODITIES. REG. 89, 93 (2008); *see also* 2018 ETF Release at 37,381 (quantifying the disparity between ETFs organized at mutual funds and as UITs). Thus, throughout this Article, registered investment companies and registered funds (and a tax law analogue acronym, RICs) are used exclusively to refer to mutual funds and ETFs. Other forms of registered investment companies, such as UITs (which do not have boards) and closed-end funds (which cannot be organized in separate series portfolios in a single trust), fill a relatively small niche of the registered investment company space and are not addressed in this Article.

2. *See* Joseph R. Fleming, *Regulation of Series Investment Companies Under the Investment Company Act of 1940*, 44 BUS. LAW. 1179, 1179 (1989) ("as a cluster of individual investment companies organized or administered under a single set of fundamental documents—charter, by-laws, certificate of incorporation, articles of association, or trust indenture"). Virtually all registered investment companies are organized as trusts or corporations. *See infra* note 6. Business trusts (including both statutory and common law business trusts) possess unusual flexibility of its organizational principles. S*ee* Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 ILL. L. REV. 31, 31–55 (2005) (discussing the unusual organizational flexibility of trusts as business entities). This suggests why such vehicles were the first business entities to embrace series structures. Common law trusts, primarily Massachusetts, may be organized in series form. *See* Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 457 (1988). The Delaware Statutory Trust Act, enacted in 1988, was specifically amended in 1990 to "recogniz[e] the creation of series . . . to organize as statutory trusts in Delaware." Eric A. Mazie & J. Weston Peterson, *Delaware Series Trusts – Separate but Not Equal*, 16 INV. LAW. No. 2, 2 (2009). Maryland also allows corporations that are investment companies to do so as well. MD. CODE ANN., CORPS. & ASS'NS § 2-208.2 (West 2018) (allowing for segregation of assets and liabilities of different series in corporation registered as investment companies); s*ee also* James J. Hanks et al., *Maryland Law: Continuing Support for Investment Companies*, 11 INV. LAW. 1, 6 (2004). Throughout this Article the term "series trust" will be used to refer to any series structure in the fund industry whether a common law business trust (as in Massachusetts), a statutory trust (as in Delaware), or a series corporation (as in Maryland).

3. This development is codified in Delaware's LLC statute. *See* DEL. CODE ANN. tit. 6, § 18-215 (series concept first extended to DLLCA in 1996).

4. INV. CO. INST. (ICI), 2018 INVESTMENT COMPANY FACT BOOK 34 fig.2.1 (58th ed. 2018) [hereinafter 2018 ICI] https://www.ici.org/pdf/2018_factbook.pdf.

5. *Id.* at 52 fig.2.15.

trusts, or Maryland corporations.[6] All three of these entity structures permit use of series structures and so the vast majority of funds are organized in entities that are series eligible. Even a very conservative estimate would suggest that a significant majority of the funds are organized in series form and these funds almost surely represent a majority of the $22 trillion in assets managed by these funds (i.e., more than 50% of total industry AUM is held in series funds).[7]

This Article focuses on a relatively recent development in the fund industry that involves a variation on the series structure concept: the *shared* series trust.[8] The series trust and shared series trust differ in one fundamental respect: the relationship of the trust's sponsor to the sponsor of the funds in the trust. In a conventional series trust, the trust sponsor is an investment adviser or an affiliate of the adviser, and the investment adviser typically manages the assets of each fund in the trust. In contrast, in a shared series trust, the sponsor of the trust is typically not a fund investment adviser and has little interest and no stake in the management or strategic decisions of the underlying funds in the trust. Rather, in the shared series trust, the trust sponsor or its affiliate is a third-party provider of non-advisory fund services (such as fund administration, compliance, and transfer agency). The sponsor of the individual funds in the trust (not to be confused with the trust's sponsor) typically will be the future investment adviser for the proposed new fund that will become a new series in the trust. In this arrangement, the fund sponsor/investment adviser will select a trust to house the proposed fund as a cost-efficient way to secure non-advisory services, including entity governance. This particular service feature, namely participation in a shared trust, provides the fund sponsor with an entity to house the fund and an "off-the-rack" board of trustees (including, most importantly, the requisite complement of independent trustees).[9]

The distinction between a series trust and a shared series trust can be concretely

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6. *Id.* app. A at 281–82 & fig.A.1 (method of organization—Delaware Statutory trust (40%), Massachusetts business trust (35%), Maryland corporations (16%). The remaining 9% of funds formed in other jurisdictions may also have a series structure, for example, an Ohio common law trust.).

7. The basis of this estimate can be explained intuitively. The use of series structures began to become prevalent in the mid-1980s. *See infra* Appendix B (showing Fidelity began to use series trusts in 1984 in its funds business); *see also* Jones et al., *supra* note 2, at 457 ("The desirability of the Massachusetts business trust as a vehicle for series funds received another dramatic boost following a 1984 [tax ruling that conferred a short-lived tax advantage]"). Mutual fund AUM did not even reach $1 trillion until 1990. Today, mutual funds manage nearly $19 trillion in assets (*see* 2018 ICI, *supra* note 4, at 277–302), indicating most of the assets currently under management arose after the use of the series form had become commonplace. Moreover, this does not include ETFs which did not exist in 1990. As of end of year 2017, there are roughly 1900 ETFs managing $3.4 trillion in AUM. *Id.* at 218–19. Indeed, the common use of series trusts applies with even greater force in forming ETFs. *See infra* note 55. Accordingly, there is every reason to believe that under current industry norms the series structure is not merely commonplace but pervasive. *See infra* note 56.

8. The term "shared series trust" is used commercially in the fund industry interchangeably with other terms such as "umbrella" trust or "turnkey" trusts. One such sponsor has trademarked the name: "ETF-in-a-Box." *See infra* Appendix A. This Article uses the phrase "shared series trust" to encompass these related terms.

9. Throughout this Article, I will frequently use board of trustees and independent trustees to refer to the governing bodies of the registered investment company and their independent members. This is not strictly accurate in the case of all mutual funds and ETFs since not all mutual funds or ETFs are in trust form. Many are in corporate form, in which case, board of directors or independent director would be the correct terminology. However, it is also common for some industry commentators to refer to "independent directors" in lieu "independent trustees." The ICA and rules thereunder typically refer to "independent directors" since "director" is defined to mean "any director of a corporation or any person performing similar functions with respect to any organization." 15 U.S.C. § 80a-2(12) (2012).

illustrated. The Fidelity family of funds has several hundred funds, and virtually all are housed in more than a dozen series trusts.[10] The principal advisers to each of the funds in the Fidelity family is a privately-owned adviser, Fidelity Management & Research (FMR) whose primary source of revenue are the management fees it derives in managing funds in the Fidelity family. In virtually all cases, FMR or an affiliate serves as the original sponsor of each fund in the Fidelity family of funds.

The shared series trust entails an alternative hypothetical scenario in which a third party (A1 Service Provider) forms (sponsors) a shared series trust entity—for example, the Generic Series Trust. Unlike the model in which an adviser sponsors the entity and the component fund series, the shared series trust sponsor is a non-adviser and the trust may have a dozen funds, each managed by unaffiliated investment advisers, such as Adviser X, Adviser Y, etc. The individual funds are typically sponsored by the adviser who manages the funds sponsored by that adviser. For example, A1 Service Provider may sponsor the Generic Series Trust, Adviser X would be the sponsor of the Adviser X Premium Fund, and Adviser Y would be the sponsor of Adviser Y Tactical Fund.

The governance outcome for the two types of series trust are starkly different. For the conventional series trust sponsored by an adviser, the board for any new fund will be the board of an existing series trust sponsored by the adviser.[11] An unaffiliated adviser who sponsors a new fund will likely approach the governance question differently. The unaffiliated adviser could seek to form the fund in a new stand-alone business entity (and recruit a board). Alternatively, the unaffiliated adviser might seek to have the new fund become a series within an existing shared series trust entity, such as the Generic Series Trust, under that trust's board. This latter situation—searching for an existing registered investment company entity and board to govern the fund—effectively treats governance as a commodity rather than as a core aspect of the fund's business. The unaffiliated adviser shops for an entity and board whose purpose is to provide a formal entity and board for the new fund.

The commoditized governance result should be of interest to both policymakers and legal scholars. For policymakers, this type of arrangement offers insights into how investment company governance functions in practice. The selective emergence of this approach to fund governance is a consequence of the evolution of governance practices in the registered investment fund space resulting both from changing business models in the industry and the unintended effects of fund governance regulation that places paramount significance on board independence.[12] An obvious concern is whether this form of commoditized governance model (an extreme form of independence) can effectively achieve the overarching governance objectives sought by regulation. In addition, if merely by contrast, an analysis of the shared series trust situation raises explanatory and normative implications for fund governance as a whole.

The commoditized governance phenomenon is also significant for legal theorists who focus on governance of business entities. As noted, the way governance functions for a shared series trust offers, at the very least, an unusual, and possibly unique, example in

10. *See infra* Appendix A.

11. *See* Fleming, *supra* note 2, at 1192 ("In the Commission staff's judgment, section 18(i) of the 1940 Act requires the shareholders of the entire investment company as a group to elect the board of directors as a whole, unless otherwise required by law."). *See also infra* notes 98–101.

12. *See* discussion *infra* Parts III.A.1–2.

which entity governance is commoditized (i.e., procured by a business from an external provider). More formally, when I refer to commoditized governance, I mean situations where (i) governance is treated as a non-core feature of an operating business; (ii) that can be obtained through a third-party arrangement; and (iii) whose selection is primarily the result of price and quality attributes associated with its provision.

Shared series trusts provide a means to study the theoretic implications of commoditized governance—both in terms of conditions and utility—generally for business entities. Quite simply, why is commoditized governance feasible in the shared series trust context? And more importantly, does commoditized governance in that context shed light on why governance of most business entities, in contrast, is a core feature of the business and not commoditized?

As argued here, commoditized governance is viable in the investment company industry as a result of special factors peculiar to the industry. As discussed below, commoditized governance requires two conditions to be feasible, both of which apply in the fund industry: (i) there must be sufficient similarities among otherwise segregated businesses to permit realization of economies of scale in governance; and (ii) the board's decision-making responsibility must primarily concern compliance and conflict-of-interest oversight rather than review of managerial or strategic enterprise objectives. The relevance of the first condition is fairly intuitive. No business will seek a third-party to provide governance unless it is cost-effective. The most likely source of cost efficiencies are economies of scale that might be derived from governing many similar, but independent, businesses.

The second condition, as explained below, is more complex. Specifically, governance can be thought of as involving two broad types of decisions being made by a board (which, in turn, can be divided into a host of sub-categories): (a) compliance and conflict-of-interest monitoring and (b) managerial and strategic decisions about the business. Compliance and conflict-of-interest oversight concerns the board's roles as bargaining agent with management, as ultimate compliance monitor in the firm, and as conflicts umpire when conflicts of interest arise. This form of oversight, rather than managerial and strategic decisions relating to the business, is paramount for fund boards. Hence, unsurprisingly in the fund industry, a commoditized solution to entity governance is potentially feasible for this kind of routinized oversight. Of course, although the predominance of these oversight decisions at the board level is a necessary condition for commoditized governance, such a condition does not imply that governance in this form will be uniformly optimal, or even preferable to other forms of governance, in all circumstances. Indeed both forms of governance (commoditized and non-commoditized) exist side-by-side in the fund industry.

In contrast, conventional public company boards discharge other decisional responsibilities not characteristic of fund boards that relate to enterprise management and strategy. These decisions concern enterprise capital formation and structure, availability of control premiums in change of control transactions, operational activities of the underlying business, and long-term business strategy. Where these types of managerial and strategic concerns are significant for a business, commoditized governance will be largely unworkable. In other words, where the entrepreneurial methods and strategies of the business and compliance and conflict-of-interest oversight are not easily segregated, commoditized governance will be disfavored.

The analysis is divided into four parts. The first two parts address the proliferation of series trusts in the fund industry and the role of governance for funds generally: Part II

describes the history of series trusts in the registered investment company space; and Part III discusses how regulation has shaped the objectives of governance in the fund industry. Part IV explores the pros and cons of shared series trusts (i.e., commoditized governance) within the fund industry, including special attention to situations that reveal the darker side of commoditized governance. The final part of this Article turns to the implications of commoditized governance in business entities with respect to corporate law theory. Specifically, Part V situates the phenomenon of commoditized governance with respect to well-known corporate theory themes of nexus of contracts and the separation of ownership and control and the normative preference for greater independence at the board level. The considerations provide a basis for understanding why commoditized governance is feasible in the fund industry in some cases, but is unlikely to be so in the case of conventional public companies.

II. THE EMERGENCE OF SERIES TRUSTS IN THE INVESTMENT COMPANY INDUSTRY

Virtually all modern treatments of series business entities offer a tip of the hat to the early adoption and increasingly widespread use of fund series in organizing multiple funds in a single trust entity.[13] However, this acknowledgement tends to gloss over the details of exactly how and why this is so. Today, most practitioners would explain the rise of business trusts in terms of the operational cost efficiencies afforded by this type of arrangement, an observation which is certainly true in terms of contemporary practice.[14] This Part explains the history that led to widespread use of series trusts in the investment management sphere, but does so by disaggregating the two categories of contributing factors, namely business and regulatory considerations.

Shared series trusts emerged as the result of a stepwise historical process. First, funds and mutual funds frequently used common-law business trusts as a preferred entity for organization. Second, given the relative flexibility of business trusts as an organizational form, use of the business trust form eventually led legal planners to recognize the feasibility of organizing new funds as separate series within the same trust. Third, as regulatory uncertainty and unfamiliarity with use of series business trust (and other series entities) by investment companies was resolved, use of series structures grew rapidly. The shared series trusts emerged as a novel end-stage variation on this structure and was especially suited for use by otherwise unaffiliated stand-alone funds or extremely small fund groups (i.e.,

13. *See, e.g.*, Ann E. Conaway & Peter I. Tsoflias, *The Delaware Series LLC: Sophisticated and Flexible Business Planning*, 2 MICH. BUS. & ENTREPRENEURIAL L. REV. 97, 102 (2012); Thomas E. Rutledge, *Again, for the Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311, 313 (2009).

14. *See* Conaway & Tsoflias, *supra* note 13, at 99 ("increasing popularity" of use), 132 ("efficient tool for business planning especially in the venture capital and private equity paradigm"). There are other indirect measures of increasing interest among practitioners. For example, Conaway & Tsoflias report that series concepts were added to Delaware's Statutory Trust Act in 1990 (*id.* at 103 n.28) and in 1997 to its Limited Liability Company Act (*id.* at 105 n.37). At the time of their article, nine U.S. jurisdictions had added the series concept to their LLCs statutes. *Id.* at 102–03. For example, as discussed in note 7, the use of series entities in the fund industry has become pervasive since the 1980s and thousands of funds are organized in series form and manage trillions of dollars in assets. Appendix B shows at a practical level how one of the largest U.S. fund families began to adjust their trusts to accommodate series funds beginning in 1984 and now covers hundreds of funds in their family of funds.

consisting of only a few funds). [15]

This Part recounts the first steps in this history. However, in order to better understand this progression, it is worth sketching out the basic entity elements of series trusts, and their relevance to the organization of investment companies. Business trusts are trusts with tradeable interests in the trust and thus offer a way of organizing a business entity. The business trust's development as a recognized business entity was intertwined with the development of the modern corporation.[16] Massachusetts has been a notable U.S. jurisdiction in legally recognizing common law business trusts; the earliest mutual funds were organized as Massachusetts business trusts.[17] Perhaps the defining feature of a business trust relative to a corporation is the flexibility in structuring a trust's internal affairs and its stakeholders' rights in the declaration of trust. As noted above, the perceived utility of common law business trusts led Delaware in recent times to adopt a statute authorizing formation of statutory trusts for business purposes which is essentially a statutory version of the common law Massachusetts business trust.

Business trusts lend themselves to organization in series form since a trust's assets and liabilities, as a matter of common law trust principles, can be partitioned as separate series in which the assets and liabilities and business affairs of one series are completely segregated from the assets and liabilities and business affairs of another. The series concept did not have to be legislatively authorized since common law trust principles and private ordering offered sufficient basis to effectuate organization of a trust in series form in the same way that trusts make use of sub-trusts to partition assets.

The series structure was easily adapted to investment companies, especially since it is common in the fund industry for funds to be affiliated in a group or family advised by the same investment advisers or affiliated advisers.[18] While fund families can arrange their affairs as a collection of stand-alone funds, they can also use one or more trusts to house multiple funds, with each fund representing a different series in a particular trust.[19] The affairs of each series fund in a single trust are overseen by a single unitary trust board.[20] The assets and liabilities of each series fund are, of course, legally segregated.[21] Accordingly, the assets of sibling series funds are never commingled, although they may share some common expenses, such as the costs of the board of trustees, common legal

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15. *See infra* text accompanying notes 125–31. Appendix A provides current examples of shared series trusts and their date of formation.

16. The historical use of business trusts is exhaustively canvassed in John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145 (2016).

17. *See* Jones et al., *supra* note 2, at 446. However, the real growth in use of Massachusetts business trust for fund series occurred after 1980. *Id.* at 451–58.

18. *See* Fleming, *supra* note 2, at 1180 (discussing industry practice with respect to series trusts).

19. *Id.* This is illustrated in Appendices A (shared series trusts) and B (with respect to Fidelity funds), which shows placement of multiple funds within a single investment company entity (e.g. trust).

20. *See* Fleming, *supra* note 2, at 1190–91. This result is derived from the limitations on issuance of senior securities found in ICA Sections 18(f)(1), 15 U.S.C. § 80a-18(f)(1) (2012); 18(f)(2), 15 U.S.C. § 80a-18(f)(2) (2012); and 18(i), 15 U.S.C. § 80a-18(i) (2012). Indeed, rule 18f-2 under the ICA, 17 C.F.R. § 270.18f-2 (2018), expressly exempts election of directors from the separate series voting requirements otherwise mandated for series funds in the same entity (e.g., trust).

21. *See* ICA § 18(f)(2), 15 U.S.C. § 80a-18(f)(2) (permitting mutual funds to issue multiple securities series if and only if each series "is preferred over all other classes or series in respect of assets specifically allocated to that class or series"). Rule 18f-3 under the ICA, 17 C.F.R. § 270.18f-3 (2018), spells out requirements for allocation of expenses among different series with respect to fundwide and series-by-series expenses.

fees, and the funds' chief compliance officer.[22] The public shareholders of each fund participating in a series trust are unique to that series and the combined shareholders of all the funds constitute the series trust's shareholders.[23] Typically, the assets within each fund will be either directly or indirectly managed by a single investment adviser or affiliated advisers. In such situations, the trust sponsor will likely be the fund adviser or an affiliate of the adviser.

A. The Origins of Registered Investment Company Use of Series Trusts

Although series trusts are commonplace in the fund industry today, that was not always the case. The emergence of such entity structures was aided, notwithstanding some initial impediments, by regulatory considerations. However, as a business matter, certain changes in the fund industry were separately significant in paving the way for the emergence of the series model in the latter half of the twentieth century. In this sense, the series model has organic roots in the fund business, although this context is hardly divorced from the subsequent regulatory framework under the ICA.[24]

The invention of the first mutual funds in 1924 followed close on the heels of the introduction of investment trusts to the United States (i.e., business trusts that functioned similarly to present day closed-end funds). The first mutual funds reflected the culture of wealth management in Boston at the time when the Boston trustee and prudent man rule were well-established. This style of investment management is a far cry from contemporary investment management practices in the fund industry.

The initial mutual funds were not organized in fund families, but rather typically as a sole flagship fund and sometimes with a smaller ancillary fund.[25] The funds were invariably internally managed, meaning the trust's trustees or employees would directly manage the fund's investment portfolio. Today, of course, the world is entirely reversed. Externally-managed funds are the rule rather than the exception (albeit the one exception to this rule is a major one: a majority of the funds in the Vanguard fund family). Nor should this initial state of affairs be surprising. The conceit of the early funds was that the funds' portfolio managers were persons steeped in principles of prudent investment practices who had considerable business acumen relative to the investment community of yesteryear. In short, they were offering a product based squarely on an active management premise that the fund could deliver a diversified and superior performance based on prudent and

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22. *See* 17 C.F.R. § 270.18f-3 (2018).

23. Section 18(f)(2) was enacted precisely to remedy the voting conundrums created by the fact that "each series of stock [in the same investment company] represents a different group of shareholders" but that shareholders in such companies were voting on matters "irrespective of series." *See* Fair and Equitable Treatment of Series Type Investment Company Shareholders, Investment Company Act Release No. 7276, 37 Fed. Reg. 17,384–85 (Aug. 26, 1972) [hereinafter Fair and Equitable] (adopting release for rule 18f-2 under the ICA, 17 C.F.R. § 270.18f-2 (2018)). The section and the rules thereunder were meant to ensure fair and equitable treatment of series type investment company shareholders.

24. 15 U.S.C. § 80a-1 *et seq.* (2012).

25. *See generally* MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW 10–18 (2d ed. 2011); ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 105[1] (2017). A small list of the original funds include: Massachusetts Investors Trust (1924) (now known as MFS Massachusetts Investors Fund); State Street Investors Corp. (1924); Incorporated Investors Fund (1925) (now known as Putnam Investors Fund); Pioneer Fund (1928); Century Shares Fund (1928); Industrial and Power Securities Company (1929) (now known as Vanguard Wellington Fund); CGM Mutual Fund (1929); and Fidelity Fund (1930).

typically fundamental investment management principles.

The later development of fund families, where fund family behemoths of today can offer hundreds of funds, reflects a different approach to funds in modern times. There is widespread recognition of many different conceivable and valid fund objectives and strategies.[26] Whether a manager is active or passive, the manager manages fund performance relative to a myriad of benchmarks which reflect expanding classes of assets and a proliferation of different investment styles and securities selection strategies among these various classes.[27] Whereas before it may well have been reasonable to manage with respect to a single active management investment thesis, that philosophy has been supplanted by a world of highly differentiated investment strategies in which supply of multiple fund offerings is the dominant strategy of most fund sponsors.

The history marking the industry transition from isolated actively managed funds to highly differentiated funds within a fund complex or family was slow and uneven. The first series trust appears to have been the Keystone Custodian Funds—a series of four of an eventual ten fixed income funds—which first appeared on the scene in Boston in 1932.[28] The four funds operated pursuant to a single Agreement of Trust with a single corporate trustee.[29] Each series reflected a separate and distinct agreement of the corporate trustee with the investment adviser and what today would be described as a class of shareholders participating in the series. The next significant series trust did not appear until 1940, the

26. The Investment Company Institute categorized the 7956 mutual funds (excluding ETFs) into three major categories and 13 composite objective sub-categories. 2018 ICI, *supra* note 4, at 213 (Tables 1 & 6). Separately the ICI gathers data for 42 recognized investment objectives with respect to track investor flow-of-funds. *Mutual Fund Investment Objective Definitions*, INV. CO. INST. (Nov. 2016), https://www.ici.org/research/stats/iob_update/classification/iob_definitions (Level 5 classifications are the most detailed); Morningstar uses a 3-x-3 style box to classify both equity and fixed-income mutual funds investment styles in which classification is based on a detailed decomposition and weighting of each fund's investment portfolio. *See* MORNINGSTAR, MORNINGSTAR FIXED-INCOME STYLE BOX METHODOLOGY: MORNINGSTAR METHODOLOGY PAPER (2012), https://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/FixedIncomeStyleBoxMeth.pdf; MORNINGSTAR, MORNINGSTAR [EQUITY] STYLE BOX METHODOLOGY: MORNINGSTAR METHODOLOGY PAPER (2018), http://corporate1.morningstar.com/ResearchLibrary/article/678263/morningstar-style-box-methodology; In the financial economic literature, appropriate classification of mutual fund styles is a significant methodological issue that arises in assessing relative performance of money managers. For a rigorous quantitative analysis of this issue, see Stephen J. Brown & William N. Goetzmann, *Mutual Fund Styles*, 43 J. FIN. ECON. 373 (1997).

27. Mark Potter, *Organization, Structure and Services of Mutual Funds*, *in* MUTUAL FUNDS – BUILDING BLOCKS IN INVESTMENT PORTFOLIOS 404–05 (H. Kent Baker et al. eds., 2015) ("proliferation of fund categories" has been spurred by "customers demand[ing] more choices"). The sheer number of funds attests to the explosion in types. *See supra* note 26.

28. FINK, *supra* note 25, at 52. See Amendments to Agreement of Trust Keystone Custodian Funds (dated July 15, 1939) which referenced the original Agreement dated March 1, 1932 (on file with the Journal of Corporation Law and available from the electronic archives of the Corporations Division, Secretary of the Commonwealth of Massachusetts, http://www.sec.state.ma.us/arc/arcidx.htm (last visited Nov. 18, 2018)).

29. Use of a corporate trustee (Keystone Custodian Funds, Inc.) differed from other business trust investment company structures that used natural person trustees. *See, e.g.*, Massachusetts Investors Trust Agreement and Declaration of Trust (as amended to Apr. 1928) (listing succession of trustees to the trust instrument) (on file with the Journal of Corporation Law and available from the electronic archives of the Corporations Division, Secretary of the Commonwealth of Massachusetts, http://www.sec.state.ma.us/arc/arcidx.htm (last visited Nov. 18, 2018)).

year the ICA was enacted.[30] There was increased usage of series trusts thereafter; but, as discussed in the next Part, the major expansion of the series structure occurred well into the ICA's existence after the Investment Company Amendments Act of 1970 (1970 ICA Amendments).[31]

In addition to the proliferation of differentiated fund strategies, externalization of fund operations is a second business factor paving the way for shared series trusts. Externalization of fund operations ranging from front to back office arrangements is the industry norm today.[32] Vanguard Funds uses an internalized advisory function for most of its funds, having famously gone from an externalized model to internalized one in the 1970s.[33] The first mutual fund with a long and proud tradition of internal portfolio management, Massachusetts Investors Trust (MIT), finally gave up the ghost in 1969 and switched to an externally-managed contractual relationship with MFS, an investment adviser formed from the existing MIT assets and resources that had performed the function on an internalized basis.[34]

Undoubtedly, the transformation of the investment management industry predominantly characterized by an externalized investment adviser model (i.e., one characterized as a contractual relationship between the adviser and the fund) and away from an internalized investment adviser model has fundamentally altered the economics of the investment management business.[35] Today, the externalization of the investment advisory function has become intertwined with the vast industry of external service providers with respect to so-called "back-office" functions, including fund administration, pricing services, transfer agency and distribution that had typically been provided on an external basis and custody, both as a matter of significant scale economies and regulation, is necessarily externalized. Externalization of fund functions in other areas has been driven largely by cost considerations, since many services entail significant scale economies, and by realignment of business affiliations and service provider arrangements around the

30. This series known as the United Funds was established in Kansas City by Waddell & Reed. PUBLIC POLICY REPORT, *infra* note 38**,** at 47. As noted previously, the ICA was enacted in 1940. Pub. L. No. 76-668, 54 Stat. 789 (1940).

31. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970).

32. *Id.*

33. *See* John C. Bogle, *Re-Mutualizing the Mutual Fund Industry – The Alpha and the Omega*, 45 B.C. L. REV. 391, 403–07 (2004).

34. *Id.* at 393–97. Bogle returned to the theme of the transformation of the mutual fund industry as illustrated by MIT in a lecture before the Boston Security Analyst Society given on May 17, 2013, republished as *"Big Money in Boston": The Commercialization of the Mutual Fund Industry*, 40 J. PORTFOLIO. MGMT. 133 (2013) in which he recounts the influence a journalistic profile of MIT had on his choice of career—*Big Money in Boston*, FORTUNE 116 (Dec. 1949). The article gave a candid behind the scenes chronicle of the origins and workings of MIT as of 1949, the largest mutual fund at that time. The mutual fund operation described reflects a bygone staid era of investment management that bears faint resemblance to fund complexes of today.

35. The issue of internalization versus externalization was an issue of unusual public policy significance in shaping the industry that periodically rose to the surface in public debates between industry and the SEC over regulatory measures and especially with the 1970 ICA Amendments. *See* William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 183 n.14, 185 (1971) ("Although the possibility of requiring internalized fund management was discussed in its PUBLIC POLICY REPORT [(*see infra* note 38)], the Commission's recommendations for legislative changes assumed that the existent pattern, by which funds typically secured their investment advisory and management services from separate, external advisers, would continue.") By default, the resulting statutory and regulatory scheme is properly viewed as enabling the externalization that has come to characterize the industry.

externalized fund investment adviser rather than the fund.[36] The net effect of externalization in the fund industry means that funds function without employees subject to oversight from a governing board.[37]

The move toward externalization alone did not cause the prevalence of series trusts in the fund industry, but it was a major factor indirectly contributing to their pervasive use in the industry. Externalization fueled the movement toward fund complexes and the proliferation of fund offerings by fund complexes, and series trusts in turn provided a useful and efficient entity vehicle for fund complexes. While series trusts offered a useful device for fund complexes built around externalized relations with service providers, the rise of *shared* series trusts as a species of series trusts is uniquely tied to the externalization phenomenon, because the utility of the *shared* series trust vehicle requires funds whose operations are fully externalized. In other words, the trend toward externalization figures as a contributing factor in the use of series trusts, and a direct causal factor in the emergence of *shared* series trusts (a fund model incorporating commoditized governance), which exemplifies a more radical form of externalization.

B. The Regulatory Response to Series Funds in the Registered Fund Industry

In its important *Public Policy Report* completed in 1966 on the investment company industry, the SEC explicitly addressed the issue of growing use of series companies.[38] The Report engaged in a broad re-examination of many industry arrangements and practices and used the study as a basis for proposing significant changes in the original regulatory framework of the ICA.[39] The Report's recommendations were embodied in comprehensive draft legislation prepared by the SEC and introduced in identical bills in Congress on May 1, 1967.[40] These initial proposals were enacted in a substantially revised form as the 1970 ICA Amendments.[41] The Amendments resulted in material changes to the ICA in the area of governance that continue to shape contemporary governance practices in the fund industry as discussed below.

In addition to major revisions regarding governance practices, the Amendments specifically addressed the increasing usage of the series fund structure. In the *Public Policy Report* itself, the SEC noted the increasing incidence of series fund structures. Indeed, it categorized this phenomenon as one manifestation of the trend toward fund complexes.[42] However, the report later also boldly recommended terminating further creation of series trusts under the ICA. Its recommendation acknowledged that the SEC "did not believe that

36. *See* Fama & Jensen, *infra* note 156, at 304.

37. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 564 U. S. 135, 138 (2011) (majority opinion of Thomas, J.); *Id.* at 149–50 (Breyer, J., dissenting).

38. *See* SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 47–49, 330–32 (1966) [hereinafter PUBLIC POLICY REPORT].

39. *See id.* The Report followed on the heels of another study, the so-called Wharton Report that the SEC commissioned to review and evaluate business, commercial and economic practices in the mutual fund industry. WHARTON SCH. OF COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962).

40. INVESTMENT COMPANY ACT AMENDMENTS OF 1967, H.R. Doc. No. 90-9510 (1967); MUTUAL FUND LEGISLATION OF 1967, S. REP. NO. 90-1659 (1967). *See generally* Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677, 693 (1969).

41. Pub L. No. 91-547, 84 Stat. 1413 (1970).

42. PUBLIC POLICY REPORT, *supra* note 38, at 331. *See generally* Donald W. Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205 (1970).

[the] problems [identified were] sufficiently serious to warrant upsetting the organizational structure of series companies."[43] Nevertheless it regarded certain problems as sufficient justification to recommend that "no new series company be permitted to register under the Act."[44] That recommendation was subsequently reflected in the originally proposed House and Senate legislation in 1967.[45]

The SEC's position reflected two related issues. The first involved inchoate concerns regarding whether series funds were in fact separate investment companies as opposed to different funds within the same investment company.[46] Second, there was a related practical aspect to this issue tied to the famously rigid statutory structure of the ICA. The ICA imposes a number of affirmative requirements on funds, including requirements relating to voting by shareholders, either to elect trustees or to secure approval for certain fund actions. Series trusts posed a potential problem with respect to these shareholder voting requirements. At the time, it was debatable whether the ICA's voting requirements should be applied literally to the trust as a whole and all shareholders collectively in the trust, or in a more focused fashion only to each fund and that fund's shareholders. In the conventional stand-alone fund, by way of contrast, the fund and the associated business entity are the same (i.e. the entity is the fund, and the fund is the entity). Perhaps most importantly, in the stand-alone setting, the shareholders of the fund are also the entity's only shareholders. This equivalence breaks down in the typical series fund trust. Each series fund has its own shareholders and the trust's shareholders are an aggregation of all funds' shareholders. As a result, at that time, series funds produced situations where the statute was at best ambiguous (and possibly inconsistent) regarding whether requisite shareholder approval in particular instances was required on a cross-series basis (for example, with respect to the election of trustees) or merely on a fund-specific basis (for example, with respect to the changes in the fundamental investment policies of a particular fund).

This problem was resolved in the 1970 ICA Amendments. Although initially the SEC adhered to its view favoring the elimination of series trusts under the ICA subject to grandfathering existing series trusts,[47] that formulation sparked sharp industry opposition and resulted fairly quickly in a compromise jointly advocated by the SEC and industry.[48] Essentially the definition of senior security in ICA Section 18(f) compelled funds to

43. PUBLIC POLICY REPORT, *supra* note 38, at 331.

44. *Id.*

45. *See supra* note 40.

46. The issue of "one investment company but many funds" on the one hand or "as many investment companies as funds" on the other was a formal concern related to a separate issue that the SEC had recently successfully litigated regarding the status of variable annuity plans under the ICA. PUBLIC POLICY REPORT, *supra* note 38, at 331 n.25 (citing Prudential Insurance Co. v. SEC, 326 F.2d. 383 (3d Cir. 1964)). The *Prudential* decision established that an unincorporated fund (the investment fund of a variable annuity program) was an investment company within the meaning of the ICA, and therefore, could be required to register as such. Analytically, *Prudential* indicates that each series fund was required to register as an investment company, but did not address the status of an umbrella vehicle or its relationship to individual underlying funds.

47. *See Mutual Fund Legislation of 1967: Hearing on S.1659 Before the S. Comm. on Banking & Currency*, 90th Cong. 171 (1967) (Statement of Manuel Cohen, Chair, U.S. Securities and Exchange Commission) (endorsing prospective statutory prohibition of investment company series trust—July 31, 1967).

48. *See Investment Company Amendments Act of 1967: Hearing on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 85 (1967) (statement of Manuel Cohen, Chair, U.S. Securities and Exchange Commission) (announcing mutual agreement of the SEC and the ICI to compromise language—Oct. 10, 1967).

employ simplified capital structures, a requirement that impeded use of different share series in a single trust.[49] The compromise in 1967 paved the way for an amendment, now reflected in Section 18(f)(2),[50] that gave the SEC authority to adopt rules that would secure fair and equitable treatment of series company shareholders, including with respect to voting rights, in a series investment company structure. The compromise in 1967 was not ultimately enacted until resolution of a much larger package of significant changes to the ICA—the 1970 ICA Amendments—enacted three years later.[51] The SEC, for its part, moved quickly to adopt an implementing rule that spelled out how voting requirements would be applied in series trusts.[52] Thus, a major stumbling block regarding the use of the series trust was resolved and, as already noted, the fund industry offered a business context that is highly amenable to the series structure.[53]

The amendment and rule, however, have had an ironic effect. Specifically, codification of the practice regarding series trusts eliminated uncertainty as to the status of such arrangements. Given the operational and cost efficiencies resulting from such a structure, it emerged in the 1980s as the preferred way to organize fund families.[54] This pattern is even more pervasive in the case of ETFs, which did not come into existence until

49. 15 U.S.C. § 80a-18(f) (2012) (which, prior to 1970, consisted only of what is now Section 18(f)(1)).

50. 15 U.S.C. § 80a-18(f)(2) (2012).

51. Pub L. No. 91-547, 84 Stat. 1413 (1970). *See* Gerard H. Manges, *The Investment Company Amendments Act of 1970—An Analysis and Appraisal After Two Years*, 14 B.C. L. REV. 387, 387–91 (1973) (chronicling the legislative history of the 1970 ICA Amendments, noting that "provisions with respect to regulation of management fees proved to be the major stumbling block . . . congressional work on the proposed amendments was delayed while the SEC and industry representatives endeavored to reach a consensus").

52. 17 C.F.R. § 270.18f-2 (2018); *see also* Fair and Equitable, *supra* note 23, at 37.

53. The amendment did not resolve other technical regulatory issues posed by the use of series structures, and many such issues have been addressed with no-action guidance from the staff. *See* Fleming, *supra* note 2 (cataloguing various issues resulting in no-action guidance in the first twenty years of Rule 18f-2). Such issues continue to arise. *See, e.g.*, DIV. OF INV. MGMT., SEC, IM GUIDANCE UPDATE, NO. 2014-06 (2014) (SEC staff indicated a general approach in such matters of "ensur[ing] that investors receive the same protections under the 1940 Act regardless of whether they invest in a mutual fund organized as a series company or a mutual fund that has a single investment portfolio"), https://www.sec.gov/investment/im-guidance-2014-06.pdf. Although regulatory positions under the ICA relating to investment company series fund structures are now largely well-defined, that is less true of regulatory treatment under the federal securities law of series structures in other contexts. *See, e.g.*, Financial Industry Regulatory Authority (re: Broker Dealers Operating Under a Series LLC Structure), SEC No-Action Letter (Sept. 1, 2009) (indicating regulatory hurdles under the Exchange Act's financial responsibility rules if broker-dealer tried to reorganize various business segments into different series of a series LLC). Nevertheless, the SEC has permitted individual private fund series of series LLCs to act as issuers at the series level. *See, e.g.*, Base Camp Fund (a series of Payden Cash Management Fund, LLC), Notice of Exempt Offering of Securities (Form D) (Feb. 9, 2016).

54. This is borne out in two respects. First, practitioner advocacy for the series trust approach began to appear only after the 1970 ICA Amendments. *See, e.g.*, David H. Woodward et al., *Series Investment Companies*, 15 REV. SEC. & COMMODITIES REG. 815 (1982) (subtitled: "The issuance of classes of shares by a single registered company may be cost-attractive alternative to a complex of mutual funds."). This advocacy has been repeated with respect to Delaware's Statutory Trust Act. *See, e.g.*, Mazie & Peterson, *supra* note 2, at 1–3. Second, after the 1970 ICA Amendments, fund sponsors increasingly began to adopt the series structures in forming new business trusts for investment companies. A sense of this can be observed in the case of the largest fund family in the 1980s, Fidelity Investments. Today, Fidelity has over 300 funds spread across more than a dozen different trusts. A selective survey of Fidelity trust declarations, coupled with participating fund Statements of Additional Information, reveals that prior to June 1984, Fidelity sponsored trusts did not provide for series, and thereafter they do. Moreover, over time, pre-1984 Fidelity trusts for registered investment companies were amended to enable the trust to sponsor different series. *See infra* Appendix B.

after the series structure had already begun to predominate in the 1980s, because of additional regulatory advantages for ETFs in using a series structure.[55] While there is no exact tabulation, it appears likely that the vast majority of funds in existence today are formed as part of a series entity.[56]

III. THE ROLE OF GOVERNANCE IN THE REGISTERED INVESTMENT COMPANY CONTEXT

The use of business trusts to house fund series is the first part of an explanation of how commoditized governance has selectively appeared in the fund industry. The other major factor is how fund governance functions for registered investment companies. This factor presents issues of nuance that make a quick explanation difficult. Federal regulation under the ICA has significantly shaped governance in the industry. This regulatory overlay on governance, however, operates in tandem with the practical structural realities that pervade fund governance. As explained below, the emergence of commoditized governance as an option in the marketplace represents the confluence of both these factors: a business model that relies heavily on externalization of service providers and a governance model that routinizes many aspects of governance creating significant economies of scope across separate funds in terms of governance issues. However, in order to gauge the effectiveness of investment company governance, it is also necessary to consider the significant scholarly debate regarding how investment company governance functions in practice. The debate in part turns on different views of what normatively should be the goal of investment company governance. Having some theory of investment company governance is necessary to assess the prospects and desirability of forms of commoditized governance in the investment company industry and in evaluating problems that have already emerged in terms of commoditized governance. These topics are addressed sequentially in this Part.

A. The Typography of RIC Governance

The collection of functional business and regulatory considerations that have contributed to the development of investment company governance in practice defines the

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55. This is evident from the fact that there are roughly 1900 ETFs operating pursuant to SEC orders of which 300 have been issued granting exemptive relief from a variety of provisions under the ICA. *See* 2018 ETF Release, *supra* note 1, at 33,733–34 n.2. Simple arithmetic shows that each order on average covers six funds, although some are surely for stand-alone ETFs (or in some cases for funds that no longer exist) while other ETF exemptive orders cover trusts that no longer have any funds. In short, many orders support the operation of more than six funds. For example, the shared ETF series trust identified in Appendix A, Exchange Traded Concepts, supports 27 series funds in three trusts. This is also evident as a matter of common sense. It is much easier administratively to get a single exemptive order that covers many funds than an exemptive order for each fund.

56. The relevant factors are these: (i) 91% of all funds belong to entities that permit a series structure in the jurisdiction of formation (*see supra* note 6 and accompanying text); (ii) most funds in existence were formed after legal issues under the ICA relating to use of series structure were resolved (*see supra* note 7 and accompanying text); (iii) practitioner literature had widely identified the issue in the 1980s and either recommended or noted growing use of series structures (*see supra* notes 11 & 54); (iv) specific considerations favor use of series structure with respect to ETFs, the fast growing sector of the fund industry (*see supra* note 56); (v) fund activity is concentrated among large fund groups (according to the ICI, 2018 ICI *supra* note 4, at 47, 77% of the industry AUM for mutual funds and ETFs is managed by 25 sophisticated fund complexes, the very kinds of fund complexes that are most likely to be sensitive to the advantages of using series structures); and (vi) as a practical illustration, one of the five largest fund family with over three hundred funds has intensively used series structures since 1984 (*see infra* Appendix B).

typography of investment company governance. Notwithstanding similarities, governance of investment companies is characterized by different factors than governance of public companies.[57] One prominent feature derives directly from the rise of mutual fund complexes. The multiplication of affiliated funds within a complex or family leads naturally to the use of so-called "unitary" boards or "cluster" boards for funds within the complex.[58] In short, one board will typically oversee all or many funds within a fund family or complex. The logic of this arrangement is illustrated by practical example. Suppose a very large fund complex has 300 funds and five directors (or trustees) per board. This situation would result in 1500 directors within the given complex—a situation that would be administratively untenable not only in terms of turning out materials for each board, but also managing idiosyncratic procedures that each board might impose with respect to its fund. Of course, having a single board of five oversee 300 funds might overtax any board member and so unusually large complexes might propose to have several boards with each board overseeing 100 funds, and hence, the desire in some circumstances for a cluster board.

Having a board oversee many funds has an obvious logic, wholly apart from the administrative convenience and cost savings, by reducing the number of potential board members that may figure in the affairs of any complex. Some of the reasons are likely quality-enhancing. For example, the more streamlined the governance structure, the more compensation that can be offered to induce qualified candidates to sit on boards. A common board for affiliated funds likely generates efficiency and learning curve benefits for board members and the adviser. Knowing the business and issues of one fund casts light on issues relating to the operations and strategies of other funds within the complex. Advisers typically adhere to consistent positions and policies across funds because board members naturally seek to minimize inconsistencies, and such arrangements inevitably cause board members to question such arrangements and refine questions regarding each fund's activities. In short, overseeing multiple funds and encountering a greater variety of issues from service providers across many funds should, over time, make directors more knowledgeable and experienced in addressing the issues of any one fund. In addition, by acquiring a deeper sense of the organization that they oversee, board members reduce governance risk with respect to oversight and delegation that might arise from excessive fragmentation.

Not surprisingly, these considerations have favored heavy use of unitary and cluster boards in the fund industry among fund complexes.[59] This result is true whether the complex is organized as many funds in a handful of entities, or as separate funds in separate entities. In either case, economies of scope favor the use of a single board for all funds or,

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57. *See infra* note 62 concerning governance of public companies.

58. A unitary board entails using the same board for each fund in a fund family or complex (including each fund within any given investment company entity such as a trust). Alternatively, a fund complex may use several cluster boards, rather than a single unitary board, where the complex groups of funds form into clusters and each cluster will have its own board (in which case all funds within a particular investment company entity will be part of the same cluster). *See* IND. DIR. COUNCIL, OVERVIEW OF FUND GOVERNANCE PRACTICES 1994-2016 5 (2017), https://www.idc.org/pdf/pub_17_fund_governance.pdf (reporting as of 2016 that 87% of fund families use a unitary board while 13% of complexes use cluster boards).

59. ICI ADVISORY GRP., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS: ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS 27 (1999), https://www.ici.org/pdf/rpt_best_practices.pdf.

if not practicable, a limited number of funds with respect to clusters of funds in the fund complex.[60]

1. The Push for Independence on Fund Boards

The original seed for independent trustees (or in terms of the lingo of the ICA—persons who are not "interested persons") was present in the ICA as-enacted in a less stringent form, but that has been strengthened by subsequent statutory amendments and rules.[61] The ICA actually was ahead of its time in championing the role of independent directors in public company governance.[62] The Act's original legislative findings and declaration expressed a strong distaste for investment companies "organized, operated, managed, or their portfolio securities [being] selected, in the interest of directors, officers, [and] investment advisers . . . rather than in the interest of all classes of such companies' security holders."[63] The text of the original statute contained specific substantive requirements relating to independent directors and trustees. Specifically, Section 10 addressed affiliations and interests of directors and notably imposed a minimum 40% or more independence requirement for the composition of boards of registered investment companies, subject to exceptions that could in some cases reduce or increase the independence threshold.[64] In addition, the ICA mandated minimal shareholder voting procedures that required shareholders to have some role in the election of trustees and other

60. The industry predilection for unitary or cluster boards fits comfortably with the inherent governance structure of a series trust. As discussed earlier, the need for either a unitary board or a cluster board system is a necessary feature of the series fund trust structure. *See supra* note 23. The trust generally will have multiple funds that vote collectively for a single board. The single board for a series trust can also serve as the board for other trusts in the same complex or other affiliated funds that may be separately incorporated.

61. *See supra* notes 43–45 and accompanying text and *infra* notes 64 & 67.

62. Independence is a theme running through public company governance, but the theme is of more recent vintage that its appearance in discussions about investment company boards dating back to 1940 and surrounding the 1970 ICA Amendments. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1473–75 (2007) (noting a big push with respect to independent directors of public companies occurred in the 1970's as opposed to earlier corporate law dichotomy between inside and outside directors). Indeed, legal commentary in the public company area on this subject follows the 1970 ICA Amendments and its explicit attempt to address the role of independent directors (trustees) under the ICA. *See generally* Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455 (1984); William C. Greenough & Peter C. Clapman, *Role of Independent Directors in Corporate Governance*, 56 NOTRE DAME L. REV. 916 (1981); Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976). The special role of independent directors in public company governance, of course, became a centerpiece of federal legislation in the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 704, 116 Stat. 745, 799 (2002). *See* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1847–53 (2007) [hereinafter Langevoort, *Social Construction*] (discussing interpretive effects of statute on role of independent directors of public companies); Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1377 (2006) (describing relatively limited role exercised by the SEC over independent directors of public companies prior to the Sarbanes-Oxley Act).

63. The legislative statement of national public interests and purposes of the ICA are set forth in 15 U.S.C. § 80a-1(b)(2) (2012).

64. As originally enacted, the Act's independence threshold was solely directed at affiliations with the investment adviser as defined in ICA § 2(a)(3). Pub. L. No. 76-768, 54 Stat. 789, 791 (1940). The relevant independence standard was substantially enlarged in the 1970 ICA Amendments. Pub L. No. 91-547, 84 Stat. 1413 (1970) with its definition of interested person. *See infra* note 67.

matters.[65] As previously noted, preservation of annual shareholder meetings or election of directors is largely sidestepped in most key fund state jurisdictions.[66]

Board independence is of unusual importance in fund activities because of the board's role in overseeing the investment advisory function of each fund, whether internalized and especially, as is typical today, externalized. In the externalized context, the fund's board functions as the fund's bargaining agent vis-à-vis the adviser in fixing the management fee, which surely is the board's most significant role in the fund's economic affairs. The 1970 ICA Amendments dramatically enhanced the statutory significance of the role of independent trustees in overseeing this relationship in three respects.

First, Congress inserted a new defined term into the ICA—"interested person" (Section 2(a)(19))[67]—that expanded the relevant threshold for determining independence in practice. By imposing a more exacting requirement on independence, the net effect was to prohibit funds from using board members to satisfy independence requirements where ties to the adviser or principal underwriter were evident, but did not rise to the level of statutory affiliation.[68] The effects of a more stringent independence standard, in turn, ripple through other ICA requirements that are conditioned on the approval of a majority of the independent directors. For example, greater independence arguably influences the manner in which those trustees approve investment advisory agreements (including the fees thereunder) and their renewal.[69]

The second major change effected by the Amendments encompassed the effect of the enhanced independence threshold on approval and renewal of investment agreements. As noted, the stricter standard of independence now governed independent trustee approval

65. The ICA addresses the right of shareholders to elect directors. §16; 15 U.S.C. § 80a-16 (2012). While the section prescribes certain minimums—a majority of the board must always have been elected by shareholders and the board cannot fill vacancies if less than 2/3 of the board has been elected by shareholders—the section's minimum default rules give considerable latitude to the incumbent board that circumvent a robust shareholder franchise. Other provisions of the Act require express shareholder approval. *See, e.g*., ICA § 15(a) (2012) (requiring shareholder approval for initial investment advisory agreement, but not for renewals); 15 U.S.C. § 80a-15(a) (2012).

66. As noted, the three key jurisdictions for fund formation are Massachusetts (common law business trust), Delaware (statutory trust), and Maryland (corporation). *See supra* note 6. These jurisdictions do not require investment funds to have an annual election of directors, and the ICA imposes no such requirement. The SEC was slow to address this issue because many funds were organized as corporations and state law in the jurisdiction of incorporation would trigger the need for an election of directors. In 1974, the SEC acquiesced in a registration statement of a new fund trust that for the first time did not call for annual elections which implied that the SEC agreed that the ICA did not create an independent mandate for annual elections. *See* Jones et al., *supra* note 2, at 453. The staff subsequently explicitly confirmed this position in a no-action letter in connection with a fund organized as a corporation in a jurisdiction that did not require annual election of corporate directors. *See* John Nuveen & Co., SEC No-Action Letter (Nov. 18, 1986). Shortly thereafter, Maryland amended its corporate statute to eliminate the requirements of an annual election of directors in the case of registered investment companies. MD. CODE ANN., CORPS. & ASS'NS § 2-501 (West 2018) (dispensing with requirement for annual meetings to elect directors except as required by the ICA). Annual elections are not a feature of the Delaware Statutory Trust Act.

67. 15 U.S.C. § 80a-2(a)(19) (2012). Prior to the amendment, the statute had relied on the narrower term "affiliated person" as the proxy for independence (or persons who are independent) found in 15 U.S.C. § 80a-2(a)(3) (2012). Pub. L. No. 91-547, 84 Stat. at 1413 (1970) (inserted the statutory definition of "interested person" and then in the statute inserted references to persons who are "not interested" as a proxy for independence (or persons who are independent)). The phrase "independent director" itself is not used in the statute.

68. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109–291, § 4(b)(2)(A), 120 Stat. 1337 (2006).

69. 15 U.S.C. § 80a-15(c) (2012). Pub L. No. 91-547, 84 stat. at 1413 (1970).

and renewal requirements. In addition, however, Congress created a wholly new information-sharing obligation between the adviser and the independent trustees in which the independent trustees would be required to request, and advisers to supply, information as part of the independent trustees' approval and renewal process.[70] The information-sharing requirement explicitly enlarged the role and obligations of independent trustees in overseeing the relationship between adviser and fund.

The third change did not directly relate to obligations imposed on independent trustees, but indirectly elevated the role of independent board members in overseeing the fund's relationship with its adviser. Congress adopted Section 36(b), which for the first time imposed a fiduciary duty on investment advisers of funds (and significantly encompassed investment advisers whose relationship to a fund was merely contractual) for fees that they received.[71] While this change was obviously significant in recalibrating the obligations of advisers with respect to the funds that they advised, it also had an indirect effect on the role of independent board members' oversight and process in approving management fees. The integrity of this oversight process has easily become the most important factor in determining whether an adviser's compensation is excessive or otherwise unreasonable.[72] Thus, this provision has had the effect of incentivizing advisers to actively promote appropriate formal review processes by independent board members, and thereby obtaining greater deference from courts to challenged management fees approved by the board. Not surprisingly, the very factors used to determine whether fees are excessive are frequently the core of the Section 15(c) approval and renewal process.

2. Affirmative Delegated Regulatory Role of Independent Trustees

The 1970 ICA Amendments represented a watershed in the SEC's thinking about independent directors. The agency had been the principal advocate in reimagining the role of independent directors for registered investment company boards, and in turn, it internalized this ethic in its rulemaking. The SEC incorporated an independent director voting condition (i.e. requiring the approval of a majority of independent board members) in many ICA rules in the succeeding years as a further check on fund integrity and accountability.[73] In this way, the SEC greatly expanded the pivotal role that it sought

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70. *Id.* In recent years, the SEC has brought actions against advisers relating to material inaccuracies and omissions relating to the information-sharing requirements. *See, e.g.*, *In re* N.Y. Life Inv. Mgmt. LLC, Investment Company Act Release No. 28747, 2009 WL 1480831 (May 27, 2009); *In re* Morgan Stanley Inv. Mgmt., Inc., Investment Company Act Release No. 29862, 2011 WL 5562535 (Nov. 16, 2011). Rare actions against independent directors for 15(c) failures occurred only in the last five years. *See infra* notes 140–42 and accompanying text.

71. 15 U.S.C. § 80a-35(b) (2012). This change to the law was easily the most contentious and controversial aspect of the 1970 ICA Amendments. *See* Manges, *supra* note 51, at 393–97 (discussing the evolution of the resulting standard in the legislative history).

72. *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 (2d Cir. 1982) (describing important factors that show how informed an adviser is, and the extent of the "care and conscientiousness with which they perform their duties"). In Jones v. Harris Assocs. L.P., 559 U.S. 335, 345–47 (2010), the Supreme Court expressly endorsed *Gartenberg*'s fundamental articulation of the relevant fiduciary standard and cited with approval *Gartenberg*'s subsidiary analytical framework.

73. *See* Amy B. R. Lancellotta et al., *Fund Governance: A Successful, Evolving Model*, 10 VA. L. & BUS. REV. 455 (2016); *see also* Tamar Frankel, *The Scope and Jurisprudence of the Investment Management Regulation*, 83 WASH. U. L.Q. 939, 946–67 (2005) (surveying, with supplementing appendices, SEC rulemaking

independent directors to play in the governing of investment companies' affairs. Professor Palmiter has described this as an episode in "regulatory outsourcing,"[74] which may overstate the SEC's pragmatic goal. At the very least, however, the SEC deliberately sought to expand the oversight role of boards, and, more specifically, the special enhanced role of independent board members acting as a group within the board.

Many of these new rules that mandated a role for independent directors were exemptive rules to the affiliated transaction prohibition under ICA § 17(a).[75] In effect, the SEC substituted its exclusive role of issuing exemptive orders with respect to non-compliant transactions on a case-by-case basis for greater reliance on class-based exemptive rules that among other conditions, included an independent director approval condition. Such rules ensured at a minimum that independent directors would be in the proverbial "loop" at the inception of fund procedures and policies that sought to take advantage of the class-based exemptive rules.

Rule 12b-1, adopted by the SEC in 1980, stands out for the significance it attached to the substantive role performed by independent directors.[76] The rule provided a rule-based procedure that authorized funds for the first time to use, on a limited basis, fund assets to pay for distribution services.[77] As originally adopted, the rule specifically imposed requirements for involvement of independent board members. For purposes here, the rule did more than merely assign a role for approval by independent directors. It conferred on directors the power to terminate the plan, required annual oversight of expenditures in connection with the plan's operation, imposed documentation requirements relating to findings (with respect to factors spelled out in the original adopting release), and required that the nominating committee for independent directors be composed entirely of independent directors.[78] In short, the rule for the first time imposed far-reaching affirmative

over preceding 65 years, including rules relating to board independence requirements); Matthew P. Fink & Jacqueline Edwards, *The Changing Role of Independent Directors of Mutual Funds*, 23 INV. LAW. 4, 4–7 (2016).

74. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 165 (2006). While I agree with Palmiter's characterization that the SEC has deputized independent directors to perform a supporting role in advancing regulatory objectives, it is misleading to think that the SEC's so-called outsourcing cedes much, if any, of its vast regulatory oversight in this area. Deputization in this context merely involves assigning tasks to private parties to supplement available regulatory resources but does preclude the agency from challenging the fund's conduct itself.

75. 15 U.S.C. § 80a-17(a) (2012). *See, e.g.*, ICA Rule 17a-7(e), 17 C.F.R. § 270.17a-7 (2018) (exemption for certain cross-trading transactions among affiliated funds and specifically requiring board of directors and its independent members to each approve trading procedures and to review all such transactions quarterly).

76. 17 C.F.R. § 270.12b-1 (2018); *See* Bearing of Distribution of Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Nov. 7, 1980) [hereinafter Bearing of Distribution] (adopting release).

77. Bearing of Distribution, *supra* note 76, at 73,903 ("Permitting the use of fund assets for distribution is a major regulatory change for the Commission."). The SEC existing position at the time was that such conduct, absent SEC authorization, appeared to violate the spirit of ICA. *See id.* at 73,901-02.

78. *See id.* at 73,905 (setting forth the rule's original text as adopted). The SEC hoped that these formal provisions, while not insuring that directors would make the right decision, would "breed an atmosphere in which actual independence will develop." *Id.* at 73,903. Some of the novel features of independent director involvement were subsequently superseded by the rule's condition that reliance on Rule 12b-1 is subject to the fund governance standards. *See* 17 C.F.R. § 270.12b-1(c) (2018). "Fund governance standards" is a defined term in the ICA rules. *See* 17 C.F.R. § 270.0-1(a)(7) (2018). *See* Role of Independent Directors, *infra* note 83. The rule continues to be controversial, not least because of its overly aspirational reliance on independent directors. *See* Mutual Fund Distribution Fees; Confirmation, Investment Company Act Release No. 29367, 75 Fed. Reg. 47,064, 47,073 (Aug.

delegated responsibility on the independent directors in fulfilling a purely regulatory mandate of the SEC.

Continued robust regulatory reliance on the oversight role of independent directors also manifested itself in 1999 when the SEC carefully reviewed how the independence requirements operated in practice. In adopting amendments to Rule 17j-1 which governs the responsibility of funds to adopt and enforce a code of ethics,[79] the SEC enhanced the role of independent director oversight. As originally promulgated in 1980, the rule required fund boards to adopt a code, but did not specifically single out a special role for independent directors.[80] However, the rule's focus on potential conflicts of interest by fund personnel led the SEC to subsequently amend the rule to require separate approval by the fund's independent directors and consideration of a report at least annually by the entire board regarding the code's effectiveness and manner of implementation.[81]

The rule amendment's adoption was followed shortly by an interpretive release in which the SEC articulated a full-throated defense of the importance of independent directors in overseeing the affairs of mutual funds in a time when certain fund controversies had raised doubts about the ability of independent directors to withstand challenge.[82] The interpretative release was a stopgap measure followed shortly by the SEC adoption of its fund governance rule. The rule greatly strengthened the SEC's commitment to the integral role served by independent directors in governance of funds and introduced measures that bolstered the effectiveness of independent directors in that role. The rule itself operates at the outer periphery of the SEC's rulemaking authority pursuant to its exemptive authority[83] and, in its original form, had three key components. First, the fund governance rule

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4, 2010) (proposing rule amendments) (noting mounting perception "that one of the fundamental premises of rule 12b-1— that independent directors would play an active part in setting distribution fees—does not reflect the current economic realities of fund distribution and the role 12b-1 fees play in it.").

79. 17 C.F.R. § 270.17j-1 (2018).

80. *See* Prevention of Certain Unlawful Activities with Respect to Registered Investment Companies, Investment Company Act Release No. 11421, 45 Fed. Reg. 73,915, 73,916 (Nov. 7, 1980) (adopting final rule) ("[T]he introduction and tailoring of ethical restraints on the behavior of persons associated with an investment company can best be left in the first instance to the directors of the investment company.").

81. *See* Personal Investment Activities of Investment Company Personnel, Investment Company Act Release No. 23958 64 Fed. Reg. 46,821, 46,823–24 (August 27, 1999) [hereinafter Personal Investment Release] (adopting release).

82. *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083, 64 Fed. Reg. 59,877, 59,877 (Nov. 3, 1999) ("Congress intended to place independent directors in the role of 'independent watchdogs,' who would furnish an independent check upon the management of funds and provide a means for the representation of shareholder interests in fund affairs.") [hereinafter Independent Directors Interpretation].

83. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816, 66 Fed. Reg. 3734-01 (Jan. 16, 2001) [hereinafter Role of Independent Directors]. The SEC lacked rulemaking authority to impose, at least directly, such governance requirements. However, it made compliance with the fund governance rule a condition on fund reliance on any of 10 different exemptive rules. The 10 exemptive rules are among the most commonly relied upon exemptions under the ICA. Accordingly, as a matter of practice, few if any mutual funds or ETFs can function without reliance on the relief obtained by reliance on the exemptive rules and therefore for all practical purposes, the fund governance rules establish minimum governance standards for the vast majority of mutual funds and ETFs. This specific aspect of the fund governance rules was sustained over a subsequent judicial challenge to the funder governance rules. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 141 (D.C. Cir. 2005) [hereinafter *Chamber of Commerce I*] ("[T]he Chamber points to nothing in the ICA to suggest the [sic] Congress restricted the authority of the Commission to make 'precautionary or prophylactic responses to perceived risks.").

mandated a 50% or greater threshold for independent directors in the composition of fund boards[84] which the SEC later attempted to raise to 75%.[85] Second, the rule prescribed a variety of measures designed to encourage the independence of the independent directors, including mandated independent director-only executive sessions and giving independent directors the authority to retain their own experts.[86] Third, the rule codified for funds relying on the rule's protection an emerging best practice among fund boards: representation of independent directors by independent legal counsel.[87]

The significance of this third component (along with the ability to hire experts) cannot be overemphasized. It underscored an emerging feature of independent directors: the ability to control supplementary resources to assist the board and more specifically independent directors in the discharge of their responsibilities. Experienced independent legal counsel is a valuable dedicated resource for independent directors who otherwise meet only periodically over the course of the year. Counsel, by virtue of their practice, typically advise other boards and advisers and almost certainly will also function in this or other contexts in representing the investment company. The ability to appoint the fund's independent auditor supplements the role of the independent directors in ensuring accountability by key gatekeepers which, as discussed below, was further enhanced by the subsequently adopted compliance rule under the ICA.

The SEC attempted to further strengthen the fund governance rule in 2004 by principally increasing the threshold for independent director composition on fund boards to 75% and mandating an independent chairman for the board. These requirements were challenged and struck down by the D.C. Circuit in a decision of mixed significance. The D.C. Circuit squarely affirmed the SEC's authority to structure exemptive rules conditioned on fund governance standards and deferred to the agency's judgment as to what fund governance requirements were most appropriate.[88] However, the D.C. Circuit struck down the rule amendments on a narrow technical ground of failure to deliver a compliant cost-benefit analysis subject to notice and comment.[89] Thus, the decision appeared to vindicate the agency's method of formulating governance standards, but the court also insisted on strict compliance with congressionally-mandated rulemaking

84. *See* Role of Independent Directors, *supra* note 83, at 3736.

85. *See* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381–82 (Aug. 2, 2004).

86. *See* 17 C.F.R. § 270.0-1(7)(iv)-(vi) (7) (2018). These features were a combined result of the 2001 and 2004 rulemakings. Most funds, as discussed above in note 83, are subject to the fund governance conditions.

87. *See* 17 C.F.R. § 270.0-1(6) (2018) [independent legal counsel definition]. The independent counsel rule does not mandate that independent trustees use independent counsel. However, if independent directors seek to rely on the advice of independent counsel, then that counsel must be professionally independent from the adviser and other specified service providers. Accordingly, the rule's practical effect is that independent trustees will have counsel that is separate from the adviser's, though either counsel can serve as fund counsel.

88. *Chamber of Commerce I*, *supra* note 83, at 138–39 ("[§ 6(c) of the ICA] conspicuously confers upon the Commission broad authority to exempt transactions from rules promulgated under the ICA, subject only to the public interest and the purposes of the ICA.").

89. *Chamber of Commerce I*, *supra* note 83, at 136 (holding "the Commission did not exceed its statutory authority in adopting the two conditions, and the Commission's rationales for the two conditions satisfy the APA . . . however . . . the Commission did violate the APA by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a proposed alternative to the independent chairman condition."); Chamber of Commerce v. SEC, 443 F.3d 890, 906 (D.C. Cir. 2006) (affirming *Chamber of Commerce I* holding that SEC failed to provide adequate cost-benefit analysis and notice).

protocols. Although the SEC lost the judicial battle over specific amendments to the fund governance rule, it can claim success in moving governance practice in the direction of the failed portions of the 2004 rule amendments. Today, better than 80% of funds meet the 75% independence standard and a substantial majority have an independent chairperson.[90]

The SEC's 2004 fund governance initiative followed closely on the heels of the SEC's adoption of the fund compliance rule (ICA Rule 38a-1[91]) and the adviser compliance rule (Rule 206(4)-7 under the Advisers Act[92]). These rules largely coincided with efforts to enhance the independence requirements.[93] The SEC turned to independent directors to perform the critical task of consideration and approval of the fund's compliance rules and procedures,[94] as well as working with the fund's chief compliance officer with respect to the adequacy of service provider compliance rules and policies.[95] More importantly, Rule 38a-1 mandates appointment of an officer, individually responsible for administering the fund's compliance policies and procedures. The fund's independent directors have control the employment terms of the chief compliance officer.[96] Once again, the rule supplements the ability of independent directors, who cannot monitor the day-to-day affairs of the fund, with use of an officer administering the fund's compliance policies and procedures.

What does this history show about governance of funds and how is it relevant to the emergence of commoditized governance? Two major evolutionary features emerge. First, the SEC (with the infrequent, though timely support of Congress) has moved consistently to expand the composition and substantive role of independent directors in all aspects of fund operations and the fund's relationship to external service providers.[97] Second, and perhaps most significantly, the SEC, through its fund governance rule, expressly provided means for improving the expert resources available to independent directors in discharging their duties and established process requirements in conducting their duties. These changes may be incremental in nature, but when put together, they clearly have changed the dynamics of the independence model associated with fund governance created both a higher degree of standardization and routinization in governance, and established a higher standard of conduct for independent directors.

90. *See* IND. DIR. COUNCIL, *supra* note 58, at 6, 11.

91. 17 C.F.R. § 270.38a-1 (2018).

92. 17 C.F.R. § 270.206(4)-7 (2018).

93. Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714 (Dec. 24, 2003) (final rule). Indeed, both the fund governance amendments and the compliance rules initiatives was in direct response to the late trading/market timing scandal. *Id.* at 74,720 (discussing the imperative need to address "market timing" issues in relation to the Canary Scandal).

94. 17 C.F.R. § 270.38a-1(a)(2) (2018).

95. 17 C.F.R. § 270.38a-1(a)(4)(iii) (2018).

96. 17 C.F.R. § 270.38a-1(a)(4)(i)-(ii) (2018).

97. This trend has not gone unnoticed in industry circles and has recently elicited critical comments from industry proponents. Letter from Susan Ferris Wyderko, President, Mutual Fund Directors Forum, to Jay Clayton, Chairman, SEC (dated June 20, 2017) ("We are concerned that the Commission's approach in recent years has placed too many burdens on directors, has gone too far in implicitly impelling them to become involved operationally in their funds activities, and thus has inhibited their ability to spend time on issues that matter most to their shareholders and to exercise their business judgement flexibly on behalf of those shareholders."); *See also* Fink & Edwards, *supra* note 73, at 7 (arguing that recent "developments constitute a major departure from independent directors' traditional focus on conflicts of interest involving funds and their advisers. It is too early to tell how successful directors will be in overseeing functions that require highly specialized expertise and that do not involve intrinsic conflicts of interest between funds and advisers.").

B. The Theory of What Fund Boards "Should be Doing"

While the preceding Part shows certain trends in terms of federal governance mandates with respect to fund boards, there is another part to the equation: as a matter of policy, what should fund boards be doing? This of course is an inherently normative question, but it certainly lurks in the background of any appraisal of commoditized governance. After all, the merits of commoditized governance in the investment company industry rest in no small part on general views regarding state, and more importantly, federal governance mandates. In this regard, there is significant debate both at the scholarly and industry level regarding the role of fund boards and more specifically independent members of the board.

It bears repeating that fund boards have significantly diminished accountability to shareholders as a practical matter for three reasons.[98] The initial selection of independent board members is in the hands of the fund sponsor. Although technically elected by shareholders, the sponsor is typically the initial and sole shareholder when the board is formed.[99] Second, investment companies typically avoid the need for annual election of directors by choice of jurisdiction and choice of entity. Business trusts are not subject to annual board elections in any state jurisdiction and some states relieve other types of fund entities of this requirement.[100] As discussed above, federal law creates modest default rules that will eventually trigger the need for board elections, but in practice these situations are few and far between. Finally, mutual funds and ETFs are entities whose structure encourages shareholders to vote with their feet. On any trading day, dissatisfied shareholders can redeem their shares in a fund. Moreover, with so many near substitutes, the shareholder can redeploy the proceeds in a substitute fund with very small transactions costs. The view that shareholders are irrelevant to fund governance has been long accepted by industry commentators.[101]

1. Current Appraisals of Fund Governance: The Good, the Bad and the Ugly

Assessments of the quality with which investment company boards discharge their responsibilities extend across a spectrum. Academics generally have been highly critical of the role and performance of fund boards,[102] while industry experts have offered

98. Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 908 (1982) ("[S]hareholder voting in the context of mutual fund shares has served a largely ritualistic purpose.").

99. The fact that the initial sole shareholder will select the independent directors in the first instance and that those directors' tenure is generally not subject to annual election is a potentially overlooked feature of how independence works in practice in the fund context. *Cf.* Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271 (2017) (arguing that the presence of controlling shareholders in selecting independent directors warrants use of more exacting procedures that would result in "enhanced independence" directors).

100. The ICA does not impose any requirement for annual voting or even regular shareholder meetings, notwithstanding the fact that the Act can trigger shareholder voting. As noted, ICA Section 16(a) [15 U.S.C. § 80a-16(a) (2012)] requires a majority of the currently serving board.

101. Even more pointedly, critics have suggested that shareholder voting is a wasteful cost for mutual funds. *See* Phillips, *supra* note 98, at 908 ("Unfortunately, it often is a very costly ritual, since fund managements commonly must devote considerable resources and energy to soliciting shareholders in order to obtain the vote of the holders of a majority of the outstanding shares.").

102. *See generally* Palmiter, *supra* note 74; Anita K. Krug, *Investment Company as Instrument: The*

extended scholarly analyses defending investment company boards and criticizing academic critics.[103] Much of the debate turns on how fund boards are viewed. Generally, if the board is viewed as a substitute or proxy for stringent SEC oversight, then the board almost surely will be found wanting. On the other hand, if the board is viewed deferentially and analogous to any corporate board, then the assessment tends to be more favorable. However, this broad-brush categorization makes it difficult to meaningfully assess the role of investment company boards. More than a few critics are chary of the view that fund governance provides a meaningful form of oversight.

Among critics, there is a broad consensus that independent board members are ineffective at zealously negotiating with the investment adviser over fees.[104] Perhaps the strongest empirical attack was mounted by two business professors, who noted the sharp disparity between management fees paid by actively managed funds and management fees paid by institutional investors (or for that matter, earned by sub-advisers managing such strategies).[105] To some extent, these disparities are in the eye of the beholder depending on what one views as the board's role regarding fees. If the board's role is viewed as a form of rate regulation, then undoubtedly boards do not meet the standard of the zealous rate regulator. On the other hand, if the board's role is viewed from the vantage point of rational dealings by a business entity, then one would hardly be surprised to find that courts are more deferential to the judgment of boards, relying indirectly on forces of competition to mitigate excessive fees.[106] This deferential view is reflected in the current statutory

Limitations of the Corporate Governance Regulatory Paradigm, 86 S. CAL. L. REV. 263, 305 (2013) (stating that the corporate governance model of investment companies "fails" to achieve regulatory goals and recommends abandonment of the corporate governance paradigm); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2028 (2010) ("[C]orporate governance . . . regime [is] flawed. Even well-intentioned independent directors lack the tools to provide a meaningful evaluation of the fairness of transactions involving conflicts of interest."). Other critics have been more equivocal in their assessment. *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1019 (2005) [hereinafter Langevoort, *Private Litigation*] (arguing that "disinterested directors do add value as a form of shareholder protection" but "their checking power will be moderate at best"); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 133 (2010) [hereinafter Morley & Curtis, *Exit Rights*] (case for eliminating boards' role in some areas is clear while not in others).

103. *See generally* Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH. U. L. REV. Q. 1045 (2005); Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1 (2016) [hereinafter Roiter, *Disentangling Fund Governance*] (recommending how to improve mutual fund governance); Lancellotta et al., *supra* note 73, at 489 ("[F]und directors have been an anchor, overseeing fund operations to serve as a check on fund management and protect the interests of shareholders.").

104. *See, e.g.*, Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 502–05 (2008). A nuanced catalogue of the shortcomings and reasons, therefore, is provided in two successive articles: Morley & Curtis, *Exit Rights*, *supra* note 102, at 122; Quinn Curtis & John Morley, *The Flawed Mechanics of Mutual Fund Fee Litigation*, 32 YALE J. ON REG. 1, 30–33 (2015); *see also* Langevoort, *Private Litigation*, *supra* note 102 (discussing limitations of the process of mutual fund corporate governance).

105. *See generally* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001).

106. Jones v. Harris Assocs., 559 U.S. 335, 352 (2010) ("It is also important to note that the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions."). For a strong assertion of the benefits of competition in the fund industry, see John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007).

approach. As noted, Section 36(b) creates an unusual private right of action and this remedy has given courts ample opportunity to formulate legal standards regarding the role of fund boards in approving management fees. The net result has been a judicial approach in which courts defer to a governance process in which independent board members have the obligation to consider a range of factors in approving management fees.[107]

As to the board's quasi-regulatory mandate, critics have emerged on both sides. All agree that the SEC has consistently pushed for an approach that indirectly effectuates regulatory objectives by imposing governance requirements that affect the board's composition and processes, and that mandate conditions for obtaining the approval of the board's independent directors. On one side, critics claim that these palliatives merely "create [] an illusion of investor protection,"[108] implying that the measures achieve very little in the way of substantive improvements for shareholders generally. On the other side, there has been a consistent drumbeat that the SEC's efforts are misguided and undermine effective entity governance. Critics argue that these measures impose too great a burden on directors (and thereby may discourage individuals from serving as independent directors) or are overly prescriptive in mandating more stringent fund independent governance requirements when business entities should be given some latitude in arranging their affairs.[109] While the latter position has generally favored greater deference to boards in conducting the affairs of the fund, the former position has understandably led to calls to largely sideline boards from regulatory oversight and for alternative means of regulation.[110]

While there are undoubtedly shortcomings to investment company boards and boards may not always be well suited to achieve the aspirational role that they have been assigned, it does not follow that boards serve no meaningful role in advancing the interests of shareholders. There are several ideas that have been conflated that may contribute to a lack of clarity as to what boards can and cannot reasonably accomplish. First, many commentators have noted the defining features of mutual funds (principally, daily issuance and redeemability of shares at NAV) means that from a shareholder's perspective that shares function more as products rather than investments.[111] In turn, this observation has

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107. Freeman & Brown, *supra* note 105, at 651–52.

108. Palmiter, *supra* note 74, at 208.

109. *See, e.g.*, Roiter, *Disentangling Fund Governance*, *supra* note 103, at 72 ("[A]dopting Rule 12b-1 . . . has led to a board ritual of annual approval of 12b-1 plans, regardless of whether funds are attracting or losing shareholders, or growing or contracting their assets . . . . What exactly is the business judgement at work here?"); Lybecker, *supra* note 103, at 1089 ("The Commission's ongoing insistence that mutual fund directors 'fair value' securities is similarly misguided—that is a subjective task that will not ever squeeze every last opportunity for arbitrage out of a mutual fund's NAV.").

110. *See, e.g.*, Krug, *supra* note 102, at 308–09, 319 (advocating a financial services model and dispensing with boards); Palmiter, *supra* note 74, at 207–08 ("The very existence of an internal monitor may actually be counter-productive. Rather than constraining management excesses, the presence of the supposedly independent board may actually embolden management firms to disregard their responsibility to fund investors, on the glib belief that the board performs its functions."); Morley & Curtis, *Exit Rights*, *supra* note 102, at 117–32 (arguing that boards are "a bad idea" because they do not do anything that cannot be achieved more efficiently by other means).

111. *See* Robert H. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058, 1059–60 (1967) (stating that mutual funds are primarily a product (a professionally managed investment portfolio) sold to "consumer-shareholders"); Langevoort, *Private Litigation*, *supra* note 102, at 1037 (stating that "mutual fund investments are products"); Morley & Curtis, *Exit Rights*,

led some commentators to question the utility of corporate governance in safeguarding fund shareholder interests.[112] But how funds are characterized does not logically determine whether in some respect fund governance serves a useful purpose. Indeed, a number of factors may account for integrity and accountability in fund products, including affirmative SEC regulation, oversight, and market forces, as well as fund governance. The combined effect of these factors should be evaluated, rather than focusing on the sufficiency of board oversight to advance shareholder interests. In addition, others have noted that fund boards do not perform equivalent functions to conventional corporate boards.[113] But once again that poses the question of whether, notwithstanding the difference, fund boards serve alternative useful functions.[114] Indeed, if taken to its extreme, critics' views faulting the goals of fund governance would imply that the quality of a board's efforts is irrelevant to shareholder interests. Commoditized governance, on this view, does not warrant any more scrutiny than use of dedicated boards by fund complexes.

2. A Process-Oriented Perspective on Fund Governance

This Part offers a perspective on fund governance that suggests the SEC's so-called "watchdog" theory is defensible,[115] but probably insufficiently nuanced or adequately

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supra note 102, at 103, 132 (noting "mutual funds' resemblance to products" and stating that mutual funds should be regulated in the same fashion as "consumer products"); Fisch, *supra* note 102, at 1965 (discussing the relation to "retail investment products"); Roiter, *Disentangling Fund Governance*, *supra* note 103, at 13 ("[F]unds have a hybrid nature as both product (the provision of investment management) and legal entity.").

112. *See* Fisch, *supra* note 102, at 2011 (stating the utility of current corporate governance mechanisms is unclear).

113. *See, e.g.*, Langevoort, *Private Litigation*, *supra* note 102, at 1032 ("Thinking about mutual funds . . . as a species of 'corporations' . . . is completely misguided.")

114. *See, e.g.*, Mundheim, *supra* note 111, at 1059 (asserting that unaffiliated directors of mutual funds perform a different, but "particularly important" role relative to conventional corporate directors); Roiter, *Disentangling Fund Governance*, *supra* note 103, at 74 ("[T]he SEC should strengthen the role of fund directors as compliance monitors and not attempt to transform them into the procrustean corporate mode of business decision-makers.").

115. At a minimum, the watchdog theory can be distilled from the notion that the independent board serves as a check on the role of the adviser in managing the fund and affiliated directors on the board. While the ICA and its legislative history did not expressly embrace the "watchdog" formulation of the role of independent directors (or unaffiliated directors as they were originally conceived), the SEC advocated for the unaffiliated director requirements to "furnish an independent check upon the management" of investment companies. *Investment Trusts and Investment Companies; Hearings on H.R. 10065 before a Subcomm. of the House Comm. on Interstate & Foreign Commerce*, 76th Cong., 109 (1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission). The actual term "watchdog" apparently was first used in 1967 by an attorney for mutual fund investors at a University of Pennsylvania Law School *Conference on Mutual Funds*, 115 U PA. L. REV. 669 (1967). *See* Abraham Pomerantz, *The Mutual Fund Management Fee*, 115 U. PA. L. REV. 726, 739 (1967) (remarks of Abraham Pomerantz) (noting that independent directors should serve as "watchdog[s]."). In short order, this metaphor was widely adopted, both as a normative aspiration for fund boards and as a critique of board shortcomings. *See, e.g.*, *Hearings on S.1659 Before the Senate Comm. on Banking & Currency*, 90th Cong. 1200 (1967) (Appendix 3—Memorandum of the Securities and Exchange Commission in Response to Testimony) (unaffiliated directors "create the appearance of [] independent 'watch-dog[s]'" but actually serve to insulate advisers from scrutiny). The term also found its way into case law, culminating in its endorsement by the Supreme Court. *See* Burks v. Lasker, 441 U.S. 471, 484 (1979) ("Congress' purpose in structuring the Act as it did is clear. It 'was designed to place the unaffiliated directors in the role of 'independent watchdogs") (quoting Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977)). As originally used in the 1960s, the watchdog term has referred to the board's role in approving the adviser's management fee, but it has gradually acquired a broader

explained. Fund boards are inextricably tied to the entity-status of funds and therefore the role of a board should ultimately be tied to advancing the legitimate objectives of the fund and its shareholders.[116] However, because of the nature of the fund business and its objectives, the role of the board may be weighted somewhat differently than in other business entities.[117] In this sense, imposing a quasi-regulatory purpose on fund boards (and their independent members) is not inherently objectionable. Rather it requires the board, the fund's shareholders, its adviser and other service providers, and regulators to have a better understanding of the purpose served by fund governance. This article advances a view of fund governance that could be dubbed a process-oriented approach: the primary value of a fund board lies in overseeing a more stringent form of process-oriented accountability for a fund's adviser and service providers in the operation of funds with respect to obvious conflicts of interest.

The independent trustees on a fund board discharge three targeted functions within the broader backdrop of duty of care, loyalty and good faith: they serve as (i) bargaining agent for shareholders; (ii) as monitors of compliance oversight; and (iii) umpires for conflicts. In addition, they serve another role: they are the locus and effective guarantor of processes to resolve issues relating to fund activity and ensure orderly and regular deliberations. The specific and primary functions of fund boards suggest a different orientation and more circumscribed role for fund boards relative to the typical public company board. The different orientation may serve to explain why the emergence of commoditized governance is not entirely unexpected and the limits of commoditized governance as a governance approach with respect to other types of business entities.

First, fund boards are the bargaining agent for shareholders with respect to fund service providers, and most notably the fund's most important external relationship, the fund's investment manager. From the viewpoint of critics, it is plainly obvious that boards and independent directors rarely, if ever, engage in sharp-elbowed bargaining. If that is the goal, or even the pretense, it would seem boards are not terribly aggressive in negotiation. This is borne out by various facts and considerations.

If board bargaining were sharp-elbowed, one would expect much more turnover among the investment advisers of funds. Replacement of an investment advisers, however, is rare except in the unremarkable situation where an investment adviser is acquired and replaced by the acquirer.[118] Similarly, management fees are notoriously sticky. They have

meaning in terms of the full purview of directorial activities, such as, in *Burks*, the oversight of derivative suits. *Id.* at 473. This broader characterization of the watchdog role of an independent director is evident in more recent SEC pronouncements on the role of independent directors. *See, e.g.*, SEC, DIV. OF INV. MGMT. , PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION 253 (1992) ("'watchdog' function"); *accord* Role of Independent Directors, *supra* note 83, at 3751; Independent Directors Interpretation, *supra* note 82, at 59,877; Personal Investment Release, *supra* note 81, at 46,823.

116. This idea is a corollary to commentators' observation about business entities: Delaware has "long attempted to provide business structures that reflect the demands of the business community in an efficient, productive, and predictable manner." Conaway & Tsoflias, *supra* note 13, at 97. The duties of boards, both fiduciary and regulatory, can be seen as an attempt to achieve a functional balance that is efficient, productive, and predictable for board functions.

117. *See* Roiter, *Disentangling Fund Governance*, *supra* note 103, at 6 (arguing that public company boards provide an inapt model for assessing the conduct and decision-making of fund boards).

118. *See* ICA § 15, 15 U.S.C. § 80a-15 (2012). In contrast, cases may attest to the challenges board's face in replacing an investment adviser. *See generally* Navellier v. Sletten, 262 F.3d 923 (9th Cir. 2001) (describing difficulties resulting from a board's removal of an investment adviser and ensuing litigation disputes).

gone down slowly, although competition from ETFs has served as a catalyst for fee reductions by active fund managers in recent years. In these situations, typically fee reductions are the result of voluntary reductions in fees initiated by the fund adviser. Finally, fund boards frequently view the adviser from a relational contracting perspective, but relational contracting is not consistent with sharp-elbowed bargaining.

The relational nature of funds' relationship to an external investment adviser, especially where the adviser manages affiliated funds within a fund complex, requires some comment. The ICA recognizes, as a practical matter, the relationship of a fund and its incumbent adviser is not easily severed.[119] Thus, although the independent directors annually review the adviser's management fee, they do so from an initial starting point of preserving the fund's relationship to the family of funds. This perspective inevitably and implicitly informs the process so that the board's independent members are tasked with the duty of guarding against abuse and overreaching rather than generating a result that mimics a competitive bidding process.[120] In addition and in the absence of a realistic alternative, the independent board members are bargaining agents for the fund's shareholders charged with overseeing a process that approximates the results that might have been obtained through arm's length bargaining without the benefit of an actual arm's length bargaining process.[121] While the board may rely on a number of considerations to provide a basis for its judgment, the process can never be as satisfactory as a true arm's length process.

The second fund board function—as quasi-regulatory monitor—is shared by public company boards to a lesser degree.[122] As noted, the independent members of fund boards have been increasingly tasked by the SEC with greater responsibilities to approve and monitor fund practices that might implicate conflicts between the adviser and fund shareholders. These regulator prescribed governance obligations involve a significant portion of the typical board's agenda. However, because these issues present substantially similar considerations across funds, there is significant standardization to the boards' deliberations. In addition, this quasi-regulatory function feature has specifically resulted in allocating more time to board deliberations affecting compliance policies and procedures. As a result, the investment company board spends far more time in relative terms on compliance issues than the typical public company board. Criticism of this function as too burdensome or as an inadequate proxy for direct regulation miss the mark. Instead, it is an approach that seeks to reconcile divergent objectives: the need for added oversight with respect to this type of entity and the preference for business flexibility handled by a strongly decentralized means.

Third, the board serves as a conflicts umpire. By conflicts umpire, I mean a decisional authority that has the ability to impose a near-binding resolution on situations where

119. Jones v. Harris Assocs. L.P., 599 U.S. 335, 338 (2010).

120. *See id.* at 339.

121. *Id.* at 347.

122. There is of course a vast literature on federal efforts to improve public company governance practices through the Sarbanes-Oxley Act, both critical and in some cases less so. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251 (2005); Langevoort, *Social Construction*, *supra* note 62; Alicia J. Davis, *The Institutional Appetite for "Quack Corporate Governance*," 2015 COLUM. BUS. L. REV. 1. Although these legislative, and in some cases, SEC-implemented efforts may be regarded as heavy-handed and overly directive, the changes appear to be less directive in the ultimate decision-making process of conventional public company boards as opposed to the oversight applied to fund boards.

conflicts actually arise. Virtually any problem of execution that manifests itself in the fund's operations involving service providers requires board involvement for resolution. For example, trade errors, problems relating to execution of fund portfolio trades, or a temporary violation of investment guidelines must all be reported to the board because the fund's service providers cannot resolve the situation without potentially violating fiduciary or contractual duties to the fund client. Ordinary operational mistakes are unavoidable and funds must rely on the board to assess and approve solutions for the mistakes that inevitably arise. Such a function could happen with a public company board as well in the case, for example, gross misconduct of a senior officer, but typically senior officers with delegated authority from the board resolve most operational problems, including those involving misconduct by employees, without active board involvement (or that may at most entail board notification). In this respect, the fund board's conflicts-umpire function demands more frequent involvement in ordinary fund problems than would be true for the typical public company board.

In addition, however, a fund board serves an enhanced deliberative process function (different in character from a public company board). A fund board ensures there is a well-defined hierarchical structure within the organization for deliberating over, reviewing and resolving issues affecting the fund and its shareholders.[123] This, of course, is true in any business entity. However, because of the special quasi-regulatory responsibilities assigned to the board, it forces the board and the key managers (the investment adviser) to have a common framework for thinking about regulatory and compliance issues that the SEC has prioritized. The investment adviser is typically the major non-board participant in discussing all issues that come before the board. At a symbolic level, this creates a sense of accountability. As noted, while not different from a function performed by boards in other business entities, it nevertheless plays out somewhat differently in the fund complex.[124] By prioritizing issues (particularly regulatory ones) for the board, the SEC has

123. While the legal literature regarding the putative benefits of a board deliberative process function is thin, its relevance in the investment company context finds support in Professor Donald Langevoort's analysis in *The Human Nature of Corporate Boards: Law, Norms and Unintended Consequences of Independence and Accountability*, 89 GEO. L. REV. 797 (2001). There, Professor Langevoort assays the benefits of independent directors in terms of board dynamics and the potential and uncertain psychological and behavioral effects that board composition may have on board decision making. Specifically, he raises the possibility of a board serving a "debiasing mechanism" to address (and in other cases, exacerbate) cognitive biases resulting from the relative contribution of inside and outside directors. Professor Langevoort's confined his observations to conventional corporate boards, but his approach can be usefully applied to investment company boards, and especially how board processes address behavioral bias in the control of funds. Although Langevoort suggests caution regarding the unqualified putative benefits of outside directors alone providing effective debiasing, there are strong reasons to believe that independent trustees are likely to be more effective in that role in the investment company context. First, the board's primary control function is more limited in that it largely focuses on compliance and conflicts of interest where an outside perspective is needed to offset internal bias. Second, independent trustees have limited control with respect to an adviser's operational decisions because of the contractual nature of the relationship to the fund. Third, unlike conventional independent directors, investment company independent trustees routinely draw on the significant industry expertise from independent counsel (whom the independent trustees select—*see* ICA Rules 0-1(a)(6) & (7), 17 C.F.R. § 270.0-1(a)(6) & (7) (2018)), the company's chief compliance officer, (whom the independent trustees appoint—see ICA Rule 38a-1, 17 C.F.R. § 270.38a-1 (2018)) and the independent auditor. Boards processes (both in terms of the preparation and sharing of work product and participation in meetings) thereby invariably include professionals (tasked with reporting and advising the independent trustees) and other service providers who employ consistent practices across a wide range of fund clients.

124. In this way, SEC mandated responsibilities serve an analogous function to process views of the

forced board processes to serve not only as an actual constraint, but also as an expressive behavioral constraint, on the investment adviser and other services providers. In addition, unlike the typical company board, fund board processes where frequently many funds are subject to the oversight of the same board will foster consistency in approaches across many funds.

These considerations collectively suggest that fund boards may serve a more circumscribed role than boards of typical public entities. As discussed in Part V, conventional public company boards are more involved in assessing managerial and strategic objectives of the underlying enterprise, but that stems from the nature of the underlying business. A frequent mistake among critics of fund boards is that they assume fund boards are flawed because the board fails to assume greater oversight of managerial decisions of advisers and strategic planning. However, this ignores the value of the functions that fund boards do discharge in terms of compliance and other oversight, and the utility of the board's deliberative process function in fostering a sense of organizational accountability on the part of a fund's adviser with respect to the fund's shareholders.

IV. SHARED SERIES TRUSTS: PROMISES AND PITFALLS

The emergence of shared trusts in the investment company industry is comparatively recent. As described in Part II, fund series trusts received a significant boost in their legal footing with the 1970 ICA Amendments and the 1980s saw a pronounced movement toward series trusts as the fund industry's preferred organizational model. Today, series trusts account for the overwhelming market share of funds, both in terms of number of funds and assets under management.[125]

In the late 1980s, shared series trusts emerged as a new breed of series trust. In form, shared series trust are the same as conventional fund series trust, except that shared series trusts combine multiple funds managed by unaffiliated advisers within the same trust. Shared series trust are sponsored by third-party service providers that typically make services, such as fund administration, compliance and transfer agency services, available to funds. Governance and entity structure provided by the shared series structure are marketed as an extension to other forms of back-office services provided by the sponsoring third-party service provider. Once the fund industry embraced the series structure organizationally, shared series trusts became a realistic alternative sponsored by a service provider rather than an adviser.

On its face, a shared series trust should not affect the way in which independent trustees discharge their responsibilities as board members. However, there are basic differences in the constituent relationships of shared and conventional series trusts. In the shared series trust, an adviser is the sponsor of only the fund within a trust and not the trust whereas in the conventional fund series trust, the same adviser (or its affiliate) will be the sponsor of both the trust and its funds. In practice, this means the trustees for a shared series

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corporate due care fiduciary obligation. *Cf.* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgement Rule*, 96 NW. L. REV. 675, 692 (2002) (arguing that Delaware conception of business judgement rule evinced in *Van Gorkom* "encourage[s] corporate directors to exercise due care in making choices in circumstances in which courts cannot evaluate the wisdom of the choices themselves").

125. *See supra* notes 7 & 56 (explaining why the series form in organizing funds has been a dominant historical trend).

trust are initially recruited by the trust sponsor (a non-advisory service provider) whereas in the conventional series trust trustees are likely recruited by the sponsoring adviser. For the shared series trust sponsor, governance is just part of the package of services provided to prospective fund sponsors whereas an adviser who sponsors a trust to house funds in its complex views governance as an organic feature of each fund's operation. These differences in constitution provide an opportunity to consider possible differences in practice between commoditized and non-commoditized forms of governance within the same business model and these issues are addressed in this Part.

A. The Shared Series Trust Business Model

As noted, the earliest shared series trust goes back to the late 1980's. The number of participants in this niche are relatively small and Appendix A provides a non-exhaustive list of shared series trusts and their sponsors to provide a sense of the landscape. In early 2012, one industry study reported "approximately 435 mutual funds resided in 18 shared trusts . . . [relative to] 169 funds in 15 shared trusts at the end of 2006."[126] In those five years, shared trusts grew from approximately $32 billion [in assets under management] to more than [$69] billion."[127] By the same token, there were 65 funds in shared trusts with $1.5 billion in assets as of 2002.[128] In short, there has been steady growth in this sector, especially considering the number of total funds was relatively flat between 2008 and 2012, albeit total assets under management continued to grow during this period. Another source of growth has been the recent appearance of shared series trusts for ETFs. In some ways, new advisers organizing ETFs may be attracted to a shared series trust because of the heightened sensitivity to fund expenses in the ETF space.

The commoditized governance approach of shared series trust space can be gleaned from marketing materials on trust sponsor websites.[129] A basic theme in these materials is that third-party service providers provide an inexpensive way for investment advisers who want to start funds and do not want to incur upfront costs in or divert attention to establishing back office services.[130] Typically websites tout the shared trust as another service no different than fund administration, transfer agency, or compliance services. In these presentations, governance and entity structure are seen as supporting infrastructure analogous to back-office services. However, the way governance is described varies somewhat by provider. Some funds appear to devote some prominence,[131] while others are more perfunctory, in referring to the existence of a functioning board.[132] While this pitch

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126. BOB KERN, U.S. BANCORP FUND SERVS., MUTUAL FUND SHARED TRUSTS EXPERIENCE RECORD GROWTH 7 (2012), http://www.usbfs.com/usbfs/documents/2013/white-papers/Whitepaper_MST_2012.pdf.

127. *Id.*

128. Sue Asci, *Series Trusts Gain Popularity with Funds*, INV. NEWS (Mar. 24, 2008, 12:01AM), http://www.investmentnews.com/article/20080324/REG/438853815/series-trusts-gain-popularity-with-funds.

129. *See infra* Appendix A (excerpting the marketing materials of selected shared series trust sponsors).

130. *Id.*

131. U.S. Bancorp Fund Services quotes a fund adviser testimonial: "The trust provides immense value in keeping up with compliance issues and allowing [us] to focus on managing our fund's investments." KERN, *supra* note 126, at 6.

132. Forum Funds – Multiple Fund Trusts states: ["The shared umbrella trust] also relieves you of the responsibility of administering the board, freeing your firm to focus on managing the fund and raising assets." *Infra* Appendix A. Gemini Fund Services notes: Fund "trusts offer many advantages that may not be achievable through a standalone fund, including: . . . [t]he ability to attract qualified board members who possess the

has resonated with some small investment advisers sponsoring funds, the numbers in total also suggest that the shared investment trust is a small niche in the registered fund world where large fund groups predominate.[133]

From a fund sponsor's perspective, the attraction of a shared series trust and its commoditized form of governance is the potential to reduce costs in operating a fund. These cost savings may appeal to a fund at the start-up stage or if the funds managed by an adviser are relatively small in terms of assets under management. Even though shareholders technically shoulder the direct costs of operating a fund, additional operating expenses in terms of independent trustees and legal counsel are reflected in the fund's expense ratio to which prospective investors are sensitive. Moreover, advisers typically subsidize the operating costs of smaller funds by entering an expense reimbursement cap with the fund to subsidize its costs before the fund operates at an economically feasible scale.[134] As a result, advisers will seek out cost efficient entity structures.

The alternative to a shared series trust for the unaffiliated adviser seeking to sponsor a fund would be to establish its own series trust (or establish a series of stand-alone funds, i.e., funds in separate trusts or companies) which would result in a board dedicated to that adviser's funds. Put simply, a fund sponsor must determine whether the costs and benefits of a comparable non-commoditized governance arrangement warrant the extra costs entailed. The additional costs may reflect not only out-of-pocket expenses in terms of trustee fees, but also the opportunity costs associated with assembling a board and the ongoing time and costs in maintaining an effective governance structure. In addition, a small fund group may find it difficult to garner credible reputational benefits for its own unique board because of difficulties in recruiting independent board members. All of these factors weigh in favor of smaller fund groups securing a commoditized governance solution.

While cost considerations contribute the main incentive for prospective fund sponsors to seek out a shared series trust, these unaffiliated advisers must accept reduced direct influence over the governance structure as part of the arrangement. There are several possible explanations for the willingness of unaffiliated advisers to surrender influence over governance in the shared series trust. First, they may be persuaded that any board selected by the trust sponsor will not be an impediment to their economic interests. Although they will not have recruited the board, they can expect a sympathetic board given the service providers interests in assembling a board and their own ability to shop, as it were, among competing shared trusts. Alternatively, a small investment adviser may welcome the ability to benefit directly from experienced industry professionals that have been assembled for it by an experienced third-party service provider. In this way, the adviser is able to garner greater credibility by association with an established shared series trust than it would be able to garner if it had to rely on its efforts alone. Finally, wholly

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expertise to provide proper board compliance and oversight." *Mutual Funds*, GEMINI (Mar. 31, 2018), http://www.thegeminicompanies.com/registered-funds/mutual-funds/.

133. 2018 ICI, *supra* note 4, at 47 fig.2.12 (noting that 25 largest fund groups account for management of 77% of fund assets under management). *Infra* Appendix A.

134. Expense reimbursement arrangements are common in the fund industry. A similar result is achieved in the case of a fund that uses a unified fee—a single fee paid to the adviser that encompasses both the management fee and operating expenses. In such a fee arrangement, the adviser assumes the risk that the unified fee will fall short of operating expenses which is a possibility when a fund in its early stages is not operating at a break-even stage.

apart from the obvious interests an adviser may have in securing either a friendly and/or knowledgeable board, an adviser may conclude that the board's role will have a fairly modest impact on the success of the fund and undertake the decision solely to minimize costs. Under this view, the adviser may believe its success in managing the fund is of overwhelming significance in dictating the success of the fund and that the board's oversight role is sufficiently routinized that it will have only marginal effects on the success of the fund.

B. Pitfalls in Practice

Two relatively recent SEC enforcement actions against sponsors of shared series trusts and the trustees of those trusts, including the independent trustees, reveals instances of isolated regulatory problems in the shared series trust context that suggest potential issues in quality of governance. The first, the *Northern Lights Matter*,[135] is a virtual poster child for problems, real or imagined, presented by commoditized governance trust vehicles. The SEC brought a settled administrative proceeding and imposed sanctions against a compliance service provider, a fund administrator and the five trustees of two shared series trusts.[136] The two shared series (described by the SEC as "turnkey") trusts included 71 fund series (i.e., 71 separate funds).[137] During a roughly two-year period, this entailed approval or renewal of some 113 advisory agreements and 32 sub-advisory agreements.[138] The SEC found that fund disclosure relating to the board's approval of those contracts was materially misleading for which the trustees' were sanctioned, noting instances where fund disclosure documents (i) asserted that board deliberations had been based on materials (peer group comparison) distributed to the board, when in fact the board had not been given such materials;[139] and (ii) misleadingly implied that peer group comparisons supported the board's findings when in fact shareholders of the affected funds were paying materially higher fees than the relevant fund's peer group.[140] Not surprisingly, the funds' corresponding minutes approved by the trustees were deemed deficient.[141] The SEC sanctioned the service providers for omitting required disclosure, failing to preserve records of information provided to the board, and failing to adhere to fund compliance policies and procedures.[142] In short, the *Northern Lights Matter* attests to the dangers of commoditized governance where seeming assembly line governance practices compromised the trustees' and service providers' fidelity in discharging and supporting the shared series trusts' governance functions.

The second action, *Commonwealth Capital Management*,[143] also involved a shared

135. *In re* N. Lights Compliance Servs. LLC, Investment Company Act Release No. 30502, 106 SEC Docket 1134 (May 2, 2013).

136. *Id.* at 1.

137. *Id.* at 2, 4.

138. *Id.* at 5.

139. *Id.* at 6.

140. N. *Lights,* 106 SEC Docket 1134 at 7.

141. *Id.* at 6–7.

142. *Id.* at 11–12.

143. *In re* Commonwealth Capital Management, LLC, Investment Company Act of 1940 Release No. 31678, 111 SEC Docket 4383 (June 17, 2015).

series trust formed by a mutual fund service provider[144] that serviced two series fund entities—a Delaware statutory series trust (with 11 series) and a Maryland series corporation (with 6 series).[145] The order arguably only touches on commoditized governance peripherally because the problems encountered related to a fund advised by the affiliated adviser of the service provider.[146] However, the particular board deficiencies identified could just as easily have occurred with respect to the trust's unaffiliated funds because those funds presented the same kinds of issues and were part of the trust merely to obtain non-advisory services (including in part a commoditized governance arrangement). The SEC's order nevertheless suggests a need for closer scrutiny of the board's role in a shared series trust and faults the particular series trust's independent trustees for failing to obtain responses to their own inquiries pursuant to a Section 15(c) process relating to comparable fund fees and the nature and quality of the advisory services provided to selected funds.[147] While the deficiencies of the board's oversight in *Commonwealth Capital Management* appear less severe than in the case of *Northern Lights*, the order serves notice that the SEC intends to target perfunctory oversight of the advisory contract approval and renewal process, an area where commoditized governance may prove vulnerable.

C. Implications for Commoditized Governance

The dynamics of commoditized governance are potentially unsettling, but are multi-layered. The *Northern Lights* and *Commonwealth Capital Management* orders reveal an unflattering side to shared series trusts that bear out concerns about a board's discharge of its fiduciary obligations in a commoditized governance setting. Quite simply, does the pressure to provide a low-cost governance solution (a primary rationale for the shared series trust commoditized approach to governance) equate with reduced quality in terms of governance?

In theory, placing governance in a commoditized package raises concerns regarding the overall commitment of the purchaser and provider to high standards of fiduciary responsibility. Marketing materials of trust sponsors tread a fine line. Some emphasize the desire to reduce the cost and time commitment for fund sponsors with respect to governance and other back-office functions while other materials point to the ability to provide experienced and knowledgeable boards.[148] Undoubtedly price competition may be deleterious to the extent that sponsors seek to reduce costs associated with governance by economizing in terms of the independent trustees recruited to serve on the trust's board, in terms of a fund's compliance function, or in terms of the legal services procured for the fund and its independent trustees.

This view, however, should not be overstated. Shared series trusts provide a package of services that reduce the costs of entry into the fund industry. The appropriate comparison

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144. *Id.* at 3 (the service provider administrator was formed "as a turnkey investment company platform for advisers that want to manage small to mid-size mutual funds without having to administer the day-to-day operations of a fund, including the management of corporate governance and regulatory compliance").

145. These two fund vehicles have since been consolidated into the World Funds Trust (consisting of 11 investment advisers and 25 series). *Id.* at 3.

146. *Id.* at 3.

147. *Id.* at 11 (finding of violation) and 6–11 (factual predicate for finding of violation).

148. *See infra* Appendix A (providing descriptions of series trust and governance for listed trust sponsors).

in this situation is not whether the governance resources of a fund from a small adviser is qualitatively equal to the governance infrastructure available to a large adviser and its family of funds, but rather whether the shared series trust enables the small adviser to obtain higher quality governance services for a sponsored fund than the fund would otherwise secure if the fund were required to obtain such services on its own. Notwithstanding a shared series trust sponsor's interest in reducing overall costs, the trust sponsor's extensive industry experience would suggest that it is an informed purchaser of services and may be discerning in selecting experienced providers of legal and compliance services. However, such sponsors face conflicting incentives in recruiting independent trustees. On the one hand, tough-mined independent trustees may not be helpful to the sponsor's overall cost-sensitive business model, but may provide reputational benefits for the shared series trust.

More directly, the viability of commoditized governance in the fund industry is likely to turn on competitive forces. In the short run, price competition is likely to be the most salient feature of competition of which governance costs are a component. There are instances of funds shifting from one shared series trust to another.[149] The quality of governance and other services could also have competitive effects.[150] Governance deficiencies may have an adverse reputational effect that large service providers will seek to avoid. Problems identified by regulators—either in examinations or in enforcement proceedings can lead to non-ordinary expenses in rectifying problems retroactively. Moreover, competing shared trust sponsors are likely to impress on prospective fund sponsors deficiencies in other shared series trusts. Over time, shared series trust sponsors have at least incentives to adhere to governance procedures that are minimally effective to avoid findings of deficiency. It is unclear, however, whether trust sponsors have an incentive to invest in governance functions that provide unusually high quality of services. One problem is that participating funds in the trust (and their advisers) may not value high quality governance because they are unlikely to garner any unique reputational benefits, given that any benefits of high-quality governance are shared among all the participating unaffiliated funds in a trust.

In short, the overall effect on governance in the commoditized governance situation are equivocal at best. There is no clear dynamic of a race to the top, but by the same token it should not unambiguously lead to a race to the bottom.[151] In such circumstances, the

149. *See, e.g.*, Northern Lights Fund Trust III, Registration Statement (Form N-14) (Feb. 14, 2013), https://www.sec.gov/Archives/edgar/data/1537140/000091047213000500/marathonn14.htm (registration statement containing combined proxy statement and prospectus for reorganizing Marathon Value Portfolio Fund, a series of Unified Series Trust, as a new series in Northern Lights Fund Trust III) ("The primary purpose of the Reorganization is to move the Existing Fund from UST to NL III. As a series of UST, the Existing Fund retains various service providers who provide an array of services to all series of UST. These services include custody, administration, accounting, transfer agency, distribution and compliance. Spectrum Advisory Services, Inc. ("Spectrum"), the investment adviser to the Existing Fund, has determined that the Existing Fund could benefit from the services currently provided to series of NL III and, therefore, has recommended that the Existing Fund be reorganized as a series of NL III.").

150. *But see* Mathew R. Morey, *Predicting Mutual Fund Performance*, *in* MUTUAL FUNDS – BUILDING BLOCKS IN INVESTMENT PORTFOLIOS, *supra* note 27, at 349, 357–58 (reviewing financial literature and noting "empirical results on the relationship between governance and fund performance are mixed").

151. The race to the bottom thesis is a well-known concept in standard corporate law discourse. As originally formulated, it was hypothesized that state competition for corporate charters caused state (principally, Delaware) to compromise shareholders rights as a means of attracting corporations to incorporate in the state. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 669–70 (1974). An

presence of commoditized governance at the very least argues for regulatory standards that make it difficult for governance standards to fall below a minimally acceptable level. Such initiatives may take the form of the kinds of affirmative mandates that regulators have already imposed on independent trustees of registered investment companies. However, the SEC may wish to consider explicit, and surely more controversial, structural mandates for shared series trust boards which might include: (i) capping the number of funds overseen by independent trustees of a single board (especially because shared series trusts involve funds managed by unaffiliated advisers);[152] (ii) imposing limits on duration of board membership of independent trustees;[153] and (iii) express concurrent training requirements for independent trustees.[154]

V. THE LESSONS AND LIMITS OF COMMODITIZED GOVERNANCE

Commoditized governance is a reality for shared series trusts in the context of the investment management industry, although with equivocal and uncertain normative implications. Mutual fund and ETFs are not the only intensive users of series entity structures, but they appear to be the only ones that have proven amenable to commoditized governance. That fact presents an opportunity to theorize about commoditized governance. The topography of registered investment companies represents an unusual combination of features where shared series trusts on a commoditized governance model have succeeded, but with two important caveats. First, the defining entity governance features of registered investment companies are seldom collectively present in other business contexts, suggesting that conditions necessary to make commoditized governance viable many not exist in other contexts. Second, even in the investment company context, shared series trusts represent only one type of entity model that has gained a footing, but it is not the

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opposing view emerged to the effect that competition among states would actually spur the development of optimal corporate law standards. Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254 (1977). The issue remains contested, although subsequent formulations have elicited more nuanced perspectives. *See, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002). Here, the issue is not one of competition among states, but rather whether market competition among funds themselves would likely lead to higher or lower levels of quality with respect to governance. At a casual empirical level, it seems unlikely that a fund could long survive if notoriously deficient in terms of fund governance, but at the same time, it is likely difficult for shareholders to be able to directly observe fund governance quality and therefore, market competition alone may still lead to considerable divergence in governance quality across funds.

152. There is no obvious legislative authority for such rulemaking other than the avenue previously used by the SEC in connection with the fund governance rule. *See supra* notes 88–99 and accompanying text.

153. There is no analogue for such limitations on board membership in other corporate contexts. However, Congress in the Sarbanes-Oxley Act directed the SEC to impose analogous durational limitations (and caps on number of clients) in the context of lead engagement partner rotation requirements in its independence rule for independent auditors. *See* 17 C.F.R. § 210.2-01(c)(6) (2018). Durational limitations in the board context would probably need to be much longer than the five-year rotation requirement applicable to lead engagement auditing partners. A likely side effect of such a recommendation would be the need to revisit board nomination procedures for independent trustees. In the past, the SEC has not been fully informative regarding the nomination requirements of the fund governance rule. *See* 17 C.F.R. § 270.0-1(7) (2018). This issue might provide an opportunity for a fuller discussion of what constitutes robust nomination procedures. *See generally* INDEPENDENT DIRECTORS COUNCIL, CONSIDERATIONS FOR BOARD COMPOSITION: FROM RECRUITMENT THROUGH RETIREMENT (2013), https://www.idc.org/pdf/pub_13_considerations_board_comp.pdf.

154. One might well question why such structural mandates should be limited to shared series trust boards. Nothing in this article would foreclose such an inquiry.

exclusive or even dominant mode of organization among registered investment companies. In other words, it is one of several modes of organization that co-exist in the investment company context. These observations suggest a more complicated understanding of the phenomenon.

This Part explores commoditized governance and its incidence in terms of underlying themes in corporate law theory and relates those themes to attributes associated with investment companies. This analysis is used to show why commoditized governance is likely to remain confined to this niche. In addition, it offers a general framework for understanding why governance in business entities is seldom amenable to commoditization.

A. Situating the Issue of Commoditized Governance in Corporate Theory

The commoditized governance result in the shared series trust resonates with deeper themes in corporate theory. Three themes are especially salient: nexus-of-contracts, separation of ownership and control, and the utility of independent directors in governing public companies. The first two themes are associated with descriptive explanatory concepts in corporate law scholarship while the final theme is a matter of normative policy.

The nexus-of-contracts concept has exhibited a significant, although waning, impact on corporate law scholarship. Some corporate law scholars drawing on an economic theory of the firm advanced by Ronald Coase[155] recast Coase's theory of the firm as a way of thinking about the corporation as an economic organization: the corporation in its relationship with its various constituencies should be understood metaphorically as a nexus-of-contracts.[156] According to this view, nexus-of-contracts refers to the notion that corporations (or presumably economic entities generally) can be thought of as analogously to the Coasean firm as a nexus in which internal activities are coordinated by a managerial/governing contracting function and external activities are regulated by explicit contracts in markets reflecting the discipline of pricing mechanisms. The nexus-of-contract

155. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 388 (1937) ("Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production."). Coase himself never used the term nexus-of-contracts. The central Coasean conundrum is why firms internalize some exchange relationships while externalizing others. While many insights have emerged from this exchange coordination explanation, it has not always proven successful in rendering specific analytic insights into the organization of actual business entities. *See generally* Charles R. T. O' Kelley, *Coase, Knight, and the Nexus-of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate*, 35 SEATTLE U. L. REV. 1247 (2012) (discussing conceptual discontinuities between Coase's original article and its use to motivate a nexus-of-contract view of the corporation).

156. The initial exponents of the nexus-of-contracts approach in the economic and legal sphere came years after Coase's motivating insight. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) ("The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships."); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983) ("An organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers."). On the legal side, undoubtedly its most forceful assertion is found in Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989). A more nuanced neo-nexus view is offered in Stephan M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 20 (2002) (offering an account of the corporate board as the actual nexus of contracts within the corporation and as the normative basis for a director primacy view of corporate law).

metaphor offers a corresponding explanation of entities in terms of (i) internal contracts (both implicit and explicit) overseen by a managerial/governance function with respect to various organizational participants, and (ii) external contracts that govern the organization's relationships with customers and vendors in markets generally. Although the appeal of an unvarnished nexus-of-contract approach in business entity law has ebbed in the face of criticism and refinements over the years, it remains a powerful construct in understanding corporations as entities.[157]

The nexus-of-contracts explanation has special relevance in the externally-managed investment company context. Specifically, an externally-managed investment company is an unusual form of entity that operates exclusively through contracts with outside service providers (e.g., an investment adviser, a fund administrator, a distributor, a transfer agent, a custodian, etc.). Its internal structure is minimalist; there are generally no employees, and the board will appoint officers who are typically employees of the adviser. In this sense, a fund is not merely metaphorically a nexus of contracts, but literally constitutes a nexus of contracts. The shared series trust adheres to this basic characterization, but also reflects an extension of the contracting model to governance itself. A sponsor of a fund (typically the adviser) selects an entity in which to form the fund and the selected entity will have an existing board and governing documents. The selection of a trust by an adviser is tantamount to selecting a form of off-the-rack governance for a critical aspect of the adviser's business, namely the fund it wishes to form and for which it will serve as adviser.

While a fund's structure conforms to a nexus-of-contracts entity model, it also represents a unique take on the issue of separation of ownership and control, a theoretic feature of public corporations in the corporate law literature. As Berle and Means observed nearly a century ago, as the corporate entity grows and ownership becomes dispersed, two structural features of entities, namely ownership and control, begin to separate.[158] This separation occasions a fundamental agency problem in any publicly-held business entity. Once ownership and control are separated, how can shareholders (the owners and principals) ensure that managers (as agents) act in their interests? Directors occupy a role that potentially bridges that of principal and agent. In the public company, the board oversees the entity's management and the board's fiduciary obligations promote fidelity to the entity's owners, namely its shareholders. Of course, this elementary account has never functioned perfectly in practice since managers may be in a position to co-opt board level monitoring by virtue of their direct interaction with the board and management's role in

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157. *See* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 98 (1996) ("That it has been instructive to view the firm as a nexus of contracts is evident from the numerous insights that this literature has generated. But to regard the corporation only as a nexus of contracts misses much of what is truly distinctive about this mode of governance."). *See, e.g.*, William W. Bratton Jr., *"Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 410 (1989) (discussing that while the theory is helpful in some contexts, it is highly overvalued); Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819 (1999); Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of "Nexus of Contracts" Theory*, 109 MICH. L. REV. 1127, 1144 (2011) (reviewing LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010)) ("The nexus of contracts model does not represent the reality of the modern corporation, and it has misled us for too long.").

158. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, 84–86 (1932). *See generally* C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century*, 51 U. KAN. L. REV. 77 (2002) (discussing the historical context for the Berle & Means insight in terms of the broader debate relating to the role of corporations in society).

shaping the composition of the board.[159]

Fama and Jensen offered a theoretical refinement of this relationship that attempts to more fully integrate the themes of separation of ownership and control and a nexus-of-contracts theory of the corporation.[160] Their account of separation and control offers a higher degree of nuance than the basic account of the separation of ownership and control in two important respects. First, in their account, the separation of ownership and control is divided between an external risk-bearing ownership role (occupied by security holders) and an internal decision-making mechanism that effectuates control over the entity, split between management and the board.[161] This feature of their account is supplemented by a second feature: recognition that control encompasses multi-faceted decision-making responsibilities.[162] Fama and Jensen described the internal decision-making mechanism in terms of four categories of decision-making: initiation (management), ratification (board), implementation (management) and monitoring (board).[163] Another point of elaboration is in order. Fama and Jensen acknowledge the specific allocation of decision-making functions are likely to vary across different types of business organizations[164] and specifically postulate that boards of mutual funds are less likely to exercise the same type of control function exercised by the board of a public company in part because market discipline plays less of a constraining role on management.[165]

Funds, when structured with an external adviser, necessarily entail a separation of ownership and control.[166] Shareholders of each fund are the risk-bearing owners of the

159. These issues implicate the discussion relating to independence of public company boards in Part III.A.1.

160. Fama & Jensen, *supra* note 156.

161. *Id.* at 302–04.

162. *Id.*

163. *Id.* at 304.

164. *Id.* at 307–11.

165. Fama & Jensen, *supra* note 156, at 317–18.

166. Professor John Morley argues that the unambiguous historical trend in the fund industry towards externalization (discussed in the text accompanying notes 35–37 and which he terms the separation of funds and managers) is a "central phenomenon" in understanding investment funds (registered and unregistered) generally and further "explains" why such an arrangement is a "particularly efficient" pattern that "benefits fund investors." John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1232–33 (2014). I agree with Professor Morley that externalization is a salient feature in understanding many fund complexes today and, in my case governance of funds particularly. However, Professor Morley's overriding thesis strikes me as unpersuasive; the economic effect of externalization is at best equivocal. It undoubtedly is beneficial for advisers and, to that extent, may incentivize advisers to provide better service to investors. However, there are real and unresolved empirical issues whether this is in fact the case. In other words, there is a question whether the added incentives afforded to advisers by externalization (that may contribute to added costs for investors) generates corresponding outsized benefits for investors (in terms of improved performance or services). I am unaware of any studies that provide empirical support for Professor Morley's position. However, this issue is well beyond the scope of this Article. As a result, this Article evinces an agnostic position with respect to the overall benefits of externalization. Instead, it assumes that the effects of externalization will differ on a case-by-case basis. In some cases, perhaps it engenders superior performance or services for investors and in others, facilitates rent-seeking behavior by advisers. There are separate reasons why Professor Morley's externalization position is dubious in the case of mutual funds and ETFs. First, he suggests that externalization may be the result of economies of scale and scope, but among large fund families the same economies of scale and scope are equally available whether the fund family uses an internalized structure (Vanguard) or an externalized one (Fidelity). Similarly, redeemability neither argues for externalization or for internalization since the NAV calculation from which performance is derived will reflect real-time investment performance and real-time accrual of expenses. Finally, although externalization does separate investment risk

constituent fund and the board and management (as delegated to the adviser) jointly exercise control. Fama and Jensen's nuanced account of the control function provides a more suitable construct for parsing the different layers of control in a fund. At the board level, control involves disproportionate emphasis on monitoring and the board's special role in controlling compensation of the manager. Virtually all control over operations from initiation of fund products to day-to-day fund management are in the hands of the external investment adviser. While the board cannot directly affect the internal operations of an external adviser, the formalized processes for fund governance mandated by regulation preserve a significant level of board control over fund activities in terms compliance, conflicts of interest, and expenses incurred by the fund. The board oversees compliance in the fund and the external adviser takes the lead in managing the fund.

As Fama and Jensen suggest, the basic allocation of control responsibilities for a fund may fundamentally differ from control responsibilities in other types of enterprises. By the same token, ownership functions differently as well. As to ownership, shareholders have less voice with respect to board composition. As noted, open-end registered investment companies typically do not have annual elections.[167] Moreover, owners of mutual funds and ETFs have significant market liquidity for their shares. Thus, unlike typical shareholders, their commitment of capital to the enterprise is different: they are able to realize the intrinsic value of their shares on a current basis. In such circumstances, there is no opportunity for change-of-control transactions that have an opportunity to yield control premiums.

These factors also contribute to the unusual allocation of responsibility for control in the fund between the board and the adviser. The board has little or no role in assessing strategic opportunities that benefit shareholders or in the funds day-to-day management or operations.[168] Instead, the board's role is primarily limited to three functions: compliance monitor, conflicts umpire, and bargaining agent with respect to the manager (adviser).[169] The fund board's role is severely circumscribed in terms of other common forms of public company board activities[170]: decision-making regarding capital formation and structure,[171]

from risk associated with an adviser's and other service providers' operating profits and losses (P&L), volatility in fund performance results almost entirely from investment performance rather than P&L of the fund's service providers (i.e., generally costs are stable while investment performance is not). In short, the relevant risk for investors participating in a registered fund is fluctuating investment returns rather than fluctuating costs. Indeed, as the Vanguard fund family shows, internalization may actually contribute to a lower aggregate expense structure for investors. In one sense, however, externalization may be very relevant to risk. Formation of new funds entails entrepreneurial risk which advisers and service providers are better suited to bear when funds are operating at a very small scale or are sponsored by new entrants to the industry. *See* PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 84–87 (AEI 2007) (discussing Vanguard internalized structure and noting that need for start-up capital favors externalized advisor over internalized methods of organization).

167. *See supra* note 100 and accompanying text.

168. *See* FED. REGULATION OF SECS. COMM., FUND DIRECTOR'S GUIDEBOOK 57 (2d ed. 2003) [hereinafter GUIDEBOOK] ("Fund directors do not manage funds on a day-to-day basis. . . . The board typically delegates these responsibilities [to service providers] who are responsible for the ongoing operations of the fund.").

169. *See id.* (a board must "monitor[] the adequacy of management's internal controls and compliance programs. These responsibilities are heightened in the case of matters in which conflicts of interest exist or problems have been identified.").

170. For more elaborate assertions of this point, see *supra* notes 114 & 117.

171. ICA Section 18(f) imposes express limitations on the capital structure of investment companies and

corporate control transactions,[172] operational activities,[173] and initiatives relating to long-term business strategy.[174] The limitations on fund boards are not the result of artificial constraints, but rather are a direct result of the nature of a fund business. The difference between fund boards and public company boards in allocation of control responsibilities can be loosely divided into two categories: (i) compliance and conflict-of-interest oversight; and (ii) managerial and strategic decisions affecting the entity. Fund board decisions fall within the former category and are weighted toward generic oversight issues that involve a high degree of consistency across funds. In contrast, public company boards must address both types of decision-making, and more importantly, it is the latter kinds of decisions that assume the greatest importance. Given fund board's limited role in shaping the managerial or strategic side of the enterprise, the need for a board uniquely dedicated to the fund's business is substantially reduced and makes commoditized governance more palatable as a governance solution for some funds. Of course, there are factors discussed below that may lead many fund groups to prefer a board specifically dedicated to the fund family.

A final theme that has figured in the commoditized governance foothold in the fund industry is the importance of independent directors. As previously noted, the ICA proved

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specifically prohibits open-end companies from issuing securities senior to its common shares. *See* 15 U.S.C. § 80a-18 (2012).

172. Mutual funds and ETFs as a rule are not subject to discipline from market for corporate control forces. *See generally* William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999). To the extent that mutual funds and ETFs merge or acquire assets of other funds, such transactions are done strictly on a current net asset value basis. As a result, there is no opportunity for shareholders to receive a control premium. Similarly, an acquirer will be unable to capture any direct economic benefit from buying shares that trade at a discount to their intrinsic value because funds will only sell shares at their NAV (intrinsic value) or, in the case of ETFs, at values that approximate their NAV. For a discussion of economic motives in acquisitions in conventional M&A transactions, see Reinier Kraakman, *Taking Discounts Seriously: The Implications of 'Discounted' Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988). In the case of series trusts, a change in control of the trust at the board level is virtually impossible because the board is elected based on the aggregated vote of shareholders across many different participating series funds. *See supra* notes 11 & 20. However, even more importantly, an investment company trust once operational is not required to hold another board election, unless the number of incumbent directors elected by shareholders drops below a 50% threshold. *See supra* note 65. Thus, an acquirer would conceivably need to wait many years before having an opportunity to make a bid for control, which is untenable. Of course, mergers and other forms of friendly acquisitions can occur in the context of investment companies. However, the motivation of such transactions is tied to other facts such as: (i) a fund that is not successful (rather than liquidating it may make sense to join with a fund with a similar investment objective); (ii) a change in control of the adviser as a result of its acquisition which may trigger automatic termination of the investment advisory agreement or the need for board processes, pursuant to Section 15(f), to avoid such an outcome; or (iii) movement of a fund in one series trust to another series trust. *See generally* Jon D. Rand and Mary C. Carty, *Mergers and Acquisitions of Investment Managers* (pts. 1–2) 9 INV. LAW. no. 6, 2002, at 1; 9 INV. LAW. no. 7, 2002, at 18; Jon D. Rand et al., *Mergers and Acquisitions of Investment Managers* (pt. 3) 9 INV. LAW. no. 9, 2002, at 17. For an empirical assessment of takeovers in the fund industry, see Ajay Khorana et al., *Board Structure, Mergers, and Shareholder Wealth: A Study of the Fund Industry*, 85 J. FIN. ECON. 572 (2007).

173. *See* GUIDEBOOK, *supra* note 168. Indeed, the very nature of an externally-managed fund is to contract with a separate and economically distinct investment adviser to oversee fund operations.

174. Funds are constrained in developing long-term business strategies. First, a fund must adhere to its stated investment objectives and cannot deviate from those objectives absent a shareholder vote. Second, within the limited area for business strategy tied to distribution, the primary decision maker with respect to marketing strategy is the adviser or an affiliated principal underwriter. The board will be advised of these strategies and may be called upon to ratify certain enabling steps to implement such strategies.

innovative in assigning essential statutory and regulatory responsibilities to board members denominated as independent.[175] As noted, the SEC has consistently given much greater weight on the independence of fund boards.[176] This focus on independence was a forerunner of the cry for increased board independence among public companies.[177]

The regulatory requirements relating to independence in the fund industry, coupled with the explosion in the number of funds requiring boards, has had an unintended effect in enabling commoditized governance. The agenda and obligations of boards in the fund industry increasingly have been controlled by regulatory requirements[178] and, predictably, this has required a move toward increasingly systematic approaches in discharging these responsibilities. Thus, it could be argued that an unintended consequence of SEC policy (as it is doubtful that the SEC harbors warm feelings for commoditized governance) has, in part, created conditions that have enabled the emergence of commoditized governance in the fund industry.

Another point is worth noting: the shared series trust represents a collection of features that combine to make commoditized governance a viable outcome. However, it is only employed in a relatively small segment of the registered investment company world. This fact indicates that the presence of certain structural factors alone is not sufficient to produce a preference for commoditized governance. Thus, while certainly contributing to a commoditized governance outcome, structural factors are not sufficient to decisively shape such an outcome. Why?

Two additional factors may account for this variety in approach to governance. First, it appears that economic factors may play a decisive role in determining whether fund sponsors seek a commoditized or non-commoditized governance approach. Size (or more aptly, economies of scale) is likely to affect a sponsor's decision regarding the merits of governance. Smaller fund groups or solo funds may find a commoditized governance approach economically appealing for the reasons earlier identified in terms of the overhead (namely, arranging for a dedicated board and supporting resources as well as the opportunity costs in terms of the sponsor in establishing a dedicated board). For large funds, the economics of the commoditized and non-commoditized approach may be very

175. The term independent is not used in the statute or regulations. Rather, as previously stated *supra* note 67, 15 U.S.C. § 80a-2(a)(19) (2012) defines a class of persons who are "interested" and what is commonly regarded as independent directors or trustees are non-interested persons for purposes of the ICA. For some purposes, the SEC's regulations refer to these independent board members as "disinterested" directors. 17 C.F.R. § 270.0-1(7) (2018).

176. *See* Part III.A.2.

177. *See* Part III.A.1.

178. *See supra* note 97. Recently, the SEC staff has acknowledged concerns regarding the possibility of regulatory overload in the case of boards with a project that has been dubbed the "board outreach initiative." Dalia Blass, Dir., Div. of Inv. Mgmt., Keynote Address at the ICI Securities Law Developments Conference (Dec. 7, 2017), https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017. The staff's preliminary views on the evolving Board Outreach Initiative have begun to take shape. *See* Dalia Blass, Dir., Div. of Inv. Mgmt, Remarks at the IDC 2018 Fund Directors Conference (Oct. 16, 2018), https://www.sec.gov/news/speech/speech-blass-101618 (referencing ICA rule 17a-7, noting that directors have questioned the value of using their time to individually review "*all* cross-trades of *each* fund"); Indep. Dirs. Council, SEC No-Action Letter (Oct. 12, 2018), https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm (confirming the staff's view that a fund board need not individually review transactions effected in compliance with ICA Rules 10f-3, 17a-7, and 17e-1, provided the board receives a written representation from the chief compliance officer that the transactions were effected in compliance with board approved procedures).

different. The overall costs of governance relative to assets under management of governance become dramatically small and so there are considered scale economies in governance. A dedicated board may yield reputational benefits that are valuable to the large sponsor, but are of less value to the small money manager. Finally, a shared board does risk diffusion of information that the sponsor regards as propriety.

A second factor is that differences between commoditized and non-commoditized governance approaches may be less significant in some business contexts than others. Thus, in the fund industry, there is a difference between a dedicated series trust and a shared series trust in terms of governance, but this difference is not nearly as great as the effect would be among manufacturing enterprises that were to choose between a commoditized or non-commoditized governance approaches. Put differently, commoditized and non-commoditized governance are closer substitutes in the case of investment companies than might be true in other business contexts based on the structural factors identified in the preceding discussion. If they are in fact near substitutes, other factors, such as scale or size, will produce the potential for variety in preferences for commoditized and non-commoditized governance solutions.

B. A General Theory of Commoditized Governance

The lessons of commoditized governance in the fund industry and its relationship to well-known themes in corporate governance provide the foundation for advancing a general theory of commoditized governance. Admittedly the theory is heavily based on experience garnered from its incidence in fund industry governance. Hopefully, however, situating these lessons to overriding themes in corporate governance provides a sufficiently robust basis for opining on the limits of commoditized governance mechanisms in business entities.

Commoditized governance requires two fundamental conditions which must coincide with other supporting factors. The two conditions are these: (i) there must be sufficient similarities among enterprises to permit realization of economies of scale in governing separate enterprises; and (ii) the board's role consists primarily in compliance and conflict-of-interest oversight rather than managerial and strategic oversight of the relevant enterprises. In what sense does governance lend itself to scale effects? It does so in circumstances where there is a fair amount of standardization and repetition in the underlying businesses and the oversight issues affecting the various enterprises. This standardization results from several factors. The underlying businesses must have a high degree of similarity. For example, you would not expect to see commoditization in highly differentiated businesses. Moreover, one would expect businesses supported by non-complex organizational platforms (i.e., the business is organizationally flat and not diverse in its business functions). These certainly include funds as well as some types of real estate ventures or franchises. The existence of many similar horizontal firms in a line of business is essential to create the demand necessary to sustain a commoditized governance solution. In addition, scale-effects to governance are more likely where there are impediments to combining many similar firms in a single or hierarchical entity. A significant factor, especially in the fund business, is the ease of entry in operating an individual firm, but barriers in simultaneously launching many parallel individual firms. Such conditions create an opportunity to realize economies by sharing organizational costs with other similarly situated firms. The fund industry illustrates this type of situation, a situation where there are obstacles to creating an enterprise with many underlying similar firms, notwithstanding

the efficiency of combining the many individual firms organizationally.

How does this relate to use of series entity structures? A series structure is neither a necessary nor a sufficient condition for commoditized governance. After all, a commoditized governance arrangement can be achieved by replicating many identical business entities under the same board. Series entity structures, however, are a natural vehicle for implementing a commoditized governance solution. Put differently, if a given business model is unsuitable for a series entity structure, in all likelihood it will be also be a poor candidate for commoditized governance.

The second necessary condition for commoditized governance is the segregation of managerial and strategic enterprise objectives from compliance and conflict-of-interest oversight decisions. The former type of control responsibility is less likely to lead to a standardized decision-making model, while the latter type will. A concrete illustration of the difference is that compliance or conflict-of-interest decisions can frequently be resolved by policies and procedures while managerial and strategic decisions are less susceptible to such treatment.

To be sure, there may be significant correlation among these different control objectives. In the fund industry for example, if a particular fund does well, the adviser benefits as do shareholders. The adviser will reap a larger management fee as a fund's assets under management grow (spurred by superior performance). Similarly, shareholders benefit from good performance and any ensuing asset growth because more assets spread operational costs across a wider asset base. Despite this alignment of interests, an investment adviser's success need not depend on the success of any particular fund, but rather the success of the complex's stable of funds. As noted, commentators have likened different externally-managed funds (the so-called businesses) to different products.[179] To the extent that that this observation is valid, it underscores the difference between the adviser's entrepreneurial objectives and those of the fund's shareholders on whose behalf the independent board members act. Commoditized governance is consistent with this basic model. In the case of the fund industry, commoditized governance can serve to better align the managerial and strategic objectives of fund advisers and the compliance and conflict-or-interest oversight objectives of shareholders.[180]

While the conditions that make commoditized governance viable may be necessary, they are hardly sufficient. Indeed, even within the fund industry where commoditized governance has emerged as one potential approach, it exists as a limited niche rather than enjoying a tidal wave of acceptance. As noted, the niche appeal of commoditized governance, even in the fund industry, is most likely when the economic conditions of the industry are amendable to commoditized governance. In the fund industry for example, the costs of governance affect small competitors differently than large competitors, resulting in different preferences with respect to governance. As noted earlier, the fund industry reflects very diverse adviser clienteles. Larger fund complexes are interested in maintaining brand quality or preserving the confidentiality of proprietary business practices. In such cases, use of a dedicated, rather than a shared, governing board may be

179. *See supra* note 111.

180. The fund is somewhat different in this regard to other kinds of businesses that may seem similar to the publicly offered fund, such as hedge funds. Hedge funds typically involve a significant economic commitment by the entrepreneurial actor that sponsors the fund, and the performance incentive fee structure further binds the entrepreneurial objectives of the adviser to the interests of the fund investors.

preferred. The large complex benefits from the consistency that it can achieve in governance matters and it is also insulated from negative publicity that can arise from deficiencies in a generic governance apparatus. A small fund group, with either limited assets under management or few funds, may evaluate the costs and benefits of commoditized governance differently. Commoditized governance will generally offer a more economical solution for a small fund group and may actually offer better governance than the same small fund group can achieve with its own dedicated governance apparatus.

In this context, shared series trusts (and its implicit commoditized governance apparatus) serve to ease organizational entry barriers that small group funds would otherwise encounter. In short, commoditized governance may be a product of the economic demands of a competitive marketplace.

Registered investment companies have roughly $22 trillion in assets under management spread across 10,000 funds and offer business conditions. Is the experience of shared series trusts a harbinger of commoditized governance for businesses beyond the investment company world? There are reasons for skepticism regarding the viability of commoditized governance to other business entities. Simply put, there generally are not significant economies of scale in governance with respect to public companies, and it seldom makes sense to partition control responsibilities in a business entity in terms of compliance and conflict-of interest oversight on the one hand and managerial and strategic decision-making on the other.

In the case of most enterprises, the larger the business, the more complex and unique are all aspects of the business. Moreover, even among smaller publicly-held businesses, the enterprises are far less standardized than what is seen in the fund industry. These factors suggest the absence of significant economies of scale in providing governance and managerial and strategic control across different enterprises. In addition, commoditized governance will not be relevant to series vehicles of private entities because governance in such series vehicles are tightly aligned with the owners' interests. A statutory trust with a single trustee or a single member LLC will never devolve into a commoditized governance arrangement because governance and ownership issues are co-extensive (i.e., there is no separation of ownership and control).

Even if limited to governance of public series entities, commoditized governance is not likely to be replicated outside the fund industry. The major hurdle would appear to be envisioning business arrangements where (i) compliance and conflict-of-interest issues of a business can be segregated from managerial and strategic business issues, and (ii) shareholders prefer that the board address only the former and not the latter. As noted, commoditization would only make sense for relatively non-complex businesses where shareholders can directly monitor management's business strategy and costlessly exit the enterprise (as is the case with mutual funds and ETFs). In the case of funds, it is shareholders ability to indirectly monitor the results of managerial decisions (through daily performance information) and the ability to obtain the net asset value of their investment on a current basis that makes it possible to dispense with significant governance oversight of managerial decisions. Because it is hard to envision other business models where the same conditions are met, the feasibility of commoditized governance may be largely limited to a niche within the fund industry. In short, commoditized governance appears to be an extreme case in terms of governance of business entities, series or otherwise.

VI. CONCLUSION

Shared series trusts in the investment company industry represent a rare example where commoditized governance has gained a foothold. While economically feasible, it is not without problems as a form of entity governance. It may fall short of providing shareholders vigilant oversight in protecting investors' interests. However, shared series trusts also show why commoditized governance may nevertheless be a feasible and useful approach to governance in the conditions that characterize the fund industry, even if such an approach is generally unsuited for the vast majority of business entities. In short, commoditized governance is likely suitable only when board decision-making is primarily focused on relatively routinized forms of compliance and conflicts-of-interest oversight and an entity's underlying businesses' managerial or strategic can be delegated to professional managers. In most business contexts this will not be the case and so commoditized governance will be less preferred as a mode of entity governance.

VII. APPENDICES

Appendix A

Table of Selected U.S. Registered Investment Company Shared Series Trusts[*] (2018)

This table gathers together data from different sources relating to a selected shared series trusts. It is not comprehensive, but it does identify well-known shared series trusts. Public descriptions of the trust sponsor come from websites maintained by the sponsor. Information regarding the specific trust were obtained from documents filed with the Securities and Exchange Commission and typically a Statement of Additional Information (SAI) for a component fund which must identify information about its entity status (i.e., the relevant shared series trust). The number of funds in each trust (when not found in a member fund SAI) was approximated from the trust's most recently filed N-PXs (a disclosure document relating to proxy voting by component funds). This may understate the number of funds in the series trust if no N-PX is required to be filed for a member fund. While this appendix tries to provide a snapshot of the shared series trust space, it is only a snapshot of a dynamic niche market.

Note: During the Article's preparation for publication, two sponsors of shared series trusts identified in the appendix, The Gemini Companies and Ultimus Fund Solutions, which also happen to be leading providers of fund administration services, entered into definitive acquisition agreements in which a private equity firm would acquire and combine both businesses. *GTCR Announces Strategic Combination of Ultimus and Gemini* (PR Newswire Pr. Rel. Nov. 19, 2018).

Trust Sponsor: Atlantic Fund Services	**Description of Series Trust and Governance** (https://www.forumseriestrust.com): Series trust vs. stand alone: "Organizing a registrant and launching a mutual fund is a complex process with a broad range of requirements. With a series trust, the regulatory, compliance and operational structure is already in place, simplifying the process for the advisor and fund sponsor." Management of the Trust:

[*] Although shared series trust can be defined generically, the term is not a strict legal category. The important point is that this chart is meant to be a useful description of representative shared series trusts and does not provide a formal census of shared series trusts.

<table>
<tr><td></td><td colspan="2">“Listed below are processes and tasks required to operate a mutual fund. With a stand-alone registrant, fund management is responsible for these tasks. In a series trust, the Board of Trustees manages these tasks, minimizing resource requirements, risk, and time-to-market.” (visited website: 10-8-18)</td></tr>
<tr><td>Trust Name:
Forum Funds</td><td>Established: 1995
Delaware Statutory Trust
(successor entity to Forum Funds Inc.)

SAI Absolute Strategies Fund Statement of Additional Information (9-1-18)</td><td>Funds (approx.): 22

Forum Funds N-PX Filing (dated 8-22-18)</td></tr>
<tr><td>Trust Name:
Forum Funds II</td><td>Established: 2012
Delaware statutory trust

SAI Baywood ValuePlus Fund (2-1-18)</td><td>Funds (approx.): 16

Forum Funds N-PX Filing (dated 8-22-18)</td></tr>
<tr><td colspan="3"></td></tr>
<tr><td><u>Trust Sponsor</u>:
(originally jointly by Northern Trust/Beacon Hill Fund Services (since acquired by Foreside Financial))</td><td colspan="2"><u>Description of Series Trust and Governance</u>:

“A ‘Series Trust’ or ‘Umbrella Trust,’ as it is commonly known as</td></tr>
</table>

	in the United States, is a registered investment company (RIC) filed with the SEC. This structure enables multiple unaffiliated registered investment advisers to manage separate portfolios or 'series' within the same trust. The Advisers Investment Trust is a comprehensive solution that supplies an experienced independent team of professionals and fund officers to ensure best practice governance and operational infrastructure, allowing the adviser to focus on money management, distribution and sales success." (BusinessWire, Press Release, July 27, 2015)	
Trust Name: Advisers Investment Trust	**Established:** 2017 Delaware statutory trust (successor to an Ohio business trust formed in 2011) SAI JOHCM International Select Fund (1-28-18)	**Funds (approx.):** 16 Advisers Investment Trust N-PX Filing (dated 8-10-18)
Trust Sponsor: UMB Fund Services	**Description of Series Trust and Governance** (https://umbfs.umb.com/turnkey-solutions/series-trust): "The Investment Managers Series Trusts provide a simple, cost-efficient means of starting and	

	operating a mutual fund—ideal for advisors who wish to offer a mutual fund to enhance their product line. . . ." Benefits and Highlights: Board of trustees, fund auditors, legal counsel and other service providers are already in place" (website visited: 10-8-18)	
Trust Name: Investment Manager Series Trust	**Established:** 2005 Delaware Statutory trust SAI Zacks Dividend Trust (4-18)	**Funds (approx.):** 67 27 Investment Manager Series Trust N-PX Filings (dated 8-18)
Investment Managers Trust Series II	**Established:** 2013 Delaware statutory trust SAI Vivaldi Merger Arbitrage Fund (2-1-18)	**Funds (approx.):** 12 7 Investment Manager Series Trust II N-PX Filings (dated 8-18)
Trust Sponsor: SEI	**Description of Series Trust and Governance** (https://seic.com/who-we-serve/traditional-asset-managers/mutual-fund-series-trust): "If you're interested in launching a new mutual fund, or you're seeking a more convenient governance and	

	operational model for your existing mutual funds, consider The Advisors' Inner Circle Fund. This series trust solution addresses every facet of a fund's operations." (pdf brochure website: visited 10-8-18) "The Advisors' Inner Circle Fund provides a cost-effective, turnkey structure to comprehensively address the many facets of a fund's operations and deliver: › Faster fund launch (about 95 to 120 days) › A fund chief compliance officer (CCO) and legal team › An experienced accountable strategic relationship manager › The financial benefits of sharing CCO, insurance, legal and trustee fees with other members of the trust › Cost-effective access to the industry's best auditors, custodian banks and transfer agents › Enhanced marketing and distribution › **Ongoing, useful established and independent** **board of trustees and legal counsel"** (website pdf brochure: visited 10-8-18) (emphasis added)

Trust Name: Advisors' Inner Circle Fund	**Established:** 1991 Massachusetts business trust SAI LSV Value Equity Fund (3-1-18)	**Funds(approx.):** 58 20 Advisers' Inner Circle Fund N-PX Filings (dated 8-31-18)
Trust Name: Advisors' Inner Circle Fund II	**Established:** 1992 Massachusetts business trust SAI Westfield Capital Large Capital Growth Fund (3-1-18)	**Funds(approx.):** 33 10 Advisers' Inner Circle Fund II N-PX Filings (dated 8-31-18)
Trust Name: Advisors' Inner Circle Fund III	**Established: 2013** Delaware statutory trust SAI BNP Paribas Emerging Markets Total Return Fixed Income Fund (1-28-18)	**Funds (approx.):** 26 13 Advisers' Inner Circle Fund III N-PX Filings (dated 8-31-18)
Trust Sponsor: Gemini Fund Services LLC)	**Description of Series Trust and Governance** (https://www.thegeminicompanies.com/registered-funds/mutual-funds/): Mutual fund board & compliance: "Gemini provides a comprehensive suite of specialized services, which	

	includes access to series trust solutions that provide an experienced board of trustees, compliance oversight, and fund legal counsel. The mutual fund benefits from the economies of scale available through the use of these shared resources.” (website: 10-8-18) **Shared (Series) Trust** “This type of trust is composed of independent funds, all managed by separate investment advisors. This means your fund would be registered in a trust with other funds, but you are still fully in control of managing your fund as an independent advisor. Your fund would share some costs with other funds in the trust, easing the financial burden for costs incurred while running a fund. Specifically, series trusts offer many advantages that may not be achievable through a standalone trust, including: Access to trust level selling agreements, if applicable. Increased operational efficiencies, as funds in the trust share directors/trustees, chief compliance officers, and officers as required by the SEC. Reduced operating costs, as a group of advisors shares expenses such as those for auditors, fund counsel, insurance, legal, trustees, blue sky, and more. The ability to attract qualified board members who possess the expertise

	to provide proper board compliance and oversight. Freedom for the advisor to focus on portfolio and relationship management. Gemini offers access to multiple series trusts, giving you several options to meet your needs." (website: 10-8-18)	
Trust Name: Northern Lights Fund Trust	**Established:** 2005 Delaware Statutory Trust	**Funds (approx.):** 79 SAI Power Income Fund (10-30-17)
Trust Name: Northern Lights Fund Trust II	**Established:** 2010 Delaware statutory trust	**Funds (approx.):** 23 SAI North Star Dividend Fund (4-1-08)
Trust Name: Northern Lights Fund Trust III	**Established:** 2011 Delaware statutory trust	**Funds (approx.):** 33 SAI Absolute Capital Defender Fund (2-1-18)
Trust Name: Northern Lights Fund Trust IV	**Established:** 2015 Delaware statutory trust	**Funds (approx.):** 23 SAI Moerus Worldwide Value Fund (3-30-18)

<table>
<tr><td>Trust Name:

Northern Lights Variable Trust</td><td>Established: 2006

Delaware statutory trust</td><td>Funds (approx.): 16

3 Northern Lights Variable Trust N-PX filings (8-18)</td></tr>
<tr><td colspan="3"></td></tr>
<tr><td><u>Trust Sponsor</u>:
U.S. Bancorp Fund Services</td><td colspan="2"><u>Description of Series Trust and Governance</u>
(http://www.usbfs.com/usbfs/mutual-fund-solutions/products/multiple-series-trusts.aspx):

Multiple Series Trusts: “. . . Our turnkey solution reduces the legal work necessary by adding your fund to an existing trust, essentially lowering the costs compared to establishing an entirely new fund.”

“Multiple series trusts offer several advantages, including
. . .
Governance and service expertise of an existing board”</td></tr>
<tr><td>Trust Name:
Advisors Series Trust
Trust</td><td>Established: 1996
Delaware statutory trust</td><td>Funds (approx.): 41

SAI Edgar Lomax Value Fund (2-28-18)</td></tr>
<tr><td colspan="3"></td></tr>
</table>

<table>
<tr><td><u>Trust Sponsor</u>:
Mfund Services</td><td colspan="2"><u>Description of Series Trust and Governance</u>
(http://mfundservices.com):

“Fund utilizes the turnkey Mutual Fund Series Trust platform which features low start-up and ongoing costs” (website visited: 10-8-18)

[Note: no mention of board or governance]</td></tr>
<tr><td>Trust Name:
Mutual Fund Series Trust</td><td>Established: 2006
Ohio business trust</td><td>Funds (approx.): 47

4 Mutual Fund Series N-PX filings (8-27-18)</td></tr>
<tr><td colspan="3"></td></tr>
<tr><td><u>Trust Sponsor</u>:
Ultimus Fund Solutions LLC</td><td colspan="2"><u>Description of Series Trust and Governance</u>
(https://www.ultimusfundsolutions.com/series-trust):

“Each series trust already has selected: trustees, officers, fund counsel, distributor, auditors, and custodians. A series trust enables investment managers to bring mutual funds to market in an efficient and cost-effective manner.” (visited 10-6-18)

“Each series trust has an established Board of Trustees, slate of qualified officers, and has experienced fund counsel and auditors in place to serve your fund(s). Ultimus can work with</td></tr>
</table>

<table>
<tr><td></td><td colspan="2">any number of qualified custodians and has selling relationships with all of the significant distribution intermediaries. With established competitive fee structures in place, our series trust offerings should result in lower operating expenses, lower than an adviser would likely obtain on their own.” (Ultimus Fact Sheet -- pdf last viewed 10-6-18)</td></tr>
<tr><td>Trust:
Ultimus Managers Trust</td><td>Established: 2012

Ohio business trust

SAI Lyrical U.S. Value Equity Funds (March 30, 2018)</td><td>Funds (approx.): 20</td></tr>
<tr><td>Trust:
Capitol Series Trust</td><td>Established: 2013:

Ohio business trust</td><td>Funds (approx.): 10

SAI Meritage Growth Equity Fund (6-4-18)</td></tr>
<tr><td>Trust:
Unified Services Trust</td><td>Established: 2002

Ohio business trust</td><td>Funds (approx.): 18

SAI Auer Growth Fund (3-30-18)</td></tr>
</table>

Trust: Valued Advisers Trust	**Established:** 2008 Delaware Statutory Trust	**Funds (approx.):** 11 SAI BFS Equity Fund (3-30-18)
<u>Trust Sponsor</u>: Exchange Traded Concepts	**<u>Description of Series Trust and Governance</u>** "ETF-In-A-Box™: A Complete Turnkey Solution for Private Label Passive and Active Exchange Traded Funds." (https://www.exchangetradedconcepts.com/ visited 10-6-18) "ETC's ETF-In-A-Box™ Solution provides and efficient and cost-effective method to bring exchange-traded funds to market with the operational and regulatory experience necessary to manage the complexities of launching and managing and ETF." "ETC Fund Services All functions are critically necessary to launching and operating a successful ETF . . . . Board of Trustees"	
Trust: ETC Trust	**Established:** 2009 Delaware statutory trust SAI AllianceBernstein	**Funds (approx.):** 13

	ETF Funds (10-13-17)	
Trust: ETF Series Solutions	**Established:** 2012 Delaware statutory trust SAI AlphaClone Alternative Alpha ETF (7-31-18)	**Funds (approx.):** 7
Trust: ELF Trust (formerly, Exchange Traded Concepts Trust II)	**Established:** 2012 Delaware statutory trust SAI Insightshares LGBY Employment Equality ETF (1-8-18)	**Funds (approx.):** 7

Appendix B

Table of Series Trusts by Sponsors Affiliated with Fidelity Management and Research (2018)

This table compiles data from different sources relating to series trusts that are part of the Fidelity Investments fund family. According to Fidelity's website (visited 10-9-18), it offers 346 mutual funds. This may not include Fidelity funds that are closed for investment and does not include ETFs. The table does not attempt to provide an exhaustive survey of the underlying entities in which every Fidelity fund is housed, but rather is intended to illustrate some basic points about one of the largest fund families. First, it relies heavily on series trusts (in this case Massachusetts business trusts) to offer its array of funds. Second, the timing of the first use of series trusts by Fidelity in newly formed trusts is pretty easy to identify—June 1984. Trusts formed by Fidelity prior to that time did not authorize use of series, and subsequent to June 1984, the trust declarations of those earlier trusts were gradually amended to permit use of series. The information compiled in the chart employed

three basic sources. First, the Secretary for the Commonwealth of Massachusetts maintains an electronic corporate archive that can be used to examine declarations of trust and amendments thereto for business trusts (http://corp.sec.state.ma.us/corpweb/CorpSearch/CorpSearch.aspx). Second, the trust name can be used in the SEC Edgar database to look up filings with the SEC and determine the individual funds in each trust (usually by examining the trust's annual N-PX filing). Fidelity invariably does one annual N-PX for each trust. Finally, a Statement of Additional Information for a representative fund in each trust was used to determine the number of funds in the trust as of its most recently filed SAI prior to Oct. 1, 2018.

Name of Current Trust	**Funds in Trust**	**Original Declaration Date (Prior Trust Name)**	**Trust Declaration** (began permitting use of series funds)
Fidelity Union Street Trust	2	**3-1-74** (Fidelity Daily Income Trust)	Amended (11-21-86)
Fidelity School Street Trust	5	**9-10-76** (no change)	Amended (3-24-87)
Fidelity Summer Trust	9	**3-23-77** (no change)	Amended (2-4-87)
Fidelity Court Street Trust	2	**4-21-77** (no change)	Amended (2-12-87)
Fidelity Capital Trust	7	**5-31-78** (no change)	Amended (8-20-86)
Fidelity Advisor Series VII	10	**4-21-80** (no change)	Amended (10-30-87)
Fidelity Select Portfolios	43	**11-20-80** (no change)	Amended (1-1-90)
Mt. Vernon Street Trust	6	**10-12-81** (Fidelity Emerging Growth Fund)	Amended (8-1-86)

Fidelity Hanover Street Fund	(central fund)	**5-17-82** i. Equity One Trust ii. Fidelity Adviser Series III	Amended (8-15-86)
Fidelity Advisor Series I	21	**10-12-82** Equity Portfolio Growth 82	Amended (11-7-84)
Fidelity Financial Trust	3	**10-20-82** (No change)	Amended (4-27-87)
Fidelity Financial Trust	3	**10-20-82** (No change)	Amended (4-27-87)
Fidelity Advisor Series IV	1	**5-6-83** (Fixed-Income Portfolios)	Amended (11-7-84)
Variable Insurance Products Fund	(variable annuity portfolios)	**6-1-83** (Fidelity Advisor Series VI among others)	Amended (3-4-85)
Fidelity Advisor Series VIII	8	**9-22-83** (Fidelity Special Situations Fund)	Amended (8-10-84)
Fidelity Investment Trust	33	**4-20-84** (Fidelity International Fund)	Amended (8-10-84)
Fidelity Corporate Trust	Terminated (12-31-91)	**5-16-84** (Fidelity Adjustable-Rate Preferred Stock Fund)	Amended (8-10-84)
Fidelity Municipal Trust	9	**6-22-84** (Fidelity Municipal Bond Fund)	Original

Fidelity Destiny Portfolio	2	**6-20-84** (no change)	Original
Fidelity Magellan Fund	1	**6-25-84** (no change)	Original
Fidelity Municipal Trust	9	**6-22-84** (no change)	Original
Fidelity Income Fund	17	**8-7-84** (no change)	Original
Fidelity Income Fund	17	**8-7-84** (no change)	Original
Fidelity Salem Street	65	**9-5-84** (no change)	Original
Fidelity Contrafund	6	**10-1-84** (no change)	Original
Fidelity Trend Fund,	1	**9-18-84** (no change)	Original
Fidelity Securities Fund	16	**10-1-84** (no change)	Original
Fidelity Puritan Trust	8	**10-1-84** (no change)	Original
Fidelity Devonshire Trust	11	**3-4-85** (no change)	Original
Fidelity Advisor Series II	4	**4-23-86** (no change)	Original
Fidelity Garrison Street Funds	(2 central funds)	**4-23-86** (Fidelity Advisor Series V among others)	Original

Fidelity Concord Street Trust	17	**7-10-87** (no change)	Original
Fidelity Union Street Trust II	2	**6-20-91** (no change)	Original
Fidelity Aberdeen Street Trust	66	**6-20-91** (no change)	Original
Fidelity Colchester Street Trust	7	**6-20-91** (no change)	Original
Fidelity Hereford Street Trust	4	**11-18-93** (no change)	Original