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Finding the Right Balance for Mutual Fund Regulation

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I'd like to add my own thanks to all the many participants in today's conference, as well as to all the ICI staff who have worked hard to make this event a success. I also hope you do not object to my being added to the program today to share a few thoughts about the regulation of our industry.

When I reflect upon our recent regulatory history, I am reminded of the Biblical story of Joseph in Egypt. You will recall that Joseph was falsely accused and imprisoned. He got out of jail by interpreting dreams that none of Pharaoh's soothsayers could explain – dreams in which seven fat cows were consumed by seven lean cows, and seven fat ears of grain were laid waste by seven blighted ears.

Joseph told the Pharaoh that his dreams were a warning that seven years of prosperity would be followed by seven years of famine – famine that would destroy all the wealth that the nation of Egypt amassed during its years of plenty.

Well, from a regulatory perspective, the fund industry has certainly experienced seven years of plenty. The period from 1999 through 2006 has been one of extraordinary rulemaking activity for mutual funds – and consequent prosperity for the investment management bar!

Now, I am not predicting that '40 Act lawyers are about to suffer seven lean years.

My own dream, however, is that we will now have a period of reflection and review to weigh the effects, including the unintended consequences, of these seven years of plentiful new rules.

Strong Regulation Is Necessary

I will explain at length why I believe this period of reflection is necessary. But let me emphasize at the outset that the Investment Company Institute supports strong regulation and strong SEC oversight. Mutual funds historically have enjoyed a very high level of public confidence that is rooted in our framework of laws and the vigilance of our regulator. When our industry was shaken in 2003 by revelations of market timing and late trading, we embraced regulatory reforms. The Institute repeatedly has called upon Congress to assure that the SEC has all the resources it needs for its important mission of protecting investors. Having worked with chairs and members of the Commission, and with its staff, for many years, I have great admiration for their dedication and professionalism, and a very healthy regard for how difficult the SEC's job can be. I offer the comments that follow in a constructive spirit and with the conviction that all of us have the same interest in regulation that is both effective and efficient.

The Record

What were the seven years of regulatory "plenty" for mutual funds? I date them from 1999 and the passage of the Gramm-Leach-Bliley Act. This was a landmark in financial deregulation. But for mutual funds, Gramm-Leach-Bliley was largely notable for creating a

new set of rules governing customer privacy.

Next, in 2001, the Commission approved Chairman Levitt's fund governance reforms, followed shortly by the requirement that funds disclose after-tax returns.

Congress passed the USA Patriot Act in 2001, with extensive anti-money laundering obligations.

In 2002, President Bush signed the Sarbanes-Oxley Act, with its certification requirements, disclosure controls and procedures, and code of ethics and financial expert provisions.

Sarbanes-Oxley was intended primarily to apply to corporate issuers, but the SEC elected to apply a host of its new provisions to mutual funds.

And in 2003, proxy voting disclosure rules for mutual funds took effect.

All of this activity came before September 2003, when revelations about late-trading and market-timing abuses broke. Then, the SEC launched a dozen new proposals for mutual funds. The Institute supported this process and the majority of the SEC's specific proposals. But taken together, these rules represent a surge of new regulations unlike any that the mutual fund industry had experienced in more than 60 years.

What have all these new rules brought us? More disclosure, certainly, and useful safeguards against abuse. But I also see two types of regulation that have brought higher costs and compromised the competitiveness of mutual funds.

Costs Without Equal Benefits

The first class of problem rules: those that entail costs entirely disproportionate to their benefits.

The Sarbanes-Oxley certifications fall in this category. Sarbanes-Oxley requires CEOs and CFOs to personally certify the accuracy of their companies' financial statements. The goal was to make personal liability the final backstop to prevent public operating companies from distorting their financial reports.

Mutual funds' financial statements have never offered such opportunities for distortion or been subject to such abuse. Nonetheless, the SEC chose to impose these same requirements on funds. Investment companies incurred substantial costs to set up certification systems, and large complexes now must complete literally scores of fund-by-fund certifications every quarter. This cumbersome process returns little or no value to fund investors.

The New York Stock Exchange's pending proposal on proxy voting offers another example. The Big Board would change the treatment of uncontested director elections, eliminating brokers' ability to vote proxies on behalf of the substantial majority of fund investors who hold their shares in street name. Our research on this issue shows that only about a third of these beneficial owners return their own proxies. Most funds would not be able to muster a quorum to conduct routine but important corporate business without discretionary broker voting.

Our economists estimate that funds' costs of soliciting proxies will more than double – from $1.65 per shareholder account to $3.68 – under the NYSE proposal. The proposal could add between 1 and 5 basis points to funds' expense ratios. And the benefit? Well, since we're talking about uncontested elections, the same directors will be elected whether funds bear these costs or not. It's hard to see any benefit at all.

I could cite other examples as well. But the basic point is this: Rules impose added costs – and, ultimately, investors bear those costs. In return, investors should receive an equal or greater benefit.

The Unfair Playing Field

The second class of worrisome rules consists of those that impose regulations uniquely on mutual funds – without addressing other, similar investment products. These other products compete with mutual funds for the same management talent, the same distribution channels, and in many cases the same customers. Yet mutual funds carry extra regulatory burdens.

Over time, what are the potential consequences of these increasing regulatory disparities?

First, there are grounds for concern that investment advisory firms and top portfolio management talent will avoid mutual funds in favor of alternatives that have many of the features of mutual funds but less – in some cases, far less – regulation.

We see this happening in overseas markets. U.S. mutual funds are not seen as a competitive product for export to fast-growing foreign markets. Instead, European-based funds, known as "UCITS," are rapidly gaining regulatory approval and sales, particularly in

Asia and Latin America. Indeed, European-domiciled investment funds boosted their net sales outside the Continent from $4.5 billion in 2004 to $17.6 billion in 2005. One of the strengths of the UCITS "brand" is its ability to accommodate simpler organizational structures – such as common funds and trusts – as well as investment companies. But the European funds also benefit from the fact that they are free of many regulations that apply to U.S. funds.

A second concern is that brokers and other intermediaries will focus their energies on selling products with fewer regulatory headaches. Take the SEC's proposed point of sale rules, which would force brokers to provide extensive disclosures before selling an investor a fund. As proposed, the rules principally would affect mutual funds. And they evidence little regard for the sales process that brokers actually follow in serving their fund customers. If the SEC continues on this course, brokers predictably will conclude that it's easier and more rewarding to sell some alternative –a separately managed account, say, or a private fund. And that would be harmful – not just to mutual funds, but to investors. As former NASD Chairman Robert Glauber said last spring, "An investor should be sold a security because it's right for him or her, not because it's easier to sell than something else."

A third concern is that this mounting regulatory disparity will encourage some market participants to reserve their best service for mutual funds' competitors. Take the restrictions on soft-dollar arrangements for advisers to investment companies and ERISA pension plans. We support those restrictions. But today, when brokers face strong downward pressures on commissions, these same restrictions give broker-dealers every incentive to favor hedge funds. It's not called "prime brokerage" for nothing. After all, hedge funds are active traders, concerned more with execution quality than with trading costs – and they are at greater liberty to make soft-dollar payments.

SEC rulemakings often are hotly contested. I'm not here today to reopen old debates. But one has to wonder: If there are sound policy reasons for a rule, why apply it only to mutual funds? On proxy votes, for example, the SEC decided it is vital for the public to know how mutual fund advisers cast their ballots. Mutual funds hold 25 percent of the shares of public companies – about the same stake as other institutional investors. Why is it not equally important to know how public and private pensions, insurers, and banks vote their shares? If soft dollars create serious conflicts of interest, aren't those conflicts just as significant, and just as worthy of regulation, for private managers? If point of sale disclosure is a good idea – and I believe it is – why is it not good for products other than mutual funds, like the $800 billion in separate accounts?

Mutual funds draw the attention of regulators precisely because of their importance as a financial tool for millions of investors. The Institute's latest figures show that 62 percent of the households that own mutual funds have incomes between $25,000 and $100,000. Regulations that unnecessarily burden this unique vehicle will raise the costs and limit the options for average Americans saving for their children's educations, their own retirement, and other goals.

It would be highly ironic and unfortunate if, in our zeal to "perfect" mutual funds, we make them decidedly less competitive, less innovative, less attractive to talented investment managers and intermediaries – and less available or advantageous to the average investors they are designed to serve.

Cost-Benefit Analysis

Earlier, I called for a period of reflection and review to work out the effects of the extraordinary burst of regulation that we've seen since 1999. How could we use that pause to make regulation more efficient and effective for fund shareholders?

My suggestion: Let's get deadly serious about the mandate in the securities laws to consider the effects of regulation on efficiency, competition, and capital formation. Congress has directed the SEC to consider these factors – not just for public companies or securities markets, but for investment companies as well.

As the DC Circuit pointed out in its first decision on the SEC's fund governance rules, the SEC has a "statutory obligation to do what it can to apprise itself … of the economic consequences of a proposed regulation before it decides whether to adopt the measure."

And let's be candid: The SEC has not always heeded this mandate as it should. ICI members tell us that their costs routinely run far above the estimates upon which the SEC bases its analysis.

Clearly, more timely, informed, and rigorous analysis of the costs and benefits of SEC regulation is in order. At ICI, we are working hard to advance the state of the art in cost-benefit analysis, tapping all available data and our members' expertise to help inform the policy process.

For example, when the Commission reissued its fund governance rules last summer, we filed an additional comment letter that focused on the special burdens the rules would place on small funds. We are particularly concerned about small funds, because any costs imposed on them create barriers to entry for entrepreneurs who want to bring their talent, innovations, and capital to our industry.

Our findings: In isolation, the costs of the independent chair and independent director super-majority rules appear small. But the SEC has recently passed many rules for funds – and the cumulative cost is quite high. Given the lack of demonstrable benefits from the governance rules, we strongly urged the Commission not to require every fund to select an independent chair, but to leave that choice to individual fund boards.

Principles for Cost-Benefit Analysis

How would a more rigorous approach to cost-benefit analysis work? Let me offer some principles.

First, regulators should act when they must – and only then. Often, market forces will resolve the problems that regulators feel impelled to address. Regulators also need to look closely at whether they can harness market forces to solve problems and protect investors' interests.

Second, in those cases where a significant market failure justifies intervention, regulators should examine whether the problem isn't addressed in existing laws and regulations. The '40 Act already comprehensively addresses a wide array of potential market failures for mutual funds, such as conflicts posed by affiliated transactions. Strict enforcement of the rules that are on the books – rather than new rules – can often be the answer.

Finally, when new rules are required, regulators need to rigorously examine all possible options with a sharp eye toward their relative costs and benefits. It is not enough just to ask: Will this proposal protect investors? Instead, the key question is: How can we best protect investors, consistent with a statutory mandate to promote efficiency, competition, and capital formation? Rules that erode these key qualities of the marketplace – factors singled out by Congress for special attention in our securities laws – demand close scrutiny and must prove their benefits. If our zeal for investor protection blinds us to the impact of regulation on our markets, investors will end up with higher costs, fewer options, and ultimately less protection.

The View From London

Some of you may recognize that my principles are not entirely original. In Great Britain, the Financial Services Authority has a mandate to ensure that any burden or restriction it places on a regulated firm is proportionate to the expected benefits. The FSA takes this responsibility seriously and has established a rigorous procedure to carry it out.

Its approach suggests that the FSA regards an important part of its mission to be maintaining the City of London as a vibrant global financial market. I don't have to tell you that many market participants believe that London is rapidly overtaking – even surpassing – New York as a financial center. So far during 2006, while the New York Stock Exchange carried out only 22 initial public offerings for foreign companies, the London Stock Exchange added 96 listings by foreign companies. Other foreign financial centers are gaining ground as well: Last month, the world's largest IPO went to the Hong Kong stock market.

American officials have awakened to the fact that our market is no longer the unrivaled center of the financial universe. Treasury Secretary Henry Paulson recently questioned whether U.S. regulators are striking the right balance between integrity and accountability on one hand and innovation and growth on the other. He singled out Sarbanes-Oxley's accounting and governance reforms as necessary changes that have been implemented in ways that "may be creating unnecessary costs and introducing new risks to our economy."

Secretary Paulson is not alone. SEC Chairman Christopher Cox has already launched an effort to determine whether Sarbanes-Oxley can be made to work more efficiently. And last Thursday, the Committee on Capital Market Regulation – a panel of business, financial, and academic thought leaders – called upon the SEC, the NYSE, and NASD to, among other things, systematically analyze the relative costs and benefits of their proposed rules. These recommendations should get a receptive hearing in Washington, because leaders on both sides of the aisle cannot be indifferent about the U.S. continuing to lose ground in the global financial competition.

Those of us in the mutual fund industry offer our strong encouragement to these efforts. But these are issues that go far beyond the narrow interests of Wall Street – or even our Main Street investors. America's pre-eminence in financial services has served our economy well. Every industry, every business, has benefited from ready access to capital and from financial innovations – including those creative ideas that mutual funds represent so well.

For several generations now, the SEC has protected the interests of investors while shepherding the success of our markets. Historically, this has not been an either-or proposition. Regulators can protect investors effectively while encouraging a robust and competitive financial industry.

Still, from my vantage point – after the seven years of plentiful regulatory activity that I have outlined – we do need a pause. And we do need to call upon our regulators to consider more carefully and seriously the impact of their work. Inability to fully consider the

effects of regulation – or, worse, indifference to the range of its possible consequences – could carry a heavy cost.

The Bible tells us that Pharaoh heeded Joseph's warnings. He ordered his countrymen to build huge granaries to store the rich harvests of the seven years of plenty, and Egypt was able to feed many refugees as well as its own people through the seven years of famine. I don't claim any prophetic powers. But I am optimistic that our regulators and our political leadership can strike the right balance and protect the enormous asset that we have in our American financial markets. In this vital task, we in the mutual fund industry stand ready to help in every way we can.

Thank you for your attention, and I hope you will enjoy the rest of our conference.
