Independent Directors Council

Promoting Excellence in Fund Governance

Economic Issues in the Mutual Fund Industry

Economic Developments In The Mutual Fund Industry

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Good morning.

I am Matthew Fink, President of the Investment Company Institute. I am delighted to welcome you to the Institute's first Conference on Economic Issues in the Mutual Fund Industry.

Countless previous conferences have focused on regulatory or marketing issues in the mutual fund industry. This is the first devoted to economic issues. This is in recognition of the changes that have occurred in the fund industry.

We are pleased that today's audience includes experts from a number of different fields. Since many of you do not deal with the mutual fund industry on a daily basis, some historical background may be useful.

The first mutual fund was created back in 1924. Today, they are the most popular and well known type of investment company. At yearend 1996, the nation's 6,270 mutual funds had combined assets of $3.54 trillion and were owned by sixty-three million individual shareholders.

Mutual funds have proven to be a way by which middle-income individuals and families can receive the same benefits of professional money management and diversification of investments as wealthy individuals. In doing so, mutual funds have opened the securities markets to millions of Americans.

Middle America's long-term retirement saving is a key element of mutual fund growth. Over thirty-five percent of all mutual fund assets are held by retirement plans of various types. Overall, mutual funds hold about one-fifth of all U.S. retirement assets.

For many years, mutual funds concentrated in common stocks of American companies. As recently as 1971, 94 percent of industry assets were in equity funds. In contrast, the fund industry of the nineties is diversified. About fifty percent of industry assets is in equity funds, twenty-five percent in bond and income funds, and twenty-five percent in money market funds.

It's interesting to note that in the period since 1990, investment performance has been as big a factor in the industry's growth as new cash flows.

The key to the success of the mutual fund industry has been the comprehensive scheme of federal regulation under the Investment Company Act and other securities laws.

In the 1930s, Congress passed a series of laws regulating various aspects of the financial services industry. Most of these laws were enacted over the strong opposition of the affected industries. Thus, Wall Street opposed the Securities Act of 1933 and the Securities Exchange Act of 1934, the banking industry opposed the Glass-Steagall Act, and the public utility industry opposed the Public Utility Holding Company Act.

But regulation of the investment company industry was quite a different story.

In 1935, Congress directed the Securities and Exchange Commission to study the investment company industry. After six years of study, the SEC issued a 5,100 page report and proposed strict legislation.

The leaders of the industry could have opposed enactment of legislation, as other industries had opposed other laws. And they might have succeeded. By 1939, the New Deal was running out of steam, Congress did not look forward to drafting a highly complex statute in the face of industry objections, and the nation was turning its attention from domestic issues to the war in Europe.

But, the investment company industry decided to cooperate with the SEC in formulating a law. The industry saw enactment of a federal Investment Company Act as an opportunity to prevent abuses and to create public confidence in the industry.

Industry leaders formed a task force that engaged in five weeks of intense negotiations with the SEC. These negotiations produced the legislation that was enacted by Congress in 1940.

This remarkable cooperation between the industry and the SEC was hailed by SEC Commissioners, by members of Congress, and by President Roosevelt when he signed the Investment Company Act of 1940 into law.

It is interesting to note that the SEC originally wanted to impose economic regulation—for example, by limiting the size of a fund to $150 million, by limiting the number of funds a single firm could sponsor, and by dictating the basis on which management compensation could be paid. These economic provisions were not part of the final act. I believe that this turned out to be a very good thing—for the industry, for investors, and for the SEC itself.

The Investment Company Act of 1940 is generally considered the most complex SEC statute. Mutual fund activities are subject to pervasive substantive regulation that goes far beyond the disclosure and antifraud provisions of the other federal securities laws. For example, the Investment Company Act contains provisions providing for simple capital structures, assuring the integrity of fund assets, prohibiting or regulating conflicts of interest, and providing for shareholder democracy. Restrictions are imposed not only on the fund themselves, but also on their investment advisers, principal underwriters, directors, officers, and employees.

The Investment Company Act of 1940 encourages SEC-industry cooperation. The act essentially took snapshots of good business practices that existed in 1940 and froze them into law. Escape valves from this rigid structure were provided by giving the SEC broad rulemaking and exemptive authority. It therefore became a necessity for the SEC and the industry to cooperate in fashioning appropriate rules and regulations to meet changing conditions. Indeed, it was a realization of the need for this ongoing cooperation that led the industry to convert its ad hoc task force into a permanent association, the Investment Company Institute.

In the years since the passage of the Investment Company Act, the mutual fund industry, through the Institute, has continued to cooperate with the SEC. We comment on SEC proposals. We often provide the SEC with our own suggestions for change. Sometimes our suggestions are designed to modify outdated regulatory requirements. Other times, our suggestions call for more regulation to meet new problem areas. And we often develop recommendations for voluntary industry self-regulation, as in the area of personal investing by mutual fund managers.

New entrants in the mutual fund industry and outside observers often remark on how unusual it is for an industry to call for strong regulation of government, and for even higher voluntary standards. But these are hallmarks of our industry, and I am convinced that they are keys to our success.

Over the last half century, the industry has undergone continuous change in types of funds, types of fund sponsors, and distribution methods. In 1940, as I mentioned earlier, mutual funds were almost entirely invested in domestic equities; today, there are money market funds, bond funds, and international funds, in addition to domestic equity funds. In 1940, most fund sponsors were firms whose only business was advising and distributing mutual funds. Over the years, investment counseling firms, insurance companies, broker-dealers, investment banks, industrial firms, and foreign companies have entered the U.S. mutual fund industry. In 1940, most funds were sold by full service broker-dealers. Today, funds are also distributed by financial planners, insurance agents, banks, discount brokers, and directly by fund organizations themselves.

With all of this vast growth and change, the Investment Company Act of 1940 has withstood the test of time. Over the past half century, the mutual fund industry has avoided the kinds of problems and scandals that have repeatedly wracked other segments of the financial services industry. And we have few individual regulators: the SEC division which is responsible for mutual fund regulation has fewer than two hundred employees, in contrast to the over 40,000 individuals who regulate banks.

The work of the Investment Company Institute has changed as the industry has changed. In 1940, the Institute's almost exclusive focus was on SEC regulation under the Investment Company Act. Over the years, the Institute became involved in other regulatory areas, such as mutual fund taxation, state securities regulation, and retirement plans. Soon after the creation of the Institute, it was realized that economic data on the industry was needed by regulators, the media, the public, and the industry itself. Therefore, for decades the Institute's Research Department regularly has compiled and disseminated economic information on the industry. Our Research Department has also played a critical role in providing economic analysis in connection with scores of legislative and regulatory initiatives. And the Institute's Research Department regularly conducts studies that assist members in setting their individual marketing strategies.

The growth and change in the mutual fund industry has raised a number of economic policy issues, and our Research Department, headed by John Rea, increasingly is devoting its time and resources to these policy issues.

Indeed, today's conference is intended to promote discussion, dialogue, controversy, and hopefully a better understanding of some of these policy issues. Let me enumerate a few issues.

1. Shareholder Behavior

Some allege that when market has its next major break, mutual fund shareholders will panic and redeem in droves, forcing portfolio managers to dump securities, pushing stock prices down even further, and causing a "run" on funds similar to bank runs. Based on this thesis, Henry Kaufman has urged governmental action now to limit redeemability. In contrast, other observers, such as Richard Lipstein of the Solomon-Page Group, claim that "the small investor has been less prone to overreact" than institutional investors to big market moves. Others believe that fund shareholders will actually buy more fund shares in market dips. I believe that fund shareholders will behave as they have in other market breaks: they will not engage in panic redemptions, but they will lessen their new purchases of fund shares.

Which view is correct?

2. Investments by Shareholders in Retirement Plans

Some claim that investors in 401(k) and similar retirement plans are overly conservative in saving for their retirement and are investing too heavily in short-term instruments, such as guaranteed investment contracts. Others allege the opposite—these investors are too influenced by the recent bull market in stocks and invest too heavily in equities.

Who's right?

3. Industry Concentration

For years, I have read articles claiming that the mutual fund industry is consolidating and that there will be fewer and fewer firms in the business. Yet, whenever I ask the Institute's Research Department for hard data, it provides me with evidence that the industry has grown less concentrated over time. Will the industry continue to grow less concentrated, or will there be a move to more concentration, or will things remain pretty much as they are?

These are the types of issues that the Institute's Research Department is considering. And they are the types of issues we will discuss today. We want your active participation. So after each panel, there will be ample time for questions and answers.

And we don't want today to be the end of your involvement. We'd like to continue this discussion with you after today's conference ends. To help us do this, we'd very much appreciate it if, after the conclusion of the conference, you would complete and return the evaluation form.

Organizing the industry's first economic conference has required a great deal of hard work. I'd like to thank our panelists who are drawn from industry analysts, academia, and the mutual fund industry itself. I'd particularly like to thank John Rea, the Institute's Vice President-Research and Chief Economist, and Paul Stevens, the Institute's Senior Vice President and General Counsel. This conference was their idea and they were the people who put it together.

Finally, I'd like to thank all of you in the audience, today, who have taken time out of your busy schedules to be here. I hope that you find this conference useful and that it is just the beginning of a discussion of economic issues in the mutual fund industry.

Thank you.
