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News Release

Will The Investment Company and Advisory Industry Win An Academy Award?

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Will The Investment Company and Advisory Industry Win An Academy Award?

The past twelve months have certainly been a banner year for the investment company industry. Today, we estimate that the assets of registered investment companies total at least $1 trillion. There are more funds than ever before, many advised and sold by newcomers to the business. According to the ICI, more than 26 million American families own investment company shares. Mutual funds and other investment company products seem to be the investment of choice for most individual investors. Securities salesmen and their firms today get a very large part of their earnings from selling mutual funds, unit investment trusts, variable life insurance products, and, yes, believe it or not, shares of closed-end investment companies, even though they often trade at a discount from net asset value. Commercial banks have seen the success of this industry, and noted with interest - perhaps amazement - the huge amounts of money to be made. The banks understandably want to join in, and it looks to me as though there's a better than even chance that the 100th Congress

will amend the Glass-Steagall Act to allow banks to underwrite investment company shares, in competition with you. Banks already do virtually the same thing today, but usually a registered broker-dealer is brought into the transaction, at least in a nominal way. Given the large customer base reached by banks throughout the country, this likely will mean even more spectacular growth in years to come. One day soon, I may be able to give the folks who decide our budget and staffing levels a number even they can understand. Yes, OMB, the SEC's tiny little Division of Investment Management is responsible for overseeing an industry with assets that equal the national debt. In fact, if I count the assets managed by all investment advisers, I can say that today.

The success and growth of the investment company industry reflects the extremely high level of investor confidence that everyone in this industry has worked hard to earn and keep. As far as I can tell, ethical standards are high, and most people in the business seem to believe that good compliance is good business, and they act accordingly. You all have a right to be proud of your outstanding reputation and record of service to investors. The trick is, of course, to hang on to your good reputation.

As you know, during the past year, our Enforcement staff has uncovered some pretty amazing examples of criminal behavior

in certain parts of the broker-dealer side of the securities industry, and, I'm particularly sorry to say, the securities bar. The people who have pled guilty so far to insider trading and other crimes have <u>not</u> been the "usual suspects". Nor have they all been juvenile delinquents - yuppies whose moral compass went wrong, or never existed. To the contrary, some very highly placed and previously well-respected people have confessed that they, too, went wrong -- in pursuit of more money, more fame and recognition from their peers, the thrill of risk taking, a mental breakdown -- who really knows? Lots of theories have been put forward to explain why they did it, but nobody yet claims to have the answer.

My own personal theory is that there was something lacking in the corporate culture of the firms where these people worked, perhaps on Wall Street, so that people were willing to overlook warning signs or suspect behavior by "big producers". After all, they were bringing in a lot of money, so they must have been doing something right. I'm not willing to lay the blame on educational institutions, or early childhood. These crooks all left home and got out of school years ago. I'd like to know what sort of guidance, leadership and discipline they were getting from the senior people in their firms. Or was everybody too busy chasing big bucks to worry about that sort of thing? At this point, no one really knows what went wrong, or why, just that it

did. But serious crimes were committed, by people in positions of the highest trust and confidence, and they personally, as well as everyone in the securities industry - guilty and innocent alike - are being called to account for their misdeeds. The SEC and Justice Department investigations are continuing, and we can expect more cases to come.

So far, despite all its rapid growth, and the huge sums of money being handled, no investment company has been directly implicated. So far so good. But problems of the sort we're seeing in the brokerage industry and the bar could so easily arise. The SEC can only do so much to prevent out and out fraud. Most often, we're left to mop up after the damage has occurred. And in a business like yours, where reputation and public confidence are so critical to success, I can't take much comfort from simply knowing that we'll eventually catch up with wrongdoers, and put them away for a few years. By then, the damage will have been done.

You, on the other hand, can do something that will help. You can take steps, right now, as individuals, as firms, and as an industry, to make sure that the investment company and advisory business remains free of scandal. You can redouble your compliance efforts. Make sure that your systems of control are in place, are adequate and are properly working. Stress the importance of high ethics and good compliance to all your people, throughout your organizations. Sure, it takes time. Yes, it costs money. You might have to pay your compliance people a bit more, or add

to your compliance staff. But preventive measures at this stage, before serious problems arise, will be far cheaper than any after the fact cure.

This is the first point I want to get across to you today. Don't sit back and be complacent. Take a hard look at yourselves. Good compliance is good business, and it's well worth the cost. A good reputation is hard to earn, and very easy to lose. Don't let that happen in this industry. Too many people, ordinary people who can't afford to lose their savings, are counting on you.

Now, on to the second point I'd like to make. It's related to the first, and it's something that I think people in the investment company and advisory industry must keep first and foremost in their minds at all times. The management of other people's money, through investment companies or by giving advice about investing in other securities, is a business, to be sure it's a very profitable business, and there's nothing wrong with making profits, that's the American way. But it is not just a business, certainly not an ordinary business. It is a fiduciary activity, a trust. The people in this business, most particularly investment advisers and investment company officers, directors and staff, are from the outset and in the end, much more than business people. They are fiduciaries, entrusted with the savings of millions of people, to whom they owe a fiduciary duty in the handling of those savings. And so fiduciary principles, the highest standards of care, loyalty and judgment about what is in the best-interests of your clients and shareholders, not merely what makes good business sense from your own point of view, must guide your actions.

When I listen to industry representatives or their lawyers argue with us, about what they must disclose, what they can or cannot do, I am often left with the impression that people in this business don't focus often enough on the fact that they are fiduciaries, or have conveniently forgotten what that means. Well, it may come as a shock to some, but it is a point worth emphasizing: those who manage money other people have entrusted to them as advisers or through investment companies, are by law fiduciaries and have a legal and a moral duty to act according to fiduciary standards. If there's anyone here who doesn't understand that, or doesn't like it, then you should get out of this business and go sell used cars.

It has often been said that "to say that a man is a fiduciary only begins analysis." 1/ Today, I want to explore with you what such a characterization may mean in the context of investment companies.

The median household income of investment company shareholders has been estimated to be about $46,000 a year, not a lot of money. Some probably regard their investments as savings for retirement or for the education of children, and some may depend upon the money for their living expenses. For these investors, the question whether their advisers, or the officers, directors and employees of their investment companies, have been faithful

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1/ SEC v. Chenery Corp., 318 U.S. 80, 85-86, 63 S. Ct. 454, 458, 87 L. Ed. 626 (1943) (Frankfurter, J.).

to their trust is not an abstract or academic issue, but a real issue of dollars and cents, affecting their daily lives.

The words "fiduciary duty" refer to the duties, of first, obedience to the terms of one's trust, second, diligence and care in the carrying out of one's fiduciary functions, and third, undivided loyalty to the beneficiaries of one's trust.

Where are these duties spelled out? Some are found in the Investment Company Act itself. Others are derived from the common law, and have been developed over hundreds of years.

Under Section 36(a) of the Act, the Commission can bring an action against a person for breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which the person serves as officer, director, member of an advisory board, investment adviser, or depositor or principal underwriter, except a principal underwriter for a closed-end investment company.

Under Section 36(b) of the Act, the investment adviser of a registered investment company is deemed to have a fiduciary duty with respect to compensation for its services, or other payments of a material nature, paid by the registered investment company, or by its shareholders to the adviser or its affiliates, and both the Commission and a shareholder can bring actions for a breach of this duty.

Although Section 36(a) applies only to a breach of fiduciary duty involving personal misconduct, actions under that section are not limited to situations where actual intent to violate the law can be shown or to acts of affirmative misconduct.

Nonfeasance of duty or abdication of responsibility also could constitute a breach of fiduciary duty involving personal misconduct. 2/

We have viewed Section 36 and other provisions of the Act as a codification of common law principles and as authorizing the federal courts to create a body of federal law delineating the duties and responsibilities of directors and other persons affiliated with investment companies. 3/ The Investment Advisers Act of 1940 also has been construed by the courts to impose fiduciary duties on advisers.

The exact nature and scope of these duties may be determined by reference to several sources. Courts have inferred fiduciary duties from specific provisions of the Company Act 4/, as well as its purposes 5/, as stated in Section 1(b). One such purpose is to mitigate and, so far as possible eliminate, the operation of investment companies in the interests of special persons, including fiduciaries, rather than in the interests of all classes of their shareholders. 6/ Courts may also look to the common law of trusts, as developed in the several states, and the law of corporations.

2/ H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970).

3/ Radmer, Duties Of The Directors of Investment Companies, 3 The Journal of Corporation Law 61, 70 (1977).

4/ Cf. Rosenfeld v. Black, 445 F.2d 1337, 1345 (2nd Cir. 1971).

5/ Aldred Investment Trust v. SEC 151 F.2d 254 (1st Cir. 1945), cert. denied, 326 U.S. 795 (1946).

6/ Investment Company Act of 1940 §1(b)(2), 15 U.S.C. §80a-1(b)(2).

The purpose of these references would be to ascertain the "prevailing standards" 7/, that is, those fiduciary standards with the widest support that are the most fitting in light of the essential characteristics of an investment company.

Let me give you some examples of how these fiduciary duties of obedience to one's trust, care and loyalty apply in the context of investment companies. First, obedience to the terms of one's trust. This would seem to require an adviser and investment company officers, directors or employees to make sure that the company's assets are invested in accordance with the company's stated investment objectives, polices, and restrictions. It also requires that the Company's assets be held for, and used for the benefit of, its shareholders, and not for the benefit of other persons or funds.

The second duty generally requires the degree of diligence, care, and skill which ordinarily prudent men in like positions would exercise under similar circumstances. A fiduciary who acts with the required diligence and care is not responsible for errors in judgment, but there is some authority for holding one offering services to any higher skill and judgment which he

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7/ H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970).

professes to have. 8/ One eminent trust scholar, George Bogert, has stated that

> On principle it would seem that a trustee should be required to exercise all the skill and prudence which he actually has, and also all that he professes to the settlor to have. 9/

Now that's a interesting point for investment advisers to think about before they advertise claims to genius and success in giving investment advice!

A fiduciary cannot shift the burden of meeting his or her duty of care to others. 10/ Reliance on the advice of lawyers, accountants or other experts, of course, can help show the use of reasonable care, but it is not conclusive and, at a minimum, the fiduciary would have to show that he had a reasonable basis for relying on the expert. This duty of care, it seems to me, is particularly pertinent today when investment companies contract out many of their responsibilities, like shareholder servicing, accounting, pricing and transfer agent functions. If the agent screws up, it is not enough to say "we hired a big bank and assumed they would do a good job". There is, I think, a continuing duty and responsibility on the part of investment company fiduciaries to monitor and make sure that the agent is in fact doing a proper job.

8/ G. BOGERT, TRUSTS & TRUSTEES, §541, p. 170 (rev. 2nd ed. 1978).

9/ Id., 171.

10/ Id., 164, 165.

The third duty, the duty of loyalty, prohibits a fiduciary from gaining advantage at the expense of a beneficiary or by reason of the fiduciary's office. This duty is sometimes enforced by a rule that prohibits self-dealing between a fiduciary and a beneficiary, such as the purchase or sale of property or the borrowing of money or property, without permission of a court or some other public body. Section 17(a) and (b) of the Investment Company Act spell out such a rule.

Sales and redemption practices should be examined to determine whether they are consistent with the duty of loyalty, that is, whether they are in the interests of the investment company and its shareholders and are not unjustly enriching the fund's affiliated brokers, transfer agent, or custodian bank. Investment company fiduciaries should not tolerate undue delays in the transfer to a fund of payments made by investors for shares of the fund, and they should make sure that the proceeds of a redemption, pending payment to the shareholder, are being held for the benefit of the shareholder or of the fund.

The duty of loyalty is also sometimes enforced by a rule barring the taking of commissions, or limiting the amount of commissions. Section 17(e) of the Act is an example of such a rule. Other rules, such as Section 17(j) of the Act, may deal with the taking of corporate opportunities and the use of corporate information. To prevent loss of a company's opportunities and the use of its information by others, investment company fiduciaries should carefully examine the adequacy of the code of ethics and reporting practices of the company and its adviser.

Where the existence of a conflict is not prohibited, the duty of loyalty usually requires disclosure of the existence of the conflict. For example, an investment adviser to an investment company who receives a loan from the fund's bank custodian has a fiduciary duty to disclose the loan to the fund's disinterested directors. 11/ The duty is to disclose plainly, not to obfuscate.

As stated by Austin W. Scott, the reporter of the Restatement of the Law of Trusts,

> If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance. 12/

Disclosure alone, however, will not satisfy the duty of loyalty. The fiduciary must act in a manner that the fiduciary believes, in good faith, to be in the beneficiary's interest, and any transaction, where a fiduciary has a conflict, must be fair and reasonable to the beneficiary.

When a fiduciary causes an investment company to enter a business transaction, and the fiduciary has a chance to profit in some way for himself, great care must be exercised to make sure that the incidental benefit to the fiduciary does not consciously or unconsciously cause the fiduciary to slight the interest of the fund. 13/ In some cases, the fiduciary may be required to forego

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11/ Cf. In the matter of Steadman Security Corporation, ['77-'78 Transfer Binder] CCH Fed. Sec. L. Rep. 81,243, remanded on other grounds, Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979).

12/ Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949).

13/ Cf. G. BOGERT, TRUSTS & TRUSTEES, §543 Q, p. 344 (rev. 2nd ed. 1978).

the benefit, or give it to the client. At a minimum, full disclosure of the conflict, in advance, must be made, and prior client consent is desirable. This issue arises, for example, in the case of an adviser who receives referrals of advisory clients in return for the placement of fund brokerage business.

What about an investment company's advertising? Unlike other companies, an investment company's customers are its present or future shareholders. Thus, the investment adviser, and the officers, directors and employees of an investment company seem to me to have a duty to act in the customers' interests, and, I think, this duty applies to advertising. 14/ In fact, I think that if investment company advisers and directors made very clear to their marketing people and outside ad agencies the fiduciary principles that apply to this business, and could get them to adhere to those high standards, there would be little need for SEC rules on the subject.

Lawsuits charging breach of fiduciary duty to investment companies have usually arisen under Section 36(b), and have involved challenges to the size and nature of advisory fees. Most have been settled out of court. The leading litigated case, Gartenberg v. Merrill Lynch Asset Management, Inc., established

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14/ See Radmer, Duties of the Directors of Investment Company, 3 The Journal of Corporation Law 61, 100 (1977).

what I consider to be a fairly easy standard to meet in defending the reasonableness of fees, and that is whether parties acting at arms length would have entered into the advisory contract. 15/ Because the plaintiff has the burden of proof in actions under Section 36(b), it would appear that no action under that section can succeed unless the plaintiff can prove that no reasonable man would find the adviser's compensation to be reasonable. But despite the court decision in Gartenberg, fear of litigation under Section 36(b) has led to industry efforts to get the provision amended or repealed, and countless words have been written and spoken trying to divine what will or will not constitute breach of fiduciary duty with respect to advisory fees. More recently, the discussion has involved 12b-1 fees, which probably are also covered by Section 36(b) if they go to an adviser or its affiliates.

I won't try to rehash the theories and arguments about Section 36(b) here. I don't have the time, and I'm sure you don't want to hear it again. I do recognize and appreciate the pain that litigation like this can cause. I'm sure its like being charged with EEO complaints, which happens to people in my job. The fact that you're ultimately found "not guilty" is nice, but it doesn't eliminate the suffering you experience along the way.

As I said before, and what I want to stress, is that Section 36(b) isn't the only source of fiduciary duties placed on

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15/ Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 928 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983).

investment company advisers and personnel, and advisory fees, while they are the most basic and obvious area of conflict of interest between advisers and investment companies, aren't the only area that requires close scrutiny and the application of fiduciary principles.

In monitoring advisory fees and other areas where conflicts of interest arise, we at the SEC and you in the industry have tended to heavily rely on the "disinterested directors". They have been called "the watchdogs" 15/ of the investment company and it is their special function to scrutinize those aspects of the business where the investment adviser or the interested directors have a conflict of interest. The disinterested directors do perform a vital function, and, in my opinion, almost always do an outstanding job. But I think we may have relied on them too much, and that's not fair. Why should disinterested directors bear most of the burden? After all, they're not the only ones with fiduciary duties. All directors are fiduciaries, so is the adviser, and, to some extent at least, so are the folks they hire to do the work. In fact, this heavy emphasis on the disinterested directors may be one reason why everybody else tends to be forgetful about their particular status and fiduciary role. I'd like to see the rest give the disinterested directors more help.

14/ Burks v. Lasker, 441 U.S. 471, 99 S. Ct. 1831, 60 L. Ed. 2d 404 (1979).

During the next four days, we'll hear discussions of issues of current interest to the investment company industry. Just to name a few: the impact of the Tax Reform Act -- what did Congress do unto you, and what can you do unto Treasury and the IRS to minimize the pain; 12b-1 plans -- how much money can you get, how deep can you bury the disclosure about it and how long can you avoid accounting for it; new products -- I call this the "Ripley's Believe it or Not" panel; banks, or how to keep the competition out of your business except when you can make more money by bringing them in; communications with investors, which will probably focus heavily on the SEC proposal to clean up some of your less desirable advertising practices, and, of course, the usual railing at the regulators, always a popular sport.

As we proceed to listen to the panel discussions, I hope that each of you will think about these issues like the fiduciaries that you are. Merely because there's no express statutory prohibition or SEC rule saying that you can't do something, doesn't mean that it's OK - full speed ahead, damn the torpedoes. Statutory analysis is just the beginning, not the end of the process. You still must determine, as fiduciaries, whether your proposed action is in the best interests of your clients or shareholders and consistent with your duty of obedience, care and loyalty.

The performance of the investment company and adviser industry, as a profession and a trust, depends, in part, upon how the members of the industry have discharged their fiduciary duties. I hope that in the years to come you will ask yourselves that, and that your answer, and the answer of the public, will be that the industry deserves an academy award. Thank you.