"MUTUAL FUND DIRECTORS AS INVESTOR ADVOCATES"
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
THE SECOND ANNUAL SYMPOSIUM FOR MUTUAL FUND
TRUSTEES AND DIRECTORS
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To speak frankly about other people's reponsibilities is to come very close to pontificating. Joseph Kennedy, Sr., who left Wall Street to become the first Chairman of the SEC, had a clever way of avoiding the implication that he was holier than his audience: he used to tell people that, had the Commission existed just ten years earlier, he might never have become a millionaire. He was kidding, of course.

The truth is, no one has a monopoly on morality. As long as we remember that, then we can reason together about your role as directors and trustees of mutual funds.

This Symposium has attracted such distinguished speakers as Adam Smith, Mike Lipper, George Putnam, and our own Barry Barbash. I thought I would try to complement this rich variety of views by addressing the issue as a citizen and businessman-turned-regulator.

I came to the Commission after managing enterprises in such fields as finance, agriculture, and publishing, and after serving on the boards of more than a half-dozen major public companies. That experience gave me a healthy respect for the structure and order imposed on market participants by the securities laws. The SEC is part of that structure. But after almost two years as Chairman, it is clearer to me than ever just how vital a role you play in maintaining discipline within our markets. We hold many obligations in common.

We share a responsibility to investors.

We share a responsibility to funds.

We share a responsibility to the nation.

And lately, those responsibilities have grown.

Mutual funds are now a cornerstone of American investment.

More than 38 million Americans now depend on us -- they've entrusted their retirement savings, their children's education savings, and even their ready cash to the investment company industry.

As the industry has grown, so has the number of questions about its practices -- and it's our task to address them.

I would characterize the relationship between the SEC and fund directors as a partnership in the public interest. Your supervision complements our oversight -- in fact, the SEC's abilities as a watchdog pale in comparison with yours. You're in an ideal position to monitor new developments and trouble-shoot problems as they arise.

That's why we're so pleased about this Symposium. All fund directors may be called upon to take significant action at some point. Yours is a complex job that requires enormous diligence, skill, and responsibility. You must be prepared to step in at any time; you must know what to look for; you must know when to act; and, lest we forget, you must also know when not to act.

This conference addresses the critical issues facing fund directors today. But underneath all those complex questions lies a simple truth, one that has guided me without fail in both private and public sectors. I've learned over the years that you'll end up on the right side of almost any issue you'll confront in the securities industry if you make the interests of investors your guide.

This formula applies even to your decision to accept a nomination. A few basic questions will give you an idea of your fellow directors' priorities and degree of commitment to investors. I don't mean any one of these should be controlling -- every rule has exceptions -- but they are important questions to consider. For example:

How many times a year does the board meet? I don't care how talented you are, it's hard to be a good watchdog if you're only on limited patrol. The commitment of adequate time is an essential requirement for directors.

What kind of people are on the board, and how did they get there? I'd be especially wary if I saw too many board members with personal or social ties to the CEO.

Is the board conscientious about expenditures and sensitive to symbolism, or have its members turned imperial, demanding expensive perquisites? Are they more concerned about what they receive than what they contribute?

Does the board understand where the investment company has been and where it is headed?

Even more important: Do board members speak their minds, or do they march in lockstep with management? Board independence is crucial; strictly defined, it means that directors are sufficiently removed from conflicts of interest to be able to take views without regard to management's interests.

You've heard by now of the bipartisan legislation introduced last Friday in the House by Congressmen Fields and Markey, to modernize mutual fund regulation. One provision would require that a majority of directors on investment company boards be independent -- it's about time this was written into law.

Asserting an independent voice can be made difficult by one feature of all successful organizations -- "team spirit." It's a wonderful thing, but it can lead people to subordinate personal judgements to those of the group. That's where fund directors play an absolutely critical role. In many cases, it falls to you to serve as the fund's conscience. We at the Commission have a sense of how thankless a task this can be; it's even harder to stand apart from the team when you're a member of it, as you are.

But stand apart you must. How else is a fund manager to know when a judgement is wrong, or a standard too low, unless someone with a clear sense of right and wrong has the courage to question it? Even one person can make a tremendous difference.

Thirty years ago, it was common to curry favor with New York City policemen by offering them "gifts." One officer couldn't accept the system; his efforts succeeded in raising law enforcement standards in New York and throughout the nation.

Not every question is that clear-cut. You are in a position to define and maintain standards for your funds. I want to talk to you today about four broad areas of board activism and involvement: compliance activities; derivatives; "soft dollar" arrangements; and disclosure. I think it's useful to keep directors abreast of the SEC's agenda for the months ahead.

Compliance is the least concrete of these issues, but the most important. It underlies all the others. The Commission has been devoting a great deal of attention to all aspects of compliance. We recently consolidated all of our inspection functions within a single Office of Compliance Inspections and Examinations, to ensure that our program is as cost-efficient as possible. Directors ought to be paying at least as much attention to compliance activities as we are.

We don't expect directors to be involved with day-to-day matters, but we do expect you to ask the hard questions. What resources has a fund manager devoted to compliance activities? The mutual fund business can be a very profitable one. Isn't it incumbent upon fund managers to plow some of those profits into making funds work better, as compliance surely does? Does the compliance staff receive the full support of management? To whom do they report? When the auditors report a problem, what is the reaction of management? When SEC examiners send a deficiency letter, how quickly does management respond?

Asking these questions makes good business sense. A fund manager's financial success depends heavily on reputation. Compliance problems are suicide -- they can take you off the road to prosperity and into the vicious circle of bad publicity, shareholder redemptions, further compliance problems, fewer new shareholders and so on.

And speaking of bad publicity, let's move on to derivatives. A few years ago, few people had heard the word "derivative," and most did not know what it meant. Today, "derivative" has become a household word... and most people still don't know what it means.

When I called upon directors more than a year ago to review derivatives policies, some people were skeptical. "That's of concern to money managers, not directors," they said.

Some asserted that I was expecting too much of directors, asking them to get involved with something as technical as derivatives. But like it or not, you're already involved with something the moment it appears in your fund's portfolio.

It might be argued -- though not by me -- that the average American can afford to be ignorant on this esoteric subject; but in your case, when it comes to derivatives, ignorance is not bliss -- it's an invitation to disaster. Consider the casualties over the last year alone: Gibson Greetings. Proctor & Gamble. Bankers Trust. Air Products. Piper Jaffray. Orange County, California. Barings PLC. All ended up on the wrong side of some pretty big bets.

Let me make it clear that I do not view these as solely "a derivatives problem," as if derivatives somehow had the power to force people to invest in them. As I've said on numerous occasions, it would be a grave error to demonize derivatives and blame them for these losses. Derivatives are not inherently good or bad -- they're something like electricity: dangerous if mishandled, but bearing the potential to do good. What these spectacular losses highlight for me is the importance of proper oversight and supervision. The best defense any system of investment can have against major loss is an effective risk management system and stringent internal control mechanisms.

If directors don't take the time to understand how derivatives work, how a fund is using them, how clearly they are described to shareholders, and what the exposure of shareholders is -- well, if the investment portfolio begins to explode, those directors are likely to get burned along with the fund and its shareholders.

We've been working with the securities industry and our fellow regulators to establish voluntary standards for dealers' use of derivative products. Earlier this month, we announced the adoption of guidelines by the 6 securities dealers with the largest derivatives business. I commend these guidelines for your review -- the principles discussed in them may be useful for funds as well.

The use of "soft dollars" is another issue directors would do well to stay on top of, for it also presents the potential for problems. In the typical soft-dollar arrangement, an adviser routes client brokerage orders to particular brokers and in exchange, gets research. More recently, brokers have agreed with some funds to pay for or provide certain services that funds normally would pay for directly, including custodian arrangements and transfer agent services.

The Investment Company Act requires directors to request and review all information necessary to evaluate the terms of the contract between adviser and investment company. Because they may bear upon the reasonableness of advisory fees, soft dollar arrangements must be disclosed to boards by fund managers. As directors, you need to react to this disclosure, because the practice opens the door to so many valid questions: Which broker is being used, and why not another? What is the value of services being provided? How does it benefit shareholders?

That brings us to public disclosure, an area in which directors clearly can make a difference. Your responsibility for the fund's disclosure obligations gives you an extraordinary tool with which to protect investors. Does the fund clearly describe its strategies? Are risks adequately conveyed?

As you know, the Commission has taken a special interest in cutting through some of the dense prose that has come to characterize mutual fund prospectuses. The law of unintended results has come into play: the Commission's passion for disclosure has interacted with portfolio managers' thirst for flexibility and lawyers' instinct for ironclad liability protection. The result has been prospectuses that are more redundant than revealing.

How can we expect investors to read and understand materials that even securities lawyers find daunting? Why not set a standard: If board members cannot readily understand the fund's prospectus, then it's back to the drawing board until the drafting committee gets it right.

The Commission is encouraging the industry not only to use clearer language in writing prospectuses, but also to organize information in more accessible ways. Last year, I announced that eight major fund groups had stepped forward to pilot a "profile prospectus," that is, a prospectus that includes a concise summary of salient points, for clarity and comparability. We and our state regulator colleagues now have prototypes in hand, and we hope that profile prospectuses will be in use in the very near future.

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I hope that I've given you an idea of my views on the responsibility we share in protecting investors. I recognize that not all of you may agree with what I've said. Some of you may think I've overstated the obligations of the board.

In reply, I ask you to remember your critical role as investor advocates.

I ask you to remember that you have a constituency, usually numbering in the thousands.

Every time you sit down at the table with your fellow directors, thousands of investors sit with you.

Every time you stand up for what's right, even if you think you may be alone, thousands of investors stand with you.

What's more, the SEC stands with you. For the actions you take, and the standards you set, have an impact far beyond any individual fund. The 38 million Americans who invest in mutual funds are counting on you and me to look after their interests.

That's a tremendous show of faith. We must keep that faith -- in the years ahead just as well as in years past. I'm sure we will.

Thank you very much.

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