

MEMO# 17731

July 1, 2004

REMARKS BY INSTITUTE PRESIDENT, SEC OFFICIAL AT MUTUAL FUND COMPLIANCE PROGRAMS CONFERENCE

[17731] July 1, 2004 TO: BOARD OF GOVERNORS No. 47-04 CEOS CLOSED-END INVESTMENT COMPANY MEMBERS No. 45-04 COMPLIANCE ADVISORY COMMITTEE No. 68-04 INVESTMENT COMPANY DIRECTORS No. 33-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 66-04 SEC RULES MEMBERS No. 95-04 SMALL FUNDS MEMBERS No. 75-04 UNIT INVESTMENT TRUST MEMBERS No. 28-04 RE: REMARKS BY INSTITUTE PRESIDENT, SEC OFFICIAL AT MUTUAL FUND COMPLIANCE PROGRAMS CONFERENCE On June 28, Institute President Paul Stevens delivered the opening remarks at the 2004 Mutual Fund Compliance Programs Conference, which was sponsored jointly by the Institute and the Independent Directors Council ("IDC"). Lori A. Richards, Director of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") prepared the luncheon address. Their remarks are briefly summarized below.¹ Remarks by Mr. Stevens Mr. Stevens began by applauding the IDC, a dedicated forum for independent directors within the Institute. He stated that the IDC, acting through its education, policy, and communications committees, will engage fund directors on an array of issues affecting both mutual funds and their shareholders. Mr. Stevens observed that the conference is the first of many such programs to inform and assist fund boards, and he offered his strong support to the IDC as it develops its programs in the months and years ahead. The subjects to be addressed at the conference, said Mr. Stevens, "concern, most fundamentally, how to build a system of compliance that helps sustain a culture of ethical conduct." He indicated that the conference is part of an effort to ensure that the kinds of abuses involving mutual funds that have been uncovered since last September never happen again. ¹ A copy of Mr. Stevens' remarks, "Toward Sustaining a Culture of Ethical Conduct - Implementing the New SEC Compliance Rule," is available on the Institute's website at http://www.ici.org/new/04_cpc_stevens_spch.html. Ms. Richards' speech, "The New Compliance Rule: An Opportunity for Change," is available on the SEC's website at <http://www.sec.gov/news/speech/spch063004lar.htm>. ² Turning to the mutual fund compliance rule, Mr. Stevens remarked that it is one of many new mutual fund rules that the SEC has proposed or adopted to address the violations of law and abuses of trust that have come to light, and he expressed the Institute's strong support for these broad-based reforms. He opined that, of these important rulemakings, the compliance rule might have the greatest long-term impact, both because of its broad scope and the fact that it seeks to assure that fund boards are fully informed on compliance matters. Mr. Stevens also stated that the rule will facilitate a more "risk-based" approach to SEC inspections, which hopefully will result in greater efficiencies for the SEC staff and funds alike. Mr. Stevens highlighted the fact that the compliance rule imposes additional, specific responsibilities for

fund directors with respect to oversight of a fund's compliance program. He noted that other reforms by the SEC, including the fund governance proposals adopted last week, likewise focus on the role and responsibilities of fund boards. With respect to the new requirement that fund boards must have independent chairs, Mr. Stevens observed that the Institute was "pro-choice," in that it had recommended that the SEC allow independent directors to decide the question independently. He remarked that this requirement had been the subject of intense debate and that "the vote at the [SEC] itself demonstrates that this is a subject about which reasonable people, all intent on advancing the interests of fund investors, can disagree." Now that the SEC has ruled on the issue, said Mr. Stevens, the Institute will assist mutual funds in fully and effectively implementing all of the new governance proposals. Mr. Stevens emphasized that the Institute's support for strong fund compliance programs is not new. In fact, he said, the Institute proposed to the SEC that it adopt a compliance rule for funds ten years ago, when the fund industry was growing much faster than the SEC's ability to oversee it. The Institute concluded that one way to address the growing gap was to assure that each mutual fund had an internal compliance system meeting certain basic requirements – including many of the specific provisions that the SEC now has adopted in its rules. Adoption of the compliance rule, said Mr. Stevens, provides a unique and valuable opportunity for the industry to reassess the adequacy of compliance policies and procedures, to establish even more effective ways of identifying and addressing compliance issues, and to fashion new working relationships to promote compliance. He urged that the industry take the fullest advantage of this opportunity and, in so doing, maintain and enlarge the broader fiduciary culture on which the industry's success ultimately depends. Mr. Stevens stated that the Institute has been discussing with members how it can assist them in fully realizing the potential of the compliance rule. He announced that the Institute expects to create a new standing committee comprised of Chief Compliance Officers ("CCOs"), which will provide them the opportunity to share perspectives on the compliance challenges they face and to expand their knowledge. Mr. Stevens said that the Institute also plans to provide guidance on compliance issues by publishing white papers in areas of special concern identified by members. He stressed that, in these and other ways, the Institute will do its part to support the compliance regime that the SEC has now prescribed for funds and advisers. In closing, Mr. Stevens observed that if the mutual fund industry is to sustain the trust of investors, industry participants must rededicate themselves to fulfilling their obligations as 3 fiduciaries, and that a vigorous and successful compliance program is an essential part of this proposition.

Remarks by Ms. Richards² Ms. Richards' remarks began by responding to criticism in the press and elsewhere that the SEC has been overreacting to the mutual fund scandal. From her perspective as an examiner, Ms. Richards believes that the fund reforms that the SEC has proposed and adopted are "clearly called for by recent experiences." With regard to the more fundamental question of why the wrongdoing occurred, Ms. Richards opined that it was rooted in a shift in philosophy toward a fund firm's bottom line and away from putting the investor first. In her view, this shift signals the need not only for aggressive enforcement actions and specific rules to prevent and detect the specific misconduct already identified, but also "to think about how to prevent the next type of fiduciary breach, by reorienting fund groups to their fiduciary obligations to serve the needs of investors first and foremost." Ms. Richards' remarks noted that regulators can help advisers to establish a "culture of compliance" by ensuring that firms have adequate internal controls. In her view, the SEC's adoption of the compliance rule will help to ensure that fund organizations "shore up their infrastructure of checks and balances." She cautioned that firms viewing the rule as "just another compliance obligation" will fail to seize the opportunity it presents and that the likely result will be "vulnerability to the next form of abuse and securities laws' violations." Ms. Richards' remarks advised that firms should use this opportunity to: (1)

question past practices, including those that are technically legal but may not be ethical; (2) identify actual or potential conflicts of interest; (3) engage in dialogue with all business units and service providers about their activities; (4) review disclosures to clients; (5) inventory the firm's obligations under the securities laws and its disclosures; (6) match the inventory to the firm's policies, procedures, and controls, and throw out those that do not serve; (7) adopt new policies and test them; and (8) educate employees on conflicts, the culture of the firm, and their responsibilities within the firm. With regard to the requirement that each fund appoint a CCO, Ms. Richards' remarks indicated that the SEC will look to the CCO as its ally, as it already does with a fund's independent auditors and its board of directors, particularly the independent directors. She noted that the SEC's examination process likely will begin with a discussion with the CCO and will have as its goal an assessment of whether "the compliance program as a whole is effective in light of the fund it serves." Ms. Richards' remarks cautioned that firms should not assume that the CCO should be part of a firm's legal department or report through its General Counsel, because intertwining corporate legal duties and the duties of the CCO may create conflicts in the implementation and examination of the compliance program. She noted that routine compliance monitoring is not subject to attorney-client privilege and that all reports under the federal securities laws (including the CCO's reports to the fund board) must be made available to the SEC staff for examination. As for "outsourcing" the CCO function, Ms. Richards is "wary about whether a compliance 'rent a cop' could really be up to the task" of administering an effective compliance program. With respect to CCO compensation, Ms. Richards opined that it should be structured to "reinforce or incentivize the objectivity of the CCO, and to motivate her 2 John Walsh, Chief Counsel, OCIE, delivered Ms. Richards' remarks on her behalf. 4 to perform her responsibilities." Finally, her remarks reminded firms to provide their CCOs with the resources necessary to do the job well, observing that "while compliance is not a profit center, lapses can cost an enormous amount." With regard to the adoption of comprehensive compliance policies and procedures, in Ms. Richards' view, the SEC realizes the process will evolve as the industry progresses toward best practices, but it expects that process to be "dynamic, proactive, and innovative." As for the requirement that the CCO report at least annually to the fund board on the operation of the compliance program, Ms. Richards' remarks indicated that SEC examiners will expect to see these annual reports, as well as copies of all briefing materials presented to the board in connection with its review of the compliance policies and procedures and a "cogent summary" of the board's deliberation process. Her remarks noted that the compliance rule does not preclude more frequent reporting by the CCO to the board and stressed that a dynamic compliance program must be subject to continual assessment and reassessment, particularly in light of new risks. Ms. Richards' remarks also discussed the requirement in the rule that a fund board must approve the policies and procedures of the fund's service providers, noting that the SEC's adopting release makes it clear that the board may fulfill its obligation by reviewing summaries of the providers' compliance programs that were prepared by the CCO or others. She suggested that, in order to ensure that the board is fully informed of "changes that may affect its views of service providers," the board could direct the CCO to conduct a periodic review of the service provider's program in light of changes that may affect risks to the fund. In closing, Ms. Richards' remarks noted that SEC examiners will be asking the following questions once firms are required to be in compliance with the new rule: Has there been an honest effort on the part of all parties to establish an effective compliance program? Has the CCO diligently and intelligently administered that program? Is the program being reviewed and updated frequently in light of the nature of the firm's business and the risks it faces? Has the firm created a vibrant culture of compliance? Her remarks emphasized that fund firms must set a "clear and unwavering tone that, as fiduciaries, you not only know what must be done but that you are

putting every effort into doing it and doing it the right way, in the best interests of investors.” Rachel H. Graham Assistant Counsel

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