

Mutual Funds' Duty to Investors

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By Paul Schott Stevens

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In June 2004, when I became president and chief executive of the Investment Company Institute, the fund industry was still reeling from revelations regarding late trading and market timing.

Implicated in the wrongdoing were a relatively small group of fund companies, as well as a number of hedge funds, brokerage firms and other sales intermediaries. Now, a decade after news of the scandal, it seems appropriate to reflect on its impact and the state of the fund industry.

Many things have changed in the past decade, but one thing remains constant: Mutual funds continue to serve the investment and savings needs of millions of Americans. In fact, the total net assets of registered investment companies had almost doubled to \$14.9 trillion by the end of July, from \$7.8 trillion in December 2003.

Why is this? What is it about funds that has allowed the industry to bounce back from a scandal in which the misconduct of the few put at risk the reputation of the many?

A number of factors did, and still do, foster public confidence in our industry. Principal among them is the fiduciary obligation that we owe to our millions of shareholders.

Collaboration, cooperation

At its core, mutual fund investing is a social enterprise — one based on trust. Any violation of that trust potentially puts every firm at risk.

This is why the ICI responded so forcefully to evidence of wrongdoing in 2003, calling for tough law enforcement and strong measures to prevent further trading abuses. We drew on a long tradition of working closely with the Securities and Exchange Commission and other regulators, encouraging sensible and rigorous new requirements to protect the investors who have entrusted their savings to our industry.

In fact, the very origins of the ICI lie in our industry's recognition of the critical need to regain and retain the confidence of investors, following the abuses of the 1920s, when funds were virtually unregulated.

Soon after President Franklin D. Roosevelt signed the Investment Company Act of 1940, industry leaders came together to form the association that became the ICI. Ever since, we have sought to give voice to the industry's strong support for effective regulation and sound fiduciary practices.

Compliance infrastructure

One example of this approach has special relevance to the late-trading and market-timing era.

In the early 1990s, there were suggestions that the fund industry create a self-regulatory organization to oversee firms' compliance with laws and regulations.

The ICI's members strongly preferred the accountability and transparency provided by direct SEC oversight. So we sought an alternative.

At the time, I was serving as the ICI's general counsel. I suggested that each fund organization be required to have written

compliance policies and procedures, as well as a designated person or persons to oversee implementing them.

Members supported and developed the idea, and the ICI formally recommended this approach in a letter submitted to the SEC in November 1994.

The SEC didn't act on the proposal at the time but resurrected it in response to the late-trading and market-timing problems, and the compliance rule that it ultimately adopted in December 2003 reflected the concepts advanced by the ICI almost 10 years earlier. That rule has become a cornerstone of our compliance infrastructure, and it stands as perhaps the single most important regulatory outcome of the scandals.

This rule, adopted with the ICI's support, requires every registered investment company to implement written compliance policies, review them annually and designate a chief compliance officer who reports directly to the fund's board. The SEC adopted a similar rule for registered investment advisers.

Although compliance has always been an essential aspect of the industry, funds and financial advisers have made marked improvements in this area over the past decade, largely due to these strict regulations.

Extraordinary responsibility

So where does the fund industry stand?

To be sure, adoption of the compliance rule wasn't the only result of the scandal and the intense scrutiny that it occasioned. There were numerous other important reforms adopted, as well, and we are stronger and more accountable as a result of them all.

More broadly, there is no doubt that the late-trading and market-timing problems were a chastening experience, and not just for those firms found to have engaged in misconduct of some kind.

The Irish statesman and philosopher Edmund Burke observed, "Those who don't know history are doomed to repeat it." As it is part of our history, the scandal era should, and does, serve as a continuing reminder and caution.

Customers have many choices when it comes to investing their hard-earned savings. We can never be complacent about our obligations to them.

For America's mutual funds, the road ahead isn't so very different from the road we have traveled.

We must continue to build upon the framework of accountability to our investors.

We must always provide them with the fair and equal treatment that they expect.

We must continue to inform them fully and meaningfully about their fund investments.

And most important, we must remain unflinchingly loyal to the interests of the investors whom we serve and deeply conscious of the obligations we assume as fiduciaries on their behalf.

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