



Speech by SEC Chairman:

Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds

Remarks by

Chairman Arthur Levitt

U.S. Securities & Exchange Commission

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I'm here this morning to refresh, renew, and catalyze an old relationship. We came together nearly six years ago when I first joined the Commission. We talked about mutual goals -- about my desire to protect and educate America's investors. We talked about the importance of full disclosure and empowering investment company independent directors.

By and large your trade organization, the ICI, has done a good job of using voluntary efforts to accomplish better practices. Sixty-six million people, however, who own today's mutual funds -- many of whom have never experienced a down market -- motivate us to nudge the process along.

New potential summons new challenges; new possibilities bring forth new risks. Our markets may yet reach even greater highs. Investors may yet realize greater returns. But, our responsibilities and our obligations do not abate; nor do they remain stagnant. The protection of investors and the preservation of their confidence require a universal vigilance and a common determination for constant improvement.

That improvement -- for the mutual fund industry -- lies in promoting and safeguarding independence, accountability and transparency.

Last month, the Commission hosted a roundtable to discuss the increasingly important role that independent directors play in protecting fund investors, and what steps can be taken to increase their effectiveness.

We also discussed your role -- as fund executives, inside and outside counsel, accountants and compliance managers -- in providing the kind of advice and information independent directors rely upon to do their jobs well. After two days of frank and substantive discussions, there was, I believe, broad agreement that the mutual fund governance structure could be and should be improved so that directors are better able to serve shareholders.

In my closing remarks at the roundtable, I asked Paul Roye, Director of our Investment Management Division, to undertake an intensive, serious effort on what steps we could take to improve mutual fund governance. I requested that Paul report back to me with specific proposals within 30 days. Everybody there thought it was a joke -- except Paul.

So, today, 28 days since the roundtable, I'm here to propose four straightforward, but concrete measures which will form the cornerstone of a major Commission initiative to improve mutual fund governance.

First, fund boards should have a majority of independent directors.

Second, independent directors should nominate any new independent directors.

Third, outside counsel for directors should be independent from management to help ensure that directors are getting objective and accurate information.

And, fourth, fund shareholders should have more specific information on which to judge the independence of their funds' directors.

At the roundtable, I raised three primary questions. First, are independent directors really effective? Second, can they act as an effective check on management? And third, are they serving investors' interests above all others? These four proposals, along with other measures we are considering, are a determined and, quite frankly, overdue step forward to ensuring that the answer to these questions will soon be an unequivocal, yes.

It has been almost thirty years since significant steps were taken to improve the mutual fund governance structure. And, it's worth noting that the environment in which that reform was effected was vastly different from today's.

During the 1960's, many mutual funds discarded their historically cautious investment approaches and emphasized, instead, performance. In the process, many people raised questions about levels of fees and risk as well as fund impact on the securities markets. As a result, many -- including lawmakers -- were clamoring for action.

Today, there may not be that same urgent desire for action. But the need is no less important or warranted. Whether shareholders realize it or not, how directors fulfill their responsibilities directly affects them every day. From negotiating and overseeing fund fees, to monitoring performance, to policing potential conflicts of interest, fund directors should be on the front lines in defense of the shareholder interest.

They need to have the tools, the access and the power to faithfully fulfill their legal duty and moral mandate as the shareholder's representative.

First, all fund boards should have a majority of independent directors, rather than just 40 percent as the law currently requires. In 1962, when the SEC published the Wharton Study of Mutual Funds, it was noted that the 40 percent level was ineffectual. Over the years, the great majority of the industry has apparently agreed.

Most large fund families already have a majority of independent directors on their boards. And many funds whose sponsors have undergone reorganizations in recent years have boards that are at least 75% independent directors. If we all recognize the value of majority independent boards to protect the interests of fund shareholders -- and I think we do -- then why shouldn't all fund shareholders benefit from the protections that a majority independent board can provide?

Even before 1962, the idea that mutual funds needed a majority of independent directors had currency. The bill that eventually became the Investment Company Act of 1940 originally called for boards to have a majority of independent directors. Ironically, this requirement was dropped out of fear that boards would be too independent, and would disregard the advice of management. But, I'm willing to take that chance.

Our second proposal -- reflecting the consensus at the roundtable -- is that independent directors should nominate any new independent directors; that is, they should be "self-nominating."

Many boards already meet that standard. As you know, funds that pay for their own distribution expenses under Rule 12b-1 are required to have self-nominating independent directors. If the primary role of independent directors is to protect the shareholder interest and act as a check on management, wouldn't self-nominating independent directors be more effective -- not just in distribution issues -- but in any conflict of interest with management?

Several independent directors at the roundtable who serve on self-nominating boards said that they felt it gave them an additional degree of independence from the fund management company -- especially over time -- as new independent directors joined the board.

Moving on to the third initiative, we need to make sure that the information that independent directors receive is accurate, objective, and tells the whole story. Even the most independent and assertive directors can't do their jobs effectively if they aren't getting the right information at the right time from the right people.

I think the Commission can assist independent directors by helping them obtain the information they need. We can begin to do that by reviewing what they're being given now. I will ask the Commission's Office of Compliance Inspections and Examinations to pay special attention to materials such as advisory contracts and distribution plan renewals during their examinations.

We need to know whether directors are getting enough information to carry out their fiduciary responsibilities to the shareholders in these and other areas.

Obviously, most of this information comes from management. And, while many board matters may be routine and don't require outside consultation, fund directors should have access to independent counsel and auditors and perhaps other external experts.

It is vital that they receive objective advice from counsel and their auditors -- particularly when there is a conflict with management interests. Those upon whom directors rely for such guidance need to be truly independent of fund management in fact and in appearance. For instance, should directors be concerned when the auditor for the fund is also the auditor for the investment advisor -- especially when the auditor performs extensive consulting services for the adviser?

Lastly, I'd also like to see shareholders get more information about directors. I know that there are

directors who may technically be considered to be independent, but who have had business or other relationships with management. Shareholders should know that. Shareholders should also know whether the directors' interests are in line with their own interests. They should know whether and how much the directors have invested in the funds they oversee.

There have also been questions raised in the press and in the courts about whether simply serving on multiple boards or portfolios compromises a director's independence. Recent court decisions say it doesn't. And, I'm inclined to agree. But the extent of a director's service and his remuneration is information that an investor has a right to know.

As the first part of our initiative to improve fund governance, I've outlined four proposals for reform that we will address through our own rulemaking and disclosure process. There is no question in my mind they are the right things to do for the mutual fund industry and for shareholders. Consequently, I've asked the Division of Investment Management to turn these proposals into concrete reforms as soon as possible.

Some at the roundtable made the point that the Commission, in allocating key governance responsibilities to independent directors, needs to be actively involved and pursue charges of illegal conduct by fund managers whenever they occur. I couldn't agree more.

Let me assure you that we have always taken allegations of wrongdoing very seriously. You should know that even if our findings can't be publicly revealed, we look into every allegation by an independent director that the securities laws have been violated. And if we find a violation, we take aggressive action to support them and the interests of investors.

Some said that the Commission didn't do enough to support independent directors during recent conflicts with management at certain funds; that we took a neutral stance as we always do in highly charged proxy battles. Some had gotten the impression that the Commission didn't care or wasn't willing to take action. I think it's fair to say that we at the Commission do listen, and we will continue to look for opportunities to support independent directors where appropriate.

Short of Commission action, I think there are things that independent directors can do to help protect themselves before these types of conflicts with management arise. I recently learned that most insurance policies for fund directors and officers have a standard exclusion for claims brought by co-insureds. Now, there may be a reasonable basis for such provisions in some circumstances.

In the investment company context, if the fund's board and investment adviser have a joint policy, a broad insured vs. insured provision policy won't cover the directors if they are sued by the investment adviser. That does not work for independent fund directors who need this kind of coverage. It seems to me that independent directors of a mutual fund would serve themselves well by making certain that their insurance policies do not have such an exclusion.

In addition to discussing fund governance generally, our roundtable also explored a number of specific issues that involve independent director oversight. Let me focus for a moment on one of these issues: soft-dollars and best execution. This is clearly an area where independent directors should play an important role. After all, the direction of fund brokerage and the reciprocal benefits that are derived from that brokerage involve the use of fund assets.

The roundtable made clear that some questions about fund brokerage need to be asked by fund directors. For example, they need to know what services are being received in return for the

placement of their fund's brokerage, what it is costing their funds, and whether the cost is reasonable in relation to the services received – consistent with overall best price and execution.

We also talked about disclosure issues. Some suggested that shareholders need more information on the effect of taxes on their investments. I share this concern. As you may know, a bill was recently introduced in Congress that would direct the Commission to adopt rules requiring disclosure of the after-tax effects of portfolio turnover. Some funds already provide shareholders this information.

We look forward to working with the industry to evaluate whether, and how, to improve disclosure in this area.

The roundtable, in addition, explored independent directors' roles in connection with funds' distribution arrangements, advisory contracts, and valuation procedures. For example, some at the roundtable said that the 1980 standards under which directors review fund distribution arrangements need to better reflect current practices. Other panelists said that the Commission's guidance on valuation also is outdated.

These points appear to me to have merit, and they require more careful study and thoughtful discussion. As we do so, we have an opportunity to improve not just the effectiveness of independent directors, but also the effectiveness of the rules under which they operate.

Over the past several decades, Commission rules have placed greater responsibilities on independent fund directors. Many practices that were once prohibited or required Commission approval are now permitted if approved by a fund's independent directors. Effective and accountable fund governance reduces the opportunity for people to say that the industry is incapable of looking after the interests of its investors.

And yet, without the contribution and cooperation of the mutual fund industry, fund governance will never be what it can and should be. I appreciate that we may approach these issues from different perspectives; that we may differ on some of the details. But, I believe all of us recognize a central truth: enhancing independent director effectiveness is good for investors. And, what's good for investors is good for business.

You can count on the Commission to do its part. But, it would be unfortunate if those were the only footsteps of action that mutual fund investors hear. Given the leadership represented here and at the roundtable, I want to strongly urge the industry to undertake a similar effort in enhancing the role of independent directors.

Several years ago, when questions arose regarding personal trading practices, you came together as an industry and arrived at a model that all funds can aspire to. There's no reason a similar result can't be achieved here.

At the roundtable, some stated that the Commission needs to do more than just give sermons about director independence. As one of the preachers of those sermons, I couldn't agree more. But I've often said that director independence is more a state of mind than a legal status. Reminding directors of that fact is valuable in itself.

I urge you as industry professionals to join me. Talk to the directors of your funds. Tell them what the Commission is doing. Tell them what we expect of them. And tell them how you plan to address the concerns that we have raised today. I can't think of a better first step to ensure the health and

vitality of the mutual funds industry for the next 75 years.

Thank you very much.