

Coping in the Expanding World of Compliance

Coping in the Expanding World of Compliance

Opening Remarks

The Mutual Fund Compliance Programs Conference

Karrie McMillan

General Counsel, Investment Company Institute

May 5, 2011

Marriott Wardman Park Hotel

Washington, DC

As prepared for delivery.

Good morning, everyone. I'm Karrie McMillan, ICI's General Counsel, and it's my privilege to kick off this year's Compliance Conference.

This is our eighth year holding this conference, which we began right after the adoption of the mutual fund compliance program rule in 2004.

Each year, our conference agenda tackles the hot-button topics, the burning and pressing matters of the day. This year's conference is no different: our panels and speakers will address Dodd-Frank ('cause you can't get away from Dodd-Frank), the latest pronouncements from the regulators, and the compliance challenges that you face with specific products and strategies.

But, before we all get into those burning matters, I'd like to step back and look at the big picture—to remind ourselves why your function is so important, and how it is evolving.

Mutual funds depend for their very existence on investors' trust. We have to earn that trust each and every day.

So how do we do that? Well, our funds are governed by a comprehensive regulatory regime that offers an array of important investor protections.

When investors buy a mutual fund, they receive a diversified, professionally managed portfolio that's transparent and liquid. Unlike many other financial products, that fund has a simple capital structure and makes limited use of leverage. Its assets are held under strict custody, and its value is marked-to-market every day, following a strict pricing discipline.

These protections are backed by stringent disclosure requirements and overseen by a strong system of governance, with independent directors serving as watchdogs for the interests of investors.

But the strongest rules can be thwarted or sidestepped. That's why fund advisers and directors also have a fiduciary duty to their shareholders. Every person who works in this industry—from the CEO to the portfolio manager to the sales team to the call-center operator—must be a steward of our fiduciary culture.

We all must remind ourselves of our duty to always put the interests of investors first. But as compliance officers, you play a special role. Your job is to make sure the rules are followed—and thus to help maintain our fiduciary culture and the investor trust that it fosters.

That is why ICI embraced the concept of a mutual fund compliance program, and it's why we support your role so vigorously. It's also

why we get a little frustrated sometimes when that role is misunderstood—as I'll discuss a bit later.

Ok—That's the big picture—the important framework through which we always approach compliance. But today, I want to spend my time with you to bring that down to three topics: How your role is evolving; How you can meet the new challenges of those changes, and how we can work together to improve understanding of your role—particularly among regulators.

How is your role changing? Well, I can sum that up pretty quickly—in fact, in just six words: The world of compliance is expanding. And no one knows that more than you. Your world is getting bigger, and in this case, bigger isn't always better.

Of course, the work of compliance personnel has never exactly been a cup of tea. But it's getting tougher. From where I sit, it seems like you all are getting pulled away from what we used to think of as “core” mutual fund issues. Or maybe it's just that the core in question is growing and growing and growing. Either way, you are doing more, and often with less—particularly at smaller firms, where resources are sometimes stretched thinner.

This trend toward “doing more with less” isn't likely to relent soon. Just look at the sheer volume of rulemaking out there. The 2,300 pages of the Dodd-Frank Act contain about 240 rulemaking provisions. And they aren't deregulatory rules!

The harsh truth is that some of these new rules could fall well short of perfect. The standout example so far has to be the Securities and Exchange Commission's proposed whistleblower program. You thought I was going to say pay-to-play, didn't you? I'll get to that one in a bit.

But first, the whistleblower proposal. Dodd-Frank requires the SEC to set up programs to reward people who voluntarily provide regulators with original information about a violation of the federal securities laws. If that information leads to a successful enforcement action, the whistleblower gets a reward—ranging from 10 percent to 30 percent of the monetary penalty assessed by the SEC. And, as we all know, that can be huge.

Now, an industry that depends on investor trust has every incentive to establish effective programs to bring wrongdoing to light. But this SEC proposal has serious flaws, ones that could wind up hurting funds and their investors.

The biggest problem here is that the SEC program creates incentives for employees to report problems directly to the SEC, rather than a fund's internal compliance personnel. So the program undercuts compliance controls that funds have maintained since the adoption of the mutual fund compliance program—and that were informally in existence long before then.

That's not where we want to be headed. So ICI, among other things, has strongly recommended to the SEC that it change the proposed rule's language to prevent this front running of internal compliance programs. The proposal is still pending at the Commission. Hopefully they'll hear the many concerns voiced by ICI and others.

Here's another way your world is expanding. Besides dealing with new rules, you also have to contend more with old rules that you may not have had to worry about previously.

A standout here is the Foreign Corrupt Practices Act, which is more and more on compliance folks' radar because of the global expansion of our business. The FCPA is designed to ensure that companies don't resort to bribery or other corrupt practices to win business abroad.

Those same concerns are in play here at home, of course, particularly in the states. In some states, if an investment adviser is soliciting business from the state government, it has to register as a lobbyist. So now, you may have to brush up on lobbying laws if your employers want to, say, sell funds to a state's retirement plan.

Finally, I couldn't discuss the expanding world of compliance without mentioning the ever-increasing focus of regulators on risk. This is a particular concern for the compliance community. After all, aside from requirements around disclosure of portfolio risk, there's nothing in the federal securities laws that specifically governs oversight of investment company risk.

As you know, this issue is particularly salient in the context of working with fund boards. After lunch, our joint session with the Independent Directors Council will get into particulars. But just to give you a flavor now, we understand from the Office of Compliance Inspections and Examinations that the SEC is zeroing in on several facets of board oversight of risk.

For example, OCIE wants to know how boards are structuring the risk oversight function. And recruitment—are boards attempting to recruit members with a risk management background? Other factors that OCIE is apparently looking at are board training on risk and risk reporting.

We're watching these developments closely. To the extent the SEC is looking to boards to assume greater responsibility for risk, and those boards don't have dedicated risk officers, then that responsibility is probably going to fall on you. Welcome to the expanding

world of compliance, everybody.

I'm very confident you all are going to pick up plenty of ideas during this conference on how to deal with these new complexities in your expanding world. Let me offer you one such idea now.

As I see it, there are two skills that you will need to draw on more than ever in the days ahead. The first one of those skills is communication. The second, collaboration.

Communication and collaboration. In recent months, I've seen firsthand the power of communication and collaboration to get us through this tough environment. At ICI, we're using all modes of communication, vigorously. We continue to hold webinars, including recent ones on both the FCPA and the regulation of placement agents.

We're also continuing to put out comment letters, memos, research, and white papers. We're holding events, some outside of our usual conferences. We've even got a blog of our own now, and we even tweet!

I think one issue that showcases the value of a multilayered communications approach is how we're working with all of you on the pay-to-play issue.

As you all know, regulators want to eliminate the connection between state and local political contributions and the awarding of government investment advisory business. To that end, the amended pay-to-play rule sets up detailed reporting and recordkeeping requirements that put fund advisers on the hook for account information.

Problem is, in most instances, that's information that advisers and funds don't control and can't get. Unless the SEC or FINRA creates similar reporting requirements for brokers and other intermediaries that operate omnibus and similar accounts, funds and their advisers simply will not be able to comply with the new pay-to-play rules, through no fault of their own.

At ICI, we've been intensely working this issue since last October. We've held monthly conference calls with members to discuss pay-to-play concerns and to get a handle on everyone's access, or rather, lack of access, to the information in question.

In these calls, we've discussed ways to deal with the impossible situation we find ourselves in. One thought was simply to have advisers prohibit political giving by their employees or people associated with them. But members were concerned that doing that might run afoul of the laws surrounding political contributions.

So we hired an outside law firm to produce a white paper to address those concerns. If you haven't seen that paper already, I invite you to take a look. The bottom line is that you can't prohibit contributions outright, but you can limit them effectively.

Armed with our white paper and our member input, we've also been communicating and meeting with SEC staff about the possibility of getting no-action relief. Our hope is to fix the practical recordkeeping concerns while still addressing the SEC's fundamental objectives.

And that leads me to another important point on communication and collaboration. In this expanding world of compliance, we need to communicate and collaborate not just among ourselves, but also more than ever with the regulators that oversee our industry.

In the compliance area, ICI strives to provide even more industry input to the SEC in the hopes of improving the inspection process. Recently, for example, we've held seminars at the SEC on the basics of how our industry operates, how our processes flow, and what exactly happens from the moment an investor sends us a check until the moment that investor redeems his or her shares. As we see it, to the extent SEC staffers have a solid grasp of the nuts and bolts of our industry, they are going to be more informed examiners and rulemakers.

We're also engaging with OCIE as it explores having a CCO-like function of its own, something I know OCIE Director Carlo di Florio is keenly interested in. To begin with, this is a great idea—to have someone at OCIE who talks to the examiners, studies the exam reports, and makes sure everything squares with OCIE's own policies and procedures.

But a key ingredient here is industry input. Without industry input, regulators could end up just talking to themselves. So, as OCIE explores having this CCO-like function within it, we're discussing with them how to get regulated entities to provide perspective to the SEC on what their experiences were like.

This kind of robust dialogue between regulators and industry is critical. So many of our problems on the regulatory front—and pay-to-play is a perfect example—come about because regulators don't have a full understanding of how our businesses work. That often leads to the imposition of rules that are very difficult or even impossible to comply with.

Dialogue also helps regulators stay sensitive to the different roles played by various constituencies within our business. In the

compliance context, compliance professionals oversee; they do not manage. They are thus distinct from fund management, just as they are distinct from the board.

As these distinctions get blurred, ignored, or overlooked by regulators, confusion about the appropriate role of compliance professionals, which should be to oversee compliance with the federal securities laws, can creep in.

And dialogue doesn't just promote understanding—it also helps foster flexibility. This is particularly important in our changing and expanding world, where sometimes simply applying old rules to new situations doesn't work.

I'm thinking in particular of the brave new world of electronic communications. Today's rules governing communications were designed when the only media out there were print, radio, and television. While some of the old rules can continue to govern in a world of social media and the Internet, some of them can't. So regulators need to keep a measure of flexibility and adapt to the times, as we all are doing.

Along those lines, we were pleased to hear that FINRA has reconvened its Social Networking Task Force. This is definitely a step in the right direction, because the task force will help FINRA hear firsthand from the industry on whether regulators should provide more guidance on the use of social media. Tomorrow morning, one of our panels is going to examine the compliance issues presented by social media and other evolving means of communication. It ought to be an interesting discussion.

Now I'm aware that dialogue is just a process. And communication and collaboration are just tools in a tool kit. They are a means to an end. The real goal is to produce the best results we can for our shareholders. You—compliance professionals—play such a critically important role in this endeavor. So thank you all very much for being here. I look forward to spending this time with you, communicating, collaborating, and making our way through this expanding world together. Thank you.