

## The State of Governance in a Post-Enron Environment

# 2003 Investment Company Directors' Workshop

Keynote Address

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April 8, 2003

Washington, DC

Good morning and welcome to our investment company directors' workshop. I'm Craig Tyle, the General Counsel of the ICI. Today's workshop is one of a series of programs sponsored by the ICI for mutual fund directors. These include an annual conference on current issues of interest to fund directors; workshops such as this one that focus on particular areas of interest or concern; regional meetings of directors hosted by ICI staff; and regulatory and legislative updates before individual fund boards by our President, Matthew Fink, and Marguerite Bateman, who heads up our directors' program. All of our programs are under the supervision of the Institute's director services committee, which consists of 19 fund directors, 16 of whom are independent directors.

Our workshop today focuses on the responsibilities of fund directors in a post-Enron, post-WorldCom, post-Sarbanes-Oxley environment. These include reviewing financial statements, internal controls and oversight of outside auditors. All directors of public companies, including investment companies, have additional responsibilities in these areas. Today's workshop is intended to explore and illuminate what particular issues arise for directors of investment companies in carrying out these functions.

The reason that all directors are facing these new challenges is that policy makers concluded that the recent corporate and accounting scandals demonstrated a need to enhance corporate governance and director oversight. As a result, Congress, the SEC and self-regulatory organizations like the New York

Stock Exchange have all taken steps towards that end.

For example, the [Sarbanes-Oxley Act](#) requires all listed companies to have audit committees composed solely of independent directors and responsible for overseeing the company's auditors. The New York Stock Exchange has proposed listing standards that would require companies to have a majority of independent directors on their boards and tighten the definition of independent director.

Stepping back, one can see certain underlying themes in these initiatives. The first is a demand for greater independence on the part of boards of directors. Having independent directors on corporate boards will no longer be optional. In addition, certain minimum standards have been established to determine which individuals qualify as independent. The second theme is to assign directors specific responsibilities in certain areas. These areas include oversight of auditors, nomination of other independent directors, and implementation of company codes of ethics. Third and more broadly, as several legal scholars and commenters have noted, these reforms represent an unprecedented level of federal regulation of corporate boards, an area that traditionally has been the province of state law.

What's interesting here – at least to me and, I suspect, to people in this audience – is that while these are all novel issues for corporate boards, they are not new for investment company boards. Indeed, in many respects, these reforms are an extension of the principles of investment company corporate governance to operating companies.

Since the enactment of the [Investment Company Act in 1940](#), mutual funds and their directors have been subject to direct federal regulation. So federal regulation of mutual fund governance is nothing new. The Investment Company Act requires funds to have a specified minimum percentage of independent directors on their boards, and includes a strict definition of who qualifies as “independent”. The mutual [fund governance rules](#) adopted by the Commission in 2001 go further and require virtually all funds to have a majority of independent directors, and to make those independent directors responsible for the selection and nomination of other independent directors.

Fund boards also have a series of specific duties under federal law. Some of these—approval of the advisory and underwriting contracts, approval of fund auditors, and valuation of certain securities—are set forth in the statute. Many more are established by SEC rules.

The imposition of independence requirements and specific duties on corporate boards has made them more like investment company boards. This should be, by and large, a positive development. Mutual fund investors clearly have benefited from the “watchdog” role performed by fund directors, including, in particular, independent directors. Thus, there is every reason to believe that shareholders in public companies will likewise benefit from an enhanced system of director oversight.

At the same time, it is important to acknowledge that, even after these developments, there still will be vitally important distinctions between the role of directors of operating companies and that of fund directors.

The most obvious way in which the roles of the two differ concerns the scope of their various responsibilities. While recent reforms have expanded the role of corporate directors, mutual fund directors still have a vastly greater array of [specific duties](#). SEC rules require director oversight in numerous areas, ranging from certain types of affiliated transactions to approval of the use of fund assets for distribution expenses under a [Rule 12b-1 plan](#) to oversight of personal investing activities by advisory personnel. The SEC has also, through releases and interpretive letters, assigned fund directors responsibilities in other areas, such as brokerage allocation.

Why do fund directors have these additional responsibilities? The primary reason is that shareholders in a mutual fund are different than shareholders in a public operating company. Fund shareholders are also the customers or the clients of the fund's adviser. A mutual fund is, after all, essentially a means for an investor to obtain the services of an investment adviser. These services are provided on a pooled basis, which makes them affordable to investors, such as middle-income Americans, who could not otherwise afford the services of a professional money manager.

Directors of mutual funds, then, are not simply responsible for assuring the basic rights applicable to a shareholder in any corporation. They are also, more importantly, serving in a consumer protection capacity. That is, they are overseeing the adviser-client relationship between a fund's adviser and the fund's shareholders.

It is as if the directors of General Motors were responsible not for ensuring the rights of GM stockholders, but rather for ensuring that purchasers of GM cars are treated fairly by GM.

Over the years, some have questioned whether it makes sense for fund directors to have this extensive set of investor protection duties. But, experience has confirmed the value of our system of director oversight. Many of the matters for which directors have responsibility, such as valuation, brokerage allocation and affiliated transactions, necessarily involve questions of judgment. There is no single best way, for example, to fair value a security or to seek best execution. Directors, pursuant to their duty to act in the interests of fund investors, are able to exercise their judgment in these and other areas. They are also able to revise previous positions to take into account changing circumstances.

In 1999, an [advisory group](#) of fund directors organized by the ICI adopted a series of [best practices](#) recommendations for fund boards. In its report, the advisory group summed up the duties of fund directors as follows:

[T]he fundamental responsibility of directors is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law . . . and in accordance with investor expectations reasonably created by the fund's prospectus and other disclosure documents. Within this context, it is the responsibility of the fund's board to evaluate the performance of the fund's investment adviser and that of its other service providers on the basis of what is best for fund shareholders and to apply that same standard in evaluating any proposals for change in fund operations or expenses. On those occasions where the interests of the adviser and fund shareholders

diverge, the fund's directors and, in particular, the independent directors, must effectively represent the interests of the fund and its shareholders.

By all accounts, fund directors have successfully carried out these responsibilities. But, ironically, when things are going well, they tend not to be noticed. The absence of the types of conflicts of interest and scandals that plagued the investment company industry in the 1920s and 1930s is now taken for granted. Fund directors, in turn, do not receive the credit they deserve for the basically scandal-free nature of the mutual fund industry. Instead, in recent months, fund directors have been the subject of increased criticism. These criticisms usually take the following form: Mutual fund directors are ineffective because they rarely terminate the fund's advisory contract, particularly in cases where a fund has above-average fees or below-average performance.

These criticisms, although they receive a lot of attention in the media, represent a fundamental misunderstanding of the role of fund directors.

First, they incorrectly assume that directors do not carefully consider fund fees and performance, when in fact the opposite is the case. Indeed, in many instances, directors require fund management to make changes in these areas, such as changing portfolio managers or revising fee schedules.

Second, these criticisms effectively ignore all of the other important duties of directors, relegating them to second-tier status. It is by performing these duties, however, that directors have been able to effectively protect fund shareholders from conflicts of interest and otherwise ensure that funds are being managed in the best interests of shareholders.

Finally, these criticisms ignore the underlying realities of investing in a mutual fund. As I said earlier, when an investor purchases shares of a mutual fund, she does not simply become a stockholder in a public corporation—rather, she becomes a client of the fund's adviser. She has chosen the fund with full knowledge of which firm will be managing her assets. In many cases, this may have been one of the most important, if not the most important, consideration in making her investment decision. In addition, we know that most investors purchase shares with the assistance of some intermediary, such as a broker-dealer, financial planner or retirement plan sponsor. These intermediaries invariably take into account the record and reputation of fund advisers in determining which funds to recommend to their clients or employees.

Asking fund directors to second-guess an investor's decision to invest in a fund with a particular adviser thus ignores the fact that most of the duties of fund directors are intended to protect fund shareholders in their capacity as clients of that fund's adviser.

Alfred Jaretzki, one of the draftsmen of the Investment Company Act, summarized the role of fund directors in this area when he said:

[T]he board of directors does not act in a vacuum. . . . [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances.

To put it another way, a mutual fund is a unique type of corporation. It is not a pre-existing entity that just happens to contract with a certain investment advisory firm to manage its portfolio. Instead, it is an entity created by that advisory firm to offer its services to the investing public – its clients – on a pooled basis.

Nevertheless, even if it is rarely exercised, the ability of directors to terminate an advisory contract can serve valuable purposes. First, it allows the directors to take drastic action when circumstances warrant, for example, if a fund's adviser has committed fraud or serious mismanagement. Second, it enhances the relative bargaining power of the board, which makes it easier for directors to ensure that the decisions they make in the context of their other statutory, regulatory and business responsibilities are acted upon.

The same type of reasoning applies to directors' duties with respect to investment advisory fees. Directors obviously need to take account of the fact that investors, when they purchase shares in a fund, have received full disclosure of that fund's fees. It is not up to them to call into question these shareholders' investment decisions.

Nevertheless, under Section 36(b) of the Investment Company Act, directors have specific responsibilities to oversee the level of a fund's advisory fees. How can this be reconciled?

The answer can be found in the legislative history underlying Section 36(b), which was enacted in 1970. At that time, Congress was concerned because it appeared that few funds adjusted their fees to take into account changes in circumstances, such as the realization of economies of scale due to growth in a fund's assets. Accordingly, Congress enacted Section 36(b), which, as subsequently interpreted by the courts, relies upon fund directors to regularly review and approve the fees charged to the fund.

As in the case of the issues I mentioned earlier, directors are ideally suited to undertake this type of review. There is obviously no single "correct" fee level for all mutual funds. Funds differ in their investment objectives, in the level of services provided (including services provided by third parties), in other factors that affect their costs, and, importantly, in the expectations of investors with respect to a fund's fee structure. Directors are able to review these various factors and, just as they do in connection with their other duties, apply their best judgment in determining whether a fund's fees satisfy the requirements of the Investment Company Act. But, the Act does not require them to put out the advisory contract for competitive bid. As former SEC Chairman Levitt stated, "Directors don't have to guarantee that a fund pays the lowest rates." Instead, they are supposed to "make sure that fees fall within a reasonable band."

Based on available evidence, it appears that fund directors are successfully discharging their responsibilities with respect to fees. Numerous studies have shown that fund investors generally do realize benefits from economies of scale—as funds grow, they tend to have lower advisory fees. In addition, the overall costs of investing in mutual funds are well below those of similar financial products.

In conclusion, despite the additional duties that have been imposed upon corporate directors in recent months, mutual fund directors still are subject to responsibilities that go well beyond those of corporate directors. This is because fund directors are charged with more than securing traditional rights of shareholders—they are also responsible for overseeing the entire relationship between the fund's investment adviser and its clients, the fund's shareholders.

This is a very broad and challenging mandate. It is only likely to grow in the future, as the SEC continues to impose new duties upon fund directors in response to new challenges. It is my hope that, as outside observers continue to pass judgment on how well fund directors are performing, they do so by looking at the unique role of fund directors – “watchdogs” charged with protecting fund shareholders in their capacity as clients of the fund's adviser. They should not judge fund directors on the basis of a standard that is inconsistent with both Congressional intent and business realities.

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