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1999 Mutual Funds & Investment Management Conference: Keynote Address

Institute President's Keynote Address at the 1999 Mutual Funds and Investment Management Conference

by
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Good morning. It is a great honor to share the stage with Chairman Levitt. The Chairman will soon add another distinction to his already remarkable tenure. In September, he will become the longest serving Chairman in the history of the United States Securities and Exchange Commission.

Chairman Levitt's milestone will soon be upon us, but another significant one just passed. Yesterday marked an important anniversary. The world's first mutual fund, Massachusetts Investors Trust, was introduced in Boston on March 21, 1924, exactly seventy-five years ago.

With the advent of mutual funds, the world changed for investors and for our society. Professional management of a diversified portfolio was no longer just for the wealthy.

The history of our industry is one of the great American success stories. Many factors have contributed to our success—from our ability to develop new products and services to meet the changing needs of our investors to the strong securities markets of recent years.

But the real key to our success is more basic. It lies in the safeguards, unique to our industry, that are the backbone of regulation under the Investment Company Act. Redeemability, daily marking to market, strict limits on borrowing, full and fair disclosure, prohibitions on affiliated transactions, and oversight by independent directors. We in the industry are so used to these investor protections that we take them for granted. But it is these simple, common sense protections that have kept our industry free from serious problems and have earned us the trust and confidence of our shareholders.

We are so overloaded day to day with information that it’s easy to lose a long-term perspective. But looking back over the past seventy five years, it is clear that whenever a crisis strikes a pooled investment—the real estate trust debacles of the early 1970s; the limited partnership problems of the 1980s; the Orange County scandal of 1994; or the hedge fund collapses of this past year—the crisis can be traced directly to the absence of the basic, powerful investor protections of the Investment Company Act. Indeed, we know this first-hand because of experiences of some in our own industry in the 1920s and 30s.

Justice William O. Douglas, Chairman of the SEC from 1937 to 1939, once observed that "Common sense... makes good laws." I am firmly convinced that our industry has flourished because it operates under a strong and effective regulatory system—a system that traditionally has applied common sense to address the concerns that affect our shareholders’ interests. This morning I would like to discuss the virtues of a common sense approach in four areas: mutual fund governance, mutual fund disclosure, defined contribution plans, and Individual Retirement Accounts.

Mutual Fund Governance

As is evident from Chairman Levitt's speech this morning and the SEC Roundtable held last month, he has spent a great deal of time thoughtfully considering the governance structure for mutual funds. So I would first like to share my thoughts about the role of investment company directors.

To my knowledge, the only companies in the world that are required by law to have independent directors—and to delegate certain critical decisions to those independent directors—are U.S. mutual funds and closed-end funds. Since 1940, our industry has grown from $400 million to over $5.5 trillion without a single major self-dealing scandal. In my view, independent directors deserve much of the credit for this record.

Fund directors oversee the operations of the fund to make sure that it is operated in the best interests of its shareholders and to guard against conflicts of interest between the fund and its adviser. This unique watchdog role gives our shareholders the confidence of knowing that those who manage their investments are subject to meaningful and independent oversight.

The SEC has always paid special attention to the responsibilities of fund directors, and to their effectiveness in fulfilling those responsibilities. The Investment Company Act lists four specific duties of directors—approving the advisory contract, approving the underwriting contract, approving the auditors, and valuing illiquid securities. But the SEC has repeatedly shown its confidence in the ability of directors to stand up for shareholder interests by assigning many additional duties—12b-1 plans, foreign custody, and insurance contracts, to name a few. Directors have thus successfully met new challenges when they have arisen in the past, and I am certain they will continue to do so in the future.

In short, the system of independent oversight that governs our industry is at the heart of a regulatory system and fiduciary culture that puts investors first. In its landmark 1992 Report, Protecting Investors: A Half Century of Investment Company Regulation, the SEC staff found that "[t]he oversight function performed by investment company boards of directors, especially the ‘watchdog’ function performed by the independent directors, has served investors well, at minimal cost."

Though our corporate governance system is working effectively and has succeeded in helping to keep our industry free from major scandals, common sense tells us that such a

critical bulwark of protection for fund shareholders should be reexamined from time to time. Last month, Chairman Levitt hosted experts from a variety of different disciplines to take a hard look at how mutual fund governance is meeting the challenges of the late 1990s. This morning, he shared with us an overview of the SEC Roundtable. The mutual fund industry welcomes and applauds the SEC's effort to determine whether our strong system of fund governance can be made even better. But we have also always taken the view that establishing and reinforcing high standards of professional and ethical conduct "starts at home."

Mutual funds have consistently embraced standards of conduct that far exceed those written in statutes or enacted by regulation. We want to ensure that this remains our touchstone as we move into the 21st century. So I am pleased to announce today the formation by the Investment Company Institute of an Advisory Group on Best Practices for Fund Directors. Its members consist of Jack Brennan, Chairman of the Board of Governors of the ICI and Chairman and CEO of the Vanguard Group, Dawn Marie Driscoll, an Independent Director at the Scudder Funds, Robert Glauber, an Independent Director at the Dreyfus Funds, Paul Haaga, Executive Vice President of Capital Research and Management Company, Dr. Manuel Johnson, an Independent Director at the Morgan Stanley Dean Witter Family of Funds, and William Lyons, President and COO of American Century Investments.

The mission of the Advisory Group is straightforward. It will identify and evaluate "best practices" associated with the work of mutual fund directors that the group believes should be brought to the attention of every fund board. The group will work swiftly and start its work immediately. A broad range of experts will be called upon for advice and suggestions.

To us, working to identify and reinforce high standards for mutual fund directors is not a unique challenge or a once-in-a-lifetime effort. Instead, it is an essential and constant element of what it takes to earn and maintain the trust of millions of American families. In other words, it's just plain common sense.

Mutual Fund Disclosure

The second area that I would like to discuss is mutual fund disclosure.

The goal of disclosure is to help ensure that investors understand the securities that are being offered to them.

And yet, in the years when Chairman Levitt and I were starting our careers, the rules that governed mutual fund disclosure often hindered this goal. Regulators were of the view that the Securities Act of 1933 prohibited funds from advertising their past performance. Prospectuses were required to contain long complex presentations that were incomprehensible to the average investor. And sales literature was needlessly complicated by a Byzantine set of rules known as the Statement of Policy.

The disconnect between what investors need and can understand, and what the law requires funds to provide, may have reached its zenith in 1974 when the SEC proposed a performance chart, reproduced below. The goal was certainly laudable: in one place provide information for each year in a ten year period on total return before expenses, total return after expenses, capital appreciation, absolute level of expenses, changes in the S&P 500, and several other things.

Results of an Investment in XYZ Fund
with Dividends and Capital Gains Distributions
Reinvested, Before Taxes

That is a lot of information to pack into one chart. It was well intended, but could even one investor in a hundred possibly make sense of this flood of information? As Chairman Levitt has repeatedly reminded us, "disclosure is not disclosure if it does not communicate."

In 1979, the Commission began a reform effort. The SEC adopted Rule 482, which allows mutual funds to advertise their performance. That same year, the SEC replaced the needlessly complicated Statement of Policy with a simple but potent antifraud rule. And, in 1983, the SEC adopted a new registration form, Form N-1A, which was intended as a short, simple prospectus that actually could be understood by an investor. Form N-1A was improved in 1988 with the addition of an easy-to-understand, uniform fee table.

These common sense reforms by the SEC were true to the spirit of the Investment Company Act and paved the way for an even better industry. For the first time, investors could learn directly of a fund's past performance. Advertisements, sales literature, and prospectuses became readable and informative. Investors now had the tools to make informed choices, whether by themselves or with the help of an adviser. It's no coincidence that in the years following reform, vigorous competition increased. An important result was that sales loads fell, shareholders moved to lower cost funds, and between 1980 and 1997, the total cost of investing in mutual funds fell across-the-board: in equity funds, by more than one-third; in bond funds, by 25 percent; and in money market funds by 15 percent.

Mutual Fund Fees Decline Since 1980

Many factors contributed to these changes. But the SEC's disclosure reforms, based on a common sense approach to what investors really need and understand, led the way.

I've spoken in the past of how the reforms of the 1970s and 1980s were inadvertently eaten away over time by "disclosure creep," until the original simplified prospectus became nearly as lengthy and unreadable as its predecessor.

But in the past few years, Chairman Levitt and the SEC, with the enthusiastic support of the fund industry, confronted this problem directly and forcefully. The SEC's top-to-bottom revision of Form N-1A and adoption of Plain English requirements identified the problem for investors—the need for clearer, more concise information—and offered common sense solutions.

We need to apply the logic of these prospectus reforms to other disclosure documents. We are pleased that the Commission has targeted mutual fund shareholder reports for review. And, we look forward to working with the SEC and NASD as they take a fresh look at fund advertising rules. I was also particularly pleased by Chairman Levitt's statement this morning that the Commission, working with the industry, intends to consider ways to improve disclosure about the impact of taxes on mutual fund performance.

Once comprehensive reform of shareholder communications is achieved, we must avoid the pitfalls of disclosure creep that eroded previous attempts at disclosure simplification. Vigilance won't be easy. It will be hard to resist well-intended calls for more and more detailed requirements. But we must resist at times if we are to be true to the SEC's bold

reforms. Our objective must always be to provide investors with meaningful disclosure.

Therefore, as we consider new disclosure requirements, we must be mindful of the impact on overall investor understanding. If we disclose every piece of information that could be of interest to someone, we'll be back where we started—with dense, complex, and unreadable disclosure. We must not allow our hard-earned gains for investors to be inadvertently rolled back.

Defined Contribution Plans

The third area where a heavy dose of common sense is needed is defined contribution plans.

One of the most serious long-term problems facing the United States is that Americans don't save enough for retirement. But though encouraging retirement savings is a national priority, the rules that govern defined contribution plans are needlessly complex and confusing to investors. Paradoxically, these rules to some extent undermine our ability to achieve higher rates of retirement savings.

It's easy to understand how this came to be. We celebrate another anniversary later this year—the Employee Retirement Income Security Act was enacted twenty-five years ago. At that time, most retirement plans were defined benefit plans. Congress' main concern in enacting ERISA was to ensure that these plans were adequately funded so that workers would receive the benefits that employers had promised to them.

Defined contribution plans were fairly uncommon back in 1974, and ERISA pays them scant attention. But the world has changed since 1974. Today, over 44 million employees are active participants in defined contribution plans. Only 24 million are covered by defined benefit plans.

Despite this dramatic shift to defined contribution plans, the rules governing these plans are a hodgepodge of confusing and sometimes conflicting requirements. I speak from personal experience. My wife participates in a 403(b) plan at a small employer. It took two lawyers and an accountant to figure out her maximum contribution, and even then they couldn't be sure.

In addition, over the years, a variety of different defined contribution plans have developed. There are 401(k) plans for corporations, 403(b) plans for school systems and charities, and 457 plans for state and local governments. Even though all serve the same purpose—to encourage retirement savings—there are separate rules for each.

Common sense tells us that if increased retirement savings are truly a national priority, we must do better. Congress has taken a few steps, by making trust requirements more uniform and by allowing some employers to choose between a 401(k) and a 403(b) plan. These are all good ideas. But much more needs to be done. I am pleased to note that pending legislation would permit employees to roll over assets from one type of plan to another when they change jobs, regardless of the types of plans involved.

Common sense also tells us that we should make defined contribution plans more widely available, and allow each worker to save more. Again, I'm happy to note that pending legislation would do just that, by raising the limits on contributions, permitting after-tax contributions in some plans, and giving small employers tax credits for setting up plans.

It may not be possible to develop a single, universal defined contribution plan. It may not even be desirable. But surely we can establish more simplicity, uniformity, and availability than currently exists.

Individual Retirement Accounts

Hand in hand with defined contribution plans are individual retirement savings, the final topic that I will discuss this morning.

ERISA began the most successful retirement savings vehicle the country has ever had—the Individual Retirement Account. Originally, IRAs were available only to workers who were not covered under an employer plan. But in 1981, Congress made a deductible IRA available to every worker, thus creating the universal IRA.

The universal IRA was extremely effective in increasing retirement savings. Contributions rose dramatically from $4 billion in 1980 to $38 billion in 1986. Most significant for policy makers, IRAs became especially popular among those workers who needed it the most—the median income of workers contributing to IRAs dropped from $41,000 in 1982 to $29,000 in 1986.

The universal IRA made sense. It was simple, easy to understand, and very effective in stimulating retirement savings.

But then—in a supreme irony—as part of its effort to simplify the tax code in 1986, Congress eliminated the deductible IRA for workers covered by employer plans and those above certain income levels. A simple way to encourage retirement savings suddenly became fragmented and tremendously complicated, and contributions dropped significantly. Most disturbingly, contributions by those workers still eligible to make fully deductible contributions dropped substantially, apparently due to confusion over eligibility and the complexity of the rules. For taxpayers making $25,000 or less, 30% fewer claimed an IRA deduction in 1987 than in 1986, even though their eligibility to participate in this part of the IRA program had not changed: 3.65 million individuals in 1986 compared to 2.55 million in 1987. It is our understanding that the participation rate has still not recovered.

In 1997, Congress took some positive steps toward making the IRA attractive again. Congress raised the income levels for deductibility, and created the new Roth IRA, where withdrawals, not contributions, are tax-deductible.

Despite the important reforms in 1997, we are far from the universal IRA of 1986. What once was simple for the average worker to comprehend is now a morass of rules, regulations and exceptions. In 1982, the IRS publication explaining IRAs to taxpayers was 12 pages long. By 1998, the publication had grown to 82 pages.

Common sense tells us that a return to the universal IRA, or its close approximation, will increase retirement savings. I'm pleased to report that Chairman Roth has introduced legislation to restore the universal IRA.

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This morning, I have discussed four areas where investors need and deserve common sense regulation.

In the case of investment company directors, we owe it to our shareholders to ensure that the system of independent directors that has worked so well since 1940 remains effective.

The work of the SEC and the best practices that will be identified by the Advisory Group should ensure that this is the case.

With respect to mutual fund disclosure, twenty years of hard work by the SEC and the business have greatly simplified and improved the fund prospectus, producing immense benefits to investors. Now we join with the SEC in recognizing that it is time to apply the same common sense logic to other disclosure documents.

In the case of defined contribution plans, we believe that retirement savings would be increased if plans were simplified, and I am pleased to say that reform is underway.

In the case of IRAs, a once simple system has become fragmented and complicated. But pending legislation would restore the universal IRA.

In these and other areas that affect our shareholders, the mutual fund industry has an obligation to play an active and constructive role. We must remain true to our traditions—educating investors, supporting strong pro-consumer regulation, vigilantly guarding the industry's commitment to fairness and integrity, and setting the highest possible professional standards for ourselves beyond the legal requirements that bind us.

By doing so, we will help see to it that the next 75 years will be as productive and successful as the years since the creation of the first mutual fund three-quarters of a century ago.

Thank you.
