IDC Independent Directors Council
Promoting Excellence in Fund Governance

2000 General Membership Meeting: President's Report

ICI President's Report at the 2000 General Membership Meeting

by

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Good morning. I'm pleased to join Jack Brennan and Bill Lyons in welcoming you to the Institute's annual General Membership Meeting.

The Institute is extremely fortunate to have Jack Brennan as its Chairman. Jack has skillfully guided us to the beginning of a new century—an era of extraordinary opportunities for our shareholders and our members. Jack is an outstanding leader and a true friend, and we too look forward to many more years of working together.

I also would like to commend Bill Lyons for the outstanding job that he has done as Chairman of this year's Meeting. The Institute's strength is derived from individuals like Bill and Jack, whose intellect and creative energy are matched by a profound understanding of the core values that have made our industry so trusted and so successful.

The theme for this year's meeting is Continuing a Tradition of Integrity. Left unstated from the title—but obvious from many of the presentations you will hear—is that carrying this tradition forward in a time of extraordinary change ranks as one of the most formidable challenges ever faced by our industry. Technological developments in the world of financial services, as well as in virtually every other sector of the economy, are breathtaking. These developments are fueling countless entrepreneurial ventures, rewriting the rules of competition, and prompting wholesale reconsideration of the role of regulation.

The creation of the new economy has led to an understandable euphoria in many quarters. Inherent in such exuberance, however, is the danger of a type of hubris—a belief that the new economy must necessarily transform everything that preceded it.

It is obvious that to serve fund shareholders, our industry must embrace change. However, at the same time, we must vigilantly guard against a ‘new-economy’ hubris that could result in our abandoning basic principles that have been instrumental to our success. Fortunately, balancing the need for change and the need to maintain core values is built into our industry’s culture.

Sixty years ago this month, SEC and fund industry representatives reached agreement on legislation that became the Investment Company Act of 1940. The paramount concern of the Act’s framers was the elimination of abuses that infected the fledgling fund industry and eroded shareholder trust during the 1920s and 30s. The Act thus establishes strict investor protections—flat prohibitions on self-dealing; a requirement that every fund mark all of its assets to market every day; tough limits on leveraging; oversight by independent directors—that form the bedrock upon which our industry has grown and earned the confidence of 83 million shareholders.

The Investment Company Act’s framers also recognized that investor needs would change over time, and that innovation must not be inhibited by an inflexible regulatory system. For that reason, the Act provides the SEC with broad administrative power to adjust the regulatory scheme to meet new conditions.

The balance in the 1940 Act has worked. The Act’s exacting fiduciary standards have helped keep mutual funds free from major scandal and have contributed to extraordinary investor confidence in our industry. At the same time, the SEC’s ability to administer the Act flexibly has permitted dramatic innovations that have benefited millions of fund shareholders. Respecting this balance is essential if we are to ensure success for our shareholders in the years ahead.

This morning, I will cite examples showing how the Investment Company Act provides regulators with flexibility to meet new conditions. I will also discuss instances where we must adhere to core principles. I will conclude by describing how the balanced framework built into the 1940 Act helps guide us with respect to current issues.

Three examples demonstrate how the SEC has effectively made use of its authority to serve evolving shareholder needs.

First, in the early 1970s, the SEC permitted the creation of money market funds with one dollar per share net asset values. This development was endorsed almost instantaneously by millions of investors, both small and large. Indeed, enthusiasm for money market funds continues to this day, and

the funds are viewed by individuals and institutional investors as an essential element of prudent cash management. The SEC, with strong support from the industry, has continued to refine its rules in this area, and by doing so has helped build an even firmer foundation for the $1.5 trillion dollar money market fund business.

Second, in 1979 the SEC adopted Rule 482, allowing mutual funds for the first time to advertise their performance. Again, this regulatory development prompted far-reaching changes. Most notably, performance advertising contributed to the rapid growth of direct marketed, no-load mutual funds. The subsequent popularity of no-load funds throughout the 1980s led to competitive pressure on fees and expenses, particularly in the area of distribution costs. One result of this is that since 1980, the total cost of investing in equity mutual funds has fallen by 40 percent. The total cost of bond fund investments has declined by 29 percent, and money market funds by 24 percent.

The ability to advertise performance depends, to this day, on the SEC's continued faith that the industry will exercise the privilege responsibly, adhering to the spirit as well as the letter of the law. The extraordinary performance of many technology funds in 1999 recently created special challenges in this area. I am pleased that the overwhelming majority of funds have addressed these issues promptly and seriously. I also was pleased to see the NASDR issue guidance on the use of extraordinary performance figures in advertisements. But ultimate responsibility lies with us: if we don't continue to advertise prudently, questions will inevitably arise about additional restrictions.

A third example of how the SEC has flexibly administered the Act is more recent. In 1998, the SEC overhauled many of the rules governing mutual fund prospectuses and permitted the use of fund profiles. Similarly bold disclosure reforms are planned for shareholder reports. The overall impact of the disclosure reforms has been very beneficial to fund investors and I believe their significance will become more apparent in the years ahead. At a time when the importance of investing has grown significantly in the lives of average families, the SEC worked with the industry to make key information about mutual funds far more accessible and far more understandable.

These are just three examples. There are many more. Each one reminds us that our industry must constantly identify and work for regulatory innovations that allow us to better serve our shareholders.

It is equally vital that we oppose change that would harm our shareholders' interests. This brings me to the second way in which we can ensure success for our shareholders in the years ahead—by safeguarding the core protections of the Investment Company Act.

One example arose last year. A proposal was advanced that effectively would have repealed Section 17(a) of the Investment Company Act, which prohibits transactions between a fund and its affiliates. Advocates of repeal argued that other financial service providers are not subject to comparable

restrictions. While true, this argument misses the point. Yes, our system of regulation is different and tougher. But therein lies the source of our strength.

The Institute vigorously, and successfully, opposed the effort to repeal Section 17. We argued that the proposal was too broad, and could lead to conflicts that would harm fund shareholders. However, some of the concerns that led to the proposal merit regulatory attention. So, to address new market conditions, we urged the SEC staff to use the flexible authority provided by the Act to adopt a number of exemptive rules under Section 17. That process is now underway.

The Institute took a similar protective approach to the Act's core protections in 1996, when Congress expanded exemptions for hedge funds from regulation under the Investment Company Act. In the mid-1990s there were calls for a series of sweeping exemptions—exemptions that would have given a green light to unregulated pooled investment vehicles and put investors at risk. The Institute therefore worked for and succeeded in obtaining much narrower exemptions that apply only to hedge funds that are not publicly offered and that are owned only by high net worth individuals and institutions. The wisdom of our approach has been borne out in recent years, as a series of hedge funds have encountered serious difficulties and even gone bankrupt.

We must always be alert to proposals, however well intentioned, that would put the Act's fundamental protections at risk. To those who chafe under the Act's tough standards, I would quote former Supreme Court Justice Felix Frankfurter, who observed that "He who is unwilling to assume the responsibility of a fiduciary has no business to be a fiduciary."

The issues I have described thus far illustrate how the Investment Company Act has provided regulators with flexibility to permit innovation while requiring fidelity to core investor protection principles. Several current examples illustrate the Act's continued vitality.

First, the Act's corporate governance provisions have worked exceedingly well in the years since 1940, and have played a large role in promoting strong business practices and deterring conduct that would put shareholders' interests at risk. As the industry has grown beyond even the most optimistic forecasts, Chairman Levitt suggested that our corporate governance system be reexamined, with a particular focus on the role of independent directors. Director Paul Roye and Commission staff undertook a substantial review, and proposed rules to modernize and strengthen several key elements of the system—rules that we generally welcome and support. In addition, an advisory group of industry leaders and independent directors, headed by Jack Brennan, promulgated a series of far-reaching best practices for fund directors that go well beyond legal requirements. I am proud that the Institute's Board

of Governors has recommended that they be considered for adoption by all fund boards.

Second, we continue to pay close attention to the various financial regulators in Washington as they implement the historic Gramm-Leach-Bliley legislation that repealed the Glass-Steagall Act and modernize the regulation of American financial services. For years, the Institute has supported "functional regulation," a concept that I am pleased to say was successfully realized in the legislation. In our case, "functional regulation" is shorthand for requiring all financial regulators to embrace—rather than replace—the SEC's successful system of regulating the fund industry and protecting fund shareholders under the Investment Company Act. As the new rules are written, we must remain vigilant that functional regulation moves from a concept to a reality.

Third, later this month the SEC is holding a roundtable to examine the regulation of investment advisers. The explosive growth of financial services—especially financial advice—over the Internet is challenging current regulatory assumptions and practices. Indeed, this could be the leading current example illustrating the importance of adhering to core investor protection principles while also permitting innovation. We will be urging the SEC to consider the broad ramifications of internet-based investment advice, and to take steps that will reassure investors that the Internet can be a trusted and reliable source of information

This morning, I have shared with you my views on what we must do to serve fund shareholders in an era of rapid change. I believe that the key to maintaining the confidence of 83 million mutual fund investors is to embrace innovation that benefits them and to oppose change that would harm their interests. In sum, to meet our shareholders' needs, our business practices must change, but our business principles must not.

Sixty years of experience under the Investment Company Act leaves no doubt in my mind that we will rise to this challenge. We have repeatedly proven that we can put aside our individual differences to work on behalf of our shareholders. In the 1930s, it was widely predicted that closed-end funds and mutual funds would prove incapable of working together on legislation. It was even more widely predicted that the investment company industry would oppose reform legislation and prevent its enactment. But mutual funds and closed-end funds confounded these observers and helped the Investment Company Act become law.

Since the Act became law, our industry has continued to support laws and regulations designed to protect our investors. We also have supported and developed tough voluntary standards beyond the requirements of the law, such as our recommended best practices on personal investing and mutual fund directors. Last June, Investor's Business Daily reported that "You might think that the fund industry would chafe under what some think is the most pervasive regulatory environment. But few complaints surfaced at the annual meeting of the Investment Company Institute."

Our industry’s support for the high fiduciary standards of the Investment Company Act has produced widespread public confidence in our industry. The Financial Times recently reported that "even consumer groups—thorns in the side of big players in financial services—are unnervingly nice about mutual funds."

Past generations have done their job. Now it is up to us. We must live up to the tradition of integrity established by those who came before us. We must continue to put aside our differences and speak with one voice on behalf of our shareholders.

Our industry’s success was neither pre-ordained nor a random occurrence. It is the direct result of the willingness of each and every one of us to put our shareholders first—to seek change that benefits them and to oppose change that would harm them. If we continue to work together, I have no doubt that the next sixty years will be as successful for our shareholders and for our industry as the years with which we have been blessed since 1940.

Thank you.
