

MEMO# 10286

September 15, 1998

RECOMMENDATIONS FROM STUDY OF THE FUTURE ROLE OF THE INSTITUTE

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Introduction

In May 1997 the Board of Governors authorized a study of the Institute's future role in serving its membership. Eight years had passed since the previous study of the Institute's role had been conducted. The study, which was guided by a subcommittee of the Executive Committee, proceeded on three parallel and integrated tracks: 1) The Board of Governors and the Executive Committee identified major issues which are likely to face the investment company industry in the future. 2) A survey of the membership was conducted to help determine members' priorities with respect to current and future Institute activities. 3) Matt Fink prepared a paper addressing future issues from a staff perspective, addressing whom the Institute should serve and what services it should perform. From those three sources, consultants for the study, Dick Pogue and Phil Kuehl, distilled a list of ten important issues. Those issues, along with the Executive Committee's recommendations as to their disposition, are discussed below. Time is being allocated at the October 9 Board of Governors meeting for a discussion of these issues and recommendations. If you have questions or comments, please call me (713-993-4220) or Matt Fink at the Institute. The

Process A. The Board of Governors and Executive Committee identified four major areas of future opportunity and challenge to the industry: 1. **Downside Risks:** Given the tremendous growth and popularity of investment companies over the past decade, the industry is faced with elevated or potentially unrealistic public expectations which might be frustrated by a securities market downturn or an industry operations disaster. The result could be a significant blow to public confidence in investment companies. What role should the Institute assume to help the industry maintain public confidence? 2. **Technology:** Industry growth has been substantially facilitated through adaptation of new information technologies. Numerous regulatory, legislative and operational questions of industry-wide importance are raised related to the use of new technology. Is the Institute adequately equipped to help the industry respond to these new concerns? 3. **Globalization:** The financial services industry and financial markets have become global. US investment companies are investing world-wide. US investment advisers are seeking markets for their services world-wide. Foreign funds and advisers are seeking entree into the US market. What role should the Institute play in this process? 4. **Financial Services Restructuring:** Banks, insurance companies, securities firms, industrial companies, foreign firms as well as traditional investment advisory organizations are now engaged in the investment company segment of the financial services business. Some investment company executives fear that the fiduciary culture of the industry may be lost or diluted by the entry of many new firms whose parent companies have a different culture. How should the Institute respond to the

needs of a much broader, diverse membership? B. The Institute surveyed member complex CEOs/Senior ICI Contacts about their needs and priorities for the Institute. A report of the survey made to the Board on May 6, 1998 showed the following principal findings: 1. Members believe the Institute is highly effective in the performance of its functions. 2. Members rate highly important the information services, regulatory and legislative work and operational assistance provided by the Institute. 3. Members value membership more highly for the benefits it offers their particular companies than for the benefits that are industry-wide. This is particularly true for small and medium-sized companies; larger companies tend to place greater value on industry-wide benefits. 4. Members believe that the current mix of ICI activities is about right to meet their future needs and that the cost of ICI services is appropriate to the value members receive. C. The paper prepared by Matt Fink addressed which entities the Institute should serve and what it should do for those companies going forward. Several possibilities for expanding or contracting the definition of companies eligible for membership were considered, as were changes to the list of ICI activities outside the core of regulatory and legislative work. Several of the issues raised in that paper are among the ten specific questions addressed below. Major Conclusions 3The Executive Committee concurred with consultants Kuehl and Pogue's belief that to be effective in the future ICI must balance three factors: 1. Focus on the core legislative and regulatory mission where ICI can achieve excellence and dominance. 2. A breadth of programs sufficient to provide value to a wide array of members. 3. Inclusiveness of all segments of the industry in the policymaking mechanisms of the Institute so that members do not feel compelled to develop a separate voice on policy matters. The Executive Committee noted that ICI's mix of policies, programs and participation has served the membership well in the past and that the challenge is to determine the balance that will work well in the future. Following a thorough review of material developed in the three tracks of the Future Role Study, the Executive Committee concluded that ICI's historic focus on being the regulatory and legislative advocate on behalf of companies registered under the Investment Company Act of 1940 is the proper one to continue for the future. Most of the decisions as to whom the ICI should serve, what it should do for those companies, and how it should respond to future issues flow naturally from this central premise. Specific Issues and Recommendations Issue 1. Downside risks: Should ICI substantially increase its public education/investor awareness efforts, possibly including a major advertising program, to attempt to ameliorate adverse public reaction to a precipitous or a prolonged market drop? Current ICI Position: ICI conducts an extensive media relations program and a modest public education/investor awareness effort. No resources are allocated to investor awareness advertising programs. Being recognized as a leader in investor awareness initiatives is strategically necessary to accomplish other goals. Conversely, damage to the industry's reputation can have an adverse effect on policymakers' disposition. Executive Committee Recommendation: The Committee noted that 1) members are in a better position than the ICI to communicate with their investors about risks and rewards, 2) ICI would have to spend a large sum (e.g. \$5-10 million) on institutional advertising to begin to have an impact on investors, 3) even a campaign of that magnitude would have difficulty rising above advertising by members and other financial organizations, and 4) ICI's present program of media education and support for public initiatives such as the SEC's Investor Awareness Campaign continue to be the most effective use of resources. Therefore, the Committee does not endorse a special advertising campaign directed toward the investing public. *** 4Issue 2. Downside risks. What should ICI do to assist the industry to improve operations systems and processes to handle major peaks in shareholder activity and to preserve integrity of shareholder accounts against fraud? Current ICI Position: Operations and fraud prevention activities are principal activities of ICI's Operations Committee and Operations Department. ICI Mutual Insurance Company maintains a fraud database and a

fraud prevention program for its insureds. This past year a capacity planning paper and workshop were developed to focus attention on this matter. ICI has convened a high level Technology Task Force of members in response to discussions at the Board and Executive Committee regarding downside risks and technology issues. The top priorities for the Task Force are Year 2000 readiness and computer security issues. The Operations Committee is developing industry utilities for IRA asset transfer, 401(k) processing, and IRA/financial planner order processing; however, support for these utilities, both from within the industry and from counterparties, has been slow. Executive Committee Recommendation: Implementation of enhancements to the ICI operations/fraud prevention activities should remain in the hands of the Operations Committee and Technology Task Force. ICI should support the development of industry utilities and standards and encourage members to use them, though ICI should not take on operating responsibility for such entities. The FY 1999 ICI budget should include resources for an enhanced effort to expand usage of industry utilities. *** Issue 3: Technology: In the face of accelerating rates of technological innovation and consumer acceptance of technology, ICI needs to be technologically proficient in order to help the industry with a wide variety of legislative, regulatory, business standard and other issues that are likely to arise. Three areas of particular concern are: a) Year 2000 computer issues; b) Computer security, especially as it relates to shareholders' access to their accounts over the Internet; and c) Development of standards, procedures and regulations for electronic commerce. Current ICI Position: Professionals in the Legal, Operations, Information Services and Legislative Affairs Departments work on industry technology matters, including Y2K, computer security and electronic commerce. However, ICI does not have depth of technological expertise in its staff comparable to that in other substantive areas. As noted above and in response to discussion at previous Board meetings, ICI has convened a high level Technology Task Force to advise it with respect to technology matters. Executive Committee Recommendation: Assign to the Technology Task Force (and the Operations Committee where appropriate) the role of advising ICI on its involvement in industry technology matters. The Committee also supports including resources in the FY 1999 budget to add a technologist to the staff. *** Issue 4. Globalization: Financial markets have become globalized and many investment management firms operate internationally. Many ICI members are involved in investing abroad, operating funds abroad and managing non-fund portfolios abroad. What is the appropriate role for ICI to assume? Current ICI Position: ICI is active in four areas: 1) US fund investments overseas; 2) sale of US investment company shares overseas; 3) the ability of US money managers to sponsor and distribute foreign-domiciled investment companies; and 4) the ability of US money managers to advise foreign pension funds and other private accounts. Two attorneys in the Legal Department are devoted to this effort. Legislative and research personnel are involved on a part-time basis. On April 17 the Institute held a meeting of top executives of member companies active abroad for the purpose of advising it on ICI's international activities. That group concluded that the ICI had been quite successful to date, that its international activities should be enhanced and its focus shifted to areas 3 and 4 above. Executive Committee Recommendation: The Committee endorsed the consensus reached at the April 17 task force meeting, with the following additional recommendations: ICI should prioritize foreign issues and pursue those with the greatest potential impact on members' interests; ICI should continue to build relationships with counterpart associations overseas; and ICI should work with foreign regulators to develop standards that protect investors and are compatible with US standards. *** Issue 5: Financial Services Restructuring: The lines that traditionally separated securities firms from banks and insurance companies have virtually dissolved. A large number of major investment company groups are now part of financial conglomerates. Foreign financial conglomerates are entering the US fund business. Inter-

industry mergers are occurring frequently. Some Board members have expressed concern that the investment company industry may be in danger of losing its clear definition as a separate line of business, and that, consequently, ICI may become non-essential to companies which regard investment companies as just one of several product lines used to gather assets. Should ICI expand its scope to represent a broader array of asset gathering activities undertaken by its members and their affiliates, e.g. those of investment advisers registered under the Investment Advisers Act of 1940, bank trust departments and insurance company separate accounts? Current ICI Position: In addition to representing investment companies, their advisers and underwriters, since 1976 ICI has selectively represented investment adviser members on non-fund matters, including federal investment adviser legislation, rule-making by the SEC, Department of Labor and other federal agencies, and state laws and regulations pertaining to investment advisers. In addition, associate membership is available to SEC registered advisers who do not advise investment companies. There are approximately 500 associate members which pay annual dues totaling \$350,000. ICI has not represented other money managers such as bank trust departments and insurance company separate accounts. Executive Committee Recommendation: Continue to maintain the focus of ICI on investment companies registered under the 1940 Act, their investment advisers, underwriters and shareholders, with no expansion of scope. The ICI's engagement on behalf of investment advisers on issues affecting their non-investment company business should be pursued only to the extent that this does not conflict with ICI's basic mission. *** Issue 6: The "fiduciary culture" is the cornerstone of public confidence in the investment company industry. Some observers suggest that the industry's "fiduciary culture" is in danger as a result of rapid growth, new entrants and absorption of much of the industry into larger financial services companies. What should ICI do to preserve the "fiduciary culture" of the industry? Current ICI Position: Many ICI activities, including the Directors Services Program, ICI conferences and seminars, and compliance education and training courses, help maintain the "fiduciary culture". Participation in ICI committees is a major way the culture of the industry is passed along. ICI has an active program to bring new fund groups into membership and to make them aware of educational, training and committee service opportunities. ICI represents almost all mutual fund groups, having 98% of total mutual fund assets. ICI's Board has consistently opposed creating an industry self-regulatory organization which, presumably, would have preserving the culture as one of its unstated objectives. Executive Committee Recommendation: Defining "fiduciary culture" and determining whether someone does or does not have it is very subjective. ICI should continue current efforts to recruit all industry participants into membership and to involve both new and seasoned members in committee work, conferences and seminars, mailing lists, etc.; but ICI should not become a self-regulatory organization. Instead, ICI should continue to pursue legislation and regulation that promote fiduciary principles, support voluntary standards such as the Blue Ribbon Committee's recommendations on personal investing and produce papers on best practices. *** Issue 7: What should be ICI's role with respect to education and training of industry personnel? Current Situation: ICI education and training activities consist of three components: 1) Sponsorship of fourteen major annual conferences. 2) Sponsorship of regional workshops on subjects such as SEC filings, blue sky compliance, portfolio compliance and shareholder communications. 3) Production of basic study courses (many of which are self-taught, computer-based) and co-sponsorship with the National Endowment for Financial Education (NEFE) of the Chartered Mutual Fund Counselor Program. Much of this menu is compliance oriented. Some ICI training programs are being used by members to help comply with NASD continuing education requirements, which are growing. All training and education programs were developed in response to member demand and in aggregate are self-financing. There is no member subsidization through dues. Furthermore,

according to the recent Membership Survey, these activities are part of the glue that holds a diverse membership together: 80% of respondents said they value ICI membership for the specific services it provides to their companies. Executive Committee Recommendation: Continue member education efforts through conferences, seminars and training courses at the current level of effort. These activities promote high ethical standards, help insure compliance with applicable law and regulation, and directly respond to member requests. They help preserve and lend credibility to ICI's reputation as a quasi self-regulatory organization, which has been extremely valuable when issues relating to SEC resources and calls for formal industry self-regulation are raised. The current educational and training programs are self-financing and the market will determine if and when a particular program has outlived its usefulness. *** Issue 8: Should ICI engage in marketing support activities? If not, what should it do with committees that formerly engaged in marketing support? Current Situation: During the 1980s in response to member interest, ICI developed a variety of marketing support activities through six committees under the supervision of the Marketing Policy Committee. In recent years, the overwhelming public acceptance of mutual funds has made these efforts superfluous. Consequently, during the 1990s ICI shifted resources away from marketing support to policy-oriented purposes. Thus, the rationale for retaining ICI marketing-related committees is questionable. However, many members of these committees would likely prefer that ICI continue to support these activities. Indeed, ICI recently received a request that it consider establishing a new committee to serve as an information exchange and possible advocate for policies needed to facilitate member activities on the Internet. The seven affected committees are: Marketing Policy Public Information Research Industry Statistics Direct Marketing Sales Force Marketing Shareholder Communications Executive Committee Recommendation: Although the ICI is no longer involved in marketing support activities, most of these committees appear to serve other useful functions. The Research Committee provides guidance and where needed entree to member data sources for policy research. The Statistics Committee provides assistance to the staff regarding data classification and collection methods. The Public Information Committee and Shareholders Communications Committee help develop industry policy messages and investor awareness and media education initiatives. The Direct Marketing and Sales Force Marketing Committees 1) provide an opportunity for ICI staff to apprise industry marketing personnel of current legislative and regulatory issues and to involve them in maintaining the industry's fiduciary culture; 2) keep ICI staff apprised of business developments in the industry, particularly sales and marketing developments that are likely to raise policy issues; and 3) are extremely popular with industry marketing personnel. Dissolution of these committees would likely lead their members to forums outside of ICI, which is not a preferable result if it leads to strengthening competing industry voices. The remaining question is whether there is a continuing role for the Marketing Policy Committee. The Executive Committee has asked that committee to make a recommendation to the Executive Committee on its future role. The Executive Committee therefore recommends that, with the possible exception of the Marketing Policy Committee, the former marketing-related committees continue to function in their current roles. *** Issue 9: Should ICI undertake representation of variable insurance products? Current Situation: Variable annuities are among the fastest growing segments of the investment company business. Approximately 1033 funds which serve as the underlying investments of variable insurance contracts are members of ICI. Many such funds are associated with member mutual fund groups, although a number of stand alone variable annuity groups are also members, presumably to receive ICI services that benefit all investment companies. However, ICI has never represented the particular interests of variable annuities, such as insurance tax issues and SEC variable annuity issues, but has been asked to do so several times by members. Historically, ICI determined every time the

question was raised that it should not assume that role. 9However, many ICI members now sponsor variable insurance funds. If ICI were to undertake overall representation of variable insurance funds, it would have to acquire new expertise in some areas of the federal securities and tax laws and, more importantly, under state insurance laws. Also, it would have to face the issue of whether or not to promote and protect the special tax-deferred nature of variable insurance products when to do so might conflict with the interests of mutual funds. Executive Committee Recommendation: ICI's primary mission is to represent investment companies registered under the 1940 Act, the overwhelming number of which are mutual funds. Therefore the ICI should not undertake the general representation of variable annuities because of possible conflicts with its primary mission. It should cautiously support variable annuities on issues where to do so will not compromise ICI's primary mission. *** Issue 10: Should ICI admit service providers to US investment companies (i.e. independent transfer agents, custodians and third party administrators) into some form of membership? Current Situation: At times service providers such as transfer agents, custodians and accounting firms have sought some form of membership in ICI. They argue that they should be represented in policy decisions that can have a significant impact on their business. Service providers have also pointed out that some competitors, through affiliations with member groups, already have access to ICI committees and other desired services. To keep the service community informed, the ICI has made many of its services for members (memoranda, training materials, conferences, etc.) available for fees. A number of service providers as well as members of independent public accounting firms are represented on advisory committees to the Operations Committee. The National Investment Company Service Association has arisen to serve the needs of the service community. Executive Committee Recommendation: In order to maintain ICI's primary focus on its mission of serving investment companies regulated under the 1940 Act and their shareholders, ICI should not admit service providers to membership. Next Steps Following Board discussion and approval, the Institute will send a report to the membership and will implement the decisions reached. Don G. Powell Chairman