

Mutual Integrity, Mutual Trust

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by Paul G. Haaga

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It is not news that mutual funds experienced remarkable growth over the last 20 years. More than 60% of middle-American households now own fund investments. In a 1999 Pew Research survey, Americans said mutual funds were one of the 1990s three "best trends," alongside civil rights and equality for women in the workplace.

But if fund leaders do not act to restore the high standards which led to such widespread confidence in mutual funds -- standards which always put fund investors first -- we will not see facts and findings like this again. Nor will we deserve to. This is why the Investment Company Institute, the national association of mutual funds, is today calling for [major reforms](#) relating to "soft dollars" and "directed brokerage."

The Institute's Board of Governors, which I chair, is today calling on the Securities and Exchange Commission to restrict substantially the use of soft dollars. Soft dollars resemble frequent flier miles. Investment managers receive credits based on the commissions funds pay when buying and selling securities. Managers can use these "soft" credits instead of "hard" dollars to acquire investment research products and services. Concerns have long been expressed that some managers choose higher rather than lower cost brokers because of the opportunity to receive soft dollars.

Although protected by a safe harbor Congress enacted in 1975, this longstanding practice has created many more problems than the practice was originally intended to solve. Most investment research should be paid from management fees, not from shareholders' assets.

Our second proposal addresses the practice whereby some fund managers steer brokerage transactions to reward securities firms that also sell the managers' funds. Mutual funds are among the largest buyers and sellers of securities, and generally execute their trades through broker-dealers.

While fund managers are obligated to seek best execution (i.e., best overall value) for their transactions, funds are permitted in some circumstances to "direct" brokerage transactions to securities firms in consideration of the firm's sale of fund shares.

The Institute is calling on the SEC to abolish this form of directed brokerage. While the potential conflicts associated with these arrangements have generally been contained by existing regulations, it is also true that directed brokerage causes some to suspect that fund managers could "pay to play" using shareholders' money.

These are substantial proposals. They build upon initiatives fund leaders proposed in October to combat late trading and abusive market timing. To stamp out late trading, the Institute said that all trades must be received by a mutual fund before the market closes at 4 p.m. to receive the current day's price. While unpopular among some in the financial services industry, this "hard" close is tough medicine that is undeniably effective.

To strengthen funds' ability to deter abusive market timing, the Institute asked the SEC to impose a minimum mandatory 2% redemption fee (payable to the funds' long-term shareholders, not fund managers) on any sale within five days of the original investment. Redemption fees, coupled with additional SEC guidance about a valuable but subjective technique known as "fair value" pricing, will provide mutual funds with stronger tools to combat abusive market timing.

The significant new policies the fund industry is calling for today will benefit millions of investors by substantially diminishing potential conflicts of interest and strengthening the operating integrity of mutual funds. Fund investors need these new protections. But tough requirements, whether old or new, have to be followed and enforced.

Three weeks ago, Institute President Matthew Fink told Congress that fund executives "who acted willfully against the interest of fund shareholders should be sanctioned severely. Those found to have violated criminal laws should be sent to prison. The law enforcement message should be loud, clear and memorable." Supporting vigorous enforcement is not an empty promise; mutual funds have long endorsed increased funding for the SEC. And we pledge to work hard to ensure the Commission gets the resources it needs to fulfill its mission of protecting investors.

We make no excuses for the behavior of those in our industry who violated the letter or the spirit of the law -- because there are no excuses. By substantially reducing conflicts of interest, the proposals we advance today, along with the steps we took in October, reflect our commitment to doing whatever is necessary to restore trust and confidence in mutual funds, upon which tens of millions of Americans depend.

We know that integrity is not demonstrated, and trust not earned, by adopting a new strategy or issuing a press release. Integrity and trust are the products of a culture that honors fiduciary principles, unshakeable ethics, broad vision and a profound commitment to those you ultimately serve. We ask

only that we be judged by our actions.

Today, some question whether integrity and trust are genuinely valued by mutual-fund companies that provide the public with vital financial services. It is our responsibility -- and ours alone -- to answer that question decisively and unambiguously. If we fail, it will not matter if regulators are smart, prosecutors tough and legislators far-sighted. If we fail, we will have endangered the historic accomplishments that mutual funds have come to represent for more than 92 million Americans and their families.

Despite the current tumult, many experts believe mutual funds remain the best way for Americans to invest for the future. We are convinced of this as well. For most of us -- and most of our history -- our words and our deeds have been fully aligned. The result is that mutual funds democratized our financial markets and energized the capital formation process. In the wake of recently discovered abuses, we are moving swiftly to offer tough, practical solutions, and will continue to call for changes to address broader concerns. Everything remains on the table to ensure that the interests of mutual-fund investors are, and always will be, served above everything else.

Mr. Haaga is chairman of the Investment Company Institute and executive vice president and director of Capital Research and Management Company.

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