IDC Independent Directors Council
Promoting Excellence in Fund Governance

ICI President: System Working to Protect Investors

Conference of Western Attorneys General Financial Issues Summit

Remarks of

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Good afternoon. I am honored to speak at this Financial Issues Summit convened by the Conference of Western Attorneys General. As the new President of the Investment Company Institute, I welcome this opportunity to share some thoughts with you -- and I look forward to a continuing, constructive dialogue with you concerning issues of importance to mutual funds and fund shareholders in your states.

In light of recent events, it seemed to me appropriate to address four specific topics in my remarks today: first, the reaction of the mutual fund industry to the scandals that emerged a little over a year ago; second, the ways in which law enforcement and other officials, including many of you, have addressed the situation; third, Congress's division of responsibilities for oversight of mutual funds between federal and state governments, as set forth in the National Securities Market Improvement Act of 1996; and finally, the importance of cooperation between the states and the Securities and Exchange Commission to advance and protect the interests of fund investors. After my remarks, I would welcome any questions or comments you may have.

Table of Contents

I. The Fund Industry's Response to the Scandal

II. Actions of State and Federal Officials to Protect Fund Investors

III. NSMIA's Allocation of Responsibility

IV. Necessity of Close Coordination Between the States and the SEC

Preliminarily, however, let me say a few words about the ICI and the mutual fund business. The Institute is the national association of U.S. mutual funds. It traces its roots back to 1940, when President Franklin Roosevelt signed into law the Investment Company Act, one of the last pieces of New Deal reform legislation. That statute provided the framework for remarkable growth in mutual fund investing, especially over the last quarter century. Today, the members of the ICI manage total assets of about $7.4 trillion, entrusted to them by almost 87 million shareholders, representing over half of all U.S. households.

The Institute has three fundamental missions -- to advance the interests of mutual funds, their shareholders, directors and advisers; to encourage all industry participants to adhere to high ethical standards; and to promote public understanding of the mutual fund business. These missions have never been more important than they are today, nor have they ever been more challenging.

This is because we have become a nation of investors, and more particularly a nation of mutual fund investors. The growth of participant-directed defined contribution pension plans, the IRA and 401(k) account, revolutionary new products like money market funds, new ways of delivering financial services like the Internet, and competition generally among providers of financial services of all types – these and many other developments, taken together, have had a transforming effect. We are still coming to understand the implications of these developments. This is why your Financial Issues Summit is so timely – and why I am pleased to be here.

Protecting investors -- and sustaining their confidence in the fairness of our financial markets -- has never been more important.

Mutual funds have been at the epicenter of all these changes, and the wide acceptance of mutual fund investing over the past 25 years was no accident. Such acceptance derives from the fact that mutual funds offer diversification of investment risks, professional investment management, a high level of customer service, and a degree of transparency unexcelled by any other financial product—all at relatively low cost.

These attributes make mutual fund investing a very powerful financial tool indeed, and the very best way that most Americans can accumulate wealth for education, retirement, and similar purposes. In a 1999 Pew Research survey, Americans identified mutual funds as one of the decade's three best societal trends. The other two were civil rights and equality for women in the workplace.

Also contributing to the growth of the industry is the fact that, prior to the last year, mutual funds had earned a reputation of being relatively scandal-free, which helped to build the confidence and loyalty of fund investors.

Since September 2003, when Attorney General Spitzer announced his settlement with Canary Capital Partners, this reputation has been significantly compromised. Over the past year, mutual funds have been the subject of state and federal investigations that are, I believe, as intensive as any ever undertaken of U.S. financial institutions. Numerous fund companies, as well as many broker-dealers and hedge funds, have been implicated in wrongdoing. Government investigations are continuing, as are the related private lawsuits.

Against this backdrop, let me turn to four points I outlined above.

I. The Fund Industry's Response to the Scandal

First, I want you to know that the leaders of our industry share your outrage and deep concern about the abuses that have come to light.

From the outset, we have recognized this situation for what it is – the worst scandal to hit mutual funds in more than sixty years. We have sought neither to downplay the issues nor to shift the blame. Instead, we have cooperated as fully as possible in a wide array of efforts to address the problems.

We have called for tough law enforcement, and commended the efforts of federal and state officials. For fund executives who acted willfully against the interests of their shareholders, we have urged that the law enforcement message be loud, clear, and memorable.

We have called for full restitution to fund shareholders.

Last fall, we urged the SEC to administer strong medicine – in the form of mandatory redemption fees and new trading restrictions – to stop abusive market timing and late trading, the practices at the heart of scandal.

Since that time, we have voiced our strong support for regulatory reforms developed by the SEC, under Chairman William Donaldson. These reforms address the core trading abuses, but also go further and impose detailed new compliance practices, disclosure requirements, and fund governance arrangements -- all in the interest of preventing such misconduct in the future.

Finally, we have pledged our efforts to do everything possible to assist Institute members in implementing the new SEC requirements and realizing their full potential on behalf of fund shareholders. This effort will continue long after the enforcement docket is cleared and the last new regulation takes effect.

In short, we recognize our collective stake in the success of public and private efforts not merely to root out misconduct, but to preserve and bolster the confidence of our shareholders. As I have observed numerous times since joining the ICI, the misconduct of some has risked the reputation of all. We cannot afford to see a recurrence of conduct that abuses the trust of mutual fund investors.

II. Actions of State and Federal Officials to Protect Fund Investors

Second, with respect to government's response to the scandal: at a time when it seems beyond fashionable to regard "the system" as broken and corrupt, the actions of those government officials responsible for policing our securities market should be highly reassuring. Far from broken, the system is working as it was designed. To their great credit, state and federal law enforcement officials have acted promptly to identify and punish misconduct, to deter it from happening again, and to hold investors harmless.

It is significant that the trading abuses were first identified by a State Attorney General, and that senior officials in numerous other states likewise have taken steps pursuant to their enforcement authority under existing law to protect investors in their jurisdictions from fraudulent practices. Similarly, the SEC has been both aggressive and thorough in its response to the scandal.

Moreover, while there is no perceptible gap in existing laws, federal regulators, with an eye toward the needs of a national marketplace, nonetheless have crafted and are imposing a comprehensive set of additional regulations in response to the scandals.

These new regulations are designed, as I said, to enhance the accountability and transparency of funds.

It bears noting that strong, corrective market forces have been at work as well, exacting a high toll on those companies implicated in the scandal, in the form of lost assets and investor loyalty. For example, companies named in investigations or enforcement actions during the last four months of 2003 experienced a combined outflow of $9.4 billion per month in their bond and stock funds from September through March of this year. In contrast, other companies not named in any enforcement proceedings registered a combined in-flow of $35.3 billion per month over the same period.

III. NSMIA's Allocation of Responsibility

Third, in my judgment, the mutual fund industry's recent experience demonstrates the soundness of the policy for shared federal-state oversight of mutual funds that Congress adopted in the National Securities Market Improvement Act of 1996 (NSMIA). There is a saying in Washington that where you stand is where you sit – and I submit my point of view while recognizing some of you may see things differently.

Having served as general counsel of the ICI during the 104th Congress, when NSMIA was considered and enacted, I was "present at the creation" of this statute and I have written about it at some length.* As you probably know, in NSMIA, Congress determined that mutual funds should be regulated exclusively by the SEC, while the state would retain only certain investigative and enforcement powers.

Congress came to this judgment in light of the national character of the market in which funds now operate and their importance in the economy overall. When signing NSMIA into law in October 1996, President Clinton likewise noted that the legislation represented a more efficient division of oversight responsibility and would assure that "[m]utual funds, which are sold nationally, will be regulated nationally."

Under this new division of labor, NSMIA preserved the ability of the states "to investigate and bring enforcement actions with respect to fraud and deceit" or "unlawful conduct by a broker or dealer" in connection with sales of fund shares. At the same time, the Act foreclosed states from exercising any authority – whether by statute or administrative action – over the registration of mutual fund shares, the regulation of fund prospectuses and disclosure documents, or the operations of investment companies. Congress was aware that enforcement powers potentially may be used in a manner tantamount to regulation. For this reason, it directed that the states exercise their retained investigative and enforcement authority in a manner "consistent with" the broad pre-emptive policy of the Act.

Over the past year, state officials have wielded their remedial, "anti-fraud" authority to good effect – as they should and as NSMIA intended – in order to protect mutual fund investors in their jurisdictions. At the same time, the SEC has exercised its prescriptive, regulatory authority – as it should and as NSMIA also intended – to impose new, comprehensive nationwide standards on mutual funds in response to the scandal. In my judgment, the events of the past year have validated Congress's design in NSMIA. To date, the scandal has not been – nor should it be-- the occasion for divergent and inconsistent regulatory responses by different states. Responses of this sort characterized state regulation of mutual funds prior to 1996 and ultimately led to the enactment of NSMIA.

IV. Necessity of Close Coordination Between the States and the SEC

Fourth, I believe in order to fulfill their respective roles under NSMIA, it is absolutely essential that the SEC and the states cooperate closely, both in the law enforcement realm and on matters of regulatory policy.

I recognize that the experience of state officials -- Attorneys General, Securities Commissioners, and others -- may suggest the desirability of modifying or adding to the body of mutual fund regulations in force through the SEC. This may include, for example, seeking to impose new disclosures to investors that a state official deems necessary or desirable to illuminate aspects of the fund or its advisor's business practices. To advance the interests of fund investors most effectively, however, the framework established under NSMIA should be respected by operating to encourage a vigorous, continuing dialogue between the SEC and responsible state officials on issues of this kind.

The SEC, for its part, has proved highly receptive to improvements in fund regulation, especially in the area of disclosure practices.

In closing, let me emphasize our commitment to helping protect the interests of fund investors, in your states and nationwide. In the aftermath of the mutual fund scandal, there is much to be done to sustain confidence of fund shareholders. We welcome the opportunity to work with you toward this critically important objective.

Thank you.

Endnote

* See generally, Mutual Funds, Investment Advisors and the National Securities Markets Improvement Act, 52 Bus. Lawyer 419 (1997) (with C. Tyle).

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