Securities and Exchange Commission Historical Society
Interview with Paul Schott Stevens
Conducted on June 9, 2016, by William Thomas

WT: This is an interview with Paul Schott Stevens for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I'm William Thomas. The date is June 9, 2016, and we're at ICI in Washington, DC. So, thanks very much for agreeing to speak with us today. Before we get to your time with ICI, why don't we start with a little bit of personal background, as well as some of your experience prior to this?

PS: I was born in New Orleans. Went to college at Yale and then on to the University of Virginia School of Law.

WT: What did you study as an undergrad?

PS: It was a special major called the Scholars of the House Program. They essentially allowed you to take all of your senior year classes off and write a large paper and audit any course in the university that appealed to you. I wrote a paper about a figure in modern English poetry, and you might say my major was sort of literature and philosophy.

WT: That's very interesting.

PS: Yes. Perfect to later on be involved in securities regulation and capital markets, but it was good preparation for law school.

WT: Did you know you were going into law?

PS: After I graduated from Yale, and that was in 1974, the country was in a very steep recession and it was very difficult to find a job. I thought the law would be a good profession for me. I'd always been involved in speech and debate in high school and forensics argument, so it turned out to be a very good choice. And I had the choice of working on Wall Street, back in New Orleans, or in Washington, and I'm glad, in retrospect, I chose this city to begin my professional life.

WT: So when you were at the University of Virginia, did you know that you wanted to be in a particular area, litigation versus corporate law?

PS: I had the idea of being involved in litigation, white-collar criminal defense. And I went to a firm, then a really up-and-coming firm, Dickstein, Shapiro and Morin, as the forty-second lawyer in what became later a much, much larger firm. And I had an incredible series of opportunities working on lots and lots of different things. Among them were mutual fund–related matters. In fact, one of the earliest assignments I had as a young lawyer was a proceeding at the SEC called *In re Intercapital Liquid Asset Fund, Inc., et al.*, which was the administrative proceeding that essentially authorized money market funds to keep a constant $1.00 net asset value per share.

WT: Oh, well, that came, and that was very relevant later on then, wasn't it?

PS: It was very relevant later on—much later on here at ICI and after the financial crisis. But I did lots of others things as well. It was an incredible training in the law. And I then went into the government for three years—four years all told—in areas completely unrelated to what I've been doing at ICI. I joined the staff of a presidential commission which was working on defense issues, chaired by David Packard, the former head of Hewlett Packard Corporation. Then went on to the White House for two years, where I was the first legal advisor of the National Security Council [NSC] during the Iran-Contra days, trying to set the place right with the team that came in there after that scandal, and then was chief of staff of the National Security Council for the last fifteen months of the Reagan Administration.

Then I went over to the Defense Department, where I was part of John Tower's transition team. Senator Tower did not get confirmed as secretary of defense. And I was invited to remain to help the secretary—who was Dick Cheney at the time—prepare a report to President [George H. W.] Bush on defense management issues. I then went back to private practice and have been out of government ever since.

WT: How did that opportunity come about in the first place? Did you just apply to it, or was there a—

PS: Well, through my varying experiences at the law firm, I had gotten to know a lot of different things about abstruse areas of government regulation and law. I was involved with an independent counsel investigation of Ed Meese, who subsequently became Attorney General of the United States, and it involved things like financial disclosure policy. I got exposed to issues concerning Sunshine in Government, Freedom of Information Act, and a variety of other things.

And so when what was called the Packard Commission—it was technically the President's Blue Ribbon Commission on Defense Management—was being organized, a partner at Dickstein was going over to be the executive director and asked me to come over as general counsel, so I could help make sure that the Defense Management Commission didn't mismanage its own affairs. I ended up doing what many lawyers do: rolling up my sleeves, understanding the issues, and I eventually was the principal staff author of the Commission's reports to President Reagan.

And it really was an extraordinary group of Americans. Rod Hills's wife, Carla Hills, was a member of the Commission; Frank Carlucci; a celebrated group of Americans. And then when the Iran-Contra affair hit, President Reagan asked Frank Carlucci to become National Security Advisor, and he invited me, with President Reagan, to come over and to be the first legal advisor to try to help sort out the affairs of the NSC. I ended up being tasked with reviewing all of these covert action programs at the CIA, rewriting the rules for how the NSC system would operate, and rewriting the rules for the approval process for these intelligence programs.

And it was truly a fascinating assignment. There still are legal advisors of the National Security Council, and it's a very important position over there on the staff. And then I became the chief of staff, essentially the third in line at the NSC, running a staff of about 200 policy and administrative professionals for the President.

WT: I'm sure we could talk about it all day. And I'll just limit my questions to asking about whether you found that that experience translated into your subsequent experience in the investment company area.

PS: Yes, in a number of different respects. Obviously, the areas of the law and the policy issues are very different. But experience at the White House at a senior level, the way I was, really gives you an understanding of how this town works, the relationships between the executive branch and the Congress. I think the experience of being asked on very short notice, I'm talking about five or ten minutes, to accompany the National Security Advisor to brief the President in the Oval Office on a particular issue—after that, nothing else holds any terror for you. So it gives you a sort of self-confidence in dealing with senior government officials and the like, and a degree of seasoning. And I was doing all that at age 35. So I think it prepared me for increasingly significant responsibilities, including the job I currently have, which has really been, I think, the highlight of my career.

WT: So you were back in private practice for, it looks like, about four years.

PS: Yes.

WT: Were you working in the same areas as you were before, or the same breadth of areas?

PS: Yes. I was working with mutual fund clients, had corporate clients that I was involved with. I argued a case in the United States Supreme Court, having nothing to do with securities. It was a Foreign Sovereign Immunities Act issue. That, too, is a remarkable experience. I actually think of the roles that I've had as appropriate to a litigator or advocate over the years, but I've just been working in different kinds of courthouses.

WT: So then, ultimately, it was in 1993 that you came here to ICI for the first time as general counsel.

PS: Yes, that's right.

WT: How did that opportunity come about?

PS: They were a client. Matt Fink, my predecessor as president here, was, I think, feeling his way toward greater involvement by ICI on international issues. And I had had an opportunity, after I returned to law practice from the government, to go and spend a considerable amount of time in Japan as a U.S.-Japan leadership fellow. This is something that the Japan Society in New York had sponsored as a program to get

Americans and Japanese into closer relationships, understandings professionally—a mid-career fellowship, if you will.

It was a wonderful experience. And it just so happened that ICI was looking toward an initiative in Japan to encourage the Japanese to liberalize pension investment mandates to non-Japanese investment advisers. I helped advise and guide the Institute as they were working through that process, and so they became a client. There came a point in time when the general counsel's position became vacant, and Matt said, "Would you like to come over and tackle it?" And I agreed. It was a wonderful four years, and we had a lot of exciting stuff that we worked on.

WT: So there are a lot of particular issues. I would like to start generally, though, with the context of the mutual fund industry and investment company industry in general at the time. The 401(k) revolution had happened. Later in the decade, there's the booming stock market. How did that influence the issues that you saw at ICI at that time?

PS: I think when I arrived here in 1993—in fact, I've got a chart that I'll show you—industry assets were about $2 trillion. And during that four-year period, they may have doubled to almost four. The wind was clearly at the back of the industry in those days. And the issues that we were wrestling with were how to serve fund shareholders better through the disclosure regime, working with the Commission, and encouraging modifications to that. We certainly were wrestling with issues concerning state regulation of mutual funds that were resolved, more or less, during that four-year period, and have not been a feature of the Institute's policy work since.

I would say that the disclosure issues were a major preoccupation. We all realized at the time that fund disclosure documents were simply too cumbersome, too detailed, too lengthy to serve people very effectively. And the Commission was wrestling with the choice of what to do about that, because it did not want to deprive people of information in the marketplace, on the one hand, but realized that the documents that were being distributed really weren't, for most ordinary investors, serving the kinds of needs that they clearly had.

WT: Was the sense of the ordinary retail investor—was there a sense that that was a really new concern, or had that dated back some years before that?

PS: Well, it probably has been something that the industry has been wrestling with for a long time. I think of the way that the industry has evolved as in different stages. And one particular stage that predates the time that I was here as general counsel is a stage in which most investors got to know mutual funds for the first time, and that's through money market funds at the time of the very, very high rates of inflation, where people were trying to get a current return on cash that they simply couldn't through a depository institution. So money funds really introduced people to the powers and values of mutual fund investing in a definitive sort of way. That was then followed by—and if you think about the Reagan presidency—a huge bull market that began in the early Eighties. And so equity investing became a real focus for the industry.

And the industry kept maturing over that period of time. You're right, the 401(k), which you can date back to the seventies, was just coming on stream, and people were seeing mutual funds in that form as well, so that by about 1993, the installed base of assets invested in mutual funds had reached a pretty significant level in terms of what were the investable assets at the time in the United States. So these issues were about, "Are we serving people really well? Are we informing them? Are they sensitive to the key things that they need to know about their funds?" Cost is a very important aspect of the risks associated with fund investing—those were really, I think, front and center of the Commission's concerns at that time.

WT: Let's talk about some of the specific things that were going on with disclosure. In the Eighties you had the invention, as it were, of the two-part disclosure with the statement of additional information. What was the status of that at that time? I know that in a couple years, you get the profile prospectus.

PS: Right. Well, I think people realized that the two-part prospectus was a useful device. Again, you're taking some of the hugely detailed information that might be of interest to a financial adviser or an institutional investor, and making it available, but not trying to circulate it to people. But nonetheless, what was remaining was a very lengthy document. Matt Fink articulated this notion of disclosure creep that no doubt he spoke about in his own interview. That was because as events in the market occurred, the instinct of the [SEC] staff was to require more and more disclosures about risks or aspects of the fund or the markets that they invest in. And so in addition, issuers, the funds, and their advisers, had every reason to try to make sure that there was stuff in the prospectus, because they didn't want to be accused of having misled by omission, omitting things in the prospectus that an investor might be interested in, and would be important as a way of defending the adviser or the fund in the event of a lawsuit later on.

So there were lots of forces even in the first of the two-part prospectus that would make it grow. The idea was—and it's one I spent a lot time on as general counsel here—how can we develop a summary prospectus, a profile prospectus? And in that regard, I think that it's particularly noteworthy, because this was about 1993 or 1994, Matt really made an important strategic decision, which was to invest in a greatly expanded research effort here, something that I encouraged very much. ICI had always historically been a research organization, in that we collected industry statistics and we reported them to the government.

We were the principal source to the SEC, to the Federal Reserve, and others about trends in mutual funds at that level. But this was mostly a statistical collection and reporting activity. It didn't have a lot of analytical aspect to it, and so in the mid-Nineties there was a decision that we really had to add that. We had to add it, I think, because the industry was becoming so large and significant. And there really was not much academic interest in the mutual fund industry at the time. Academic interest was elsewhere—

banking, insurance—not on mutual funds, because they were fairly new and not well understood.

There also was not, at that time, much in the way of capacity at the SEC to do econometric analysis. So we began to build a research team, and John Rea was our first chief economist. I worked with him. Matt actually put the research staff under me as general counsel, so the chief economist reported to me. And I was incredibly enthusiastic about the prospects that research would provide to us, to understand the industry, the markets we're investing in, the retirement arena, which was so important, and would add a lot of perspective to what we could contribute to the SEC in regulatory policy contexts.

And I'm getting back to the disclosure issue now. One of the early projects for our research staff was to try to understand what it is that people need and want by way of disclosure. So we worked with our members to put together, if you will, a sample profile prospectus, which we then field tested. We had focus groups, and then we did surveys. So that in the early industry proposals, in those days to the SEC, to get a short-form prospectus, it was substantiated by the research that we did and the polling and survey results that we could provide about what helped people and what didn't, what information they thought was most important, and what forms they would prefer that information in. In many respects, it was a fairly commonsense exercise. But it was the first time the SEC tried to provide any scientific support around that. The SEC is a wonderful organization, but it has largely been dominated by lawyers throughout its history.

Lawyers tend to be normative thinkers. They look at standards. They're not typically disciplined to look at data and facts. And I think supplying the two: normative understandings of the policy universe that the SEC is working in, but informed by facts that represent the truth on the ground for our investors or our markets or whatever it might be, that's a powerful combination. And so I would say in the mid-Nineties ICI began, in earnest, to try to put those two together, and the first target was disclosure reform.

WT: One issue concerning disclosure that I've run across in looking at newspaper accounts of the period was the question of risk and bond funds and how that should be characterized in disclosure. Could you provide an example of this research that you're talking about and the role of ICI in trying to come to a position on something like that?

PS: Well, you know, the thing about bond funds, and we continue to worry about it today, is whether people who are investing in bond funds understand that when interest rates go up, the value of their bonds goes down. It's kind of counterintuitive. You would think, "Oh, well, I'm getting more interest on those bonds." Well, no, you're not. If you have bonds that already have a coupon, in order to sell those in the market you've got to adjust it to what is the current market price. There was a big boom in bond investing at the time.

And I think there was a real concern in those days that there was going to be a huge bust in bond investing, too, when interest rates went up and people realized that they were going to have a hit to their principal as a result. There were, no doubt, some surprised investors. I don't think we had a bust by any means. The example you cite, I think, underscores what has been a perennial concern, which is trying to improve levels of financial literacy and sophistication among our investors.

I think over time, we've done a lot of that. I would never say, "Mission accomplished." Because there's a whole new generation of investors always coming to the table that you have to educate. We are not, as a nation, yet set up through our educational system and otherwise to supply that deficit. So, government is concerned about that and certainly industry and our members have been concerned about it.

WT: I know that this area was also a major concern to Arthur Levitt from the first.

PS: Yes.

WT: When he first arrived at the SEC as chairman, could you tell me a little bit about working with him, and what it meant to have somebody with that interest working at the SEC?

PS: Right. Well, I associate our closest engagement with Chairman Levitt around an issue of personal investing by fund portfolio managers. There were issues that arose at the time that he was chairman concerning portfolio managers for funds who were trading for their personal accounts in companies that they were also buying or selling for the fund. And obviously, that presents the possibility of a serious conflict of interest. The investing opportunities that are discovered by a portfolio manager during the course of his or her responsibilities for the fund are opportunities for the fund, not for the manager.

There was a huge outcry about the need to develop tighter standards around personal investing by essentially fund advisers and personnel serving the fund shareholders. That's a great example of something that ICI has faced in other contexts. Because what we did is put together a working group to try to develop standards for the industry and standards to recommend to the SEC about how to address the problem. It was a project that I worked on as general counsel, with a whole range of our industry senior leadership. We put out a very, very detailed report. And I remember very distinctly that when Chairman Levitt was speaking at an ICI event, he was quite generous in his praise for the work that we had done. Because it took what was a very difficult issue and removed it in some respects from the SEC having to address it entirely through regulation, and helped to move the ball considerably down the field by way of industry standards that the SEC then could work from, in order to make sure that the safeguards were appropriate and in place. So this is an example, and I could cite many others, of ICI working very collaboratively with the SEC in ways that ultimately help fund shareholders.

WT: I know that in some of Levitt's speeches, at least one or two, he would have in his back pocket the possibility of an investment company SRO. I know that those were never serious proposals, but at the same time, they were there. And Matt Fink mentions them in his book.

PS: Right. Yes, I seem to recall that Arthur may have actually thought that ICI was an SRO before he became chairman of the SEC. And that's always something I thought was nice to think, because it means that we were associated with solving problems and trying to promote sound structures that help fund shareholders. Yes, Chairman Levitt did have the idea, potentially, of doing that. You know, the growth of the industry, the number of different players involved were, I think, imposing significant demands on the SEC.

This organization has never supported the idea of a fund SRO, frankly, because we think that the SEC has done a very good job. We'd much prefer working directly with our regulator. An SRO, in any event, is going to have to be both an SRO and ultimately accountable to the SEC, so it simply adds another layer of regulation, in a sense.

WT: It would have to be funded by the industry as well, of course.

PS: Yes. But I don't think that was the primary consideration by any means. It was more that we think the current arrangement is working very effectively. But we also gave a lot of consideration to what might be alternatives. And here my involvement at the Packard Commission on these defense issues has some real bearing on what I had recommended and what eventually transpired in this industry. At the time of the Packard Commission's work, there was a huge scandal concerning spare-parts procurement. For a lot of complicated reasons, you could look at a defense contract, and if you were looking at the spare parts, the parts would just have flabbergasting numbers associated with them. You know, a toilet seat might cost $900. Only DOD could find a $900 toilet seat, right?

But it raised all sorts of issues, because at the same time there were scandals in defense contracting, cost overruns, fraudulent activities, and things of that sort. And so working with the members of the Commission, and with Carla Hills in particular in the lead on this, we developed, with the defense industry, standards of business ethics and conduct. And these were standards that were voluntarily embraced by major defense contractors, implemented across their firms. There was a lot of detail to them. It was a challenging undertaking to move an industry like that in this direction, but it struck me as probably more likely to have prospects for success, than simply trying to superimpose it through regulation or enforcement and the like.

You've got to have it come from the bottom up as well. So when we were thinking about the idea of a fund SRO, I observed to Matt that maybe what the SEC really should do instead is lay down certain expectations for what the compliance organizations within funds and their advisers should look like, and establish, if you will, minimum industry standards around that. You know, we thought about the idea. We worked with our members around the idea.

Matt eventually submitted a proposal to the SEC along those lines about elements of compliance programs that would be common across the industry, the role of a chief compliance officer [CCO], and things of that sort. The SEC never took up the proposal, certainly not under Chairman Levitt, although it did return to it a number of years later.

WT: I wanted to ask specifically about what the similarities and differences might have been between that proposal and the one that was ultimately the subject of rulemaking in 2004, I think.

PS: Well, I've not gone back and looked at it in quite some time. But one specific thing I know that we expressed a concern about to the Commission is that the compliance rules should not, in themselves, become a compliance trap. You were trying to encourage people to put a vigorous, effective structure in place. They had every reason, I think, to do that. But we worried about enforcement actions against CCOs, if for some reason the compliance program had a failure. I think we were certainly concerned that this not be looked at as some sort of guarantor that there would never be a compliance lapse. Human nature is just not equal to that proposition.

And we thought that the SEC should be very supportive of these structures and the people who were put in place to help administer them, in order to provide positive encouragement and support for them to do their jobs within the firms. I worry that the compliance rule has not quite lived up to that or the SEC's relationship with compliance officers did not quite live up to that. I think that there's been evidence of a more adversarial relationship than probably is desirable on certain issues and at certain times. Nonetheless, I think it has been a remarkably effective standard in the industry. And it's certainly helped to minimize compliance lapses and to serve the interests of investors very effectively. So I think it really has earned its place, if you will, in the SEC's regulatory strategy for the industry.

WT: Back in the Nineties, was it common for companies to have a chief compliance officer, or some similar position?

PS: Some did. Some didn't. I don't think many of them had one that would report to the independent directors on the fund's board the way that they do now. Some had internal audit functions. More recently, they have risk-management functions. As you know, there's got to be a CCO for the fund, and there's got to be a CCO for the adviser, and different companies structure those responsibilities differently. But I don't think anyone had it quite exactly the way the SEC rule had proposed. Indeed, I would say that the original ideas behind ICI's proposal were looking at what the best practices were across the industry and saying, "We can standardize those."

WT: Coming back to the disclosure-prospectus issue, one of the things that Arthur Levitt is most associated with is plain-English requirements. What was the implementation of those requirements like in the industry?

PS: You know, I think everyone would acknowledge that plain speaking is a really desirable thing in all the documents that we prepare. And I think there's been a lot of effort to do that. In sense, the whole idea of a profile prospectus was plain thinking. Because it was, "Well, here are the 10 things you need to know." I'm just making that number up, but say 10. "And here actually is the most important." So you rank them in some sense.

And you talk about them in concise terms. You use pictures, or graphs when that's helpful, and it's very often true that a picture is worth a thousand words.

So I think Chairman Levitt's initiative was embraced. It was one that was widely acknowledged as an appropriate one. On the other hand, I would say that mutual funds are complicated investment vehicles, and so the English can get only so plain and not much plainer. I think everyone, too, understood that getting the jargon out—a lot of this is lawyer speak, too, because they often are the ones who prepare the prospectuses—and trying to chisel the English better is going to be a perpetual, perpetual issue.

So it's never a job that is done. It's one that has to be worked on, especially as there are new disclosures, there are new risks; there are new issues that arise. How do you talk to people about them, particularly people who aren't necessarily highly sophisticated?

WT: And these were also the early days of the Internet. How interested was the industry back then in that for disclosure, as well as for transaction like we see it now?

PS: Yes. That's a very interesting subject. It is exactly during that period of time when I was general counsel that the Internet became something that everyone was thinking about. How do we use it in our business? How does it affect our personal lives? I mean, I think it would be unimaginable if I were to ask my sons, "Do you remember your first time going on the Internet?" I mean, I can remember that. I can remember the first time I ever used an email. That was at the White House, when I was at the National Security

Council. I think people didn't know quite what to make of it early on, certainly in those years.

And I don't think any of us back then would have predicted quite what a powerful tool, in fact, omnipresent reality for us it would become in such a very short period of time. Certainly, no one imagined the security risks that were going to emerge with respect to Internet-based activities. There, no doubt, were some companies very early on that saw the potential for it. As you know, in 1997 when I left ICI, my time as general counsel came to an end. I went to Charles Schwab and Company where I was counsel for their mutual funds and international enterprise. By that point in time, the sort of dot-com stuff was going hot and heavy, and many at Schwab just sort of thought of the firm as Schwab.com. It had a strategy that way. Of course, it lived in Northern California, not very far from Silicon Valley.

And the rates of adoption of mutual funds into businesses reflect in some sense both the nature of the business and the business culture that's involved. I would say that in looking forward, one of my concerns for our industry are the limitations that we have in using the new technologies. We're fighting a battle right now to try to support the SEC's proposal that we provide shareholder reports on mutual funds online, unless a shareholder chooses to opt out and requests it in written form, an option that they would be given in writing each year.

So much of our life now revolves around electronic dissemination and receipt of information. Ninety-one percent of mutual fund shareholders—and we've been doing this research for many years—have access to the Internet and use it, including elderly Americans, so moving sensibly in that direction is really important. But the Internet actually ultimately had a huge influence on, if you will, the simplification of prospectus disclosure. You remember I told you that in the mid-Nineties, the Commission's principal concern was a net loss of information to investors, because they thought if the people weren't getting the full first part of the prospectus that they otherwise wouldn't have access to it very easily.

Flash forward a number of years, by the time the SEC actually did adopt a profile prospectus rule—simplified prospectus rule—it was able to do so in part with the confidence that all the rest of that material would be available to investors online. And so that, in a sense, meant for the Commission, and for the industry and its investors, there will be no net loss of information, and we now have the liberty to devise something for you that will probably serve the needs of most retail investors much, much more effectively.

WT: Coming back to something you mentioned earlier, which is the division between federal regulation and state regulation resolution, I assume you meant with NSMIA.

PS: Right.

WT: Could you tell me a little bit about what that situation was like at that time?

PS: I had not had much exposure to what we call blue sky regulation before coming to ICI as general counsel. My practice just didn't take me in that direction. But I would say that when I got here, it became a real preoccupation. The North American Securities Administrators Association [NASAA], which includes all other securities regulators from the 50 states, was quite active. It was a real presence in policy circles. It had a membership which went in very distinctly different directions about how to regulate mutual funds. And at the time, they were, for example, authorized to regulate our disclosure practices, and they certainly had no hesitancy about exercising the authority that they had.

So we worked with NASAA, we worked with the individual state regulators to try to resolve issues, but there came a point in time when frankly, it seemed to me, reading the tea leaves up in the Congress, that we really had an opportunity to, if you will, preempt state regulation of funds in a sensible way, and to rely upon the substantive regulation to be done by the SEC. This is something that I think the industry, the Institute, had dreamed about for a long time. But we were very concerned about moving forward with it, frankly, advancing that suggestion up on Capitol Hill, because the conviction was that if we did that, the state regulators would take it terribly amiss and would start, well, maybe taking it out on funds and their advisers as a result and actually doubling down, not backing off.

So I remember very distinctly, with the signals coming out of Capitol Hill that they might very well be receptive to it, that we were having an Executive Committee meeting, perhaps it was a dinner. And I suggested to the Executive Committee of the Institute, which was then chaired by Ron Lynch, the late Ron Lynch, who was the head of Lord Abbett, an old-line fund sponsor in New York, that this was the time that we had to really aggressively move forward with an effort to preempt state regulation. And Ron, God bless him, said, "No. No. No. There will be terrible consequences for us if we do that. We can't possibly do it."

And then Chairman Levitt came to visit the Executive Committee the very next day. And Levitt said, "I really think that there's an opportunity for the industry to move forward successfully with legislation to preempt state regulation of mutual funds." To which our chairman, Ron Lynch, said, "We were just talking about that yesterday, and I agree with you completely, Mr. Chairman." So we moved forward. And it really was, I think of it as the single greatest accomplishment of my time as general counsel to the Institute. Because one of the things we were trying, most importantly, to do is to convey what problems this disparate pattern of regulation posed for the fund industry. And we certainly could describe it in the thousands of words and explain it all. But I seized on the idea that what we really needed to do is to prepare a color-coded map of the United States, which would reflect the disparate ways in which states regulate mutual funds. And so I tasked my staff with devising such a map, and they came back with something that really looked like a crazy quilt. We were going to be going into hearings in what was then the House Energy and Commerce Committee, which regulated the fund industry in those days, and Matt Fink was going to be testifying. And we had a huge blowup of this map, and it must have been as big as this table, you know, six by eight, with all of the different color coding and explanations for what differences they represented.

And the people at NASAA, on behalf of the state securities regulators, got a gander at the map. And they sort of pulled us aside and said, "You know, if you don't bring that map into this hearing room, we will be happy to try to work with you to achieve a satisfactory resolution of this." So the map never got into the hearing room. The picture was going to be worth so many thousands of words that it really broke the back of the issue. What the states were mostly concerned about is making sure that they had no net loss of revenues, because they charged fees for shares of funds that were sold within their state. And the fee issue was not the principal concern. It was the substantive regulatory authority.

They also wanted to have certain enforcement capabilities that would remain to them in the event of out-and-out fraud and the like, and that was not an issue for us either. But they were willing, I think very reluctantly, to relinquish their regulatory authority. I remember I took that map, and I made a series of two Christmas cards out of it. Had you heard of this before?

WT: I don't think I've heard about the Christmas cards.

PS: No? So this would be Christmas of—when was NSMIA, 1996, correct?

WT: That sounds right.

PS: So in 1995, I put this crazy quilt—the colored map of the United States—on the front of a Christmas card. And in the inside of the Christmas card was the same map, except all the states were in white. And the legend on the card read, "Dreaming of a white Christmas." And then for Christmas of 1996, after NSMIA was passed, the map on the cover was all in white. And inside the legend read, "May all your Christmases be white." People still remember those Christmas cards. And I still have a Lucite block with the map in it, if you want to see it.

WT: The crazy-quilt map.

PS: Right. Right.

WT: Was having that be part of a larger legislative package that was NSMIA introduce a lot of complications? I think Arthur Levitt ended up coming out against it because of a separate issue.

PS: Yes. That's true anytime you are moving legislation. It's not simply rifle shot. You have to balance a whole bunch of things. There were other aspects of NSMIA that have proved subsequently to be very significant for the Commission, and I think all in all very good for its policymaking. And that had to do with changing the mission of the SEC to include the promotion of efficiency, competition, and capital formation, because those now became, after NSMIA, substantive aspects of all of the major federal securities laws. And that in turn is part of what was relied upon in the challenges to some of the Commission rulemakings, this is under Chairman Donaldson now, that the Commission had not really taken into account cost-benefit analysis and things of that nature. So NSMIA was more important even than some of us realized at the time.

WT: And of course, then there's the hedge fund issue and the expansion of those following NSMIA and the question of it, the prolonged debate about hedge fund adviser registration. I understand that ICI was in favor of that.

PS: You know, people would probably say, "Gee, all this is is competitive jealousies." But hedge funds were growing in their significance in the capital markets. They were products that we thought were appropriate for some sophisticated, financially able investors, but not for the general public. And we certainly never wanted to see their presence in the market potentially erode the advantage that we have in our ability to publicly offer our funds.

If you think about that, registered funds have that ability because they are so closely regulated. Hedge funds do not. They are, by definition, private funds, because they are not regulated in the same way. So I believe, if I'm remembering correctly, that we were in favor of hedge fund adviser registration. And we certainly traditionally have opposed the expansion of sort of the investment authority, in terms of number of individuals that you could sell a private fund to, or what the financial sophisticated investor standards are. That still is an issue in some ways that percolates around in legislation. Recent proposals of the SEC, for example, have talked about raising and indexing it for inflation. But it's never been satisfactorily addressed, I think, as yet.

WT: Now Gramm-Leach-Bliley passed after you left ICI. But certainly in the Nineties, things were pointed in that direction. And in fact, a lot of the barriers between banking and investment companies, insurance companies, and whatnot had already been eroded. Could you tell me what the thinking was at ICI at the time concerning those issues?

PS: Well, it's interesting, because if you think historically about ICI, we had always been in the camp—and literally *ICI v. Camp* was the case—of keeping banks out of the securities business, and took a very strict view about the Glass-Steagall separations. History took the country and the financial services industries in a different direction. And by the time I came here as general counsel, we were actually reaching out to bank sponsors of mutual funds. They clearly were going to be a permanent feature on the horizon. The real issue was how would the legislative standards be reformed? We were no longer out there beating the drum to sustain Glass-Steagall. Glass-Steagall had sort of disappeared a long time ago, largely by regulatory action. So it's like T. S. Eliot said, "This is the way the world ends. Not with a bang, but a whimper." So Glass-Steagall kind of went out with a whimper in Gramm-Leach-Bliley, didn't it?

WT: Yes.

PS: And I think ICI recognized that the banks were going to be major players in the industry. They certainly have proven to be. We didn't focus so much on other potential risks of investment banking activity or their serving as dealers, in terms of risk capital and things of that sort. Our focus has always been a little bit more narrow on that question. So, I think Sandy Weill is the person who put the nail in the coffin of Glass-Steagall, and reality just sort of caught up with it.

WT: What are you referring to in that case?

PS: Well, you remember when Citibank bought Travelers Insurance Company? I think that was a transaction that, if there was anything left to Glass-Steagall, probably would not have gone through. The fact that the regulators allowed it to, and perhaps that Congress subsequently blessed the arrangement, indicated that facts on the ground had forced Washington's hand, if you will. But I don't think there was any grand design in all of it. It's interesting to hear people calling now for, "Let's go back to Glass-Steagall. Let's just tab it in the business of banking and keep it away from other things that are riskier." I don't know whether we will ever get back to that. But to the extent we moved away from that, it was not as a result of some grand, national debate. It was a creeping process over decades.

WT: So is there anything that we should talk about from this general counsel period, before we move on, that we haven't so far?

PS: No. I think we've touched on most of it.

WT: Okay. I know that Arthur Levitt was interested in governance issues. But I'd like to cover those when you come back.

PS: Sure.

WT: Just to cover the interim, very quickly, so you were at Charles Schwab. And then you were in private practice again?

PS: Right.

WT: Okay. Could you tell me a little bit about, particularly the Schwab experience, as to what that perspective on the industry, what was new to you, what did you find out?

PS: So, I think one thing it underscored for me is that life feels very different when you're in a law firm, on the one hand, or when you're counsel within a company, on the other. Schwab was incredibly innovative as a distributor of mutual funds. It became famous for the mutual fund supermarket, and was making available to its customers an extraordinarily wide array of fund choices. And so I was able to look at that from the point of view of counsel to a distributor of mutual funds, as opposed to the mutual funds directly.

But Schwab was also a sponsor of mutual funds, so I was involved in some of that as well. Some of my work at Schwab involved its international enterprise. At the end of the day I think, and the people there would no doubt acknowledge this, Schwab was a very domestic company with not much of an international focus. So some of that is, if you will, a little bit of a sideshow. But the two years were very enjoyable for me. I realized, and this is why I came back, that I missed Washington. I missed the public policy focus, and I think my family was happier back here, too.

I came back and had the very good fortune to become a partner at Dechert. Allan Mostoff, who had been division director at the SEC's Division of Investment Management years prior, recruited me to come into the firm as a partner. And I was able to take on a number of different clients, mutual fund firms, serving as counsel to fund independent directors. So by that point in my career, in my law practice career, I really was truly focusing exclusively on fund issues. And that was in 1999. It was probably the summer of 1999 or thereabouts that I joined Dechert, and I stayed there until June of 2004, when I became president here. So it's five years in practice, and five very eventful years, because it was in those years that you had the rulemakings out of the statute. Sarbanes-Oxley was coming online. Am I getting this chronology correct?

WT: 2002?

PS: Yes. You had the issues concerning the governance and other focus that the Commission was bringing to the fund industry going on.

WT: Yes. SEC had its first rules in this period.

PS: Correct.

WT: That was for a majority board, right?

PS: Correct. And so I was working as counsel to funds and their advisers and to fund boards during that period and left private practice in the early phases of the late trading and market timing scandals.

WT: I know Matt Fink retired around that time.

PS: Yes. That's right.

WT: Was your coming to ICI associated with the response to those scandals? How did you get recruited to ICI, or did you seek it out?

PS: Well, I will you tell very candidly, I've always thought the world of this organization. I would say perhaps immodestly, and I'm not taking any of the credit for myself, it's a trade organization that's head and shoulders above most others here in town, representing a terrific industry with great, great support from our membership and a wonderful staff. So I threw my hat into a ring when they said, "Well, we're going to conduct a search to see who might be the president." I have 15 years in law practice, but private law practice has changed over those years and lots of lawyers, if they're honest with you, would say, "Might like to do something a bit different."

Although I look back on my Dechert years as wonderful years, full of accomplishment and a lot of personal satisfaction. I think it was a combination of things, perhaps, that made my potential candidacy attractive. One, I had, through my law practice and my prior professional experience, gotten to know the industry and the issues. Second, I had worked here at the Institute, so I know how this organization worked. And a lot of people had had experience working with me. And thirdly, I certainly had had a lot of experience in government, and so I understood the city of Washington, which is a very important part of the responsibilities for whomever leads an association like that, like ICI here in town.

I was asked, even before I was tapped to be the new president of the Institute, to represent ICI at a hearing up on Capitol Hill. This was of a Senate oversight committee, which was in response to the late trading and market timing scandals, among other things. Matt, who would normally have done that, was meeting with the [ICI] Board, I believe, at our January meetings. I'm not sure if it's January, but he was not available and so they asked me to do it. And I think that was maybe a little bit of a live-fire interview for the job. It was an interesting event, because we had some of the academic critics of the industry who were there, and leveling their criticisms about excessive fees and conflicts of interest and all the rest of it. And I was there representing the industry and responding to some of those claims.

WT: So, it was very much a time of crisis for the industry. Traditionally, it had been looked on as very clean and all of a sudden you have what appear to be systemic series of scandals. Can you tell me exactly how much of a crisis that seemed to be?

PS: I wouldn't minimize it by any means, but I would start by saying that not every fund was involved in this inappropriate activity—by no means. I think that if it were limited even to one, though, that would be far too many. The aspect of the business I think everybody understands is that, you know, whatever the organization may be, whatever the fund or organization may be, the likelihood that one of its investors is ever going to actually meet a person who works at that organization can be quite slim. So it's built on trust. It's built on a simple proposition of trust.

And people are sending their life savings, the things that they've worked so hard to accumulate by way of resources, and they are trying to make sure that they are well tended for long-term, incredibly important personal objectives. That imposes a great deal of responsibility on the funds. So I think the inappropriate activities of some in the industry really did, and as I said at the time, jeopardize the reputations of everyone. And that's why it was a crisis for the industry writ large. People, especially the Managed

Funds Association and others, really recoiled when I pointed out there were a couple of other aspects of this.

One, some of it was activity being conducted by broker dealers unbeknownst to the funds, who are contriving with their own customers to allow them to trade after the close of trading in the fund, after the fund had struck its NAV [net asset value]. And that's not something that the funds could necessarily detect or monitor. That was really inappropriate activity by intermediaries. And some of those intermediaries were serving favored customers, including hedge funds, who had investment strategies based upon late trading in mutual fund shares.

So, there were some bad actors well beyond the mutual fund industry that were involved here, but I think historically, nonetheless, it's still thought of as the "mutual funds scandal." The real issue was how to respond to it, what the core issues were, and what the core reforms were.

WT: Before we get to that I want to ask specifically, this is just a couple years after the whole Enron and WorldCom scandals, in which people were losing their life savings. It's not the case in this case, but you do have the figure of Eliot Spitzer lending it additional prominence in the public sphere. How important was that to, one, casting the public eye on the scandals, but also two, advancing reforms after them?

PS: Right. One aspect of the prosecutorial function in our society is subject to its own conflicts of interest. Prosecutors, especially people who are ambitious politicians, feast upon and have every incentive to pump up, aspects of this kind of wrongdoing. And Spitzer was certainly not averse to doing that. I would tell you that I do not criticize him at all for going after wrongdoing where he found it. I think the manner in which he did it, perhaps, could be reexamined in certain instances. And he had an incredibly supple legal instrument in New York, which is essentially a fraud statute for which you don't have to prove any intent, and that's something that is really quite extraordinary.

Spitzer certainly did break the case, if you will, I think set in motion a dynamic where the SEC was trying very hard to catch up, and gave the SEC every incentive to be as hard or harder on those it had found to have violated the law. I think that had the regulatory and enforcement authorities, though, not been as tough as they were on the people who were found to have acted improperly, that we might not have recovered from the scandal as quickly as we did. I will say that probably the even more significant punishment for some who were in the crosshairs in those days is that it took a huge toll on their business. Some fund families have not ever really recovered; some even went out of business. And so the penalty that they paid in the marketplace, if you will, was at least as great as any that they paid in any kind of enforcement or other kind of litigation proceeding.

So I look back at that period as perhaps among the most regrettable. There were a lot of people who looked to ICI and were disappointed in us because we didn't, perhaps, detect the market timing. I don't know how we could ever have discovered the late trading activities, given the nature of those things. So it was a hard time for everybody, frankly, and for those of us who think very highly of the industry and the work that is done, it was a real disappointment that we found ourselves in that situation.

I made the decision when I became president of the Institute that I had to address it very early on, and so among the first things that I began to do when I arrived here at the Institute June 1, 2004, was to be in preparation of a speech which I gave at the National Press Club that same month. The speech really was, in a sense, my first, definitive comment on the scandals. But one of the things, if you go back and look at it, that I emphasize, is what is the nature of a fiduciary and what is the responsibility we've taken on when we stand in this relationship to the people that we serve? And it's a theme to which I have returned many, many times.

You will search in vain to see me ever celebrate the industry as, gee, we're better than others, we're cleaner than others, we have a better reputation than others. I told my staff and I told myself, no matter how good it is, never dance in the end zone, because we never get to the end zone. It's something that you've got to prove anew every single day. And what, instead, the messaging has been is let's be conscious of the level of responsibility and trust that we have and commit ourselves completely to fulfilling it as best we can, because that's not only the thing we owe our customers, but it's going to be the best way to build the business too.

WT: So let's talk about some of the regulatory responses and potential regulatory responses that were out there at the time. We've already discussed the compliance officer rules. I don't think we necessarily need to retread that, but there were quite a few other things that were out there. What stands out to you in your memory? I know that there was a possibility of some legislative action, wasn't there?

PS: Yes, and so this is, I think, an important part of the legacy for me at least. You would have thought that those late trading and market timing scandals would have prompted a wholesale response by the Congress. They didn't. We worked very, very hard with committees on both sides of the Capitol and legislators and policymakers on both sides of the aisle to try to make them understand that reforms were underway through the SEC, the problem was being addressed, and that legislation was not necessary. And I think that was heeded. And I think partly it was the credibility that we'd amassed over the years. I think it was the seriousness of the way in which we approached the problems that were there, and the level of earnestness that people perceived, and the industry's willingness to work with the SEC and try to come to appropriate reforms that would keep this from happening.

WT: So what are some of the reforms that come out then? I know that the 12b-1 fees are under scrutiny, but that ICI is against doing anything concerning that. But then there are soft dollars, there's directed brokerage, which ICI is in favor of.

PS: Right. So here's what I guess I would say. If you look at what the late trading and market timing scandal was about, one aspect of it, market timing, needed to be addressed through appropriate, fair valuation of mutual funds' securities and appropriate pricing of fund shares. And I think the pricing disciplines were improved. You remember it focused to a significant degree on international funds, where there was information in the market that would affect the securities price that wasn't really being, if you will, priced into at the 4:00 [p.m.] close when the fund was striking its NAV. So I think pricing disciplines were very, very important as a focus for the SEC.

The late trading aspects of it, they focused really upon funds' abilities to monitor the activities of the broker-dealers and other intermediaries that they were using, and to try to use fund boards as well as fund advisers as a way of disciplining. That has proved more challenging because of the omnibus account relationships that we have with them, but that was another obviously very relevant aspect of the reform effort.

But it's an old Washington story that when you have a problem like this, people's attention tends to go to a lot of other areas that were not actually implicated in the crisis. If you think about Dodd-Frank, for example, Dodd-Frank's 2,038 pages, there's a lot of stuff in there that has little or nothing to do with the financial crisis we just went through. This was a convenient vehicle to move it forward. So, yes, a lot of the old issues that we've been dealing with for a long period of time—revenue sharing, 12b-1, other things—got caught up in this mix here, including fund governance issues.

So I think the SEC had what it thought of as a broad-based agenda for mutual fund regulation in response to the scandal, only specific elements of which actually related to the scandalous activities. The ones that, I think, got the most play were the governance reforms. And I and a couple of others just authored a piece about the evolution of fund governance over the 75 years since the passage of the '40 Act, and it just came out in the *Virginia Law & Business Review.* I think that, if you will, the scandals certainly did focus attention on the effectiveness of fund governance. Although I would tell you that, again, particularly the late trading part of it, I'm not sure how fund boards could have monitored and prevented those activities very effectively. Perhaps the market timing stuff from the point of view of valuation and the like might have been more relevant for those purposes. But there was a general disappointment in the effectiveness of fund boards, and the question was what to do about it.

Now, I don't think that the industry, by no means, had rejected the idea of improvements in fund governance. In fact, during the time that I was not here, between my general counsel's days and coming back as president, there had been a very successful effort by the industry to develop recommended practices with respect to fund governance that were, in turn, in many respects adopted into the SEC's rules.

As I recall, though, the big bone of contention had to do with Chairman Donaldson wanting to do two things. One, to establish a higher regulatory percentage of independent directors on fund boards on the one hand.

WT: Seventy-five percent?

PS: Seventy-five percent. And on the other, to make sure that the chairman of the funds' boards would be an independent director. And I think there was strong disagreement in the industry about the desirability or need for those changes. Looking back, though, it's kind of ironic. We survey fund governance practices on a biennial basis, just to keep our hands on the pulse, so to speak, of how board practices are changing. We have evolved into an industry in which, overwhelmingly, fund boards have 75 percent or even more independent directors. Many more boards now have independent director chairs, and those that don't almost universally will have a lead independent director that functions in more or less the same way.

So a lot of people, I think, at the time were feeling, why does the SEC have to regulate or legislate in this way? Let the industry's practices evolve. And I think they were also very skeptical about whether the claimed benefits for these changes could be demonstrated in any tangible way. What's the problem, and why do these specific reforms solve it? And in a sense, I guess, when it came to litigation, and that's, as you know, litigation that the Institute was not involved in, the courts agreed that the SEC had proceeded with the regulation, without the appropriate substance to support the regulatory policy.

WT: The cost-benefit analysis?

PS: Yes.

WT: Did ICI have any sort of position on the Chamber of Commerce's prosecutorial strategy there?

PS: No. No, and I don't recall that there was any kind of a particular coordination with them. We realized that the suit could have potential consequences in other contexts because it was going to be a challenge of a sort that the SEC had not faced before, and part of it was based upon that NSMIA standard that was fairly new. I think it was something of a remarkable development, for both the industry as well as for the SEC, when the Commission lost the decision. And I think that was a start of a recognition that they need to begin developing regulatory policy, not out of their back pocket, but by the numbers, doing much more analytical work to support their regulatory decisions.

WT: Did ICI have any views on SEC's use of its exemptive authority as the regulatory lever with these sorts of rules?

PS: Well, that's been something that the SEC has done in other contexts, and I don't recall that we objected to it. You remember when the first set of governance reforms that the Commission imposed, they conditioned on a dozen or more exemptive rules, no one complained with that, so it had been a path that had been well-worn, if you will.

WT: Right. Well, I definitely want to devote sufficient time to the financial crisis and the aftermath, so if there's anything else that we need to get to in this period, we should probably bring it up. Otherwise, I'd like to move on.

PS: That's fine. Let's move on.

WT: Okay. Well, then, just tell me about your experience of the financial crisis, in particular the situation with the money market funds.

PS: In 2007, in August, my wife and I had just purchased a house down at the Chesapeake, a second home, and I was literally in a truck with a bunch of household goods and my wife and one of our children, driving down to our new house when I got a call from Buddy Donahue, who was at the time the head of the Division of Investment Management. Buddy's someone I had known for a very long period of time. And the call was kind of "Houston, we have a problem," and I knew that we were heading into a period of crisis in August of 2007. That's really when the first reverberations came and the money markets began to get very dodgy, if you will.

I don't think even then, though, that we'd realized how far a slide it was going to be. And just by way of perspective, I would tell you that I want to talk about and focus on the money market fund aspect of this, but this was a very broad-based crisis, and I don't think that there is a case to be made that it was brought on by money funds. It was a deep crisis in our banking system—ultimately banks didn't trust each other, a failure of regulation, a failure of oversight of a massive kind.

And actually, the thing about money funds to me is that they maintained their resilience as long as they did. It was only at that point in time when the commercial paper markets completely froze up that money funds began to have the serious problems that they did. And that took—I should have this number because I've cited it so many times—but there were so many large financial institutions before the Reserve Primary Fund broke a dollar that had failed, gone into receivership, had been the subject of forced mergers. And the government policy was sort of shifting back and forth. Bear Stearns was bailed out, or there was a shotgun marriage arranged for it, and then Lehman Brothers was allowed to collapse. And the different signals to different participants in the market were such, and the underlying conditions and lack of transparency about the conditions of major participants in the financial market meant that things just simply froze.

I spent a good part of that period of time, though, nursing the flu at home and on the phone constantly throughout the day as we heard about the Reserve Primary Fund.

WT: Yes, in September of 2008.

PS: That's exactly right. So it was something I hope no president of the Institute has to go through again, but I have memories of a number of aspects of it that I'd like to emphasize. The Treasury Department came up with the idea of a guarantee. They had already developed this concept to a considerably high degree before it was ever shared with ICI, or the industry for that matter, to my knowledge. They'd gone up to the Congress, and it was Speaker Pelosi at the time, and had indicated what they had planned to do. And when they finally did contact the Institute and we consulted with our members, we said first, "Gee, we'd prefer that you not do this, but if you do do it, make it as limited as possible." Because we were very afraid that an open-ended guarantee of any form would destabilize the banking system, that money would come out of depository institutions and into money funds with a government guarantee associated with them. So that is in fact what happened, they limited it very significantly.

And what you'll hear from some people is, "Gee, the money market funds just wanted an unlimited guarantee, and it was only because the banks pushed back." That's not true. We were the first to say, when they told us that there was going to be this guarantee program, you've got to limit it. It turned out to be much more limited than people understand. You'll hear very often this notion that the government entered into an open-ended obligation to guarantee $3 trillion invested in money market funds. Actually, that wasn't the case at all. The funds that wanted to buy into the guarantee program—and you had to pay a premium for this purpose—were only buying a guarantee that would, in the event of a fund breaking a dollar, it would be forced to liquidate, and the difference between the liquidation value and $1.00 is what the guarantee would cover. Now, of course, no fund ever broke a buck [after the guarantee program was implemented]; no fund was ever put in that position. But it would be a fraction, a very small fraction potentially, of the $3 trillion that the taxpayers might ever have been on the hook for. And that, again, was by design, to try to minimize its footprint as much as possible.

I would also tell you that there was discussion among many of our members about whether they would participate in the guarantee program. Some of those who had Treasury funds, for example, saw no particular reason why they would have to participate. After all, the Treasury funds don't present a credit risk in the way that the Lehman paper had done for the Reserve Primary Fund, so they said why should we participate? I actually, and maybe this was incorrect in hindsight, I told all of our members that I thought that, for purposes of promoting public confidence in the industry, that everybody ought to participate in the guarantee program, that that was going to be a useful measure to help the country move away from this period of crisis. And virtually all of them did. Of course, no good deed—

WT: The thinking was that people wouldn't really distinguish between (indiscernible 1:21:28)—

PS: Yes, that's part of it. But it's not like people were out there saying we have a guarantee. They weren't marketing funds on this basis, again, because the guarantee was almost negligible when you get right down to it. So we ended up, collectively as an industry—I don't know what the number was. I used to know this. But it's a substantial amount of money that we gave to the Treasury, in excess of a billion dollars, I believe, with no claims ever made against it.

And I was going to say no good deed in Washington goes unpunished. So a lot of people said, "You see, they had to bail out the whole industry," when that was hardly the case. Once the guarantee had been imposed, and once we'd had Reserve Primary Fund break a buck, I knew that our life had changed; certainly the life of money market funds and probably the life of the industry at large. And so that had a number of implications.

I was blessed at the time, as I am still and have been throughout my time as president here with an incredible Board and Executive Committee. And Jack Brennan, a former chairman of ICI Board, then chairman and CEO of the Vanguard Group, was on our Executive Committee. And once all this happened, I told the committee we need to form urgently a working group to analyze this situation and to propose reforms about money market funds but also the money markets because there was a strong sense that it wasn't just the fund structure, it was the way the money markets operated.

And so we worked for a period from September until April or thereabouts I think. I don't know if I got the time frame exactly right. April of 2009, I guess that would be, developing a report of the money market fund working group that we would provide to the SEC as a blueprint for what regulatory actions they might take. And I was present when Jack and others met with Chairman Schapiro and provided her the blueprint, and she expressed at the time tremendous gratitude, and she said, "Oh, thank you so much. You've given us a road map for the way forward."

And sure enough, the SEC—they didn't take it exactly as we had proposed it, but pretty close—was able, in a much shorter period of time than they would have been able to do otherwise, to impose this first of the two sets of regulatory reforms on money market funds. And it's a source of pride for us here at ICI that, in a sense, the money market funds were the first part of the financial system that were reformed after the crisis.

WT: It's important to note that this was not part of Dodd-Frank.

PS: No, no. Dodd-Frank had hardly a word in it about mutual funds, and no word about money market funds. Why? Because the Institute gathered all the resources of the industry to recommend a series of pretty thoroughgoing reforms and worked and supported our regulator in trying to move those reforms along lickety-split. And so I think that's what, again, kept the Congress from beginning to write rules around money market funds.

WT: So the first rule is basically amendments to Rule 2a-7.

PS: Right.

WT: So, essentially saying what can and cannot be in a money market fund. Are there any specifics that we should talk about there, or is it sufficient just to generalize it at that level?

PS: Well, 2a-7 had always been a much more prescriptive rule about the way in which money market fund portfolios would be constructed than the SEC had to date adopted anywhere else in the industry. And you remember I told you I was involved in this SEC administrative proceeding—this is way back in the early Eighties—that baptized amortized cost method evaluation, which in turn allowed funds to maintain a stable $1.00 net asset value per share. So all of the 2a-7 structure was focused on how you do that, and how you respond through a board process if that is not going to work, if you're going to break a buck, right?

So the first set of reforms were very commonsense in the sense of: we had never had minimum liquidity standards and money market funds before, and so we establish them now by regulation. They really reflected the standards that were commonplace across the industry, but I think there was a sense that we had to address what Jack Brennan referred to as—and I think this is okay for my transcript, isn't it—he called it "shithead risk." It's the risk that some stupid player in the industry was going to screw up its portfolio in a way that the Reserve Primary Fund clearly did and that that would redound to the disadvantage of the rest of the industry.

So these enhanced credit quality, minimum liquidity standards, and other things that the SEC did were really trying to make sure that the marginal players brought their game up quite significantly. I think from the point of view of the regulatory policies that underlie it, if you're going to continue to allow funds to continue to have a $1.00 net asset value per share, it was all very sensible stuff.

WT: So then the second round now is a bit more contentious. You have the possibility of a floating NAV, a couple other things that the SEC tried to propose, couldn't even get—put out a release, I think is what happened. So tell me about this, because I know that ICI was definitely opposed to these proposals.

PS: Yes, so let me step back a little bit, but just as a general observation about the Commission—I have never worked at the SEC, and I have tremendous admiration for the agency, its historic success. In fact, I've said it many, many times, if you look at the growth of this industry under a statute administered by the SEC over the past 75 years, no one could conclude anything other than the SEC has been enormously successful in the oversight of the industry, the administration of the statute. Because, 75 years ago no one thought that mutual funds would become the kind of financial intermediary that they are today.

That having been said, and as a close observer of the SEC over the years, it seems as though regulatory policymaking at the Commission has grown more and more vexed over time. The relationships among and between the commissioners have deteriorated at certain points. Real differences in points of view have emerged. These aren't just policy differences, but they can sometimes seem to blossom into personal antagonisms and the like. And all of that makes what's a complex regulatory process just all the more difficult.

I think in the context of money market funds, there were some very serious differences of opinion about what was necessary. Certainly, the industry had its perspective. There were the bank regulators on the one hand who were saying we simply ought to outlaw money market funds. The Paul Volckers of the world thought that a money market fund was simply a kind of fund that shouldn't exist. The industry's perspective was quite different. As people who provide investment solutions of all kinds to investors, the idea that you didn't have a cash management solution for them just made no sense whatsoever. And the value of money market funds had been proven abundantly.

During the crisis, I often had occasion to cite this number. When I asked our economist, "From the time of the first money market mutual fund to the time of the crisis and its aftermath, how much money had gone into and out of money market funds on a constant $1.00 basis, that is to say, without loss of principal?" What do you think the number would be?

WT: I don't want to even guess.

PS: It's well over a third of a quadrillion dollars.

WT: Quadrillion?

PS: Yes, that's a number you don't even hear in Washington, do you? But that's something like $340, $350 trillion.

WT: So these are all transactions basically, money coming in?

PS: Yes, money coming in, money coming out.

WT: Cumulative over time?

PS: Cumulative over time.

WT: Okay, got you.

PS: It's a pretty impressive number. And so, I think there was a strong sense in the industry that this was a product that had proven success, and that it was a wrong reading of a financial crisis to say that somehow or other this had been the source of the crisis or had been the focus and center of the crisis. Instead, the crisis seemed to us to be how the commercial paper markets were functioning—and ironically, part of the Fed's responsibility under the National Banking Act passed over 100 years ago is to make sure the commercial paper markets function effectively. They weren't at the time of the crisis.

I would also say that it wasn't just us, and this is a very important aspect of the response to the SEC's second set of proposals, or the direction that Chairman Shapiro wanted to bring money market fund rulemaking. There were a lot of people who were issuers into the money markets and investors in money market funds who had organized themselves very, very effectively to oppose what the SEC had in mind. By way of issuers, I mean people who tap the money markets for sources of capital. They might involve state and local governments who are selling their paper through various structures to tax-exempt money market funds, certainly corporations who are issuing commercial paper as an important source of diversified capital fundraising, and for whom the money market funds were absolutely indispensable.

So those were the people who were issuers, but there were also a lot of people who were investors, in particular, corporations whose corporate treasurers had to manage substantial amounts of cash for their own operations who wanted to achieve some kind of current return on that cash, and for whom banks were not a very attractive option because they would, essentially, have to monitor the creditworthiness of the banks that they had more than $250,000 in potentially, and that was just a daunting prospect. So in addition to the back office, the way in which the operations of money market funds worked with these investors, particularly the institutional investor community were ones that had proven to be very, very important to them.

So what the Commission heard, what Congress heard was a huge array of voices, not just the industry's voice, about the need to preserve money market funds. And so that was the environment in which they were undertaking their rulemaking.

WT: So, the chief objection to the floating NAV, is that primarily an accounting issue, that if it floats then all of a sudden things can become much more complex, or are there other factors besides that?

PS: Well, the argument has always been that if there's a sense that the fund is about to break a buck, that institutions or others will place redemption requests for the fund, and they have every reason to get at the head of the line. So there's a first-mover advantage that they may get $1.00, whereas the person behind them in line may get 99 cents. And so that would then fuel disorderly redemptions and a run on the fund. And it's a reality, I think, that bore itself out in the Reserve Primary context, but again influenced very much by the surrounding circumstances of September of 2008.

I think that one key insight that we had that we shared with the Commission is that institutional investors and money funds and retail investors and money funds actually respond somewhat differently. There was, in fact, if you looked at retail money market funds during the crisis—and I'm talking about prime funds, funds that invest in commercial paper—there were any number of them that actually had increases in their assets during that period of time. They were looked at as a place of safety. The institutional players were a little bit different. Their money moved more quickly. In fact, it was sovereign wealth funds, I believe, that caused the collapse of the Reserve Primary Fund because they moved en masse out of the fund after the Lehman problem.

While the industry had never, and certainly early on, proposed an institutional-retail split, I think everyone realized that the behavior of the investors was somewhat different. And ultimately, that was something that the Commission took into account when it crafted its second set of reforms. There was also the reality that I pointed to about Treasury funds. The Treasuries do not have the credit issues that a prime fund might with respect, for example, to a commercial paper issuer, and so the Treasury funds were treated differently in the final set of reforms as well.

WT: So it's been a couple of years now since the rules came out in 2014. How have they worked out in your view?

PS: Well, we haven't seen them really come online yet. That doesn't happen until October of this year.

WT: Oh, okay.

PS: There's been an enormous effort with respect to compliance here. The rules have certainly changed the shape of the market in some respects. For example, I understand that money market funds are not going to be able to be used, prime funds anyway, in 401(k) plans. That money will probably move over the stable value funds, which are insurance products, I guess. So how institutional investors are going to feel about a fund that has fees and gates, I don't know. We'll see. The early reports are that a lot of institutions are simply not willing to invest in a fund of that kind, so they may prefer

Treasury funds, for example, or other cash management solutions. As we sit here, I believe money funds still have about $2.5 trillion in assets under management, so it's still a very large factor out there, and I think managers are carefully working up to that October full, final implementation date on the SEC's rules. So we'll have to wait and see.

WT: Aside from money market funds, tell me about some of the other things that occurred in the aftermath of the crisis. I know that CFTC looked to have funds registered that invested in derivatives. You, of course, objected to that, preferring the SEC as an investor. There was the hedge fund adviser registration that finally came through following its failure to do so before the crisis. I'll let you choose what the most important things are here to talk about.

PS: Well, I testified in the Congress on behalf of the Institute any number of times during the period where Dodd-Frank was in preparation, although I think there are so many aspects to Dodd-Frank that really weren't subject to hearings or what you would call the normal order. It was a massive piece of legislation that was passed in a remarkably short period of time. But I think among the most important, and this is a little bit ironic, has to do with Title I of Dodd-Frank. I was testifying with Damon Silvers of the AFL-CIO before the Senate Banking Committee, and both Damon and I, at the hearing, recommended that the committee consider the idea of a council of regulators that could coordinate regulatory policy across different regulatory jurisdictions. It was a simple idea.

I thought it was useful because of my experience at the National Security Council. The National Security Council does that with respect to foreign policy and national security policy. And the core Council has a relatively few number of members. There's the President, the Vice President, the Secretary of Defense, the Secretary of State, with the Chairman of the Joint Chiefs and the head of the CIA as advisors, and then presidents can put other people onto the Council if they want.

And having been so close to that process during my White House days, I thought a similar sort of body that sort of formalized the president's Working Group on Capital Markets, which had been formed, I believe, during President George Herbert Walker Bush's time in office, would be a good thing. And Damon Silvers sort of concurred.

So, the germ of the idea that eventually became the Financial Stability Oversight Council [FSOC], I guess, might have been mine. Whatever my idea was, it didn't appear in Dodd-Frank, though, and among the most important things we've had to deal with since is the threat of bank regulation being imposed on funds and fund advisers. And we have been working on that flat out since the passage of Dodd-Frank.

I will tell you that I've spoken a lot about this, written a lot about it, testified about it, but the structure that is created in Title I of Dodd-Frank essentially gives the FSOC a roving commission to go find institutions that may be threats to financial stability. And if they determine that you are a threat to financial stability, a systemic risk, then, what happens is pretty clear under the statute. The Federal Reserve steps in as an enhanced prudential regulator. There are capital requirements that are imposed on the institution to make sure that it has financial resources in the event that it begins to fail. It can be subject to chipping in to bail out a failing SIFI, another systemically important financial institution.

We looked at all of that in the context of our industry with some horror. And we have tried from the very first to communicate to the FSOC, to the banking regulators, and others, that this industry simply doesn't present risks of that kind, and that the imposition of these kinds of reforms in the context of a mutual fund would be highly inappropriate. It causes all sorts of issues. I've actually said that if a mutual fund or a fund complex or a fund adviser were designated as a SIFI, it wouldn't be too big to fail, it would too regulated to succeed. Because all those capital requirements, where does the money come from? Fund advising has never been considered a capital-intensive business. Funds are either zero capital or 100 percent capital. They're actually 100 percent equity capital, so why would they need to add more capital to it?

So the thought had been that there would be an imposition of some sort of capital buffer within the fund. Well, take a capital buffer of 3, 5, 7 percent, whatever you want to do, all that does is make the fund less effective in achieving its investment objectives, which will mean it's less attractive by comparison to other funds, which means investors are likely not going to stay with it, they're going to go someplace else. And the prudential supervision essentially means that the Fed comes in and tells you how to run your portfolio, it supplants the fund governance with its own ideas about what governance would be, and there's a thorough Fed intervention overlay over the existing forms of highly successful regulation.

So we have been embarked on a process of trying to explain why these funds don't present those kinds of risks on the one hand, and communicating our concerns about the potential consequences on the other, both to the FSOC and all of its many agencies, as well as the Financial Stability Board, to the International Organization of Securities Commissioners, the Basel Committee, you name it. Actually, in 2011, one of the key changes for the Institute was the establishment of ICI Global, and it was in recognition of the fact that regulatory standards, emerging standards, of discussions that focus on our industry are now a global phenomenon, and we had to engage well beyond Washington in order to be effective on behalf of our members.

WT: Where do you think the notion comes from that a mutual fund could be systemically important in the sense that they mean? Obviously, you're not in their heads, but do you think it comes from the role of money market funds in the crisis? Do you think it comes from just a general too-big-to-fail mentality?

PS: Yes, it's very interesting. During the money market fund debate we heard many people say, well, you know, this is a problem unique to money market funds, not other funds. And the reason for that is because money funds don't strike a mark-to-market NAV. You have a stable NAV, which creates first-mover advantages and potential for all sorts of negative consequences. So we dealt with the money market issue, but now people have shifted grounds and are saying, "Oh, no, it could be true with any open-end fund form; any redeemable security could present these concerns." The problem is we have 75 years of data about how funds have operated and how their shareholders have reacted in every conceivable kind of market cycle, including the financial crisis. And the kinds of hypothetical circumstances that they cite have never occurred.

So I have to believe that it's not necessarily empirically based, and certainly there's no historical predicate for it. I think part of it is bureaucratic politics. I will tell you that about maybe two years ago, I received a call from one of Paul Volcker's staffers inviting me to come join [Volcker] for dinner. And I was rather surprised. I had met Chairman Volcker many years ago. We were very clear in terms of our differences of point of view about money market funds, but I think he wanted to talk to me about this issue of systemic risk and the like, so I was happy to go and meet with him.

And he said something just at the beginning of the conversation that I've returned to in my mind many, many times. And I'm almost quoting him exactly now, but he said, "Paul, you've got to understand that you"—and he was talking about asset managers and, in particular large regulated funds—"are growing ever more important in the financial system. And the banks are growing less important. That means we"—and I took it to mean the Fed—"that means we need to regulate you."

So from his perspective, it was simply the size and importance of the intermediation function that we perform. It wasn't focused on particular risks. It wasn't focused on inadequacies of SEC regulation. It was focused instead on what is the shifting landscape in the world and funds now becoming so important. Put differently, really, the capital markets have become extraordinarily important, the banking sector somewhat less so as a source of financing, at least in the United States, and so there's a sense that the Federal Reserve as our central bank needs to get to regulate this.

Capital markets are a very, very different breed of cat, and they have not prospered as a result of the kind of regulation that the Federal Reserve applies to the banking system. I don't believe that many people over at the Fed know much about the fund business or our history or the way in which funds are managed, or the way in which they're regulated even, so a large part of what we've been trying to do is education. But I think that deep down there is an aspect of, it's simply, gosh, we need to regulate you because you're so big.

WT: I live in strange economic times. Interest rates have been so low for so long, and markets are more volatile than they used to be. Do you think that's had an effect on people's mentality as far as the role that mutual funds, or indeed equities in general, play in the economic system?

PS: I don't know. Yes, the markets have been choppy, although if you look at the distance that we've come since January of 2009, people who have maintained their investments in the equity markets have done awfully well. So people have to understand the risks and they have to be able to tolerate the volatility. The fixed-income markets have been deranged as a result of interest rate policies, which have been very punishing for a lot of investors, for lots of people saving for their retirement and trying to hedge risks and still maintain some reasonable rate of return, for people running pension funds and trying to meet long-dated obligations.

I think that part of the international interest in this area, put the domestic context aside, is also pointed out by the fact that fund investing has become a global phenomenon. You begin looking at regulated fund assets globally, and we now are, I suppose, a unique trade association representing regulated funds on a global basis. We have about, I believe, $2 trillion in our members' assets that are non-US funds.

That phenomenon is going to continue to grow, and frankly, when I travel around the world to different jurisdictions, everyone is saying, how can we get a more vibrant capital market? How can we diversify the sources of our financing away from our banking sector? The Europeans desperately want to do that, because their banking sector has been so dominant for so very long, and their banking sector has some real concerns with it. If they want to grow the pot, if they want to create new economic opportunities, finance entrepreneurs and new businesses, it needs to diversify the sources of funding available to them.

Well, the Japanese are trying to do the same thing, and the Indians are trying to do the same thing, and it's a global phenomenon. And they all look to the United States, frankly, as "wow." And it's not just the fund sector. It's the capital markets more generally in the United States. It's our retirement system as well, which has been an incredible success story in 401(k) from the point of view of others around the world who would love to have what they call that second pillar to support retirement security.

So I think that that underpins some of these policy debates that we're having now. That having been said, I believe the SEC now is adopting a program that, while it's not exactly prudential regulation, it's much closer to bank-type regulation than anything we've ever seen for the industry. I'm talking about their proposals with respect to liquidity risk management, and funds' use of derivatives, we'll have a resolution planning, living will regulatory proposal out, and a stress testing proposal. It all sounds like what the bank regulators are doing, doesn't it?

WT: Yes. Well, I'm conscious that we're coming to the end of to our allotted time here. We've covered a very wide range of issues. If there's anything else that we haven't covered that you'd like to, please do feel free to bring it up.

PS: Oh, I don't know. Did we cover everything on your list?

WT: Not quite everything, but I think we've covered really the main—

PS: I'm willing to stay for a minute or two more if there's something else that you—I don't have the list in front of me.

WT: Okay. Well, let's see. We haven't discussed the Department of Labor's fiduciary rule. It seems a bit more like a detail compared to some of the things that we've been discussing, but I know that it's hot news at the moment.

PS: Let me just spend a minute or two on retirement issues, because we really haven't dealt with those very much and that's a large part of what ICI does. If you think about funds, mutual funds in particular, about half of all the assets in 401(k)s and individual retirement accounts in the United States are invested in funds. So we were the biggest single repository of those kinds of retirement assets in the United States. And we have a great deal of interest in the success of our retirement system.

In fact, I talked about the rise of our research function. Literally all of the major regulatory comment letters that we now issue have a research component to them. Certainly that's true in liquidity risk management, derivatives very recently, DOL fiduciary the same way. We were looking at the economic case that they had made for the kinds of changes they were proposing in that market.

The concern we've had with the fiduciary rule at its core is maybe two- or threefold. One, we still don't believe that the Labor Department or the Council of Economic Advisors understood the way this market works and the changes in the market. Their analysis was stuck in a period 10 years ago when there were far more load funds being sold to the public, and the cost features of funds looked very, very different than they do today. We think they were misinformed about the effectiveness of the kinds of funds that brokers are recommending to retirement savers in terms of how they perform vis-à-vis other funds. So that was one concern based upon our own analysis of the market.

A second concern is how convoluted and complex their solutions have become, including introducing major new liabilities to class-action lawsuits under state law that Congress didn't see fit to put into ERISA [the Employee Retirement Income Security Act of 1974] when it passed ERISA itself. So that's a second concern.

A third concern, frankly, is that—and I'm not necessarily making a prediction, but at least expressing a worry—it may very well be that the DOL standard occupies the field for the future, and it's a field that really the SEC should have occupied. Now, think about this for a moment. You go to a financial adviser. That financial adviser may advise you about the disposition of your retirement assets in a 401(k) account or an IRA, also may be advising you with respect to the disposition of your retail assets outside of a tax-advantaged account in a normal retail account.

The DOL does, indeed, have some jurisdiction on the retirement side, but the SEC has its own jurisdiction on the retail side. The fact that it has not developed a rule of its own, or has not worked hand in glove with the Labor Department to come to a harmonious rule with them, I suspect is going to mean that for a lot of people the DOL fiduciary rule is going to be the rule, and I'll have to work with you as a retail customer within the confines of that rule. Because people don't make different business models, take on one hat, take off another hat. They find one way of relating to customers. So that's a major source of concern as well.

And then, finally, the reality is that people need help in terms of investing and saving for retirement, and putting obstacles in the way of their getting it is not a good thing. I think there is every reason to believe that you will have a lot of small, more marginal savers who simply aren't going to get a level of assistance that they need, simply because it's not economically feasible given the strictures that the Labor Department has imposed. We care a lot about the proper functioning of the retirement system and take great pride in our role in helping to build it, so from that point of view, the DOL rule is a worrisome development.

WT: Another thing in the category of current events is exchange-traded funds [ETFs] have increased prominence at least. What's the thinking surrounding those right now?

PS: Well, I think of exchange-traded funds as one in a very, very long line of innovations that have kept the regulated fund industry in the United States so very vibrant, and there's a long, long list of those innovations. Money market funds are obviously one of them, international investing, municipal bond funds for tax-exempt income, and you can go on and on and on. Target date funds would be a great example.

So ETFs are just another in a long line. Now, the ETFs, because they are traded, do operate within a structure of our markets. And I think there have been a lot of challenges to the market structures that have been introduced by high-frequency trading, the real change in, an explosion of, the number of trading venues that we've seen over time, the evolution of the exchange model from one that was both a center for exchange activity but also an SRO, into what are now large, highly competitive international businesses very much run on a for-profit basis. So lots of changes in the markets; the size of the markets have grown.

I think that much of the concerns about ETFs reflect not so much problems or concerns about the products themselves, much more concerns that have yet to be resolved about the structure of the markets in which they participate. They also are complex mechanisms, so I think a lot of people talk about ETFs but don't necessarily understand them in detail. But that's an educational enterprise that is part and parcel of what we've had to do on so many other subjects as well.

WT: All right. Well, as far as I'm concerned that seems like a very good place to wrap up. You've covered a very wide variety of topics, as I say, so I thank you very much for your insights.

PS: Good, thank you.

[End of Interview]