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REMARKS BY SEC OFFICIALS AT THE MUTUAL FUND DIRECTORS FORUM'S ANNUAL POLICY CONFERENCE

[16962] January 12, 2004 TO: BOARD OF GOVERNORS No. 2-04 INVESTMENT COMPANY DIRECTORS No. 1-04 SEC RULES MEMBERS No. 7-04 SMALL FUNDS MEMBERS No. 2-04 RE: REMARKS BY SEC OFFICIALS AT THE MUTUAL FUND DIRECTORS FORUM'S ANNUAL POLICY CONFERENCE William H. Donaldson, Chairman of the Securities and Exchange Commission, delivered the keynote address at last week's annual policy conference sponsored by the Mutual Fund Directors Forum. The luncheon speaker at the conference was Paul F. Roye, Director of the SEC's Division of Investment Management.¹ Their remarks are briefly summarized below. Remarks by Chairman Donaldson Chairman Donaldson's keynote address focused on the vital role and fiduciary responsibility of mutual fund directors in protecting the interests of investors and in responding to the "ills that currently befall the mutual fund industry." He observed that the current trading scandal has led to greater focus and scrutiny of the role played by independent directors in particular, noting that "[s]ome have questioned whether mutual fund directors are too passive, are captives of fund management companies, sit on too many boards, lack the knowledge to keep apprised of a fund's activities, and are paid too much for any value they bring in protecting fund investors." Chairman Donaldson added that "these are appropriate questions to be asked in view of the widespread nature of the problems we are encountering." Noting that the full extent of problems in the industry is not yet known, Chairman Donaldson stated that there are already some important lessons for fund directors from the current scandal. He remarked that effective fund directors must possess "a healthy dose of vigilance and skepticism." The Chairman called upon fund directors to "continually challenge and question fund management" in high-risk areas such as portfolio management, pricing, sales of fund shares, and a fund's overall program of compliance and internal controls. He noted that although directors have an oversight role, they must test those to whom they have entrusted the 1 A copy of Chairman Donaldson's address, "America's Need for Vigilant Mutual Fund Directors," is available on the SEC's website at <http://www.sec.gov/news/speech/spch010704whd.htm>. Mr. Roye's speech, "Enhancing the Fund Director's Toolbox," is likewise available at <http://www.sec.gov/news/speech/spch010804pfr.htm>. 2 day-to-day management of the fund's operations and demand accountability to ensure that investors' interests come first. Chairman Donaldson emphasized that fund directors must be extremely vigilant when it comes to fund fees, performance, and pricing of portfolio securities. On the issue of fees, the Chairman stated that he and his fellow Commissioners strongly believe that the SEC should not act as a "rate-setter." He further stated that the amount investors pay for the services they receive from a fund is better left to informed investors who have an

“independent and vigorous” board of directors looking out for their interest. Chairman Donaldson also touched on SEC proposals to enhance fee disclosure and improve the effectiveness of independent directors in monitoring fees. With respect to fund governance, Chairman Donaldson stated that “[t]he breakdown in compliance controls evidenced by our enforcement actions raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds.” He noted that the SEC would consider several proposals at its January 14th open meeting to empower independent directors to better serve as an effective check on fund management. These proposals would: require that the chairman of a fund’s board of directors be independent; raise to three-fourths the percentage of directors who must be independent under certain SEC rules; provide independent directors with the authority to retain staff; and require independent directors to perform an annual self-evaluation of their effectiveness, including consideration of the number of funds they oversee and the board’s committee structure. Chairman Donaldson concluded his remarks by emphasizing that fund directors cannot simply follow the letter of the law and of SEC rules. Rather, to be truly effective, directors must require funds and their service providers to establish new standards of integrity, so that investors can “see for themselves that fund companies, and fund directors, are living up to their fiduciary obligations and the spirit underpinning all of our securities laws.”

Remarks by Mr. Roye The theme of Mr. Roye’s speech was that independent fund directors, as “front line” watchdogs, must have the necessary tools in their “director’s tool box” to protect fund investors. The first such tool, he said, was the use of independent legal counsel to help “drill” down through the information received by the board to identify the core issues requiring particular director attention and evaluation. In Mr. Roye’s view, “recent events dictate that all fund boards would be well advised to have independent legal counsel.” He noted that independent counsel can identify key regulatory issues on which directors should focus, can offer a perspective on an issue that might be different from that of the fund’s adviser, and can keep directors up-to-date on industry trends and regulatory issues. Mr. Roye stated that the second and newest tool available to fund directors is the chief compliance officer (“CCO”), who can “hammer” home the importance of complying with regulations and with a fund’s policies and procedures, as well as “hammer” down on persons who are not meeting their compliance obligations. He noted that the compliance rule recently adopted by the SEC envisions the CCO as being a person of “sufficient seniority and authority within the fund group.” As such, he encouraged directors to select “individuals of integrity and competence who will, most importantly, act as your eyes and ears on compliance matters and keep you informed regarding compliance issues.” Mr. Roye offered his opinion that the CCO requirement could prove to be one of the most important and most meaningful protections for fund investors that the SEC has adopted in recent years. A third tool available to fund directors is the fund’s independent auditor, which Mr. Roye referred to as a “flashlight” that can illuminate weaknesses in controls and identify issues that could result in risk for the fund. He stated that auditors provide independent and expert insight on a variety of fund accounting and related issues, such as pricing and valuation, and observed that this tool is “possibly underutilized” by fund directors. Mr. Roye accordingly urged independent directors to be sure that their executive sessions and other meetings with fund auditors are “meaningful discussions and not perfunctory exercises.” Mr. Roye stated that the fund governance proposal to be considered at the SEC’s January 14th meeting contains additional tools that would strengthen the ability of independent directors to represent fund shareholders. He observed that with an independent chair and with independent directors comprising at least 75% of a fund’s board, independent directors would “control” the board and thus would be “calling the shots.” Mr. Roye further observed that by enabling fund directors to retain staff, the SEC “would be emphasizing the importance of relying on experts outside of a fund’s management in certain circumstances

to provide information to the board.” In concluding his remarks, Mr. Roye noted that many of the tools he described are designed to decrease independent fund directors’ reliance on fund management companies as a sole source of information and would encourage them to seek out, where appropriate, outside sources of information when examining fund fees, performance, accounting issues, compliance matters, and conflicts of interest. Rachel H. Graham Assistant Counsel

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