

LETTERS TO THE EDITOR & RESPONSES

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Investment Company Act Turns 80

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By Paul Schott Stevens

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Eighty years ago, on August 23, 1940, President Franklin Delano Roosevelt signed into law the [Investment Company Act of 1940](#), the culmination of the New Deal's rewrite of American financial regulation. One is hard-pressed to find any financial regulatory legislation as successful as that bill, which created the modern legal structure for the regulated fund industry—including mutual funds and exchange-traded funds (ETFs).

The '40 Act was based on a deep foundation of study, investigation, and research by Congress and the newly formed Securities and Exchange Commission (SEC). It was especially important to policymakers to get this legislation right because it was intended to salvage fund investing in America, which in the Roaring Twenties was so rife with abuses that economist John Kenneth Galbraith described it as "the most notable piece of speculative architecture of the late twenties."

With the '40 Act, policymakers were spectacularly successful in setting a new course for funds and investors. The bill gave rise to the most powerful form of financial intermediation for individual Americans. Over the last 80 years, fund investing grew incredibly in the United States—from less than \$500 million managed by US mutual funds in 1940 to more than \$24 trillion today. And for those 80 years, the industry that grew from the '40 Act has operated with remarkable integrity.

If that's not enough, the success of US fund investing inspired thriving fund industries in many other countries and regions around the globe.

There are several key ingredients to the '40 Act that have led to its historic success.

Robust investor protections ensure that funds operate in the best interests of shareholders, not the financial industry. Regulated funds are a professionally managed investment vehicle with strict requirements. These funds must, for example, limit their use of leverage, follow clear investment objectives, and diversify their holdings. Funds are also the most transparent financial instruments: investors and prospective investors receive the fund's prospectus, which contains important information in plain English and in a standardized format, followed by a wealth of periodic disclosures.

These requirements are reinforced by a strong governance framework, with a fund's board of directors overseeing the management, operations, and investment performance of the fund. The majority of these directors are typically independent of the fund's manager, providing an extra level of accountability. Taken together, there is simply no equivalent in the private markets to the structure and investor protections offered by regulated funds.

Another strength of the '40 Act—and part of its enduring success—is the authority it grants the SEC to provide flexibility to funds and the industry. For instance, the act gave the SEC the ability to grant so-called exemptive relief to individual funds and to adopt exemptive rules allowing all funds that meet strict conditions to engage in activities that otherwise are prohibited. But this authority is not unbridled. The act directs the SEC to only grant funds permission if it first finds that doing so is in the public interest and protects investors.

This flexibility allows for innovation in a rapidly growing and ever-changing industry. The creation of ETFs is the most notable example. ETFs allow investors to buy or sell ETF shares through a broker or in a brokerage account throughout the day, just as they would the shares of any publicly traded company. And as we saw in March's market turmoil, ETFs also can help provide price discovery.

Another important example is money market funds. These funds play a critical role in the US economy and provide a vehicle for cash management for individuals, businesses, and nonprofit organizations.

Other popular innovations are index funds for investors wanting the most diversification at the least cost; municipal bond funds for those trying to manage tax liabilities; and target date or other lifecycle funds for workers wanting to simplify the management of their retirement assets.

Importantly, throughout all the advances, regulators, policymakers, and industry professionals never lost sight of the '40 Act's key principles of investor protection and strong governance.

As we look to the future, it's remarkable to see how well the '40 Act has withstood the test of time, and it's inspiring to think of the framework it provides for future growth—over the next 80 years and beyond.

As long as the industry keeps its focus on the most important legacy of the '40 Act—putting investors' interests and protections first—it will continue to grow, evolve, and thrive for decades to come.

As I observed in June 2004, in my first speech as president and CEO of ICI, we will continue to serve our investors by remaining unflinchingly loyal to their interests and deeply conscious of the obligations we assume as fiduciaries on their behalf.

On behalf of more than 100 million American shareholders, happy birthday to the Investment Company Act of 1940.

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