NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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FOR RELEASE: Thursday, November 11, 1976, 12:30 p.m.

The Investment Company Board: Myth vs. Reality

An Address By

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ALI-ABA
Hyatt Regency
Washington, D. C.
November 11, 1976

Among the cacophony of current proposals for reforming the American business corporation, I clearly and repeatedly hear the proposition that the mutual fund board of directors should be the model for the corporate world.

Many of the reforms being urged on the directors of the business corporation must sound "old hat" to the investment company industry.

-- Many corporate boards today include only a small minority of outside directors and others are composed completely of insiders, investment company boards have been required to include a substantial percentage of outside directors for more than 35 years.

-- Outside directors in the corporate community are more often today voting separately on matters where the interest of management may not coincide with theinterest of stockholders; outside directors of funds have been doing this for years when approving the advisory and underwriting arrangements and selecting the auditors.

These, of course, are some of the reasons that the fund board of directors is often pointed to as a model. However, the fact that this Conference is being conducted confirms the proposition that in many cases the theory of the investment company board may be more worthy of emulation than the reality.

Despite the existence of federal requirements prescribing the composition of the board and the conduct of investment company directors, from my perspective, which is admittedly distant, too little attention has been given to the essential question:

> "Can we imbue the invesment company board with a truly independent character?"

It also seems possible to me at least, that federal regulation may have inhibited the development of an independent character. The '40 Act sets out a minimum percentage of independent directors for the board -- yet in too many cases the minimum has come to be regarded as the norm. The definition of an "interested" or non-independent director, while creating a safe harbor, does not encompass many "interests" such as cross-directorships or close friendships with advisers which tend to keep directors from being truly independent.

There are often a number of examples where independent directors, in practice, do not seem to be providing the monitoring function intended by the '40 Act:

-- Too often the independent directors are selected by -- and therefore are unwilling to criticize -- the adviser. Advisers often do little to make the directors aware of their duties or their liabilities as directors.

-- Counsel for the adviser is often also sole counsel to the fund with the result that vigorous inquiry and criticism by the independent directors is stifled.

-- Information provided to the independent directors is usually the product of management and of the adviser, and no resources are given to the directors to make an independent investigation.

-- For many funds, meetings are held infrequently and directors compensation is set at a figure which makes it apparent that no real work is expected.

-- Rarely do the independent directors discover wrongdoing by management; it is left to the Commission's staff and the shareholders.

I wish to emphasize strongly that these abuses are by no means universal and that the independent character which is missing on some boards is clearly present on others. We do have splendidly performing investment company boards.

But the fact that we do not see independence at work on far more boards has inhibited the work of the Commission's staff in its effort to rationalize the regulatory burdens on the investment company industry and to reduce those burdens consistent with the interest of the investor. If regulatory burdens are going to be reduced, the Commission and the industry together must take steps to create a truly independent character in the investment company board.

Some non-investment companies have voluntarily taken steps to create just such an independent character in the board:

-- A major life insurance company announced this year that its board will in the future consist entirely of outside directors, plus the chief executive officer.

-- Major corporations have established a position entitled "Officer of the Board" who may be a former officer of the company but who now devotes his full time to the work of the board.

-- Audit committees composed of outside directors are being created to monitor the performance of management, and the New York Stock Exchange Board of Directors voted last Thursday to require all listed companies to create such committees.

As we look for ways to improve the independent character of the board, we should encourage the poorly performing boards to emulate the better ones.

For example, audit type committees may be appropriate for investment companies as well as industrial corporations and many investment companies have them. Their function should not be restricted to a review of accounting matters, but should extend to independent and extensive investigations of the activities of the fund and the adviser. A separate audit committee may not be necessary for smaller funds if the outside directors periodically hold separate meetings to consult on fund matters.

Whether or not they are designated formally as an audit committee, the outside directors should consult privately with the auditors about the scope of the audit and encourage the auditors to consult with them about any questionable matters.

Larger funds might consider a full-time "officer of the board" whose principal allegiance is to the fund and the outside directors rather than the adviser.

Perhaps outside directors should act as a nominating committee to fill vacancies on the board, and it should be the outside directors who initially approach the nominee. This would reduce the automatic allegiance of many outside directors to the chief executive officer or the adviser.

Unquestionably, the outside directors should be urged to engage separate counsel for the fund, at least for some matters.

Our staff finds that counsel for the independent directors tend to thoroughly investigate and openly disclose information of importance when preparing the fund's disclosure documents. By contrast, our staff seems to believe that counsel selected by the adviser often seems to think that his client's interests require him to try to get by with as little disclosure as the staff will allow.

The point is small but critical -- do the independent directors have access to informal counsel of their own. We must also ask that the independent directors take far more interest in encouraging greater shareholder participation in the fund's decision-making processes. Some directors have literally "brought the fund to the shareholders." For example, last spring the directors of one fund -- discouraged with low turnouts at previous meetings and aware that a large number of the fund's shareholders were retired in Florida -- decided to hold the annual shareholders meeting in St. Petersburg instead of Boston.

However, this point, too, is a modest one. Mutual fund managements have too often taken the opposite approach and some have held meetings at obscure locations to escape shareholder proposals. In such cases, the independent directors should see the logic of encouraging shareholder participation to insure that shareholder democracy is a reality as a practical matter and not merely a statutory skeleton.

The capacity of the independent directors to perform depends vitally upon the flow of information from the adviser. The adviser must recognize his affirmative obligation not only to present the directors with information, but to present it in the most coherent and understandable fashion.

There are other points to be listed if not made -- should advisers, for example, establish automatic mechanisms to encourage the independent directors to meet with the staff of the advisory company and the fund. What standard procedure will cause fund employees who are subordinate to the President for operations to report to the board on all questionable matters.

And how can directors understand the value of seeking information from outside sources. In the course of reviewing the advisory and underwriting arrangements, the directors surely must consider whether there are viable alternatives --

including "internalizing" the management of the fund if the fund is large enough to make this economically feasible. Similarly, the directors cannot intelligently examine a merger proposal without considering available alternatives.

Proxy material for one group of funds this year described the search by the independent directors for a new adviser. It included solicitation of proposals from the entire securities industry, screening by a committee of the board and an in-depth evaluation by an outside consultant. Surely a variant of this procedure would be appropriate whenever the existing advisory arrangements are being reviewed.

These suggestions may only scratch the surface. Other measures to strengthen the independent character of the investment company board have, and will, emerge in the course of this Conference.

The point of my remarks is that the federal government cannot -- by regulation or by legislation -- create an independent character in the board of directors of the American corporation -- investment company or non-investment company. To this extent the proponents of federal chartering for our industrial corporations have an exaggerated view of the therapeutic powers of federal regulation. Recent cases involving investment company boards merely confirm this proposition.

The kind of independence I am referring to cannot be legislated. It is the ability to honestly question, criticize, investigate, evaluate and if necessary, turn out the existing management. The task essentially must be accomplished from within.

My message this morning is that the Commission and its staff stand ready to provide encouragement and assistance to independent directors and to funds who wish to strengthen the independent character of the board.

As we go about our task of re-examining the current regulatory framework, it will be easier for us to shift regulatory functions from the federal government to the industry if we know there is a strong independent board of directors to shoulder the responsibility.

The agenda is clear: we must make the investment company board -- in reality as well as in theory -- a model to be emulated by the corporate world at large.