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The Modern Fund Industry at 75

David W. Blass
General Counsel, Investment Company Institute

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As prepared for delivery.

Good morning, and thank you, Heidi [Hardin, Senior Vice President and General Counsel, Janus Capital Management, LLC], for the very warm introduction.

Welcome to the 2015 Mutual Funds and Investment Management Conference—thank you all for joining us.

Thanks also to our sponsors, our speakers and panelists, and ICI staff for their tremendous efforts in organizing this event.

I hope you all enjoyed the video, and found it to be a fitting tribute to the modern fund industry's 75th anniversary.

Equally fitting for our anniversary, today happens to be the 75th day of the year—that's right, we begin our conference on the 75th day of the industry's 75th year of operation. Now that's what I call good planning.

Significant anniversaries offer opportunities to reflect on where you've been, and to take stock of where you are going. In my remarks this morning, I'd like to seize both of those opportunities:

- First, I'd like to share my take on a central feature of our industry over its 75-year history—the efforts of industry leaders and the Securities and Exchange Commission to work together to promote the interests of fund investors.
- And second, I'd like to look at three trends that have the potential to shape our industry for years, if not decades, to come—trends related to the roles and responsibilities of fund directors ... the SEC's role in promoting financial stability ... and the evolution of funds' payments to distributors.

On the plane from Washington, I got to thinking about the symbol of a 75th anniversary—a diamond. You might not know it, but diamonds get their name from an ancient Greek word meaning "unbreakable."

What an appropriate symbol for the modern fund industry. A diamond embodies immense strength, resilience, and durability—much the same as regulated funds.

For 75 years, as business cycles have driven returns up and down, sometimes quite dramatically, regulated funds have endured as a highly effective way for families to meet their long-term financial goals.

One constant through those 75 years has been an open, productive dialogue between industry leaders and regulators, particularly the SEC, toward a single, high-minded goal—how best to serve and protect the interests of investors.

This working relationship goes back to our earliest days. As the video explained, the modern fund industry was born out of a collaborative spirit.

You see that spirit in our founding documents. The Investment Company Act and the Investment Advisers Act of 1940 were signed into law only after fund managers recognized the need for new investor protections following the market abuses revealed by the

Great Depression.

I see that collaborative spirit every day at ICI, and it was there at the Institute's very beginning. The committee that became ICI was formed only after the SEC recognized the need for an industry counterpart to help it implement the two new acts.

Today, our shared commitment to an investor-centered regulatory framework, and to sound fiduciary practices, invites the trust and confidence of more than 90 million investors.

When I think about what goes into that framework, I often come back to our governance model, which relies so heavily on strong board oversight—particularly from independent directors and trustees.

Fund boards' talent and diligence have been crucial in promoting investor confidence in our funds. Through their oversight, boards seek to ensure that their fund is operating in the best interests of its shareholders, while they check for potential and actual conflicts of interest that could arise between the fund and its adviser.

For many years, though, questionable interpretations of directors' oversight role have been making the rounds. That's the first trend I have an eye on.

I'm particularly wary of a "responsibility creep" that could impose obligations on directors and trustees beyond their appropriate oversight role.

The problem with using the board as a "default" for any or every issue that comes up is that doing so could divert directors' focus from the areas where they add value, including oversight of investment performance and compliance, among other duties.

Instead of piling new responsibilities on boards, how about stepping back—and updating and rationalizing the requirements placed on them today?

I say, let's let a fund manager do its job—to manage the fund and to perform the duties delegated to it by the fund's board. And let's let the board oversee and help guide those activities.

The second trend I have an eye on is the evolving role of the SEC in promoting financial stability.

As the United States' only federal regulator with expertise in the capital markets, the SEC works to advance a three-part mission:

- to protect investors;
- to maintain fair, orderly, and efficient markets; and
- to facilitate capital formation.

For the better part of 75 years, the SEC has balanced this mission skillfully and admirably.

Even so, the experience of the recent financial crisis—now more than six years behind us—has introduced a new focus across many regulatory bodies on systemic risk.

No doubt, there is a need to take a hard look at systemic risk, and ICI stands ready to provide experience-driven empirical data to regulators to better inform them of the operations of the regulated fund industry.

Like many of you, we at ICI are busy preparing a detailed response to the Financial Stability Oversight Council's recent request for information on the asset management industry.

But what most concerns me is that the debate about systemic risk so far has borrowed generously and heavily from bank regulation concepts.

And the tools that the FSOC has employed to date have been just that—bank-like regulation.

Designation of a company as systemically risky has been followed by oversight by the Federal Reserve Board, which then has imposed capital requirements and other regulations that essentially are similar to those for large banks.

But bank-like regulation is not appropriate for regulated funds and their managers and is not needed. Let me tell you why.

In the simplest terms, banks take deposits, which can be withdrawn at any time, and make loans of various maturities. Banks use leverage to make those loans.

That use of leverage, combined with the ability of depositors to withdraw their money at any time, means that even small losses can send a bank deep into financial distress. This dynamic has led to bank regulators' focus on so-called run-risk—the potential for bank depositors to be so concerned about the safety and soundness of their bank, and therefore their deposits, that they all try to withdraw their deposits at one time.

In that environment, I can understand bank regulators' look to cash buffers and capital requirements to protect the safety and soundness of deposit-taking banks.

It is an entirely different story for regulated funds. Fluctuating asset prices can result in losses for fund investors—never a welcome thing, of course—but regulated funds operate under strict restrictions on leverage. And regulated funds have never experienced the kind of runs that the FSOC asserts.

You might be thinking, what about money market funds? Yes, money market funds were caught up in the crisis, but long-term stock and bond funds were not. And of course, U.S. money market fund regulation has been comprehensively updated since the crisis—not once, but twice. Money market funds are not relevant to the current debate, which concerns long-term funds.

Simply put, history has demonstrated time and again that U.S. stock and bond fund investors show muted responses to even severe financial market shocks. This was the case in the most recent financial crisis—and investors that followed this pattern have reaped tremendous gains since.

Now, is there a reason beyond leverage that banks and regulated funds react differently to periods of declining asset prices? There are many, in fact, but the SEC's commitment to its mission is a big one.

Unlike banks, capital markets rest on the type of transparency that the SEC promotes to support investor protections, capital formation, and the efficient functioning of the markets.

In well-functioning markets, risks are clearly assigned, well understood, and knowingly accepted by all parties. As information enters the market, asset prices adjust and investors experience gains and losses.

Investors accept losses because risks are disclosed, and because they believe gains will win out in the balance. Many investors use a wide array of funds—bond funds, equity funds, international funds, and more—as elements of a well-diversified portfolio. Selling out any one of those elements entirely during a down market would eliminate the diversity investors seek.

The real risk is that the capital markets themselves will come under bank-like regulation—putting the SEC's mandate of investor protection, capital formation, and efficient functioning of the markets in conflict with bank regulators' desire to see risks eliminated, or at least dramatically reduced, in order to promote the safety and soundness of large banks and other designated financial companies.

And this risk is real. Skepticism of the capital markets abounds among bank regulators—many of whom refer to our industry with the pejorative term, "shadow banking."

Just imagine what bank regulation in the asset management industry could look like. Just as one example: a few months ago, the International Monetary Fund issued a paper suggesting that high-yield bond mutual funds—and other mutual funds that invest in securities less liquid than the most highly traded equities—should be required to stop offering daily redeemability. This upends the very notion of what a mutual fund is, and fundamentally alters how many Americans save for their most important financial goals.

The IMF is not alone in this view—a virtual chorus of banking regulators are questioning daily redemption of mutual funds. This is a harmful solution to a hypothetical problem—a problem not empirically grounded.

This brings me back to the SEC. I have taken heart in recent comments from Chair Mary Jo White, who has proposed an extensive regulatory agenda that draws on the SEC's core mission to promote potential enhancements that also can provide benefits to financial stability.

After all, if the SEC is following its core mission of investor protection and promoting capital formation and the efficient functioning of the markets, should it not, by doing that, also be promoting a sound financial system? And it's not like bank regulation has prevented a series of bank crises since the Great Depression.

ICI stands ready to assist the SEC's efforts to move forward with Chair White's agenda, and also to help identify and discuss some areas that could be problematic, such as overly prescriptive liquidity management requirements or excessive public exposure of portfolio information, which can harm funds and their investors.

Over the next three days, we'll be diving deeper into that agenda—and many other issues as well. I'm not going to walk you through

the program—as Heidi explained, we've got an app for that—but I do want to wrap up by touching on a topic of special interest to me, one I'll be moderating a panel on tomorrow morning. That topic—the evolution in funds' payments to distributors—is the third trend I have an eye on.

As we speak, SEC examiners are conducting a sweep they call "Distribution in Guise." Examiners are looking at what are colloquially referred to as "sub-accounting" services provided by broker-dealers through an omnibus account.

As you all know, Rule 12b-1 permits a fund to use its assets to pay for activities that are primarily intended to result in the sale of fund shares, as long as payments are made under a written plan approved by the fund's board. The examiners' concern is whether payments to intermediaries for other, non-distribution services, such as recordkeeping and sub-accounting, include hidden payments primarily intended to promote the sale of fund shares.

Now, a title like "Distribution in Guise" makes you wonder if the examiners might have had a finding in mind before the exam began. Officially, the exam is still ongoing, and the results have yet to be determined. But if I were still at the SEC, I'd be thinking hard about two very important points as I consider next steps.

The first point is that the very concept of "hidden fees" for legitimate non-distribution services is problematic.

If fees are hidden, they are hidden in plain sight. All fund fees—including fees for recordkeeping and sub-accounting—are included in the expense ratio, which everyone can see.

The second point involves the history of Rule 12b-1.

As the SEC has watched over the rule's operation since it was adopted 35 years ago, it has always left discretion on oversight of payments to intermediaries in the capable hands of fund directors and trustees—an entirely appropriate responsibility for them.

Upholding this tradition is very important. It respects the business judgment of directors and trustees as they oversee the shareholder services that funds pay for, as well as the amounts that funds pay for those services.

To do otherwise—to dismiss directors' business judgment—would undermine their critical role. It also would override many years of sound legal interpretation in this area. It's as simple as that.

One more thing—I was heartened to read recent comments from the co-chief of the Enforcement Division's Asset Management Unit, in which she announced that the SEC will not engage in so-called "rulemaking through enforcement" in this area. This is good news indeed.

If the SEC staff believes changes should be made in this area, an open, transparent process is the only appropriate next step—it is the right next step in fundamental fairness, and the right next step under the Administrative Procedure Act's legal requirements.

Of course, no matter the results of the exam, ICI stands ready to work with the SEC to help develop effective regulation and promote sound fiduciary practices, just as it has for the past 75 years.

It is our industry's strength, resilience, and durability—our diamond-like qualities—that have served investors so well for so long. Our multi-faceted relationship with the SEC demonstrates those same qualities—and it is those qualities that will continue to serve investors down the road.

As far as I can tell, and I've done some digging on the subject, there is no gemstone to commemorate anniversaries past 75 years. But I'm sure we'll find something. We'll have to—because our shared dedication to the investing public is rock-solid. And that might be our most diamond-like quality of all.

Thank you very much for your time and attention.

Now, I am delighted to introduce our next speaker, SEC Commissioner Michael Piwowar. I was lucky to have had the opportunity to work with Commissioner Piwowar while I was on the SEC staff, and I know him to be true to his self-declared mandate—advancing and defending the SEC's core mission.

Commissioner Piwowar is on his second tour of duty at the SEC. He was previously on the staff between 2002 and 2006 in the predecessor to the Division of Economic and Risk Analysis. You may not know this, but based on my research, Commissioner Piwowar is only the third PhD economist ever to serve as commissioner at the SEC.

Commissioner Piwowar's storied career has taken him to the heart of some of the most difficult debates facing our industry—he has served as a senior economist on the President's Council of Economic Advisers, and as the Republican chief economist for the U.S.

Senate Committee on Banking, Housing, and Urban Affairs.

Commissioner, we are truly privileged to have you here today.

Ladies and gentlemen, please welcome SEC Commissioner Michael Piwowar.
