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Meeting the Challenges of Financial Crisis

# “Meeting the Challenges of Financial Crisis” President’s Address


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Good morning. Thank you, Amy and Jack, for your remarks, and let me add my welcome. Once again, working with the Federal Bar Association, we have assembled an outstanding program. This conference has always been the leader in providing the most substantive program on the regulatory and legal issues confronting our industry, and our attendees testify to the knowledge and insights they gain through three intensive days. I’m confident that this year’s conference will meet and exceed that standard.

As I look out from this stage, I can’t help but recall last year’s conference and reflect on the experiences of the last 12 months. At last year’s conference, the registered attendance was higher, but I remember well that many attendees couldn’t make it to all of the sessions. Instead, they were in their rooms or in the hallways, dialing in to emergency board meetings about the rapidly unfolding events surrounding the rescue of Bear Stearns. It was a tense and foreboding time, and—as we all know all too well—it accelerated the financial slide that turned into an avalanche six months later, with the bankruptcy of Lehman Brothers.

I don’t need to recount for this audience the tremendous disarray that these events have caused in all sectors of the financial world. After all, you have lived through this, too.

Instead, I would like to highlight the three major issues that the financial crisis has raised for mutual funds and other investment companies.

First, money market funds: More than a year into the credit crisis, and after an unprecedented string of failures and government interventions, a single money market fund succumbed. Last September 16, the Reserve Primary Fund saw its net asset value fall below $1.00, becoming only the second money market fund in history to “break a dollar.”  By the end of that week, the Federal Reserve and the Treasury stepped in, taking several actions to shore up the money market in general and to calm money market fund investors in particular, including the Temporary Guarantee Program for Money Market Funds. This episode raised new questions about how the money market operates and how money market funds should be regulated within that market.

Second, regulatory reform: The crisis has cast in stark relief the gaps and other flaws in our system of financial regulation. The public policy debate about how best to strengthen the system is of tremendous interest to funds in their dual roles as investors and issuers.

Third, retirement security: The decline in equity prices has brought on a precipitous drop in retirement plan assets, including the balances that America’s workers hold in 401(k)s. The deep and natural anxiety caused by these declines has raised questions in some quarters about the adequacy of our system of retirement savings—a system in which mutual funds and their sponsors are major actors, providing both investment vehicles and plan services.

How should we, as an industry, respond to these effects?  At ICI, with the leadership of senior executives of our member complexes, we have chosen to pursue a vigorous policy agenda to address problems laid bare by the crisis. I’d like to describe today our

activities in each of these areas.

Let me begin with money market funds. As you probably know, ICI's Executive Committee formally chartered a Money Market Working Group, composed of senior industry executives, last November. We did not act out of any concern that money market funds pose a significant challenge to the stability of the financial system—quite to the contrary. In the 25-year history of Rule 2a-7, one-third of a quadrillion dollars has flowed in and out of money market funds. In that quarter of a century, until September of 2008, only one small fund had ever broken a dollar. But the events of last fall tested money market funds severely, with many sponsors offering support for their funds. So we had a responsibility to examine those events and to propose ways to make money market funds even stronger.

Vanguard's Chairman Jack Brennan led an intensive examination of these issues. The Working Group's challenge was daunting: It had to preserve the characteristics that make money market funds so valuable to investors, to issuers, and to the economy, while increasing their resilience so that these funds can better withstand even the most adverse market conditions.

It was an exhaustive effort. Supported by industry practitioners and ICI staff, the Working Group consulted broadly, with advisers to funds and other pooled investment vehicles, issuers, regulators, academics, institutional investors, and advisers to individual investors. The Working Group considered a wide range of ideas, including proposals offered by outside commentators since last fall.

With a 224-page report issued just last week, the Working Group literally "wrote the book" on money market funds. We believe that they also have written the blueprint for the future of this vitally important product. The Report offers new and heightened standards for the operation of money market funds in every key area, including liquidity, credit quality, maturity, client concentration, and transparency.

For example, the Working Group proposes imposing, for the first time in the history of Rule 2a-7, daily and weekly minimum liquidity requirements on money market funds. These requirements would be backed by regular stress testing of the portfolio, because some funds may need to operate to even higher standards.

The proposals would tighten limits on portfolio maturity by reducing the maximum weighted average maturity from 90 days to 75 days and introducing a new maturity limit that would further tighten portfolio durations.

Credit quality standards would be increased. The Report's recommendations would require funds to create a "new products" committee to review new investment vehicles—the "SIVs of tomorrow," if you will. The Working Group also proposes barring money market funds from investing in Second Tier Securities.

Significantly, the Report addresses a risk that current regulations overlook: "client risk." The Working Group found that a money market fund's ability to maintain liquidity is closely related to the composition and diversification of its shareholder base. Under this proposal, funds would be required to adopt robust "know your client" procedures and to disclose their client concentration levels by type of client on their websites each month.

As these recommendations are adopted, tomorrow's money market fund investors will face even less risk than today's do. But the Working Group went further, to look at how to treat all investors in a fund fairly if that fund should break a dollar in a future financial crisis. They propose that the Securities and Exchange Commission authorize a money market fund's board to suspend redemptions of fund shares temporarily if the fund is facing a cascade of redemptions that it is unable to meet—and permanently for funds preparing to liquidate, in order to treat all shareholders fairly.

The Working Group also considered proposals made by others that would fundamentally alter the current regulatory or business model of money market funds—ideas such as barring funds from using the fixed $1.00 net asset value, or requiring insurance for money market funds, or converting these funds into special-purpose banks. In each case, the group concluded that these ideas are impracticable and could hurt investors, issuers, and other participants in the money market. I would commend to you its thoughtful analysis of those ideas.

Jack Brennan and the Working Group didn't just file a report and go home. The fund complexes represented on the Working Group signaled their willingness to adopt voluntarily those proposals and practices that can be implemented without regulatory action. Last week, ICI's Board of Governors unanimously endorsed the Report's recommendations and called upon all money market funds to follow suit. Specifically, funds are urged to act before September 18—the last day that Treasury has legal authority to operate the Temporary Guarantee Program, should it be extended. That will provide fund investors with additional assurance and to facilitate an orderly transition out of that program.

I believe this effort represents our industry at its best. It is in the tradition of previous instances—as with personal trading in 1994 and board best practices in 1999—when the fund industry imposed higher standards of conduct upon itself prior to rulemaking. And we look forward to working with the SEC and other government agencies to carry out all of the Report's recommendations.

In ordinary times, the Report of the Money Market Working Group would be achievement enough. But these are not ordinary times, and we have had other irons in the fire.

One issue of great importance to funds as both issuers of securities and investors in the capital markets is the national debate over financial services regulation. The financial crisis has demonstrated that the current regulatory system is not up to the challenges posed by modern financial markets. Yet the crisis also provides a public mandate for Congress to take bold, thoughtful steps to strengthen and modernize regulatory oversight.

Earlier this month, ICI published a white paper [Financial Services Regulatory Reform: Discussion and Recommendations] detailing proposed reforms, with particular focus on the functioning of the capital markets and the regulation of investment companies. I'd like take a few minutes to summarize our proposals. You can find the white paper in your conference materials or on our website, and tomorrow morning's panel moderated by ICI General Counsel Karrie McMillan will explore these ideas in more depth.

First, it is crucial to improve the government's capability to monitor and mitigate risks across the financial system, so ICI supports creation of a "Systemic Risk Regulator." This could be a new or existing agency or inter-agency body responsible for monitoring the financial markets broadly; evaluating and identifying risks that are so significant that they implicate the health of the financial system; and acting in coordination with other responsible regulators to mitigate these risks.

In our white paper, we stress the need to carefully define the responsibilities of the Systemic Risk Regulator and its relationships with other regulators. Addressing systemic risk effectively need not and should not mean stifling innovation, retarding competition, or compromising market efficiency.

Given the nature of the current crisis, discussion of a Systemic Risk Regulator has dominated the debate in Washington. Yet, as SEC Chairman Mary Schapiro noted earlier this month "We will need the SEC—or something that looks very much like it," in any new regulatory framework. We agree, which is why our paper devotes a great deal of attention to creation of a new Capital Markets Regulator that would encompass the combined functions of the SEC and the Commodity Futures Trading Commission.

The Capital Markets Regulator would bring a consistent policy focus to U.S. capital markets. Its statutory mission should focus sharply on investor protection and law enforcement. But it also must have a mandate to consider whether its proposed regulations promote efficiency, competition, and capital formation, because investors are also harmed when market participants cannot innovate or operate efficiently.

There are several areas where the Capital Markets Regulator needs specific legislative authority to close regulatory gaps. These areas include hedge funds, derivatives, and municipal securities, particularly to improve disclosure. The regulator also needs explicit authority to harmonize the regimes for investment advisers and broker-dealers.

The Capital Markets Regulator should act as the standard setter for all registered investment companies, including money market funds. Funds and fund investors will benefit from having a strong, independent regulator, with experienced personnel who can fully grasp the complexities of today's marketplace and with the resources to successfully fulfill its mission. Our regulatory scheme, which grew out of the New Deal as a result of the last major financial crisis, has proven remarkably resilient. Fund investors enjoy a range of vital protections, including:

- Daily pricing of fund shares, with mark-to-market valuation;
- Separate custody of fund assets;
- Minimal use of leverage;
- Restrictions on affiliated transactions and other forms of self-dealing;
- Oversight by trustees and directors, including independent directors; and
- The most extensive disclosure requirements faced by any financial product.

Funds have embraced this regulatory regime and prospered under it. In light of recent experience, we've suggested that policymakers consider extending some of these same disciplines to other marketplace participants.

What I've described so far is a full plate. But there's another major area where we are engaged in intensive policy activity: retirement security.

The bear market has had a significant impact on retirement savings. One large recordkeeper reports that the average defined contribution account balance fell by 27 percent in 2008. These declines are not due to any fundamental flaw in 401(k) plans. Balances are down because the stock market is down.

The fund industry is entrusted with the retirement savings of 46 million American households. We have a large stake in ensuring that policymakers understand the importance and value of today's savings vehicles. Critics have used the decline in account balances to argue that 401(k) plans should be scrapped or shoved aside. We reject that idea.

Despite their declining balances, working Americans tend to agree with us: They strongly support 401(k)s.

Beginning last fall, well into the market decline, we examined account records of 22 million DC participants [Retirement Saving in Wake of Financial Volatility]. They were not panicking: Throughout 2008, only 3.7 percent stopped contributing to their accounts, and fewer than one in 25 took any withdrawals. Clearly, 401(k) savers are staying the course.

None of this suggests that 401(k)s or our retirement system are flawless. In fact, we believe 401(k) plans are at a crossroads and that they can and must be improved. In testimony last month before the House Education and Labor Committee, I spelled out seven proposals that ICI believes Congress should consider:

- First, we should improve disclosure—not just about fees, but also about risks, performance, and more.
- Second, to help retirees manage their assets more effectively, we should relax the rules on required minimum distributions.
- Third, we need to make it easier for employers to diversify participants out of heavy concentrations of company stock as they near retirement. Workers should not have to face the double risk of losing both their jobs and a significant portion of their retirement savings if a single company fails.
- Fourth, we should consider requiring all 401(k) plans to use automatic enrollment and automatic savings escalation, after some time to assess the rapid voluntary implementation and success of these innovations.
- Fifth, we must make it easier for employers to offer savings plans, and for all workers—even those of very modest means—to save for their future. We have proposed making it easier for employers to offer very simple plans, and also creating a new series of Treasury savings bonds—what we call "R" Bonds—as a convenient way to invest those savings.
- Sixth, we must redouble our efforts to provide financial and investor education to all Americans at every age. This is a job for educators, government at all levels, financial institutions, and all firms that serve the retirement market.
- Lastly, we must put Social Security on a sound financial footing for the indefinite future. Social Security has been, and will continue to be, the primary source of retirement income for millions of workers. If Washington wants to bolster confidence in retirement security, it should fix Social Security.

In the last month, we have articulated much of the Institute's policy agenda for the foreseeable future. It has been an exhilarating time. We hope it has left ICI and its members well-positioned to engage in the critical debates facing our industry and our nation.

The core of this conference is law and regulation. But let's step back for just a minute and consider our true purpose as members of the fund industry. Let's remember that funds are, quite simply, the best vehicle for investors of average means to reach the financial markets and achieve their financial goals.

I am optimistic that funds can continue to play that role. And I have faith that for most Americans, wise investing will be the way forward—no matter what the indexes are telling us at the moment.

The United States has the world's most open, integrated, and flexible economy. Its capital markets are wounded, but not mortally. Its entrepreneurs, engineers, and scientists are still expanding the frontier of our knowledge and know-how. And that relentless quest for new ideas that will spur economic growth and opportunity is not confined to our shores.

Consider the potential investment ideas of the next 20 or so years. What good things might happen? A few candidates: harnessing nanotechnology to make solar energy affordable, producing power using nuclear fusion, treating people with drugs tailored precisely to their genetic composition, and reverse-engineering the human brain to create computers with true intelligence.

These are not my ideas. They are among 14 engineering challenges that a blue-ribbon committee, convened in Washington last year by the U.S. National Academy of Engineering, identified as tough but doable. These innovations, or something like them, will occur. And the innovators will take their place in the litany of companies that have shaped our economy and lives. The fund industry will be there to help the average American share in the investment opportunities of tomorrow.

That is our challenge. And I welcome your commitment to helping our industry to meet it.

Thank you for your attention. It's now my great honor and pleasure to introduce our keynote speaker.

In our media-driven culture, the highest accolade is to be known as a "one-name" celebrity—Cher, Hillary, Bono, and lately, Rihanna.

In our world, there's only one such person . . . and that's Buddy.

Andrew J. "Buddy" Donohue has been Director of the SEC's Investment Management Division since April of 2006. He has been a frequent speaker at our conferences and always brings new insights and ideas.

Before he joined the SEC, Buddy was Global General Counsel for Merrill Lynch Investment Managers—and before that he spent more than a decade as Executive Vice President and General Counsel for OppenheimerFunds. Buddy's years of hands-on legal and compliance experience have proved to be invaluable as the SEC addresses the challenges I've discussed this morning.

Ladies and gentlemen, please join me in welcoming . . . Buddy.

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