

## 2004 Tax and Accounting Conference: Keynote Address

# 2004 ICI Tax & Accounting Conference

Keynote Speech by

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### Introduction

Good morning and welcome to the Investment Company Institute's 2004 Tax and Accounting Conference. I'm Elizabeth Krentzman, the General Counsel of ICI. As many of you know, I joined ICI just a few months ago from Deloitte, where I was the National Director of the Regulatory Consulting Practice for seven years.

It is a pleasure to see so many old friends and colleagues here today. For those of you who do not know me, I am a mutual fund person. Like many of you in this room, I have been in this industry my entire career. After law school, I worked in the '40 Act practice at Ropes & Gray and then spent just over six years at the SEC. During this period, I've seen the industry go through many changes.

Today, I would like to review briefly where we've been and the current state of the mutual fund industry. I would then like to share my thoughts about where the fund industry is going and the roles we all must play in helping the industry get there.

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### Reflection on Past Year and Current State of the Industry

Let's start with where we've been. Last year's conference began just 12 days after the mutual fund scandal broke. At that time, the scope of the scandal was not clear. One thing that was clear, however, was that we were entering a period of change.

Over the past year, the fund industry has been under intense scrutiny. This scrutiny has come from Federal and State authorities, the Congress, the media, industry critics, and, most significantly, fund investors.

Since September 2003, members of Congress and regulatory agencies have put forth an unprecedented stream of reform proposals. Most of the SEC's mutual fund reform initiatives have been adopted. I believe the Congress has appropriately taken an active

oversight role, while deferring to the agency to craft responsive regulatory requirements.

With so much focus on our industry, there is no question that the past year has been extremely tough. The recent scandal has challenged us to raise the bar of our already high standards and be more diligent, more rigorous, and more uncompromising than ever before. History will judge whether we have met that challenge. Much will depend on how we navigate the road ahead.

## The Road Ahead

So where should we as an industry be going, and how do we get there? There is an ancient proverb that says that chaos gives rise to opportunity. If this proverb is true – as I believe it is – then we are in the midst of almost limitless opportunities. As an industry, we must take advantage of these opportunities to sustain and strengthen investor confidence and trust.

To do this, we must begin by renewing our commitment to the simple, overarching principle that has helped us succeed in the past. We must put fund shareholders' interests first. In this post-scandal environment, the reform process is an important part of firmly reestablishing this principle.

Undoubtedly, going through a reform process can be very painful, and quite frankly more than a little scary. At the same time, being at the ICI has given me an important and comforting perspective on the history of our industry.

In 1940, industry leaders faced another crisis in response to countless scandals involving investment pools. Rather than resisting reform, industry leaders called for strict regulation. By working closely with the Congress and the SEC, the industry helped enact the Investment Company Act of 1940. As some of you may know, at a dinner of government and industry leaders celebrating the Act's adoption, it was suggested that the industry form an association to continue the constructive dialogue that resulted in the 1940 Act. The Investment Company Institute was the result.

This history is instructive. While the road ahead will lead us in some new directions, in many ways we are traveling down a familiar path in embracing constructive regulatory change. But we do so today with a deeper and sobering understanding of what is at stake.

I would like to turn to a few initiatives that we at the Institute are pursuing to help the industry move forward. While I could go on and on about these initiatives - and others - I'll be brief. I understand all too well that most of you probably have tee times later today.

## Compliance Issues

Let me start with compliance. As a threshold matter, a strong compliance culture is a necessary foundation for advancing shareholders' interests. In the last few years, scandals in the corporate world have led to a series of legislative and regulatory reforms affecting accountants and auditors. These new laws have strengthened the role of accountants and auditors, while holding accounting professionals to ever-stricter standards. Many of you have been on the front lines at your firms. You have implemented requirements under the Sarbanes-Oxley Act that are designed to enhance compliance and accountability.

As I'm sure you are aware, as of tomorrow, all mutual funds will be required to have a formalized compliance program and a chief compliance officer to administer that program. Some of you may be surprised to hear that ICI first called for a compliance rule ten years ago. It is impossible to say whether, if the SEC had adopted a [compliance rule](#) sooner, the recent scandal could have been averted. As the rule expressly recognizes, even the best compliance system cannot guarantee 100 percent success. But the rule has given the industry a unique and valuable opportunity to enhance existing compliance programs and strengthen our culture of compliance.

To assist members in implementing strong compliance programs, ICI has formed a new standing committee comprised of chief compliance officers. The committee will provide a forum for CCOs to interact with their peers, share their perspectives on the compliance challenges they face, and expand their knowledge of industry compliance practices. The committee will hold its first meeting next month.

## Fair Value Pricing

ICI is seeking to assist members in another important area as well – [fair value pricing](#). It goes without saying to this audience that pricing is a critical aspect of our industry. For obvious reasons, there are few things that are more important to a fund than calculating its NAV.

Over the past year, fair value pricing has been in a unique spotlight. In large part, this heightened focus is due to the relationship between fair valuation and market timing and, in particular, the ability of market timers to capitalize on stale prices.

As part of the spotlight, some have suggested that if funds use fair value prices every day, there would be no market timing. On this point I must disagree, and it's important to inform the discussion about the reasons why.

First, the goal of fair value pricing is not – nor should it be – the elimination of any particular trading strategy. The goal of fair value pricing is to estimate, in good faith, the current value of the fund’s portfolio securities.

Second, some seem to believe that there is a single “right” fair value price for every security. That is simply not the case. Fair values are, by definition, estimates, and different funds, exercising good faith, reasonably can arrive at different prices. The key point here is the presence of good faith and a robust process. As long as a fund arrives at a fair value price in good faith in accordance with its board-approved procedures, the resulting price is as correct as it can be. This has long been recognized by the SEC and its staff as one of the bedrock principles of fair valuation.

Finally – and importantly – while fair value pricing is part of the solution to the market timing problem, it is not a silver bullet. Professor Gregory Kadlec, a noted academic in this area, recently authored a study that concludes that no matter how sophisticated the model for fair value pricing, it is not the “end-all be-all” solution to market timing. Rather, other trading frictions such as [redemption fees and short-term trading prohibitions](#) are also necessary to stop market timing in mutual funds. Professor Kadlec is absolutely right.

None of this is to say that funds should not fair value or that the spotlight on fair valuation is inappropriate. Just the opposite – given the events of the past year, funds absolutely should be focusing on their fair valuation procedures to ensure that they are as robust as possible. These efforts serve a core objective of the 1940 Act – insuring fair valuation of investor purchases and redemptions.

## Pro-Investor Disclosure Issues

Now, I would like to turn to another core principle that benefits investors -- full and fair disclosure. While disclosure has many facets, I will focus my remarks today on [disclosure in the retirement plan context](#).

Everyone in this room should be proud of the role that mutual funds play in serving America’s retirement needs. Mutual funds are the investment vehicle of choice for defined contribution plans. Mutual funds manage nearly half of all defined contribution plan assets and nearly half of all 401(k) plan assets. Meeting the retirement needs of America’s workers is a critical goal for the industry. We can all appreciate that meeting our individual retirement needs is an important goal for each of us.

Less than two weeks ago, I [testified on behalf of the Institute](#) on disclosure issues before the Department of Labor’s ERISA Advisory Council. Our testimony called for additional and more uniform disclosure to plan sponsors about the costs of a plan’s operations and the costs of the plan’s investment options. We also strongly supported disclosure about compensation arrangements, including revenue sharing, between service providers. Given the evolution and complexity of compensation arrangements in the retirement arena, we recommended the formation of a Task Force to assist in developing a disclosure regime for plan sponsors. We are already contacting sponsors, service providers, and investment product providers about this important effort.

Our testimony also called for better disclosure to plan participants. 401(k) participants that invest in mutual funds typically receive important information about a fund’s investment objectives, performance, and fees. With other types of investment products, participants may receive far less.

We want to change this result. Our testimony recommended that participants be provided, upon request, with an easy-to-read “investment summary” for all investment options available under the plan. This disclosure would help participants make informed decisions by explaining the key features of all investment options offered under their plan.

We also recommended that the Advisory Council strongly encourage and facilitate the use of electronic media to provide these disclosures. Like other statutes enacted before the internet explosion, ERISA requires paper documents -- which can be expensive to prepare and burdensome to distribute. Electronic dissemination of information offers significant opportunities to make information readily accessible.

## Buy-Side Initiatives of Interest to Tax and Accounting Professionals

Before concluding, I would like to touch upon one last area in which investors have a significant stake -- buy-side issues.

Tens of millions of individual investors participate in the U.S. capital markets through mutual funds. On behalf of investors, funds hold approximately \$4.2 trillion in equity and fixed income securities of U.S. corporations. As one of the dominant players in our capital markets, we have a keen interest in issues involving the regulation and integrity of those markets. In our increasingly active role as an advocate for the buy-side, the Institute seeks to promote the interests of fund and other investors.

An issue that we have weighed in on recently I know is of particular interest to this audience. It involves the [accounting treatment for stock options](#). We believe that accounting principles should ensure full and fair disclosure of a company’s financial results and condition. For this reason, the ICI several years ago called for the FASB to [require the expensing of stock options](#). More recently, we supported the FASB’s proposal to require such expensing. The Institute’s view is that rigorous accounting and disclosure requirements, including expensing of stock options, are necessary to promote investor confidence in our capital markets. The FASB

proposal will improve transparency and benefit all investors, whether they invest in equities through mutual funds, through other investment pools, or directly.

I know you will hear a great deal more about additional accounting and tax issues over the next three days.

## **Conclusion**

In closing, I would like you to think about two numbers -- 95 million and 7.4 trillion. Our industry provides professional services to 95 million Americans who have invested \$7.4 trillion in mutual funds. These two numbers should humble us all. They also should inspire us.

Notwithstanding the challenges we have faced in the past year, mutual funds remain the most powerful investment model for the average American. We must not run from the challenges that remain before us. We must not blame others. We must prepare ourselves to be held to even higher ethical standards than before. We must take the lead in ensuring that mutual funds provide investors with value and help ensure their financial security.

All of us, including tax and accounting professionals, have a role to play. And if we all abide by the enduring principle of putting the interests of fund shareholders first, the future of our industry will be bright indeed.

Thank you.