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Promoting Excellence in Fund Governance

1997 Mutual Funds & Investment Management Conference: President's Keynote Address

ICI President's Keynote Address at the Mutual Funds and Investment Management Conference

by

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Good morning.

In my past two keynote addresses at this Conference, I spoke of the need to change laws and regulations to keep pace with the changing needs of investors.

I praised the gradual, incremental refinement of mutual fund regulation that has served investors so well. But I also called for totally new approaches in mutual fund disclosure and in state regulation. I observed that change, whether big or small, is difficult to achieve, but that we had to persevere in the interests of investors.

Since we met last year, much has been accomplished. Congress enacted a series of pension reforms. We are on the brink of sweeping reform of mutual fund disclosure.

And, most significantly, President Clinton signed into law the National Securities Markets Improvements Act of 1996. The 1996 legislation is a case study in how major change can be accomplished in the interest of fund shareholders.

During 1996, many press reports indicated that the legislation was unlikely to survive. These press reports were reminiscent of those that preceded the enactment of the Investment Company Act in 1940.

But in the end, the 1996 legislation was enacted for many of the same reasons as the Investment Company Act—there was industry unity on behalf of fund shareholders; strong leadership at the SEC; bipartisan support in both houses of Congress; and plain, old-fashioned hard work.

But most importantly, as in 1940, the legislation identified and solved specific problems for investors. The heart of the 1996 legislation was its historic redefinition of the role of states in mutual fund regulation. The bill targeted the problem—disparate, inconsistent, and unnecessary state regulation of mutual fund portfolios and disclosures—and hit the mark.

Some state officials argued that the existing flawed regime should be left in place. Others, completely fed up with state regulation, argued for total preemption. The legislation adopted neither of these extreme positions. Rather, it eliminated the specific problem, state regulation of fund portfolios and disclosure, while leaving in place state antifraud authority that serves investors' interests.

As the first Chairman of the SEC, Joseph Kennedy, once said of the Securities Act of 1933: "The problem was national; the approach was prudent; and the method adopted was reasonably calculated to bring about the desired objectives." These same words describe the National Securities Markets Improvements Act of 1996.

More needed change can be achieved. Not by looking to short-term business interests. Not by seeking to accommodate the law to the latest fad. Not by pursuing a rigid ideological agenda. But by working with Congress and regulators to identify and solve specific problems for investors in a responsible, measured fashion.

Today, I would like to discuss five current issues: disclosure reform; bond fund risk ratings; qualified purchaser funds; financial services reform; and retirement savings. In each of these areas, our goal must be to effect change in the interest of investors in a responsible, measured fashion.

1. Mutual Fund Disclosure

Those of you who are regular attendees at this conference are familiar with my thoughts on the problems of the current system of mutual fund disclosure. Time and again the SEC and the industry have tried to simplify the fund prospectus. But it seems that disclosure creep always sets in, and the "simplified" prospectus soon becomes as unwieldy as its predecessor. Mutual fund disclosure is far superior to that of other products, but we know we can do better.

Under Chairman Levitt's leadership, the SEC has tackled this problem head-on by proposing sweeping reform. The SEC's recent proposals identify the precise problem for investors—the need for clearer, more concise information—and offer targeted solutions.

One of the proposals would substantially revise the traditional mutual fund prospectus to focus it on essential information about the fund, including a new risk/return summary.

But the SEC realized that improving the traditional prospectus isn't enough. Therefore, a second proposal would authorize optional use of the profile prospectus, which gives investors a concise statement of key information.

Some observers, disenchanted with years of trying to reform the traditional prospectus have suggested that we simply scrap the whole notion of requiring prospectuses. At the other extreme, others have ridiculed reform.

The SEC proposals reflect neither extreme viewpoint. The SEC's proposals target the problem—the need for meaningful, understandable disclosure—and identify precise solutions in the interest of shareholders.

2. Risk Ratings

Providing clear, understandable disclosure to shareholders of the risks of investing in mutual funds is critical. The fund industry has worked long and hard to identify the best ways to help investors understand risk.

We have learned that there is no magic bullet -- no single all-encompassing measure of a mutual fund's risk that squarely hits the mark. No one letter, number, or phrase can do the trick. Institute research finds that investors prefer and are more likely to understand narrative and graphic presentations of risk information.

The SEC wisely decided not to require the use of an alphabetical or numerical risk measure in fund prospectuses. Instead, the SEC's proposal calls for a risk/return summary that would provide investors with narrative and graphic information that is readily understandable.

However, we now are presented with risk disclosure that has an even stronger potential to mislead investors than quantitative risk measures. A recent notice by the NASD solicits comment on the use of bond fund risk ratings in supplemental sales literature.

The use of these ratings would totally miss the mark for investors.

Like risk measures, bond fund risk ratings cannot account for all aspects of a fund's risk. The ratings also can become stale quickly for actively managed funds, unbeknownst to investors.

But bond fund risk ratings present additional problems. Unlike quantitative risk measures, bond fund risk ratings are often highly subjective.

And, there are substantial questions about the accuracy and reliability of these subjective ratings. The fact is that assigning a risk rating to a bond fund is a much more difficult proposition than assigning a

credit rating to a debt instrument. Just consider the faulty risk ratings assigned by the rating agencies to the Orange County municipal pool.

Moreover, these subjective ratings are developed by commercial entities that are not regulated by the SEC, and that are liable to no one for their actions.

Our research to date suggests that investors are unlikely to understand these limitations.

The fund industry is deeply concerned that an NASD ruling permitting the use of these ratings risks a race to the bottom in which more informative risk disclosure will inevitably be replaced by an inferior substitute—a stark example of Gresham's law in operation.

The NASD's decision must be based on a clear understanding of how investors are likely to interpret and use the ratings. I am pleased to report that the Institute plans to conduct further research to answer these questions.

Giving investors better information about the risks of mutual fund investing is a goal to which we all should aspire. But we must resist the allure of disclosure shortcuts that would harm investors.

3. Qualified Purchaser Funds

Congress always has been reluctant to exempt pooled investment vehicles from the Investment Company Act. When Congress has established exemptions, it has done so cautiously and deliberately, recognizing the perils to unsophisticated investors that can arise when pooled vehicles are free from the protections of the act.

The problems that existed prior to the Investment Company Act are testimony to the abuses that can result from unregulated pooled vehicles.

But we don't need to go back to the 1920s and 30s for examples. Recent debacles—from the Theta and Askin hedge fund collapses to the fiasco in Orange County—offer compelling proof of the dangers posed to investors by pooled funds that are not subject to the Investment Company Act.

Last year, the mutual fund industry supported a new statutory exemption for pools sold exclusively to investors who can fend for themselves because Congress carefully set standards that did not compromise investors.

Specifically, new Section 3(c)(7) of the 1940 Act exempts pools sold exclusively to natural persons who own $5 million in investments and institutions with $25 million in investments.

Some hedge fund advocates urged Congress to adopt a much broader exemption. On the other side, some in our industry opposed any change. Congress, however, drew a bull's eye on a precise question—should the law give greater flexibility to financially sophisticated investors?—and provided a precise answer.

The 1996 Act directs the SEC to define the term "investments" for purposes of the financial thresholds. In response to SEC's proposal, the Institute has submitted a comment letter urging standards that will ensure that exempt pools operate as Congress intended—to the exclusion of unsophisticated investors. In particular, the SEC should not permit the assets of unsophisticated participants in defined contribution plans to be aggregated to meet the threshold.

Indeed, a prior exemption in the Investment Company Act has created exactly this problem. In 1970, Congress exempted bank and insurance company pools sold exclusively to retirement plans, on the theory that the purchasers were sophisticated employers with defined benefit plans. However, there has been a dramatic shift to defined contribution plans, where individual employees make their own investment decisions.

Today, as a result of the 1970 amendment, thousands of small unsophisticated investors in defined contribution plans are deprived of the fundamental protections of the federal securities laws.

We must make certain that the new exemption from the 1940 Act does not give rise to similar problems for unsophisticated investors.

4. Financial Services Reform

No issue has produced more teeth-gnashing than efforts to restructure the financial services industry. The Institute has testified on this matter more than twenty times over the last 22 years.

So far, Congressional action has been stymied by the strong, very disparate, and often highly ideological views of various industry groups and regulatory agencies. Every time I prepare to testify on this issue, I recall Theodore Roosevelt's observation about banking legislation: "This financial business is very puzzling. The minute I try to get action, all the financiers and businessmen differ so that nobody can advise me ..." We can only imagine what T.R. would make of current efforts to reform Glass-Steagall.

But there are signs that the sixty-year-old logjam is breaking. A consensus is emerging on key issues. First, that banks, securities firms, and insurance companies should be permitted to affiliate with one another. Second, that some degree of affiliation with commercial entities also should be permitted. Third, that each entity in a financial service conglomerate should be subject to functional regulation, under which the SEC would be the primary regulator of securities firms, and a banking agency the primary regulator of banks.

The major sticking point is that the Federal Reserve Board insists that bank regulators have jurisdiction over the holding company and all affiliates. The securities, mutual fund, and insurance industries adamantly oppose being subject to regulation by a bank regulator.

A middle ground is developing under which the banking regulator could obtain information from the bank concerning the activities of other affiliates that may impact the safety and soundness of the bank.

If the bank regulator discovered a problem, it could take action with respect to the bank.

While I would not bet on the enactment of legislation this year, I believe that this middle-ground approach offers a real opportunity to break the 64-year deadlock. It is a measured, non-ideological response that would hit the mark for investors.

5. Retirement Savings

Finally, retirement savings. We're all familiar with the problems posed by the impending retirement of the baby boom generation.

We're also all familiar with our nation's dismal personal savings rate. In spite of widespread lack of confidence in the Social Security system, many Americans are not saving enough.

Sensible reforms that increase retirement savings must be among our highest national priorities.

The mutual fund industry has an important role in this debate. Increasingly, mutual funds serve as the investment medium of choice for retirement programs. Approximately thirty-five percent of fund assets are held by retirement plans.

Targeting the problem is easy—investors aren't saving enough for retirement on their own, and the government will pick up less and less of the tab. Devising solutions that serve investor interests is more difficult.

Passions run high on the Social Security debate. Some argue for total privatization of Social Security, which would place the entire burden of retirement savings on the investor and completely eliminate the government safety net. Others have resisted any modification to Social Security.

Investors are not served by extremists on either side of this issue. The mutual fund industry supports proposals that would allow, but not require, taxpayers to invest some portion of their Social Security tax in individual accounts. This is a targeted, moderate approach that would encourage voluntary personal savings and strengthen the Social Security system.

This same moderate approach makes sense elsewhere. Some have urged drastic change that would force investors to save in mandatory IRAs or require all employers to sponsor retirement plans. Others reject any IRA or pension reforms as futile efforts to boost savings.

Neither extreme hits the mark. The fund industry supports a moderate legislative and regulatory agenda that would allow more American workers to invest more in IRAs and 401(k) plans. We support measures that will encourage more employers to offer plans for their employees. We support measures to improve pension portability, and make plans easier to administer and understand. These are targeted solutions that make sense for investors.

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This morning I have described the factors that are essential to our industry's success in Washington—industry unity, cooperation with government, and, above all, identifying specific changes that benefit fund shareholders.

These factors helped produce a series of legislative and regulatory reforms this past year. These same factors can help obtain additional reform in the years ahead.

But the real key to our success in Washington is the reputation of mutual fund organizations located throughout the country. For members of Congress and regulators do not consider issues in isolation. Rather, changes in mutual fund law are made in context of the reputation, credibility, and public stature of our industry.

Industry leaders can deliver strong testimony in Congress. The Institute can submit well-researched position papers to the SEC and IRS. We can obtain advice from leading experts. But laws and regulation will be most influenced by the credibility and public trust generated by individual fund organizations.

Ever since the enactment of the Investment Company Act, mutual fund organizations, through their individual efforts, have earned a high degree of public trust and acceptance. An editorial in Mutual Funds Magazine concluded: "[t]he American mutual fund industry has a record of integrity and fair dealing with investors that is the envy of the world."

It was this record that made possible our success in Washington this past year.

Please keep up the good work. Educate your shareholders about the risks, as well as the rewards, of mutual funds. Comply with the spirit, as well as the letter, of the law. Above all, keep putting fund shareholders first.

Our industry owes thanks to many people for the successful enactment of the historic 1996 legislation. To Chairman Levitt for his leadership; to Congressmen Bliley, Dingell, Fields, and Markey; and to Senators D'Amato, Gramm, and Dodd for their extraordinary spirit of bipartisan cooperation.

But even more, I would like to thank each of you in the audience today. It is the personal integrity and hard work of every one of you that has earned our industry such an outstanding reputation, and made possible our success in Washington. Thank you.

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