MEMO# 21011

April 2, 2007

Remarks by Institute President, SEC and NASD Officials at the 2007 Mutual Funds and Investment Management Conference

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SEC RULES MEMBERS No. 41-07
SMALL FUNDS MEMBERS No. 27-07
UNIT INVESTMENT TRUST MEMBERS No. 8-07 RE: REMARKS BY INSTITUTE PRESIDENT, SEC AND NASD OFFICIALS AT THE 2007 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

Last week, Institute President Paul S. Stevens delivered the opening address at the 2007 Mutual Funds and Investment Management Conference in Palm Desert, California. Andrew J. Donohue, Director of the Securities and Exchange Commission's Division of Investment Management, and Elisse B. Walter, Senior Executive Vice President at NASD, also delivered keynote addresses. Their remarks are briefly summarized below. [1]

Remarks by Mr. Stevens

In his remarks, Mr. Stevens called for regulation that preserves the competitive position of America's financial markets without weakening investor protections. Describing "a global economy of which the US is an important part, but not so pre-eminent as in years past," he described a “quiet crisis” in the area of securities regulation. Securities regulators are still following a model from the 1930s, an era closer in time to the Civil War than today. Mr. Stevens described the work of three groups that have recently “documented reasons for concern about the erosion of our competitive position as the leading center of the world capital market.” Each of these groups, he noted, recommends a review of the structure of the Securities and Exchange Commission, “with respect to such matters as the roles and responsibilities of the SEC's divisions, the status of the SEC's international efforts, the conduct of its inspections and examinations, the place of economic research and cost-benefit analysis, and the adoption of a more principles-based approach to regulation.” Mr. Stevens urged the SEC to give “every consideration” to the recommendations.

Turning to mutual fund regulation, Mr. Stevens highlighted the ongoing risk that regulators can advance “significant new rules … in the absence of any evidence of a market failure or problem, and with little or no effort given to sizing the costs, assessing the balance of costs and benefits, or considering possible alternatives.” He cited the New York Stock Exchange proposal on broker voting and the SEC’s fund governance proposal as examples of rulemakings that should be abandoned for lack of benefits to justify their substantial costs. With regard to the governance proposals – which would mandate a 75 percent supermajority of independent directors and an independent chair on every fund board – Mr. Stevens stressed that the Institute has long supported strong fund boards. “Fund boards, and independent directors specifically, are integral to the structure laid down in the Investment Company Act of 1940. That structure has supported successfully the rise within just the past generation of mutual funds as the nation’s largest financial intermediary,” he said. Yet the SEC’s own economic analysis, Mr. Stevens said, showed no “compelling evidence of economic benefits” from the rule. Conversely, Mr. Stevens noted the value of the re-examination of the roles and responsibilities of fund boards launched recently by Mr. Donohue, which Mr. Stevens described as “a timely and important exercise … we commend Buddy Donohue for pursuing it.”

Reform of fund disclosure was Mr. Stevens’ final topic. He called upon regulators to consider the “quick-start guide” approach, likening the clear, concise summary document that investors would prefer to the quick-start cards that now accompany consumer electronics products. “With this guide, you can use the device without having to slog through a long, detailed, but often confusing user's manual. … Is there any reason why we shouldn't give fund investors something like a quick-start guide when they buy fund shares?” Mr. Stevens noted Mr. Donohue’s interest in developing a summary disclosure document. This change would not deprive the marketplace of any information, Mr. Stevens noted, “because we can call upon the power of the Internet to give quick and easy access to the additional information some investors may want.” This model could be applied in many areas, he noted: “The ‘quick-start guide’ that we propose for mutual funds may serve as a disclosure model for a range of other investment products, in 401(k) plans and the retail markets.”

Remarks by Mr. Donohue

Mr. Donohue began by offering his view that one of the fund industry’s greatest strengths is its effective regulatory regime, and he strongly disagreed with suggestions by some critics that this regime is rigid, outdated, or anti-competitive. He pledged to follow the example set by prior Directors of the SEC's Division of Investment Management in "promot[ing] investor-oriented policies and a healthy fund industry benefiting investors." Mr. Donohue went on to suggest several areas of focus for the fund industry and regulators going forward.

First, Mr. Donohue remarked that the Division of Investment Management "must seriously consider which of the regulations we administer has outlived its utility or is in need of a 21st century makeover." In particular, he stated that the Division has begun a comprehensive review of the recordkeeping requirements applicable to funds and investment advisers, which has included onsite meetings with chief compliance officers and compliance and back-office staff to learn about practical and effective recordkeeping techniques. Mr. Donohue observed that this modernization of the rules "should be done right" so that the revised rules "will work in a 21st century global, technological, competitive and investor-oriented environment."

Second, Mr. Donohue commented that, in the current global economy, our fund regulatory regime cannot be "isolationist or U.S.-centric." He spoke of working with his foreign counterparts to understand what works well in their regulatory regimes, which were often developed decades after our regulatory regime and have a more modern approach. He similarly encouraged industry members "to look overseas for investor-oriented practices that can be imported to the U.S. fund industry."

Third, Mr. Donohue cautioned that industry members and regulators alike must "remember the basics" – a theme common to many of his speeches. He stressed that the fund industry must continue to adhere to its "fundamental fiduciary, compliance-oriented culture," and he described as "intolerable" the fact that investors could potentially be harmed by breaches of basic regulatory requirements. Mr. Donohue also discussed two areas of focus for his Division: (1) a review of fund director responsibilities under the Investment Company Act and related rules and under SEC exemptive orders; and (2) modernizing fund disclosure. With regard to director responsibilities, he emphasized that he will be reaching out to directors to learn how the SEC can revise its rules or provide additional guidance in order to maximize directors' ability to serve and protect investors. On the topic of disclosure, Mr. Donohue encouraged funds to participate in the SEC's voluntary program to file their risk/return summaries using interactive data tagging; he also described the staff's efforts to develop a short-form disclosure document for fund investors, which would be coupled with investors being able to obtain additional information via the Internet or in paper form.

Finally, Mr. Donohue identified several "emerging areas of concern" for regulators and the fund industry. With regard to Rule 12b-1, he described the changes that have taken place since the rule's adoption in 1980, and he announced that reconsidering both the rule and the factors that fund boards must consider when approving/renewing a 12b-1 plan is a high priority for his Division this year. Mr. Donohue commented that he also worries about the proliferation of certain yield-based investment products, and he cautioned that funds – and those who sell fund shares – must make clear to investors how the yield is generated, whether the yield is from income, and the risks that may be associated with a fund and its yield-generation techniques. Lastly, Mr. Donohue noted that he has “concerns on multiple levels” with regard to the increasing use by funds of derivatives and sophisticated financial instruments. In particular, he said it is “imperative” that legal, compliance and accounting personnel understand any new type of investment and its implications, and he suggested that fund firms’ compliance systems may not be sophisticated enough to handle such instruments effectively. In closing, he made the broader point that regulators and industry members should not ignore problems but instead “investigate further and seek to manage the issues that are the most worrisome or perplexing.”

Remarks by Ms. Walter

In her address, Ms. Walter began by commenting that the financial services industry must adapt to fundamental changes – for example, in such areas as economics, demographics and technology – and that the “stiffest price” for failing to do so would ultimately be borne by investors. She stressed the need to be proactive in protecting and serving investors, citing three areas in particular: improving the regulatory framework; appreciating and responding to investors’ changing needs; and the pressures that globalization places on the U.S. regulatory system.

Ms. Walter spoke in detail about the consolidation of NASD and NYSE member regulation as an example of regulatory reform that will improve investor protection. In her view, “[i]t would have been easy to stick with the old fragmented system . . . but the industry and its regulators chose to take the right course of action, not the safe course of inaction.” With regard to investors’ changing needs, Ms. Walter focused on the issue of retirement savings, noting the industry’s important role in helping investors do a better job at managing their money. She remarked on NASD’s efforts in this area, including: (1) amendments to NASD advertising rules that permit brokers to offer investment analysis tools to their customers; (2) NASD’s commitment to investor education; and (3) NASD’s collaboration with AARP and the Retirement Security Project to encourage employer adoption of automatic enrollment features in their 401(k) plans. On the topic of globalization, Ms. Walter commented that regulators must perform a “finely-tuned balancing act” between strong regulation to promote investor confidence and strengthen markets, on the one hand, and avoiding unnecessary regulatory burdens that could have the effect of encouraging multinational firms to move their activities outside the United States, on the other hand. In particular, she stated that NASD has created a pilot program to analyze the impact of recently enacted rules, with the goal of ensuring that the rules are working as intended and that their benefits justify the burdens they impose.

Ms. Walter also commented on the issue of disclosure, offering her view that “we owe investors a far more streamlined and effective disclosure regime.” In particular, she noted NASD’s “enthusiastic support” for the SEC’s point of sale proposal while also suggesting possible enhancements to that proposal as recommended by an NASD task force. With regard to investors in employer-sponsored plans, Ms. Walter recommended that if the SEC approves a short-form disclosure document for mutual funds, the agency should consider extending a similar requirement to other investment products offered in employer plans.

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endnotes

[1] Mr. Stevens' address, *When You Come to a Fork in the Road, Take It: Improving Financial Regulation in America,* is available on the Institute's website at http://www.ici.org/policy/regulation/disclosure/07_mfim_stevens_spch. Director Donohue's address is available on the SEC's website at http://www.sec.gov/news/speech/2007/spch032607ajd.htm, and Ms. Walter's address is available on the NASD's website at http://www.nasd.com/PressRoom/SpeechesTestimony/ElisseB.Walter/NASDW_018876.