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SUMMARY OF SEC ROUNDTABLE ON ROLE OF INDEPENDENT DIRECTORS

[10784] March 10, 1999 TO: BOARD OF GOVERNORS No. 14-99 DIRECTOR SERVICES COMMITTEE No. 9-99 PRIMARY CONTACTS - MEMBER COMPLEX No. 23-99 SEC RULES COMMITTEE No. 17-99 RE: SUMMARY OF SEC ROUNDTABLE ON ROLE OF INDEPENDENT DIRECTORS ____
The SEC Roundtable on the Role of Independent Investment Company Directors was held on February 23 and 24. The roundtable brought together independent directors, representatives of management companies, academics, investor advocates, legal counsel to funds and regulators to discuss the role of independent directors and how their effectiveness may be enhanced. The roundtable panels covered an array of topics, including negotiating fees and expenses, distribution, fund brokerage, valuation and liquidity, disclosure, acquisitions and mergers and the effectiveness of fund directors. A copy of the program is attached, and the panel discussions are briefly summarized below. SEC CHAIRMAN LEVITT'S OPENING REMARKS Chairman Levitt opened the roundtable by commenting on the important role directors play in protecting investors. He credited independent directors with ensuring accountability in fund management and said that the SEC is committed to promoting the effectiveness of independent directors. He then posed three broad questions: 1) Are independent directors really effective? 2) Do they, or can they, act as a check on fund management? and 3) Are they serving shareholder interests above all else? Chairman Levitt challenged directors to ask questions and generate substantive responses. He said he did not favor government intervention in the area of mutual fund governance. A copy of Chairman Levitt's opening remarks is attached. PANEL 1 - NEGOTIATING FEES AND EXPENSES The first panel addressed the role of independent directors in negotiating fees and expenses. The panel reviewed the Gartenberg standard for advisory fees (i.e., that the fee may not be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.") Robert C. Pozen, President and CEO of Fidelity Management and Research Company, explained that in practice, three types of factors are relevant to directors' evaluation of fees, including process factors (the quality of the board, the nature of the information provided to them, the nature of the deliberative process, the receipt of advice from independent counsel), the quality of the investment adviser (investment management services, the compliance function, research and shareholder services provided, personnel), and various financial considerations (adviser costs, payments received by the adviser, "spin-off" benefits, profitability). 2Mr. Pozen identified three deficiencies with the current fund governance system as it relates to negotiating fees and expenses. First, the Investment Company Act of 1940 was predicated on the concept of one fund and one set of directors. Now, most funds are part of multi-fund complexes. As a result, fund directors regularly face issues of allocation and overlapping services. Second,

independent directors cannot consider sales and promotional expenses of the adviser unless a Rule 12b-1 plan is in place, and thus are deprived of valuable information. Lastly, Mr. Pozen contrasted mutual funds to hedge funds and expressed concern that the lack of regulation of hedge funds creates an unlevel playing field that could affect the mutual fund industry’s ability to attract and retain talented portfolio managers. He suggested that hedge funds should be required to regularly report their portfolio holdings and to adopt a code of ethics, and that to the extent they charge performance fees, such fees should have to be structured as fulcrum fees. Bruce K. MacLaury, independent director of the Vanguard Funds, cited the use of incentive fees (e.g., fulcrum fees) and breakpoints as ways to align the interests of shareholders and management. He stated that incentive fees eliminate conflicts between the fund and the adviser and breakpoints allow investors to automatically benefit from increased assets. Kenneth E. Scott, a professor at Stanford University and an independent director, described the directors’ role in negotiating fees and expenses as one to oversee management. To do so effectively, directors should measure a fund’s performance and services against objective standards, including benchmarks of risk and return and costs. With respect to fees, directors could either serve as an “outer check” on management (with a competitive marketplace serving as the primary check) or as an independent bargaining agent for shareholders. John D. Markese, President of the American Association of Individual Investors, expressed concern that there are two “disconnects” relating to fees and expenses. First, there is a disconnect between shareholders and independent directors because shareholders have no role in the selection of independent directors and, in many cases, do not know who they are. Second, there is a disconnect between fee disclosure and shareholder understanding of fees. Mr. Markese proposed that independent directors should be appointed by shareholders and that shareholders should receive individualized fee disclosure on their account statements. Harold Evensky of Evensky, Brown & Katz argued that the market’s performance has masked fees. Although the prospectus and SAI provide useful information, it is not meaningful or complete. Mr. Evensky advocated quarterly account statements, as well as more disclosure of soft dollar practices, to shareholders. PANEL 2 - FUND DISTRIBUTION ARRANGEMENTS Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, opened the panel discussion on fund distribution arrangements by observing that the variety of sales charge alternatives and distribution options make the independent directors’ role in evaluating distribution and deciding what is in the best interest of shareholders more difficult than it was in the 1980’s. The panel observed that directors should focus not only on fees and expenses but whether there is good value to the shareholder. To do this they should highlight the effectiveness of distribution by asking questions about sales and redemptions, the cost-effectiveness of services, the appropriateness of services, the appropriateness of charges (i.e., over time what are shareholders paying and what are they getting) and sales practices. The panel discussed some of the issues concerning the board’s role in approving a fund’s participation in a fund supermarket that were addressed in the SEC staff’s letter on this issue. Chairman Levitt asked whether fund supermarkets put upward pressure on fees and whether fund directors are in a position to question the fees they charge. Faith Colish, an independent director, noted certain benefits of the supermarkets (e.g., they allow smaller fund groups to compete with larger ones). She stated that 3directors are able to evaluate fund supermarket costs and pointed out that there is competition among supermarkets. Several panelists commented on the need to revisit Rule 12b-1 under the Investment Company Act. The rule was originally adopted to allow the use of fund assets to pay for advertising. Now 12b-1 fees are being used primarily to compensate brokers. This creates problems for directors trying to assess compliance with the rule. The panelists agreed that some of the concepts in the rule are good, e.g., it requires a majority independent of directors, who must be self-nominated. It was suggested that the factors directors are required to consider when adopting a 12b-1 plan should be updated. PANEL 3 - FUND PORTFOLIO BROKERAGE This panel examined the issues of soft dollars, best execution, “paying up,” directed brokerage and unbundling of services. The panelists generally agreed, as a fundamental matter, that commissions are a valuable asset of the fund. While directors do not review individual trades of portfolio securities, they do review the fund’s brokerage allocation policies and receive reports and analyses where appropriate. Panelists Henry H. Hopkins, Managing Director and Chief Legal Counsel of T. Rowe Price, and Heidi Stam, Principal of The Vanguard Group, agreed that it is important for the adviser to provide the board with a clear statement of policy and approach on brokerage allocation and to provide adequate information to the board. John Hill, an independent trustee, noted that the funds he serves have formed a brokerage committee made up mostly of independent trustees to review brokerage- related issues. PANEL 4 - VALUATION OF FUND PORTFOLIO SECURITIES AND PORTFOLIO LIQUIDITY The independent director panelists described their experiences with pricing, which were quite similar. The board relies on the adviser to do daily pricing under board-approved policies and procedures. If a pricing issue arises, action usually must be taken quickly. Depending on whether the fund’s pricing policies dictate how to address the issue, it may be necessary to convene a meeting of the valuation committee, which usually includes at least one independent director. The action is later reported to the board. The panelists agreed that fair value pricing issues are becoming increasingly complex. Edward L. Cameron, a partner of PricewaterhouseCoopers, suggested that it would be of great benefit to have a safe harbor for directors in fair valuing securities. Other panelists commented that directors must exercise meaningful oversight of the pricing process and that consistency in the application of pricing methods is important. The discussion next turned to liquidity. The panel agreed that liquidity is inextricably linked with fair value because, if there is no liquid market, it is difficult to set a price. The relationship between liquidity and pricing is especially significant in emerging markets and may become important in the year 2000 context. PANEL 5 - FUND DISCLOSURE AND COMMUNICATIONS This panel discussed the role of directors in the communication process. Several directors described their experience with the SEC’s recent plain English initiative, including the use of consultants during the process, the cost, and the involvement of independent directors. The panelists agreed that the conversion to plain English was a worthwhile experience, but expressed some concern about the potential for liability by diverging from time-tested language. One panelist felt that directors were 4adequately protected by the business judgment rule, while another panelist suggested that the SEC consider a plain English “safe harbor.” Robert E. Denham of the law firm of Munger, Tolles & Olson LLP opined that, because investors' choices are affected by disclosure, increased attention should be given to performance and investment approach in disclosure documents. He argued in favor of tax-adjusted performance data, as well as improved risk data. Chairman Levitt added that he would like to see more frequent disclosure of management personnel changes and the impact of those changes on the investment objective of the fund. When Chairman Levitt asked what the Commission could do for independent directors in the area of disclosure, several suggestions were made. First, if there is litigation over a fund’s use of plain English, the SEC was urged to intervene at the earliest possible moment. Second, the SEC was urged to continue to promote initiatives that foster shareholder understanding. Third, the SEC should challenge directors to be more actively involved in matters of policy and strategy but at the same time, the SEC should work with industry to reduce the volume of materials directors receive on matters of procedure that could be handled by others. Fourth, the SEC should look for ways to promote directors’ activities in the area of communications to highlight best practices for the industry. PANEL 6 - ROLE OF DIRECTORS IN ACQUISITIONS OF INVESTMENT ADVISERS AND REORGANIZATIONS OF FUNDS The panelists first discussed the role of directors in evaluating a proposed acquisition on behalf of investors. Although in most cases the interests of the adviser and the shareholders are aligned, panelists stressed the need for directors to take sufficient time to thoroughly assess the benefits, risks and costs of the transaction. Panelists said that directors should also consider the integrity of the acquiring company, the company's financial condition and personnel, the company's compliance program, and the implications if the transaction is not completed. Quite often directors employ independent consultants such as independent accountants and legal counsel to review materials and report to the directors on their findings. While in the case of mergers not involving a change in control of the fund there is less concern, the panel discussed the importance for directors to determine whether the merger imposes any new restrictions on the fund (for example, a merger with a bank) and to be aware of the challenges they may face if they have become part of a global organization. There was some discussion of whether any regulatory changes were necessary in light of the wave of recent consolidations. The existing rules on affiliated transactions were cited as having the potential to deny participation in a transaction that could benefit shareholders, and it was suggested that the SEC should consider appropriate changes to these rules. PANEL 7 - ISSUES FOR INDEPENDENT DIRECTORS OF CLOSED-END FUNDS, VARIABLE INSURANCE PRODUCTS AND BANK-RELATED FUNDS Closed-End Funds - Deborah Gatzek, General Counsel of the Franklin Templeton Group, observed that many closed-end funds trade at a discount, and as a result, their advisers are under increased pressure to open-end the fund. Ms. Gatzek stated that directors of such funds should first ask if the fund is most appropriately organized in a closed-end format; for example, whether there are valid portfolio considerations, such as that the fund invests in illiquid securities in emerging markets and therefore could not operate as an open-end fund. Directors should also pay attention to prospectus disclosure concerning actions to be taken in case of a discount. Ms. Gatzek stressed that if a particular action would be required under certain circumstances, it is important that the prospectus disclosure relating to such action is clear and understandable. 5Variable Insurance Products Funds - Diane E. Ambler, a partner at Mayer, Brown & Platt, explained that the process followed by the board of a variable insurance product fund is the same as for other funds. Variable annuity and variable life products are viewed by boards largely as an alternative means of distributing fund shares. The board of an underlying fund is mindful in its review of the advisory agreement that the insurance company imposes additional fees and charges on the product. Boards must monitor for conflicts when the same underlying fund is used by different and sometimes unaffiliated insurance products. Bank-Related Funds - The panelists agreed that there was not a lot of difference in the role of directors of bank-related funds as compared to other funds. Richard J. Herring, an independent director, noted that directors of bank-related funds are aware that multiple layers of regulation (e.g., state banking authorities, the SEC, and the Federal Reserve Board) may increase compliance costs. Kathleen Dennis, Senior Managing Director of Key Asset Management, said that directors of bank-related funds may express an interest in sales practices. Although they are not necessarily responsible for regulatory oversight of sales practices, they often seek to make sure effective compliance and monitoring systems are in place. Also, if the bank acts as a service provider to the fund, directors should ensure that the fee charged by the bank for the service is competitive with the fee charged by other providers. PANEL 8 and PANEL 9 - ENHANCING THE EFFECTIVENESS OF INDEPENDENT DIRECTORS (PARTS I and II) The first panel on effectiveness opened with a discussion of corporate governance. Ronald J. Gilson, a professor at Columbia and Stanford Universities and an independent director, explained that mutual fund governance has three parts: 1) the relationship between the shareholders and the directors is corporate in nature; 2) the relationship between the SEC and directors is regulatory in nature; and 3) the relationship between the directors and the adviser is contractual in nature. In his view, the regulatory relationship between the SEC and directors positions the directors to assist the SEC in enforcing its regulatory regime. Professor Gilson urged the SEC to begin an investigation following any allegation by independent directors of improper conduct by the adviser. This would energize independent directors and evidence the SEC's support for the role directors play. The panel discussed the role of independent directors in a competitive marketplace and the need to focus director activism where it is truly needed. For example, panelists noted that directors are most effective in monitoring conflicts of interests. In evaluating the independent directors' relationship with management, it was agreed that directors could satisfy their supervisory responsibility while maintaining a good working relationship with management. They should look to see that any proposal is legal, ethical, good business and in the shareholders' best interest (though not necessarily in that order). The directors need continuous access to relevant information and to people, including portfolio managers and advisory personnel. They should understand the adviser's business, be well-prepared, detail-oriented in oversight and open to learning. The panelists argued against the perception that independent directors are self - interested and beholden to management because of the compensation they receive by noting that they have a legitimate right to be compensated and that they set their own compensation on a fund-by-fund basis. Given the important role directors play, funds need to be able to attract experienced, talented persons to their boards. The panelists also addressed the misperception that directors' primary responsibility is to reduce fees. They indicated that the role of directors is to represent shareholders in conflict of interest situations, not necessarily to reduce fees or increase performance. Their role is to ask difficult questions of the adviser, ensure that the advisory contract is reasonable and make sure that the fund manager has the resources it needs. 6John R. Haire, an independent director, opened the second panel by explaining that the reality is that shareholders choose the adviser and that directors should not substitute their judgment if fees are reasonable, performance is adequate and the promised services are being provided. They should evaluate any changes to the original bargain in midstream (e.g., changes to the portfolio manager or investment objectives of the fund) to ensure that they are in the best interest of investors. In the case of a poor-performing fund, the directors share the interest of the adviser to see what can be done to solve the problem. The panel then discussed ways that independent directors may be more effective. Several "best practices" suggested by the participants of the panels include: 1. .Having a majority of the board consist of independent directors; 2. Having a nominating committee of independent directors; 3. Appointing a lead trustee to communicate with management and to represent the independent directors in discussions with consultants; 4. Employing independent counsel for the independent directors; 5. Providing access to outside consultants; 6. Having regular meetings of independent directors without management; 7. Instituting a committee structure; 8. Instituting a program of compensation set by independent directors; 9. Adopting a mandatory retirement age; and 10. Instituting a program of tenure for directors. It was suggested that the SEC consider a cooperative effort with the ICI, outside counsel and experienced directors to memorialize best practices for directors. Panelists commented that these might be particularly useful to assist independent directors at new or smaller fund groups. The panel suggested two other ways in which the SEC could assist independent directors: 1) support independent directors, especially if they seek to "take the keys away" from an errant adviser; and 2) educate investors about economies of scale, e.g., explain that the growth of assets through the addition of new shareholders brings with it the need for additional services, so economies are not automatic. The panel next discussed whether changes are needed to the definition of "independent director" in the Investment Company Act. The consensus was that there is no problem with the definition and there was a concern that a more restrictive definition would exclude qualified people.

Furthermore, it was noted that the adviser has a significant interest in having effective independent directors on fund boards because to do otherwise could jeopardize the validity of board actions. SEC CHAIRMAN LEVITT’S CLOSING REMARKS Chairman Levitt committed to look carefully at what the SEC can do to empower the independent directors in the trenches. He noted that he is reluctant to seek legislation or regulatory solutions to enhance director effectiveness because they are unpredictable. On the other hand, identifying best practices may not be enough to achieve meaningful change. Chairman Levitt urged the industry to take steps to enhance the effectiveness of independent directors and asked the SEC staff to also develop recommendations in this area. Marguerite C. Bateman Associate Counsel 7Attachments

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