SECURITIES AND EXCHANGE COMMISSION
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CORPORATE GOVERNANCE FOR MUTUAL FUNDS -- IS IT READY FOR A CHANGE

PANEL PRESENTATION

BY

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Introduction

The purpose of this panel is to consider alternative approaches to mutual fund governance which were initially advanced by Stephen West 1/ and Richard Phillips 2/ and which were discussed at some length in an advance concept release issued by the Commission on December 10, 1982. 3/

In May of 1980, at a general meeting of the Investment Company Institute, Mr. West suggested the creation of an alternative type of mutual fund--a unitary investment fund ("UIF")--that would be internally managed, without voting shareholders or directors, and whose investment manager would charge a uniform, nearly all-inclusive management fee which would not be subject to challenge under Section 36(b) of the Investment Company Act of 1940 (the "Act").

Approximately a year and a half later, Mr. Phillips delivered a paper at the 1981 fall meeting of the American Bar Association Committee on Federal Regulation of Securities which was subsequently published by the Business Lawyer in the spring of 1982. Mr. Phillips concluded that, although "the UIF concept is an imaginative challenge to many of the traditional concepts of investment company regulation; . . . the regulation of management fee compensation provided by Section 36(b) affects the most critical economic aspect of the mutual fund industry . . . and the elimination of the independent check provided by the disinterested directors is a step that must be taken with great caution." Accordingly, he recommended that mutual fund corporate governance be modified only to the extent of giving funds an exemption from shareholder voting requirements under the Act.

In its advance concept release the Commission described the West and Phillips approaches in detail and requested comment on whether these or any other changes in mutual fund governance

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1/ See speech by Stephen K. West, Esq., General Meeting of the Investment Company Institute (May 1, 1980).

2/ See Phillips, De-Regulation under the Investment Company Act --De-regulation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 Bus. Law. 903 (1982).

3/ See Investment Company Act Release No. 12888 (December 10, 1982), [Current] Fed. Sec. L. Rep. (CCH) ¶83,303.

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

are desirable. The release also called for specific comment on certain issues that would have to be resolved before either of the described approaches could be implemented, such as the timing and amount of notice of management actions which should be given to non-voting shareholders.

Assuming that participants in this Conference are all familiar with the West speech, the Phillips article and the Commission's advance concept release, I would like to focus on the following questions: (1) If the Commission were to decide that any major changes would be in the interest of investors and the public, should such changes be made administratively or legislatively? (2) Is Section 36(b) necessary to assure reasonable investment management fees? (3) Would funds switch to a UIF mode of operation if given the opportunity? (4) Would funds dispense with shareholder voting if given the opportunity? and (5) Are other approaches to mutual fund governance worth exploring? Let me share some of my present thoughts on these questions with you and bring you up to date on the views being expressed by commentators. You understand, of course, that my views are subject to change on the basis of additional information and analysis and that they do not necessarily reflect the views of other members of the Commission. Although the expiration of the comment period was recently extended from March 10th to April 18th and we expect to receive a number of additional letters, certain trends are apparent from the comments we have already received.

Should action be taken administratively or legislatively?

The Commission stated in its advance concept release that, in its preliminary judgment, the changes being considered are of such magnitude that if they are to be implemented it should be done by legislative action. Congressman John Dingell, Chairman of the Commission's House oversight committee stated in a comment letter that he "whole-heartedly agree(s)" with that judgment.

It seems to me that the decision to proceed administratively or legislatively should be a function of the precise alternative to be implemented. There is a wide divergence in the scope of suggested changes. They range from exempting only money market funds from shareholder voting requirements under the Act to creating a new UIF regulatory system without Section 36(b). I believe that implementation of the UIF approach as originally proposed by Mr. West would involve such a significant structural change that it should only be effected legislatively, even if the Commission arguably has the authority to do so by rulemaking. On the other hand, it might be feasible to use the Commission's broad exemptive authority to adopt rules conditionally exempting money market funds from federal shareholder voting requirements. In other words, it is my view that the more significant the change, the

more appropriate it would be for the Commission to recommend that it be accomplished through legislative action.

Is Section 36(b) necessary to assure reasonable management fees?

On the basis of my economics training and my experience in government, I believe that market forces are generally the best mechanism for establishing fees. It can be effectively argued that in a unitary investment fund context, subject to full disclosure and other aspects of the UIF, it is preferable for fees to be governed by such market forces rather than by what might be considered an unrealistic fiduciary duty imposed on an adviser who is essentially negotiating with itself over its fee. When the asset performance of comparable funds is similar, one would expect competitive pressures to maintain advisory fees at a reasonable level. Investors would be expected to focus on fees in the context of their impact on a fund's net rate of return and judge whether to make an initial investment or to redeem at net asset value. On the other hand, if superior asset management enables a particular fund to outperform its competition despite higher management fees, it is unlikely that the higher fees would deter people from investing or remaining in that fund.

In fact, both the Commission and the Second Circuit Court of Appeals have stated that "[c]ost reductions in the form of lower advisory fees . . . do not figure significantly in the battle for investor favor." 4/ Moreover, in response to the Commission's December release, one commentator has suggested that as competition increases, so would UIF advisory fees as funds devote a larger budget to marketing expenses. By way of analogy, this commentator notes that marketing expenses under Rule 12b-1 plans have reached as high as one percent of assets. Although this line of thought appears to ignore the fact that the sponsor of the UIF would bear all marketing costs, it is not unreasonable to suggest that as long as the marginal return from marketing activities exceeds marginal marketing costs, a sponsor would have an incentive to increase its fee.

It is also important to recognize that Congress has made judgments on this issue. In 1940, Congress made clear its view that the disclosure regulations established under the Securities Act of 1933 and the Securities Exchange Act of 1934 were not adequate protections in the investment advisory field. In 1970, Congress found that the problem of excessive

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4/ Gartenberg v. Merrill Lynch Asset Management, Inc. [Current] Fed. Sec. L. Rep. (CCH) ¶99,001 at 94,716 (2d Cir. 1982), quoting from Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) at 126.

advisory fees necessitated adoption of Section 36(b) specifically to hold investment advisers subject to a fiduciary duty regarding their fees. Thus, before eliminating Section 36(b) in the UIF context, it would be appropriate for Congress to determine that there has been a sufficient change in the industry to warrant such a basic change in its regulatory approach.

Such a determination would include an important value judgment. Because advisory fees are so small relative to net assets, a successful adviser could perhaps double or triple its fees without reducing the fund's net return to such an extent as to make it non-competitive. Congress would have to decide whether the adviser should be entitled to these larger fees which some characterize as reasonable compensation and which others deem to be a windfall profit.

Would funds switch to a UIF mode of operation if given the opportunity?

The Commission indicated in the advance concept release its belief that UIF investment managers should be held to a federal fiduciary standard with respect to compensation. Evidently, many people believe that funds would not switch to a UIF mode of operation if investment managers remain subject to Section 36(b) liability, because without the traditional defenses of shareholder and director approval of the management fee, UIFs would be particularly vulnerable to suits under that Section.

Interestingly, of the approximately 30 comment letters received thus far, only four have directly addressed Section 36(b) issues. Many didn't reach these issues apparently because they strongly oppose the elimination of boards of directors. Most of the commentators argue that directors, and particularly the independent directors, have served an indispensable function in monitoring fund operations that neither the Commission nor an independent third party could or should perform. A representative comment is that: "Boards of directors provide the best alternative among a number of imperfect alternatives to counter the self-interest of those who serve the funds as investment managers and distributors." Commentators seem to be casting a strong vote in favor of the Commission's policy during the last several years of adopting exemptive rules which ease regulatory requirements by shifting more responsibility to the board of directors. It is also my impression that this de-regulatory program is working reasonably well.

To counter the allegation made by some industry observers that boards of directors are costly, the president of Lipper Analytical Services submitted ratios of directors fees and expenses to fund assets and to total fund expenses based on November 1982 data. He found that funds with under $25 million

in assets had a directors fees and expenses to assets ratio of .078%, and that these fees and expenses accounted for 5.78% of total fund expenses. For funds with over $250 million in assets, he found a directors fees and expenses to assets ratio of only .010%, and that these costs accounted for only 1.45% of total fund expenses. Mr. Lipper concludes that although there are relatively high director cost ratios for smaller size funds, those costs appear "reasonable and justifiable because smaller funds even more than the larger ones need the breadth of perspective provided by boards of directors." Overall, Mr. Lipper believes that "the shareholder is paying an extremely small insurance premium for the perceived benefits" of having a board of directors. Mr. West indicates that the main goal of the UIF is not to eliminate the cost or inconvenience of having directors or shareholder voting, but to create a more natural and simplified pooled investment product. If the cost savings are _de minimis_, unless there are more concrete benefits of the UIF structure, there is a serious question whether the elimination of independent directors can be justified.

Would funds dispense with shareholder voting if given the opportunity?

Commentators so far have shown considerable ambivalence on whether shareholders would consider the redeemability of their shares a fair exchange for the elimination of their voting rights and on whether the costs of eliminating shareholder voting would exceed the costs of maintaining the present system.

Several commentators have expressed concern that mutual fund shareholders would not consider their right to redeem their shares at net asset value an adequate _quid pro quo_ for the extinguishment of their voting rights. These commentators note that, even if a fund is no-load, shareholders may be reluctant to redeem shares for a variety of reasons. They may believe that the net asset value of the shares is depressed or diluted; that they have been paying an unusually high fee to managers who have not yet provided a satisfactory return on investment in terms of capital appreciation or in terms of investment income; or they may simply want to avoid a taxable event.

Other commentators, however, think that mutual fund shareholders would not be disturbed by the elimination of their voting rights. Some suggest that even load funds should be permitted to eliminate shareholder voting since statistics indicate that shareholders in neither load nor no-load funds have the power to change management decisions. Others believe that load funds should be permitted to rely on exemptions from shareholder voting only if they have adopted a schedule which allows a shareholder to recapture some or all of the sales load paid depending on the length of time he has held the shares. One individual suggests that sales loads should be refunded only if the proceeds have been paid to the adviser or distributor

to cover distribution costs, excluding proceeds paid to the fund directly to cover brokerage commissions. Finally, a number of commentators feel that elimination of shareholder voting would be appropriate only in the case of funds which charge no sales loads or redemption fees.

Another issue on which opinions differ is whether the costs which would be incurred by eliminating shareholder voting would exceed the costs of complying with the present shareholder voting requirements under the Act. Several commentators point out that, although the cost of shareholder voting in dollar terms appears high, that cost expressed as a percentage of total industry assets is surprisingly low. 5/ According to information that has only recently become available, the dollar cost of mutual fund shareholder voting in 1982 can be estimated to be $14.6 million or about .0052% of total industry assets. 6/

We have not yet received data on estimated costs of re-capitalizing or re-organizing funds to take advantage of exemptions from shareholder voting requirements. Such data would be very helpful to us in our attempt to weigh potential costs and benefits. It may be that in a few states, a fund might not have to re-organize or re-capitalize to rely on such exemptions. One commentator observed that Minnesota amended its Business Corporation Act in 1981 to provide that a regular shareholder meeting need not be held unless requested by more than 3% of a company's voting securities. The Minnesota statute also provides that special shareholder meetings need not be held unless requested by more than 10% of a company's voting securities or in certain other limited circumstances, such as a proposed merger or transfer of control or dissolution. Other states may have enacted similar amendments to their corporate statutes.

In discussing the costs of relying on exemptions from shareholder voting requirements, commentators have focused on several less tangible potential costs which were not mentioned in the Commission's release. For instance, it has been suggested that elimination of shareholder voting may erode investor confidence in the industry and that there may be potential problems involved in a Congressional re-examination of investment company regulation.

Several commentators have raised additional issues which the Commission would have to consider if it decides to

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5/Lipper Directors' Analytical Data (Feb. 1983).

6/Based on $277 billion total industry assets as of June 30, 1982.

provide exemptions from shareholder voting requirements. One question is, if exemptions were conditioned upon shareholders having referendum rights, could those rights be defined by reference to state law, rather than by reference to Section 16(c) of the Investment Company Act as suggested in the advance concept release. Another consideration in fashioning referendum requirements is whether some means could or should be devised to limit access to shareholder lists in order to prevent solicitations of fund shareholders by competing banks or funds.

Are other approaches to mutual fund governance worth exploring?

Commentators have also suggested some other approaches to improving mutual fund governance which I think are worth considering. Based on the belief that directors are indispensable to fund operations, several suggestions have been made to enhance the effectiveness of directors. One suggestion is that the Commission adopt rules requiring that directors be nominated by the independent board members rather than by the adviser. A rule change could also require that the compensation of independent directors and their staffs be paid by the fund, rather than by the adviser. Another suggestion is that the Commission endorse the practice followed by many independent directors of retaining outside counsel unaffiliated with the adviser to help them in their deliberations.

In the shareholder voting area, one commentator suggests that nothing about federal shareholder voting requirements be changed except the plurality requirements. For example, management actions could be approved by 30% or more of the outstanding voting securities of the fund, rather than by 50% or more. This would obviate the need for funds to incur additional re-solicitation costs. Another suggestion is to change nothing about federal shareholder voting requirements, except to state explicitly that funds organized in trust form are not required to hold annual shareholder meetings under the Act.

Conclusion

Preliminary commentator reaction causes me to question whether there is sufficient support among investors and industry members to effect changes in mutual fund corporate governance along the lines originally envisioned by either Mr. West or Mr. Phillips. I do, however, believe that their suggestions and others we are receiving deserve careful consideration as we continue our attempt to adequately protect investors without unnecessary regulatory burdens. I look forward to the dialogue here today and the additional input any of you or other members of the industry or public can provide to improve the Commission's decision making on corporate governance for mutual funds.