

MEMO# 5631

March 2, 1994

SEC COMMISSIONER ROBERTS' SPEECH ON DIRECTORS' RESPONSIBILITIES

March 2, 1994 TO: BOARD OF GOVERNORS NO. 21-94 SEC RULES COMMITTEE NO. 25-94
RE: SEC COMMISSIONER ROBERTS' SPEECH ON DIRECTORS' RESPONSIBILITIES

Securities and Exchange

Commissioner Richard Roberts recently delivered a speech, concerning the responsibilities of mutual fund directors, to the directors of the IDS Mutual Funds. A copy of the speech is attached. In his remarks, Commissioner Roberts stated that the investment company industry has been "a shining example of investor protection," which he attributed to "vigilant oversight" by boards of directors and by federal regulators. He indicated that the industry's growth is over-taxing federal oversight, making necessary "a more vigorous first line of defense" at the board level. Commissioner Roberts spoke of the board's important role in policing conflicts of interest, and discussed in particular the inherent conflicts involved in fee proposals from management. He suggested that fund directors consider alternatives to straight, percentage-based investment advisory fees, and observed that it is not much more difficult for a portfolio manager to manage \$500 million than \$100 million. Roberts also urged vigilant board oversight in the area of contracts for ancillary services with affiliates of the investment adviser. Concerning board independence, Commissioner Roberts noted his agreement with the recommendations contained in the staff's Investment Company Act study that a majority of the board be independent and that independent directors be self-nominating. He added that he would entertain a requirement that all directors be independent, stating that, in his opinion, "independence is the tonic for conflict of interest situations." Acknowledging that the board cannot and should not "micromanage" a fund's day-to-day operations, Commissioner Roberts referred to the Commission's recent elimination of certain unnecessary annual board review requirements and suggested that the board use its resulting extra time to give additional scrutiny to issues relating to personal securities trading, derivative securities and foreign securities. Specifically, with respect to personal trading by portfolio managers, Commissioner Roberts expressed his own preference for a ban on this practice because of the great potential for a fund manager's economic interest to be "nonaligned" with those of shareholders. He advised that if personal trading is to be permitted, the board should be very careful to establish a screening process to minimize potential conflicts of interest, stating that the greatest risk in this area is the loss of investor trust and confidence, which has been critical to the investment company industry's success. On the subject of derivatives, Roberts cited certain recent instances of financial losses resulting from the use of these instruments and said that these experiences should serve as a warning to fund directors to take greater interest in fund investments in derivatives. Roberts recommended that, at a minimum, the board take the following four steps on a periodic basis: (1) review the fund's disclosure documents to determine whether the risks associated with its investment strategies are appropriately

disclosed and are compatible with the fund's disclosed investment philosophy; (2) meet with the adviser to ensure comfort with the adviser's knowledge of the risks associated with using derivatives and with hedging in particular; (3) become comfortable that the fund's trading strategies do not violate the restrictions on leveraging under Section 18 of the Investment Company Act; and (4) review the fund portfolio to ensure compliance with the 15% limit on investments in illiquid securities. Finally, in the area of foreign securities, Commissioner Roberts stated that the volume of fund investments is "staggering," and expressed concern that recent "red hot" performance may mask the risks associated with such investments. Roberts urged that directors devote special attention to possible liquidity problems, and to the adequacy of disclosure to investors of the risks of investing in foreign securities, including in particular the risks of currency fluctuations. Paul Schott Stevens
General Counsel Attachment

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