

**MEMO# 5728**

March 28, 1994

## **SEC CHAIRMAN LEVITT'S SPEECH ON MUTUAL FUND DIRECTORS**

March 28, 1994 TO: BOARD OF GOVERNORS NO. 29-94 MEMBERS - ONE PER COMPLEX NO. 21-94 SEC RULES MEMBERS NO. 20-94 RE: SEC CHAIRMAN LEVITT'S SPEECH ON MUTUAL FUND DIRECTORS \_\_\_\_\_

At the recent Mutual Funds and Investment Management Conference in Scottsdale, Arizona, Securities and Exchange Commission Chairman Arthur Levitt gave a speech entitled "Mutual Fund Directors: On the Front Line for Investors." A copy of the speech is attached. Chairman Levitt began by noting the important role of fund directors who, he said, "are positioned, uniquely, to promote the interests of fund shareholders; to ensure that funds are managed responsibly and ethically; to maintain their own independence and to uphold the public trust." Chairman Levitt indicated that he agreed with the conclusion of the staff of the Division of Investment Management in its 1992 report on investment company regulation that "the 'watchdog' function assigned to independent directors is fundamentally sound and has served investors well." In addition, he noted his support for the report's recommendations that a majority of a fund's directors be required to be independent, that the independent directors have the authority to terminate an investment advisory contract, and that the independent directors be self-nominating. After commenting on certain mechanisms and resources used by one group of outside fund directors with whom he recently met, Chairman Levitt focused on four issues which, in his view, demand increased attention by fund directors. These issues are: fund investments in derivatives; portfolio liquidity; shareholder activism; and personal trading by fund managers. With respect to derivatives, Chairman Levitt suggested that fund directors ask fund managers whether derivatives achieve intended results, and satisfy themselves that portfolio managers have appropriate expertise, that the use of derivatives is consistent with fund policies, that appropriate limits are set and observed, and that managers "are not blinded to the risk." In addition, directors should ask management if the prospectus adequately described investment risk. Where derivatives are used, directors should review pricing issues, trading strategies, accounting questions and internal controls, although they need not "immerse themselves in the minutiae of individual derivatives transactions." In the area of liquidity, Chairman Levitt recommended that directors ask portfolio managers various questions about how liquidity determinations are made, and inquire whether the manager has considered potential changes in liquidity under different market conditions and over the life of an entire business cycle. On shareholder activism, Chairman Levitt urged fund directors to ask management questions about its policies with respect to voting shares held by the fund on various issues such as anti-takeover measures, proxy fights for control of a portfolio company, elections, and executive compensation. Regarding portfolio managers' personal trading, Chairman Levitt noted his "personal reservations" about the practice, but said he would avoid definitive comment pending completion of the SEC's survey. He stated that he

was "pleased" that the Institute has appointed a blue ribbon panel to consider personal trading issues. Chairman Levitt also stated that "[w]hat we have here is a great industry that has been relatively free of major scandal for decades," but he expressed concern that trading by managers and the allocation to them of initial public offerings may create a "perceptual problem." Levitt added that if he were a director, he "would have reservations about trading by managers would be greatly troubled by their buying and selling IPOs." Chairman Levitt then urged directors to ask hard and sometimes "impolite" questions, such as whether to bar personal trading, what purpose it serves, how it benefits shareholders and should it be allowed -- but only with limitations? In addition, if fund management is satisfied that personal trading "is desirable and fills a useful purpose," directors should ask why this is so. Finally, if personal trading is permitted, Chairman Levitt said, directors should "ensure that the fund's code of ethics contains strict safeguards, reporting and verification procedures." He added that "[i]t is important that fund management and fund directors find the right solutions -- before someone else takes action in your stead." In concluding his remarks, Chairman Levitt stated, among other things, that "directors who do their job well can give enhanced confidence to the investors on whom your industry -- and its credibility - - depend." Paul Schott Stevens General Counsel Attachment

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