Securities and Exchange Commission Historical Society
Interview with Matthew Fink
Conducted on March 9, 2006 by Dr. Kenneth Durr

KD: This is an interview with Matthew P. Fink conducted on March 9, 2006 at his home in Chevy Chase, Maryland. I was interested in your history and background. The first thought that comes to mind was, were you planning on law school from the start?

MF: No. I think that, like a lot of liberal arts people, I didn't know what I wanted to do. When I saw Professor James Blaine Hedges at Brown, with whom I was close, he advised me to go to law school rather than get a PhD in history. So I headed towards law school.

KD: Was it accidental that you got into finance?

MF: No. I worked for Chadbourne Parke, a New York law firm, one summer, and then I worked for them after law school. Then I went into the Army. I didn't want to go back to New York, so I came to Hogan & Hartson, a Washington, D.C. law firm, in 1968, where I did financial work. I was there two and a half years or so; I liked the people a lot and it was a very good law firm, but I did not love doing financial documents. Dave Silver, who was then General Counsel of the Institute, got my name from a mutual friend and approached me about the ICI job.

The ICI in 1971 had very few people; I think it was about 20 or 24 people. When I checked around, just everybody had very positive things to say about the mutual fund industry and about the Investment Company Institute. It had a reputation different than other associations in that it was more pro-regulation and more public-spirited. People I spoke to both in industry and in government spoke very highly of it and of Bob Augenblick, who was the President, and Dave Silver, who was the General Counsel.

KD: Did you find that to be the case?

MF: Yes, I was knocked over by it. I had not liked college very much; I had not liked law school. Law practice—I liked the people, not the work. Almost from the first day at the Institute, I was very impressed by the intellectual caliber and integrity of the people there and in the fund industry.

KD: How would you describe that?

MF: The fund industry was started in Boston by money managers who had a fiduciary attitude. I think that attitude has endured and trade associations reflect their industry. I think the people they chose to run their trade group and the culture they wanted in that group reflected their own business culture. They were out to make money but they were somewhat a different breed than most people in commerce.

KD: Did Augenblick come from the industry?

MF: No, Augenblick had been a lawyer. He had gone to Harvard Law School and had been at Sullivan & Cromwell, then his own law practice, and then came to the Institute. He was a litigator and came to the Institute in the early '60s.

This is a bit of a digression but for 60 years or so, from 1936 on, the Institute's outside tax counsel was a fellow named Eddie Cohen. Cohen had represented the industry even before the Institute was created. He had known Augenblick at Sullivan & Cromwell, so when the Institute in the early '60s was looking for a General Counsel, he referred them to Bob Augenblick. Augenblick was first General Counsel and then President. Dave Silver had come from the SEC to the Institute.

KD: Followed a similar pattern?

MF: Yes. In fact, there were four in a row because Augenblick, Silver and Fink were all General Counsels and then Presidents. Now, Paul Stevens is the President. I hired him as our General Counsel in the mid-'90s. He left for other things but returned to be President. So we've had four former General Counsels as Presidents.

KD: Let's move back before you became General Counsel. What was your day-to-day work when you came to the ICI?

MF: It was varied. First, in 1970, for the first time in thirty years, since the Investment Company Act in 1940, Congress had enacted new mutual fund legislation, the 1970 Amendments to the Investment Company Act. There were a number of provisions that required rules to be adopted by the SEC. The SEC would propose a rule and the ICI would comment, so my job was preparing the industry's comment letters. In addition, the SEC asked us to give them the drafts of several rules, so two of the first things I worked on were drafting the rule that requires funds to have fidelity bonds, and the rule that requires funds to have codes of ethics dealing with personal investing. I sat down with people in the industry and outside counsel and drafted rules.

Second, the ICI did not have a tax attorney; there were only three attorneys—Dave Silver, Barbara Santos, and myself; I became our *de facto* tax attorney. Mutual fund tax has its own body of law called Sub-Chapter M of the Internal Revenue Code; it's like a mini-Investment Company Act, so I was the fellow on tax.

Third, Congress had begun to consider pension legislation, which became the Employee Retirement Income Security Act of 1974 (ERISA) and I was the ERISA lawyer. Very few people in the industry knew anything about retirement plans. I had a committee of three people in the industry and we cobbled together a program of things we wanted in ERISA, and we got all of them.

KD: Did you work with Senator Javits on ERISA?

MF: I worked with his staff—Mike Gordon. I think the Democrats controlled the Senate, so I also worked with Senator Williams' staff, Steve Paradise and Steve Sacher.

KD: What was the process like?

MF: It was much simpler in those days. ERISA was largely aimed at one problem, defined benefit plans at large corporations which had promised their employees certain amounts when they retired. There had been bankruptcies in the late '60s; Studebaker had gone bankrupt. It was a scandal that these plans did not pay what they promised and were not funded, so 95 percent of the attention in Congress was on addressing defined benefit plans. Those plans were of no interest to the mutual fund industry; we didn't fund defined benefit plans. We had a tiny toe in the water with small employer defined contribution plans like Keogh plans for the self-employed and their employees.

Through my efforts with people in the industry, I put together a program dealing with defined contribution plans. I would come in the office at 7:00 a.m. and write testimony until 9:00 and then go up to the Hill. We had no lobbyists on our staff; I was the client, the lawyer and the lobbyist. This was all under Dave Silver's supervision. We were extremely successful and our work formed the basis for what later became the fund industry's success in the individual retirement account market and the 401(k) market.

There is one provision in ERISA—I can't remember the number of it—that was often referred to as the Matt Fink provision. There was no opposition to us because I was the only person up there on defined contribution plans and IRAs, so it was fairly easy sledding from that point of view.

KD: What was the industry like? Who were the big players that you were seeing?

MF: The industry when I joined the ICI in 1971 had about 50 billion dollars in assets. That soon fell to about 32 billion because we had a bad market in the early '70s. The principal players I remember were Jack Barnard of Massachusetts Financial Services; that was the first mutual fund group. John Haire was with Fundamental Investors, and Jack Bogle was at Wellington; those were three of the most influential members on big issues.

Since we were mostly a legislative regulatory group, the general counsels of the fund groups were critical and there were a series of them about my age, who were quite active. Three were Henry Hopkins at T. Rowe Price, Arnie Scott at Mass Financial Services, and Dick Reilly at Fidelity.

KD: So there wasn't a lot of defined benefits expertise?

MF: Mutual funds were not used to fund defined benefit plans.

KD: Did the industry evolve then to follow the rise of this with ERISA?

MF: Yes, I'll give you examples. There was a section in the Internal Revenue Code called 403(b) that permitted universities and charities to have something that looks like 401(k) plans for their employees. You could reduce your salary and contribute and the school system could contribute. But since it went in the code, whatever year it went in, you could only buy insurance annuities. It had been written, I think, for TIAA-CREF. We were successful in having ERISA provide that, in lieu of buying insurance annuities, you could invest in mutual funds.

That was one example. Other examples related to Keogh plans. Before 1962, all you had were corporate retirement plans; self-employed people could not have plans. A law named after a Congressman Keogh went in that permitted doctors, lawyers, etc. to have plans. Mutual funds funded something like 30 percent of the Keogh market.

ERISA increased the amounts that could be contributed to Keogh plans and also made a number of technical improvements.

KD: There were some amendments in '75 when Dave came in?

MF: They were in the securities law, not ERISA. This is Dave Silver's expertise but I'll tell you what I can remember. There had been a court decision against Lazard…

KD: Judge Friendly?

MF: Judge Friendly—that said that in effect an investment advisor to a mutual fund could not sell his business for a profit; it was a sale of a fiduciary office. Dave, working with members and outside counsel, came up with a legislative solution to the problem and obtained the SEC's agreement. In '75 there was major securities legislation, not mutual fund legislation, and my recollection is this got added as a provision to that securities legislation, allowing a transfer if certain conditions were met.

KD: That would seem like a fairly smart thing to do if you're trying to make the mutual fund industry attractive to investors.

MF: Yes, people wouldn't have an incentive to build up a business if they couldn't sell it.

KD: The backdrop to this is the net redemption situation?

MF: You probably have the numbers from somebody but I believe just about the time I joined the ICI, the fund industry went into net redemptions for something like twelve straight years.

KD: Yes, I think it pulled out in the late '70s—something like that.

MF: It went on a long time—at least a decade.

KD: My sense of it would be there must have been some amount of demoralization or some wondering what we can do to get out of this thing?

MF: The Institute to some degree is different than the industry. We are Washington oriented, and there's a difference between that and being at Fidelity or MIT or Dreyfus. I don't think there was demoralization in the industry; I think there was a belief that the mutual fund was a terrific product and that somehow we would come out of this. I don't remember anybody despairing or quitting. I don't think many people dropped out of the business—either firms or individuals. It was a very small industry then.

KD: Right.

MF: The Institute always had its annual membership meeting here in Washington, DC. In 1974 or 1975, we held the meeting at the Shoreham Hotel. The first day the session ended at 4 o'clock and the cocktail party wasn't until 6:00 so people had no place to go. I said to the people in the room, "My wife and I have an apartment three blocks from here. Let's go over there." And we crossed Connecticut Avenue; somebody bought a case of beer and somebody bought a case of soda. My wife and I had a moderate-sized two-bedroom apartment and we all fit in the apartment easily. It may have been 40 people. That was half of the executives, lawyers and marketing people in the fund industry in '74—'75.

KD: In '77 you come in as General Counsel.

MF: Right.

KD: It sounds like all along you were very close to Dave Silver.

MF: Oh yes.

KD: Can you tell me a little bit about what you saw that he brought to the ICI to shape the Institute?

MF: First of all, Dave was very bright, very tough intellectually, and a great strategist, who often used surprise. I used to say to Dave that he would throw a 90-yard pass on first down. Dave was a superior strategist dealing with the SEC, dealing with the Hill. Like Augenblick, his ethical behavior was very strong— never do anything you don't want to see in the *New York Times* tomorrow; look at the long view—that sort of stuff. But he also was able to think outside the box.

I'll give you one example. The securities laws said that a company that's issuing stock can advertise its product but not its securities because a securities offering is going on. Since mutual funds are offering their shares every day, they basically couldn't advertise. The SEC liberalized a few rules, but you still couldn't do much. T. Rowe Price could not run an ad tomorrow saying, "You ought to think about our XYZ fund; it was up 45 percent last year." It was illegal.

Dave came to me one day and asked, "Have you been reading the Supreme Court cases on the First Amendment?" I replied, "Dave I am very busy." He asked, "Have you read them?" I said, "No, I saw the headline in the paper but—". He said, "Well they hold that commercial speech is protected by the First Amendment." And he said, "How can the SEC prevent mutual funds from advertising?" And I said, "Dave, the securities laws don't allow it." And Dave said, "Which do you think has precedence—the First Amendment or the securities laws?" This led the ICI to submit a memo to the SEC on the First Amendment and mutual fund advertising.

I don't think anybody else in the world ever would have thought of that.

KD: We're on advertising and that's going down the list. You can have a tombstone ad and now…?

MF: Yes, a very limited tombstone ad. Over time, one of the things that I worked on was liberalizing the tombstone rule. At first, all you could put in was T. Rowe Price Common Stock, 100 Pratt Street, Baltimore. The SEC adopted, to my recollection, a special Tombstone Rule for mutual funds that let you go further; it always drew the line at performance. You could not put past performance in. This First Amendment argument that Dave made, the SEC very imaginatively came out with a rule—I think it's Rule 482—that lets funds advertise past performance. That really helped the no-load funds reach investors.

When I joined the Institute, 90—95 percent of sales were load fund sales; no-load funds were almost non-existent. T. Rowe Price Growth Fund was the only well known no-load fund. No-load funds had no easy way to reach investors. They couldn't advertise performance. Rule 482 really opened things up. Nobody has ever written about it, but I'm convinced that resulted in huge benefits to investors. It helped the sale of no-load funds and put pressure on load funds to reduce costs. If we were to go trace the history of the advertising rules, sometimes you'll find it's the Institute leading, sometimes the SEC; here the SEC took the ball over the goal line.

KD: It seems like advertising was always coming up, maybe as a way to…?

MF: Oh, constantly. There are only about ten issues and the same ones keep coming up, yes.

KD: There was something that was called the "Omitting Prospectus." The concept is you can leave certain things out?

MF: I think that's what it was. You could take your 30-page prospectus and pick four key things.

KD: Was there a point at which all that went away and things really opened up?

MF: No it's still the same way. There still are SEC advertising rules. For example, if you include performance you have to give the fund's performance over the last one, three and five years. So there are requirements, which there should be.

KD: The Division of Investment Management reads all these advertisements?

MF: I think the NASD does, because the NASD regulates sales of mutual fund shares.

KD: I'd like to get a sense of your interactions with the SEC in the '70s.

MF: For years the industry was very badly split between closed end funds, which were the dominant form, and mutual funds. According to writers, the two groups were never able to form a single trade association. The 1940 Act legislation forced them to get together. There was a dinner after the '40 Act was enacted at which the head of the SEC investment company effort, David Schenker, urged the industry to form an association. The '40 Act would require decades of SEC rule-making and the SEC wanted the industry group to have a single representation that the SEC could work with.

So the ICI was created in a sense to assist the SEC. I would say during most of my time the relationship has been very good. If it ever was antagonistic it was on the merits of an issue. The industry never had—like a lot of other industries - a reflexive anti-regulation attitude. The investment company industry worked to get the '40 Act enacted.

During my time at the Institute, which was 33 years, it was like a marriage. While it was generally good, we had periods where people weren't talking to each other or slamming the door or whatever, but on the whole it was cooperative.

KD: Were there regular channels of communication?

MF: We did not deal with the Chairman or the other Commissioners a great deal. Most contact was at the level of the Division of Investment Management. If there's nothing else you get in your history, the person who really made that division was Sydney Mendelsohn. I don't know if you've heard this but when I came to the ICI there were other Division Directors who were overly strict. Every single new idea anybody had, they'd think was an investment company, and anything they wanted to do was illegal. It was very tough. Where that came from I don't know but it was in the air—stuff we would regard as totally harmless now, I mean really harmless, was regarded as a felony.

Syd Mendelsohn joined the SEC and worked in the mail room, went to night college, night law school, was the top enforcement person for mutual funds and became head of the Division in the late '70s. He had a common sense view of things. A lot of the reforms we take for granted today, readable prospectuses, performance advertising, etc. came from Syd. We would deal mostly with the Director of the Division; there was Sol Friedman, Allan Mostoff, Anne Jones, Syd Mendelsohn, Joel Goldberg, and it was a professional relationship. I would say we probably agreed 70 percent of the time and disagreed 30 percent.

KD: I did have a question about the innovations because this is an industry that's going through a lot of changes. Was most of it coming from the industry or through you?

MF: We'd have to list ten changes and then decide.

KD: There's no…?

MF: Money market funds were the biggest change. The industry, as we talked about, was 50 billion or 60 billion in 1968, and fell to 30 billion by '74. I would say to Dave, "We ought to take all our papers and give them to the Smithsonian for an exhibit entitled "The Rise and Demise of the Mutual Fund Industry." Redemptions really work.

We learned was that there's a certain core of shareholders who are not going to redeem. People have their certificates in their attic or forget about them. In the mid-'70s, different people around the country came up with the idea of money market funds. Short-term interest rates were 16-percent. The average person could only buy a bank or S&L passbook account which was limited by law to paying 5½ or 5¼ percent. If you had $100,000 you could buy a bank CD that paid a market interest rate, but if you didn't, you were out of luck. The average person couldn't buy commercial paper or buy Treasury bills. Different people around the country about the same time came up with the idea of a fund that would invest in those instruments, earn 16 percent, have one percent in expenses and pay out 15 percent. And these funds sold like gangbusters.

Some of the funds wanted to keep an one dollar per share asset value, because they sold in the trust market. One fund group – Federated - went to the SEC and the SEC denied their request. There was a public hearing at which Federated prevailed. Other money funds then copied them.

So there are two instances—the creation of money funds and the one dollar per share idea - which came from the industry, in fact the latter over SEC opposition. Then we had efforts in 24 states in the late '70s and early '80s to outlaw money market funds. Dave and I and the people on our staff were in twenty-four states in three years in these life and death battles. The SEC wasn't involved in that.

KD: Were the banks behind this?

MF: Banks and S&Ls—country banks, S&Ls—across the nation.

KD: And the banks wanted you to buy CDs?

MF: They wanted to pay you five percent on your passbook account and they'd lend it out at 16 percent.

On the other hand, the SEC incorporated the one dollar per share idea in Rule 2a-7, which had a number of different conditions. Over time the SEC tightened those conditions—sometimes at our urging, sometimes on their own initiative. And those helped to assure the safety of money market funds. So I would say that on money funds, there was a joint effort by the industry and the SEC. Similarly on advertising, both sides were involved. The industry was pushing and the SEC came up with the Omitting Prospectus. It was kind of back and forth. Product innovation has to come from the industry. But a lot of times it takes a regulatory change like Rule 2a-7 and the Omitting Prospectus to accommodate it.

KD: Makes sense.

MF: It is very much of a back and forth.

KD: You touched on the banks and that brings to mind the phrase that the Bush administration is trying to make popular now—the long war.

MF: Right, a long war.

KD: It sounds like you had a long war.

MF: Yes.

KD: I want to get to the highlights.

MF: From the beginning of the early part of the 20th century, as banks got into securities activities, liberals, reformers, and academics thought it was a bad idea. There were hearings in the House in 1913, the Pujo Hearings, and Brandeis wrote a book, *Other People's Money and How the Bankers Use It*. But then the '20s came along—the academic ideas were salted away. When the '29 Crash happened and the New Deal came in, this became an issue. Congress found a number of abuses when banks had been engaged in the securities business.

So the Glass-Steagall Act of 1933 said banks cannot be engaged in underwriting securities. The whole thing went dormant for thirty years and then in the early '60s the Comptroller of the Currency – Saxon - wanted to give banks greater powers, not just in the mutual fund area but in other securities areas. Glass-Steagall had an exception for bank underwriting of general obligation municipal bonds and he wanted to extend that to revenue bonds. He wanted to give them the powers to sponsor and underwrite their own mutual funds.

KD: Why did the Comptroller and the banks want this?

MF: It's before my time and I don't know if it was ideological or if the banks simply wanted more ways to make money. Before I joined the Institute, the Comptroller authorized Citibank to have a fund called a Co-Mingled Managing Agency Account. The Institute sued; the issue went up and down in the courts, and finally the Supreme Court held that it was illegal for banks to sponsor and underwrite mutual funds.

KD: The Comptroller is Camp and the Supreme Court case?

MF: *ICI v. Camp*. A couple of years later the Board of Governors of the Federal Reserve System adopted Regulation Y that said that bank holding companies could advise closed-end funds. That led to another Supreme Court decision. ICI sued the Board of Governors and the Court held that bank holding companies could advise closed-end funds, and by inference mutual funds.

At the same time, there were hearings in Congress. From 1978 on, Dave, and then I, testified at a series of bank powers hearings. Sometimes they were just on bank mutual fund powers; sometimes they were all powers. It also went on in hearings before the banking agencies. It was a three-ring circus going on at once: Congress, the Courts and the banking agencies. And gradually the banks started to win these court decisions and were coming into the mutual fund business.

KD: The Board of Governors case was in '81.

MF: I don't remember now. Was it?

KD: It seems like *Camp* is clearly a victory.

MF: Yes.

KD: And then the Board of Governors case I'm trying to figure out…

MF: I think what happened is in *Camp* the Comptroller simply said Citibank can do it without giving any reasoning, and the Court said come on, you can't just make up what you want without giving any reason. In contrast, the Board of Governors spent pages explaining their rationale and I think there's judicial deference to agency decisions.

This was a very bitter fight. We were suing individual banks as well as bank regulators.

KD: ICI was suing?

MF: We sued banks—these weren't the only two cases. In addition, the ICI and the banks were testifying in Congress, writing white papers, debating; it was very angry in this little world of ours.

KD: What were you saying?

MF: We were saying that number one, look what happened last time banks were in the investment company business in the 1920s. Number two, look at the things they've done since then. They've had real estate investment trusts in the early '70s. Chase Manhattan had one that blew sky-high with a lot of self-dealing. Third, we said, bank trust departments now own over 15 percent of US stocks; if they get in the mutual industry they will own 25 percent; do you really want that? On the merits, I think the fund industry was concerned about bad bank behavior tarnishing the whole industry. As a competitive matter, funds were tiny compared to the banks.

I think CitiBank made more in a year than the whole fund industry. People worried that the banks would dominate the industry. It happened with other industries they had entered, for example, mortgage banking. So there was real concern about them taking over the industry.

But banks got more and more in the fund business. When I became President of the Institute in 1991, banks managed 10 percent of the mutual funds in the country, but the ICI had only one bank member. People hated each other. I figured we had lost. So I went around and spoke to the individual bankers at CitiBank, Bank of America, Wells Fargo, etc.

There is a funny story. I told my assistant that I'd be asked to give a lot of speeches as President of the Institute and I'd have to turn most of them down. But I said I'll accept any invitation to speak to banks. I'll go to Sheboygan. So I went to New York; it's 1991 or '92 at a Bank Analysts Federation conference.

I gave a speech saying banks are great and bankers are wonderful. I then had an hour to kill; it was snowing and I had an appointment an hour later, so I went down to the Speaker's Lounge. I took off my badge and got a cup of coffee. An old man came over to me. In my mind's eye, he had a cane and a hearing aid. He said, "I very much liked your speech." I said, "Thanks a lot." He said, "I was so glad to hear somebody from the ICI give a speech without attacking bankers." I said, "Thank you." He said, "I really got sick and tired of the derogatory and evil and malicious things ICI people say about banks." I said, "Oh you must mean my predecessor, Dave Silver?" He said, "No, I mean that son of a bitch, Matt Fink." The guy had no idea who I was.

KD: So you testified in Congress?

MF: Testifying, bringing litigation—I also think sometimes there were hearings before the banking agencies. So it was constant.

KD: Where was the SEC on this?

MF: The bank regulators, like the Comptroller, were like a bank lobby group pushing for expanded bank powers. The SEC, either correctly or naively, said as long as banks register with us, it's fine.

KD: And ultimately the banks did have to register?

MF: They did. .

KD: You started out by talking about culture.

MF: Yes.

KD: And that maybe it was slightly patrician.

MF: Right; it was very much so—Boston Brahmin.

KD: Is the implication that perhaps this wasn't quite as common in the banks?

MF: Yes. It also may not have been common in other parts of the mutual fund industry. But the money management firms, not just in Boston, but if you took T. Rowe in Baltimore or Dodge & Cox in San Francisco, the top line money management firms -- also had that kind of *noblesse oblige* attitude. We're not salesmen; we're money managers.

KD: So Regulation Y.

MF: That's the Board of Governors case, that's right; yes.

KD: Right; and essentially that Regulation is saying…?

MF: It's saying that bank holding companies can advise closed-end funds, and by inference, they could advise mutual funds. So what happened is banks would fund a third-party to start a mutual fund and to hire the bank as the fund adviser. People set up businesses to be the fund sponsors and underwriters.

KD: Okay.

MF: Yes.

KD: I guess Glass-Steagall kind of went away slowly?

MF: Yes, it was piecemeal.

KD: And so by the time you came in the banks had won?

MF: Yes.

KD: How did their victory alter the mutual fund industry?

MF: I don't know how much it did. One characteristic of the fund industry from the beginning was that there should only be one association and everybody should be in the tent. If you look at other industries, the banks, the insurance industry, the brokers, they all have multiple trade associations—big banks, little banks, life insurance companies, casualty companies, etc. But one thing that Augenblick, Silver and I always tried to do was keep everybody in one association in one tent. You were much better off fighting in our boardroom, than spending time lobbing shells at each other. In other industries, half the time the rival trade groups just fight each other.

KD: Lyndon Johnson talked about this.

MF: Very much so. If you've got an association for left-handed mutual funds and one for right-handed, you spend half the time saying the other group is screwing up.

KD: Were you afraid the banks were going to…?

MF: Efforts were made; the American Bankers Association formed an affiliate for bank securities activities and somebody else set up the Bank Marketing Association. So I spent a lot of my early years as President of ICI going out and recruiting banks into membership. And a number of bankers joined our Board: Chase, Citibank, Morgan, Wells Fargo, Bank of America, etc.

KD: What did you offer them?

MF: I would go to them and say you're better off in one mutual fund trade association. The fund industry started as independent fund firms in Boston and then elsewhere. The insurance industry entered the fund business in the late '60s, the brokers in the early '70s. They all joined the ICI. We're all better in one tent working together.

As the final Glass Steagall legislation was going through one had to come up with provisions dealing with particular bank issues.

KD: Is this Gramm-Leach-Bliley?

MF: Gramm-Leach-Bliley—a whole bunch of questions. For example, could the bank fund have the same name as the bank? Could the bank lend money to its fund? I very much wanted bankers on the ICI Board as well as securities firms so we could bargain it out, and that's what happened. I had a committee of three bank guys and three non-bank guys, and we had to go through these ten provisions and figure out what position the ICI would take. We couldn't have done that as easily if they'd been in separate trade organizations.

KD: The Money Market Funds, we were talking about those and the Fed—there was a point where there was a threat that the Money Markets were going to have carry reserves.

MF: Right.

KD: Like they're checking accounts?

MF: Yes. Money market funds came in paying 15 percent—banks by law could only pay 5 ¼. My recollection is that Paul Volcker, Chairman of the Fed, wanted standby authority to put reserves on money market funds. We defeated that in Congress. That's when the banks and S&Ls went to the state legislatures. My recollection is that most of those twenty-four state bills were reserve requirement bills.

KD: The reserve would have killed the money market…?

MF: Well they certainly would have hurt. Regular bank savings accounts do not require banks to post reserves. Reserves are only required on bank transaction accounts, meaning checking accounts. Money market funds did not show the characteristics of checking accounts. They had check-writing, but people very rarely drew checks on them; they really looked more like savings accounts and every Fed study showed that.

So it seemed wrong on the merits. It also would cut the yield. The problem we had in the states is what if the state of Missouri said you have to post reserves? It would cut the yield to every fund shareholder around the country. How could the fund manager, the fiduciary for shareholders in forty-nine other states, still sell in Missouri, because to sell in Missouri would be to invoke this penalty.

KD: And Volcker you said the—the Fed…?

MF: Yes; the Fed—Volcker wanted standby authority.

KD: Even though the Fed studies said that these were…?

MF: Yes; you got it. The Fed—different Federal Reserve banks around the country—Minneapolis, Atlanta—I can't remember which, had done studies and concluded reserves weren't warranted. Volcker wanted standby authority, but the legislation was not enacted.

KD: So out to the states and this was what a three-year process?

MF: At least yes.

KD: Okay; right—we're getting up toward the 1980 Amendments.

MF: Oh that wasn't legislative; that's regulatory.

KD: I guess my assumption would be that there must have been some people thinking how do we take down this net redemption? How do we…?

MF: I think what happened was a couple of disparate things came together. The industry was in net redemptions for ten or whatever years, right. The Investment Company Act treated each fund as a separate company with its own board, so some people—including Dave Silver—said, "If a fund is going down the drain due to heavy net redemptions, why couldn't the fund's directors in their business' judgment, say let's spend $50,000 on an ad in the *Wall Street Journal* tomorrow to get more people in the fund"—because otherwise it's hurting shareholders, since, as the fund gets smaller; the expenses go up?"

Another strand was Vanguard. There was a fund group formed in 1928 or '29 in Philadelphia called Wellington. It looked like every other fund group—had an outside advisor called Wellington and had the Wellington Fund and one or two other funds. Jack Bogle joined, they had bad performance and they merged with a group in Boston called Thorndike, Payne & Lewis. At some point there was a fight and they fired Bogle as the head of Wellington Management. He got the idea of seizing control through the fund's directors. So the fund's directors took control and formed an advisor that was wholly owned by the funds. That's how Vanguard is structured. But the advisor didn't have any money to pay for the distribution of fund shares. But the SEC said the Investment Company Act prohibited funds from paying for distribution. Their only source of money was the funds. So they had to get an exemption order from the SEC allowing Vanguard funds to pay for distribution, which is exactly what 12b-1 allows.

KD: No kidding?

MF: Yes; so oddly enough even though Bogle and others are always attacking 12b-1 fees, the original 12b1—it didn't have that name -- came out of Vanguard.

KD: So Vanguard worked with the SEC to get this?

MF: Vanguard had to go to the SEC to get an exemptive order allowing the Vanguard funds to give money to their advisor to use to run ads and otherwise pay for distribution.

KD: It's a no-load fund?

MF: It's a no-load fund—there is no initial sales charge.

So that's the mix —net redemptions, Vanguard -- led the SEC to adopt Rule 12b-1, which said if fund directors make certain findings, the fund can spend money on distribution.

KD: It seems like over time 12b-1 turned into something else.

MF: Well what happened that nobody foresaw was the use of 12b-1 fees to pay brokers for the sale of fund shares. A fellow named Gary Strum, a lawyer in the fund industry, saw in the insurance annuity business that the funds paid a fee, the mortality and expense fee, part of which paid for distribution.

You bought a $100,000 variable annuity; the insurance company paid the salesman 4 percent; the fund paid back the insurance company the $4,000 over time. So Strum said, "Gee I can do that with 12b-1." We all said, "It's not there to pay salesmen," and he said, "Why not? The rule says the fund can pay for distribution." Gary Strum got his idea through the SEC and the states.

That's the change. You buy $1,000 worth of fund shares; you pay $1,000; the fund adviser pays $40 to the salesmen, and every year the fund pays off that $40. Instead of you paying a 4 percent commission in the beginning, the 4 percent comes out of the fund over time.

KD: How long after 1980 did this…?

MF: I don't recall.

KD: I know folks at the SEC are kind of two minds.

MF: Many of the rules and statutes we have are now being used for something that nobody thought of at the time they were adopted. Nobody ever thought about flag-burning when they wrote the First Amendment.

KD: And it's people just being creative?

MF: Exactly - people trying to come out with a new product and trying to figure where to pigeon-hole it. There's a lot of that.

KD: One more thing similar to that—the issue of fees. The way that set it out. There was a lot of controversy about whether fees could be fixed, whether fees had to be posted in advance…?

MF: You mean sales charges?

KD: Yes; sales charges.

MF: Sales charges.

KD: And this would be going back in the '70s.

MF: Actually, it goes back well before that. When the Investment Company Act was passed in 1940, a provision was put in, Section 22(d), which was very unusual and everybody's bet is that it was put in as part of the industry going along with the Act, that let the funds determine the sales charge. So I'm XYZ Fund, I'm selling through thirty to fifty different brokerage firms and I tell all of them that the sales charge is 4 percent or 6 percent or whatever. And Merrill Lynch, Schwab, everybody has to sell at 6 percent. There's been a 70-year debate on whether that's a good thing or not.

Over time it gets periodically raised: should Section 22(d) be scrapped and have the broker sell at whatever price it selects.

KD: Perennial questions?

MF: Perennial.

KD: Well you've spent a good time then sitting in front of Congress.

MF: Yes.

KD: How about the lobbying function; how did that develop over time?

MF: From what I can tell, for many years, the industry did not use lobbyists. In 1940, during the Congressional process that led to the Investment Company Act, the industry was up there itself. During the '70 Amendments to the Investment Company Act, it was mostly the Institute staff—though they did have a fellow named Ramsey Potts at Shaw Pittman who was an outside lobbyist. When I joined the ICI in 1971, we had no lobbyists on our staff. Whenever we needed a lobbyist, we would go outside.

KD: To the industry?

MF: No, to law firms or lobbying firms. At some point, I'm going to say 1983, Dave Silver was President and I was General Counsel, Dave said to me, "We need a lobbyist. We've got too much or it's too complicated" or whatever. So I hired Julie Domenick. Eventually, we created a lobbying department. Today, the ICI has 4 or 5 lobbyists on staff plus it hires outside lobbying firms.

KD: Right.

MF: Similarly, we were probably the last trade association in Washington to have a political action committee. I remember Eddie Cohen, our outside tax counsel for many years, called me up and said, "You're the last ones out there—you can not do business in Washington anymore without a PAC." So we were like the last people to come to that.

KD: And this is in the mid-'80s somewhere in there?

MF: Yes; probably yes, right.

KD: And of course you're representing an industry that's growing by leaps and bounds?

MF: You know this intellectually but it's very hard to fully grasp the change when you're there. You know you've grown by leaps and bounds; you know you're no longer a cottage industry or a bit player; you know you're no longer just another player—you're *the* player; bigger than the banks, bigger than the insurance industry—nine trillion dollars; every other household; half of the 401(k) money. But if you're like me, where you grew up inside, it doesn't seem like a sharp break; it seems like a series of steps but it's quite different.

KD: There must have been some point where you realized it.

MF: When I became President of the ICI in 1991, the industry had assets of $1 ½ trillion. We had marketing committees, a media committee and a research committee, and they always had what they called a joint winter meeting in Florida or someplace like that. In 1992 or 1993, we hit two trillion dollars. The meeting had two speakers from the press,. They both said, "We've made this industry, and we can break this industry."

I don't know what they were mad about, but something had got them upset. I came back to Washington and I said, "We are now in a different league." I instituted a number of steps to try to deal with the change in circumstances. Before that time we always had a press operation which mostly spent time going around the country trying to talk to the local media into running a story on mutual funds. We had a Research Department which did mostly marketing studies.

I said we're going to change these two departments and get them both on policy issues. We're going to be at war at some point and we're going to need our press people dealing with Washington issues and we're going to need our Research Department doing work on Washington issues. It was a huge change; it was like moving from a civilian economy to a war economy media. I met resistance from marketing people in the industry who liked the old way of doing things.

KD: Who are you going to be at war against?

MF: I didn't know exactly, but I figured things were going to happen. I'll give you a couple of examples of things that were bubbling. First, we're replacing the banks; I expected the issue of reserves on money funds to resurface. Second, we had community reinvestment activists—people that want to help the inner city plus banks who had CRA calling for putting CRA on mutual funds. Third, Henry Kaufman, who was the big doom and gloom economist 15-20 years ago, gave a speech in New York and said, "Mutual Funds have replaced banks; most of these people investing in mutual funds have no idea what they're doing. When the market tanks, they're going to panic, there is going to be a run on the funds, and the funds are going to have to dump securities, so there should be a Federal law saying that if you want to redeem fund shares, you have to give notice and wait 90 days."

So glimmers like that—I can't tell you which came first—the two trillion in assets or those glimmers.

KD: But you're getting big enough to show up?

MF: Getting big enough to show up and starting to grow in the 401(k) area—people's retirement money. So I said one thing we're doing is these two departments that are busy telling people they ought to invest in mutual funds and turn them into a war machine, to get ready.

KD: Yes.

MF: The second thing I did was to decide that we needed to get fund directors better educated so that they can head off a crisis and prevent bad things from happening. So we started a Fund Director Program.

KD: Is it the 401(k) that did that?

MF: I think it was a combination—I think 401(k) probably was the biggest chunk but I think people were investing in mutual funds generally. If 401(k) didn't appear, we'd still have a problem.

KD: What was the role of money market funds because…

MF: Yes.

KD: …that was the only good news?

MF: Well yes, money market funds changed the world. In fact when Dave called me today he said, "Don't forget this." Again to go back, the industry was almost entirely equity funds from 1940 to the early 1970s. This was terrific during the early '60s. Assets grew to over $50 billion. But then the stock market declined and assets fell to $32 billion.

Money market funds came along and tens of millions of people like our parents, who never would invest in stocks or bonds or mutual funds, invested in money market funds. That introduced them to mutual funds. They used the T. Rowe Price Money Market Fund and would get a letter in the mail that *we also have an international fund;* it introduced millions of people to the industry.

KD: And…

MF: Probably the biggest single thing that happened was money market funds.

KD: In that period of time.

MF: I was thinking if I was writing a book on mutual fund history, I would say the three most important things for growth were money market funds, money market funds, and money market funds.

KD: Yes but of course they're a product of the high interest rates.

MF: Yes. But they've stayed—of the nine trillion invested in mutual funds today, two trillion is money market funds.

KD: No kidding?

MF: Yes.

KD: They don't get the press…?

MF: Well they're not colorful.

KD: Yes; something else we didn't talk about and this is a bigger question—and there's probably no great answer but why that redemption—what happened to the industry—was it just a bubble that burst?

MF: What caused it?

KD: Yes.

MF: I think basically the market went up in the early and mid '60s; it then went down in the late 60's and was flat during the '70s.

Every year, year in and year out, 20—25 percent of shareholders redeem. That's a constant; it's like mortality rate and occurs because people are sending kids to college, they're retiring, they're buying a house; it usually isn't investor dissatisfaction. It's just you got 20—25 percent of investors redeeming every year. And in bad markets, people stop buying fund shares, so redemptions exceed sales.

KD: I guess I'm wondering if demographics can have something to do with it?

MF: I don't think so. During the late '60s and the 70's, I think was more constant redemptions; redemptions didn't spike, but you had few sales.

KD: I read somewhere the ICI characterized, not now but historically, as having Democratic lobbying. What does that mean?

MF: I happen to be a Republican. Julie Domenick was our in-house lobbyist for twenty years and she was a Democrat. But of the other lobbyists working for her, probably most were Republicans, so I don't know quite what it means.

KD: Hmm.

MF: I'm guessing that's what it means.

KD: I guess most of your friends or most of your contacts are Democrats if you're a Democrat?

MF: No. Julie's may have been, but the industry is largely Republican. I'm a Republican, Paul Stevens is a Republican and Dave Silver is a Democrat.

KD: So what's involved really in doing the lobbying?

MF: I haven't done it in so many years.

KD: I just want to get a sense—in the battle days when there were three of you and you had to lobby—what did you do?

MF: It was easier then. Not being a trained lobbyist and not having a PAC, I would have an issue and lobby solely on the merits. We'll pick an issue; go back to ERISA. The 403(b) market is limited to insurance annuities. We have people around the country who would like to invest their 403(b) contributions in mutual funds. Why not allow it? So I'd go up on the merits; one thing I learned from Dave and Bob is never overstate your case and always give the other person's case. I always did that.

I don't know how I got appointments in those days. I probably would just call up the Congressional office, or we had an outside lobbyist who would make the appointment and I would go up and talk usually to the staff. I probably met with thirty Senators and 100 Congressman, but my lobbying was on the merits. In those days, you did not have political fund-raisers, you didn't have PACs. I don't know if the times are different or if we were a different industry. We were such a tiny little part of the world.

KD: I assume that's changed now days?

MF: Yes, lobbying has become a business. You'd have to check with the current people at ICI. They probably have five or six lobbyists now. They do fund-raisers; they have a political action committee, the ICI members have political action committees.

KD: I'm looking at some more of the innovations. You talked about variable annuities and that was…

MF: That was in the '60s I guess—before me.

KD: Yes; and you talked about how that led into the IRAs and 401(k).

MF: Well no, what actually happened—in this one specific market, for college professors, you could fund those with only annuities. We got that open in ERISA to mutual funds. Other provisions in ERISA, like Section 404(c), says that if an employer offers a wide-range of investment choices and the employee can select, the employer is not responsible for the employee's picks. I helped write that section and then we sent in proposed regulations that said if you had a bond fund and a money market and a stock fund, you've met that wide-range requirement. Am I answering your question?

KD: Yes it's just one…

MF: ERISA kind of laid the groundwork.

KD: And that becomes very important with the 401(k)?

MF: Yes, it set the stage for 401(k) plans. Now 401(k) itself, we had nothing to do with. If I remember the 401(k) history, Congress enacted in 1978 a statute having nothing to do with pensions, that said that History Associates can have a plan which provides employees with fringe benefits and each employee can choose the fringe benefit. A lawyer named Ted Benna writes to the IRS and asks, "Can I use this for a retirement plan?" They say, "Yes, fine;" and that's how 401(k) happened. And then the fund industry saw this and convinced employers to use their funds as the investment vehicles.

KD: We were talking about how an enterprising businessman wanted to find a way to use a vehicle…

MF: Exactly.

KD: …to do what…

MF: Exactly, different fund groups innovate differently but just to use an example. Fidelity I think has been the most innovative fund group. Part of the reason is that Ned Johnson always is trying something new. He probably tries thirty new things a year, twenty-seven are complete strikeouts, two are mediocre, and one will be extremely successful.

KD: That's interesting. That would suggest that it's the big players that do the innovating.

MF: No, I don't think so. When the Institute started in '40, 98 percent of fund management companies were small partnerships or family-owned businesses. They were small. In the late '60s, the insurance industry came in, so today 10 percent of funds are run by insurance companies. The brokers came in the '70s; today 10 percent of the fund industry is run by securities firms. Then the banks came in; today 15 percent of the industry is run by banks. Then foreign financial firms entered the money market fund business.

So today, 40 or 50 percent of the assets are managed by conglomerates. My impression is that most of the innovation happens at the non-conglomerates, like Fidelity, Vanguard, Franklin and Capital.

KD: Interesting.

MF: Money market funds were started by two guys on a shoestring. Maybe size is important, but I think a bigger factor is what is the culture of the place. If you're a subsidiary of some huge conglomerate, you could come up with the greatest idea ever, but the top people at the parent company may have no interest.

KD: Right. Well here's a great idea that did start in the Washington area—ICI Mutual.

MF: Now that was purely Dave.

KD: What was the problem?

MF: Mutual funds under the Investment Company Act are required to carry fidelity insurance against larceny and embezzlement. In addition, as a matter of business practice they carry two other kinds of insurance—Director's and Officers and Errors and Omissions. Those are combined into one policy called D&O, E&O. Every year the ICI would do a survey of how many claims mutual funds made and how much in premiums they paid. We found very few claims and premiums going up all the time. I went to London to see Lloyd's and what I found out was that mutual funds were lumped with all US financial institutions into one risk pool.

So there was one risk pool for US banks, S&Ls, and insurance companies, brokers, commodity dealers, hedge funds and mutual funds. S&Ls and brokers were always in trouble and we were paying for their claims. So I said, "Can't you create a separate pool for mutual funds?" And they said, "No; you're too small. And by the way, if we create a separate pool for you, your rates will go down. We have no incentive to create a separate pool for you."

So I came back to Dave and said, "Look, it's hopeless. They will not treat us separately." We then explored other possibilities. One possibility was creating a captive insurance company owned by the insureds. We learned most captives only look like captives. In fact, there's an insurance company involved which creates a policy for you and gives you a 10-percent discount but it's not a true free-standing captive.

KD: Right.

MF: So we said no, we don't want that. Dave said, "Okay; we'll create a real captive." Our insurance broker almost vomited. It's the last thing they wanted to hear. As we started the captive, every insurance company in the country did everything it could to kill us. And all of our members who were affiliated with insurance companies, their parents said, "No way; we're not going to let you join."

Dave went around the country pretty single-handedly encouraging ICI members to create this captive insurance company. Meanwhile, as the lawyer, I was in charge of what the mutual funds' insurance policies looked like and insurance companies would not write a separate mutual fund policy. They used what they called a Brokers Blanket Bond. It was written for brokerage firms, not for mutual funds.

And it was like having your car insured by a maritime policy. Protections that mutual funds needed weren't included. Protections they did not need were.

So the fund industry, under Dave's leadership, creates ICI Mutual Insurance Company by the skin of our teeth, raises enough capital, and ICI Mutual creates its own policies which are designed specifically for mutual funds. Before, you asked me about Dave's traits and I said morality, intellectual strength, and I said something about…

KD: Outside the box?

MF: …outside the box and tenacity?

KD: Yes.

MF: The creation of ICI Mutual was due to Dave's tenacity. It took tremendous stick-to-itiveness to do it.

KD: Yes, and he had to essentially convince the industry to buy it?

MF: You got it.

KD: Were various sectors easier than others?

MF: I know the fund companies that were affiliated with insurance companies were not happy with it.

KD: And probably a little surprised to hear about that.

MF: Yes, and I think that at other places, the internal person who buys insurance is a friend of the insurance agent.

KD: Well moving up into the early 2000s.

MF: Yes.

KD: And we're getting up—you in the history books you're bound to see this—well just like the 1850s is about the Civil War.

MF: Oh.

KD: We're leading up to something.

MF: Oh okay. What are we leading up to—the late trading market timing scandals?

KD: Yes, but I think maybe the question is, I read in several places that there were indications of what was going on in trading in the Japanese stock…

MF: Right, yes.

KD: So I understand at any rate that the SEC at some point and the mutual fund industry, the ICI, had some sense that this…

MF: Since funds were created, there has been market timing but not what we regard as bad market timing. There are people who thought that they, by stock market movements, they could guess which way the market was going, and those people traded mutual funds. They were services—I think one fellow was named Fabian.

KD: Speculating.

MF: Speculating in mutual funds. Everybody thought, good luck to them. Then fund firms started international funds. Funds compute their net asset values at 4 o'clock; for U.S. securities, they use the closing prices on the New York Stock Exchange and for Asian securities, they use the closing prices on the Asian markets. The Tokyo exchange closes at 4:00 pm in Japan; it's nine in the morning here. At four o'clock p.m. in New York, funds compute their value using that 9:00 a.m. price. Intervening events can happen; there's an earthquake in Tokyo, currency changes, whatever, which indicate that the 9:00 a.m. price is no longer accurate. People start trading these funds like mad, particularly in tax exempt accounts.

KD: Why is it in tax exempt accounts?

MF: Because there's no tax friction when you move. You move from the international fund to the money fund; you have no capital gains. Tax exempt accounts were the perfect places to do it—401(k)s, variable annuities.

KD: It's not going to be detected?

MF: Not just not detected. There's no tax consequence to you. You're right; a lot of it is undetectable because funds often don't know who is in their 401(k) plans. They just know they've got the IBM 401(k) plan with 800 million dollars in it. They don't know about the individual participant in the plan who is market timing like mad.

This hurts the other shareholders. So funds adopted procedures to stop timers. They started fair valuing more. Instead of using the old Japanese 9:00 a.m. price, they estimate what they think the four o'clock price is. They also put on redemption fees on short-term trades. But they say these are not working; we've got to get better tools. Craig Tyle, the ICI's General Counsel, is down at the SEC asking for more tools to combat timers. For example, we say funds should be able to delay exchanges. You ought to be able to redeem the money fund today but you can't go into the international fund for two days, i.e. break the arbitrage. The SEC says no; you're required to do both transactions today.

So we're down at the SEC seeking more tools; the SEC is resisting. Meanwhile, professors are putting out papers—a professor named Zitzewitz writes a paper saying that there's a lot of arbitrage going on and it's costing shareholders—I think he estimated five billion dollars a year. We looked at it and said five billion is high, but it's probably two or three billion. We're very concerned about it. Funds were using existing tools to combat timers, and the ICI was asking the SEC for more tools.

But unknown to us, some fund officials were cutting deals with timers or market timing themselves. This is how it relates personally; I had been thinking about retiring for a number of years. The Executive Committee of the ICI Board and I decided to announce my upcoming retirement on September 5, 2003. It's a Friday. This is all kept quiet but we hire a search firm, form a Search Committee, draft a press release, etc. Three weeks before, on a Saturday morning, I go to play tennis a block from here; I play with my buddy and we get done at 10:00. I walk off the court, but who walks on the court next to me but Eliot Spitzer, who I had met once. We chat, "What are you doing down here, Mr. Spitzer?" "I'm playing tennis with my niece." As I left the tennis court, he said, "How are mutual funds doing, Matt?" I said, "Just fine." He said, "Just you wait; have a good weekend."

I came back right to this house and said to my wife who is drinking coffee and reading the Saturday *Post*, "Gee Ellie you won't believe it; the god-damnest thing just happened." And she said, "You're always exaggerating, you are always worrying; go take a shower, eat breakfast, relax."

On Monday, I told my staff about this but we all thought it was a joke. The week of September 5th begins—Monday, September 1st; I come into the office thinking, "Wow, I'll be announcing my retirement this week." On Wednesday, September 3rd, about 10:00, my assistant came into my office and said, "We just had a very funny call." I said, "What's that, Carole?" She said, "The New York State's Attorney General's Office called to say that you ought to turn on CNN or Fox News."

I turn it on, and there is Spitzer announcing the Canary Proceeding, where he found four fund groups making deals with market timers on timing themselves. And my stomach flips. I knew that the media and Congressional reaction will be huge. This is in the wake of Enron and WorldCom.

So we say we're horrified, we're shocked, we're dismayed and it turns out more and more of these things come out. Plus, Spitzer is a terrific publicist. Remember, he says, "This is like betting on a race when you know the results."

Mutual funds got clobbered. The media goes wild because for years, we had told them we're an exception to the rule—we're clean, we're honest; we never used *squeaky clean*. Stories start to appear that the ICI must have known about it, sleeping at the switch, lulled the SEC, which was all baloney. And then we have one Congressional hearing after another, just bing, bang, bang.

My concern is that in the crisis atmosphere, Congress will enact bad legislation having nothing to do with market timing or late trading. So the first thing we at the ICI say is that, we're horrified; people ought to go to jail. Second, we urge the SEC to act quickly and decisively. Chairman Donaldson is a smart guy and the SEC came out with a bunch of proposals. But it was a whole year of media bashing and finger-pointing, Congressional hearings, and general unhappiness. There were fourteen people on the ICI's Executive Committee; I think five of them get fired because their firms were mixed up in this.

KD: How did the rest of the industry react?

MF: The rest of the industry was wondering what was going to happen to them. Nobody quite knew. You could be the president of your firm and you don't know that your top salesman cut a deal in Sheboygan with the Sheboygan Hedge Fund.

KD: So it must have been tough dealing with it.

MF: Some members called to say that the ICI ought to throw these firms out of membership. I said, "Wait a minute, guys. Number one, these are only allegations; number two, let's assume it's Bank of America and everything they say is right, how would it benefit shareholders of the Bank of America funds for us throw them out of membership? They won't have any part of the culture. It's shooting the horse and not the rider."

Fund directors are upset because they never knew about this. "How come nobody ever told us?" *Forbes* or *Business Week,* or both of them, write articles saying this all happened because the ICI gave sedatives to the SEC. This is baloney. In fact, we had been urging the SEC to do something about market timing. We were down there saying give funds more tools to combat timing, such as let us delay one trade on exchanges.

KD: Why didn't the SEC do the things you wanted to do?

MF: Let them break trades for example?

KD: Yes, take your pick.

MF: I think that a daily redeemability has always been regarded as the essence of a mutual fund. To say that, on an exchange, you can got out of Fund A today but you can't get into Fund B until tomorrow, flew in the face of that. Now whether that would have helped or not, I don't know. In the case of something like 40 or 50 percent of shareholder accounts, the fund doesn't know the individual shareholders.

T. Rowe Price knows most of its shareholders, but if you're Putnam or Oppenheimer -- Merrill Lynch has one huge omnibus account of a billion dollar accounts in the Oppenheimer Growth Fund. The fund doesn't know who the people are, so policing would have been very hard. Even if the funds had gotten the right to break—to delay these trades—it might not have helped. I'm not finger-pointing at the SEC. I think what we all missed was that fund insiders were colluding with market timers, were doing it themselves.

Afterwards, a number of people in the industry told me that they had been approached by hedge funds and turned them down. And they're kicking themselves because they never thought that anybody would agree to it. Several of these people told me, "I wish I called you and said I had been solicited by a hedge fund. I turned them down but I don't know if the other guy would."

KD: So there was a tendency to assume the best about the people in the industry?

MF: Yes.

KD: The vast majority?

MF: We always worried about people trading in individual securities. The fund is buying IBM; the fund insider knows about it and buys IBM shares in advance.

KD: Right.

MF: We were always worried about the funds' investments, insiders free-riding and we have a whole series of controls on that. But the industry, the SEC and the media never thought about fund people trading in fund shares or helping other people trade in fund shares—just never thought about it.

KD: So you talked about what you can do; it sounds like a lot of what you were doing is reacting.

MF: Once we found out about it, yes; we said, put people in jail. We also said that the SEC has to adopt tough rules. My recollection is vague, but I think we sent the SEC pretty tough rule proposals—one requiring redemption fees on people who traded a lot. Remember, you've got 500 fund groups; say twenty were involved, so 480 were not.

The abuses didn't cost any particular shareholder a lot of money. It wasn't like Enron or WorldCom where people lost huge amounts. But it's awful because in a fiduciary business, which this is, any abuse is unforgivable. But also the overreaction by the media and the Hill was unbelievable. Senator Fitzgerald introduced a bill in the Senate that would have hurt the entire industry and millions of fund shareholders. It just scared the be-Jesus out of me.

What I can't tell, and it's a little bit like the '20s, is were the abuses so bad or did it hit at just the right moment. I still don't know to this day. I would say on a scale of one to ten, the abuses were about a six or seven, but the reaction was a nine.

KD: Yes; and some of that is just the market for news.

MF: Enron, WorldCom, Spitzer, the Barnum and Bailey of this business.

KD: Yes, he had already practiced on…

MF: He had learned—I had some lunch with somebody the other day who said that Spitzer had stumbled a little bit with the securities analysts, but he had perfected his game by the time he dealt with us.

KD: You didn't get Sarbanes-Oxley.

MF: That came out of Enron and WorldCom. I think Sarbanes-Oxley was done by this time.

KD: Yes it's…

MF: Just happened.

KD: One of the questions was about the exemptions from Sarbanes-Oxley.

MF: Sarbanes-Oxley is mixed for mutual funds. For example, we got stuck with CEO certification. So Ned Johnson at Fidelity has to certify the internal controls of 300 Fidelity funds.

KD: The part you didn't get?

MF: I don't know recall exactly. If you said Sarbanes-Oxley to most fund people they would say, "My God, we shouldn't have got stuck with it."

KD: No that's something that has been an ongoing criticism or not, but…

MF: Yes.

KD: …you know people want to ratchet up the independent directors and…

MF: Right. I happen to be an independent director so I have first-hand experience. My fund group has an independent chair who is terrific. But I think it makes no difference at all if the chair is independent or not—it depends on the person. If you look at the worst market timing case, Bank of America, they had an independent chair.

MF: I think it's cosmetic. The ICI opposed requiring an independent chair, but we never went to war about it. Fidelity has gone to war about it. The Chamber of Commerce has brought this lawsuit, but I don't think it makes much difference. 90 percent of the agenda of a mutual fund board meeting is dictated by SEC rules. First of all, there's certain contracts the Board has to approve—the Advisory Agreement, the Underwriting Agreement, 12b-1, Transfer Agent, Custodian, so you have a bunch of service agreements. Then the Investment Company bars many transactions. They can only be done pursuant to SEC exemptive rules, which require board approval.

For example, Oppenheimer Fund A wants to sell 10,000 shares of IBM. Oppenheimer Fund B wants to buy 10,000. You can't—it's illegal. Rule 17a-7 allows it subject to a number of conditions, including board approval.

There are twenty things like that take up 90 percent of the Board meeting. Now that's going to be true whether the chair is independent or not. He's going to have the same agenda—90 percent of it is exactly the same. Some people say, well, the chair can dictate the agenda. But the agenda is dictated by law.

KD: Yes and there's not a lot of choice I guess. It's fill in the blanks?

MF: It's become the cause celebre. All I'm saying is I don't think if funds were mandated to have 100 percent independent directors, 100 percent independent chairs, it would make much difference.

KD: I want to touch on one sort of cutting edge thing and then get to some of the big questions.

MF: Yes; go ahead—sure.

KD: Where are the industries going? Technology has been through so much change and while you were still in charge, what was your concern about web-based mutual fund trading, basically putting together web-based packages?

MF: You mean Portfolios?

KD: Yes; web-based….

MF: Well it looked to us that it was a closet investment company. It looked like a mutual fund, and therefore we thought it ought to be registered as a mutual fund. In fact, a lot of the sales materials said, "This is an enhanced mutual fund." Over the years, people have come up with a lot of products that don't have the label mutual funds, but should be treated as mutual funds and I'll give some examples.

First, Citibank manages individual accounts, not trust money. What Citibank wanted to do in the late '60s was have a fund where they co-mingled individual accounts they managed. The ICI sued and the Supreme Court said, "Yes that's a mutual fund—illegal under Glass Steagall."

Second, the insurance industry comes out with a product—it's life insurance but instead of paying a million dollars at death, the premiums you pay will go into a fund and when you die your wife will get what the account is worth. ICI said that's a mutual fund, and the SEC agreed with us.

KD: I just wondered if there's a sense that technology could change things is all.

MF: Yes, take managed accounts. These are accounts where you go to a broker with $50,000 and the broker will say, "You can pick your style, aggressive or moderate or conservative, and we'll pick stocks for you that fit that."

Well they don't really sit down and look at you individually—they've got a million Kens. They look at your income, your age, and there are 50,000 people getting the same stuff. So it looks like a closet mutual fund. The SEC has adopted a rule exempting them from mutual fund regulation. So people have worried that technology can get to the point where you have created unregulated mutual funds.

KD: It's a matter of tools I guess.

MF: I still believe that mutual funds are by far the best financial product for 98 percent of Americans. I haven't seen a better widget yet, but there's always that widget problem.

KD: Well some of the big questions and then we can wrap up.

MF: Yes.

KD: *Business Week* said the SEC is in pocket. The ICI—can you talk about…?

MF: Did you ever see the letter we wrote them?

KD: I didn't.

MF: We wrote a great letter.

KD: To *Business Week?*

MF: The ICI had urged the SEC to act in a number of areas. When Paul Stevens was ICI General Counsel and we were worried about the industry growing, one idea he came up with was requiring every fund group to have a compliance officer. But Chairman Levitt ignored our suggestion until the scandals happened and then Donaldson put it on. I discovered shelf space in '94 where fund advisors, in order to sell, have to go pay brokers money under the table. I went to the NASD, I went to the SEC and begged them to do something about shelf space—they didn't do anything.

So *Business Week* said we were lulling the regulators; half the time we were kicking them. *Business Week* said ICI opposed a self-regulatory organization for mutual funds. We opposed it because we thought that it was bad for the consumer. We thought direct SEC regulation was more effective than having a bunch of competitors allegedly regulate themselves. So the *Business Week* thing really ticked me off.

KD: The point I was going to make is—and you also talked about Syd Mendelsohn and it's clear that a lot of innovation is coming from the industry. The SEC is helping make it happen.

MF: Yes; and the SEC—it also starts a lot of things, too. It works—they're not just reactive to us.

KD: I want to get a sense of how you think the ICI has been able to help shape the SEC's approach to this industry.

MF: Well that covers so many topics. I think a lot of times agencies are cut off the real world. The SEC used to have the inspections for mutual funds in the Investment Management Division; the inspectors would come back and tell Bob Plaze something smells or Plaze would say, "Go look for X." Now they're in separate silos; there's a whole separate SEC inspection arm. I think that's bad.

The ICI provides them with factual information. How many people have IRAs? I'm convinced in my old age that most disputes between people are because they have different sets of facts. The ICI has helped get the industry and regulators on the same page.

KD: How about personalities? You talked about Syd Mendelsohn.

MF: Mendelsohn was a great figure but Joel Goldberg, who was his successor, was very much like Syd.

KD: If they've all had different styles, which styles worked and why?

MF: The key is common sense. The '33 Act can be read to not let funds advertise performance, but that's bizarre. It's the one thing investors would like to know—how has the fund done. We can have prospectuses that are thirty pages that are great for lawyers to read; they're no good for the consumer. Well the lawyers said, "Well you've got to put this in and you've got to put that in," Syd Mendelsohn and Joel Goldberg said, "Well that's crazy. What good is that?" So I think common sense practicality was the most important trait of a regulator. And I was always for toughness; I always thought they tough regulators were good for the industry.

KD: This gets to an issue that I've seen in other places that the Division of Investment Management was sort of made second class under the SEC.

MF: We talked before about the Institute's culture. The SEC came out of the '34 Act, so the SEC has a broker/dealer culture. The tendency at the SEC is to stress enforcement and broker/dealer issues. It's in the walls, it's in the fabric of the place.

KD: You can see that in resources; where else can you see that?

MF: I'm not dodging that; I don't know.

KD: That's a slippery kind of concept anyway.

MF: Yes.

KD: Do you think in general that the ICI has helped the fund industry change or has it sort of been a moderating influence?

MF: Yes.

KD: You've got to pick one.

MF: I think it's been both. I mean clearly the ICI doesn't come up with products but when people have new products or services and there are legal or regulatory impediments, we've helped break those.

On the other hand I think the ICI has been very good at spreading fiduciary culture. It's helped moderate behavior. It's probably helped people from jumping off a cliff.

KD: Some of them jumped.

MF: Some of them jumped anyway right.

KD: Well is there anything at this point that you absolutely want to bring out?

MF: No you really covered the waterfront.

KD: I appreciate your taking the time.

MF: Thank you.