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Promoting Excellence in Fund Governance

The Investment Management Lawyer

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Keynote Address

Fundamentals of Mutual Funds and Exchange-Traded Funds 2011
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As Prepared for Delivery

Thank you, everyone, and good morning.

I'm Karrie McMillan, ICI's General Counsel. It really is a pleasure to be joining you here today, and there are a couple of reasons for that.

One is that it's just great to get outside the Beltway, especially these days, with all the political rhetoric, and—even better—with a trip to New York City. As much as I'm fond of living in Washington, a visit to the Big Apple always gives you an energy jolt. Happens for me every time. When you get into the city, there's this "whoa" moment where you think to yourself, "Ah yes. This is how the cool kids live."

Another reason why it's nice to be here is that I am so glad to have the opportunity to work with the folks at the Practising Law Institute. Continuing education is so important to our profession, and PLI does an exceptional job of providing it.

And, but by no means last, I'm happy to be part of this particular program. Looking at the panels and panelists lined up, I think you all are in for a very stimulating day of learning about one of the great success stories in American business, and that is the $12 trillion U.S. fund industry.

Now, ICI is the trade association for that $12 trillion fund industry, so you clearly don't expect me to get up here and say that funds are one of America's "sort of good" or "so-so" industries. But hear me out, because being a lifelong '40 Act geek, I do believe we have something amazing here.

So I'd like to spend my time this morning discussing, from this lawyer's point of view, some of the investment management industry's core strengths. Then I'd like to talk about both the challenges and the opportunities facing lawyers in this field.

So what are the strengths of the investment management business? To my mind, our greatest strength is our mission, which is to help 90 million investors save for their futures through our funds. That may sound Pollyanna, but it's really true.

Our investors are as diverse as America itself. They're the workers who are putting part of their paychecks into 401(k) accounts. They're the young couples who are socking away money to buy a house. They're the grandparents who are setting up 529 college savings plans for kids who are now just learning to crawl.

Thanks to funds, these folks get a diversified and professionally managed portfolio, with access to markets and investments they

wouldn't otherwise be able to reach. They benefit from a powerful concept, and that is mutuality—pooling money to open up opportunities.

That concept is an old one, of course, and it didn't originate in the United States. At ICI, we trace the story of funds back to 18th century Holland. In 1774, Adriaan van Ketwich, a Dutch merchant and broker, invited subscriptions from investors to form a trust. The idea then, as now, was to make investment opportunity and diversification available to a greater number of investors, not just the very wealthy.

Let's stick with our history for a minute more and jump to 1924. That's the year the first mutual funds in the United States were created, in Boston.

Now, it's worth mentioning that these early investment companies were not known for their investor protections. In fact, during the 1920s, U.S. investment trusts were virtually unregulated. And in that particular bull market, investment companies were the go-go, hot-ticket place to put your money. From 1926 to 1929, the assets of these companies grew from less than $1 billion to more than $8 billion.

Economist John Kenneth Galbraith described investment trusts as "the most notable piece of speculative architecture of the late twenties."

An even harsher assessment came from inside the industry itself, from a prominent investment company manager named Paul Cabot. In early 1929, Cabot warned of "dishonesty, inattention and inability, and greed." He predicted that investment companies were headed for a time of "disaster and disgrace" that was "inevitable."

Well, Cabot's call unfortunately was accurate, because disaster did indeed arrive for the industry with the Great Crash of 1929 and the bear market that followed.

But the mutual fund business didn't shrivel or die after that calamity - as it well could have. Instead, it reinvented itself, which brings me to another fund industry strength: its remarkable framework of regulation.

In the wake of the Crash of '29, Congress passed the Investment Company Act and Investment Advisers Act. Congress's overarching goal at the time was to elevate the practices of the securities industry, with the hope that investors might regain trust and confidence.

The industry shared that goal, and worked closely with Congress and the brand-new Securities and Exchange Commission to shape the new laws.

And it's no coincidence that in 1940, the same year these laws passed, the industry formed its trade group, ICI's predecessor. Signing the Investment Company Act in 1940, President Roosevelt commended the industry for its dedication to achieving "higher standards."

In the decades that followed, investment companies kept up that dedication, viewing effective federal regulation and oversight as indispensable assets in building their businesses and maintaining the trust of investors.

ICI has worked with Congress and the SEC to continually improve the framework of regulation for funds, and we believe it is a testament to the strength of that framework that the two laws passed in 1940 remain the cornerstones of the current regulatory regime.

That regime provides an array of important protections for shareholders. Unlike banks and hedge funds, mutual funds have a simple capital structure and make very limited use of leverage. Their assets are held under strict custody, preventing Ponzi schemes, and the value of every single portfolio asset is marked-to-market every day, following strict pricing procedures.

These protections are backed by stringent disclosure requirements and overseen by a strong system of governance, with independent directors serving as watchdogs for the interests of investors.

This framework has withstood every sort of market environment. During the most recent financial crisis, it helped protect fund investors from some of the problems faced in other areas of the financial system.

But as we all know, even the best and strongest rules can be thwarted or sidestepped. And that brings me to another, extremely important, strength of our industry.

Beyond the black-letter rules, the fund industry has consciously maintained a fiduciary culture—one that puts investors first.

The idea is simple but powerful: our industry runs on investor trust, therefore every one of us—from corner offices to cubicles—must earn and keep the trust of investors every day.

I can tell you from personal experience that this is a great culture to be a part of, and it doesn't exist everywhere in financial services.

When I was in private practice, I worked a fair amount with investment bankers. Back then, I can assure you, most of those folks weren't especially concerned about workers and grandparents and young couples saving for their future. In fact, it was quite the opposite, but I'll leave it at that.

So this combination of a fiduciary culture on one hand and a robust regulatory framework on the other has been a good one for the fund industry.

It has allowed a tremendous range of innovation, creating products that serve a wide range of investor needs—money market funds, index funds, lifestyle and target date funds, and exchange-traded funds.

It has fostered better shareholder service and flexible arrangements that help investors pay for those services through a variety of fee structures.

It has fueled the growth of funds in self-directed retirement plans. Consider this—at the end of last year, mutual funds managed 54 percent of the assets held in 401(k) and other defined contribution retirement plans. Funds also accounted for nearly half of the assets held in individual retirement accounts, or IRAs. In dollar terms, that means retirement savers now entrust $4.7 trillion to mutual funds. That's over a quarter of the entire U.S. retirement market.

Now, it hasn't been all hearts and flowers for our industry since 1940. We've had our regrettable moments too, and not just because of broader market downturns.

I'll point in particular to the late-trading and market-timing scandals that erupted in 2003. Most of you were not yet deeply involved in our industry back then, and you may not have followed the story closely. The scandals involved broker-dealers and hedge funds that found ways to profit from rapid trading in mutual fund shares, sometimes by placing illegal trades after hours.

Many funds were the victims of these traders' bad behavior. Unfortunately, there also were instances in which fund companies were complicit in these activities.

The exposure of this activity was a staggering blow to the fund business and our investors. The broker-dealers, hedge funds, and fund sponsors that participated paid millions upon millions in fines and restitution.

And while ICI and other industry leaders swiftly called for tough law enforcement and new regulation, the reputational damage was considerable. The scandals remain a stain on the history of U.S. funds.

Nobody likes to look at a stain, but I think there's actually some value in doing so now and then.

For one thing, it helps us remember the importance of that fiduciary culture. As Paul Stevens, ICI's president, has said, confidence is "a plant of slow growth," but it's one that can wither in an instant. Luckily, the fund industry did not permanently lose the confidence of its investors in 2003. But having to ponder the risk of that outcome was sobering, to say the least.

Recalling episodes like late trading and market timing also helps us to understand and conceive of the role of the investment company lawyer.

Here's how Ed Bernard, who is Vice Chairman at T. Rowe Price and ICI's Chairman, once put it. He described legal advisers to funds as the "keepers of the flame for the fiduciary culture of investment companies."

"Keepers of the flame"—That role, particularly for outside counsel to fund advisers, isn't always easy. Clients will come to you with tough questions, that's a certainty, and may sometimes propose things that may not be best for shareholders.

I don't wish these situations on you, but you may well face them. Regardless of where you sit, you might have to deal with uncomfortable pressure from clients, perhaps accompanied by that ancient and most treacherous line, "but everyone else is doing it!" I don't have direct evidence of this, but it's not hard to imagine that a few lawyers succumbed to the "everyone else is doing it" mindset regarding late trading and market timing.

So as a keeper of the fiduciary flame, you have to be ready to occasionally raise the legal stop sign, to tell the client, "That decision may meet the letter of the law, but it's not true to the fiduciary culture that your company wants to preserve." Or, to put it in terms that are less lofty, but more likely to get their attention: "Yeah, it may be legal, but is it a deal you'd want to defend on the front page of

the Wall Street Journal?"

Again, I know it's sometimes tough to be the naysayer. But life as an investment management lawyer works better when you stay true to the industry's guiding light, and that's putting the investor first.

If you choose the course of what's best for shareholders, chances are pretty good that you'll be on the right course for your client in the long run.

And the truth is that the investment management industry needs that guiding light more than ever, given the upheaval in financial services sector. I'd like to talk a bit about that now.

To begin with, I recognize that things don't look as bleak out there as they did 18 months ago. The financial crisis of 2007–2008 is in our rearview window and — I hope!—getting perceptibly smaller. Financial markets have largely regained their footing. The Federal Reserve has significantly reduced the emergency programs it set up to deal with the crisis. Congress did its part with the passage last July of the Dodd-Frank Act.

But that doesn't mean we're on easy street. For example, we're just beginning to get a sense of the profound regulatory changes coming out of Dodd-Frank. The 2,300 pages of the law call for regulators to write about 240 new rules. At ICI we're tracking 150 of them. Keeping up with all of those changes will challenge funds and their lawyers—I know my staff is still working plenty of late nights.

What makes these times particularly tough is the unusual amount of uncertainty our industry has lived with, and continues to face.

Now, I understand that the concept of "uncertainty" is sometimes overplayed. I mean, show me a business where things are always perfectly certain. But talk to folks at ICI's member companies, as I do, and the sense of uncertainty is palpable. The fund industry faces a host of questions, and how those questions get answered will affect it for years to come.

So let's run through a couple of those questions, starting with a big one. What's going to happen with money market funds? This is a $2.7 trillion business for the investment management industry, and there's considerable uncertainty hanging over it.

Last year, the SEC significantly amended the rules around money market funds to make them even better able to withstand severe market stress. But regulators are still looking at a range of options for further reform.

We've welcomed this discussion and are actively participating in it. Trouble is, some of the ideas now under consideration don't look terribly feasible. Some even pose serious threats to money market funds' value to investors and the economy.

We're working with our members and regulators to find the best way forward on reform, one that preserves the fundamental characteristics of money market funds and the benefits that they bring to investors and the broader economy.

The discussion around money market funds takes place alongside a broader Washington debate—which financial institutions are going to be deemed "systemically significant" by regulators?

The new Financial Stability Oversight Council—or "FSOC"—is aiming soon to start designating businesses outside of the banking world as SIFIs—"systemically important financial institutions." We've been through two rounds of comment on how the FSOC will make these designations, and there's still not much that we can say for sure about which companies will be designated. Nor has the Fed developed the standards it will apply to SIFIs.

The creation of the FSOC highlights another key question for the fund industry. How many regulators will we have to answer to? These days, we find ourselves dealing more and more with agencies that our industry hasn't traditionally interacted with all that much: The Commodity Futures Trading Commission, The Federal Reserve, The Treasury Department, The Federal Deposit Insurance Corporation.

As these regulators begin to think about their roles in the new world of Dodd-Frank, some are seeking to expand their authority over funds.

One recent proposal from the CFTC, for example, would make many mutual funds or their advisers subject to regulation as "commodity pool operators." The CFTC's stated policy goal is to ensure that mutual funds that offer "futures-only investment products" are subject to the CFTC's oversight and regulation.

Problem is, the proposal's language is so broad that it would sweep in hundreds, if not thousands, of our funds, including basic stock index funds and tax-exempt bond funds. These are investment products for retirement savers and other buy-and-hold investors—not for futures and options investors.

On top of that, the proposal as written sets up some requirements that would be literally impossible for our funds to meet, because they conflict with requirements in the securities laws.

Another question with serious implications for our investors: Are regulators going to radically change the ways funds are able to pay for distribution?

Last year, the SEC proposed to rescind Rule 12b-1 and replace it with a new regulatory framework for distribution compensation. The current rule permits funds to compensate brokers and other financial intermediaries from fund assets, subject to specific conditions, for services those intermediaries provide related to the distribution of fund shares.

The SEC's proposed new distribution framework drew more than 2,400 comment letters—and I can probably count on just one hand the number supporting the idea.

We've certainly weighed in on the proposal. I won't go too far into detail, but our economic analysis suggests the SEC is significantly underestimating the cost of implementing this proposal, while overstating its benefits to shareholders.

We're also worried that the SEC hasn't fully considered the possibility that a vast restructuring of fund distribution could create incentives for brokers and financial advisers to promote other, less regulated financial products. That would be an unfortunate outcome for investors.

I could take plenty more of your time this morning talking about looming questions and uncertainties. But let's wrap this up on a happier note.

Yes, change brings challenges. But change also brings opportunities, ones that I suspect that many in this audience are well positioned to seize.

You see, in some respects, contending with this changing world of investment management is easier for the newcomers to this business than it is for the old hands.

Think of it like learning a foreign language. An English-speaking five-year old who moves to France will probably parlez très bien in relatively short order. But if I had to move to France, well, I'd have my work cut out for me.

In the same way, those of you who aren't wedded to the old rules may have an easier time now than veterans like me, because I have to "translate" what I've long known about fund regulation to fit the new world order.

So there are challenges in front of us, but there are also opportunities. As we confront both, we can't forget one key value that has made this industry great. As you can probably guess by now, that value is our focus on the shareholder. If we keep the investor's interests at the forefront, we'll do right by our clients, and our business, I am confident, will continue to flourish.

Thank you all very much for listening, and I wish you a productive day learning the fundamentals of this great industry. Thank you.

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