Putting Our Principle into Practice

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2015 ICI Tax and Accounting Conference

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Thank you, Greg, for the kind introduction, and for your leadership in developing what promises to be a terrific program.

Thanks also to our sponsors, our speakers and panelists, and the entire ICI team—for lending their time, effort, and expertise to help us put this event together.

And good morning, everyone—welcome to the 2015 Tax and Accounting Conference.

Over the next three days, we'll be diving deep into issues of utmost importance to regulated funds and their managers. While we'll be coming at these issues as tax and accounting professionals, we will remember also to employ a broader view.

We will look at these issues as fiduciaries, through the lens of a single, guiding principle—putting investor interests first.

Ours is an industry built on trust and confidence, and we must always strive to maintain a culture deserving of that.

This principle of focusing on investor interests forms the core of our regulatory framework, enshrined 75 years ago last month when President Franklin Roosevelt signed the Investment Company Act of 1940. And it has informed ICI's work since its founding about six weeks later—that's right, ICI turns 75 years old on Thursday.

But principles, we all know, don't hold themselves up on their own. No matter how sound, they are a starting point—a foundation—and they take serious work to put into practice. And no matter how well-intentioned that work, it does not mean much unless supported by an expert understanding of the subject at hand.

This morning, I'm going to talk about four of ICI's top priorities—that is, the work we at ICI are doing to help put our industry's principle into practice. These four very hot topics are: retirement policy … financial stability … global fund regulation … and cybersecurity.

I could add many others to the list—there seems to be no end to regulatory changes and other developments in our industry these days. But these four areas are crucial to all corners of our industry—in each of them, the interests of investors are our guide.

Let me begin with retirement policy.

Or, more specifically, the debate surrounding the U.S. Department of Labor's proposed rule to redefine the term "fiduciary" under ERISA—the Employee Retirement Income Security Act of 1974.

If you've been following this debate at all, you know it's awash in controversy. But one thing is not controversial—ICI agrees with the principle at the heart of the DOL's proposal. Financial advisers absolutely should act in their clients' best interests when offering personalized investment advice—that's just common sense.

The question is … does the proposal stay true to that principle? When you dig deeper, would it benefit retirement savers?

I believe that, if adopted in anything like its current form, the rule would do very many retirement savers tremendous harm.

As proposed, the DOL's new definition would apply ERISA fiduciary status in a "wider array of advice relationships," but it does not adequately distinguish the interactions that would trigger a fiduciary relationship from those that wouldn't.

Faced with this lack of clarity, financial advisers would be left with little choice but to forgo providing retirement savers with a range of essential investment information—or any information at all—for fear that doing so could inadvertently trigger fiduciary status and invite legal liability.

What does this mean? Millions of retirement savers would find themselves cut off from even the most commonplace exchanges of information—like those with call-center representatives … at walk-in centers … and on websites.

The DOL attempts to address the problem with an exemption to the rule's prohibitions—what it calls the "Best Interest Contract" exemption.

But here's the catch—to qualify for it, financial advisers would have to navigate a minefield of compliance traps and barriers, effectively rendering it impossible to use.

Let me give you one example.

Before talking with a financial services firm about anything that could be construed as personalized investment advice, a retirement saver would have to enter into a three-party contract—the saver, the person talking to the saver, and the firm all must affirmatively sign the contract. That's before you can even have a conversation.

Financial services firms would balk at working under such a burdensome compliance regime—our members, for their part, already have said that they won't use the exemption. And who could blame them?

Savers who rely on these firms, meanwhile, would be left stranded. They'd be forced to either turn to fee-based advisers—and most likely pay higher fees—or go without any guidance at all.

The DOL asserts that the rule is needed to address a "substantial failure of the market for retirement advice." But it has not demonstrated anything close to that.

The DOL claims that, if its rule is not implemented, retirement savers stand to lose $17 billion a year due to "conflicted advice." But based on our review of publicly available data, that number is just plain wrong.

In fact, the rule would do great harm—and cost investors about $109 billion over its first 10 years alone.

To make the rule work for retirement savers, the DOL must draw a clear, common-sense line between fiduciary advice and investment information and reduce the regulatory excesses that are embedded in the proposal.

The second area where ICI is putting our industry's principle into practice involves financial stability.

The worst of the global financial crisis is now seven years behind us—but it has not fully disappeared from the rear-view mirror.

For the last couple years, and despite all evidence to the contrary, we've had a pair of powerful regulatory bodies pushing the idea that regulated stock and bond funds and their managers could threaten the financial system—and so should be designated as "systemically important financial institutions," or SIFIs. Designated firms would come under stricter oversight more in line with what one would expect for large banks.

I'm talking about the Financial Stability Oversight Council, a Dodd-Frank creation here in the United States, and the Financial Stability Board, a global group based in Switzerland.

Bank regulators dominate both of these organizations, so it is no surprise that a banking perspective informs their view. What is surprising—and quite troubling—is their fundamental misunderstanding of how asset management works … their unabashed use of conjecture and speculation to support their arguments … and, to date, their utter disregard of hard evidence contradicting their points.

If you look at the facts, there's no doubt about it. Stock and bond funds' existing regulation, defining characteristics, and historical experience render SIFI designation—and the resulting imposition of bank-style regulation—unnecessary, inappropriate, and extremely harmful to investors and to the capital markets.

Indeed, with designation would come supervision by the Federal Reserve Board, a bank regulator. We believe that a SIFI-designated asset manager or fund would be obligated to manage its portfolio as the Fed sees fit—with the interests of the banking system trumping the interests of its investors.

As ICI has long advocated, a more investor-centered approach to evaluating any potential outsized risks in asset management would be to review the capital markets more broadly. The good news is, this idea seems to be catching on—with the SEC taking the lead.

Last December, SEC Chair Mary Jo White outlined an ambitious, activity-based agenda for asset management.

The first proposal to come out of the agenda—which would expand the information that funds must report to the SEC on their portfolio holdings, and increase how frequently they must report it—is largely sound, and a worthwhile endeavor. Despite the costs and implementation challenges that are sure to come, the proposal would greatly enhance the SEC's ability to oversee the industry.

To be clear, not all aspects of the proposal have earned our support—I'm sure we'll hear about that on Wednesday's panel dedicated to this proposal. We believe the SEC went astray in some areas that likely are quite important for many of you.

We are strenuously urging the SEC to give funds adequate time to file new monthly reports—we have asked for those filings to be required 45 days after the end of the month—not 30, as the Commission has proposed. And we asked for 60 days after quarter-end for filings of first- and third-quarter Regulation S-X compliant portfolio schedules. The SEC proposed only 30 days.

And we are urging the SEC in the strongest terms to protect the data it collects—valuable, proprietary information about fund portfolios—from cyber and other attacks. If these data were to be compromised, predatory trading practices could wind up harming funds and their investors.

The second proposal from Chair White's agenda—on liquidity management—came out about a week ago. It also promises to have a big impact on our industry.

As you might imagine, we're just beginning to review the proposal, but broadly speaking, the SEC proposed to require mutual funds and ETFs to adopt new liquidity management programs.

These funds will need to categorize their entire portfolios based on the number of days it will take to convert each holding into cash. The funds also would have to set aside a percentage of their portfolio into cash or other highly liquid assets.

Mutual funds would have the option of using "swing pricing"—a practice common in Europe that adjusts a fund's net asset value for costs associated with days with heavy redemptions or purchases.

The SEC still has three items remaining on its rulemaking agenda—on funds' use of derivatives, stress testing, and transition planning for asset managers.

So clearly, we have a lot of work ahead—but our work does not stop at our borders.

Global fund regulation is the third area where we're putting our industry's principle into practice.

As the global fund industry has grown—and as financial markets around the world have grown more interconnected—more and more policymakers are recognizing just how critical asset management is to national, regional, and global economic success. With this recognition, however, has come heightened regulatory scrutiny—much of it with cross-border implications.

Both here and abroad, investors need funds nimble enough to navigate this complex regulatory landscape—to help them seize the opportunities that global markets have to offer.

It is with this need in mind that we built our global advocacy agenda:

- We're working with policymakers to strengthen and integrate Europe's capital markets through the region's new Capital Markets Union. Done right, this initiative would diversify and deepen funding sources, and expand investment opportunities for funds and their investors.
- We're pursuing a broad range of reforms that would make capital markets across the world more efficient for investors, covering issues related to pre- and post-trade transparency, dealing commissions, high-frequency trading, and more.
- We're supporting the development of robust private retirement systems, in which savers have access to investment products well-suited to long-term savings.
- And we're championing sound cybersecurity policies with government officials worldwide, to help protect the sensitive, proprietary information that investors entrust to funds and fund managers.

There's another piece of our global agenda I'd like to highlight for this group—international taxes. We're dealing with some serious international tax issues—and you'll hear all about them at a panel session tomorrow:

- A looming financial transaction tax threatens to harm funds and investors in Europe and elsewhere—we're advocating against it.
- Several European countries have inappropriately withheld taxes from our members—we're helping our members recover them.
- Burdensome tax-reporting regimes are challenging funds and investors—we're helping them find relief.

And we're seeing some results—most recently in India.

After Indian tax auditors suddenly began asserting that non-Indian funds owed nearly 20 percent of their capital gains retroactively under a two-decades-old tax, ICI Global led an industry coalition against it, and later joined a lawsuit before the Indian Supreme Court.

To help resolve the issue, the Indian government appointed an expert committee, which agreed that the tax never applied to non-Indian funds. The government then instructed the auditors to stop pursuing the issue, and announced that it would advance legislation to clarify that the tax never applied. As you might imagine, the many funds and investors with a stake in the Indian capital markets were relieved to hear this news.

I've mentioned cybersecurity twice in my remarks so far. It is an issue as urgent as it is complex—and it is the fourth area where we're putting our industry's principle into practice.

Cyber threats are one of our industry's greatest concerns today—they can never be taken too seriously, nor dealt with soon enough.

I want to stress that protecting investors here is far more than a technological concern—even the most advanced technology, as important as it is, will not solve all of our information security challenges.

It's people who are the key to solving them—and that's everyone in an organization, from the CEO to the traders to the administrative assistants. It is people with deep knowledge, exercising sound judgment … people sharing that knowledge on a regular basis … people nurturing relationships with peers across departments and firms, and with law enforcement agents.

Threats change. Vulnerabilities change. Only by continually learning, and sharing what we learn, can we keep up with it all—and ensure that we're protecting investors' vital savings and information.

ICI is playing an essential role arming people in our industry with the knowledge to do so—and our Chief Information Security Officer Advisory Committee is leading the way. Three committee initiatives stand out for me today:

The first is a comprehensive information security resource center that members can access on ICI's and ICI Global's websites.

Among other useful material, the resource center includes standards and guidelines for protecting against information security threats, and a detailed set of questions that fund management, boards of directors, and information security practitioners should consider when evaluating their own information security program, or that of a third-party service provider. These questions can help members better secure their networks and data, and identify threats and risks with greater accuracy.

The second initiative is one we just wrapped up—an anonymous, repeatable survey on how our member firms are building and maintaining their information security programs. As we compile and analyze the results, we'll get a better sense of how practices are developing—and a better sense of where to direct our efforts going forward.

This is the only survey of its kind designed exclusively for the fund industry—not financial services at large. So, as we share the results with our members, participating firms will be able to see how their information security programs stack up against those of their peers.

The third initiative—our latest—is perhaps the most important.

Working with the Financial Services Sector Coordinating Council—a public-private partnership formed to help protect financial services infrastructure—we've arranged a pair of open houses, where the chief information security officers of our member firms will meet with law enforcement agents from 40 field offices of the FBI and the Secret Service.

They'll have the opportunity to exchange contact information and establish a professional relationship. Our member firms will learn about the capabilities of the law enforcement offices in their jurisdictions, and the law enforcement agents will learn about our member firms' needs.

No one has ever held an information security event like this before—and I'd like to thank the FBI and Secret Service field offices for participating. Having a relationship in place in advance of a potential breach—so you're not, say, cold-calling the FBI in the middle of a crisis—promises to be a major step forward in cyber defense.

In each of the four areas I've just run through, putting our industry's principle into practice—doing what is necessary to put investors' interests first—requires that our ideas and capabilities evolve along with the industry.

It also requires that we dig deep into policy proposals—to ensure that they are sound throughout, not just on the surface.

As I've made clear this morning, there is a wide array of policy ideas out there—and not all of them are charting the right course. If we're not careful, millions of investors could be led astray.

Fortunately, our industry is loaded with extraordinarily talented professionals like you all—ready to confront all challenges, and whose commitment to our investors never wavers.

Thank you kindly for your time and attention. I look forward to a robust discussion throughout the conference.

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