Written Testimony On

Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence

Before the U.S. House Financial Services Subcommittee on Capital Markets

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Mr. Garrett, Ranking Member Waters, and Members of the Subcommittee, my name is Heidi Stam. I am a Managing Director and General Counsel of Vanguard and the Vanguard Funds. I appreciate the opportunity to speak with you today about the state of the mutual fund industry and issues of importance to mutual fund investors.

Vanguard, headquartered in Valley Forge, Pennsylvania, is one of the world's largest mutual fund complexes. We offer more than 170 U.S. mutual funds with combined assets of approximately $1.7 trillion. Individual investors, whether directly on Vanguard's retail fund platform, indirectly through financial intermediaries, or as participants in defined contribution or defined benefit retirement plans, hold upwards of 95% of our assets under management.

Vanguard's highest priority is to serve the interests of our clients, namely, the investors in our mutual funds. We believe that we bring a unique and important perspective to the industry and to our investors because of our mutual ownership structure. Vanguard is a "*mutual*" mutual fund company – that is, Vanguard is owned by the Vanguard mutual funds and therefore owned indirectly by our mutual fund shareholders. All of Vanguard's corporate management and shareholder services are provided "at cost" with "profits" returned to mutual fund shareholders in the form of lower expenses. Given this mutual ownership structure, all of Vanguard's management policies, practices, and incentives are aligned with the growth and safety of investors' assets and the long-term interests of our mutual fund shareholders.

So I speak today not only as a representative of Vanguard but also as a direct representative of millions of American workers, retirees, their families and their businesses, who entrust their assets to Vanguard. Our retail shareholders rely on mutual funds, including money market funds, to save for a down payment on a house and maintain a rainy-day fund. They save for retirement through mutual funds offered in their employer's 401(k) retirement plan or an individual retirement account, and for their children's education in 529 college savings plans. Institutions use mutual funds to manage pensions, endowments and foundations. Small businesses look to money market funds as a source of capital to finance their payrolls and for safety in their cash management needs. Municipal (widely known as tax-exempt) money market funds play a significant role in financing short-term debt for state and local governments, hospitals, school districts, and sewer authorities. Without tax-exempt money market funds, borrowing would become less efficient and more expensive, further stretching government budgets that are already trying to do more with less.

We appreciate your interest in Vanguard's views about the current state of the mutual fund industry, market stability, investor confidence, and regulatory matters, and we hope to lend to this Congressional oversight hearing today the perspective of the retail investor from Main Street, not Wall Street.

Key Advantages of the Mutual Fund Product

Mutual funds are the most efficient, effective and intelligent way to invest and they have a long history of integrity and success. They are superior in terms of liquidity, transparency, professional management, and diversification as compared to other financial products.

Mutual funds have democratized investing. By pooling the money of many investors, mutual funds allow people of ordinary means to get broadly diversified, professionally managed portfolios of stocks, bonds, and money market instruments. Investors own an equity security in the form of mutual fund shares, representing economic exposure to all the portfolio securities in the fund and receiving their proportionate share of the dividends, interest, and capital gains produced by those securities. Thus, the shareholder who has $5,000 in a fund receives the same investment return per dollar as someone who invests $5 million in the fund. Competition has continued to lower the costs of investing in mutual funds and to broaden the services available to fund investors.

Mutual funds provide superior transparency and disclosure to most alternative products. Those who place money in bank deposits or insurance products often don't know how their assets are invested. Mutual funds, by contrast, provide regular, detailed information on their holdings. They calculate and publish the net asset value (NAV) of fund shares at least daily, and are required to sell and redeem their shares at their current NAV. This daily mark-to-market requirement ensures that investors know the value of their shares, and imposes discipline on mutual funds to which other financial products are not subject.

Money invested in mutual funds is subject to many legal safeguards. Importantly, a fund is a separate legal entity and therefore its assets cannot be used to satisfy any obligations owed by the fund's adviser or any other funds. Fund assets are physically held in safekeeping by a custodian that is independent of the fund and the adviser. Funds are subject to oversight by boards of directors that are independent of the adviser, and fund advisers have a fiduciary duty to manage the fund's assets in the best interests of shareholders.

Mutual funds are registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and mutual fund shares are publicly offered securities that are registered with the SEC under the Securities Act of 1933. The Investment Company Act, the framework for comprehensive regulation of the fund industry, remains one of the most successful pieces of legislation enacted by Congress.

These characteristics of mutual funds have served Main Street investors extremely well for more than 70 years and provide investor protections that differentiate them from many other financial and investment products in the market.

Our Mutual Fund Investors' Recent Experience

Mutual funds remain the investment and savings product of choice for U.S. investors. Today, 44% of U.S. households own mutual funds, compared with less than 6% in 1980.[1] An estimated 90 million individuals own funds, covering a broad spectrum of age, education and income characteristics.

Investors in mutual funds, including participants in employer-sponsored retirement plans, weathered the recent financial crisis surprisingly well. Most investors came through the financial crisis, perhaps not unscathed but substantially intact. According to our research, retirement plan account balances over the five-year period through 2010 actually have risen as a result of ongoing contributions, a recovery in stock prices, and the diversification of participant portfolios (most participants do not hold all-equity portfolios).[2] In 2010, median account balances rose by 16% and average balances rose by 14% from 2009 levels as a result of improving markets and the impact of ongoing contributions.[3] Over the three-year period from the fall of 2007 through 2010, one of the most volatile markets in history, only 3% of retirement plan participants sold out of equities entirely.[4]

Long-term investors rode out the financial storm by remaining calm, staying the course, and tuning out the market noise. Storms inevitably will occur. Vanguard has always encouraged investors to take a long-term view of investment return, pay attention to cost, and diversify within and across different asset classes. Prudent asset allocation, broad diversification, and long-term investing using low-cost funds including exchange-traded funds (ETFs), are sustaining principles that serve the investing public well in all types of market conditions, including during the most recent economic crisis that some now refer to as the Great Recession.

Mutual funds proved to be strong and resilient in the face of extreme market volatility and duress. Continued public confidence in, and success of, the mutual fund product is due in large part to the comprehensive investor protections and detailed, substantive federal securities law and regulatory requirements to which mutual funds are subject.

To be sure, mutual fund investors and the industry faced some challenges during the financial crisis. Markets were illiquid and bank credit was frozen. The Reserve Primary Fund, a money market fund that was heavily invested in commercial paper issued by Lehman, "broke the buck" in 2008 and returned 99¢ per share to its shareholders instead of $1.00. Vanguard's money market funds, which followed stricter internal policy controls on credit and liquidity than regulatory minimums, were well positioned to address the challenging conditions when the markets seized. But the industry felt the consequences of The Reserve Primary Fund's failure, and regulators and the Investment Company Institute's Working Group on Money Market Reform began to review rules governing money market funds, looking for ways to improve the funds' ability to withstand extremely unusual market conditions. The SEC responded swiftly and soundly by strengthening money market fund rules governing liquidity, credit quality, maturity and transparency, and concerns have subsided despite the fact that these funds are mired in the lowest yielding environment in their four-decade history.

In the 40 years since they were introduced to the marketplace, money market fund assets have grown to over $2.7 trillion, representing over 25% of all mutual fund assets.[5] And over this 40-year history, only two money market funds ever have failed to return $1.00 per share: Community Bankers Fund, an institutional money market fund that paid out 96¢ per share in 1994, and The Reserve Primary Fund in 2008. Yet despite money market funds' well-earned reputation for safety over a long period of time, some commentators have called for an end to money market funds as we know them, either by having money market funds regulated as banks or by requiring them to float their net asset values, that is, turn them into short-term bond funds. We urge these commentators to maintain some perspective and carefully weigh the substantial benefits that money market funds offer to individual investors and small businesses, and the costs that would be imposed on those investors and the economy if money market funds were to disappear.

Enduring Principles of Mutual Fund Regulation

Mutual funds are subject to a comprehensive regulatory regime and are regulated under four federal securities laws: the Securities Act of 1933; the Securities Exchange Act of 1934; the Investment Advisers Act of 1940; and, most importantly, the Investment Company Act of 1940.

The federal securities laws are designed to protect investors primarily through disclosure, but the Investment Company Act also substantively regulates the structure and day-to-day operations of mutual funds and ETFs. The Act protects and requires independent safekeeping of a fund's assets; prohibits conflicts of interest and other forms of self-dealing; restricts complex capital structures; requires daily mark-to-market valuation of fund shares for price transparency in purchases and redemptions; and imposes a corporate governance framework in which independent directors (who must constitute at least a majority of the board) play a key role in protecting mutual fund shareholders from overreaching by their management companies. The role of mutual fund directors is central to protecting the interests of fund shareholders in conflict of interest situations.

Useful and usable fund disclosure

Current disclosure rules ensure that mutual fund investors receive comprehensive, accurate information about a fund. In recent years, Vanguard supported the widespread use of a summary prospectus for mutual funds, which provides key information about the fund including its investment objective and strategies, risks, and fees and expenses, in a standardized format allowing investors to more readily compare similar funds. The SEC adopted the summary prospectus for mutual funds in 2009. Vanguard also supported online disclosure of a money market fund's complete portfolio holdings in connection with amendments to SEC Rule 2a-7, which the SEC adopted in 2010. In both cases, we believe that improved transparency and greater understanding by investors of relevant fund information benefits the mutual fund industry as a whole. We also support moving to a more streamlined shareholder report for mutual fund investors to provide them the most helpful information in a usable format.[6]

Improving transparency

Importantly, mutual fund sponsors and financial advisors are adapting disclosure tools and techniques to better educate investors about mutual funds and ETFs as well as to improve investors' financial literacy. Transparency in disclosure for investors' protection has always been a key goal of the SEC. At Vanguard, we have a long history of educating investors with "Plain Talk" on a wide variety of investment topics in an easy-to-read format. We have remained focused on investor education with progressive methods for delivering content to investors, including podcasts, videos, live webinars, interactive graphics, and blogs. We encourage the SEC to continue to apply its regulatory oversight over mutual fund disclosure judiciously and effectively to embrace positive innovation that historically has served investors well.

Effective regulator

The strict regulatory regime to which mutual funds are subject has played a vital role in the growth and endurance of the mutual fund industry and continued investor protections. The SEC has served as an effective regulator of mutual funds and their investment advisers for 70 years through a variety of disruptive and unstable markets, and should continue to serve as their primary regulator in the future.

The Dodd-Frank Act gives the SEC new responsibilities in addition to its traditional market oversight and investor protection responsibilities, including oversight of derivatives trading; hedge fund advisers; municipal advisers; asset-backed securities; and NRSROs (nationally recognized statistical rating organizations). The SEC's expanded authority cannot compromise its responsibilities with respect to mutual funds and other more traditional investment products.

Current Issues Facing the Mutual Fund Industry and Investors

Vanguard understands the need for the Financial Stability Oversight Council (FSOC) to monitor risk across markets, institutions, and sectors. However, we do not believe that mutual funds, which are already highly regulated by the SEC, should be subject to oversight by that

Council. Frankly, we at Vanguard are perplexed when the words “systemic risk” and “mutual fund” are uttered in the same sentence. During the Congressional debate on the Dodd-Frank Act, it seemed clear that mutual funds were not relevant to the discussions about systemic risk.

The financial crisis demonstrated that markets can be vulnerable when certain interconnected financial companies engage in risky lending and financial engineering involving highly complex transactions coupled with the use of leverage. But none of that risky lending or financial engineering with leverage related to mutual funds. Mutual funds don’t have leveraged exposures or non-transparent, off-balance sheet liabilities. They don’t engage in short-term risk-taking through proprietary trading. They are extensively and comprehensively regulated by the SEC. Neither mutual funds nor their advisers are systemically risky under the criteria of the Dodd-Frank Act.

Mutual Funds Should Not Be Designated As SIFIs

Under Dodd-Frank, FSOC has authority to designate certain non-bank financial companies as systemically important financial institutions (SIFIs), subject to regulation by the Board of Governors of the Federal Reserve System and heightened prudential standards.

Mutual funds do not pose systemic risk and they do not exhibit the characteristics of a SIFI under FSOC’s articulated relevant factors, which include: extent of leverage; extent and nature of off-balance sheet exposures; extent and nature of transactions and relationships with other significant nonbank financial companies and significant bank holding companies; importance as a source of credit for households, businesses, and governments as a source of liquidity for the financial system; importance as a source of credit for low-income, minority, or underserved communities; size, scale, concentration, interconnectedness, and mix of activities; the degree to which the company is regulated by a primary regulator; amount and nature of financial assets; and amount and types of liabilities, including degree of reliance on short-term funding.

Vanguard submitted a comment letter to FSOC on its Advanced Notice of Proposed Rulemaking[7] in which we explained that mutual funds, by their very structure and regulation, do not pose systemic risk and should not be designated as SIFIs. Among other things, we pointed out the following:

- The SEC limits the amount of leverage mutual funds may use and requires funds to segregate assets to cover future or contingent payments. Therefore, mutual funds do not have leveraged exposures.
- The SEC requires regular and timely financial reporting and transparency by mutual funds both to the regulator and to investors. Lack of transparency, such as off-balance sheet accounting, can exacerbate hidden problems until they surprise the market. Mutual funds do not have off-balance sheet liabilities and do not engage in leveraged trading activities with systemically important financial companies.
- Mutual funds perform daily valuations of fund assets and disclose such valuations in the form of an NAV. The requirement to value securities daily, coupled with disclosure of such information, makes it difficult to mask risk.
- SEC rules require mutual funds to maintain highly liquid portfolios in order to ensure that mutual fund shares may be redeemed daily by investors. The market-wide illiquidity that occurred in 2008 did not result from mutual fund activity. It resulted from banks' unwillingness to accept each others' credit risk.

- Historically, returns from credit risk have a bias toward small frequent gains and large infrequent losses, which can be destabilizing to a financial system in a time of market crisis. Companies that have large and leveraged exposures to credit risk could magnify financial system risk. Mutual funds and their investors may experience losses, but those losses do not infect the broader financial markets.
- The SEC has been a highly effective primary regulator of mutual funds and their investment advisers. Mutual funds and their advisers are comprehensively and substantively regulated under the federal securities laws.
- Mutual fund advisers do not engage in proprietary trading for their own accounts with mutual fund assets. Mutual fund assets are owned, *pro rata*, by the fund's shareholders; each fund is its own corporate entity, separate and distinct from its adviser and all other mutual funds; fund assets are recorded on the fund's balance sheet, not the adviser's balance sheet; fund assets are subject to strict custody requirements; fund assets cannot be used to satisfy the obligations of the adviser or other funds managed by the adviser; fund advisers manage assets as fiduciaries; and investment activity of mutual fund advisers is limited by each fund's distinct objective and strategy.

Money Market Fund Reform

Money market funds are well-regulated by the SEC and should remain solely under the SEC's jurisdiction. To the extent that the debate about money market reform continues, and regulators determine that additional protections are necessary, the SEC, not FSOC, should be tasked with developing any rules governing money market funds.

During the fall of 2008, many institutional money market funds experienced large-scale redemptions, and some retail money market funds experienced reduced liquidity in terms of finding buyers and sellers for their commercial paper and other portfolio securities. The SEC's recent amendments to money market fund rules have significantly improved the funds' safety, liquidity, and resiliency under extreme market conditions. The money market fund rules now impose daily and weekly liquidity minimums, maximum weighted-average maturity and weighted-average life requirements, regular portfolio stress testing and board reporting, additional limits on second tier securities, and portfolio holdings disclosure requirements. Collectively, these changes are designed to make money market funds self-provisioning for liquidity, reducing the likelihood that a future systemic market disruption would threaten the liquidity of these funds and require government support.

Institutional money market funds experienced the greatest cash demand for redemptions and therefore the greatest need for enhanced liquidity. From September 9 through September 23, 2008, investors in the 25 largest institutional prime money market funds withdrew 30% of those funds' assets, on average. By contrast, investors in the 25 largest retail prime money market funds withdrew an average of only 3% of fund assets.[8]

Institutional money market funds typically have significantly large percentages of fund assets concentrated in the hands of a few large and highly sophisticated shareholders. These sophisticated institutional shareholders, such as hedge funds, private equity and sovereign wealth funds, often insist on same-day liquidity, meaning that they purchase fund shares in the morning and redeem fund shares on the same day, earning interest for the time that their money is in the fund.

Retail money market funds serve the cash management needs of retail investors, individuals who need to save cash to make an upcoming purchase, manage their cash, or save for retirement. Retail money market funds tend to have a very small percentage of fund assets held by any one or few shareholders, and generally do not provide for same-day liquidity. Instead, these funds permit shareholders to purchase shares on any given day, but will not accommodate a same-day request for redemption of those shares. Redemption requests in retail funds are generally performed on a one-day delay.

These two types of money market funds serve different investor needs and operate somewhat differently. If more needs to be done to enhance money market funds' resiliency under extreme market conditions, then it may be appropriate for the SEC to impose a customized set of rules including, importantly, additional liquidity requirements on the institutional money market funds. Imposing additional liquidity will result in slightly lower yields for those institutional fund investors. This is an appropriately tailored regulatory solution. Institutional investors who are likely to demand the greatest liquidity should pay for it, rather than the retail investor who occasionally writes a check out of his or her money market fund account.

We hope that FSOC will defer to the SEC on this topic and we urge the SEC to consider distinguishing retail versus institutional money market funds in the event it determines that money market fund regulation requires further reform.

Municipal bond markets

Vanguard manages over $120 billion in tax-exempt money market and tax-exempt municipal bond funds. Although much has been reported lately about the financial difficulties facing municipal governments, Vanguard believes that predictions by certain analysts of massive municipal bond defaults in 2011 do not reflect reality.

Municipal bonds trade in a large, fragmented market with a long history of repayment, and the credit and transaction structure of municipal bonds have been favorable to investors. These credit structures have stood up well in times of stress, making municipal bankruptcies extremely rare. Nonetheless, state and local governments face ongoing financial pressures that should not be ignored. These pressures could lead to some future downgrades in credit ratings, and some isolated defaults or restructurings of smaller projects in the future. That said, we do not see these pressures leading to major municipal bond defaults.

We support the efforts of the SEC and the Municipal Securities Rulemaking Board to improve disclosure and price transparency in the municipal market. We remain concerned, however, about the differences in disclosure practices between the taxable and tax-exempt municipal bond markets. Timely and updated financial information is not provided to the market on a consistent basis by all municipal issuers. We also are concerned when issuers refuse to make available to the market information that they otherwise provide to rating agencies or their governing boards. As long-term investors in the municipal markets, Vanguard supports additional measures to improve disclosure by municipal issuers on an ongoing basis, including repeal of the Tower Amendment.

Credit ratings

Vanguard supports the SEC's efforts to improve information about credit rating agencies and their methodologies, and to address conflicts of interest. Given recent problems encountered with credit rating agencies, the Dodd-Frank Act requires the SEC to remove references to credit ratings from all of its rules, including SEC Rule 2a-7. In the context of money market fund regulation, however, credit ratings have served an important investor protection role by providing a "floor," or a minimal credit rating, below which a money market fund adviser could not acquire securities.

Earlier this year, the SEC proposed a rule to remove from Rule 2a-7 all references to credit ratings and substitute the credit ratings with subjective thresholds of eligibility. The

SEC's subjective standard could permit a fund adviser to become more aggressive in its credit analysis. Although credit ratings alone do not render a security eligible for purchase by a money market fund, removing the credit risk rating as a floor could lead to imprudent management. We believe that more can be done to protect investors. Thus, should Congress re-open certain provisions of Dodd-Frank to modification, we recommend that SEC rules relating to money market funds be permitted to retain references to credit ratings.

Derivatives regulation

Vanguard supports better regulation and transparency of the derivatives markets, including centralized clearing of derivatives and posting margin to back derivatives trades. These measures will benefit mutual funds as investors in the derivatives markets and restore integrity of the markets and investor confidence.

Many of the changes coming out of the Dodd-Frank Act relate to the lightly regulated derivatives markets. In contrast, mutual funds' use of derivatives is highly regulated. Specifically, derivatives use by mutual funds is highly regulated by substantive provisions of the Investment Company Act that regulate capital structure and leverage. In addition to statutory prohibitions on leveraged structures, the SEC has issued guidance that requires mutual funds to segregate highly liquid assets to cover future or contingent payments, such as through derivatives transactions.

Vanguard has used derivatives in its mutual funds as part of prudent portfolio management for more than 25 years. Derivatives, such as futures and options, enable funds to hedge portfolio risk, lower transaction costs, and achieve more favorable execution compared to traditional investments. These uses are highly beneficial to investors. We continue to work with regulators to clarify misconceptions about derivatives use in "plain vanilla" funds, including

ETFs. Product innovation and investor choice should not be stifled where concerns do not exist, such as funds and ETFs that use derivatives as a portfolio management and cost efficiency tool.

Conclusion

Today, the fund industry overall has over $13 trillion[9] in assets under management, which serves as a testament to the trust that investors continue to have in the mutual fund product. Despite the severe market pull back and a decade of mundane stock returns, the mutual fund industry is the healthiest of all the financial industries.

There are a few critical reasons for the relative good health that we, as industry members, never take for granted. Diversification of our underlying assets; absence of proprietary trading and therefore no incentive to take on risk for short-term reward; daily valuations, which force us to "take our medicine" in down markets daily; tight controls on leverage; and, finally, the nature of our client base, which also is diversified and balanced.

Mutual funds continue to help investors reach their most important financial goals in a lifetime, including a secure retirement, a college education, a home, and a safety net. Competition in the mutual fund industry is a great regulator and also a great source of humility. We thank you for the opportunity today, on behalf of our investors, to share the view from Main Street.

ENDNOTES

[1] *2011 Mutual Fund Fact Book*, Investment Company Institute, p. 79.

[2] *The Great Recession and 401(k) Participant Behavior*, Stephen P. Utkus and Jean A. Young, March 2011.

[3] *How America Saves 2011*, A Report on Vanguard 2010 Defined Contribution Plan Data, June 2011.

[4] *Supra*, note 2, at 11.

[5] Source: Investment Company Institute.

[6] *Comment Request on Existing Private and Public Efforts to Educate Investors*, Vanguard Comment Letter, June 21, 2011.

[7] *Advanced Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, Vanguard Comment Letter, November 5, 2010.

[8] Source: iMoneynet.

[9] *Supra* note 1, at 9.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

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<tr><td>1. Name:

HEIDI STAM</td><td>2. Organization or organizations you are representing:

THE VANGUARD GROUP, INC.</td></tr>
<tr><td colspan="2">3. Business Address and telephone number:
[redacted]</td></tr>
<tr><td>4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?

☐ Yes ☑ No</td><td>5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?

☐ Yes ☑ No</td></tr>
<tr><td colspan="2">6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.</td></tr>
<tr><td colspan="2">7. Signature:
Heidi Stam</td></tr>
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