IDC Independent Directors Council
Promoting Excellence in Fund Governance

2005 Mutual Funds and Investment Management Conference: Keynote Address

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Keynote Address by

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It is a pleasure to help kick off the 40th annual Mutual Funds and Investment Management Conference, co-sponsored by the Investment Company Institute and the Federal Bar Association.

This is my first Mutual Funds Conference as President of the ICI, and our agenda is a bit different from the past. We have endeavored to cover more ground by scheduling more concurrent sessions, and by repeating sessions to enable you to choose those that most interest you.

I have committed to using the Institute's conferences on an ongoing basis to highlight and explore ethical issues and fiduciary obligations in our business. This conference features a panel that will focus on the ethical obligations of fund lawyers and compliance professionals – a matter of singular importance to this audience.

Some conference traditions should be preserved, however, and one of the best of these is the opportunity to hear directly from the leadership of the SEC. We are honored that SEC Chairman William Donaldson is here. We look forward to his remarks.

For many years, Paul Roye has been a prominent voice at this conference, and we look forward to his participation on tomorrow's regulatory outlook panel. We wish him every success as he returns to private life, and congratulate him on his leadership of the SEC's Division of Investment Management during an extraordinarily difficult and challenging period.

I hope you find the conference – both the program and the opportunity to interact with colleagues – to be enjoyable and informative.

This morning, I want to focus on three major substantive points:

- First, I want to talk about some of the regulatory changes ICI believes are necessary to provide the tools to protect the interests of mutual fund shareholders.
- Second, I want to talk about how the industry and others need the opportunity to catch up to the reforms that have already been introduced, to ensure effective implementation.
- Third, I want to discuss a non-regulatory issue. It's one of particular importance to the mutual fund industry, the investment industry as a whole, and to our shareholders: the issue of retirement security.

All of these topics share a common root: We recognize that the future of the mutual fund industry depends upon the well-being of its shareholders. That is the lens through which we view these issues: How do they affect fund shareholders? It is crucial for us to put shareholders first.

After centuries of being an elite privilege, investing has grown to become a mass opportunity. America has taken an extraordinary leap forward in creating an "Ownership Society."

Mutual funds are one of the principal reasons. The share of households with fund investments has shot up from 5 to 50 percent in just a generation, since 1978. The assets mutual funds manage have swelled from $56 billion to over $8 trillion.

Simultaneously, a huge structure of intermediation has grown up – a structure in which broker-dealers, banks, insurance companies, and retirement plans are major participants facilitating fund investing. It's a complex architecture, a vitally necessary one – but one that involves difficult regulatory and practical challenges.

In this environment, funds and their intermediaries must cooperate and share responsibilities to put the interests of their customers first. We must tackle head-on the remaining items on the SEC's mutual fund reform agenda that go to the heart of the late trading and market timing abuses – in pursuit of solutions that serve the interests of fund investors.

A month after the mutual fund trading abuses were brought to light, the Institute called for a firm rule to require that only mutual fund trades reported to mutual fund companies by 4 p.m. receive the current day's price.

We did not advance this recommendation lightly. We recognized the processing burden this would place on funds and intermediaries alike. But we concluded that a hard close would provide the ample protection against late trading abuses that mutual fund investors deserve.

There may well be alternatives that provide effective safeguards while offering greater flexibility. We support the Commission's deliberate approach to this issue because it is so important to get it right.

Curbing abusive short-term trading is another crucial challenge in light of the complex infrastructure of fund investing. Because of record-keeping conventions that are widespread in the industry, funds as a practical matter often must rely on their intermediaries to help implement policies like redemption fees. At the same time, because such policies can differ fund to fund, intermediaries confront real operational challenges – and costs – in satisfying the requirements of their various fund partners.

To resolve this dilemma, the Institute called in November 2003 for a uniform, industry-wide minimum redemption fee requirement. The fee would be payable to a fund, for the exclusive benefit of long-term shareholders.

Earlier this month, the SEC took steps to facilitate the effectiveness of voluntary redemption fees. But we remain concerned that abusive market timers will still be able to play 'catch us if you can' with mutual funds. That's why we continue to urge the Commission to devise fully effective means for funds and their intermediaries to address the problem.

The importance of intermediaries is also reflected in the debate over 12b-1 fees. The level of interest in this issue is high. When the SEC asked if it should consider changes to the rule, it received over 1,600 comment letters.

The SEC is considering requiring additional disclosure of 12b-1 fees at the point of sale and in transaction confirmations. Certainly, more can be done to improve investor understanding of these fees. As well, fund directors need better guidance on the factors relevant to their approval of a 12b-1 distribution plan, given how the fees are used.

12b-1 plans have evolved over time, and today they constitute an important mechanism for compensating intermediaries who provide advice and other assistance to fund shareholders. In fact, a survey that the ICI released just last month determined that 92 percent of the 12b-1 fees mutual funds collect from investors goes to compensate financial advisers and other intermediaries for assisting shareholders before and after purchasing funds. Only a small fraction goes toward advertising and promotion.

The importance of the investor advice and services these fees pay for is clear, and it is widespread. About three-quarters of those who purchase funds outside of 401(k) plans do so through a professional adviser. And that's consistent across our shareholder population – notwithstanding age, asset level and educational background.

Clearly, any revisions to Rule 12b-1 must to take into account the needs and preferences of fund investors, and reflect how these fees are actually used today.

It is crucial to complete these regulatory initiatives, particularly those projected in response to the fund trading abuses. As you know, the Institute has endorsed the vast majority of these SEC proposals.

At the same time, however, we believe it is prudent to take stock of the impact of the unprecedented pace of regulatory activity we have seen in recent years.

Since September 2003, the SEC has adopted or proposed 19 new fund industry regulations – 12 of them as a direct consequence of the trading abuses.

These regulations are remarkable in themselves. But they also build on a lot of recent history.

- Congress enacted the Gramm-Leach-Bliley Act in 1999.
- The SEC adopted its privacy rules the next year.
- It approved Chairman Levitt's fund governance reforms in 2001.
- Soon after, the SEC required that funds disclose after-tax returns.
- Congress passed the USA Patriot Act in October 2001, with its extensive anti-money laundering compliance obligations.
- President Bush signed Sarbanes-Oxley into law in 2002, with its certification requirements, disclosure controls and procedures, and code of ethics and financial expert provisions.
- The Commission's proxy voting rules took effect in 2003.

Virtually everyone in the mutual fund industry would agree that the combined weight of these regulations – in place and in the pipeline – is daunting. Many of the initiatives are far-reaching, intended to transform fundamental business operating systems and in some cases change business culture – not things that happen overnight.

The burden falls on all firms, but on some more heavily than others. The greatest impact falls on the smaller firms. There are indications it may drive some out of the fund business, and certainly will discourage others from entering it. That would be regrettable.

We must ensure that needed reforms do not make us less entrepreneurial, less competitive, less creative, or less responsive to investors' evolving needs.

That wouldn't just be bad for the industry – but bad for investors.

Mutual funds have powered middle-class growth and energized the economy. They have democratized investing. And they have enhanced the ability of our capital markets to perform their core function – bringing together those who are prepared to invest capital with those who are able to utilize it to create wealth and progress.

The success of mutual funds reflects the dynamic nature of our industry. Just last May, the Wall Street Journal described the industry as "a great model of market capitalism … big, diverse and madly competitive."

In the interest of investors as well as fund companies, it is crucial to preserve and foster this dynamism.

The Institute is doing everything it can to assist mutual funds in implementing new SEC regulations. We have already launched several initiatives, including the formation of a Standing Committee of Chief Compliance Officers, and publication of updated drafting guidance for codes of ethics. We are also proceeding with a compliance practices survey, a paper on compliance testing, and practical guidance on fair valuation issues.

To assist directors in implementing new governance requirements, the Independent Directors Council already has issued reports on the role of the independent chair and board self-evaluations -- and it has more projects in the pipeline.

This is not to say the job is behind us. Much remains to be done – including regulatory changes. But it needs to be done in a thoughtful and methodical fashion.

One of the areas that merit a comprehensive review is mutual fund disclosure. We're pleased that the SEC has announced plans to do that. There are a number of important considerations here, not the least of which is that disclosure today must serve disparate purposes. First and foremost, it must inform investors – and do so meaningfully and effectively. But it must serve other constituencies as well, including financial advisers, other industry participants, regulators, analysts, and the media. It also must shield fund companies from liability.

Keeping all of this in mind, we have to re-examine how we communicate with shareholders – to truly inform them, rather than simply dump data in their laps.

A related question is how we can make best use of technology, such as the Internet, to facilitate disclosure that is thorough, fast, and flexible. This could be particularly appropriate given the many third parties who perform useful services by analyzing, repackaging, and distributing information about mutual funds to the investing public.

As part of any disclosure reform effort, it will be critical to obtain the views of all interested parties – investors to be sure, and of course lawyers. But we need to insert new and broader perspectives into this important policy process. For example, we should draw upon the expertise of social scientists who may be able to provide valuable insights into how people absorb information and use it to make decisions. Working together to make sure that investors' interests are well-served by mutual fund disclosure should be a high priority for all of us.

In my judgment, we need to take time to craft a better approach to fund disclosure – to get the job done right, while maintaining the industry's robust competitiveness.

These regulatory challenges are issues that we care deeply about. Looking more broadly, there is another issue that deserves some comment – that is, how to answer the challenge of retirement security. Obviously, mutual funds play a pivotal part in that. I described my perspective and the Institute's views on this in a recent speech at the World Trade Center in New Orleans.

There are three points that I would like to share with you briefly this morning.

First, the time for a debate about Social Security – and retirement security more generally -- is now. Our nation faces a serious demographic challenge, with serious implications of the pay-as-you-go structure of Social Security. In 1940, 16 workers were helping pay for every beneficiary. According to a Wharton School study, the number of workers per retiree is just 3.9 today, and it's projected to drop to 2.2 in 2030. In 30 years, there will be 74 million older Americans – nearly twice as many as today.

We must remedy the structural imbalance in Social Security – not just for now or for the next decade or two, but as President Bush has urged with the goal of permanent solvency and sustainability. The sooner our nation addresses this issue -- in whatever way we ultimately choose to do so -- the better. We cannot afford to simply ignore the problem or defer action.

Second, time can be an ally – if we take advantage of it. Time can give people a reasonable window of opportunity to prepare for any major change in the way they must plan for their financial future. And time can give people the opportunity to accumulate retirement assets by other means.

This touches on an aspect of the current debate that demands a clear response. While the Institute is not advocating the establishment of personal retirement accounts, we are determined to respond to the argument that encouraging Americans to save and invest is like luring them to a craps table.

Rhetoric like that simply misses the mark.

It is unjustified because history demonstrates that investing – equity investing in particular – is the best way to accumulate wealth. Professor Jeremy Siegel of the Wharton School has found that the real return on equities has averaged 7 percent per year over the past two centuries. If you invest efficiently and at reasonable cost, if you diversify, if you look to the long term – hallmark values of mutual funds – you have every expectation of good returns.

Such an argument is also misleading, because it is likely to discourage people from taking necessary steps to gain greater control over their future, to plan for their financial security, and to save and invest for their retirement.

Finally, the argument betrays a deep pessimism about America's long-term economic prospects – a pessimism that is simply misplaced.

Everyone in an industry like ours should understand these points. We have an obligation to communicate them.

There is a third and last observation I want to make about retirement security. In addition to ensuring the solvency of the public retirement system of Social Security, we must also strengthen the private retirement system, including employer-sponsored plans and individual savings arrangements.

That should include simplifying plan designs, streamlining plan administration and operations, and eliminating tax provisions that discourage long-term savings.

And it should include giving American families the tools, education, and information to build meaningful retirement security in all its forms.

We can and should draw more Americans into the "Ownership Society." Mutual funds have been and will continue to be a proud part of this story.

Thank you for your attention. Please enjoy the conference.

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