

Toward Sustaining a Culture of Ethical Conduct—Implementing the New SEC Compliance Rule

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2004 Mutual Fund Compliance Programs Conference

Good morning. Welcome to the 2004 Mutual Fund Compliance Programs Conference.

This conference is a “first” in several respects.

It is the first conference the Institute has been involved in that focuses on the SEC’s new compliance rule for mutual funds, justly regarded as one of the most important reforms that the Commission has adopted in the wake of the recent scandals.

It is the first conference to be convened under the auspices of the Independent Directors Council.

And, this is the first conference hosted by the Investment Company Institute since I became President on June 1st.

I am especially pleased that the ICI and the Independent Directors Council are co-sponsoring this important conference.

The Council is a dedicated forum within the ICI for independent directors to come together to consider and respond to industry issues. Through its education, policy, and communications committees, the IDC will engage the director community on an array of issues that affect mutual funds and their shareholders. One vitally important part of the Council’s mission is the development of a world-class program of continuing education, designed by and for fund directors. This conference is the first of many such programs intended to inform and assist fund boards.

Congratulations and special thanks to Jim Bodurtha, the Chair of the IDC, and all the members of the Council for their leadership and hard work in the successful launch of the IDC. Fund boards across the industry, and the millions of shareholders whom they serve, will benefit greatly from your efforts. I have spent much of my career as counsel to funds and their independent directors and trustees, so please be assured of my strong support as you develop the Council’s programs in the months and years ahead.

We are all keenly aware of the scandalous conduct involving some mutual funds that was first uncovered fully ten months ago. As the months have passed, cases have been concluded and investigations resolved. One lesson of this experience is clear above all others, and it must remain with us into the future: it is incumbent upon us all to take steps to ensure that the kind of abuses uncovered since last September never happens again. Today’s conference is part of that effort.

It is, therefore, a great privilege for me to offer some thoughts on the important subjects you will be addressing today – subjects that concern, most fundamentally, how to build a system of compliance that helps sustain a culture of ethical conduct.

As you know, the SEC’s new mutual fund compliance rule is one of many new rules adopted or proposed to help address the violations of law and abuse of trust that have come to light since last September. The Institute strongly supports the broad-based reform process being pursued by the SEC. While each of the individual rulemakings is highly important in its own right, the compliance rule may have the greatest long-term impact. The rule is broad in scope: it touches virtually all areas of a fund’s operations, and it seeks to account for the full gamut of a fund’s compliance concerns under the federal securities laws. The rule

seeks to assure that all fund boards are, and remain, fully informed on compliance arrangements and issues affecting their funds. The rule will facilitate more of a “risk-based” approach to SEC inspections, which hopefully will result in greater efficiencies in the inspection process both for the Commission staff and for funds themselves.

The new compliance rule calls upon all mutual funds to implement a new structure and new processes to enhance their compliance with the federal securities laws. One key feature of this design consists of additional, specific responsibilities for directors – particularly independent directors – to oversee a fund’s compliance program. The rule anticipates that a fund board will engage actively with the fund’s Chief Compliance Officer for this purpose. For example:

- The rule expressly requires the board – including a majority of independent directors – to approve the appointment of the fund’s Chief Compliance Officer.
- To ensure ongoing board attention to compliance issues, the rule requires the Chief Compliance Officer to meet – at least annually, and in executive session -- with the fund’s independent directors.
- The rule also charges the board with responsibility for approving the fund’s compliance policies and procedures. The SEC has emphasized that it expects this approval process to be no mere formality. Rather, the Commission has said that a fund board, in approving compliance policies and procedures, must satisfy itself that they are reasonably designed to prevent violations of the federal securities laws by the fund, its investment adviser, and key service providers.

In its focus on the role and responsibilities of fund boards, the compliance rule is not unique among the reforms projected by the SEC. Just last week, the Commission adopted a number of other new fund governance requirements. These include a requirement that independent directors constitute a super-majority – seventy-five percent – of a fund’s board; that the independent directors meet periodically in executive session, outside the presence of management; and that fund boards conduct annual self-evaluations. Many fund boards have long observed one or more or even all of these practices. Adopted now into SEC rules, these practices will become uniform across the industry.

As you know, one provision of the SEC’s recent governance rule has been the subject of intense debate – that is, the requirement that an independent director chair a fund’s board. On this issue, the ICI was pro-choice – we recommended that the Commission allow independent directors to decide the question independently. The vote at the Commission itself demonstrates that this is a subject about which reasonable people, all intent on advancing the interests of fund investors, can disagree. The SEC now has ruled on the issue; independent directors will chair fund boards. The Institute will devote its efforts to assisting mutual funds to implement fully and effectively all these new governance requirements, just as we will other new rules the Commission adopts.

With respect to the subject of today’s conference, the Institute has worked hard over many years to support strong fund compliance programs. This is not an idea to which we pay mere lip service. Nor is it an idea that has come to us since the scandals in the industry arose. Indeed, it was the Institute itself that first proposed to the SEC that it adopt a compliance rule for funds. This happened ten years ago, in 1994, when I was the Institute’s General Counsel – long before the current problems arose.

Why did we make such a proposal, absent any evidence at the time of systemic or chronic compliance problems? At bottom, the answer is simple: the Institute has always believed that ensuring compliance with applicable laws and regulations is essential if mutual funds are to earn and keep the confidence of fund investors.

In 1994, the ICI recognized that the mutual fund industry was growing much faster than was the SEC’s ability to oversee it. We considered ways in which to address this growing gap. We concluded that one way to do so was by assuring that each mutual fund had an internal compliance system that meets certain basic requirements. The Institute’s 1994 proposal to the SEC accordingly sought to assure that “best” compliance practices were observed throughout the mutual fund industry – including many of the specific provisions that the Commission now has adopted in its rules.

It is impossible to say whether, if the SEC had adopted a compliance rule sooner, this might have prevented the recent problems. The human condition being what it is, no compliance system is fail-safe. Our laws grow ever more complex, and even the best program cannot guarantee 100-percent compliance at all times.

The new rule itself expressly recognizes that compliance problems will arise from time to time, and it provides for them to be documented and remedied. It seeks to establish a mechanism by which funds and advisers can learn from their compliance experience. From a board’s perspective, the rule also seeks to assure that bad news travels fast – so small problems do not become large ones, and large problems can be fixed promptly.

Our colleague Dawn-Marie Driscoll, who serves as an independent director and chair of the Scudder Funds and is a leader of the Independent Directors Council, is noted for her thoughtful work in the area of business ethics. She has observed that ethics should not be confused with compliance. The two are indeed different. To build and sustain an ethical business culture, to truly fulfill our fiduciary obligations to fund shareholders – this demands more than simply conforming our conduct to the requirements of the law.

Compliance is absolutely necessary -- but not sufficient in itself.

In a business as comprehensively regulated as mutual funds, however, compliance poses its own unique challenges. If we meet those challenges, in their letter and spirit, we will do much to maintain and enlarge the broader fiduciary culture upon which our success ultimately depends.

With the SEC's adoption of the new rule, we thus have a unique and valuable opportunity, as an industry, to reassess the adequacy of our policies and procedures, to establish new and even more effective ways of identifying and addressing compliance issues, and to fashion new working relationships designed to promote compliance. I urge that we take the fullest advantage of this opportunity.

Much will depend upon the oversight efforts of directors and trustees. Much will depend upon those recruited to serve on the front lines – in the important role of a fund's and/or an adviser's Chief Compliance Officer. Day to day, the success of the compliance effort will hinge upon a host of other individuals engaged in the myriad of assignments that make mutual fund investing possible -- and on the ability of fund managers, as SEC Chairman Donaldson has said, "to incorporate sound ethics and compliance measures into company business practices...."

The Institute already has been discussing with members how we can assist them in fully realizing the potential of the new rule - - now and into the future. For this purpose, we expect to create a new, standing committee of the ICI comprised of Chief Compliance Officers. This committee will provide Chief Compliance Officers the opportunity to interact with their peers, to share perspectives on the compliance challenges they face, to hone their techniques, and expand their knowledge. The Institute also plans to provide guidance on compliance issues by publishing white papers in areas of special concern identified by our members. In these and other ways, the Institute will do its part to support the compliance regime the SEC has now prescribed for funds and advisors.

As I said in my [recent remarks before the National Press Club](#), I do not by any means minimize the scope or significance of the violations of law and abuse of trust that has come to light in the mutual fund industry. Indeed, the scandalous conduct of some has put at risk the reputation of all. Still, I believe that no financial intermediary has served more clients longer with fewer lapses than have mutual funds. This reflects the long-time, dedicated efforts of fund managers and fund boards alike to protect the interests of fund investors. If we are to sustain the trust of our investors, we must rededicate ourselves to fulfilling our obligations as fiduciaries. A vigorous and successful compliance program is an essential part of this proposition.

Thank you for your attention and for joining us at this important conference. I hope that it will be of great value to each of you as you prepare to implement the Commission's new compliance rule.