

[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

Speech by SEC Staff: What Does It Take To Be an Effective Independent Director of a Mutual Fund?

Keynote Address by

Paul Roye

*Director, Division of Investment Management
U.S. Securities & Exchange Commission*

ICI Workshop for New Fund Directors
Washington, D.C.

April 14, 2000

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of Mr. Roye and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the Commission's staff.

I would like to thank the Investment Company Institute for the opportunity to speak with you this afternoon. I want to commend all of you for taking on the very weighty responsibility of serving as mutual fund independent directors and taking the time to participate in this extremely important educational effort. By the power vested in me by Chairman Levitt and the other Commissioners, I am here to officially deputize you as "SEC watchdogs" and swear you in officially as Mutual Fund Independent Directors. At the completion of this new fund directors workshop, you are invited over to the SEC headquarters to receive your official SEC Independent Director "dog tags." At this ceremony, Dawn-Marie Driscoll and John Haire will then show you the "secret" mutual fund independent director handshake. Seriously though, the Chairman and the other Commissioners have only authorized me to say that the views that I express today, are my views and do not necessarily represent the views of the Commission or my colleagues on the staff of the Commission.

I want to applaud this effort by the Investment Company Institute to introduce you to your important responsibilities as fund directors. I also want to commend the efforts of the experienced directors who are here today, particularly John Haire and Dawn Marie-Driscoll (who was recently named Fund Director of the Year by an industry publication), for taking the time to share their knowledge and experience, as fund directors, with you.

It is difficult to overstate the importance of the fund industry to our securities markets and to the financial futures of millions of investors. The

fund industry has become the principal trustee of the nation's savings, with 83 million investors having invested their hard earned dollars in mutual funds. Open and closed-end funds today own nearly 17% of the value of all equity securities trading in the United States – more than any other type of institutional investor. Clearly the growth of the industry to almost \$7 trillion has not only been beneficial for the mutual fund industry, it also has been beneficial for the U.S. economy and fund investors. While the longest bull market in history has contributed to the success of the industry, it should also be recognized that this success has been achieved because of the confidence that investors have in the mutual fund industry.

Similarly, it is impossible to overstate the importance of effective independent directors to the future health of the fund industry. Chairman Levitt has emphasized that you are on the front line for investors. You are the principal guardians of investors' trust in the industry. You are there to see to it that mutual funds earn acceptable returns, that their fees are reasonable, that fund assets are safe and that investors receive the reliable services promised. Mutual fund investors deserve more than spectators; they deserve – and the industry has thrived under – active, engaged and strong-willed directors who stand up for investor interests before all else.

I know that many of you have also served on the boards of public companies. While your experience on these boards will no doubt assist you in the discharge of your fiduciary duties on mutual fund boards, there are several important distinctions that make your new roles uniquely challenging. The Investment Company Act and our regulations impose specific responsibilities on fund directors. Congress formulated the role of the mutual fund board of directors in light of the external management structure typical of investment companies. Although a fund's investment adviser and shareholders have common interests in many areas, there are conflicts of interest and potential for abuse inherent in this organizational structure. Under the regulatory framework, you are responsible for monitoring conflicts and representing the interest of shareholders. The 1940 Act embodies a pervasive regulatory scheme that contemplates an important and vigorous role for fund independent directors, in addition to the traditional responsibilities imposed on directors by state law. Therefore, you need an understanding of the relevant provisions of the Investment Company Act and you must be appropriately informed of the scope and nature of your duties and responsibilities. Undoubtedly this workshop will contribute to an understanding of these responsibilities.

You have heard and will continue to hear a great deal about your responsibilities as independent directors. But how does one become a good independent director? I would like to spend some time this afternoon discussing, in my view, what it takes to be an effective independent director, give you some examples of situations in which directors have failed to fulfill their responsibilities to fund shareholders and finally discuss some of the Commission's initiatives that will hopefully have a positive impact on your ability to discharge your duties.

What Does It Take To Be an Effective Independent Director?

Prior to accepting the position as Director of the Division of Investment Management, I practiced law for sixteen years in a major law firm, working with a variety of mutual fund clients. This afforded me the opportunity to

observe a number of mutual fund independent directors, some good and some not so good. I would like to outline for you what I think are some keys to being an effective mutual fund director. For purposes of this discussion, I will assume that all of you meet the statutory definition of independent director and that you were selected because of your integrity, intelligence, good judgment and common sense. You clearly need these attributes in order to be a good independent director. But let me outline ten practical suggestions on how to be an effective independent mutual fund director.

1. Understand Your Responsibilities

By attending this conference, you have embraced my first suggestion, which is to understand your responsibilities as a mutual fund director. As I indicated previously, you have responsibilities under the federal securities laws, as well as duties of loyalty and care under state law. The Investment Company Act imposes on fund directors a number of specific duties and obligations that are not imposed on directors of other public companies. Moreover, fund directors have important responsibilities under the Securities Act of 1933 and the Securities Exchange Act of 1934. For example, under Section 11 of the Securities Act, as signers of a Fund's registration statement, you are liable for any untrue statement of a material fact contained in the registration statement, as well as material omissions in the registration statement. Therefore, it is important that you appreciate your responsibilities under these laws. I would suggest you spend time reading the ICI's "Guide for Investment Company Directors," as well as the "Fund Directors Guidebook," published by the American Bar Association, both of which review in detail your responsibilities as fund directors.

2. Learn the Mutual Fund Business

Next, Board members who do not have a background in the industry must be willing to invest some time learning the fundamentals. How do mutual funds operate? What are the roles of the various service providers to the funds (*i.e.*, the roles of the investment adviser, fund administrator, distributor, custodian, transfer agent, accountants and lawyers)? How are the funds sold? In what distribution channels? Who are your competitors? How is money made in the fund business? With an understanding of the mutual fund business, you will be able to make better oversight judgments and be better equipped to ask insightful questions as you carry out your responsibilities. You also need to stay abreast of industry trends and regulatory developments, as they will undoubtedly affect your fund's operations.

3. Recognize Your Limitations

Next, as Dirty Harry so succinctly stated: "A man's got to know his limitations." You are not and should not try to be a full-time, day-to-day manager of the fund's operations. The fund's investment adviser is paid to do that. You are responsible for oversight. You are there to act as a control and check on fund management. You cannot micro-manage the fund and also focus on your broad oversight responsibilities. You are not and cannot be the fund's auditor or the fund's lawyer. You are entitled to rely on reports and opinions by the fund's officers and the investment adviser so

long as you reasonably believe that they are reliable and competent with respect to the matters at issue. You can also rely upon legal counsel, outside auditors and other experts as to matters you reasonably believe to be within their professional expertise. You must use and rely on these service providers wisely.

4. Focus on the Important Issues

While fund directors cannot ignore any of their statutory and regulatory responsibilities, some responsibilities are clearly more important than others. Your workshop today focuses on three of the more important areas of director responsibilities, the investment advisory contract renewal process, which includes performance evaluation, fund distribution arrangements and board oversight of the portfolio management process. Focus on these areas, leads to focus on areas that have significant impact on fund investors, such as fee levels, fund performance and the management of the fund in accordance with the parameters set forth in the fund's offering documents. Some perspective on what is important and what is less important is useful.

5. Pay Proper Attention to Compliance/Internal Controls/Risks

Directors should have an understanding of the manner in which the fund's compliance program is structured and the nature of internal controls. This understanding is gained through regular reports and meetings with compliance personnel to discuss procedures and deficiencies. Directors should also discuss and review the adequacy of internal controls and procedures with the fund's independent accountants. You also need to understand the operational risks that arise in mutual fund operations, such as those arising from portfolio management, custody, pricing and technology. Breakdowns in compliance and internal controls can lead to major problems for the fund which can undoubtedly complicate your life as an independent director.

6. Insist on Quality Information

The quality of information provided to you by fund management significantly impacts your ability to perform your role effectively. Information submitted to you should be concise, well-organized and designed to inform. The information should be sufficiently complete to form a basis and complete record, for your decision-making. Memoranda, reports and other information should be provided sufficiently in advance of the meeting to provide time for thoughtful reflection and meaningful consideration by the directors. This is important, since if your decisions are attacked in litigation you will want the benefit of the business judgment rule. In reviewing an independent director's conduct, a court will not substitute its judgment for that of the director, provided that the director acted in good faith, rationally believed the action was in the best interest of the fund, and the director was reasonably informed. Thus, quality of information provided you is important, if you want the benefit of the business judgment rule.

7. Be Prepared

