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Volume 5
Fourth Quarter
2003

INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

MEMO TO MUTUAL FUNDS: IT'S ALL ABOUT TRUST

By Don Phillips, Managing Director of Morningstar, Inc.

We came across this article in *The Wall Street Journal* and felt that the message bears repeating. Mr. Phillips was kind enough to oblige.

Eliot Spitzer's office is on the line. Your firm is about to be named as the latest culprit in the mutual fund scandals. What do you do?

First you need to identify and isolate the problem. Don't confuse the sum of money involved with the seriousness of the issue. It isn't the amount taken from investors, but the breach of fiduciary responsibility that's at the heart of these scandals. On this score, there can be no gray area. Your people were either acting in shareholders' best interests or they weren't. If not, it doesn't matter how valuable the employees have been in building your firm — they have to go. The money management business is built on trust; it's by far the most valuable asset your firm has. A money management shop can survive the departure of even the most talented employees, but it can never withstand a soiled reputation.

The stakes here are high. Putnam has lost $21 billion in assets since being named in an SEC investigation last month. In addition, Mr. Spitzer is calling for complete disgorgement of all fees earned during the time in which improper behavior took place in a fund. But these costs may be minor next to the prospect of class-action suits. It's only a matter of time before lawyers claiming inadequate disclosure ask for investors who bought in at the market peak to be made whole. This is a tab few money managers could pay. Your business is at risk. Make sure you have a top-notch legal team in your corner.

Next you need to address what structural steps you can take to protect shareholders in the future. An internal compliance officer, a stronger fund board, a corporate ombudsman are all worth considering. If you're not sure which steps to take, bring in a corporate governance adviser to oversee this process. If you've really screwed up, bring in a big hitter like Arthur Levitt. If the sins aren't as grave, a lower-level former regulator may suffice. But in any case it must be someone who will inspire public confidence. You need a Kenesaw Mountain Landis, not a Bud Selig.

As you make these changes, you need to communicate openly and honestly with shareholders, regulators, and staff. Don't hide from the media; you need to show investors that you take these issues seriously and are taking bold actions to address them. Treat your fund shareholders like business partners. Tell them fully what happened, what steps have been taken to correct the situation, and what steps will be taken to ensure this will never happen again.

Now that you've done the easy work, it's time to address the real issue: What was it about your firm's culture that allowed this to happen? Do you hire the right kind of people? Do they have the right values? If you're constantly

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losing portfolio managers to hedge funds, it's a good sign that you've attracted people motivated too much by short-term gain. Don't confuse greed with talent. Top professionals are motivated by the ability to do great work and be part of something bigger than themselves. The best money management firms have a deep-rooted sense of purpose. Vanguard is committed to low costs, Capital Research to research excellence. Firms like Dodge and Cox, Longleaf, and First Pacific Advisors all have deep-rooted, investor-centric cultures. Have you created a firm with a purpose or have you merely gathered a lot of highly compensated stock jockeys?

Next, permanently align your employees' interests with fund shareholders' interests. If your employees aren't investing in the funds they manage or if their trading of the funds is not in keeping with the long-term focus you ask of your clients, fix it. Invest employee bonuses in fund shares and require long holding horizons. Demonstrate to fund shareholders that management's interests will be strongly linked with theirs from this day on.

Finally, remember that this is a long-term proposition. A fund management company has to win the public's trust every day. Keep your people, even your top managers, in front of shareholders. Get them on the phone lines or at investor conferences. Never let them lose sight of whom they serve. Conceptually, the asset management business is a simple business. All you need to do is treat fund shareholders' money the way you'd want your money to be handled. If you get this principle right, your firm will never lose its way again, but if you don't, any changes you make today will be fleeting.

"Honesty is the best policy, Fernbaugh, but it's not company policy."

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