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PANEL DISCUSSION

Regulation of Investment Funds, Investment Managers and Market Professionals: Are Changes Needed in Order to Protect Investors in the Next Decade?

November 14–15, 2001
Washington, D.C.

Regulation of Investment Funds, Investment Managers and Market Professionals: Are Changes Needed in Order to Protect Investors in the Next Decade?

The panel was asked to address the following questions:

- Should there be a more functional regulatory pattern for money management services offered through broker dealer discretionary accounts, investment adviser mini accounts, on-line portfolio services, hedge funds, bank trust departments, and investment companies?
- Is there a need to create a self-regulatory organization for the investment management industry?
- How can national regulators effectively supervise investment management activities in an era of globalization, where local service providers are subject to regulatory requirements that cut across legal and territorial boundaries?

PANEL CHAIR

David Silver, former Chairman, Investment Company Institute

PANELISTS

James Dannis, Berens Capital Management

Kathleen H. Moriarty, Carter, Ledyard & Milburn

Robert C. Pozen, Vice Chairman, Fidelity Investments

Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission

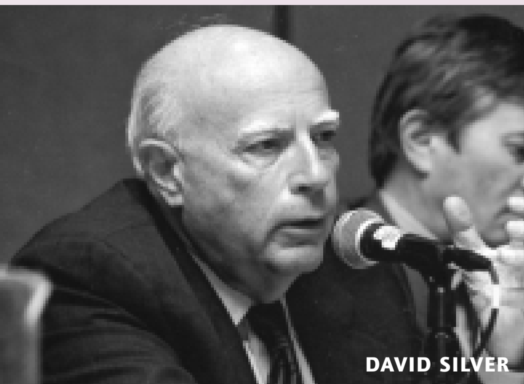
Steven M.H. Wallman, President, FOLIOfn, Inc.

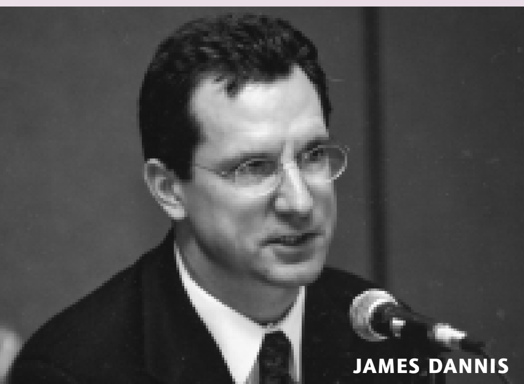
Steven K. West, Sullivan & Cromwell

Stuart Willey, Chief Counsel, Investment Business, Financial Services Authority

Mr. Silver initiated the discussion by presenting an overview of the current debates. He noted that the mutual fund industry is now a $7 trillion industry, with new investment products accounting for over $750 billion. He then asked whether the investor protections available under the existing regulatory framework, the Investment Company Act of 1940 (the "Investment Company Act"), the Investment Advisers Act of 1940 (the "Investment Advisers Act"), the Securities Act of 1933 (the "'33 Act"), the '34 Act and NASD Regulation, are intended to apply to new investment products and, if so, whether the existing regulatory regime provides adequate protection to investors in these new products.

Mr. West detailed generally the aspects of pooled investments that the Investment Company Act regulated, including: governance, management and distribution fees, capital structure, disclosure, custodial requirements, regulation of distribution of open-end fund shares, issuance and redemption and repurchases of shares to protect shareholders and investors from dilution of their asset value, distinctions between closed-end and open-end structures, and self-dealing and conflict protections for transactions with affiliates. Mr. West focused in particular on the prohibitions against self-dealing and transactions with affiliates covered by Section 17 of the Investment Company Act and stressed that these prohibitions were very important for investor protection.


DAVID SILVER


JAMES DANNIS

KATHLEEN H. MORIARTY

ROBERT C. POZEN

Exchange Traded Funds

Ms. Moriarty elaborated on the background to and regulation of exchange traded funds. Exchange traded funds, which are registered under the '33 Act and the Investment Company Act, issue two classes of equity; one of which trades like shares of conventional closed end funds and the other of which consists of "creation units" that offer a net asset redemption-in-kind privilege to investors who buy them in large units consisting of the underlying portfolio securities. This allows for arbitrage based on the redemption feature. These features were developed to address the problems with closed-end mutual funds of the gap between net asset value per share and the price at which shares were traded. Exchange traded funds are designed to operate within the existing confines of the Investment Company Act. The panel debated whether the Investment Company Act provides adequate protections, in particular, with regard to arbitrage activity and allocation of profits.

Web-based Portfolio Services

With regard to web-based portfolio services, Mr. Wallman gave a presentation of FOLIOfn products, which provide the diversification available from mutual funds, but are individual investments in individual stocks that permit investor control over each stock investment. The SEC has not yet expressed a view as to the appropriate level of regulation, and the panelists debated whether the platform which these products are offered to the public should be regulated under the broker-dealer regime, investment adviser regime or the Investment Company Act. The panelists' views depended on the aspect of the folio products on which they focused. Mr. Wallman argued strenuously that regulation of these products, beyond that associated with broker-dealers, was inappropriate in light of the level of investor control present. Mr. Roye said that the SEC is continuing to monitor folio investing to determine whether increased regulation would be appropriate.

Hedge Funds (and funds of funds)

Mr. Dannis addressed the regulation of hedge funds. Hedge funds are targeted to sophisticated investors and are largely unregulated. They typically qualify for exemption from regulation under the Investment Company Act because they either have fewer than 100 beneficial owners or they are marketed only to "qualified purchasers" within the meaning of Section 3(a)(7) of the Investment Company Act. While hedge funds present certain risks that the Investment Company Act addresses (e.g., conflicts of interest in fund management and informational asymmetry between managers and investors regarding underlying securities), most

"The SEC has previously confronted the issue of the scope of its jurisdiction in the '40 Act context, most notably with respect to variable insurance products and bank commingled managed agency accounts. However, these products primarily involve the scope of specific statutory exemptions rather than the outer limits of the Act's primary coverage. Recent years have seen rapidly changing technological and financial environments which have spawned new investment products unimaginable 60 years ago. These changes have created multiple challenges involving both the scope of the Commission's '40 Act authority as well as its ability to cope effectively with rapidly mutating products within its traditional jurisdiction."

– DAVID SILVER

"Now I would like to get back to the subject of Section 17 and what I consider the core protective section of the Act, and that is the overall treatment of transactions between a pool and its affiliated persons. I think that these particular prohibitions and limitations are central. And, as I will say later, they should not be fiddled with or eliminated, and, if they are, with great care. There are three reasons for the flat prohibition against a principal transaction between a fund and its affiliated person. Primarily it relates to securities transaction but it could relate to any property. Most people assume that the real problem is fair pricing, fair transfer price between the affiliated person and the fund. And that clearly is one issue. It is the issue which can most easily be addressed if you have liquid markets and market information so that you can test the transfer price with the overall independent market."

– STEVEN WEST

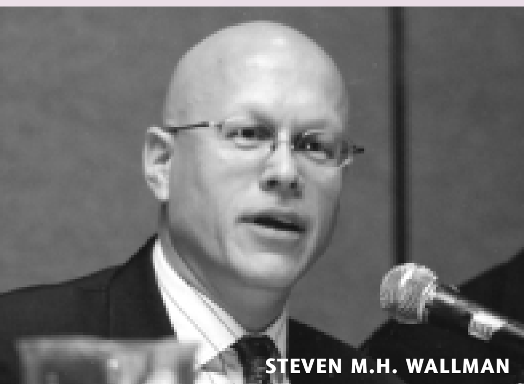
"Ideas in the past that have been floated as sort of alternatives of self-regulation have been notions of fund auditors playing a greater role in terms of reviewing fund operations, the issue of having a designated compliance officer in the fund group who perhaps could report to the board of directors, be hired by the board, work for the fund, and only accountable to the directors to oversee compliance or to monitor compliance. Issues like that would not get you to self-regulation but might be ways to ensure efficient and compliant operations of investment companies."

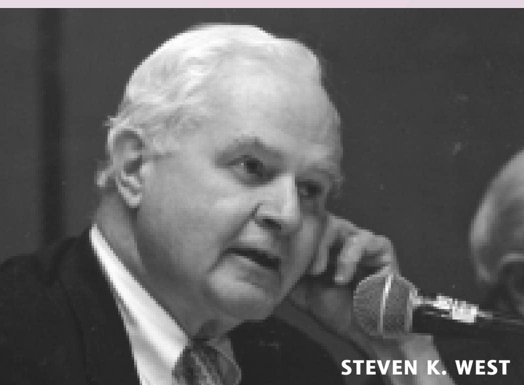
– PAUL ROYE

"If you talk to upstairs market makers, they consistently say that, rather than impeding liquidity, the existence of ETFs has helped liquidity. If you have a market for the underlying shares and then you have futures markets for the same underlying shares and then you have ETFs for the same thing, you have three ways of achieving liquidity and it actually enhances and supports the market. Without being a statistician or seeing all the data, I would think that at least from my own experience and what I've heard that it's rather the reverse, that ETFs help rather than hurt liquidity."

– KATHLEEN MORIARTY

PAUL F. ROYE


STEVEN M.H. WALLMAN


STEVEN K. WEST

STUART WILLEY

panelists agreed that hedge funds currently reflect the necessary degree of management and level of investor sophistication to avoid regulation (beyond that imposed by antifraud regulation under the securities laws). Mr. Roye noted, however, that the rapid growth of the hedge fund industry may require additional scrutiny. For example, the SEC may reconsider the investor sophistication premise underlying the exemption for hedge funds that are funds of funds. He also indicated that hedge funds could easily become regulated under the Investment Advisers Act. With regard to self-monitoring, it was noted that as the hedge fund market institutionalizes, the trend is toward increasing disclosure and increased reliance on intermediaries for due diligence and monitoring as well as informal limits on levels of leverage.

Alternative Regulatory Models

In determining whether certain products should be regulated under the Investment Company Act, the panelists considered the approach taken by the United Kingdom's Financial Services Authority (the "FSA"), which bases its regulation around two activities: the activity of managing a portfolio of investments with discretion and operating or managing a collective investment scheme. The FSA regulation of collective investment schemes extends to those that are not offered to the public, unlike the U.S. regulations. The FSA also undertakes cost-benefit analyses of proposed regulations. Representatives of the folio and hedge fund industries thought that a cost-benefit analysis would help regulators understand the inefficiency of regulating their investment products.

With regard to harmonizing European Union ("EU") and U.S. regimes, it was noted that there are very few examples of harmonization even within the EU. Some panelists felt global convergence would not be feasible although regional convergence might be.

Some panelists expressed doubt that the investment fund area lends itself to self-regulation. They did, however, propose that perhaps funds could designate compliance officers within the funds to monitor compliance with existing regulation.

"The conclusion that I come to as an investor in the market is that the ability of sophisticated investors, be they individuals or institutions, to have access to a highly innovative and highly professional set of money managers is the right balance. The exemptive provisions of the securities law make a very basic judgment or cut. Sophisticated investors should have access to innovative products in the marketplace, and that basically is the judgment that is supporting the exemption for hedge funds."

– JAMES DANNIS

"If the view is that brokerage regulation isn't sufficient because brokers today in an account can take the securities and actually with the permission of the customer and the customer agreement lend out those securities and you don't like that split, then let's address that split. But that's a market regulation issue that should apply to brokerages generally. It's got nothing to do with regard to folios, it's got to do with brokerage accounts and who's got the custody over the assets and where that split ought to be. And one can argue whether or not the money should go to the firm which then uses it to help reduce other fees that the firm otherwise would be imposing on the customer. But I think it makes sense to address the issues instead of making the mistake going forward that we sometimes made in the past which is to address labels and then try to force things into a label formed regulatory structure."

– STEVEN WALLMAN

"The U.K. legislation continues to present complexities in the definition and treatment of investment funds and of discretionary portfolio management activities. The legislation is built around two regulated activities: the activity of managing a portfolio of investments with discretion, and operating or managing a collective investment scheme. To put this another way, a distinction is drawn between a pool of assets which is to be regulated as an investment vehicle, in U.S. terms an investment company, and a separately managed segregated account, portfolio management for an individual. The regulated activity of managing assets belonging to another person describes and covers, for example, discretionary portfolio management where an investor entrusts his money or assets to an investment management firm which will manage them on an individual and discretionary basis. The assets, including if held in a nominee account by the discretionary manager, will continue to be treated as belonging to the customer."

– STUART WILLEY

"On the international front, with respect to asset gathering, we have had very few examples of true harmonization. While the EU is supposed to be a harmonized system, if you go and try to do business there, I can assure you it doesn't feel like a harmonized system because Germany and France and all these countries have different rules. Given this experience, I don't believe we can hope to have harmonized rules across the whole world. I think it's a holy grail that we ought to give up. But what we can hope for is to have large regions – maybe an Asian region, a European region, a North American region – where you can use one set of funds for all countries in the region."

– ROBERT POZEN