"America's Mutual Funds: The Road Ahead"

Paul Schott Stevens

President, Investment Company Institute

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Good afternoon.

Thank you for this opportunity to speak at the National Press Club. The Press Club is a distinguished forum for addressing matters of significant public interest. As the new President of the Investment Company Institute, I am grateful for the opportunity to address the important challenges that lie ahead for America's mutual funds. I am honored that so many friends and colleagues have been able to join me here today.

In particular, I want to thank Sheila Cherry for her kind introduction as well as John Hughes for all his help in arranging my appearance.

My one regret this afternoon is that my wife Joyce Stevens is not able to be here. In August, Joyce and I will celebrate 25 years of marriage. She has spent almost 20 of those years as a teacher, opening the minds of a generation to the wonders of science. As Joyce concludes her teaching career, the faculty and staff of the St. Stephen's and St. Agnes School in Alexandria are honoring her. This is a proud day for our family, so permit me to add my congratulations to those of Joyce's colleagues. By the way, Joyce and I have four young sons, so a life of leisure does not await her quite yet. We both recognize that new beginnings bring with them new possibilities.

This is my first speech since becoming the President of the Investment Company Institute on June 1st. Preparing my remarks -- and thinking about delivering them in the heart of our nation's capital --

brought to mind my first visit to Washington.

I came here for a debate. The year was 1969 and I was a junior at Jesuit High School in New Orleans, chosen to represent my school in a national debate tournament.

What I saw of Washington then made a powerful impression. Perhaps it is no surprise that I returned here nine years later -- after college and law school -- to begin my career.

In my experience, however, careers are made as much by accident as by design. One happy accident occurred in 1978, when a senior partner at my law firm asked for my help with a proceeding before the SEC concerning mutual funds. I told the senior partner that I knew nothing about mutual funds, but I did know quite a bit about student loans.

That set me upon a path that has led me here today. Along the way, I have spent much of my professional life as counsel to mutual funds, their independent directors, investment advisers and distributors -- in board rooms, before the SEC, in the courts, at a broker-dealer, and as general counsel of the ICI.

I want to speak this afternoon about the road ahead -- the challenges and obstacles -- for America's mutual funds. To understand these, however, it is necessary to understand the road we have traveled.

Consider the contrasts in the 25 years since I was introduced to mutual funds. Since 1978,

- the number of fund companies has grown from 119 to over 400,
- the number of funds has grown from 500 to more than 8,000,
- the share of households with fund investments has grown from 5 to 50 percent, and
- the assets mutual funds manage has grown from $56 billion to $7.4 trillion.

In 1978, mutual funds were an inconsequential part of Individual Retirement Accounts. Today, about half of all money Americans have in IRAs, or about $1.3 trillion, is invested in mutual funds.

In 1978, 401(k) plans did not even exist. Today, nearly half of all the money Americans hold in their 401(k) accounts, or about $1 trillion, is invested in mutual funds.

This background led The Economist magazine to assert, in the mid-1990s, that mutual funds were at the center of a "seismic shift in American finance." Why was this so? How is it that mutual funds achieved such acceptance and became so popular? What lessons can we draw for the future?

The strong performance of financial markets over the last 25 years has undoubtedly played an important role. So, too, did a basic fact we are apt sometimes to forget: mutual fund investing is a powerful proposition. It provides access to professional investment managers; it helps assure diversification of investments and thus reduces investment risks; it is associated with a range of valuable services to investors; and it is available to all, at relatively low cost. These are attributes of a fiercely competitive industry. They help explain why mutual funds are an ideal way for average

investors to save for retirement and education and to accumulate wealth.

Still, I believe neither of these reasons alone would have sufficed. There are four other factors at work that help explain why so many American investors have relied on mutual funds to achieve their most important financial goals. These factors are accountability, the “mutual” character of mutual funds, accessible information that is thorough and reliable, and, most important, trust.

First, funds could not have achieved such acceptance without a framework of accountability. Accountability takes many forms, but most fundamentally concerns the protections provided to a fund’s shareholders that safeguard their investments.

The critical need for accountability was most apparent from what we learned in the 1920s and early 1930s. The abuses that plagued our markets, including investment trusts -- the forebears of mutual funds -- led to the adoption of five major securities laws, culminating with the Investment Company Act of 1940. Congress’ goal was to elevate the practices of the securities industry, in the expectation that investors would respond with renewed trust and confidence. Signing the Act in 1940, President Roosevelt commended its many industry supporters for their dedication to achieving “higher standards.” That same year, the association that would later become the Investment Company Institute was formed. Investment companies and the Institute in that day saw effective federal regulation and oversight as an indispensable asset, not a liability. So it has been. So it remains.

In the intervening years, the SEC has applied the Act’s legal requirements diligently, adapting to changing circumstances and market developments as mutual funds have grown. Unlike most other industries, the legal framework and regulatory process overseen by the SEC is among the primary forces that have given mutual funds their shape and character. And this process is ongoing.

Last year, the SEC reported that it had adopted 40 new rules affecting mutual funds since 1998, an average of one every seven weeks. Since the mutual fund trading scandals were revealed last September 3, the SEC has moved even faster. Sixteen new regulatory initiatives, twelve of which are a direct consequence of the trading scandal, have been adopted or proposed. Under Chairman Donaldson’s leadership, the SEC has clearly undertaken the most extensive reexamination of mutual fund regulation in the Commission’s history.

Make no mistake -- the Institute strongly supports this reform process. We have called upon the Commission to administer strong medicine to prevent such trading abuses in the future, and we have endorsed the vast majority of other proposals it has developed, including in the areas of fund governance, disclosure practices and compliance programs. We will bend every effort to assist mutual funds to fully implement the SEC’s new regulations, in whatever form they are adopted. We will work hard to assure that these reforms realize their full potential.

Because of the SEC’s efforts, mutual funds have been and will continue to be governed by a detailed and rigorous regime of laws and regulations. I believe it is essential that the SEC always have the

authority and the resources to punish wrongdoers, to deter future misconduct and to protect investors. The record of its recent investigations amply demonstrates that the SEC has the authority it needs, and is wielding it aggressively, just as it should.

A second factor in the public acceptance of mutual funds is their “mutual” character. Much has been said about the impact of mutual funds in “democratizing” the capital markets, in giving rise to a new “investor class.” These observations relate to the sheer number of Americans who have been drawn to investing, many for the first time, because of the wide availability and attractiveness of mutual funds.

Equally important, however, is that mutual funds hold out the promise of a square deal and equal treatment – with the opportunities and the costs shared alike, with each investor receiving his or her proportionate share of the gains, and likewise paying his or her share of the expenses. Mutual fund investing is a proposition that appeals to so many because it is predicated on this fundamental notion of fairness.

A third factor that has contributed decisively to the acceptance of mutual funds is access to information. Both current and potential new fund investors benefit from the ready availability of many sources of information. These include financial advisers, employers who sponsor retirement plans, the business and financial press, and numerous industry analysts and commentators.

Most fundamentally, however, investors must be able to rely upon information provided by funds themselves. Today, the extensive information that all fund investors receive is among the most salient achievements of the mutual fund regulatory system the SEC has designed and administers. We take so many of the SEC’s landmark innovations for granted:

- the availability of standardized information about fund performance,
- the availability of detailed information about fund fees and expenses, and
- prospectuses that feature summaries of much other key information in a common format and in simple, understandable terms.

But we should bear firmly in mind that these and other regulatory innovations are part of the bedrock foundation of any success we may achieve.

The SEC deserves particular praise for making it so easy for investors to “shop around” when evaluating mutual funds. This is a unique quality of American mutual funds. It is not found to the same degree with other financial products or services here, and certainly is not characteristic of investment funds overseas. The SEC’s disclosure requirements also have played an important role in promoting mutual funds’ accountability to investors. They provide the common ground on which all those concerned about the industry meet.

Are there ways to improve access to information? Of course, but we always need to remind ourselves that requiring the disclosure of more information to investors does not assure greater understanding or insight. Last year, Federal Reserve Chairman Alan Greenspan cautioned that “in our laudable efforts to

improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."

The challenge of "transparency" is especially important for a retail investment like a mutual fund, and thus it is a subject which has received considerable attention from the SEC and the Institute. Meaningfully informing investors -- not simply making disclosures -- must be our common and constant objective.

The fourth and final factor may proceed from the others, but it occupies a very special place. It is the sine qua non – that without which the rest not would matter. That factor is trust.

It is likely that only a small percentage of the nation's 92 million fund shareholders have ever met someone who works for their mutual fund, or have ever visited an office operated by their fund company. Most investors know about their mutual funds principally by reputation and results. Americans may prefer mutual funds because of the advantages they provide, because of the laws and regulations that attach to them, because they expect to be treated the same as other investors, and because they have a lot of information about funds. But they are unlikely to commit their savings to a mutual fund unless they feel it is a fund they can trust. Investors are unlikely to risk their security in retirement or the education of their children unless they trust that their fund is managed prudently and committed to their interests. They understand that markets go up and down, and they may accept these inherent risks in investing. But the risk of abuse or dishonest conduct is a different matter altogether.

This explains why revelations of late trading and market timing abuses have cut so broad and deep.

Consider the number of firms -- mutual funds, selling intermediaries and hedge funds alike -- that have been implicated.

Consider the prominence and seniority of some of the individuals.

Consider the venal nature of the conduct and the blatant improprieties involved.

The government, the media and -- not inconsequentially -- the marketplace, has responded sternly to those involved in the scandals. The reason we regard the recent abuses to be so outrageous is precisely because we had come to expect better from mutual funds, and because the abuses depart so radically from the duties we know mutual funds owe to their investors.

By no means were most fund companies involved in these scandals - quite the contrary. As a broad proposition, I still believe no financial institution has served more clients longer with fewer lapses than have mutual funds. Still, even if it was just one fund company implicated, that would be one too many. The scandalous conduct of one can and does risk the reputation of all. This is the reason that the Institute and its members so strongly support a comprehensive, forceful and effective response by government officials.

But apart from the many specific reforms to mutual fund business practices that have been adopted or proposed, a larger question looms. Paul Haaga, the Institute's Chairman, identified the question in remarks last month. He said, "If the discovery of abuses within our own industry did not teach us important lessons about our responsibilities to fund investors, then -- even as cases are concluded and investigations resolved - the scandal will not really have ended."

The lessons, I think, have to do with what we must demand of ourselves -- and what others have a right to insist on from us -- when we accept the role of a fiduciary. Three weeks ago, SEC Chairman Donaldson observed, "It is extremely troubling that so much of the conduct that led to the scandals in the mutual fund industry was, at its core, a breach of the fiduciary relationship between investment advisers and their advised funds." He is correct. But what is a fiduciary? What is it about the nature of a fiduciary relationship that makes it so distinctive?

The concepts underlying the term "fiduciary" spring from customs and beliefs of the ancient Romans. The pagan goddess Fides was the personification of good faith. Her symbol was the outstretched hand, given as in solemn agreement. "Fiducia" -- a term in Roman law meaning confidence, trust, reliance, assurance -- is closely related to the Latin noun "fides," signifying belief or faith. The adjective form, taken by the U.S. Marine Corps as part of its motto, is "fidelis" -- meaning a person or institution that can be trusted or relied upon, who is true, steadfast and faithful.

Essentially, a fiduciary is one who takes it upon himself to act for or advise another, thus inviting the other's confidence and trust. Under our law, the distinguishing obligation of a fiduciary is the obligation of loyalty. Fulfilling such an obligation is no small matter. Especially in a social enterprise as large and important as mutual funds, trust -- that is, the expectation that one will do what one is relied on to do -- is precious and necessary indeed. As Thomas More says in A Man For All Seasons, when a person assumes such a responsibility, "he's holding his own self in his own hands. Like water. And if he opens his fingers then -- he needn't hope to find himself again."

Doing what one is relied upon to do, placing the interests of clients first, ahead of everything else -- these are the lessons of the recent scandals for all who take upon themselves the trust and confidence of mutual fund investors. Supreme Court Justice Felix Frankfurter once said that "he who is unwilling to assume the responsibility of a fiduciary has no business being a fiduciary." Rededicating ourselves to first principles, and bolstering the fiduciary culture upon which the industry was founded, must be an essential part of how mutual funds respond to the scandal. It is the key challenge we shall encounter on the road ahead.

We all recognize that -- first and foremost -- this is a mutual fund scandal. But the scandal is not limited to mutual funds. Enforcement actions and regulatory reforms at the SEC are addressing mutual fund issues comprehensively and forcefully, but the record developed since last September makes it clear that more is needed if we are to successfully prevent future abuses.

For example, mutual funds make their shares available to their 92 million investors through myriad financial institutions -- including many thousands of brokers, financial advisers, banks, insurance companies and retirement plan administrators. Typically, each of these financial institutions -- often referred to collectively as “intermediaries” -- obligates itself under a contract with the fund to abide by applicable laws and regulations (such as those regarding late trading) and to implement the policies of the fund (such as those regarding market timing). In the case of many intermediaries, however, funds have no access to information about the ultimate owners of their shares or about transactions in their individual accounts -- and thus no ability to enforce their policies against abusive short-term trading.

This problem arises because of recordkeeping conventions that are common across the industry. If a mutual fund’s market timing defenses are to be effective, however, this problem must be addressed. We are committed to working with all interested parties to address this challenging issue. Recent experience demonstrates that real progress can be made through collaborative efforts to address tough problems such as these. The Institute recently participated in a joint industry initiative, under the effective leadership of the NASD that helped solve the problem of properly determining sales charge breakpoints for fund investors.

The SEC, the NASD, mutual funds, and those many institutions with which we work to make fund investing possible for millions of Americans, all of us have a strong common interest in getting this right. I am confident we will address the implications of the recent scandals for fund intermediaries.

I believe we also must do so with respect to hedge funds.

In reports about the scandals, it is often noted that market timing is not unlawful. When undertaken in an open, above board way, this is perhaps true. As practiced by some hedge fund advisers, however, market timing was often done by stealth and deceit, in ways designed to frustrate the ability of mutual funds to detect and prevent it.

The investigations have revealed that some hedge funds induced mutual fund advisers to breach their fiduciary duty, typically through promises of sticky assets. Others prevailed upon a broker, an insurance company, a non-fund advisor or another financial institution to help cover up their market timing efforts. These were highly deliberate and predatory trading strategies, pursued largely by advisers to hedge funds that are not registered with the SEC, to pick the pockets of long-term mutual fund investors.

Much has been said, pro and con, about the need for regulation of hedge fund advisors, including the desirability of some scheme of registration. Unregistered hedge fund advisors oppose even a modicum of regulation because, well, it might screw up their business model. I am hard pressed to understand how -- assuming that model is ethical and ethically pursued. It would be ironic indeed to draw as a lesson from the recent scandals that myriad new regulations are necessary for mutual funds -- but as for hedge fund advisors, it should be business as usual. If the disparities in our scheme of regulation become too stark -- with mutual funds regulated so comprehensively and competing investment vehicles not at all -- it will simply invite sharp operators to go where they can escape scrutiny and

maximize profits. SEC Chairman Donaldson has called for at least some scheme of registration for hedge fund advisors. His call should be heeded.

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In conclusion, let me add that, for America's mutual funds, the road ahead is not so very different from that which we have traveled -- but it will be demanding and it will test us in new ways. It will demand that we work even harder to maintain the framework of accountability to our investors. It will demand that we always accord them the fair and equal treatment they expect. It will demand that we continue to inform them fully and meaningfully about their fund investments. Most importantly, it will demand that we be unflinchingly loyal to the interests of the investors whom we serve, and deeply conscious of the obligations we assume as fiduciaries on their behalf.

My predecessor Matt Fink led the Institute through a period of dramatic growth in mutual funds and in fund investing. I have become president of the ICI at a time of widespread concern about whether America's mutual funds can continue to vindicate the confidence and trust that millions of investors have placed in them. Let me be plain: I have absolute confidence that they will. And I am determined to do everything in my power at the ICI to help in this process.

Thank you for the privilege of sharing these thoughts with you, and I welcome the opportunity to respond to any questions you might have.

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