

## 2007 Operations and Technology Conference: Opening Remarks

# 2007 Operations & Technology Conference

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Thank you, Don, for your kind introduction, and for all the good work you and your staff have done to pull this conference together.

As I was mulling over what I would talk about today, it occurred to me that operations and technology are to mutual funds, ETFs, and other investment companies what logistical support is to an army. Logistics is the art of moving, quartering, and supplying troops. And it has its own fascinating history.

Consider Alexander the Great in the 3rd Century BC.

At the age of 25, Alexander toppled the Persian Empire. Over the next eight years, he led his army 11,000 miles farther, founded more than 70 cities, and established an empire stretching across three continents and some 2 million square miles.

The historian Donald Engels has said that Alexander was a successful field general because he forged “the fastest, lightest, most mobile force” then in existence. Alexander understood the importance of a short line of supply to an army on the move. He assured his force would be well supplied, but in a way that would not slow it down or deny it the advantage of surprise. He knew how many hours of work per day he could get out of a pack-horse (eight) as opposed to an ox (five), how much weight each could carry, and how fast they could be expected to walk.

Arguably, it was Alexander's genius at logistics as much as anything else that made him a legend of the ancient world. But you have to turn to some pretty obscure texts to find history of this kind. Most military historians devote scant attention to the absolutely vital role that logistics plays.

Likewise, the many authors and journalists who have written at such length about the fund industry have paid precious little attention to how much that success owes to the work of operations and technology experts like you.

The so-called back office of our industry has had an indispensable part in delivering every new product and every advance in shareholder service, in meeting every new regulatory requirement, and in facilitating the exponential growth in the scale of the mutual fund business.

None of this is glamorous or sexy. I don't expect ever to see a TV drama series about fund services. Unlike our high-flying portfolio managers, you're probably never going to be a household name.

But you are the logistical geniuses of our industry, and your accomplishments not infrequently are heroic. So, I'm particularly pleased to be able to spend some time with you today.

And there are three things I'd like to talk to you about:

- First, I want to review briefly how events of the last few years have affected our industry, the operations side of it in particular.
- Second, I want to go over some of the policy-related projects that ICI has worked on in tandem with you to help you adapt to new regulations and other mandates.
- Third, and I think most important, I want to bring you up to date on the regulatory and legislative initiatives we're working on now and about how you can help us influence policymakers to craft rules that work in the best interests of investors.

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### **The Critical Role of Ops & Technology**

You don't need reminding that the SEC and other regulators were, shall we say, busy during the past few years. And it was operations professionals and technologists who had to do all the heavy lifting to bring funds into compliance with the regulations they imposed, such as the redemption fee rule and mandates having to do with business continuity planning, information security, anti-money laundering, XBRL data-tagging, breakpoints, and more. Along with the new rules of recent years have come voluminous recordkeeping and reporting requirements on funds, all them ultimately landing in your laps. The training of new operations and service employees inevitably has gotten longer and more complex.

No less important in setting your agenda have been market forces impelling a global approach to the fund business and indeed to financial services in their entirety. In addition to the outsourcing of certain operations and technology functions, some of our member firms have opened facilities in India and China. This, of course, presents linguistic, cultural, compliance, time zone, and other management challenges, whether those offices are overseen locally or from a U.S. headquarters. This trend is sure to continue as funds and investors, both here and abroad, reap the economic benefits of globalization.

I could go on, but I'm preaching to the choir.

At ICI, we have been and intend to continue doing all we can to help you cope with this burgeoning workload. Let me recap briefly some of our latest efforts.

### **ICI's Strong Focus on Ops & Technology**

An ICI working group, concerned with implementing the redemption fee rule, has finished development of an automated facility through which funds can receive transaction data from fund intermediaries in a standardized format that includes information on shareholders' identities for prevention of market timing. I'd like to congratulate and thank Stuart Bateman of Franklin Templeton, chairman of the Institute's Bank, Trust, and Record-keeper Advisory Committee, for leading this initiative; and also Barbara Simon and her team at DTCC for bringing this new service on-line.

Our Broker-Dealer Advisory Committee wrapped up its work on building a national repository of breakpoint information to help funds and intermediaries assure that investors get the volume discounts on sales charges that they've been promised. Not content to stop there, the committee crafted a data repository encompassing the full range of funds' operating rules to help ensure the best possible levels of accuracy and service for fund investors. I want to commend committee chairman Nino Palermo of

American Funds, Chris Silge of Goldman Sachs, Laura Stanley of Invesco, Jeff Naylor of SunGard, and of course our partners at DTCC for their leadership of this project.

As you may know, ICI is proud to represent our members on the Financial Services Sector Coordinating Council, a public-private partnership sponsored by the Treasury Department, to improve the finance industry's ability to cope with disasters. In its work to date, the Council has focused on sharing information about cyberspace and physical threats, ensuring that we have the robust telecommunications capacity required to meet a national emergency, and addressing the contingency of a pandemic flu epidemic. Not a pleasant prospect, any of this, but we owe it to our shareholders, as the Scouts would say, to be prepared.

Member services such as these are a large part of why the Institute exists and how we earn the support of our members year by year. But we cannot do our job without regular, substantive input from you, our members. And here, the operations and technology community of our industry truly shines. The advice and counsel we receive from you through our Operations Committee and its affiliated advisory committees and our Technology Committee are invaluable to us.

## **Current Policy Issues and Challenges for our Industry**

With that in mind, let me give you a sampling of the legislative and regulatory policy issues that most concern us now and about which we again will need your advice and counsel. Among prominent issues today are -- how to improve 401(k) disclosure, what will be the future of Rule 12b-1, what are the prospects of fundamental reform of the fund disclosure system, what cost-basis reporting requirements will look like, and the need for a more informed regulatory process. Let me discuss each of these briefly in turn.

### **401(k) Disclosure**

The debate about how to improve 401(k) disclosure is proceeding on two tracks. One is a [multi-prong regulatory process](#) that is well under way at the Department of Labor. The other is a legislative process, driven by Congressman George Miller, Chairman of the House Committee on Education and Labor, who introduced [a bill addressing 401\(k\) fees and disclosure](#) in July.

As new standards unfold, be assured that we will be working closely with both the Labor Department and Congress. We are strongly in favor of improving the quality of disclosure provided to 401(k) plan participants, and are urging policymakers to bear in mind four salient points:

- One, any new disclosure regime must recognize that plan sponsors (employers) and plan participants (employees) have markedly different disclosure needs. Regulators need to avoid the temptation to overload employees with detailed and voluminous information that may confuse or intimidate them.
- Two, workers need to know about fees and other costs associated with investing, but not in isolation. Fees are only part of the picture required to make good investment decisions. No less important is information about each plan investment option's historical performance, its relative

- risks, its investment objectives, and the identity of its adviser or manager.
- Three, disclosure should allow employees to make comparisons between and among different investment options, although employers should have the discretion to decide on the right presentation for their workers.
  - And four, employees should receive fee and other key information at enrollment and that information should be updated at least annually thereafter.

ICI joined with eleven other trade associations to [offer these recommendations](#) and others to the Labor Department in July.

As I said, ICI strongly supports improved disclosure to employees who participate in 401(k) plans – especially now that automatic enrollment is gaining traction. But it's important to note that even though the disclosure regime could stand some improvement, the 401(k) system is working, and working quite well. ICI research shows that participants generally make sensible choices in allocating their investments. And 401(k) savers are doing a good job of finding low-cost, low-turnover mutual funds: more than three-quarters of stock mutual fund assets in 401(k)s are in funds with expense ratios of less than one percent.

We have urged both the Labor Department and the House Education and Labor Committee to consider these points carefully as they review possible improvements to the 401(k) disclosure regime.

## **Rule 12b-1**

Let me turn now to Rule 12b-1. A “hardy perennial” of the mutual fund regulatory agenda, 12b-1 once again has blossomed as a live issue here in Washington. In June SEC Chairman Christopher Cox launched a comprehensive review of the Rule, questioning the validity of 12b-1 fees and colorfully styling them “a sales load in drag.” Recent months have seen a flurry of commentary on Rule 12b-1 – including a daylong SEC Roundtable devoted to it. While there is a wide range of opinion and no shortage of debate, surprisingly little sentiment has emerged -- or factual basis been advanced -- for a radical reform of the rule as we know it.

It will come as no surprise to you that, while we think the SEC's review is altogether appropriate, we too would [oppose any fundamental changes to the Rule](#). So it seems would most people who have sent comment letters to the SEC.

Rule 12b-1 was the product of extended and meaningful SEC consideration in the 1970s that included public hearings, several rounds of public comment, and five releases over a course of four years.

The rule, as finally adopted, prohibited an open-end fund from using its own assets to pay for any distribution costs unless it had adopted a written plan approved by the fund's board and its shareholders and the fund's distribution payments were made pursuant to the plan. The rule included no restrictions on the types of distribution activities that funds could finance and, in fact, was intended to be flexible enough to allow funds to develop new distribution practices - as, in succeeding years,

they certainly have.

Today, mutual funds have over \$11 trillion in assets and more than 90 million shareholders. Rule 12b-1 is essential to a complex infrastructure that makes mutual fund investing available to these millions of investors. As I mentioned earlier, I commend the SEC for its decision to review Rule 12b-1. In doing so, however, the Commission should recognize that the rule, for all the ways it might be improved, is basically a success story - for the fund industry and, more importantly, for investors.

## **Cost-Basis Reporting**

On cost-basis reporting, you probably know that the Senate Finance Committee is considering legislation to make it mandatory for funds and broker-dealers. We told the committee in June that [a substantial segment of our industry already provides cost-basis numbers](#) to a large proportion of its shareholders. And that proportion is growing.

As you well know, depending on how and when it must be done, cost-basis reporting could involve some awfully complex operational issues, not to mention very significant expense. Our objectives, working with Congress and the Treasury, are threefold: first, to make sure any reporting regime can be administered without undue difficulty; second, to secure the ample lead time necessary if our reporting infrastructure is to work properly; and third, to assure that funds and shareholders have some flexibility in deciding how to compute and cost-bases.

## **Fund Disclosure Reform**

I also should mention the ICI's long-running quest for a better mutual fund prospectus disclosure regime. We at ICI have been calling for the SEC to provide investors something concise and understandable, something they will actually read or consult -- something like the "quick start" card that comes with new consumer electronic products. We have been calling for the SEC to leverage the power of the Internet to make the universe of other disclosure detail available to the more enterprising investors and to all other market participants who may want it. In short, we have been urging a new, win-win approach that will serve all our shareholders' interests far more effectively.

Is this quest likely to succeed? There is some hope – especially because SEC Chairman Chris Cox likewise understands the serious flaws of a system that expends such enormous effort on delivery of a document that so few actually use. Buddy Donohue, the head of the SEC's Investment Management Division, and his staff colleagues once again have this issue before them. Maybe, just maybe, this time will be different. If so, the operations and technology communities within our industry will be called upon once more to make the new regime a reality for our investors.

## **Cost-Benefit Analysis**

Finally, let me add a word about the ICI's approach today to the regulatory process. No matter the issue, we adhere firmly to the view that sound regulation requires sound economic analysis, including

close consideration of regulatory alternatives and relative costs and benefits. No proposal should be advanced – let alone adopted – without such scrutiny.

Sounds sensible, right? Unfortunately, this kind of analysis is not something that can be taken for granted. Look no further than the recent proposal by the New York Stock Exchange that would have ended discretionary broker voting in uncontested elections for fund directors. The NYSE gave little or no thought to the implications of its October 2006 proposal for mutual funds, ETF's and closed-end funds. It had not considered that fact that funds typically have a much larger base of retail shareholders than do public operating companies, nor the time and money funds would have to expend to solicit proxies to reach a quorum, nor the questionable benefit of engaging in this exercise simply to elect an uncontested board slate. [ICI stepped forward with the facts](#) -- and succeeded in establishing that, by any sensible measure, the relative costs and benefits of the proposal were all out of line.

I am happy to say that the NYSE saw fit to withdraw the proposal. But this and other recent experiences have taught us an important lesson. We will be looking to the operations and technology communities to be our partners in future efforts to size regulatory costs and in this way better inform the public policy process. Your assistance is vital in this process. One effort on the drawing board for 2008 is a retrospective analysis of the costs of implementing Rule 22c-2, the SEC's redemption fee rule. I invite you to assist us in this project.

## **Conclusion**

I hope I've given you a good picture of how ICI has tried to help you, how you have helped us, and how very grateful we are for all you do. We at ICI look forward to working with all of you in the days ahead as we take on the issues I've discussed and others still to come.

It's been my great pleasure to talk to you today. Thank you very much.

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