IDC Independent Directors Council
Promoting Excellence in Fund Governance

1998 Mutual Funds & Investment Management Conference: President's Keynote Address

ICI President's Keynote Address at the 1998 Mutual Funds and Investment Management Conference

by
Matthew P. Fink, President
Investment Company Institute

Orlando, Florida
9 am, Monday
March 23, 1998

Good morning.

We will spend much of the next several days discussing SEC and NASD regulation of mutual funds. This is as it should be. Our industry's success is based on public confidence in mutual funds, confidence that results from the effectiveness of the Investment Company Act of 1940. As a cover story on mutual funds in Business Week observed, the web of rules that govern mutual funds may very well be the reason our industry has avoided the sort of scandals that have rocked other financial institutions.

Maintaining high public confidence in our industry requires that we constantly reexamine the 1940 Act system of regulation to ensure that it continues to meet the needs of investors. This conference is one of the ways in which we do this.

But refining 1940 Act regulation, while crucial to our continued success, is no longer enough. Widespread public acceptance of mutual fund investing has enabled our industry to expand into many new business areas. As this occurs, the mutual fund industry encounters systems of regulation that differ substantially from traditional 1940 Act concepts. Our future will depend not only on the continued efficacy of 1940 Act regulation, but also on the ability of other regulatory systems to work in the interest of fund shareholders.

This morning, I would like to discuss three such regulatory systems—retirement plan regulationbank holding company regulation, and foreign securities regulation.

Retirement Plan Regulation

Retirement plans are regulated by the Department of Labor under the Employee Retirement Income Security Act, commonly known as ERISA. When ERISA was enacted in 1974, most plans were defined benefit plans, under which employers promise a specific amount of retirement benefits to workers, and make investments to back those promises. Defined contribution plans, where employees make their own investment decisions and bear the risks of these investments, were far less common. Given this background, it is not surprising that ERISA focused on defined benefit plans, and gave far less attention to defined contribution plans.

Over the last quarter century, however, there has been a dramatic growth in defined contribution plans. Today forty-four million employees are active participants in defined contribution plans, as compared to only twenty-four million in defined benefit plans. By the end of this decade, it is expected that defined contribution plans will have twenty-four million more participants than defined benefit plans.

Under a defined contribution plan, employees select investments from a menu of options offered by the employer. The investment decisions facing these employees are the same as those faced by any investor.

Common sense and fairness tell us that employees are entitled to complete information about their investment choices and full information about fees and expenses. But many employers simply do not provide employees with this basic information.

The Department of Labor could address this problem by adopting regulations requiring employers to provide employees with full disclosure regarding all investment options, including costs, investment objectives, risks, and past track records. But the Labor Department has not yet done this.

The only department regulations that encourage informed decisionmaking by plan participants are those under ERISA Section 404(c). These regulations provide that, if a plan offers employees a wide range of investments, the employer will not be liable for an employee's investment decisions. But these regulations fall far short of full and fair disclosure.

For example, the regulations provide that prospectuses, if available, must be provided to employees. This ensures that, if a 401(k) plan uses mutual funds, employees will be given fund prospectuses. But if an investment option is not registered under the federal securities laws, employers must provide employees with information on operating expenses only upon the employee's request. Obviously, many employees will not know that they should ask for this information, and thus they will never receive it.

A similar problem exists with respect to disclosure of plan administrative expenses. The regulations only require disclosure to employees of transactional fees, but do not require disclosure of account maintenance fees.

In November, the Department of Labor held hearings on 401(k) plan expenses. At those hearings, the mutual fund industry called for the adoption of regulations mandating disclosure to employees of all fees. But representatives of other industries opposed disclosure.

Following the hearings, an editorial column in Pensions and Investments stated:

"Sponsors, insurance companies, and banking organizations take an absurd position when they decline to disclose to participants the fees they have to pay. Participants deserve to know the fees and the impact the fees can have on returns."

I could not agree more.

I also agree with the column's warning that "when participants are kept in the dark about fees" there is a "risk of erosion of support for 401(k) plans." This risk is of great concern to the mutual fund industry, since we are major players in the defined contribution market.

Therefore, in the interest of both millions of employees and of our industry, I commend the Department of Labor for focusing on these important issues, and urge it to require employers to provide complete information about every investment option under every 401(k) plan.

Bank Holding Company Regulation

The second area that we must ensure works in the interest of mutual fund shareholders is bank holding company regulation.

A series of laws, such as the Glass-Steagall Act and the Bank Holding Company Act, produced a system under which financial services were strictly segregated. Banks, securities firms, insurance companies, and commercial firms were prohibited from engaging in each other's activities.

Market developments, technological change, and regulatory actions have eroded these historic separations. Simply put, financial service providers are in one another's backyards.

Ancient battles over powers are fast becoming moot. There is growing consensus as to comprehensive legislation that would permit banks, insurance companies, and securities firms to affiliate, and that also would permit these financial conglomerates to have some degree of affiliation with commercial firms. The chances for enactment of comprehensive legislation have improved. I hope that this legislation is enacted.

To date, most of the debate has been over powers. Too little attention has been paid to what will, in the long run, be at least as important—the regulatory system that will govern the new financial conglomerates.

Our existing regulatory systems pursue very different objectives. Banking regulation has as its guiding principle the safety and soundness of banks. There is an antipathy to public disclosure for fear of producing runs on banks. There is a huge federal safety net, in the form of federal deposit insurance, bank access to the Fed window, and the doctrine of "too big to fail."

In contrast, the federal securities laws value not the soundness of any institution, but the protection of investors. There is no federal safety net and securities firms are permitted to fail.

These very different regulatory systems made sense when industries were separated. But if Congress permits amalgamation of the various financial service industries, what type of regulatory system would be appropriate?

Unfortunately, the most common proposal in Congress today is schizophrenic.

First, the bills provide that each entity in a financial services holding company would be subject to "functional regulation." Thus, the SEC would regulate securities subsidiaries; federal banking agencies would regulate bank subsidiaries; and state insurance departments would regulate insurance company subsidiaries. This makes perfect sense.

In addition, however, the Federal Reserve Board would serve as the overall "umbrella regulator," with authority to regulate not only the holding company, but all of its subsidiaries, including securities firms, mutual funds, and insurance companies. This makes little sense.

Granting the Fed such sweeping authority raises the likelihood that it will seek to impose banking doctrines of safety and soundness on securities firms. As SEC Chairman Levitt has warned, this would "constrain securities firms' ability to respond quickly to market movements" and "could change the risk-taking character of the securities business and affect the capital formation process."

These are not theoretical concerns. In 1984, when the FDIC permitted state banks to sponsor mutual funds, it imposed safety and soundness restrictions on the types of funds they could manage. Professor John Coffee of Columbia Law School has observed that an umbrella regulator might have barred or restricted money market funds in the early 1970s, because of the competition they posed to bank deposits.

William McDonough, President of the Federal Reserve Board of New York, recently stated "all global financial conglomerates...should...be subject to...consolidated supervisory management that has market stability as its grounding principle." Mr. McDonough's speech made absolutely no mention of the need for regulation designed to protect investors. His sole message was the need to impose safety and soundness regulation.

Legislation must address legitimate concerns regarding the stability of the banking and financial systems, but do so without suffocating creativity in the securities markets. This can be done in a number of ways, including: eliminating the use of an umbrella regulator and relying instead on functional regulation; using an approach that provides for limited umbrella oversight of subsidiaries; using an umbrella regulator only for financial services holding companies with relatively large bank subsidiaries; or having the Federal Reserve Board serve as an umbrella regulator, but carefully delineating its powers.

It would be unfortunate if, after so many years of debate, Congress were to enact legislation that successfully addresses the issue of powers, but that only deals with regulation as an after-thought. It would be particularly ironic if the highly successful system of securities regulation is replaced by an inappropriate system of bank regulation.

Foreign Regulation

Foreign regulation is the final area that I will discuss. As in retirement plan and bank holding company regulation, it is critical that foreign regulation provide adequate protection to our shareholders.

Both U.S. investors and U.S. asset management firms increasingly operate in a global marketplace.

American investors have diversified their portfolios by investing in mutual funds that invest abroad. The number of U.S. mutual funds dedicated to investing outside the U.S. has grown from 44 in 1985 to 985 today. Assets of these funds have grown from $8 billion to $388 billion.

Moreover, U.S. investment management firms increasingly have sought to provide mutual fund and pension management services to foreign investors.

As a result of these developments, U.S. fund sponsors find themselves required to comply with foreign regulations that are very different from those in the U.S.

Foreign markets and legal systems reflect differences in cultures, traditions, tax regimes, and economic and political experiences. Things that work well in the U.S. simply may not work well in other countries.

There are two areas, however, where investors worldwide would benefit if other countries adopted laws and practices similar to U.S. investor protection principles.

First, foreign clearance and settlement systems.

In many emerging markets, securities transactions do not settle with a simultaneous transfer of title and cash; share registration and transfers are complex and lengthy; securities depositories do not exist or need improvement; and there are questions about whether market professionals are adequately regulated. These deficiencies pose problems for U.S. mutual funds because of the strict custody, pricing, valuation, and liquidity rules imposed under the 1940 Act.

Securities markets and regulators around the world should consider adopting practices similar to those in the U.S. and other developed markets. Improving clearance and settlement systems would benefit all emerging markets and all market participants. Securities markets that improve the settlement process inevitably will attract greater interest by U.S. mutual funds and other institutional investors.

The second area where investors would benefit from the adoption of U.S.-type principles involves open markets.

An important reason for the success of the U.S. mutual fund industry is the absence of barriers to entry. Anyone with a clean disciplinary record easily may enter the business of sponsoring and managing mutual funds or managing pension assets in the U.S. As a result, firms that sponsor mutual funds and provide pension services in this country include domestic and foreign firms of all sizes and types—advisory firms, brokerage firms, investment banks, insurance companies, commercial banks, and industrial companies. This has fostered a highly competitive environment that benefits investors.

While the U.S. market is completely open, many foreign markets are not. Some countries restrict foreign participation. Others impose high capital or other requirements designed to limit competition. Still others employ restrictive licensing requirements..

Requirements that limit competition are misguided. Having a market that is open to new entrants encourages the constant development of new products and services that meet investors' needs. In the interests of our shareholders and therefore in our self-interest, we must continue to urge the opening of markets overseas.

* * * * *

In conclusion, I recall that in 1941, the first head of the Investment Company Institute, Paul Bartholet, expressed the belief that "the Investment Company Act can be a constructive force in the growth of the business."

Bartholet's belief has been borne out by experience. Operating under the strict fiduciary standards of the 1940 Act, the mutual fund industry has grown some ten thousand-fold, from less than $450 million in assets in 1940, to over $4.5 trillion today. This is not by accident. The mutual fund industry has grown because we operate under a regulatory system that puts investors first.

Our industry's success has enabled us to move into new business areas, areas unimaginable to Bartholet's generation. As we do so, we encounter systems of regulation very different from the 1940 Act, systems that don't always put investors first.

This morning, I have discussed three such regulatory systems—retirement plan regulation, bank holding company regulation, and foreign regulation—and I have suggested that each system be adjusted to meet the needs of investors by incorporating the types of standards required by the 1940 Act. These reforms are vital to the interests of our shareholders. Therefore, they are vital to the future of our industry.

In order to convince legislators and regulators to adopt reforms based on 1940 Act concepts, we must continue to demonstrate that the 1940 Act works. We must oppose efforts to dilute the core principles of the act. We must seek legislative and regulatory changes that update the act to meet new conditions. We must educate our officers, employees, and directors to implement the spirit, as well as the letter, of the act.

As individuals, as firms, and as an industry, we must see to it that the 1940 Act continues to work in the interest of mutual fund shareholders.

Thank you.
