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Needed Industry and Regulatory Actions

2003 ICI Securities Law Developments Conference

Opening Remarks
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Good morning. I'm Craig Tyle, General Counsel of the Investment Company Institute. I'd like to welcome you to the 2003 Securities Law Developments Conference. As in years past, our panels will cover a variety of proposed and adopted rules, as well as significant Commission and staff orders and interpretations. But this year has been very different from previous years, as one series of issues clearly overshadows everything else – the late trading and market timing scandals that came to light in the fall, and whose repercussions are likely to be felt for some time to come.

It is still too early to offer a definitive analysis of just what went wrong in the mutual fund industry, what were the underlying causes, and what steps should be taken to ensure that they not recur. However, I would like to offer my own preliminary thoughts.

First, tough enforcement of the securities laws is a necessity. Clearly, wrongdoers need to be punished. Perhaps even more important is the deterrent effect that enforcement actions provide. The actions by the SEC, Attorney General Spitzer and others have undoubtedly led to an increased focus on these issues at every fund complex in the country. Fund complexes have responded by conducting comprehensive internal investigations, in many cases aided by outside experts. Indeed, some of the recent allegations have been uncovered by funds themselves and disclosed to regulators.

Second, we need to take steps to enhance the SEC's oversight of mutual funds. Many have questioned how the SEC could have failed to uncover the late trading and market timing activity that has since come to light. Some even appear to have drawn the conclusion that another body – perhaps one modeled on the Public Company Accounting Oversight Board – should take over some or all of the SEC's responsibilities for regulating and inspecting funds.

I'm not interested in criticizing the SEC. And I am highly skeptical of proposals that would fragment the regulation of mutual funds. But, I think that recent events demonstrate a need to take a step back and consider possible enhancements to the SEC's inspection program. I hope that the industry and the SEC can work together to identify problems and develop solutions.

Third, the recent scandals point out the need for SEC oversight of hedge funds. As SEC Chairman Donaldson has noted, the fact that the initial allegations involved trading activity of a hedge fund underscores the importance of providing the SEC with the means to monitor hedge fund trading activity.

Fourth, improvements are needed in the way that information is shared between fund companies and intermediaries. It appears, for example, that one of the reasons that some mutual fund investors did not receive the correct breakpoint discounts on front-end sales charges is that neither the fund companies nor the brokers had all the information necessary to ensure that the correct sales charge was applied.

Similarly, inadequate sharing of information can hamper the ability of a mutual fund to deter short-term trading activity that the fund believes is not in the best interests of its shareholders. Many investments are held in omnibus accounts, where the fund cannot monitor trading activity at the individual account level. Chairman Donaldson has announced that the NASD will form a special task force to study this issue and develop recommendations. We strongly support these efforts.

Fifth, if there has been any doubt regarding the necessity of forward pricing, recent events have laid that to rest. The alleged improper trading activity – both late trading and market timing – was motivated, at least in many cases, by a desire to take advantage of "stale prices." This is precisely what forward pricing is intended to prevent. Accordingly, late trading is – and should be – flatly prohibited. The SEC has just proposed rules that are intended to facilitate compliance with this requirement.

Fair valuation of portfolio securities in certain circumstances also can help to deter trading activity that can harm fund shareholders. Fair valuation, however, is an inherently subjective process and, consequently, has its limitations. For this reason, fair valuation cannot be, by itself, the complete "solution" to problematic short-term trading. It is, nevertheless, an important element and all funds should have procedures in place that cover when, and how, they will fair value securities.

Sixth, like fair valuation, funds need to have specific policies and procedures in place that address potential conflict situations. And, as a general matter, these policies and procedures should involve fund directors. In hindsight, it appears that some funds may have had rather general and less formal policies and procedures on short-term trading activity. The lack of clear guidelines, and of the discipline of director oversight, may have allowed practices to go forward that would not have under a more formalized review process. Moreover, guidelines that are too general in nature can lead to truly innocent and benign activities being called into question by overly aggressive regulators and prosecutors. Thus, specific and well-thought out policies and procedures can serve to protect both fund shareholders and fund managers.

Seventh, legislators and regulators should avoid the trap of fighting the last war. The Enron and Worldcom scandals were seen as being caused by a failure of corporate governance. Perhaps for this reason, many have assumed that the mutual fund scandals also must reflect a failure on the part of the director oversight system. But not every problem is a corporate governance problem. It is not fair to blame directors for not ferreting out deficiencies that were not brought to their attention.

Many suggested changes to the standards applicable to fund directors have been made in recent weeks. Some, such as the SEC's new compliance rule, should give directors additional tools to carry out their oversight responsibilities and seem entirely appropriate.

But some of the other proposals that have been incorporated into pending legislation are simply misguided. Especially problematic are proposals that would require fund directors to make a series of detailed certifications about the operations of the funds on whose boards they serve. Whatever one might think of the certification requirements under the Sarbanes-Oxley Act, at least there the responsibility was placed upon senior officers who manage the day-to-day operations of the corporation. But fund directors are NOT supposed to be managing funds – they are responsible for providing general oversight and guarding against conflicts of interest.

Many things may need fixing in the mutual fund industry. But director oversight is one thing that has worked very well. I hope that policymakers will avoid an overreaction here that will ultimately detract from the ability of directors to do their job.

Eighth, the late trading and market timing scandals should not be used as a pretext for wholly unrelated changes to the system of mutual fund regulation. Some have suggested shoehorning, either into settlements of individual actions or into reform legislation, radical notions that would change the economics of mutual funds, such as requiring advisory contracts to be put out for competitive bid, or imposing some other type of limitation on fund advisory fees.

Proposals such as these have nothing to do with late trading, nothing to do with market timing, nothing to do with insider trading, and nothing to do with selective disclosure of portfolio holdings.

In addition, it is important to remember that, despite the serious problems that have come to light, mutual funds remain the best – and I might add, the cheapest – way for millions of Americans to participate in the markets and to meet their long-term investment needs. Drastically changing the economics of the mutual fund business will result in a less diverse, less competitive, less innovative industry. This would truly be a disservice to the investing public.

My final point is the need for all of us to place the interests of the average mutual fund investor first. In years past, I've used this principle as a basis for critiquing the SEC. For example, last year I argued that, while disclosure of individual proxy votes seemed to be important to certain special interest groups, it was not to the average investor. And, ironically, two years ago, when I opened this conference, I urged the SEC to give funds more tools to combat market timing because this would protect average investors.

This year I think we have to turn the critique on ourselves. It seems that some of our colleagues lost sight of the need to place the interests of that average fund investor first, and were instead more focused on the big client or – even worse – on their own trading accounts.

I still do not believe that the average investor cares about proxy vote disclosure, or about portfolio manager compensation, or about most of the issues that seem to capture the attention of outside commentators. But they do care about whether they are being treated fairly.

Consequently, maybe the most important step for all of us to take is to make sure that, going forward, the companies we work for and those that we represent make it a practice of approaching each issue by asking – is this fair to the average investor? If we can do this, we can regain the confidence of fund investors.

Thank you very much. I would now like to introduce our keynote speaker, the Director of the Division of Investment Management, Paul Roye.
