IDC Independent Directors Council
Promoting Excellence in Fund Governance

Challenges Facing Funds

2004 Mutual Funds and Investment Management Conference

Keynote Address

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Good morning.

It is a privilege to address you for the 13th time in my capacity as President of the Investment Company Institute.

This annual conference has afforded me the opportunity to contribute to discussions of how mutual funds can continue to faithfully and effectively serve tens of millions of Americans. I particularly looked forward to talking with you this morning, partly because of my imminent retirement, but mostly because of the unprecedented challenges that confront every one of us.

Before I proceed with my prepared remarks, I'd like to touch briefly on something that arose in one of this morning's papers. Today's Wall Street Journal has a story you all should read.

The article suggests that, during an Institute conference call with members – the purpose of which was to discuss ways to combat suspected market timers – a participant apparently made a comment that the Journal has interpreted as an indication that some funds may have been facilitating rather than combating market timing. The article criticizes the ICI for failing to convey this information to the SEC.

Let's get to the truth.

Why did the ICI hold the call?

The purpose of this call, and many other ICI efforts like it, was to identify effective ways to restrict market timing, not facilitate it. One of the major subjects discussed during these calls was whether the ICI should ask the SEC for authority to impose additional restrictions.

What did ICI members say on the call?

Members mentioned a number of steps they had implemented to restrict market timers and prevent and deter abusive short-term trading. These steps included denying suspected market timers the ability to invest in certain funds, limiting the number of roundtrip trades, requiring suspected market timers to provide prior notice of intended transactions, and forcing investors who failed to comply with such restrictions to redeem their investments.

Whatever words members used - arrangement, restriction, limitation, method, technique, or deal - they meant the same thing. Everyone was discussing ways to protect long-term mutual fund investors from the abuses of short-term traders.

Finally, what did the ICI tell the SEC?

The ICI told the SEC everything we knew about our members arrangements to address abusive market timing. Again, all of these arrangements involved restrictions on suspected timers. Eight weeks or so after the conference call cited by the Journal, the ICI sent a draft no-action request to the SEC, asking the SEC to authorize mutual funds to delay exchanges as a way to combat abusive market timing. In the letter we sent on January 16, 2001, we stated:

“Fund groups have sought to employ a number of methods to try to deter market timing, such as imposing redemption fees, limiting frequent trading, and restricting exchange privileges.”

Bottom line: at no point during these conference call discussions did any ICI staffer or ICI member suggest or imply that market timing or market timers were being accommodated, or should be accommodated. Indeed, the entire purpose of these discussions was to find forceful and effective ways to combat abusive short-term trading.

It is sadly paradoxical, perhaps even a bit Orwellian, to see serious, sincere and consistent efforts to protect long-term shareholders by combating abusive short-term trading recast as an effort to help facilitate it.

With that said, I would like to add that it is an honor to share the assignment of opening this conference with Paul Roye, the Director of the SEC’s Division of Investment Management. Last year, I noted that Paul and his staff had completed one of the most demanding years in SEC history. Little did we know.

Today, due to the trading scandals involving mutual funds, Paul, his staff, and indeed all of us, are in the midst of the most demanding year ever.

Although I didn't know it at the time, I began responding to the scandals even before the Canary case was announced on September 3rd.

Ten days earlier, on a pleasant Saturday morning, I played tennis with a friend on a court near my home in Maryland. As we finished and left the court, two other players approached. One of the players was Eliot Spitzer, the Attorney General of the State of New York.

We had met briefly several months before. We said hello to each other. Mr. Spitzer then asked: "How are mutual funds doing?" I replied: "Fine." Mr. Spitzer then said: "Just you wait."

On the following Monday I shared the episode with some colleagues. Everyone thought the Attorney General had had a laugh at my expense.

Ten days later, the Canary investigation was announced. There has been little to laugh about since.

All of us were horrified to learn about the abuses that have been revealed. They represent a shocking betrayal of fiduciary principles. I testified before Congress in November, and I meant it when I said that:

"Government officials must identify everyone who violated the law. Those who acted willfully against the interest of fund shareholders should be sanctioned severely. Those found to have violated criminal laws should be sent to prison. The law enforcement message must be loud, tough, clear, and memorable."

While the experience is often painful and at times not without controversy, there is no doubt that the law enforcement message being sent to every mutual fund, every fund adviser, every fund distributor, every fund director, every fund lawyer and every fund shareholder has been "loud, tough, clear and memorable."

As a result of these trading abuses, our hands are full with matters that once seemed foreign to mutual funds: subpoenas, investigations, Wells notices, enforcement actions, indictments and waves of civil litigation. Due to the velocity of these events – as well as extensive Congressional hearings, a sweeping set of tough SEC rules, and enough press articles to provide a lifetime of reading – we have had little time to step back and think about basic questions, such as: What went wrong? How did we miss it?

The process of considering these questions has started in earnest. It is evident in many of the SEC's new proposals, and in intense discussions at Congressional hearings. These questions will be the

central focus of our first panel this morning. I can safely predict that they will be the subject of conferences, seminars, articles and books for years to come.

We have had little time to study these basic questions because we face so many urgent, immediate issues. Many of you have been consumed with an unprecedented volume of requests for information from state and federal officials, as well as from clients and shareholders. At the same time, many of you have conducted extensive operational reviews, and initiated a broad range of changes to your internal policies and procedures.

At the public policy level, we have been faced with analyzing and responding to a stunning number of legislative and regulatory proposals. The ideas are coming from all directions: from the SEC, Congress, industry participants, state officials, interest groups, consumer groups, consultants, columnists, editorial writers and more.

By one count, there are 106 different mutual fund reform ideas pending before Congress and various regulators. Some proposals deal with recent trading abuses. Some address areas involving potential conflicts of interest, such as soft dollars, directed brokerage and revenue sharing. Some involve new disclosures, particularly with respect to fees and expenses. Others seek to enhance the independence and effectiveness of fund directors.

We are also experiencing an unprecedented period of regulatory change at the SEC. Even before September 3, the SEC acknowledged that it was engaged in the busiest mutual fund rulemaking period in its history. As of June 2003, the SEC said 40 new rules had been adopted since 1998, an average of one new regulation every seven weeks. Since September 3, the SEC has moved even faster. Sixteen new regulatory initiatives, twelve of which are related to the trading scandals, have been adopted or proposed, an average of one new regulatory action involving mutual funds every two weeks. Under Chairman Donaldson’s leadership, the SEC is clearly undertaking the most extensive overhaul of mutual fund regulation in the Commission’s history.

The ICI has sought to be a constructive and proactive participant in the reform process. We have endorsed most of the SEC’s proposals, and have called for a series of tough reforms, including:

- a 4 pm reporting deadline to combat late trading;
- a mandatory 2 percent redemption fee to help fight abusive market timing;
- a major cutback in the use of soft dollars;
- a total ban on directed brokerage; and
- actions to prevent fund employees from abusive trading of fund shares.

It bears noting that mutual funds are not recent converts to the task of proposing initiatives to strengthen regulation. A number of recent proposals reflect approaches the ICI has long called for, some for a decade or more. These include mandating internal compliance systems and officers, and requiring point of sale disclosure of revenue sharing arrangements. A number of the proposals to strengthen fund governance incorporate best practices that the ICI Board of Governors recommended nearly six years ago.

It also bears noting that proposals that capture the headlines and dominate debates are not necessarily the ones that will end up being the most important. For example, I personally believe that the SEC's new compliance rule will produce the greatest benefits for fund investors.

Most knowledgeable observers believe that reforms should be made in many key areas of mutual fund operations. I agree. But as one would expect when considering complex issues, there often is wide disagreement on the precise nature of needed reforms. On many issues, policymakers disagree among themselves. Different industry critics have proposed quite different solutions.

I suggest that we, and by "we" I mean all of us — fund officials, legal counsel, directors, policymakers, journalists, third party experts, critics, and ICI staff — evaluate each proposal, whatever its source, by one standard and one standard alone: Is the proposal likely to advance the interests of long-term mutual fund shareholders?

This standard won't settle every difference of opinion. But I am convinced that it will eliminate some differences, and shrink many others, all to the benefit of the millions of mutual fund investors, who depend on our judgment, wisdom and commitment.

The precise elements of the final package of SEC regulatory reforms remain unclear. Whether legislation will be enacted to supplement the new rules is even more uncertain.

Despite open questions about the details, I believe it is crystal clear that Congress and the SEC share the common goal of ensuring that mutual fund oversight, regulation and enforcement are improved and strengthened in a way that better serves fund shareholders.

Several recent actions cause me to feel optimistic that we are well along in the process of achieving this objective.

- First, despite the crisis atmosphere, the SEC's numerous rule proposals generally have been well thought out. And the Commission has expressed a willingness to adjust its proposals to address issues and alternative approaches raised by commentators.
- Second, Congress — initially the House Financial Services Committee and now the Senate Banking Committee — has conducted an exhaustive series of hearings, and examined an exceptional

number of issues involving the management, operation and regulation of mutual funds.

- Third, overall, investors have continued to make new investments in mutual funds. At the same time, investors have withdrawn money from some of the funds subject to investigations. The free marketplace is a most forceful regulator.
- Fourth, individual fund groups have stepped up quickly and forcefully. Senior executives and others implicated in the abuses have been fired, business practices have been scrutinized by independent third parties, internal policies and procedures have been overhauled, restitution to shareholders has been pledged, and potential problems have been voluntarily disclosed to government officials.

While the ongoing reform process is difficult, and the final results are yet unclear, at this point I am hopeful of a successful outcome, an outcome that will benefit our shareholders, and thus our industry.

My hope is that we will be able to replicate the success of the generation that produced the Investment Company Act of 1940. In 1941, Leslie Gould, a leading financial journalist of the time, wrote:

“[This] shows what can be done, if there is unity and intelligence applied to a problem. The [investment company] people got together and worked out with the SEC and Congress, after a very difficult and trying initial experience, a regulatory law …The [investment companies] are the one section of the financial business that have come out of Washington with their shirt intact.”

But having expressed my optimism, I confess that, over the years, I have earned the reputation of a worrywart. It seems only appropriate that I share with you my two principal concerns.

First, I worry that in the understandable urge to stamp out abuse and implement reform, measures may be adopted that may inadvertently, but substantially, harm fund investors.

For example, some have proposed that mutual fund portfolio managers be required to disclose their annual compensation, and be prevented from managing hedge funds. It is easy to see what is intended, but there is little evidence to suggest that such requirements would achieve their objectives. At the same time, because the proposals apply only to mutual fund managers - and not to those who manage pension funds, separately managed accounts, hedge funds or other investment products - it is clearly foreseeable that skilled mutual fund portfolio managers will choose to work in other areas of money management that have far fewer legal restrictions and regulatory requirements.

This is just one example of an area where well-intended policy changes would likely produce much more harm than good. There are others. They range from requiring mutual funds to obtain pre-approval from the SEC with respect to any new fee that would pay for a new shareholder service; to requiring that fund advisory contracts be put out to bid each year; to creating a new “cost-plus” standard for approval of advisory contracts by fund directors.

I acknowledge that these are among the more extreme of the 100+ proposals that have been suggested. And I certainly recognize that the harm that has recently been done to fund investors did not occur because of public policies. Far from it.

Nevertheless, I fear that if proposals like those I just described were adopted, they would weaken rather than strengthen mutual funds, and thus hurt, rather than help, fund shareholders. The risk of a brain drain in our business is real, not fanciful. Some of the best and brightest have already left the mutual fund industry for more lucrative forms of money management. With more disincentives, the pace of these departures would surely accelerate. Likewise, it is plausible that some money management firms would exit the mutual fund business to focus on other types of asset management that are not subject to such onerous requirements. These same onerous controls could also result in fewer new firms entering the mutual fund industry. That would be particularly regrettable, since many of the most innovative fund products and services, such as money market funds, were developed by new entrants.

We must work hard to ensure that needed reforms do not make us less entrepreneurial, less competitive, less creative and less responsive to investors' evolving needs.

As I have said today and on many other occasions, we have an obligation to support proposals that will benefit fund shareholders. But we are under an equal obligation to oppose proposals, such as those I have just outlined, which would be harmful to fund shareholders.

My second concern is even more serious, and carries even more ominous implications. It is not related to whether new public policies are or are not effective. It is related to a single fundamental mistake we may make that could render even the best reforms less effective.

In our eagerness to show strong support for tough new rules that will effectively combat abuses and benefit fund shareholders, we could still miss the forest for the trees. What I mean by this is that protecting the interests of investors requires much more than adherence to a set of rules, nor matter how tough they may be. Whatever the new rules specific requirements, the key to our future is whether all our future actions meet one standard, and one standard alone—whether it served the long-term interests of fund shareholders.

Kathie McGrath, a former Director of the SEC's Division of Investment Management, said it well in a recent New York Times interview:

"More rules don't necessarily make for better results. Each new rule proposal, each legislative proposal standing alone, seems to have a good idea behind it. But I worry that the cumulative effect … is going to impair the ability of people in the business to sit back and think about whether what they're doing is right."

I would remind this audience in particular that lawyers play a critical role in telling their clients what is right, not just what is legal. As my predecessor, Dave Silver, stated when he addressed this conference in 1991: “We should advise our clients to pursue their long term interests rather than looking for the fast buck. We are counselors, not mouthpieces.”

Or as another distinguished attorney and great American statesman, Elihu Root, told us more than a century ago: “About half the practice of a decent lawyer is telling his clients that they are damned fools and should stop.”

We must support new rules and policy initiatives that will benefit fund shareholders. But we also must keep a constant eye on what mutual fund companies are doing, whether they are our employers, clients or members. If what they are doing is wrong, we must tell them, in no uncertain terms, to stop. This is true even if what they are doing is technically legal. Indeed, those may be the situations in which our advice is most important. The bottom line is that our actions must always be guided by strict fiduciary principles. We should always ask not only whether something is legal, but also whether it is the right thing to do for fund shareholders.

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This is my last address to you as President of the Investment Company Institute. Last May, I advised a committee of the Institute’s Board of Governors that I planned to retire in 2004. The Board recently named Paul Stevens as the ICI’s new President, beginning June 1. I have known Paul for many years. In fact, in 1993, I hired him as the ICI’s General Counsel. He served in that position, and in other positions in government and the private sector, with distinction and honor. I cannot think of a better qualified person to lead the Institute in the years ahead. I ask all of you to assist Paul in every way possible.

Paul’s arrival is not the only significant change at the Institute. Craig Tyle, the Institute’s General Counsel for the past eight years, recently left the ICI for private practice. Paul Stevens and I can vouch for the fact that Craig is a truly outstanding human being, and a brilliant lawyer, whose work has benefited tens of millions of American investors.

I have had a wonderful career representing mutual funds in Washington over the past 33 years. The policy issues have been important and intellectually challenging. But what I value most are you: the remarkable people I have had the opportunity to work with and learn from. I am blessed to have hundreds of friends and colleagues in this room, and in this industry, who share my passionate belief in mutual funds. You are the resource that ensures we will learn from our current challenges. You are the reason I am confident that we will achieve many great things for fund shareholders in the years to come.

Napoleon once observed that “Those who failed to oppose me, who readily agreed with me, accepted all my views, and yielded easily to my opinions … were my worst enemies.”

Based on Napoleon’s test, I have few enemies in the audience.

You challenged me when you believed I was wrong.

You supported me when you believed I was right.

You advised me when I needed help.

You inspired me when I needed direction.

For all that, and for your friendship, I thank you, from the bottom of my heart.

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