

## 2002 General Membership Meeting: President's Report

# ICI President's Report at the 2002 ICI General Membership Meeting

by

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Good morning, and welcome to the Institute's 2002 General Membership Meeting. Many thanks to John Carifa, the Chairman of this year's meeting, who put together a terrific program. Special thanks also to the Institute's Chairman, Terry Glenn. Their advice and counsel have been invaluable to the industry and to fund shareholders, and we look forward to many more years of working together.

The theme for this meeting is Continuing a Tradition of Integrity in Challenging Times. There is only one way to ensure the continued integrity of our industry—that is to judge every action we take by one criterion and one criterion alone—whether it is in the best interests of fund shareholders.

Shortly after the Investment Company Act of 1940 was enacted, the first head of the Institute, Paul Barholet, predicted that our industry would succeed if our constant focus was meeting this criterion. In particular, Barholet stated that investor confidence would endure if we remained committed to strong laws and regulations that served shareholder interests.

Barholet urged us to take an active, pro-consumer approach to regulation. He advised us to work with, not against, legislators and regulators who are concerned about the needs of fund shareholders. And

he counseled members of our industry to put aside their differences and work together in support of high standards that served the interests of fund shareholders.

What would Bartholet see if he were with us today?

First and foremost, he'd see how consistently we have worked together to embrace strong regulation that puts mutual fund shareholders first.

Bartholet would see that we have not let the consumer protections of the Investment Company Act become watered down. We have resisted calls over the years, in good times and in bad, to roll back the Act's safeguards. Today, the Act's strict investor protections remain fundamentally unchanged from 60 years ago.

Bartholet would see that the Securities and Exchange Commission has administered the Act to permit continuous innovation in the interest of investors. Over the years, our industry has developed numerous types of funds, with a variety of investment objectives, distribution channels, and shareholder services that were unimaginable in 1942.

Bartholet would see that the mutual fund industry has opened the financial markets to millions of average Americans, providing them with diversified investment portfolios, professional management and a range of services previously available only to the wealthy. From fewer than one-half million shareholders in 1940, our industry now is entrusted with the investments of 93 million Americans.

Finally, he would see that our industry, with its many distinctions, continues to speak with one voice through one association in support of policies that put fund shareholder interests first.

In short, I'm certain that Bartholet would be enormously proud to see that the principles he set forth 60 years ago are an essential part of the mutual fund industry.

But, I'm also certain that Bartholet would be the first to warn us not to rest on our laurels. In preparing my remarks, I thought about the advice Bartholet would give if he were with us this morning.

I believe the first thing he would tell us would be to continue to protect the safeguards of the 1940 Act that are essential to investor confidence— diversification requirements; flat prohibitions against self-dealing; the requirement to mark all assets to market every business day; tough limits on leveraging; full and fair disclosure; and oversight by independent directors. From time to time, there are calls to weaken these standards. Recently, an effort was made to repeal the Act's prohibition against self-dealing, a move that threatened shareholder interests and the integrity of our industry. The Institute successfully opposed that effort, and we must always oppose proposals that would weaken core protections of the Act.

Second, if Bartholet were here today, I believe he'd agree that fund shareholders are best served by having mutual funds regulated by a single agency—a strong, well-funded SEC. Over the years, we've successfully resisted efforts by bank regulators, state officials, and others to impose duplicative and conflicting requirements, and we must continue to do so. Equally important, we have a responsibility to support legislation that gives the SEC sufficient resources to do its job. As we noted in recent [testimony](#), this includes supporting the SEC's ability to attract and retain qualified staff by compensating them at appropriate levels.

Third, I believe that Bartholet would recognize the need for continual regulatory modernization in the interest of investors. Fortunately, the Investment Company Act provides the SEC with the authority to modernize its provisions through regulatory action. Whether by permitting a stable net asset value, which gave rise to money market funds; authorizing the use of foreign custodians, which facilitated international investing; permitting [performance advertising](#), which fueled competition and drove down fees; or [simplifying prospectuses](#), which promoted investor awareness—the SEC's administration of the Act has been marked by a series of regulatory innovations that anticipated and met the changing needs of fund shareholders.

Of course, we continue to encounter areas in need of refinement. A prime example concerns rules dealing with affiliated transactions under Section 17. As I mentioned earlier, we must always defend the 1940 Act's core investor protection standard that prohibits self-dealing. However, there are cases where old SEC rules may inadvertently hamstring legitimate new activities that do not pose any risk of self-dealing. The Institute has submitted a [comprehensive review](#) of this issue that identified ways to modernize the regulatory approach without compromising investor protection. A few weeks ago, the SEC issued proposals to update some of the rules. This is a needed start, but more needs to be done.

Another example where reform is needed concerns disclosure requirements. Five years ago, the SEC amended its rules to simplify and streamline mutual fund prospectuses. The industry then stepped up and met the spirit as well as the letter of the new law, turning prospectuses into documents that shareholders can actually read and understand. The movement toward reorienting disclosure requirements to focus on conveying useful, practical and concise information should continue. Last week, the [SEC proposed important changes](#) to mutual fund advertising rules. This same successful logic should next be applied to shareholder reports.

Fourth, I am certain that Bartholet would be dismayed by the risks to investors that arise from unwarranted exemptions from the Act. Hedge funds are a prime example.

The authors of the 1940 Act were careful to keep exemptions narrow. To accommodate very small local investment entities, a narrow exemption from 40 Act regulation was established for funds with fewer than 100 shareholders that were not publicly offered. Hedge funds later emerged to take advantage of this limited opening. But in 1996, hedge funds obtained a much broader exemption that permits them to have an unlimited number of investors, so long as they are individuals with \$5 million in investment assets and institutions with \$25 million.

The ink was barely dry on the 1996 legislation when hedge fund proponents began complaining that the new exemption was too restrictive. They argue that hedge funds should be free to advertise, to conduct public offerings and even be available in 401(k) plans.

Recent history, however, suggests that the 1996 hedge fund exemption may have been too expansive, rather than too restrictive. In the past few years, we've witnessed an alarming increase in serious problems for investors in unregistered hedge funds, including bankruptcies, looting of assets, misleading accounting, deceitful communications, and unscrupulous sales to less sophisticated investors. Many of these problems seem to coincide with the expansion of unregulated hedge fund activities that occurred following enactment of the 1996 legislation. Sadly, these are precisely the types of abuses the 1940 Act was designed to prevent. Despite these warning signs, some are suggesting that unregistered hedge funds should be given even more of a green light. In my view, this is a recipe for potential disaster.

I am certain that if Bartholet were here today, he would urge policymakers to evaluate the activities of unregistered hedge funds and impose tough corrections on abusive practices.

Fifth, I believe that Bartholet would recognize that our industry's success will tempt outsiders to use mutual funds for their own benefit, at the expense of fund shareholders. We must resist these efforts. The proposal to impose community reinvestment requirements on mutual funds, which would have redirected part of individual shareholders' savings to benefit others, is a past example of this. Two other examples have arisen more recently.

Last fall, several major industrial companies urged the Commission to weaken its credit quality rules. They wanted the SEC to allow money market funds to invest in lower-rated commercial paper. Clearly, this proposal was not driven by concern for the interests of investors, who use money funds as a conservative safe haven. The Institute vigorously opposed this proposal, and we were pleased to see that the SEC resisted this effort.

To our dismay, we've also seen professional speculators and arbitrageurs use our regulatory filings in a manner that yields them quick profits, at the direct expense of fund investors. In particular, information provided on Form 13F—a formerly routine regulatory filing—is being used in a way that was never intended and is harming fund shareholders. Form 13F requires fund companies to list most of the equity securities held by their funds. The requirement was imposed at a time when the SEC was concerned about hostile takeover activities. Even though the SEC no longer appears to use or need these filings, they are posted on the SEC website. Once posted, Form 13Fs are instantly downloaded by professional traders, who use the information to identify securities the funds may be acquiring or selling.

The inescapable conclusion seems to be that 13F filings fuel abusive practices like frontrunning and freeriding that harm fund shareholders. We have urged the SEC to reevaluate the need for [quarterly 13F filings](#). Likewise, we urge the SEC not to increase the opportunity for abusive trading by requiring [more frequent portfolio disclosure](#) by funds.

In his 1942 speech, Bartholet stated his belief that:

“The investment company provides the only sound answer to the needs of the small investor.”

Therefore, I have no doubt that if he were here today, Bartholet would emphasize our continuing obligation to serve the many needs of small investors.

The number one reason why Americans invest in mutual funds is to save for retirement. While [last year's tax bill](#) included several important and long overdue changes, in several significant ways the law has not kept pace with the needs of these middle-income investors.

IRA rules remain needlessly complex—so much so that many taxpayers who could make deductible contributions are discouraged from doing so because of the sheer complexity of calculating their deductions. The Institute has [urged repeal](#) of these complex rules in order to encourage personal retirement savings.

One of the lessons of Enron is that participants in 401(k) plans need to be fully informed about their plan's investment options. The Institute has long called for regulatory action to address the major disclosure anomalies that exist for 401(k) investors. Disclosure reforms are pending in Congress, and we look forward to working with Congress and the Department of Labor to design a stronger and more useful 401(k) disclosure system.

Many 401(k) participants want advice to help them evaluate the investment options available to them. But fund groups generally have been prevented by current law from providing advice. Pending [legislation](#) would permit plan service providers to offer reasonable and prudent advice to plan participants, subject to strict fiduciary regulation and full and fair disclosure. President Bush has endorsed this bill, which has twice passed the House with strong bipartisan majorities. We hope that this much-needed reform will become law soon.

Saving for college ranks only behind saving for retirement as a goal for mutual fund investors. In establishing 529 plans and Coverdell education savings accounts, federal and state governments have paved the way for college savings to grow. Congress' historic actions in encouraging these programs may someday be seen as significant as its establishment of IRAs and 401(k) plans.

While these education plans are extremely promising, important questions remain. For example, while out-of-state 529 plans often are appropriate and attractive investments, investors should be alerted to the fact that there may be a tax advantage to investing in their own state's program. For this reason, the Institute recommended that the Municipal Securities Rulemaking Board require offering documents to include prominent disclosure in this area. We also must ensure that investors understand these new investment options. Therefore, I'm pleased to note that the Institute is releasing a new informational brochure on 529 plans.

I believe that Bartholet also would remind us that serving the needs of small investors requires us to reach out to all working Americans. Research findings tell us that, on average, middle-income African Americans and Hispanics direct a smaller portion of their income to long-term investments than members of other groups with similar incomes. The Institute's Investing for Success education program is designed to strengthen awareness about investing in these important communities.

I have no doubt that Bartholet would also tell us that we owe it to our shareholders to ensure that federal tax policies do not needlessly impede their ability to achieve investing goals. That's why 90 mutual fund industry leaders recently urged Congress to permit fund shareholders to defer taxes on reinvested [long-term capital gains distributions](#). Deferral would benefit millions of middle-income Americans, encourage investment in the U.S. economy and stimulate long-term economic growth. Given the return of the federal deficit, it may be difficult to enact legislation quickly. But we must continue to work for this important reform.

Finally, I'm sure that Bartholet would agree that advancing the interests of fund shareholders requires us to support reforms that make our markets more efficient, transparent and fair.

In recent years, we have devoted considerable attention to promoting improvements in the structure of our equity markets. For example, we have led the effort to require improved disclosure for municipal securities. The Enron bankruptcy has prompted a large number of legislative and regulatory proposals. and as in the past, we will continue to speak out when we believe doing so will benefit fund shareholders. Last week, for example, we wrote to the New York Stock Exchange to reiterate our [long-standing position](#) that exchange rules should require shareholder approval of most stock option plans. We did so because if these plans are not subject to appropriate checks, they can have the effect of transferring wealth or voting power from public investors to management.

Earlier this week, we called for another important change. Mutual fund managers are encountering far too many situations in which companies report earnings with great fanfare but limited detail. Then, after several weeks and much activity in the market, the data that reveals what the announcement did—and did not—account for is finally provided.

The SEC recognizes this problem, and has proposed to shrink the time gap between a company's public earnings announcements and the filing of its financial statements. The financial statements are critical because they contain the data that permit investors to analyze the earnings announcement. While shrinking this time gap may produce some benefits, we think the SEC should go further and attempt to eliminate the gap altogether. In a letter to the SEC this week, we recommend that companies making public earnings announcements be required to promptly file the earnings information with the SEC. In addition, whenever the announcement includes pro-forma or non-standardized earnings information, this filing should include a side-by-side reconciliation of the announced earnings to GAAP, along with a plain English narrative description of any differences.

Reforming SEC rules in the way we propose would enable fund portfolio managers to make better investment decisions on behalf of fund shareholders.

Finally, I believe that Bartholet would tell us that to serve small investors, we must go beyond law and regulation. We must continue to implement best practices in areas such as personal investing by portfolio managers and the independence and effectiveness of fund directors. We must continue to educate our officers, directors and employees to implement the spirit, as well as the letter, of the law. We must continue to educate investors about the risks, as well as the rewards, of investing. We must continue to describe our products and services to investors clearly and coherently. We must constantly remind investors of the need to diversify; about the impact of interest rate changes on bond funds; about funds' lack of FDIC insurance; about the impact of expenses and taxes; in short, about all aspects of mutual fund investing.

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This morning, I've tried to imagine what Paul Bartholet would say if he could be with us today. I believe the issues I've discussed would resonate with him. I'm certain that he would wholeheartedly agree that our most important responsibility is to continue the tradition of integrity that has been the hallmark of our industry for more than 60 years.

Bartholet's hopes for our industry in the 1940s were not his alone. They were shared by many others, including President Franklin Roosevelt, and leaders in Congress and at the SEC. SEC Commissioner Robert Healey predicted at the time that:

"Under 1940 Act regulation and this kind of sensible and honest management, mutual funds will have a very fine future, a very promising future, one rendering useful service to the small investor."

We can be proud that we have proven worthy of this prediction. But our job is far from finished. The years to come will present many challenges. So long as we devote ourselves to maintaining the integrity of our industry, I have no doubt that the future will be bright for our shareholders, and therefore for ourselves.

Thank you.

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