Independent Directors Council
Promoting Excellence in Fund Governance

2004 General Membership Meeting: First Principles

"First Principles": ICI Chairman's Remarks at the ICI 2004 General Membership Meeting

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Good morning.

It is a pleasure to welcome you to the Investment Company Institute's annual General Membership Meeting.

Before we get things rolling this morning, let me express thanks to the ICI staff and the GMM Planning Committee who worked long hours to put this meeting together. They have developed an outstanding program. Tom Simmons and Jane Forsythe from the ICI deserve to be specially commended for making this all run so smoothly. And let me also express my appreciation to Larry Maffia, who could not join us in person today, but whose annual efforts have been instrumental to the meeting's success.

Each year, the Institute's General Membership Meeting affords mutual fund industry leaders an important opportunity. We are able to put daily tasks to one side so that we can reflect on where we have been and where we are going. This is always a valuable part of the GMM's agenda. This year it is both valuable and essential.

Sixty years ago, at a time when Great Britain's future was far from clear, Winston Churchill said, "the farther back you can look, the farther forward you are likely to see."

As I look forward, I see many reasons to be optimistic and excited about the prospects for mutual funds and fund investors. All of us hope our darkest days have passed. Even if that is true, however, it is obvious that we will be dealing with the aftermath of the scandal for some time to come.

Something else is obvious too. If the discovery of abuses within our own industry did not teach us important lessons about our responsibilities to fund investors, then — even as cases are concluded and investigations resolved — the scandal will not really have ended. As Abraham Lincoln said, "my great concern is not whether you have failed, but whether you are content with your failure."

If one were to predict the future for mutual funds with nothing but the recent investigations in mind, the forecast would be grim. The abuses discovered last September — abuses that are anathema to everything mutual funds represent — were rightly viewed as an outrage. Senior officials at some fund companies admitted they exploited the trust of individual investors. A few acknowledged criminal acts; others admitted to civil frauds, serious ethical transgressions and egregious management failures. For several months, the scandal was near-constant front-page news. While questions can certainly be raised about the fairness of criticizing the many for the actions of the few, there can be no quarrel about one thing: collectively, we have no one to blame but ourselves for triggering the notoriety we received and the criticism we heard.

The future of mutual funds will be determined not just by our embrace of reforms to combat recently discovered abuses, though these reforms are of great importance. Rather, our future will be determined by our renewed commitment to the fundamental, time-tested fiduciary principles we forged and committed ourselves to in the six decades before last September.

This is an especially important point. Unfortunately, it is also quite easy to overlook. Think about it: the trading abuses were shocking and produced dramatic headlines largely because the allegations departed so dramatically from the record of integrity and fair dealing mutual funds built and sustained successfully for so many years.

At last year's GMM, I mentioned that mutual funds had, for more than sixty years, been largely free of major scandal. I also spoke at length about the meeting's theme, which focused on our efforts to carry on the fund industry's tradition of integrity. Regrettably, some believed my comments to be boasts, and, particularly in the weeks after last September 3, cited them as evidence of hubris. But my actual intent was to remind you — the current and future leaders of the nation's mutual funds — to recognize the enormous importance and great rewards of serving fund shareholders faithfully. Throughout the year, the ICI tries to show that integrity, investor confidence, and long-term success are inextricably linked: if you lose one, you lose them all. Paradoxically, the repercussions that followed in the wake of the abuses are compelling proof of that point. The value of an unblemished reputation is undoubtedly better appreciated now, as are the extraordinary costs that follow if you lose it.

Here in Washington, much of our energy has focused on the huge number of mutual fund reforms recently proposed by legislators, regulators and other interested parties. Former Senator Bill Armstrong, who is an independent director at Oppenheimer in Denver, identified 106 specific proposals, and several more have been suggested since he drafted his list. As The Wall Street Journal observed last month, "fund cops aren't just throwing the rule book at [mutual funds], regulators are rewriting it too."

Many of you already know a considerable amount about the mutual fund reforms proposed or under consideration by the SEC, so I will not review that long list here. Through the ICI's excellent work, the mutual fund industry has expressed its strong support for the overwhelming majority of the SEC's proposed reforms. In the few instances where we have disagreed with the Commission, our arguments have been carefully presented, and we are confident they will be fairly considered. Notwithstanding these disagreements, the fact is that we agree with the SEC about so much of their mutual fund regulatory reform plan. In my view, this demonstrates our continuing commitment to the legal and ethical principles that led millions of investors to trust mutual funds for more than sixty years.

Understandably, we must devote most of our attention and energy to the immense, immediate demands of the current reform effort. But we must also be aware that such single-minded focus carries risks of its own. To paraphrase a well-known expression, we must not let attending to the urgent result in neglecting the important.

I would like to spend a few of my remaining minutes this morning talking about something that is both important and urgent. I want to discuss some "first principles": core values that are — and must always be — essential parts of the business of mutual funds. I will describe four of them, but I could easily have stopped after the first. Because if we don't follow the first principle, none of the others will matter.

The first principle is that mutual fund managers must always put the interests of fund shareholders ahead of everything else, including the managers' own interests. Simply stated, if managers do not put their shareholders first, mutual funds will no longer be the investment of choice for 91 million Americans. And we will no longer deserve to be.

The second principle is our support for strong independent mutual fund governance. In light of its importance, we must vigilantly protect the independence and effectiveness of the fund governance system. Fortunately, I believe the Institute has done an excellent job in working to reinforce and enhance the oversight role of independent mutual fund directors.

- In 1999, the Institute adopted what one corporate governance advocate called "a far-reaching" and "leading edge" set of best practices for mutual fund directors. Three years later, The Boston Globe said the ICI report "reads like a blueprint for the guidelines publicly traded companies are only now being urged to follow."
- In both 2001 and 2004, the Institute endorsed the vast majority of fund governance reforms proposed by the SEC. The 2001 reforms have now been successfully implemented, including the requirements that independent directors nominate their own successors and that fund boards use

only independent legal counsel.
- Just last week, a new Independent Directors Council was launched within the ICI, chaired by Jim Bodurtha, the lead independent director at Merrill Lynch. Jim has also joined the Executive Committee of the Institute's Board of Governors. The Independent Directors Council is designed to deepen and expand the ICI's current programs for fund directors. It enjoys my enthusiastic support, and was strongly endorsed by the ICI Board. In the next few months, the Council will focus on enhancing the voice of independent directors with respect to key public policy issues, developing professional and educational advancement opportunities for fund directors, and increasing communications among directors.

The third principle is that we must continue to support tough, effective mutual fund regulation.

For more than ten years, the Institute has strongly urged Congress to provide the SEC with all the resources it needs fulfill its mission. Of course, a substantially increased budget is not enough, by itself, to ensure that the SEC will be able to do its job effectively and insightfully. We must therefore be willing to help the SEC in other ways, whether by suggesting initiatives to the SEC's regulatory staff, or by helping the Commission's new risk assessment teams "see around corners" by identifying potential problems and vulnerabilities that could pose future risks to investors.

Finally, we must recognize our responsibility to step up to help the SEC and other regulators ensure that rules and regulations are working effectively on behalf of fund shareholders. The SEC recently adopted sweeping new rules requiring mutual funds to have formal compliance mechanisms, including a chief compliance officer who reports to the fund's board of directors.

Our commitment to strong regulation and effective compliance is an important and longstanding principle. But we must be mindful that government regulation has inherent limitations. Even with across-the-board support from everyone involved, no regulatory system is perfect. It's neither reasonable nor realistic to expect regulatory requirements to prevent every problem. Last year, Fed Chairman Alan Greenspan stated it concisely:

"rules cannot substitute for character. Even when followed to the letter, rules guide only a small number of the day-to-day decisions required of management. The rest are governed by whatever personal code of values [we] bring to the table."

Chairman Donaldson made a similar point in a speech to the NASD last week:

"Our rules never have been enough, are not today enough, and never will be enough. What's really needed is a change in mindset — one that fosters not only a 'culture of compliance' but also a company-wide environment that fosters ethical behavior and decision-making."

The fourth and final principle requires us to value and support rigorous scrutiny of mutual funds by journalists, academic and third party experts and other commentators. In part because mutual funds are so transparent and information so readily available, funds have received extraordinary attention in the media and in academic journals. In a competitive and democratic society, this is something to be celebrated rather than lamented. Lucid, thoughtful, and informed reporting will often show in sharp relief the strengths and advantages of mutual funds relative to most other investments.

At this meeting last year, I also spoke about the importance of informed criticism, an observation of which I've been frequently reminded. If anything, I think the point is more important today than it was then. A point I did not make last year should also be kept in mind, however. We bear ultimate responsibility for our actions and the consequences that flow from them. In that sense, we are obliged to be our own toughest regulator and our own toughest critic. We can and should support rigorous scrutiny by expert regulators and informed critics, but their existence can never be allowed to obviate or minimize our own profound obligation for continued self-examination.

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I began my remarks this morning by noting that the GMM affords mutual fund leaders an opportunity to reflect on where we have been and where we are going. Those who lead the ICI also have a chance to look back and to look ahead. This year, a look in either direction gives us much to think about.

Ten months ago, we began searching for a new leader for the ICI because we failed to persuade the old one to postpone his planned retirement for a fourth time. As many of you know, Matt Fink, the longest tenured employee in the ICI's history, will step down as the Institute's President at the end of next week.

Matt has provided more than 33 years of exemplary service to mutual funds. At his retirement dinner — let me correct that — at one of his retirement dinners, I roasted Matt for his incessant worrying and addiction to tortured metaphors. But there is a reason we asked Matt on so many separate occasions to forego his right to retire and to continue to lead the ICI. As Ralph Waldo Emerson wrote, "Every great institution is the lengthened shadow of a single man. His character determines the character of the organization."

Matt's character is what led him to champion the highest standard — of doing what was best for best for fund shareholders — even when that was neither the easy nor popular course.

Matt's character is what led him, last September, to tell us that we had to own the issues raised by the trading abuses, not just figure out how to put them behind us quickly. Matt told us that he was appalled and disappointed in us, which was just what was needed.

I am convinced that Matt's 33 years of accomplishment and commitment to the highest ethical and intellectual standards has done more than serve the interests of mutual funds and their shareholders. I think it has infused the Institute with a character much like his. It doesn't seem to matter what's on your mind when you travel to the ICI; when you pass into the offices, parochial concerns seem to fall away automatically. The industry's common interest in reinforcing confidence in mutual funds, enhancing the protections afforded by tough and effective regulation, and serving the collective needs of individual investors, seems to take hold of all of us. Matt, we know this is no accident. We also know that is a great legacy and a marvelous gift. We will do everything we can to live up to this legacy and not let you down in the months and years to come.

Thank you, and enjoy the rest of the meeting.
