

## **SPEECH**

December 15, 2004

# **ICI President Speaks at Exchequer Club of Washington, DC**

Exchequer Club of Washington D.C.

## **Remarks of Paul Schott Stevens President, Investment Company Institute**

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It is an honor to have this opportunity to speak to the Exchequer Club, with its tradition of interest in matters of national economic and financial policy. There is a German proverb that goes, "Speak little, speak truth; spend little, pay cash." Before this expert audience I am best advised to make my remarks brief. Still, I would like to offer some thoughts on these challenging times for mutual funds and for us at ICI.

I became President of the Investment Company Institute in June – about nine months after Attorney General Spitzer announced his settlement with Canary Capital Partners. This event signaled a season of governmental inquiry more intensive and wide-ranging than any in the modern history of the mutual fund business.

Between September 2003 and April 2004, Congressional committees conducted 15 oversight hearings – 10 in the Senate Banking Committee alone. Numerous legislative proposals were introduced – two emerged from the House Financial Services Committee; one passed the House with only two dissenting votes.

The SEC's sustained regulatory attention to mutual fund issues likewise has no recent precedent. SEC Chairman William Donaldson has observed that the last two years have "been the most active period in the agency's 70-year history." Of the 37 substantive new rules adopted by the Commission during this period, 14 directly address mutual funds and another 11 extend to mutual funds as well as other regulated entities.

Public scrutiny increased markedly as well. By our count, the New York Times, Wall Street Journal, Washington Post and USA Today published almost three times as many stories on mutual funds in the 12 months following the Canary settlement as compared to the prior year.

Not all or even most fund companies were involved in the trading misconduct at the core of the recent inquiries. But enough funds were implicated – not to mention broker-dealers, other intermediaries, and hedge fund advisers – to hazard the hard-earned reputation of our entire industry and with it the confidence of our shareholders. The response of mutual fund leaders was prompt and straightforward: those who violated the law should be held to account; shareholders should bear no financial loss; the SEC should adopt regulations necessary to prevent such misconduct in future; and industry participants should move quickly to implement new policies and procedures for this purpose.

The response of fund investors is noteworthy as well. The Institute recently released the [results of our tracking surveys](#), conducted over the past eight years, concerning mutual fund shareholders' views of fund companies. Our 2004 survey confirmed that the trading abuses and the recent bear market took a toll, but fund shareholders retain a very high level of confidence in mutual fund companies: 72 percent of shareholders surveyed said they had either a "very" or "somewhat" favorable impression of fund companies. One tangible measure of this continuing confidence is new dollars entrusted to fund companies to manage. For 2004, we estimate net new cash flow to long-term mutual funds will be over \$200 billion – a level that matches or exceeds that of each of the past five years.

These facts are reassuring, but they are not reasons for complacency. A central object lesson of the trading scandal is that reputation matters in the mutual fund marketplace. Fund companies compete on many levels, and investor confidence is one of them. Lost confidence can and will exact a high price. Mutual fund shares are redeemable daily, and our investors can and do "vote with their feet." This is a powerful regulator in its own right.

By any measure, the fund trading scandal has been a significant event in the history of our industry. We are likely to be considering its implications for some time to come. There are three areas in particular I might comment on this afternoon: first, the importance of an effective SEC; second, the respective roles of federal and state government; and, finally, the role of a trade association.

## **The Importance of an Effective SEC**

Fully 11 years ago, ICI first related to the Congress its concerns that the SEC's ability to oversee mutual funds was at risk because the dramatic growth of funds was outstripping the Commission's resources. This call – to maintain the "regulatory excellence" for which the SEC was known – is one that ICI leaders would sound repeatedly in the years that followed.

During this same period, mutual funds and the capital markets generally have grown and evolved at a remarkable rate. Consider today's trading volumes on domestic and international markets, the extent of cross-border investment activity, the widespread use of derivatives and other new types of securities, the growth of hedge funds, and the number of investment advisory firms, just by way of example. Consider the new missions entrusted to the SEC such as consumer privacy and anti-money laundering regulation, and the daunting challenge of functionally regulating activities of global institutions engaged in financial services of all types. Closer to home for us, and in light of recent regulatory concerns, consider the complex interface between more than 8,000 mutual funds and the many kinds of intermediaries that help make fund investing possible for over 90 million shareholders.

Belatedly, the SEC has been provided resources that would appear at least more adequate to the challenges before it. As SEC Chairman Donaldson has recognized, however,

resources alone are not the answer. The larger challenge is for the SEC to assure not only the reach but also the effectiveness of its regulatory and law enforcement efforts. In this context, effectiveness is not readily measurable by in-puts (the number of new employees), nor even by the traditional out-puts (new rules, enforcement actions, studies and the like). It may be found, instead, in regulatory guidance that better anticipates issues; in closer integration of the activities of different SEC divisions and offices; in new inspection strategies; in new uses of technology; in better understanding of business operations; in empirical research that informs major rulemakings, and in scandals and enforcement actions, well, that do not happen.

To his great credit, Chairman Donaldson recognizes that "internal reform" is an imperative not only for those the SEC regulates. In September of this year, he remarked "[a] top priority for me upon arriving at the SEC was ... improving the performance of the SEC itself."

Every public company, every securities firm, certainly every mutual fund organization, has an enormous interest in a successful SEC. As someone who has been both deeply involved in federal department and agency management issues and an observer of the SEC over many years, I believe the improvements Chairman Donaldson has charted are on-target but they will not come easily or immediately – significant changes in an organization never do. But he and the Commission deserve our strong, continuing support as they work toward this objective.

## **The Roles of Federal and State Governments in Protecting Fund Investors**

Today, any discussion of oversight of mutual funds, and the financial services industry, soon turns to the relationship between federal and state governments. The oversight structure for mutual funds is relatively new and it calls upon federal and state governments to work together.

This policy for shared federal-state oversight of mutual funds is one that Congress adopted in the National Securities Markets Improvement Act of 1996 (NSMIA). In NSMIA, Congress determined that the SEC alone should regulate mutual funds, but the states should retain certain anti-fraud investigative and enforcement powers. Congress came to this judgment in light of the national market in which funds operate and their economic importance. Clearly, Congress was aware that states might be tempted to use their retained enforcement powers in a manner tantamount to regulation. For this reason, Congress directed the states to exercise such powers in a manner "consistent with" the broad pre-emptive policy of the Act.

The fund trading scandal has tested the structure established in NSMIA. How has it fared? I recently [addressed the Conference of Western Attorneys General](#) on this issue. I observed that both state and federal law enforcement officials have acted promptly to identify and address misconduct. State officials have wielded their remedial, "anti-fraud" authority to protect mutual fund investors in their jurisdictions. At the same time, the SEC has exercised its prescriptive, regulatory authority to impose new, comprehensive national standards on mutual funds in response to the scandal.

By and large, then, the system has worked as Congress designed. Could it work better? Probably yes. In my judgment, close cooperation and consultation between the SEC and the states will best serve the investing public. Law enforcement should not be approached as a competitive exercise, nor conducted by one level of government at the expense of another.

The states should scrupulously defer to the SEC's judgments on regulatory policy, including disclosure requirements. These propositions, it seems to me, are all part and parcel of what Congress had in mind in NSMIA.

## **A Trade Association's Role in Encouraging Ethical Conduct**

The bylaws of the Institute entrust to us a mission of encouraging adherence to high ethical standards by all participants in the investment company industry. This has never seemed more important than in the aftermath of the trading scandal. Of all the problems brought to light in the recent investigations, most disturbing was the venal conduct of some fund company executives who acted to benefit themselves at the expense of their shareholders and in clear breach of their fiduciary obligations.

How can a trade association help its members on an issue of this nature? This is a question I pondered even before becoming President of ICI. Financial institutions, because they are so extensively regulated, are given to thinking in terms of "compliance" or "risk management" — not "ethics." They develop compliance policies and procedures and train their workforces to implement and adhere to them. For many years, the Institute has assisted its mutual fund members in this process through our committees, conferences and the like.

By contrast, "ethics" is a less comfortable term — and a more powerful one. Ethics is something that resides in a culture or ethos, not a policy or procedure. It is an incident or consequence of sound and effective leadership, not an outgrowth of training. Ethics incorporates a large element of challenge. It consists not of a set of minimum expectations but of higher aspirations for ourselves personally and for the institutions of which we are a part.

I think ICI's bylaws use the term "ethics" for a reason, and we need only consult our industry's recent experience to understand what that reason was. Fund advisers stand in a trusted fiduciary relationship to their funds and shareholders. Such a relationship implies far higher obligations and exacts far stricter loyalty than the morals of the marketplace generally. If a fund firm is to succeed, it must develop an ethical culture in which these truths are deeply embedded.

Plato famously questioned whether virtue could be acquired by teaching or practice, and there are limits in any event on what a trade association can do. Given our long history and our wide-ranging membership, however, the Institute has a place in the larger culture of the mutual fund business. I have resolved to use the Institute's numerous conference programs, on a continuing basis, to put ethical obligations and issues on the table for our members. If tone, emphasis, and sustained attention to these issues can help reinforce the fiduciary culture upon which our industry's success depends, the Institute will do its part.

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It has been a pleasure to speak to you today. Best wishes to all of you and to your families this holiday season and in the year ahead.