The View from Washington: An ICI Perspective

Keynote Address

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Practising Law Institute

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Thank you, Laurie, for those kind words, and congratulations to you and Cliff for pulling together what looks to be a terrific program, and to PLI for putting it on. I am honored to have this opportunity to join your faculty this morning, which includes many folks who I consider to be both outstanding attorneys and good friends. PLI always does an exceptional job with their programs, and we all appreciate the hard work that you, Cliff, and the other members of the faculty have put in to make today's program a success.

Before I begin, let me say a few words about the remarkable industry that you are going to learn about today and the role ICI plays in it.

Mutual funds and ETFs are the two most popular types of registered investment companies, that is, funds that are registered with the Securities and Exchange Commission and available to the public. Along with closed-end funds and unit investment trusts, these types of funds managed $13 trillion in assets at the end of 2011 for more than 92 million investors in the U.S. They play a significant role in the global economy, supplying investment capital in securities markets in the U.S. and around the world. In fact, registered investment companies are among the largest groups of investors in the U.S. stock, commercial paper, and municipal securities markets.

We at ICI are proud to serve this industry as its trade association. Our mission is to encourage adherence to high ethical standards by all industry participants; advance the interests of funds, their shareholders, directors, and investment advisers; and promote public understanding of mutual funds and other investment companies.

We work with regulators, primarily the SEC on securities regulation, the IRS on tax issues, and the Department of Labor on retirement and pension issues. And we work with legislators on Capitol Hill and in the states on new legislation.

Our job, in essence, is to give the industry a voice and express its perspective on new laws and rules that may affect it. I personally am not a lobbyist, but ICI is a lobbying firm.

So knowing that, if I told you the title of this speech was "A View From Washington" and asked you to guess what single word would describe its theme, what would you say?

"Bureaucracy"?

"Partisanship"?

“Dysfunction”?

“Acrimony”?

“Gridlock”?

How about “optimistic”?

Now I know that you’re all asking the same question that I am: “What do we, in the fund industry, have to be optimistic about?” The markets are struggling. Europe is facing an economic crisis of historic proportions, and the U.S. appears not far behind, unless, as a country, we can gain control over our finances. In the fund industry, we find ourselves dealing with more critical policy issues in front of a wider array of regulators than ever before, and we seem to be at loggerheads on many of them.

Still, I’m optimistic—and here’s why. We have incredibly strong core values in our industry. We have a thriving fiduciary culture. Our industry remains vibrant and innovative. And, most importantly, despite a decade of gyrating markets and the biggest financial crisis since the Great Depression, our shareholders’ optimism and faith in funds remains.

There is no question that the financial crisis has had a profound effect on American investors. ICI’s research team asked Americans how they had changed their investment strategies recently, and nearly three out of five said they had increased their regular saving amount, delayed the age at which they will retire, or shifted their investments to a more conservative mix.

And we can see that caution in our industry data. Since the bear market, flows into domestic equity funds have been weaker, and flows into bond funds have been stronger, than market history would predict. While there are many reasons for this shift, investors’ reduced tolerance for risk is clearly part of the story.

Now, it’s hardly surprising that investors are more cautious. Decisions to save more, save longer, and take fewer risks are a rational response to market turmoil.

What is surprising, at least to some, is that through all of this, investors’ faith in funds has not wavered. As of the end of 2011, 45 percent of U.S. households owned shares of mutual funds or other U.S.-registered investment companies, representing over 53 million households and over 92 million investors. Based on our surveys, mutual funds’ favorability among shareholders is approaching 70 percent, and has been on an upward trend since the market crisis.

Those kind of numbers give me comfort, as does knowledge of the fact that, as an industry, we serve the fundamental saving and investing needs of average Americans. The typical mutual fund investor is a person in his or her peak earning and saving years, with a moderate household income, who is saving for retirement.

And it is in this space—the retirement market—that investors have shown the greatest confidence in our funds. Since the financial crisis, ICI has conducted annual research to survey Americans about their attitudes toward and actions in 401(k) plans. Even through the financial downturn, savers in 401(k)s have been consistently committed to these plans and appreciative of their key features.

Our annual research demonstrates that 401(k) savers have consistently stayed the course and continued to contribute. In our most recent survey, nearly three-quarters of households expressed confidence that 401(k) plans can help participants meet their retirement goals.

And that confidence is justified. For the 4.3 million 401(k) participants who were in our database every year from 2003 to 2009, our research found that their average account balance over that stretch increased at an average annual growth rate of 10.5 percent. Think about that for a moment. Their accounts grew more than ten percent a year. To be fair, the growth rate includes ongoing contributions. But it also reflects any withdrawal and loan activity, and covers a period—2003 to 2009—that included an incredibly severe bear market.

We strongly believe that the 401(k) is an important component of Americans’ retirement security—and one that will be increasingly central in the future. And the fact that mutual funds will continue to play a critical role in those plans should give us all reason for optimism.

So why have more than 92 million investors placed their trust in us, to serve their investing needs in saving for their retirement, or for college, or for a house?

I would like to think that one reason is our culture. Our industry has always known that putting investors first is the key to our business’ success. It is at the core of our culture, as fiduciaries to our funds and our shareholders.

I understand that some of you attending this program may be relatively new to our industry. It will be crucial to the industry’s future

success that you embrace those core values and continually seek to earn the trust and faith of our millions of investors. You will need to become the keepers of our collective fiduciary flame.

I have no doubt that you will do so. I come to these types of programs and meet innumerable bright young attorneys, like you, who make me proud to be a part of this industry. It is hard to escape your energy and enthusiasm and the speed at which you think and work, perhaps borne from growing up in an age of 24/7 connectivity and the instant availability of information.

So I welcome you with open arms to our industry, because we need every attorney we can get who has that kind of energy and enthusiasm and speed. The world is a rapidly changing place, and the pace of change in our industry is most certainly a reflection of that.

And that's what I would really like to talk to you about today—the rapid pace of change in today's fund industry.

I'll touch on four topics:

- Innovation in product design;
- The use of derivatives by funds;
- The growing use of social media by advisers; and
- The regulatory changes driven by recent legislation, including the Dodd-Frank Act and the JOBS Act.

Product Design

The first area is in product design. We have, in the investment company industry, a tremendous record of product innovations. In response to investor needs, we've created money market funds, index funds, lifestyle and target date funds, exchange-traded funds, and many other products.

Most recently, we've seen lots of innovation in the alternative funds space. Absolute return funds, alternative energy funds, arbitrage strategy funds, leveraged bull and bear market funds, "go anywhere" global tactical asset allocation funds, long-short funds…the list could go on and on.

One of the most popular categories of alternative funds are commodity funds. Commodities can offer valuable portfolio diversification, because their prices historically have not been strongly correlated with stock or bond returns. And as raw materials for the goods that businesses and consumers buy, commodities offer investors an opportunity to protect themselves from inflation. Investors, understandably, have found benefit from funds that provide exposure to a broad basket of commodities, from energy to precious metals to agricultural products.

Unfortunately, these funds have come under political attack. There are some who charge that investors' expanded use of commodity investing—through relatively new products such as commodity mutual funds—is responsible for rising and volatile commodity prices. They attack our funds as "speculators."

These critics are wrong on the facts—and wrong on the economics. Studies by a range of academics have demonstrated that the so-called "financialization" of commodities markets is not driving price developments in individual markets. Nor is it increasing volatility. ICI's research team has gone further, looking specifically at the impact of investment flows into commodity mutual funds on commodity prices. We found, quite simply, that there is no impact.

In any event, we can and should expect that innovation comes with the price of additional scrutiny. The scrutiny of commodity funds may be politically motivated, but more frequently, and perhaps more importantly, the scrutiny is motivated from a legitimate need to ensure that the new product is well understood. For example, earlier this year, FINRA issued a regulatory notice that reminded broker-dealers of their obligations to understand the complex products they sell, and ensure that their customers understand the products they buy.

And that's a theme that, as lawyers to the industry, you should take to heart. You may well be asked to help clients develop new and innovative products. You will no doubt take the time to understand the relevant law before advising your client. My advice is to go further, and do everything you can to also understand the product from a business perspective. With that understanding, your legal counsel will be far more relevant and meaningful to your client.

Derivatives

The need to understand the product before giving legal advice is particularly acute with respect to derivatives, and that's the second big area of rapid change that I wanted to talk to you about today.

From their beginning, registered 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—some called it “Mr. Rockefeller’s portfolio manager working for you.”

The Investment Company Act surrounded that promise with a strong regulatory framework to ensure transparency and liquidity, provide strong custody of assets, and prevent self-dealing. The Act also limits the ability of funds to borrow or leverage, so that funds should be able to meet their obligations to creditors. Within the bounds of those and other vital safeguards, and with clear disclosure, funds have been permitted to fulfill that mission—to provide ordinary Americans with sophisticated investment management.

In today’s markets, it’s impossible to meet that promise efficiently without using options, futures, swaps, and other derivatives. Funds of all types use derivatives to help them limit risks, minimize costs, gain exposure to investment opportunities, and generally advance their investment strategies.

Without these instruments, many modern investment strategies simply would not be available to investors of more modest means. Many of the alternative strategy funds I mentioned earlier would not exist in a retail form.

Unfortunately, the beneficial uses of derivatives—for risk management, efficiency, and innovation—have been obscured by the role of some instruments and their users in contributing to the financial crisis. And so all funds that employ derivatives are facing particular scrutiny.

As part of that scrutiny, the SEC issued a concept release last fall exploring the issues raised under the Investment Company Act by funds’ investments in derivatives. The concept release posed a number of very good questions, many of which have no easy answers.

We have actively engaged the SEC staff on these complex issues, and we stand ready to assist them in any way we can. It is critically important that the Commission and its staff resolve these issues, and help assure that the fund industry can continue to accomplish its historic mission—providing the best, and most efficient, investment management to all Americans.

Social Media

A third area of rapid change is in the use of social media. Some of the statistics are staggering:

- 96% of Generation Y have joined a social network.
- It took radio 38 years to reach 50 million users. It took TV 13 years. It took Facebook about 3 years, and it now adds 50 million new users about every three months.
- In the time I have to speak with you this morning, about 1,800 hours of video will have been uploaded to YouTube. And people will send more than 7 million tweets.

So it is no surprise that many fund complexes are either using social media or exploring the possibility of doing so. It allows them to communicate with shareholders and the public in a more dynamic and interactive way than ever before, with endless possibilities for shareholder education, brand enhancement, increased visibility, and sales assistance.

At the same time, you can never lose sight of the fact that funds and their intermediaries exist in a highly regulated industry, and many of our communications with the public are subject to the securities laws and specific SEC or FINRA rules.

As a result, there is an inherent tension between the speed and fluidity of communications via social media and the content restrictions, supervision, and filing requirements in those statutes and rules.

In our judgment, it is vitally important that funds, and the securities industry broadly, be able to use new media under a regulatory framework that is flexible enough to accommodate both today’s uses of social media and tomorrow’s technology, whatever that may be. And we are actively working with FINRA and the SEC staffs towards that goal.

One of our main concerns involves recordkeeping. The rules now in effect stem from Rule 17a-4, which broadly requires that a broker-dealer must keep originals of all communications received and copies of all communications sent relating to its “business as such.”

In 2010, Eric Schmidt, who was CEO of Google at the time, said that we now create as much information every two days as all of humanity did from the dawn of civilization up until 2003.

I realize that only a sliver of that data relates to a broker-dealer’s “business as such,” but even so, it is clear to me that the volume of data being created will render the current recordkeeping rules obsolete.

Over the coming years, we will need to find a way to balance the legitimate need to recordkeep with the practical realities of social media and other future technologies.

This is where I think that younger attorneys entering our industry have a distinct advantage. I've heard that, for most people, their comfort level with new technologies is highest before age 30. The only way that we in the policy world can come up with a new paradigm, or you in the real world can come up with compliance policies to deal with the old paradigm, is with a deep understanding of the underlying technologies. And that's a real challenge for some of us who are the industry's grizzled veterans.

So for the younger folks in the audience, here is my advice: try to couple your natural comfort level with technology with an understanding of the regulatory purpose and intent behind the rules, however "antiquated" those rules may seem to you. By doing so, you'll be better able to bridge the gaps and provide advice that allows your clients to employ social media to its highest and best use.

Historic Legislation

So I've talked about three areas where the pace of change is remarkable: product design, derivatives, and social media. There is one more category I'd like to discuss, and that's legislation.

We've seen two historic pieces of legislation in the past two years that have truly amped up the pace of regulatory change: the Dodd-Frank Wall Street Reform and Consumer Protection Act, better known simply as "Dodd-Frank," and the Jumpstart our Business Startups Act, better known as the JOBS Act.

Dodd-Frank was a massive piece of legislation that set out to reshape the U.S. regulatory landscape, reduce systemic risk, and help restore confidence in the financial system following the 2008 financial crisis. To give you a sense of the size and scope of this law, consider this: the last piece of so-called "massive" financial reform legislation was the Sarbanes-Oxley Act in 2002. It was 66 pages long and mandated 16 rulemakings and 6 studies. Dodd-Frank is 849 pages long and includes 398 total required rulemakings and nearly 70 studies.

Dodd-Frank obviously attempted to do a great many things. Two of them in particular have been a focus for us at ICI: SIFI designation and the so-called "Volcker Rule."

One of the central goals of Dodd-Frank is to address systemic risks—risks that have the potential to endanger the entire financial system. Toward that end, Dodd-Frank created the Financial Stability Oversight Council, or FSOC, and charged it with designating "SIFIs"—systemically important non-bank financial institutions. Any institution designated as such would be subject to heightened supervision and regulation by the Federal Reserve.

We have engaged intensely with FSOC as it defines the parameters for SIFI designation. Throughout, we've made two overriding points:

- First, the broad scope of the tools already available to regulators should mean that SIFI designation is used sparingly.
- Second, in any case, mutual funds and other registered investment companies are at the "less risky" end of the spectrum when considering the potential for systemic risk, and SIFI designation is not appropriate for either funds or their advisers.

Many of you may read Ignites, and may have seen the opinion piece last week on this topic that argued that SIFI designation would be "catastrophic" for a fund. I can assure you that we will continue to engage forcefully with FSOC to avoid that result.

Dodd-Frank also gave us the Volcker Rule. This complex and controversial provision was written to restrict banks from engaging in certain risky activities that might pose a threat to the safety and soundness of the bank.

One of ICI's greatest concerns is that the rules proposed to implement this provision could effectively prohibit banks from playing their historic role as market makers buying and selling securities, particularly in the less-liquid fixed-income and derivatives markets. If banks cannot provide these services, funds and other investors would face wider spreads and higher transaction costs. Corporate issuers would have a harder time raising capital. And, in the end, returns to investors would be diminished.

We are also concerned that the proposal's definition of "covered fund" potentially could treat many registered investment companies just like a hedge fund, which would prohibit banks from investing in or sponsoring them. And we're concerned that it calls into question the ability of banking entities to continue to serve as authorized participants for ETFs, something you will learn about later today.

The future of this proposal is unclear. I noted that it was "complex and controversial." That is, if anything, a major understatement. The proposal drew over 17,000 comment letters, many of which raised highly technical and substantive issues. And many have called for the rule to be reproposed. So stay tuned.

So Dodd-Frank gave us SIFI designations, the Volcker Rule, and a host of other new laws, rules, and studies. That single piece of legislation amped up the pace of regulatory change like no other I've ever seen.

And in its wake, the SEC has found itself with another set of mandatory rulemakings and studies under the JOBS Act. That Act, which was signed into law in early April, contains a number of significant amendments to the securities laws designed to make capital raising easier for smaller companies, particularly "emerging growth companies," a new category of issuers created by the Act that have annual revenues of less than $1 billion. For those types of companies, the JOBS Act has been hailed as "the most significant legislative loosening in memory of restrictions around the IPO process and public company reporting obligations."

Most of the JOBS Act has little to do with the fund industry, but we are concerned with one provision—the repeal of a longstanding ban on general solicitation or general advertising in private securities offerings. We believe that this provision has the potential to open the door to misleading ads for private funds, such as hedge funds, that may cause confusion and damage the reputation of all funds in the marketplace.

We recently submitted a comment letter to the SEC urging it to address these concerns as it proceeds with its rulemaking to implement the JOBS Act. We make a number of recommendations in that letter, including that the SEC should impose content restrictions and filing requirements on hedge fund ads similar to those that apply to mutual fund advertisements, and that they should raise the standards for the types of "accredited investors" that are eligible to invest in private funds. We also recommend that, at least initially, the SEC ban performance advertising by private funds.

Not All Change Is Good

So those are four areas where I think the pace of change in our industry is, quite simply, breathtaking: product development, derivatives, social media, and regulation borne of historic legislation.

Before I leave you today, let me mention two other topics. We've been talking about change in a very positive light, but as we all know, not all change is good. There are two areas, in particular, where we at ICI firmly believe that changes proposed or contemplated by regulators are misguided, and I would be remiss not to point them out to you today.

The first is money market funds.

Money market funds are a remarkable success story—but not just for our industry. Their evolution is one of the great success stories of modern financial regulation. Throughout the history of money market funds, the SEC has carefully crafted rules that balance these funds' competing objectives of convenience, liquidity, and yield. Under this regulatory regime, money market funds have flourished and innovated—to the great benefit of investors and the economy.

Unfortunately, the SEC—urged on by bank regulators—seems to be on a path to deprive investors, issuers, and the economy of the manifold benefits of a robust money market fund sector. On its current path, the Commission may abandon the regulatory regime under which these funds have maintained a stable $1.00 per-share value. Alternatively, it may force money market funds to adopt a complicated regime of capital buffers and redemption restrictions.

We have an enormous amount of information available on our website that relates to money market funds and our position on the SEC's anticipated reforms. The bottom line is that we see these proposals as deeply flawed. We believe that they will harm investors, damage financing for businesses and state and local governments, and jeopardize a still-fragile economic recovery. And we believe they are unnecessary.

If you are interested in this topic, I commend you to our website. We have done more economic and legal analysis on this topic over the past three years than on any other topic I can remember, and it's all available there.

Unfortunately, the SEC is not alone in pursuing unnecessary changes to its regulations. The same thing is happening with the CFTC's unwarranted, redundant, and costly amendments to Rule 4.5.

Rule 4.5 governs "commodity pool operators," or CPOs—that is, advisers to collective investment vehicles that invest in derivatives and other CFTC-regulated markets. In 2003, the CFTC amended Rule 4.5 to exclude "otherwise regulated entities," including mutual funds from regulation as CPOs. But in January 2011, the CFTC decided it needed to target a small number of what it called "futures-only investment products" that it maintained were evading CFTC regulation.

Instead of covering only these few products, however, the CFTC adopted amendments that sweep in hundreds of funds that aren't by any stretch of the imagination "futures-only" investments—and unnecessarily subjects them to a brand new regulator.

It is difficult to understand the justification for that approach. In many ways, it would appear that the CFTC simply decided that the turmoil following Dodd-Frank created a perfect opening for a regulatory land-grab. The result will either vastly expand the CFTC's

jurisdiction—or drive mutual funds out of the markets for futures, options, and swaps. Either way, investors lose.

That is why we filed a lawsuit against the CFTC earlier this year. Joined by the U.S. Chamber of Commerce, we are asking the U.S. District Court for the District of Columbia to vacate the amendments to Rule 4.5 and enjoin the CFTC from taking any actions to implement them.

Suing an agency is a highly unusual step for ICI—and not one taken lightly. But for an industry as comprehensively regulated as ours, the CFTC amendments raise grave concerns, and we felt we had no other choice.

Conclusion

Now, a lawsuit against a regulatory agency is not a particularly optimistic point on which to end. So let me return to my earlier theme, and remark again on the rapidly changing world in which we live.

The pace of change presents challenges, to be sure, but also presents considerable opportunities. Regardless of your level of industry experience, you have as much chance to become an expert in a brand new product, or investment technique, or type of media, or new law as any grizzled industry veteran. And as I said earlier, for the younger folks in the audience, quite possibly a better chance because you may be more comfortable with things like social media.

So I would encourage you to recognize that you're entering our industry at a particularly remarkable time. As former ICI Chairman and T. Rowe Price executive Ed Bernard recently reminded us, "This is what history looks like when you're actually living it." Embrace it.

We have a strong foundation in this industry, built on core values and a fiduciary culture of putting investors first. We all should remain optimistic that that foundation will allow us to deal with whatever changes may come at whatever speed, and to continue, as an industry, to innovate and indeed to thrive.

Laurie and Cliff, thank you again for inviting me to speak this morning. And to all of you in the audience, thank you for your time and attention. Enjoy the rest of the program.
