2001 Mutual Funds & Investment Management Conference: Keynote Address

President’s Keynote Address at the 2001 Mutual Funds & Investment Management Conference

by

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Good morning. I’m honored to share the podium with Paul Roye, the Director of the SEC’s Division of Investment Management. We and our shareholders are fortunate that individuals like Paul are willing to devote themselves to public service. Paul and his colleagues can count on our industry’s continued strong support for the SEC’s mission of protecting investors and reinforcing public confidence in our markets.

Support for strong regulation that helps mutual fund investors is an important part of our industry’s history. Rather than providing such support passively, the mutual fund industry has a tradition of working actively with the Congress and the SEC to identify developing issues that may present risks to investors, and to then craft practical, effective and timely solutions. Theodore Roosevelt observed that "[n]ine tenths of wisdom is being wise on time."

Experience taught Theodore Roosevelt that the ability to act early – to see and address a problem before it is widely recognized – is invariably the most important way to contribute to the public good. To put it another way, even the best new law or public policy is destined to be ineffectual if it comes too late.

In a world of complex and fast moving markets, being "wise on time" for investors is more challenging than ever before. Among other things, it requires us to ensure that investors can obtain the new products and services that they want and need. More important, it requires that we be certain that new products and services do not compromise investor protection. For sixty-one years, mutual funds have done that, leading former SEC Chairman Arthur Levitt to observe last year that the U.S. mutual fund industry is "the most trusted, transparent and respected in the world."

This morning, I will share with you my views on what we must do to maintain this tradition of trust and excellence – how our industry and our regulators must continue to be "wise on time" for investors.

The most essential way is by regularly evaluating whether mutual fund regulation is serving our shareholders effectively. Over the next few days, we will discuss many regulatory issues that affect shareholders – from the SEC’s new rules on fund directors, to the disclosure of after-tax performance, to the impact on money market funds of California utility downgrades. Each issue deserves our careful attention.

But we can’t work with blinders on. We can’t focus only on perfecting mutual fund regulation without considering the larger universe of investment management products and services in which mutual funds operate.

This broad perspective was largely missing when the Investment Company Act was amended in 1970. A nearly obsessive focus on the mutual fund provisions of the legislation led to almost complete neglect of the bill’s exemptions for bank collective trust funds and insurance company separate accounts for retirement plans. These sweeping exemptions resulted in denying millions of investors the

protections of the securities laws, an outcome the SEC lived to regret and has been unable to reverse.

We can't afford such narrowness of vision. Mutual funds do not exist in isolation. Mutual funds are part of a broad universe of investment management products and services. Therefore, being "wise on time" for investors requires that we and our regulators take a broad view, and consider how all types of investment management services affect investors' interests.

Today, I will discuss three such areas—hedge funds, Internet advisory services, and disclosure. I also will share my thoughts on a needed reform in mutual fund regulation where the same principle of being wise on time applies—the Commission's administration of one of the 1940 Act's central provisions, the self-dealing prohibitions of Section 17.

First, hedge funds.

The problems that existed prior to the 1940 Act testify to the abuses that can arise when unregulated investments are sold to the public. In more recent years, the collapse of Long Term Capital Management and the Askin and Theta hedge funds, as well as the Orange County debacle, are vivid reminders what can happen when the strictures of the Investment Company Act are not applied.

The original 1940 Act contained an exemption that permitted small pooled investment funds to operate free from regulation – an exemption for funds with not more than 100 shareholders and that are not publicly offered.

Congress added another exemption as part of the 1996 NSMIA legislation - an exemption for funds that are sold only to highly sophisticated investors and that are not publicly advertised.

The effect of the 1940 and 1996 legislation has been to permit hedge funds to operate outside of the federal securities laws – laws designed to maintain fair and orderly markets and protect investors.

Roger Lowenstein noted these qualities in When Genius Failed, his account of the Long Term Capital Management debacle:

"Unlike mutual funds, [hedge funds] need not register with the Securities and Exchange Commission."

"For the most part, they keep the contents of their portfolios hidden."

"They can borrow as much as they choose … And, unlike mutual funds, they can concentrate their portfolios with no thought to diversification."

It would be one thing if these unregulated activities affected only sophisticated investors who knowingly accept such risks. Unfortunately, we know now that the fallout from a hedge fund collapse has the potential to wreak havoc with our markets. This can affect all investors. The collapse of Long Term Capital Management's highly leveraged but nearly invisible $100 billion dollar balance sheet threatened markets around the world. Fearing a worldwide financial breakdown, the Federal Reserve Bank arranged a bailout by leading Wall Street banks.

The President's Working Group on Financial Markets, formed in the wake of the Long Term Capital disaster, called for more disclosure by hedge funds. The mutual fund industry strongly supports this initiative, which would make it less likely that a new hedge fund collapse could harm the markets and millions of investors in those markets.

The reforms recommended by the Working Group must be accompanied by strict "bright line" adherence to the standards for the hedge fund exemptions established by Congress in 1940 and 1996. Even in the wake of Long Term Capital's collapse, some hedge fund advocates are suggesting that hedge funds have "outgrown" their offering and advertising restrictions. Thus at least one web site is planning an on-line hedge fund supermarket. Others suggest that broad-based marketing of hedge funds would not put small investors at risk. And, there are ominous reports that some individual sales personnel are trying to circumvent the law by pooling the assets of small investors to meet the financial thresholds for hedge fund investing.

Being "wise on time" for investors requires us to do two things.

First, we must protect the financial markets by requiring adequate disclosure of hedge fund operations.

Second, we must not allow the safeguards established by Congress in 1940 and 1996 to be leached away through mass advertising of risky pools that are unsuitable for all average investors.

Let me be clear. I am not suggesting the uncritical application of every single mutual fund regulation to all hedge funds. Rather, I am

calling for the application of basic, common sense controls and the strict enforcement of existing limits to protect both our markets and average investors.

Second, Internet advisory services and online investment products.

Modern technology, including the Internet, is expanding the way in which investment advice can be provided and obtained. It is also playing an important role in the development of creative new financial products and in the modernization of older ones.

On the whole, technology is a tremendous boon for investors. Many services improve investor education and encourage more informed investment decisions. The Internet provides easy access to almost unlimited financial information. Technological innovations could improve the quality of investment advice through more sophisticated stock and market analysis, and could produce lower costs and reduced paperwork. Considered together, the Internet and technology are the latest source of fuel for the vigorous competition that has characterized the financial services marketplace for the last two generations.

But, as the SEC testified last year, technology also creates significant dangers for the unwary. Repeated SEC enforcement sweeps of the Internet show how easy it is for unscrupulous operators to develop sophisticated-looking websites.

Being "wise on time" requires that we get ahead of the curve on the investor protection implications of new products and services offered on the Internet. Even though this area is booming, there appear to have been few, if any, studies of the number and variety of on-line advisory services, and whether the theory of more information and lower costs is translating into practical reality for online investors. We just don’t know.

As with other historic developments, the Internet’s emergence necessarily raises many fundamental investor protection concerns. One is how to square Internet-based investment advice with the SEC’s traditional approach to administering the Investment Advisers Act, an approach designed and reasonably effective for a paper-based world. The ease with which personal financial services are offered on-line may increase the opportunities for precisely the type of investor confusion and fraud that the Act was designed to prevent.

Another concern is how technology is affecting the manner in which discretionary investment advisory programs that rely on Rule 3a-4 under the Investment Company Act are operated. The rule permits programs to be operated without regulation under the Act, if various conditions are met to ensure that clients receive individualized treatment.

The Internet has been used by some firms to create and operate "virtual" mutual funds on-line and to mass market these programs to retail investors. Among other things, the use of technology inherent in these products may raise questions about the extent to which investors in these programs are receiving the individualized treatment deemed essential by the SEC. They also may strain the SEC’s ability to monitor compliance with the rule.

As Paul Roye recently observed, the Internet is

[m]aking mass customization more feasible …. The customized separate account portfolios being marketed on a retail basis raise issues under the Investment Company Act. Are these advisory programs providing individualized advice, or are these programs the equivalent of unregistered investment companies?

Being "wise on time" for investors requires that we deal with these issues now. If we keep the blinders on—if we assume that the use of exciting new technology in financial products and services qualifies for a free pass from regulatory protections—we risk harming investors.

The SEC deserves credit for heeding Theodore Roosevelt’s advice here: the Division of Investment Management spotted many of these issues early and sponsored a major public roundtable to discuss them. But clearly, more needs to be done. We urge the SEC to consider a review of how technology is changing the ways Americans obtain investment advice, focusing on the Internet. A review of on-line services would enable the SEC to determine whether the Commission needs to modify its rules or seek additional statutory authority to address investor protection concerns.

Let me be clear. My point is not that every element of Advisers Act regulation be applied to all on-line advisory services, or that every Investment Company Act regulation be immediately imposed on all discretionary advisory programs. We don’t know enough about what’s out there. But I am suggesting that we be "wise on time." We must take a hard look now at whether technological developments are leading to the creation of products and services that, when examined functionally, implicate the vital policy concerns at the heart of these two statutes.

My third topic is disclosure.

The disclosure received by U.S. mutual fund shareholders is the best in the world, bar none. And, we've made tremendous strides in recent years to streamline and improve the quality of information that is received by each mutual fund shareholder, making a good system even better. But mutual funds are not the only vehicles through which average investors participate in the stock, bond and money markets. A growing array of other managed investments – including commingled retirement funds, wrap accounts, variable insurance accounts and individually managed accounts – are prominent.

Even though all managed investments offer investors essentially the same services, the content and frequency of the disclosure received by investors varies widely from product to product. As Tom Lemke and Gerry Lins observed in a recent article in The Investment Lawyer:

"Thus, even though all managed investments offer investors essentially the same basic investment service – access to a diversified portfolio of securities managed by a professional money manager for a reasonable cost – the content and frequency of the disclosure they receive about these products does not follow a uniform or consistent approach.

Lemke and Lins analyzed the rationale for these divergent approaches, and came up with some valuable insights. Their key conclusion?

"All too often these differences in disclosure arise primarily because current disclosure requirements focus on the legal structure of the product and how it is regulated, rather than on the information needs of investors."

"Because of this, some investors in managed investments receive more information than they reasonably need, while others receive little or none at all."

The article goes on to state that "the disclosure requirements for all managed investments should focus primarily on the investment needs of average investors" and sets forth three basic principles.

All Investors in Managed Investments Should Receive Disclosure When They Invest.

The Content of the Disclosure About Managed Investments Should Focus Primarily on the Information Needs Common to Average Investors.

All Investors in Managed Accounts Should Receive Regular Disclosure Updates.

Messrs. Lemke and Lins are urging regulators to be "wise on time." Eliminating all disparities in disclosure is not a realistic goal or even necessarily desirable. But being "wise on time" for investors requires that all investors, not just those who invest in mutual funds, receive full and fair disclosure.

Again, let me be clear. My point is not that all investments should be subject to the exact same disclosure regime. But investors suffer if we accept the development of a regulatory system under which millions of investors receive all of the information they need to make informed investment decisions, while millions of others do not.

So far, I have illustrated how we may fail investors if we focus obsessively on perfecting the regulation of mutual funds, and thereby ignore how other similar investment management products and services may compromise their interests.

In closing, I will return to mutual fund regulation, the heart and soul of how our industry serves investors. Maintaining high public confidence in our industry requires that we constantly re-examine the 1940 Act system of regulation to ensure that it continues to serve investors.

We must never compromise the Act's core protections – daily pricing, prohibitions on self-dealing, oversight by independent directors, and full disclosure. That's why the mutual fund industry vehemently opposed efforts two years ago to effectively repeal Section 17(a) of the Act, the section of the Act that restricts principal transactions between a fund and its affiliates.

But devotion to the Act's core principles shouldn't translate into inflexible adherence to archaic, technical restrictions if they no longer fit the reality of modern markets. Being "wise on time" requires that we constantly re-evaluate how our core principles should be applied in an ever-changing environment.

For example, developments in the financial services industry have led to an increasing number of situations in which the 1940 Act's restrictions on affiliated transaction inhibit legitimate activities. It makes no sense to restrict categories of activities that pose no potential for abuse. In these cases, applying section 17(a)'s restrictions can limit opportunities for investors without a corresponding benefit.

The Commission's staff has acknowledged that the impact of current restrictions has grown overly broad and that a focused rulemaking may be appropriate. To assist the staff, the Institute submitted recommendations for new rules and amendments to existing rules.

Many of our suggestions codify positions already agreed to by the Commission in exemptive orders and no-action letters. In all other cases, our proposals are consistent with positions taken by the staff in other contexts.

Once more, let me be clear. Section 17(a) should not be repealed, and we will continue to vigorously oppose any effort to do so. But Section 17 has worked well because the Commission has always been mindful of its core purpose and administered it with common sense. A number current restrictions on affiliated transactions no longer make sense, are failing to serve investors, and therefore should be changed.

Indeed, if the affiliated transaction rules are not modernized, this will add support to those who advocate Section 17(a)'s complete repeal. We therefore should heed Lord Macauley's advice: "Reform, that you may preserve."

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My remarks this morning have centered on being "wise on time" with respect to changes in legislation and regulation.

We must update 1940 Act rules to meet new conditions. Similarly, we must seek changes in other statutes and regulations that affect investor interests.

But, being "wise on time" for investors requires far more than good laws and regulations. Our success as an industry always has depended on the public trust earned by individual mutual fund organizations. The integrity and commitment of each of you here today and our colleagues throughout the industry is our most precious asset.

We must keep up this tradition of excellence.

We must continue to educate our officers, employees and directors to implement the spirit, as well as the letter, of the law.

We must continue to adhere to high business standards and voluntary practices that go beyond law and regulation.

We must continue to do all that we can to inform our shareholders about the risks, as well as the rewards, of investing.

If we remain devoted to these goals, if we and our regulators continue to be "wise on time," I have no doubt that our shareholders and, therefore, our industry, will continue to prosper for many years to come.

Thank you.

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