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When You Come to a Fork in the Road, Take It: Improving Financial Regulation in America

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

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March 26, 2007
Palm Desert, California

Thank you, Elizabeth, for the kind introduction, and good morning to you all. I am delighted to join you all in Palm Desert once again. I want to express my sincere thanks to SEC Division Director Buddy Donohue and all our speakers and panelists, to all of you in attendance, and to members of the ICI staff who have worked so hard to organize and stage this great conference. I hope it will be an informative and enjoyable experience for one and all.

In my remarks today, let me start with a significant set of policy deliberations now underway in Washington. Leaders in the Bush Administration, members of Congress, business leaders, prominent scholars, and others are all involved in wide-ranging discussions on a vital question: How can America's financial sector maintain its hallmark integrity and accountability—but also thrive in a new era where finance is a global business, where every market center, participant, product, and service is subject to intense competition?

I don't need to tell you that we live in a global economy of which the US is an important part, but not so pre-eminent as in years past. The trend is inescapable. It stems from the free flow of goods, capital and know-how; from new models of business organization; and also from advances in technology, the scope of which is hard even to fathom. Just one example of the latter that caught my eye last month: Intel announced it had succeeded in producing a "Tflop" chip, one no larger than a fingernail yet able to process 1 trillion calculations per second. Just 10 years ago the same processing required supercomputers that almost filled the average-sized American house. Look for this new Intel inside a device near you in just a few years!

As New York Times columnist Thomas Friedman points out, forces such as these are "world-flatteners" – and they have converged to break down borders, boost productivity, and create new business opportunities.

The financial world has been subject to these same forces. Indeed, by almost every measure, world financial markets in recent years have experienced explosive growth. The number of listed companies worldwide now exceeds 40,000, with a combined market capitalization of some $44 trillion. The value of share trading worldwide increased more than tenfold from 1990 to 2005, while the global OTC derivatives market more than tripled in half that time. At year-end 2006, global financial assets exceeded $140 trillion, of which investment funds held more than 15 percent.

To be sure, American producers and consumers have benefited greatly from these trends. But Friedman points out that this new, flat world has exposed a host of what he calls "quiet crises" in our social and economic systems, systems that took shape when U.S. markets were unchallenged by the industry and talent of competitors on every continent. He identifies such "quiet crises" in America's educational system and in our scientific research and development. A third quiet crisis – I fear – may be emerging in the area of securities regulation.

Three recent reports – one from the Capital Markets Commission directed by Professor Hal Scott at Harvard, a second prepared by McKinsey & Co. with the support of New York Mayor Michael Bloomberg and U.S. Senator Charles Schumer, and a third issued just last week by an independent, bi-partisan group convened by the U.S. Chamber of Commerce – all have documented reasons for concern about the erosion of our competitive position as the leading center of the world capital market.

Markets in Europe, South and East Asia, and even the Middle East account for a growing share of financial activity. U.S. exchanges are capturing a declining portion of global IPO's, measured by number and value, and a declining share of listings compared to other world equity markets. The spike in the value of 144A and Reg S offerings suggests that more companies prefer to access capital in the U.S. by non-public means. Meanwhile, American public companies are perceived to face a host of strictures unique to our market – with the Sarbanes-Oxley Act and class action lawsuits cited most often as reasons for companies to consider abandoning or avoiding our public markets.

America's Markets at a Crossroads

There is a growing consensus that we have come to crossroads, posing the question of how to ensure our financial markets are safe for investors, effective for the users of capital – and internationally competitive. The question is, what to do?

Yogi Berra, one of the great savants of the 20th Century, once observed, "When you come to a fork in the road – take it."

Yogi's wisdom, it seems to me, is particularly compelling here. The answers to questions about our international competitiveness or our approach to regulation will not emerge from a debate framed in terms of hard, fixed opposites – pro-investor or pro-business, pro-regulation or pro-market, interventionist or laissez-faire, Wall Street vs. Main Street, old regime or new.

In a speech at the U.S. Chamber last week, SEC Chairman Christopher Cox, hearkening back to the Commission's very first Chairman, Joseph Kennedy, emphasized that the SEC, from its inception, was designed to be "prosecutors of dishonesty." Few in our industry would disagree with Chairman Cox's observation that "aggressive law enforcement by the SEC is critical to the continued success of our markets."

Indeed, in the depths of the our own concerns about late trading and market timing, the ICI called upon the SEC to administer strong medicine to punish and prevent abusive practices. Some of the Commission's recent efforts to detect and curb front-running respond to long-standing concerns expressed by the mutual fund industry. We recognize and honor the SEC's role in law enforcement as a bedrock of our market's integrity, our investors' confidence and our success.

But Chairman Cox also recalled his predecessor's admonition that the SEC should be "partners of honest business." The Commission is also a lawgiver, in the sense that its regulations and interpretations define and shape our industry, our business partners and competitors, the markets in which we operate. The SEC's approach to its law-giving powers has enormous consequences for the competitiveness and appeal of our capital markets.

Hopefully, one direct result of the recent study efforts will be to sanction and stimulate a debate framed in terms of both-and, not either-or. We can protect investors and promote a thriving, vibrant financial sector. The SEC can be a tough cop and a thoughtful regulator. Indeed, it must be -- because if a zeal for investor protection blinds us to the impact of regulation on our markets, the investors who provide capital and the enterprises that use it will both end up with higher costs, fewer options, and ultimately less protection. This is not just a debate about IPO's or the economy of New York City. It is one that affects mutual funds and all our shareholders, one in which all of us in the fund industry must be engaged as well.

The Role of the SEC

How can we avoid the trap of "either-or" and take this fork in the road to benefit all players in America's markets? Today, I'd like to look at several issues, both general and specific to the mutual fund industry, and suggest some ways to do so.

One idea concerns, in effect, a systematic reconsideration by the SEC of its current organization, structure and approach to regulation. Each of the three recent studies recommends such a review, with respect to such matters as the roles and responsibilities of the SEC's divisions, the status of the SEC's international efforts, the conduct of its inspections and examinations, the place of economic research and cost-benefit analysis, and the adoption of a more principles-based approach to regulation.

In the 1930's, the birth of the SEC itself was the product of sustained attention to how to regulate our capital markets in the aftermath of the Great Crash of 1929 and the economic crisis of the Great Depression. Over the many years since, the SEC has changed and evolved far less than the markets and firms it oversees, notwithstanding its substantial growth and various organizational adjustments. As the Chamber's Capital Markets Commission observed, we operate within a structure firmly rooted in reforms adopted during "a period that was closer in time to the Civil War than it is to today.

Market forces compel organizations of all kinds today to "re-invent" themselves -- a process that can unleash surprising new energy

and ideas and uncover ways of performing key missions more successfully. Surely, this is a process that our experience proves is no less necessary, from time to time, for government departments and agencies. During my professional career, I had a hand in two such efforts concerning the Defense Department that produced notable results. I do not pretend to have any master plan for this purpose. But I do hope that Chairman Cox, members of the Commission, and leaders on the SEC staff will give the thoughtful recommendations advanced in recent months every consideration.

Priorities for Mutual Fund Regulation

To narrow the focus now, what might all of this mean to us? How do we ensure both investor protection and efficiency in the area of mutual fund regulation?

Clearly, the second part of this equation remains a challenge. It is still possible for significant new rules to be advanced in the absence of any evidence of a market failure or problem, and with little or no effort given to sizing the costs, assessing the balance of costs and benefits, or considering possible alternatives. The best recent example is the New York Stock Exchange's pending proposal on proxy voting. 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 one-third of these beneficial owners return their own proxies. Compared to operating companies, funds tend to have a larger proportion of individual investors among their shareholders. Without discretionary broker voting, most funds would not be able to muster a quorum to conduct routine but important corporate business.

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.

We have asked the NYSE and the SEC to retain the current system of discretionary broker voting for investment companies, one that has worked well for funds and their shareholders, and we are hopeful that they will do so.

In light of this experience, the Institute recently has called for requiring self-regulatory organizations like the NYSE to conduct economic analysis in their development of new rules. The logic here is the same as it is with the SEC itself: We all want to protect shareholders, but part of that protective mission concerns stewardship of investor assets. Rules impose added costs – and, ultimately, investors bear those costs. In return, investors should receive an equal or greater benefit.

This same logic suggests that, from time to time, the SEC should abandon proposed rulemakings that do not pass muster, and also reconsider established rules to alleviate undue burdens, remove unnecessary requirements and adopt new approaches in light of changed circumstances.

One example of a proposed rule that does not pass muster is the fund governance proposal first advanced in 2004 under SEC Chairman William Donaldson. This is one of the most protracted and contested rulemakings in the agency's history, and we recently urged the Commission to conclude it without further action.

Why urge the SEC to move on? Certainly not because the Institute lacks any commitment to fund governance. Fund boards, and independent directors specifically, are integral to the structure laid down in the Investment Company Act of 1940. That structure has supported successfully the rise within just the past generation of mutual funds as the nation's largest financial intermediary. As I have observed many times when meeting with boards around our industry, our 94 million shareholders are well served through the efforts and collaboration of two kinds of fiduciaries – investment advisers who sponsor and manage funds, and independent directors who represent and advance the interests of fund investors.

ICI has a long record of support for strong, well-informed boards. That is why we supported most of the post-scandal proposals to strengthen fund governance – including, for example, a requirement that funds employ Chief Compliance Officers, who report directly to their boards. Leaders of the Independent Directors Council – itself a expression of ICI's strong support for the work of fund boards – regard the CCO rule to be one of the most important regulations ever adopted by the SEC in support of sound governance.

We have suggested that consideration of this governance proposal be brought to a close because we believe that decisions about board leadership and composition are best left to fund directors to decide. And also because of the results of the Commission's own economic analysis of the proposal.

I don't have to go into detail on the history of the fund governance proposal for this audience. As you well know, the U.S. Court of Appeals for the D.C. Circuit twice sent the rules back to the SEC. The Court's decisions underscore the importance of the Commission heeding its statutory mandate and properly considering the proposal's impact on efficiency, competition, and capital formation.

Now, we have the SEC's own economic studies of this proposal, studies that reportedly were first prepared in 2005 under Chairman Donaldson, but were released last December by Chairman Cox. The SEC's own studies confirm much of what we expected. There is no one-size-fits-all model for fund boards. Economic studies of fund governance do not provide any compelling evidence of economic benefits from having an independent board chair: there is no improvement in fund performance, no reduction in management fees, and no less chance that the fund will fall into legal or regulatory problems. Similarly, there is no evidence that a three-quarter independence ratio is "optimal." Rather, what is best may vary from board to board.

The bottom line is that the SEC's own analysis does not demonstrate a need for or benefit to be derived from these rules. Our own submissions and analysis make clear, however, that the proposal would entail costs – it would disproportionately impact small fund organizations and increase barriers to talented money managers seeking to enter the fund business. On this basis – indeed, on the basis of the entire record before it – the SEC should drop this proposal.

A Better Approach to Strengthen Fund Governance

Instead, there are other meaningful ways for the Commission to focus on making boards more effective. This endeavor certainly would be worthwhile – and it fits into the category I described before, that of re-thinking existing requirements. I refer to the project that Buddy Donohue, director of the SEC's Investment Management Division, has launched to review the roles and responsibilities of boards. To his credit, Buddy, who will be our next speaker, has been doing field work – reaching out to boards and independent directors, attending board meetings, informing himself about how today's fund boards function. I suspect that some of what he's been hearing is that boards today are dealing with new and expanded responsibilities, enormous detail and complexity, and a host of new issues and pressures.

Critically re-examining the tasks we have assigned to fund directors. Making sure that directors can and do devote their time and attention to the matters that count most. Allowing directors to concentrate on tasks that are in keeping with the role of a board. This is a timely and important exercise, and we commend Buddy Donohue for pursuing it.

The Crucial Importance of Streamlined Disclosure

Another – and no less important – subject that needs re-thinking is the quality of disclosure that is available to investors when they buy mutual fund shares. And I want to close my remarks with a brief discussion of this.

The fund industry, regulators, and investor advocacy groups have been debating for sometime about the best way to provide fund investors with the information they need to make good decisions. This is a very healthy and welcome dialogue, because the challenge is significant and new approaches are sorely needed.

In German folklore, there is a tale that cunning Bavarian blacksmiths once crafted a funnel that could be used to pour knowledge directly into someone's head. Just consider the possibilities: all the mass of information that anyone might think we need to disclose, streamed straight into an investor's brain! Well, until our technology achieves something on this order, we will have to explore other options.

Experts in training and technical communication have been debating such issues for decades, as our lives and the tools we use grow increasingly complex. Other industries also face this challenge of needing to impart overwhelming amounts of information, all of it useful to someone, but most of it peripheral to a user's immediate needs. In the technology field, communications experts have developed one answer – the "quick-start" guide. You may have noticed that every consumer electronics product you've bought recently – be it a digital camera or an MP3 player or a software program – comes with one. With this guide, you can use the device without having to slog through a long, detailed, but often confusing user's manual. This has become the norm.

Is there any reason why we shouldn't give fund investors something like a quick-start guide when they buy fund shares? Buddy Donohue has been talking recently about developing a summary disclosure document that would give a fund buyer all the basic information he or she needs. We would like to see a clear, concise document that highlights the key information that a fund buyer wants and needs, in an easy-to-understand form.

Am I proposing that we give investors less information? Not at all. Here, too, we can take the fork in the road, as Yogi suggested. In today's world, we do not have to choose between either flooding all investors' mailboxes with fat prospectuses or shortchanging the information available to the market. That is a false choice, because we can call upon the power of the Internet to give quick and easy access to the additional information some investors may want.

ICI research in 2006 showed that 92 percent of mutual fund investors had Internet access. Seventy percent of those investors went on-line every day and, of those, 80 percent used the Internet to help manage their finances. We know that fund investors are logged on. So, our challenge is to figure out how to use the power of the Internet to communicate with them and better serve their interests.

In January, ICI took a big step in that direction with the release of our draft taxonomy for XBRL data-tagging of the risk-return summaries in mutual fund prospectuses. This undertaking benefited from the strong encouragement of SEC Chairman Cox, who is an active proponent of this project and of using the Internet as a vehicle to inform and educate investors.

XBRL data-tagging will enable fund investors easily to retrieve, analyze and compare information about multiple funds – information such as their investment objectives, historical performance, fees, and risks.

We view this initiative not as an end in itself but rather as one important building block in a new approach to disclosure, an approach that will serve investors in ways that traditional disclosure documents – long, legalistic, colorless, and little-read – do not.

And by “investors” I mean all investors, not just those who buy mutual fund shares. The “quick-start guide” that we propose for mutual funds may serve as a disclosure model for a range of other investment products, in 401(k) plans and the retail markets.

Conclusion

I’ll say in conclusion that all the topics I’ve addressed this morning are connected in one important way: They all call upon the SEC to be, as Joe Kennedy described it, “partners of honest business.” Through its regulations, through its examinations, and through its oversight, the Commission should foster a healthy working relationship with the law-abiding majority, a relationship that strengthens our competitive place in the world.

Our industry certainly wants to play its part in this endeavor. We offer ourselves as partners to the Commission, and will strive to live up to the highest standards.

With that, I thank you for listening and for attending this conference.

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