

2003 General Membership Meeting: President's Report

ICI President's Report at the 2003 ICI General Membership Meeting

by

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Good morning. It is a pleasure to join Rob Gordon and Paul Haaga in welcoming you to the 2003 General Membership Meeting.

Along with the members of his committee, Rob devoted considerable time to developing the content of this meeting, and the result is a stimulating, important and timely program. I would like to thank Rob for his hard work and commitment to our industry and our shareholders.

Special thanks also go to the Institute's Chairman, Paul Haaga. Paul brings to our work an invaluable combination of experience, insight, and vision. We are extremely fortunate to have him as our Chairman, particularly at this time.

Our theme, [Helping Investors Meet Today's Challenges](#), could not be more appropriate—or more important. Investors have endured an unwelcome combination of events over the last few years. The grinding bear market has tested investors' patience. Egregious corporate and accounting scandals have tested their faith.

When we met a year ago, public discussion focused on whether there were more companies like Enron. A month later, on June 25, 2002, WorldCom announced the largest accounting restatement in American history. A tidal shift in public discourse immediately followed. Many political leaders, regulators, journalists, and average citizens concluded that there were systemic weaknesses that allowed abuses to take place. Congress responded by enacting sweeping reforms in the [Sarbanes-Oxley Act](#). Meanwhile, stock market indices sank to the lowest levels of the bear market.

Recently, the news has been somewhat better. All of us hope that implementation of rules required by Sarbanes-Oxley, the doubling of the [SEC's budget](#), the settlement of regulatory actions involving [research analysts](#), and the recent positive performance of the stock market indicate better days to come.

I have attended more than 30 consecutive General Membership Meetings. At virtually all of them, industry leaders have stood before you and said that our number one responsibility is to do everything we can to maintain and enhance public confidence in mutual funds.

Mutual fund leaders didn't just politely listen to these words; they acted.

SEC Commissioner Harvey Goldschmid recently noted, "The mutual fund industry has been blessed - and blessed is the only word - by being relatively free of scandal." This record is no accident. Year after year, mutual fund companies have committed themselves to specific steps—both voluntarily and in support of proposals by federal regulators—to maintain and reinforce investor confidence.

The demanding framework created by the Investment Company Act, strong regulation by the SEC, effective oversight by independent directors, tough scrutiny by the media and independent critics—as [Paul Haaga](#) described a few minutes ago—and your unshakeable commitment to putting mutual fund shareholder interests first, have served our shareholders and our companies well. In a nutshell,

we have succeeded because the interests of those who manage mutual funds are well aligned with the interests of those who invest in mutual funds.

Statistics showing the devastating decline in some individual stocks reinforce the wisdom of investing through mutual funds. Morningstar recently calculated that in 2002, 20 percent of individual stocks lost 60 percent or more. About one-tenth of one percent of equity mutual funds experienced a loss that large. In other words, at the start of 2002, an investor's chance of choosing a stock that would lose at least 60 percent of its value was one out of five. An investor's chance of choosing an equity mutual fund that would lose that much was one out of 807.

The basic genius of mutual funds is gaining renewed respect. Just a few weeks ago, the lead editorial in The Wall Street Journal described what it called a "market reality."

"[T]he truth is that it no longer makes sense for most clients to dabble in individual stocks. That war is over. The mutual fund industry won."

This is gratifying, but we cannot confuse feeling gratified with being satisfied. We must look to the future. As President John F. Kennedy said, "Change is the law of life. And those who look only to the past or the present are certain to miss the future."

The fact that mutual funds are the principal means by which most middle-income Americans make long-term investments will mean very little if individual investors lose faith in long-term investing. Since millions of our friends and neighbors harbor serious concerns about the integrity and fairness of our capital markets—even if for reasons entirely unrelated to our actions or their mutual fund holdings—we must assume responsibility for taking meaningful actions to restore their faith and confidence.

This is not a simple task because there are no easy answers. In one of his first speeches as the head of the Securities and Exchange Commission, Chairman William Donaldson stated:

"Investor confidence is intangible. There is no statistic that can accurately tabulate it, no measuring stick to keep track of its growth. There is no single piece of legislation or rule that can send the signal to America that all the problems have been fixed, and it's completely safe to get back in the market."

We cannot be complacent. Our past work must be a prologue to our future efforts. As SEC Division Director Paul Roye urged in March:

"The fund industry can be proud of its history of promoting a culture of honesty, integrity, transparency and accountability and also should be proud of its commitment to strong fund governance and compliance practices. But [you] cannot rest on past accomplishments. You must continue to be leaders in the establishment of fair, ethical, and investor-oriented business practices."

If the mutual fund industry is to enjoy future success, we must be prepared to take additional concrete steps—now, and in the weeks and months to come—to help reinforce investors' confidence. I believe four specific principles should guide us in these efforts.

First, our support for effective SEC regulation, inspections, and enforcement in the interest of investors must be unshakeable.

Popular confidence in mutual funds is built on the effectiveness of the core fiduciary principles set forth in the Investment Company Act of 1940—flat prohibitions on self-dealing; a requirement to mark all assets to market every business day; tough limits on leveraging; and oversight by independent directors. We must never permit these principles to be undermined, diluted, or eclipsed.

During the bull market of the 90s, we resisted attempts to repeal the Act's ban on affiliated transactions, to weaken credit quality standards for money market funds, and to allow the use of credit cards for mutual fund purchases.

The most recent threat to the integrity of the 1940 Act regulatory system arose from an unlikely source: it occurred when the SEC floated the concept of replacing direct SEC regulation of mutual funds with an industry-sponsored [self-regulatory organization](#).

Like the Commission, the mutual fund industry recognizes the value of periodically reexamining regulatory assumptions and approaches. However, we join with those who remain deeply skeptical that requiring mutual funds to assume significant responsibility for regulating themselves is wise or necessary. We share the concerns of Professor Tamar Frankel who, in 1993, wrote:

"Such regulatory changes are risky because we cannot predict all their direct or side effects. If an SRO of [mutual] funds were to prove ineffective or deleterious, a successful segment of the financial system that provides satisfactory services to millions of

Americans may be adversely affected.”

A remarkable consensus exists that strong day-to-day regulation by the SEC has effectively protected millions of mutual fund shareholders for more than 60 years. But this successful system of regulation will falter, and investor confidence will be shaken, if the SEC lacks the financial and staff resources to do the job. We have continuously supported increased SEC appropriations, and most recently endorsed [legislation](#) bolstering its ability to attract and retain key professional staff, including lawyers, economists, and accountants. We are also pleased to see that the Bush Administration is proposing to nearly double the SEC’s 2004 budget from its level in 2002, a [proposal](#) we strongly endorse.

Second, we must actively support regulatory changes that are likely to provide significant benefits to investors.

In 1940, we supported enactment of the Investment Company Act. Time and again since 1940, we have worked with, not against, Congress and regulators to update the regulatory system under which we operate. In just the past 18 months, we supported the Sarbanes-Oxley Act and a series of SEC regulatory and disclosure reforms.

The SEC, for example, recently proposed a comprehensive overhaul of [shareholder reports](#). The SEC’s proposal will help shareholders by requiring summaries and analytical information about portfolio holdings and a discussion about performance. Also, for the first time, shareholder reports would disclose information about the actual rate at which fund fees were determined over the previous six months. We initially expressed concern that the element of the proposal requiring funds to disclose their portfolios each quarter will harm shareholders by inadvertently encouraging professional traders to “front run” stocks a fund is buying or selling and “free ride” on the fund’s proprietary strategies. However, we believe that, with modest modifications, the SEC’s balanced proposal will guard against these risks, and therefore will provide considerable benefits to shareholders.

In March, the Capital Markets Subcommittee of the House Financial Services Committee held an [oversight hearing](#) on mutual funds. Following the hearing, two letters were sent to the SEC seeking the Commission’s views on a variety of topics, including fee trends and disclosure, turnover and fund trading costs, soft dollars, fund governance, and other matters. Earlier in the year, Chairman Oxley and Subcommittee Chairman Baker asked the General Accounting Office for its views on many of these same issues.

When the SEC and GAO issue their reports, we will review their findings and recommendations responsibly, analytically, and thoughtfully. We are committed to working with these agencies and with Congress to improve mutual fund regulation in ways that will effectively serve present and future fund investors.

In addition to working constructively on issues concerning mutual fund regulation, our responsibility to advance our shareholders’ interests require that we seek reforms relating to the corporations and markets in which we invest.

Before Enron and WorldCom made headlines, the mutual fund industry was working to improve accountability, enhance transparency and oversight, and strengthen regulation to advance corporate and market reforms. More recently, we’ve called for: [earnings announcements](#) to be promptly filed with the SEC and made more reliable to avoid misleading investors; stronger disclosure rules for loans to and [insider selling](#) by senior executives; disclosure of critical corporate [accounting policies](#); the expensing of [stock options](#); and new legislation to promote better accounting standards, more independent auditor oversight, and substantially increased resources for SEC enforcement. We must continue to identify and seek changes in market structure and corporate behavior that will benefit investors.

Unshakeable support for a strong and effective regulatory system does not mean we are compelled to support each and every regulatory proposal. Indeed, we have a duty to oppose proposals, even if well intended, when we believe they would harm rather than help investors.

In the 1990s, for example, a prominent market expert thought fund investors would panic if the market experienced a sharp decline, and floated the idea of limiting shareholders’ right to redeem on a daily basis. We opposed this because it would clearly harm fund shareholders.

In the late 1990s, at the height of the bull market, Congress heard from some who said the prohibition on affiliated transactions was archaic. We spoke up forcefully and opposed this dangerous idea.

More recently, some industrial companies sought to weaken credit quality standards for money market funds in a way that helped them but would have significantly increased risk. We strongly opposed this effort.

While we do not have an obligation to blindly endorse every proposal for regulatory change, we are obligated to carefully consider each proposal and to judge it by one standard and one standard alone—will it advance the interests of investors?

Third, we must be prepared whenever necessary to help investors by undertaking voluntary measures that go beyond law and regulation.

Mutual funds not only have introduced millions to investing, but have played a major role in voluntary efforts to educate Americans about the basics of investing—asset allocation, diversification, various types of risk, the impact of fees and taxes, and, above all, the need for realistic expectations and a long-term focus. One measure of our success in this area is reflected in the calm and measured way mutual fund shareholders have responded to difficult times. We must continue to support and reinforce voluntary educational efforts, through bull and bear markets alike.

We also must be vigilant in identifying situations where we should establish more demanding standards and practices than are required by law or regulation.

This is exactly what we did in 1994, when questions arose about personal trading by fund managers. We quickly developed our own standards, which were broadly adopted and widely hailed as tough restrictions.

In 1998, in the midst of a booming market and long before the word “Enron” became a symbol for fraud and abusive conduct, our industry developed a hard-hitting and extensive set of best practices for mutual fund directors. The Council of Institutional Investors said that our recommended standards went well beyond the best practices the Council recommended for public companies. Last summer, the Boston Globe called our standards “a blueprint for the guidelines, publicly-traded companies are only now being urged to follow.” In recent years, the Institute has published a series of compliance papers for use by our members in critical areas such as valuation, money laundering, brokerage allocation, and privacy.

We must be constantly vigilant for new opportunities where we should go beyond the letter of law and regulation in order to help investors. We are currently working on a compliance paper on side-by-side management of mutual funds and hedge funds, a model code of ethics and a revised model fund audit committee charter.

Finally, we must help investors by supporting programs that will assist them in saving for their long-term goals.

It is not mentioned in the Declaration of Independence or the Constitution, but the ability of Americans to look forward to a dignified retirement and to support their children’s education have become bedrocks of American life. We have an obligation to see to it that national policy assists investors. That’s why the mutual fund industry supports a number of bills now before Congress, such as:

- the “[Pension Preservation and Expansion Act of 2003](#)”, introduced by Congressmen Portman and Cardin, which would strengthen and expand the employer-sponsored retirement system, offer new protections to participants and help retirees preserve their assets and income;
- legislation introduced by Congressman Boehner, which would increase the flow of meaningful [investment advice](#) to 401(k) participants, subject to strict fiduciary regulation and full and fair disclosure; and
- legislation that would [repeal the sunset provisions](#) that otherwise will cause incentives for Section 529 college savings plans to expire.
- Over the longer term, we support enactment of the [Bush Administration’s bold proposal](#) to create a simpler system of universal IRAs and defined contribution plans.

Equally important, we must support measures that encourage all working Americans to save and invest for their future. This is the reason we support the President’s proposal to eliminate [double taxation of dividends](#). This is the reason we developed—through our Education Foundation—the [Investing for Success](#) program with partners like the National Urban League, the Coalition of Black Investors–Investment Education Fund, and the Hispanic College Fund. Together with our partners, we are presenting this program in conferences and workshops across the country, on the internet, and at historically black colleges and universities.

And this is the reason we enthusiastically support [H.R. 1989](#), a bill recently introduced by Congressman Ryan. It provides for the deferral of tax on reinvested mutual fund capital gain distributions. The bill addresses the perplexing requirement that causes millions of middle-income mutual fund investors to pay capital gains taxes even when they did not sell a single share of their funds. When Morningstar’s senior mutual fund writer looked at the bill two weeks ago, he said it “saves a lot of headaches for fund investors.” Equally important, he predicted that the only people who won’t like it probably work for “Bayer aspirin and H&R Block.”

This morning I have outlined four areas where we can help restore investor confidence: support effective SEC regulation in the interest of investors; support changes in regulation that would benefit investors; undertake voluntary measures that help investors; and finally, support programs that assist investors in saving for their futures.

We are, fortunately, active in all of these areas.

We are supporting a major increase in the [SEC's budget](#). We are working closely with regulators and the brokerage industry to address problems the NASD discovered with [breakpoints](#) for fund sales. We have called on the FASB to require the [expensing of stock options](#), a difficult and controversial idea they recently agreed to renew. We are expanding our educational programs for mutual fund directors. We are developing forward-looking compliance papers to help fund industry professionals fulfill the many new regulatory responsibilities that have recently been enacted. We are supporting [legislation](#) that will help long-term investors support their children's education and prepare for their own retirement.

As I suggested in a different context earlier, this may be gratifying, but we cannot confuse feeling gratified with being satisfied. We can, and must, do more.

As we plan our future steps, we welcome constructive suggestions—from you and your firms, from policymakers, from scholars, from journalists, and—as Paul Haaga said—from our critics.

In 1940, SEC Commissioner Robert Healey envisioned a “very promising future” for the fund industry as one that focuses on “rendering useful service to the small investor.” Mutual funds have succeeded precisely because they have provided “useful service” to millions and millions of investors.

Money magazine said that “by making investing easy and affordable for almost anyone, mutual funds have given average Americans a stake in the economy that was inconceivable 75 years ago.”

Together with our shareholders, mutual funds have built an economic engine that, in the words of The Economist magazine, is “the biggest source of capital for American companies . . . giving small and medium-sized businesses unprecedented access to capital markets.”

But just as the mutual fund industry's past success was not pre-ordained, its future success is not inevitable. Our future will mirror our past success only if we redouble our commitment, day-in and day-out, to provide “useful service” to investors. As Justice Holmes believed, “the way in which the inevitable comes to pass is through effort.”

Our industry and our shareholders currently face severe challenges. We will meet these challenges provided that we continue to focus on the best interests of mutual fund shareholders and exert all of our efforts on their behalf.

Thank you.