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A CHALLENGE TO MUTUAL FUNDS

An Address by Harold M. Williams, Chairman
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"A Challenge to Mutual Funds"

Some of you in other contexts have heard me talk about my concerns about government regulation -- more particularly about what I consider to be a very compelling need for a much greater degree of introspection and self-regulation on the part of the private sector and the free enterprise system. This comes from my concern that there is a general trend in this country toward government regulation of conduct that has traditionally been regarded as private. This regulatory impulse, motivated by perceived concerns for the public interest, is not new and certainly government regulation has been a way of life for a generation of mutual fund managers. But still, the proliferation in recent years of legislation and regulation, covering everything from occupational health and safety to corporate morality, reflects an acceleration of the trend towards government involvement in corporate affairs which amounts to quantum change. I have frequently expressed my concern that this trend toward increased government regulation creates an imbalance in the relationship between the public and the private sectors.

The regulatory presence, to the extent that it becomes pervasive, tends to undermine the foundation of the private sector -- the very decision process itself and the qualities of will and iniative and self-sufficiency which are essential to the growth and preservation of private enterprise. As corporate conduct and practices become increasingly regulated, an excessive dependency on the regulator to pass on a wide variety of day-to-day activities results. This dependence can lead regulated persons to abdicate their corporate responsibilities in favor of the regulator's business judgment.

In my view, the relationship which has developed between the Commission and the mutual fund industry since 1940 is an example of this imbalance. The industry is, in my view, far too dependent on the Commission. Through rules, applications, requests for interpretive advice and ad hoc regulation, the staff of the Commission reviews both the legal implications and the desirability of a wide variety of mutual fund business practices. This is not healthy. It is neither efficient regulation nor the proper role of the staff to be so intimately involved in the corporate decision-making process. Consequently, one of my goals as Chairman is a rebalancing of the relationship between the Commission and the fund industry.

Mutual funds have an important role to play in the capital markets and they must have the freedom and confidence to respond quickly to market developments. They must be able to innovate when conditions dictate change. But the industry will not be able to meet the future needs of investors and the marketplace in an environment which stifles creativity and breeds excessive caution. For the industry to participate in such a rebalancing it must accept greater responsibility and prepare to make changes in the structure of its governance and operations. It must recognize the potential for greater liability that comes with exercising greater discretion, and must also exercise that discretion responsibly and change structurally, to minimize that risk.

All this is not to say that the Commission should withdraw from the regulatory field, but rather that it should adopt a new regulatory philosophy -- one which creates and maintains an environment which facilitates and encourages corporate accountability without destroying corporate independence or the opportunity for investment companies to compete in the market place.

Such a philosophy must, of course, reflect the public's genuine concerns about corporate abuses of power and about incestuous relationships between business and government. The need for a workable structure of accountability in the investment company area is especially apparent in view of the extensive regulation to which funds are necessarily subject by statute and by the unique circumstances of investment companies that gave rise to that legislation.

In recent months, Syd Mendelsohn and I have had many talks about how to revise the regulatory structure to redress the balance between the regulator and the regulated, while at the same time insuring that fund managers will be held responsible for the consequences of their stewardship. What has evolved is a determination to conduct a systematic review of the Investment Company Act and the rules, regulations and interpretive positions which have developed over the years. This review will have the highest priority and will be conducted by a staff task force whose members will have no other day-to-day responsibilities. In many ways this study is an acceleration of a review program which the Division has had underway for some time; however, it will be more comprehensive in scope and will have more clearly-defined objectives.

The major objectives of the study will be to develop a system of rules which are consistent and comprehensive, designed to give reasonably clear guidance to prudent fiduciaries, and to set standards of conduct and duty which will be enforceable in court, both by the Commission and by private litigants. These rules will not govern minutiae -- we are not going to tell you where or when to have your annual meeting. In the process, the staff will attempt to codify appropriate practices which have been developed by application or interpretation and to eliminate the unnecessary and the exotic. The result should be a regulatory system which relies primarily on funds and their managers to discharge their duties properly and to make full and fair disclosure, but which preserves a strong oversight function for the Commission.

An example of the kind of rule I am speaking of is proposed Rule 17j(1), which requires fund to develop codes of ethics governing trading by certain insiders in securities in which the fund itself is trading. The proposed rule contains no prohibitions nor does it give examples of regulations which the Commission might consider acceptable. I do not know how close this particular rule comes to achieving the desired objective. We will be analyzing your comments with that thought in mind. It does appear to be a step in the right direction, however and I hope you will review it in that light.

In citing proposed Rule 17j(1) as an example I should express a <u>caveat</u> that not every regulatory problem is amenable to an approach which calls on funds to, in effect, write their own rules.

Another example of the re-evaluation I have been talking about is the regulation of sales literature. As you know, the Commission announced last year a re-evaluation of the statement of policy. In its present form, the statement of policy contains such extensive dos and don’ts that it virtually prescribes and proscribes the content of sales literature. However, as is frequently the case with such detailed regulation, the staff is regularly called upon to comment on the most minor variations from established norms. The result is an unhealthy dependence on the regulator in the making of business and marketing decisions.

Of course, the implication of the rulemaking program I have outlined is that funds will bear a greater burden in insuring that their conduct complies with the letter and spirit of the Act and the rules. I anticipate fewer safe harbors, and certainly fewer liability-insulating exemptive orders and no-action letters. As this program is implemented, the staff will be taking a much stricter view toward granting relief where a substantial and genuine need or benefit cannot be shown. Funds, in turn, will have to rely much more on their own judgment as to whether certain conduct or a proposed practice is consistent with the Act and the fund’s responsibilities to their shareholders and to the public.

This new program will mean that the staff is not going to be sympathetic to applications and interpretive requests which seek to stretch the boundaries of exemptive rules. Experience shows that granting exemptive relief to deal with a significant problem frequently leads to a rush of applications seeking to erode remaining restrictions. The program we are aiming for will not work if each new rule simply spawns more requests for special treatment.

Moreover, the staff is not going to be sympathetic to application and interpretive requests which seek to transfer the burden of making compliance judgments to the staff. Again, experience shows that entirely too many in this industry want the staff to decide whether minor variations from permissible practices are acceptable. This dependency will no longer be supported.

Of course, we understand that requests for relief sometimes occur because the management of a fund seeks the advice of counsel and counsel bucks the problem to the staff. We also understand that such requests are frequently prompted by fears of private litigation. Nevertheless, it is our hope that the standards we set and the policies on which they are based will be clear enough that reasonable men will be able to determine, without the need for preclearance, whether or not a course of conduct is a proper one.

As the staff reduces its preclearance function it will be stepping up its compliance and enforcement capability. I do not mean this as a threat. In order for the Commission to carry out its statutory mandate under the new scheme, it will be necessary to conduct more frequent and thorough inspections and otherwise to improve surveillance techniques. Similarly, we will have to expand our capacity to handle, formally and informally, any compliance problems which do arise. The staff study will thus develop a rulemaking program which dramatically reduces the staff's preclearance function. This, in itself, will be a major task and will go a long way towards implementing our goal.

But the study also has another equally important and interrelated task. A central theme of the study and one which is of particular importance will be an exploration of ways in which the Commission's rules can strengthen the role of the independent or disinterested directors as an internal tension for fund accountability. Given real authority and responsibility and supportive structure and environment, fully informed, independent directors can, in my view, be relied upon to make a wide variety of decisions having both business and regulatory implications -- the kind the Commission now has to make in far too many cases. It is my hope and expectation that rulemaking can supplement the provisions of the Act which already provide that a majority of the independent directors must approve the fund's advisory and underwriting contracts and select the fund's independent accountant.

As you know, recent court decisions have provided substantial insight into, and, in most cases, support for the role of independent directors in making significant business policy decisions. You are all familiar with Tannenbaum, [Tannenbaum v. Zeller, 552 F2d 402, 418-419 (2d. Cir. 1977)] upholding a decision by independent directors to forego brokerage recapture where the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information reached a reasonable business decision to forego recapture after a thorough review of all relevant factors.

The Investment Company Act exists to exert a force to counter the strong conflicts of interest inherent in the mutual fund structure. Heretofore, that force has been embodied by the Commission staff, i.e., it has been an external force. Unfortunately, as I have said, this external force has worked its way deeply into internal matters. It is now time for appropriate internal forces to be brought to bear. I believe that the independent directors, supported and prodded where necessary by an appropriate internal structure, by the courts and by the Commission, are the appropriate source of that force.

In this regard, a focus of the staff's review of the Act will be the possibility of differential regulation of funds with independent boards of directors. I have spoken in favor of independent boards for corporations generally and I believe they are particularly appropriate for mutual funds. The Act requires, as you know, that 40 percent of a fund's directors be independent, but typically the adviser and its employees still constitute a majority of the board. If a majority or, perhaps, all of the the members of the board are truly disinterested, they can draw strength from each other and are more likely to represent the shareholders fully in dealing with management. It is my observation that if people are given real authority and responsibility they will exercise it.

Consequently, I believe that if independent directors are given the support they need to enable them to direct the affairs of the fund, they will exert the kind of force for accountability that the Investment Company Act is designed to provide and which shareholders need and deserve. In order to insure that independent directors of funds have the necessary support, several collateral matters need attention. These matters have to do with selection, compensation, liability and counsel.

First, no matter how independent a director may be in fact, there will always be a question if he is selected by management. Consequently, it would appear preferable for independent directors to be selected by the other independent directors. Such a procedure would avoid even the suggestion that directors were beholden to management.

Second, if independent directors are to have kinds of duties and responsibilities contemplated, it will be necessary to compensate them adequately. Recognizing that many devote strenuous efforts to charitable activities, it is still true that, by and large, people do not put forth the maximum effort without adequate compensation. Indeed, adequate compensation communicates greater expectation and a greater sense of obligation on the part of independent directors.

Third, some would argue that increasing responsibility may bring an increase in exposure to liability. To a degree that is so and that is appropriate. But in my judgment, the best insulation against liability is responsible performance by a board composed largely, if not exclusively, of independent directors.

Fourth, and it is appropriate to mention this subject immediately after raising the spector of liability, independent directors should have independent counsel. Recently, case after case has sounded this theme and I think it is one of which we should take heed. No matter how rational a system of regulation we develop, the responsibilities of independent directors will necessarily become increasingly complex and prudent directors are going to want to be given totally disinterested advice as to what is expected of them. In dealing with the investment adviser particularly, an area which is most fraught with the conflicts of interest which brought the ’40 Act into being, the directors should not be dependent for legal advice on counsel who is, in fact, retained by the adviser. Such counsel is in an almost impossible position -- his advice to the independent directors is inherently suspect no matter how diligent he tries to be.

Before moving on I should refer to another case which some have read as limiting the role of independent directors namely Lasker v. Burks [CCH Fed. Sec. L. Rep. ¶96,282 (C.A. 2, 1978)]. As you know, in that case the Second Circuit found that the disinterested directors of a mutual fund could not effectuate the dismissal of a nonfrivolous derivative action against the fund's majority directors for breach of fiduciary duty. I do not believe that Lasker v. Burks should be read as restricting the responsibilities or the powers of independent directors. I believe the message is that substance will be considered over form, particularly in the unique circumstances presented by that case. The court found it was, for the benefit of those of you who have not read the opinion, "…asking too much of human nature to expect that the disinterested directors will view with the necessary objectivities the actions of their colleagues" when the independent directors are nominated by the majority directors, when their continued status depends on having satisfactory working arrangements with the majority directors, when management selects special counsel for the disinterested directors and when the majority directors face considerable personal liability in the event of an adverse decision.

Moreover, the court was, obviously, very reluctant to raise any barriers to the statutory right of shareholders to sue under the Act for breaches of fiduciary duty. This latter consideration would not apply in ordinary cases involving the exercise of substantive business judgments. One may suspect that the court viewed the role of the independent director as being a check on management -- not on the fund's shareholders.

Nevertheless, a question which seems to pervade Lasker v. Burks is whether the directors there could be deemed truly independent. That question may legitimately be raised whenever directors are or appear to be more independent in form than they are in substance.

There is one other topic relating to internal governance of mutual funds which I would like to touch upon. As most of you know, last Thursday, the Commission approved a release asking for comment on the outlines of a proposal to permit funds to finance distribution of their shares under some circumstances. This is a particularly thorny issue because it entails a complicated mixture of business, legal and fiduciary considerations. The decision to spend a fund's money to sell shares involves, in very fundamental ways, the exercise of business judgment. But in view of the inherent conflict of interest on the part of the adviser and questions of fairness to existing shareholders, there are regulatory decisions that have to be made as well.

The release describing this proposal is momentarily to be issued if it is not out already. It suggests that any rules which might be developed should have three fundamental objectives -- minimizing the investment adviser's conflict of interest -- imposing adequate procedural safeguards -- and protecting the interests of shareholders. The release suggests that one way of satisfying the first objective may be to require any fund which pays for distribution of its shares to pay its adviser a flat fee which would not increase proportionately with an increase in fund size. It may be possible to satisfy the third objective, protecting the interests of all shareholders, by simply creating, in effect, two series of shares -- old shares and new shares. Rules along these lines would be somewhat mechanical.

The second objective -- procedural safeguards -- cannot be met mechanically, however. Procedures alone cannot insure the objectivity of a decision to spend fund assets. No doubt rules can contain specific requirements for approval by shareholders and by disinterested directors. Thus, the release suggests that, perhaps, the whole board would have to be disinterested. However, no rule which permits an exercise of judgment can insure that that judgment will be exercised responsibly. Consequently, any permissive rule in this area would put a great responsibility on the shoulders of the fund's directors and its success would depend on directors doing their job properly. This presents both a challenge and an opportunity and I hope you will take the time to study the Commission's release and to give us your thoughtful assistance in finding a way to permit funds to make this sort of business judgment in a way which provides some assurance that the decision reached will be in the best interest of the fund and its shareholders.

I have been speaking primarily of self-regulation for individual funds. I would now like to touch briefly on the question of self-regulation on an industry-wide basis. Syd Mendelsohn suggested this idea in his speech at the Mutual Fund Conference in Tucson and I endorse our exploration of the concept. The staff study will consider the possibility of implementing such a system, focusing on such matters as the possibility of legislation to facilitate or require self-regulation, the possibility of differential regulation for members of a qualified self-regulatory organization, and the kinds of functions that would be carried out by or under the auspices of such an organization. Initially, I would assume that such an organization would undertake inspections, review sales literature, regulate compliance and selling practices, but it would eventually, I think, encompass much more. Naturally, your input will be crucial in this process, so I strongly urge you to give this matter, as well, you serious thought.

There are several other matters I would like to touch on briefly, relating not to the internal governance of funds, but to the proper role of funds as participants in the securities markets.

The first has to do with funds as corporate citizens. Why do most institutional investors routinely vote their shares of portfolio securities for management? Isn't there a proper role in corporate governance for institutional investors who are, presumably, the most sophisticated of all investors? It may seem ironic for me to suggest this since the Commission is the administrator of beneficial ownership and institutional disclosure legislation which appears to express Congressional concern about institutional dominance. But concern is not disapproval, and I wonder if institutions are adequately fulfilling their responsibilities to the marketplace if the only meaningful vote they cast is through the so-called Wall Street Rule. How can corporate accountability and the substantive merits of shareholder participation be realized if the largest and most sophisticated shareholders abdicate the responsibilities that go with ownership? If they are not responsible, what other mechanisms or government interventions are likely to be substituted? Perhaps one solution would be to neutralize voting securities held by institutional investors.

I do not have a definitive answer to the questions I have posed and I am not suggesting a brand new field of regulation, but I have a very serious concern and I would challenge you you to think about it.

The second topic has to do with funds as customers in the market. The economic repercussions of fully negotiated rates in the securities industry have caused a substantial number of liquidations, mergers and consolidations among New York Stock Exchange member firms and dramatic shifts in marketing approach and structure among survivors. Institutional investors have not been immune. They have had to examine carefully their trading and commission allocation practices and to formulate new policies and procedures for dealing within a fully negotiated rate environment.

It is to be expected that these conditions should lead to sharply lower institutional commission rates. Yet these same circumstances can also provide the cover for other less constructive consequences. I have, in the past, expressed to the brokerage community my concerns about predatory pricing practices -- which are by definition destructive and anticompetitive. It takes a customer as well as a broker to create the problem. Indeed, the negotiating leverage of many institutions is such as to tip the initiative in their direction.

Further, there is an overriding concern on the part of some institutions with the price of the execution rather than the quality of the execution itself and the services which accompany it. I appreciate that a prudent fiduciary does not want to overpay, but it is important to consider all dimensions of execution and not merely commissions alone. Section 28(e) recognizes that institutions may legitimately pay more than a bare bones execution price for brokerage and research services, provided they do so in good faith.

Some of you may be concerned about how courts and regulators are going to define those terms. That is a legitimate concern, but it should not be an overriding one resolved simplistically by reaching for the lowest rate. It is and will remain the responsibility of a fund in the proper exercise of its fiduciary responsibilities to consider the range and quality of the services it receives as well as the long-term health of the securities markets in paying for securities transactions.

While the net result of an execution is certainly affected by the rate of commission paid, as you well know, that rate is only one of the factors determining the quality of execution and the services rendered. The quality of execution may have a far greater impact on net price than the commission paid. The cheapest is not necessarily best or in the best interest of the fund or its shareholders or the future availability of competent execution capability.

It has been my intention in my first official meeting with you to challenge you in my remarks today and I hope that you will accept the challenge in the spirit in which it is offered. There is a natural human tendency to react negatively to that which is new or different, even on the part of those who may not particularly approve of the status quo. I hope you will see this challenge as I do -- as an opportunity to find the proper balance between the Commission and the industry -- and to develop a more healthy regulatory environment.

If the program I have outlined is to work, it is essential that it have your support and participation. Accordingly, I encourage you to give us your ideas about developing an appropriate regulatory structure and I encourage your considered comment on the proposals we develop. I am certain that if we enter this venture in a cooperative spirit, we will be successful and will return much of the initiative, opportunity and responsibility to the industry.

Thank you.