The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
Washington, DC // Brussels // London // www.ici.org

Looking Ahead: An Affirmative Agenda for Fund Regulation

Paul Schott Stevens
President and CEO, Investment Company Institute

October 2, 2012
2012 Fund Directors Conference
Chicago, IL

As prepared for delivery.

Thank you, Susan [Kerley, independent chair, Mainstay Funds, and independent director, Legg Mason Partners Funds], and thanks to all of you for joining us here today. It's a great honor to speak at this conference, because it highlights the vital mission and work of fund directors, trustees, and the Independent Directors Council.

The IDC was launched just a few weeks before I rejoined the Investment Company Institute as president and CEO in June 2004. So I have watched the IDC grow and blossom into a tremendous resource for fund directors. It has built an outstanding record of promoting education, advocating sound policies, and creating opportunities—like this conference—to build a stronger director community.

All of us at ICI take great pride in the progress IDC has made, and in the outstanding work that all of you do, year in and year out, in your vital role on behalf of fund investors.

ICI's mission statement calls for the Institute to "advance the interests of funds, their shareholders, directors, and investment advisers." That means we work on behalf of more than 9,000 funds serving more than 90 million shareholders—and more than 2,000 independent directors.

Of course, all of us—directors, advisers, and the Institute—share the common mission of serving investors. For directors and advisers, that means providing nothing less than the undivided loyalty and high degree of care that are the hallmarks of a fiduciary. In stewardship of fund investments, in oversight, and in the services provided to fund shareholders, the unwavering objective must be to meet the high expectations of fund investors and to earn their trust.

That same obligation carries over to the public policy positions we support collectively through ICI.

Paul Haaga, the recently retired Chairman of Capital Research and Management, was Chairman of the Institute during the dark days of 2003 and 2004. At that time, Paul said: "As soon as shareholders don't come first, mutual funds won't be the investment of choice—and we won't deserve to be."

One result of putting shareholders first is that ICI and its members have always taken an affirmative approach to regulation. We recognize that our funds could never thrive without the public's trust and confidence—and that trust is bolstered by sound, investor-centered regulation. ICI works to support regulation that is effective, efficient, and equitable—and that protects investor interests.

Serving the interests of investors is a goal we share with regulators, particularly the Securities and Exchange Commission. For many years, we have sought to work cooperatively with the SEC and other agencies to accomplish this objective.

The Institute doesn't always agree with the SEC on how regulation can best serve investors. As you all know, we have opposed proposals from the SEC staff on some issues lately—most publicly, on money market funds.

Yet even when we are in disagreement with the SEC, we greatly respect the skill and dedication of the SEC's leadership and staff. We understand how challenging and difficult the policymaker's role can be. And we still pursue an affirmative approach to regulation that will protect investors and advance their interests by making investing easier, more efficient, and more cost-effective.

In that spirit, my mission today is to look forward to the SEC's agenda for the next four years. I want to discuss a number of items of unfinished or pending business where SEC action could benefit fund investors. These items fall broadly into three categories:

First, the SEC could help funds and investors make the most of modern portfolio management techniques by tackling a cluster of issues surrounding the use of derivatives by mutual funds and exchange-traded funds.

Second, the Commission should continue to build upon the success of the summary prospectus and work to improve the other types of information that investors receive, while also protecting investors against the risk of misinformation.

And third, the SEC can continue to strengthen its own framework for regulation by recognizing the importance of cost-benefit analysis and building upon the useful steps it has recently taken to bolster economic analysis in its rulemakings.

Now, there may be some of you who'd like to hear more about money market funds. If I have time, I'll return briefly—very briefly—to that issue at the end.

But the fact is, at ICI we've been pursuing a wide range of other issues … in tax policy, retirement policy, operations, and fund regulation … in the U.S. and abroad. And the forward-looking agenda that I want to discuss today shows that the SEC, too, has much more to think about than regulation of the money markets.

The first constellation of issues I mentioned surrounds funds' use of derivatives in investing.

From their beginning, mutual funds have had a distinct mission—to bring the best of investment management to the investor of moderate means. The early funds promised that ordinary Americans could benefit from the skills and insights that had been available only to the wealthiest Americans.

In today's markets, it's difficult to meet that promise efficiently without using options, futures, swaps, and other derivatives. Funds use these tools to manage risks; to invest more efficiently; and to gain investment exposures to markets that are difficult or costly to access directly.

But some critics ignore the benefits of using derivatives and focus solely on the idea that investing in derivatives is somehow "risky business" for funds used by average investors.

That notion has led the SEC to place roadblocks on the use of derivatives by ETFs. It has emboldened the Commodity Futures Trading Commission to try to extend its regulatory reach to registered investment companies—ignoring the fact that these funds are already comprehensively regulated by the SEC.

Fund investors deserve to benefit from the widest range of portfolio management techniques that can they can use, consistent with the restrictions on leverage and other limitations in the Investment Company Act. To make that possible, fund managers need a clear legal framework within which they can use derivatives and manage any related risks. Only then can fund investors enjoy the efficiency and risk-reducing benefits that derivatives can bring.

There are three steps the SEC should take to advance this agenda:

First, the Commission must follow up on its 2011 concept release to modernize the legal framework that governs the use of derivatives by mutual funds and other investment companies.

We have commended the SEC for taking a measured, thoughtful approach to these issues. ICI and its members commented extensively on the 2011 concept release, and we sponsored a roundtable on funds' use of derivatives in February. We are committed to helping regulators and the industry work together to find the right balance, protecting fund investors while allowing them to access the benefits that derivative instruments can offer to an investment portfolio.

We are also committed to ensuring that directors play an appropriate role of oversight of a fund's use of derivatives, and are not tasked with micro-management of these investments.

Now, it's time for the Commission to take this input and move forward. For many funds, derivatives are an integral tool for portfolio management. Funds need legal certainty on rules governing such issues as asset segregation, diversification, concentration, and other portfolio compliance testing. We stand ready to work with the SEC's Investment Management staff to advance such rules.

The second agenda item on derivatives is lifting the moratorium on new product applications for ETFs that make substantial use of derivatives.

For the last two-and-a-half years, the SEC has impeded the growth of the ETF market and created inequities among fund sponsors: those who can launch new ETFs that use derivatives under existing exemptive orders have moved forward, while new entrants are barred from the market. Mutual funds, too, can launch new funds using derivatives without first seeking permission from the SEC—further tilting the playing field.

This unequal treatment of ETFs should not continue. We would like to see the moratorium lifted as soon as possible.

While I am on the topic of ETFs, let me just add that the SEC has yet to act upon an even older agenda item—its 2008 proposal for an ETF rule. This proposal would make it easier to launch index-based and fully transparent actively managed ETFs. The SEC should establish a clear regulatory baseline for these "plain vanilla" ETFs without disrupting more complex products that operate under existing exemptive relief. It's time for the SEC to act.

The third issue relating to derivatives is the CFTC's controversial amendments to Rule 4.5 and the efforts to "harmonize" the SEC's and the CFTC's overlapping, redundant disclosure requirements.

As you know, earlier this year the CFTC amended its Rule 4.5, vastly expanding the number of fund advisers that could be required to register with the CFTC as "commodity pool operators." Under the amended rule, virtually every fund adviser will need to monitor its use of derivatives on a regular basis. Many that formerly operated under Rule 4.5's exemptions will no longer have that protection and will thus be subject to CFTC regulation atop their current SEC oversight—resulting in redundant, costly regulation that is not in the best interests of fund investors. Others may choose to reduce their use of futures, options, and swaps—another result that may not serve investors' best interests. Either way, investors could lose.

ICI and the U.S. Chamber of Commerce have brought a legal challenge to the CFTC's amendments. Meanwhile, the CFTC has proposed a new rule to "harmonize" the two agencies' redundant disclosure requirements.

There's not much harmony to be found, however, in the CFTC proposal. Instead, the CFTC would largely layer its existing disclosure and reporting rules on top of the SEC's requirements. The results would bring confusion—not clarity—to fund shareholders. And it would undo 30 years of SEC efforts to make fund disclosure clear, concise, and useful.

We've heard reports that the CFTC intends to adopt its harmonization proposal in the near future. We've encouraged the SEC staff to engage actively with the CFTC and ensure that fund disclosure continues to serve its historic purpose of informing—not confusing—fund investors.

That concern takes me directly into the second constellation of issues that we believe the SEC should be tackling in the months ahead—measures that will improve the information that investors receive and reduce the risk of misinformation. Once again, we have three items on the agenda.

First, the Commission should build upon the success of the summary prospectus by continuing to make greater use of Internet-based disclosures for investors, particularly for shareholder reports.

The summary prospectus has demonstrated the value and effectiveness of what we call "layered" disclosure—disclosure that makes essential information readily available in clear, concise terms to everyone, with additional information available on demand. This ability to "drill down" into information is what Americans are coming to expect in the Internet age—and it is a model that should be considered for funds' annual and semi-annual reports to shareholders. These reports are often complex and voluminous. Taking advantage of the benefits of electronic disclosure will improve shareholders' ability to obtain and understand information, at much lower cost. That's a winning proposition for investors.

The second measure to help funds keep investors informed would be to update the SEC's books and records requirements to meet the needs of modern communications.

Many of the SEC's recordkeeping requirements were written in the 1960s and haven't been updated since. When these rules were written, the hot new communications technologies were the IBM Selectric typewriter and the Princess telephone. It's fair to say that the speed of communications—and the volume of records that investment advisers and investment companies must keep—have grown exponentially since.

Unfortunately, the explosive growth that social media has enjoyed in many areas has been somewhat muted in our industry. In part, that hesitancy is caused by concerns that the volume of records involved could quickly overwhelm advisers' and distributors' existing recordkeeping capabilities.

If they want to reach the investors of today and tomorrow, fund managers must be able to use these new technologies and modes of communication in the ways that investors expect and demand. And they must not be constrained by recordkeeping requirements designed for the age of rotary telephones.

Fortunately, the SEC staff appears to be willing to consider new approaches, particularly in the context of social media. This will no doubt be a long and challenging project.

The third challenge in the area of investor communications takes us from information into the realm of misinformation. Specifically, the Commission must take all necessary steps to prevent investor confusion between registered funds offered to the public and unregistered investment vehicles sold through private offerings—in particular, private equity and hedge funds.

Last spring, Congress passed the Jumpstart Our Business Startups Act—better known as the JOBS Act—to make it easier for small and emerging businesses to raise capital. One provision of that act repeals the longstanding ban on general solicitation or general advertising in private securities offerings, opening the door for the first time to mass advertisements for private funds. While we expect that most private fund sponsors would use that new-found freedom judiciously, there is little doubt that some might push the envelope and create advertisements that tout performance in ways that may cause confusion and damage the reputation of all funds in the marketplace.

In passing the JOBS Act, Congress imposed very tight deadlines on the SEC and other agencies to implement the law through rulemaking. This is one area, however, where ICI believes that the Commission should move with deliberation. Specifically, the SEC should impose content restrictions on private fund advertising that are at least as extensive as the current restrictions on mutual funds. It should direct FINRA to review private fund advertising, just as it reviews mutual fund ads. It should prohibit performance advertising by private funds until it can develop clear, sensible regulations addressing how to measure performance.

And the Commission should seriously reconsider the thresholds for “accredited investor” status to ensure that private funds are sold only to those who can understand the products and bear the risks. The current wealth and income floors were adopted in 1982; if they had just kept up with inflation over the past 30 years, they would be more than twice their current level. Today’s limits no longer serve the purpose they were intended to serve—to identify a universe of investors who do not need the protections of the securities laws and can fend for themselves.

I’ve laid out a long agenda. One common thread is that the SEC should pursue rules that add investor protection without dramatically affecting the cost of investing. That approach requires the Commission to recognize the importance of cost-benefit analysis, and to build upon its recent useful steps to bolster economic analysis in rulemaking.

The SEC operates under a statutory mandate to promote efficiency, competition, and capital formation in its rules. Demonstrating that it meets that mandate requires serious and substantial attention to the economic consequences of regulations.

In the wake of several losses in the federal courts, the SEC has heightened its attention to cost-benefit analysis. Chairman Mary Schapiro is to be commended for the attention she’s directed to this issue. Unfortunately, the Commission still has much work ahead of it. We will continue to urge the SEC to inform itself to ensure that new regulations don’t make our funds less competitive, less innovative, or less available to investors.

As you can see, we do have a substantial affirmative agenda—one that the fund industry and the SEC could work on together to advance our shared mission of serving and protecting investors.

It might come as a surprise, but I believe that money market fund regulation could be added to that positive, shared agenda.

Yes, we have been at loggerheads with the Commission and other financial regulators over the proposals advanced by the SEC staff for structural changes to money market funds. We have been joined in our opposition by hundreds of groups and individuals representing mayors, members of Congress, state and local finance officials, businesses, nonprofits, and individual investors—all expressing concern that the SEC staff proposals would undermine the value of money market funds for investors and the economy.

In the face of that widespread hue and cry, a majority of the SEC’s commissioners decided that the staff’s concepts should not be published as proposed rules. Instead, they urge a more deliberative and constructive approach.

First, these three commissioners are not prepared to surrender the SEC’s regulatory role with respect to money market funds to banking regulators. We agree—the SEC has a 40-year track record of success in regulating money market funds and is the agency most qualified to consider the need for new rules.

Rather, they want the Commission to undertake a more careful study—one that will encompass systemic issues in the cash markets generally, the effects of the extensive changes that the SEC already has made to money market funds since 2008, and a variety of

regulatory alternatives. Only after such careful study would they be willing to propose rules crafted to address any residual investor or systemic risks in the structure or operation of money market funds.

ICI stands ready to assist in this process. Already, we have produced an extensive body of empirical data and research on money market funds—and we continue to work on further studies. The deliberate process endorsed by the majority of SEC commissioners would provide a useful platform for the fund industry and the Commission to move forward toward our shared objectives.

Are we likely to see all—or even a substantial portion—of this affirmative agenda enacted? That's hard to say—particularly in an election year! What we can do—and will do—is rededicate ourselves to our mission: to serve fund investors, to meet their high expectations, and to continue to earn their trust. With your help, we will do just that.

Thank you for your attention.
