MUTUAL FUNDS: A REVIEW OF THE REGULATORY LANDSCAPE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

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MUTUAL FUNDS: A REVIEW OF THE REGULATORY LANDSCAPE

Tuesday, May 10, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:00 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] Presiding.

Present: Representatives Baker, Ryun, Castle, Biggert, Kennedy, Feeney, Hensarling, McCarthy, Lynch, and Wasserman Schultz.

Chairman BAKER. I would like to call this meeting on the Subcommittee on Capital Market to order.

This afternoon the committee meets for continued examination of practices of the mutual funds industry and the potential effect on the individual investor.

As all members know, after the passage of the Sarbanes/Oxley legislation, significant operation reforms were brought to bear on all sectors of the financial marketplace, including the mutual fund industry. This, of course, was a warranted action in light of some 95 million Americans who are now vested in mutual funds and depending on one's perspective, have some difficulty in always accessing comparability of the various mutual funds investments they may hold, and so we return again today pursuant to the GAO report issued last year, which raised continuing concerns about areas that have been under examination previously.

In some cases, fees have continued to go up, turn over rates, in other words, turning rates remain unacceptably high. And transparency is still goal, which we all see, but are having some difficulty in clearly establishing.

Against that backdrop, however, I want to say a word to those within the ICI, particularly Mr. Stevens, the new leadership there, for taking a professional and positive step forward in working with not only the committee, but with regulators in crafting a higher standard of professional conduct and expectations for all those who are fiduciaries within the industry.

As we turn to the SEC, I am pleased that they have acted in such a prompt manner on so many areas, but there should be a constant balancing, in my opinion, between the new regulatory regime and the cost of compliance. I think it often missed in public discussions that whatever the cost may be ascribed to a particular compliance activity, that cost is ultimately charged against the in-

vestor's account. And so we have a due diligence responsibility, a fiduciary obligation to ensure that our regulatory standards bring about the needed disclosures, but at the same time are balanced against the cost against that individual investor's account. And so that ongoing analysis will likely be required in determining whether the disclosure regime today or one going forward is appropriate in light of these charges.

I know there is internal discussion about the effect of the hard 4 o'clock closing rule and its prejudicial effect on west coast investors, pension fund managers, large 401(k)s, and that there may be some technological way to preclude the ill-advised late trading strategy, but not at the same time preclude trading by legitimate business interests who happen to be in the wrong time zone.

I believe there to be some discussion about concerns over the sale point confirmation activities. Clearly enhanced transparency is something that most on the committee would find advisable, but in looking at what has been suggested, it takes me back to my real estate days in Louisiana where to close a first mortgage on a home purchase today will vary slightly from about 75 to 85 pages. I know from firsthand experience that most people don't read about 74 or 75 pages; they say tell me where to sign and wait on the 3-day rescission period to pass so they can get the closing done. We don't want to follow that path.

I think that disclosure should be concise and clear. It shouldn't be so complete that it is convoluted, and I think that one should question the value of disclosures made simply for the purpose of having forms executed without at the same time conveying real information to the investor.

I am hopeful going forward that we can continue a good working relationship with those in authority at the SEC. A fair, open, transparent market that enables working families to invest and build for their first home or college education is certainly a very important goal, and we should do it in the most professional environment possible, with consequences to those who just simply choose not to abide by the rules.

With that, I would yield to Ms. Wasserman Schultz for opening statement.

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman. And no, Mr. Kanjorski has not had a magical transformation——

Chairman BACHUS. Tis a pity.

Ms. WASSERMAN SCHULTZ. I will let that one hang there and send his regrets that he was called away unexpectedly.

Chairman Baker and distinguished guests, it has been nearly 2 years since late trading and market timing scandals shook the mutual fund industry. In 2003, preliminary investigations found that up to 10 percent of fund companies were aware that some customers were late trading, nearly 25 percent of broker dealers executed orders for customers after 4 p.m., potentially in violation of SEC regulations, about half of the fund groups had some arrangements with favorite shareholders to engage in market timing, close to 70 percent of broker dealers were aware of timing activity by customers, and almost 30 percent assisted timers in some way; and finally, some mutual funds executives may have traded illegally in their fund securities, to the detriment of other investors.

I hope today's hearing will shed light on the progress both the SEC and the industry have made to increase transparency, improve mutual fund governance and end abusive and unfair trade practices that undermine the integrity of our markets.

More than 90 million Americans rely on these financial instruments to protect their investments, and investor protection must always be our highest priority.

I expect that our panelists will have best practices they can share as they work to implement reform, but I realize there are still many areas that will need to be refined. I encourage both my colleagues and our guests to take this opportunity and engage in a meaningful dialogue. I hope our panelists will highlight areas that still need to be improved and strengthened, as well as the steps that we can take together to get there.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Mr. Castle, would you have a statement?

Mr. CASTLE. Well, thank you very much Mr. Chairman, I appreciate the opportunity.

I have some guests here, by the way, the winning women of Delaware who are back there, one of whom is the attorney general in Delaware, Jane Brady, who is with us today. I always worry, though, when the attorney general starts following me around, to be very candid.

I think, Mr. Chairman, that you in particular, and this subcommittee and our committee as a whole, have actually done a thorough and good job with respect to the mutual funds industry since the problems arose a couple of years ago. And I think that the SEC has followed through and done some things correctly as well. And I think the mutual funds industry has sort of, after initially sort of burying its head in the sand, has come toward and made some progress in this area as well. And I think as a result of that, when you start talking about some of the illegal trading that was going on, and some of the almost criminal problems that existed in the past, that we have made great steps.

But I still worry about the vast majority out there. I believe the statistics are about 50 percent of Americans are somehow or another involved in the mutual fund industry, it may be in an IRA or 401(k), it may be so indirectly almost don't even know it, but nonetheless, it is a heck of a lot more than, say, 25 years ago—and obviously 50 years ago, and it is probably going to increase. The complexity of investing is so difficult that you sort of want to turn it over to somebody who knows what they are doing.

But what you don't want do is to turn it over to somebody in a situation in which you don't know what the fees are that you are paying, you don't understand what the classes of mutual funds are, be it A, B, C, D or whatever, you don't really know what that means in terms of your costs. You don't know where your costs are actually coming from, how are they paying for their trading, how are they paying their other costs, or whatever it may be. I, for one, have been concerned about 12b-1 fees for some time. 12b-1 fees were created solely at a time when mutual funds were not doing that well in order to help with advertising and let people know about mutual funds.

And at some point they transferred into a sales load, indirect, of some kind or another so that mutual funds are sold and brokers are paid back over a period of 5 or 6 years. I was amazed to find that a heck of a lot of these are charged on mutual funds that are closed, which means whatever you do is selling anything as far as I am concerned. I consider practices like that to be absolutely dead wrong, and they need to be addressed as far as our future is concerned.

So my concerns, I guess, more relate not just to the clearly criminal activity that was going on before, but relate to just the transparency and the understanding of the average investor, which I would guess is 90 percent of us who invest in mutual funds, in terms of what we are getting into, what are we paying for it, what are the true costs going to be, what is our net benefit at the far end? Those are things that I think we need to better understand. And please don't ask me to read the prospectuses and all that stuff, first of all, I get bored to tears; and secondly, I stop understanding it about halfway through page one, so I don't think that is completely the answer either.

So I just share that sort of every man's concern as to where we are going. And I do apologize, Mr. Chairman, I have to go visit the Mint for some interests that they have, another matter of interest to this committee. At about 2:40 I have to leave, but I appreciate the opportunity of being here.

Chairman BAKER. I thank the gentleman for participating.

Mr. Hensarling, Mr. Kennedy, Ms. Biggert? There being no requests for further additional opening statements, it is my pleasure at this time to recognize our first witness, Mr. Meyer Eisenberg, who is the acting director of the Division of Investment Management of the Securities and Exchange Commission.

STATEMENT OF MEYER EISENBERG, ACTING DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION

Chairman BAKER. Welcome, sir. You may proceed at your own leisure. Your official statement will be made part of the official record, and you will have to pull that microphone close because it is not very sensitive. Welcome.

Mr. EISENBERG. I thank the Chairman, members of the committee, before Congressman Castle goes, I feel like I am sort of at Delaware again at the Weinberg Center talking about corporate governance.

So in any event, Chairman Baker—I gather Congressman Kanjorski is not here, but I think that in what we are going to go through, I will try to respond to some of the questions that have been raised by the chairman, that have been raised by Ms. Wasserman Schultz and by Mr. Castle, and hopefully I will do that in some reasonable order.

I am Meyer Eisenberg, I am the acting director—and I stress acting—of the Division of Investment Management. In real life, I am a deputy general counsel of the SEC. And I thank you for inviting me here to testify before the committee today on the status of the Commission's mutual fund rule making reforms.

I am pleased to be here on behalf of the Commission to provide an overview of the regulatory reforms the Commission has adopted in response to the recent unfortunate spate of mutual fund industry scandals that have involved some of the best known names in the industry, not just a few bad apples. These events sharply dramatized the need for additional measures to deal with the conflicts of interest inherent in the organizational structure of most mutual funds, to restore public confidence in the fund industry, and better safeguard the interests of fund investors in the future.

I would also like to outline some of the additional regulatory initiatives that the Commission has undertaken in this area, that may be of interest to the subcommittee.

Before I begin, however, I would like to take this opportunity, on behalf of the Commission, to thank you, Mr. Chairman, for your leadership on the issue of mutual fund reform. Many of the reforms ultimately adopted by the Commission address the important concepts included in the Mutual Fund Integrity and Fee Transparency bill that you introduced.

I also want to thank committee Chairman Oxley, subcommittee and committee Ranking Members Kanjorski and Frank, as well as members of the subcommittee and the full committee for their leadership during this very disappointing chapter in the history of the mutual fund industry. Millions of Americans—now indeed over 91 million Americans—rely on these products to safeguard and grow their savings so they can achieve their dreams of a home, an education for their children and a comfortable retirement. Your support has been vital to their protection, and to the restoration of confidence in this important sector of financial services industry.

Mr. Castle is correct, when I first joined the Commission staff many years ago, before I was in private practice, the whole mutual fund industry in the mid 1960s was $40 billion. Today there are over $8 trillion, an exponential increase. Several of the funds in some of the major fund groups exceed $40 billion, and many more people are involved than ever before.

Last year, in the wake of the mutual fund late trading, market timing and revenue sharing scandals, the Commission implemented a series of mutual fund reform initiatives. The reforms were designed to, one, improve the oversight of mutual funds by enhancing fund governance, ethical standards, compliance and internal controls; two, address the late trading, market timing and other conflicts of interest that were too often resolved in favor of fund management rather than the interest of fund shareholders; and three, improve disclosures to fund investors, especially fee-related disclosures so that people know what it costs when they are investing.

It is the Commission's hope and expectation that taken together, these reforms will minimize the possibility of the types of abuses that we have witnessed in the past 20 months from occurring again. I would like to briefly review for you the significant steps the Commission has taken to strengthen and improve the mutual fund regulatory framework. I have excerpted this from the longer written statement.

First, with respect to fund governance reform. With respect to enhancing mutual fund governance and internal oversight, the cen-

terpiece of the Commission's reform agenda was the Fund Governance Initiative. In July 2004, the Commission adopted reforms providing that funds relying on certain exemptive rules must have an independent chairman, and 75 percent of the board members must be independent. These governance reforms will enhance the critical independent oversight of the transactions permitted by the exemptive rules. Funds must comply with these requirements by January 2006.

The fund governance reforms were designed to carry out the specific Congressional instruction in the Investment Company Act, that the resolution of conflicts of interest be in the interest of fund shareholders rather than the interest of fund managers. Our fund governance reforms are also designated to facilitate the implementation of other fund initiatives that we have adopted. In reviewing these questions, we need to step back and recall the statutory direction and the policy provision of section 1(b) of the 1940 Act as it was originally enacted 65 years ago. The Act states in that provision, it is hereby declared the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

Section 1(b)(2) of that statement declares that the national public interest and the interest of investors are adversely affected when investment companies are operated, managed or their portfolio securities are selected in the interest of their officers, directors or other affiliated persons.

In addition to our fund governance reforms, other mutual funds reforms that the Commission has pursued include the requirements for compliance policies and procedures for chief compliance officers, codes of ethics, a directed brokerage ban under rule 12b-1, and a voluntary rather than a mandatory 2 percent redemption designed to forestall market timing where it is not authorized.

The new redemption fee rule mandates that funds enter into written agreements with intermediaries operating omnibus accounts that enable funds to easy information from those intermediaries so that the funds can identify shareholders in those accounts who may be violating market timing policies. Under these arrangements, the intermediary and funds would share responsibility for enforcing fund market timing policy.

There was ample opportunity for industry representatives to raise issues regarding this provision during and before the comment period. We would be interested in hearing the problems and exploring the ways in which those concerns may be resolved later.

Now that I have outlined the Commission's adopted rules, I want to focus for a moment on the so-called Hard 4 proposal, which you raised, Mr. Chairman. To address those problems associated with late trading, which involves the purchase or selling of mutual funds at a time that the funds share prices are after 4 o'clock, but receiving the price for 4:00 and buying after 4:00, the Commission, in December of 2003, proposed the Hard 4 rule, that you had to have your order in by 4:00 eastern time. This rule would require that fund orders be received by the fund, its designated transfer agent or clearing agency by 4 in order to be processed that day. We re-

ceived numerous comments raising concerns about this approach, in particular, we are concerned about the difficulties that a Hard 4 rule might create for investors in certain retirement plans and investors in different time zones. Consequently, we are focusing on alternatives to the proposal that could address the late trading problem, including various technological alternatives, electronic stamping and so on.

Chairman Donaldson has instructed the staff to take the time necessary to fully understand the technological issues associated with any final rule, and the Commission is likely to consider this final rule later this year. You see, the comments of industry, institutions and shareholders are taken seriously, and proposed rules are, indeed, modified to accommodate real legitimate concerns.

Let me now turn to the issue of mutual fund disclosure. Improved fund disclosure, particularly disclosure about fund fees, conflicts and sales incentive, has been a stated priority of the Commission's mutual funds program throughout Chairman Donaldson's tenure, even before the mutual funds scandals came to light. Thus, the disclosure enhancements have been an integral part of our reform initiatives. My written testimony discusses these mutual fund disclosure reform initiatives, including reforms related to the disclosure of portfolio holdings, the fund expenses and shareholder reports, disclosure regarding market timing, fair evaluation, selective disclosure of portfolio information, and disclosure regarding breakpoint discounts on front-end sales loads, board approval of investment advisory contracts, and portfolio manager conflicts, and compensation.

In addition to these adopted reforms, the Commission recently requested additional comment on proposed rule-making brokers—on a proposal requiring brokers to provide investors with enhanced information regarding costs and broker conflicts, like when the fund managers direct payments to brokers for shelf space so that they should be featured, and the ones that don't pay don't get featured, don't get the preferred treatment, those kinds of conflicts associated with their mutual funds transactions, the so-called point of sale proposal which was referred to.

Chairman Donaldson has stated that he is hopeful that the Commission can move on this initiative after we have had the opportunity to review comments and respond to that reasoned request. Having outlined the Commission's progress in the fund reform agenda, I want to highlight some additional mutual fund-related initiatives that Chairman Donaldson has indicated are on the near horizon. One of the most significant involves the use of soft dollars for research. Chairman Donaldson has stated that he believes it is necessary to examine the nature of conflicts of interest that can arise from the type of soft dollar arrangement which involves an investment adviser's use of fund brokerage commissions—which is, after all, a fund asset—to purchase research and other products and services. He has placed a high priority on resolving these issues.

Consequently, he has formed a commission task force that is actively reviewing the use of soft dollars, the impact of soft dollars on our Nation's securities markets, and whether allocations of soft

dollar payments further investor interest. And we will have the results of that task force from the Commission, I hope, in short order.

Other upcoming mutual fund initiatives outlined in the written testimony include a staff recommendation that the Commission propose a rule to improve disclosure of mutual fund portfolio transaction costs, a thorough and reasoned review of rule 12b-1, which was referred to, and a top to bottom assessment of disclosure.

Let me say a few words about cost benefit, with which I think you opened this hearing with, Mr. Chairman.

I want to comment briefly on the issue of cost/benefit analysis, which I understand may be raised by certain industry representatives.

The Commission is always sensitive to the cost and benefits imposed by its rules, and therefore engages in an extensive cost/benefit analysis in all of its rule makings. I want to emphasize that our Office of Economic Analysis, Division of Investment Management engage in a careful and thorough review when preparing the cost/benefit estimates in connection with these fund rules and submitted them to the Commission for its consideration.

You must keep in mind, however, that in any analysis of the cost and burdens and anticipated benefits of a rule is, after all, only the best estimate of those costs and benefits. The Commission specifically requested and seriously considered industry comments, among others, in the course of the proposing and adopting process involved in the promulgation of these rules. However, if cost/benefit analysis is to be used as a strategy to stifle responsible regulatory efforts to address the types of abuse, the fiduciary responsibilities, particularly in conflict of interest situations, that we have seen over the past, the failure to act could, again, undermine investor confidence and impair the integrity of the market in the eyes of the investors, both large and small.

Suppose, for example, that under section 404 of Sarbanes-Oxley, the financial certification rules, and an active compliance program now required by Sarbanes-Oxley had been placed at Enron or at WorldCom, there is a distinct possibility, if not probability, that the scandals that caused billions of dollars to evaporate overnight, from retirement plans and from the holdings of investors, might well have been mitigated or even largely prevented. The benefits would have undoubtedly outweighed the cost. But how can this be measured precisely or predicted when you were writing the rule? While cost/benefit analysis is a critical component of all commission rule makings, these types of estimates should not be dispositive when analyzing the utility of a particular regulation, although they are important in assessing what the costs or consequences might be.

Legitimate use of cost/benefit analysis is important, but should not be used to undermine regulatory initiatives designed to prevent the kinds of conduct covered in the recent scandals.

In conclusion, Mr. Chairman, let me thank you again for your support and for your leadership in the area of mutual fund reform. Under your leadership this subcommittee was at the forefront of recognizing the necessity that reform and initiating serious consideration regarding what needed to be done to restore investor confidence in this industry took place.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy, I think, to answer any questions you may have.

[The prepared statement of Meyer Eisenberg can be found on page 56 in the appendix.]

Chairman BAKER. Thank you, Mr. Eisenberg. Let me compliment you as well for your long-standing service to the SEC and to the investing community.

I do believe that committee and the Commission and the Commission staff have all agreed and identified on the points of concern that continue to be somewhat problematic. I think the only difference that might exist at all, if there is a difference, is in the resolution of how we address those concerns.

Since you spent a little time on the cost/benefit analysis, let me, by way of example, give you the real estate parallel. When you sit across the closing table on that first mortgage loan closing there are innumerable documents which require innumerable signatures. Most consumers don't really fathom what they have just signed, nor the consequences of their rights, as a result of those disclosures.

That has led me to conclude that a concise but clear consumer disclosure may be distinctly separate from the legal notification to which that consumer may require access at a later time. It leads me to conclude that a one- or two-page document that gives up front disclosure fees and all the appropriate agreed-upon things which most people would center on, with a notification of some electronic point where one could engage additional services at no cost at a subsequent time, and perhaps engage legal counsel, if necessary, most of that bulky rights and privileges don't come into play unless the market goes sour or it is just a fraudulent conduct, which means usually in retrospect, not at the time of closing.

I would hope in the construct of these disclosure rules that some sort of mechanism to provide the clear and concise, with access to the more detailed, would be something that would be evaluated. I, frankly, do have concern, as a strong proponent of transparent disclosure, that it is missed sometimes that the cost of compliance is a direct hit against the rate of return for the investor. It is not just the management company that takes the lick, it is passed through.

And we have an obligation, in a fiduciary nature, to those investors to make the regulatory framework effective, but get the cost down as much as is practicable.

So I am not suggesting that the Commission should alter or stop or deter or forget any of the enumerated concerns that you brought to our attention today—I happen to share all of those concerns; I do have a considerable concern about the effectiveness of a very bulky disclosure regime.

There is one other area that I wanted to explore, and it comes on the business side and regulatory approval side. It has been brought to my attention—and I think one of the witnesses later may bring up the subject, so in deference to your appearing here, to be able to address this question, there was an ETF exemptive request and it has been represented more than one, but this particular one was an association with a high-yield fixed income indices that the request has been pending now for almost 2 years.

It appears that the regulatory deafness within the enterprise to respond to changing market conditions has also taken a hit as the regulatory side has gotten more burdened. Is this a leading indicator for me that we still need more staff, or is this something else going on with regard to approval processes on this exemptive side?

Mr. EISENBERG. Well, let me—I think that what you talked about, about a summary prospectus in the first—or a summary that is made available to a shareholder that is a couple of pages and is comprehensible and is in English and is not in legalese, I think that is important. I think we agree with that, that there is an effort now, it may not be two pages, it may end up being four pages, but the point is to—and this has been done through focus groups of investors to get us to understand what it is they are interested in and to get a bottom line where an investor can tell before, at the point of sale, and that goes to the point of sale issue, that he or she can tell what it is that it is going to cost them and what the conflicts of interest are and what they should be looking at.

There is also an investor education program, which is ongoing, Web sites and that kind of thing. And you are right, and I think we agree with you that that is an important priority, and I think we have tried to do that.

With respect to the lagging exemptions. One of the things—I just got to this position last month—one of the things I hope to do is to examine the lag in the processing of exemptions and to see what we can do to tighten that up. I think that any bureaucrat will tell you yes, we need more people, and I believe with what has happened in terms of the increased regulatory burden and the exponential growth of the industry and the problems that have been piled on top of it, we may well need additional people. But we have gotten some additional people, we have gotten some additional accountants, we have deployed them, and I think that question of who we need and whether we need them, both as a Commission and both as a division, that we may well come back and say yes, we really need these people. But nevertheless, addressing the gap, a 2-year gap in processing an application for an exemption, I mean, I will look into that.

Chairman BAKER. Thank you. And one last—because my time has expired.

With regard to general policy and the responsibility of independent directors, I was an advocate of independent share, independent directors, I think that is a healthy thing to have the friction between the management company and the fund board, but on the other hand, the responsibilities of that director, I believe, are policy and broad-based.

Is it the Commission's view, or if you can't speak for the Commission, your view that the director is really responsible for everything that happens in the company or in the fund, or is it a broader fiduciary responsibility, meaning do you have to get into detailed actuarials and really understand what contract X meant?

I am concerned about the implications of service for people who may be overwhelmed with the potential liabilities contingent on the SEC view of that responsibility.

Mr. EISENBERG. For a long time I was counsel—in my previous life I was counsel to management companies and I was also counsel to independent directors, I was independent counsel to them. And I think that the Commission, and I think we generally take a broader view that directors are not there to micromanage what goes on in the fund. I think one of the key things that a director needs to do is to ask the right questions and make sure the answers are narrowed down.

The things that you discussed and things that the other members of the committee have discussed were overall broad policy questions, like trading, market timing, sticky assets, the incentives to use fund brokerage for distribution without disclosing them, those are things that in the normal course directors should be interested in. And they have helped because they should have independent counsel, they have got an independent auditor, and if the independent counsel and the auditor and now the compliance people do their jobs, they will find out about these issues and they will be able to act.

And consequently, I think the brief answer to your question is they are not responsible for micromanagement, they are responsible for the overall policy and to see to it that the compliance issues are addressed.

Chairman BAKER. That is excellent. Thank you, sir. Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman. First of all, I want to thank you for all of your work on this issue. I know the spirit in which a lot of your work has been done, which is to restore trust and confidence in the industry. And director Eisenberg, I appreciate the work that you have done on this as well.

I do have some concerns, and I would like to go right back to the issue the chairman issued about fund governance, and I would like to back it up just a little bit.

I understand the potential conflict and the spirit of the, you know, Investment Company Act in your opening remarks, the principles that guided you, and I actually voted for an amendment in the last session to have a majority of the directors be independent. However, the rule that has been adopted here for companies who enjoy certain exemptions to have 75 percent of the directors be independent and the chairman to be independent, I am concerned with that, I am concerned with it greatly.

And I am concerned that this is almost a purge, almost a purge of trying to get rid of everyone who might be best suited and most valuable and most knowledgeable from the board itself. And I am very, very concerned about that. And I think sometimes what we see is there is a crisis or a scandal, and then the pendulum swings harder the other way and we sort of cause as much damage as we are initiating a fix. And I would just like to get your sense of—is that a valid concern, or should I be happy with what is going on here? Because frankly I am not.

Mr. EISENBERG. As I said before, I have been on both sides of this thing. I came back to the Commission about 6 years ago, and I was going to be there for 2 years and now it has been 6 years because of various things that have happened.

I think, first of all, it is a concern, but I think the Commission was aware of the concern. And having viewed this from the inside

and having viewed it from the point of view of the Commission, and also from the point of view of independent directors, there are two organizations, national organizations of independent directors. One is the directors forum, and the other is an ICI-sponsored independent director's council. Both of those organizations have written and supported both the 75 percent and the independent Chair proposal. It does not seem to have had the effect that some people feared that it was going to draw people out of the board room. As a matter of fact, most of the major fund groups that I am aware of, and there was a survey taken, they already had 75 percent of independent directors, and at most, with this proposal, would end up doing would be to have the affiliated Chair become just a member of the board and to promote one of the members who are independent directors or lead directors, to have them be the independent Chair.

Now why is an independent Chair important? Well, at first, when you look at this I thought, well, it is not going to make a hell of a lot of difference; but looking back on my experience and others that we have spoken to, including meeting with the independent directors council and with the independent directors forum, the atmosphere in the boardroom is changed because there is a critical mass, you can't separate out just one of these elements, you have to take the reform generally. And that is an independent Chair, the 75 percent which gives you critical mass, you control the agenda, and I think Congress is a good place to indicate what the chairman of a group can do—that you control the agenda, and the communication is better. You also have given them an independent council, which has the right—says to them, these are the questions you really ought to ask at the meeting, we want to know from management if you are going to allocate brokerage, who you are doing it to and what you are getting for it and so on.

So I think that there was a concern, and Mr. Lynch, I think it was an important concern, but I think that after it has been put into effect many of the fund groups are already complying can it. And some of the sky is falling, kind of—the view that you may have gotten from some of your constituents has not proved out. And consequently, I think this is an important reform, it is part of a package, it shouldn't be disaggregated from it. And I would say to you that the staff issued a report, which was transmitted to the Senate committee—Senate Appropriations Committee which requested it—on the independent Chair rule. And I would be happy to submit a copy of that report, which goes through this in detail. After you or your staff has had an opportunity to review it, we would be happy to discuss it with you further. And of course that goes for any other member of the committee, and this is that report.

One more thing, and that is, we have been challenged by the Chamber of Commerce. The United States was sued, there was an argument about a month ago in the Court of Appeals for the District of Columbia. In the brief, of which I was one of the authors, I admit—we outlined the reasons for that independent Chair proposal. And rather than taking the time of the committee now, we would—I can submit excerpts from that brief for you.

Mr. LYNCH. Okay. And could I get a copy of the Chamber's briefs as well, the arguments——

Mr. EISENBERG. I would be happy to supply the chamber's briefs as well.

Mr. LYNCH. Thank you, Mr. Chairman. I just want to, in conclusion here. I understand the gentleman's remarks that some boards were sort of in that position anyway, having 75 percent independent directors and some are moving in that direction anyway. I am entirely comfortable if firms are doing that on their own, and that—in terms of the best result for the investor, and that leads us to that conclusion. The problem I have is that when you come up with a hard and fast rule, and you are now rule bound to exclude certain people, and among those people may be the very best people qualified to protect the investor's interest, and that is all I am saying. And it is 75 percent, and the director, and so you—I see a squeezing out of those people who might be qualified. I see limited seats available for those people.

Mr. EISENBERG. Let me just say quickly in response to Mr. Lynch's question that you can still have an affiliated person or two affiliated people on the board, and that is what generally does happen. So they are not really being squeezed out. But there is a chart at the end of my testimony which shows the conflict of interest that exists. And given what has happened in the real world, and given where the question is, the restoration of confidence and of governance, the Act itself originally said that you have to have at least 40 percent, then it went to 50 percent. And the reason they picked for 75 percent is basically outlined in the staff's report.

So I agree that—and this may not apply to normal—to corporations, but when you have the advisor and you have the fund and you have the directors of the fund charged with safeguarding that fund and negotiating a management contract, an underwriting contract, who is going to be the auditor and all of that, that there is some conflict, and it is better in practice and it looks better in the perception of the public if our interests are being protected.

Mr. LYNCH. Point well taken, I agree. I thank the gentleman for his testimony, I thank the Chairman for his patience.

Chairman BAKER. The gentleman's time has expired. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Eisenberg, I want to follow up on a couple of questions that the chairman asked. And I beg your indulgence, I had to step out of the hearing room for a while, and it could be that you already covered some of this material, but for my benefit it would be helpful.

I wanted to ask you about follow up on a disclosure issue, kind of a general philosophical question, and then one in specific. In the chairman's opening testimony, I think he talked about what he did in a previous life to sell real estate. I haven't sold it, but I have bought it. And last year, my wife and I purchased a small inexpensive condo in the area and I remember being presented with roughly 80 to a hundred pages of documentation, which clearly I chose not to read. I did out of curiosity ask my realtor how many home purchasers actually read the material, and she replied roughly one out of 200.

I inquired who the one out of 200 was, and I was informed it is typically a first-year law student at one of the local law schools.

So I guess as a general philosophical question, not only am I purchaser of real estate, but I am also an investor in a number of mutual funds. I have a tendency to read one, maybe two pages of materials. I have a tendency to drop in the round file the 30 and 40-page disclosure statements I receive from time to time. So I guess in a general philosophical sense, do we reach at some point the point of diminishing marginal utility and perhaps adding more disclosures without letting the more important ones really surface? Is there a point to where the less is actually more, and are we getting to the point where we are actually doing more harm than good to the investing public by adding more disclosures?

Mr. EISENBERG. Well, less is actually more in this context, in many cases, and that is why in response to Chairman Baker's question, that the Commission is in the process of developing the kind of point of sale and materials which will, briefly and in plain English, describe what it is the investor is buying, what it is the investor is paying, and what it is he can expect. I think that is easier to say than to do. The Commission convened focus groups of investors to determine what they thought was important, what they were looking for, what the expense ratio means and how you can tell that, and where can you go to review what is being offered to you in terms of the funds, and there are independent places you can go, the Commission has a Web site that compares them. And we will try—and we are embarked now in an attempt to develop the kind of material that both the Chairman and you have talked about. And I think we are working with the industry and we are working with OCIE, the Office of Compliance Inspections and Examinations and the Investor Education Group. It is a problem that has been with us for a long, long time because whenever you have additional regulation, the lawyers—and I was one of them—get on it and say we have got to disclose this and we have got to disclose that. And it is true.

And I also say the prospectus is more than just informing investors of what they are doing, it is also a way of informing professionals and the Commission and analysts of what it is that is being offered. But I agree with you, I agree with the chairman, there should be a brief, clear outline for an investor that gives him the basic facts.

Mr. HENSARLING. Let me change subjects to the independent board member reforms or initiatives.

You mention in your testimony that was adopted a little less than a year ago on a 3-2 vote of the Commission?

Mr. EISENBERG. Right.

Mr. HENSARLING. There appears to be a fairly consistent pattern of 3-2 votes on the Commission dealing with a lot of major initiatives, and it appears to usually be the same three and the same two.

We have heard a number of concerns about the practical impacts of the independent board member reforms, but I myself don't know about the dissenting views. Could you enlighten me as far as specifically what the minority views were of the Commission in adopting these rules?

Mr. EISENBERG. Well, the two dissenting commissioners, Commissioner Glass and Commissioner Atkins have filed a letter with the report which indicates what their objections are. I have reviewed those and others have reviewed it, and I think that their points are not well taken. What they have said basically is, oh, you people have rehashed this whole business about the scandal, but you really haven't shown that an independent Chair would improve the performance or improve the compliance of the company. We have had our economist look at that, and it is reported in our staff report to the Senate committee, basically you can't disaggregate that one function, the independent Chair, and say it hasn't added to performance, there are too many variables the economists say—I must say they speak a different language, but there are too many variables to reach that conclusion.

And the reason that the Commission did it was not necessarily in terms of proving that there would be better performance or not better performance, they did it because of the structure of the fund industry which sets up a conflict, and that conflict has to be managed. And that was recognized from the very beginning in 1940. And given the complexity and the new products and how many people are investing, those conflicts had to be managed. And one way of managing it is through fund governance. And giving that 75 percent independent directors and an independent Chair are just two elements of a much broader view of governance, which includes an inside compliance responsibility which includes an independent counsel so that they have the technical ability to deal with questions and the independent auditors.

And if those people do their jobs, then that would certainly help in terms of resolving those conflicts of interest, otherwise, the Chair of the fund, if he is affiliated, is, in effect, negotiating with himself as to what the advisory fee ought to be, how it ought to be distributed, where the brokerage should be go. So that is basically the short answer, the longer answer is in the report.

Mr. HENSARLING. I thank the gentleman, thank you.

Chairman BAKER. Thank you. Ms. McCarthy.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

We are probably going to go back to the same question that everybody else asked you.

In your testimony you talk about the transition cost disclosure, and I know you have talked about it a number of times. And I see that the Commission started looking at this in December of 2003. Do you have any idea of when it is going to finally come through so that we can look for it?

Mr. EISENBERG. I believe it will be before the end of the year. I believe Chairman Donaldson has indicated this is a priority. We have had a couple other things that we have had to deal with. And I think that we recognize now, and recognized then that this is something that should be addressed. I regret that it has taken that long to do this, but if you are going to do it, you have to do it right, and we will try to do that by the end of the year.

Mrs. MCCARTHY. And I hope it is done very simply because I do happen to read the prospectus, and I still can't find what it is costing me. So hopefully it will be easy.

Mr. EISENBERG. Yes. This has been an objective of commissions past that we are going to make it easy to explain. You are going to have a summary prospectus, you are going to stick it on the first part. And every time you do that, the lawyers say well, you need more, you need more.

This is a serious effort to get that kind of information, the basic information that reasonable people can understand, to tell them what it is that they are buying and to inform them as to what the conflicts are that they are facing. I mean, you would want to know that the broker-dealer who is selling you this mutual funds interest is getting paid extra in order to push A rather than B, which may have better performance and so on, the so-called shelf space because mutual funds are just like soaps, so if you pay for the shelf space, that is okay, but mutual funds are not like soap, mutual funds are different, they are harder to understand because you can't hold them in your hand. So that is why we need to do that.

Mrs. MCCARTHY. Should fund advisors or managers have the same fiduciary responsibilities as others in the financial sector; is the SEC moving in that direction?

Mr. EISENBERG. I think you are referring to the broker-dealer investment advisor rule which is now—which we have tried to deal with.

There are two kinds of responsibilities, and the question is, when are you an investment advisor? Or when does the broker-dealer cross the line from just giving advice that is incidental, to selling the shares that he is selling and become a financial planner? Or if he has discretion, he in effect becomes an investment advisor. And that line, which is fairly fuzzy, we are in the process of really, of defining that. And I think that is important because broker-dealers have more and more taken on the aura of being financial planners, of giving you advice, and not just the things which are normally incidental to the brokerage, and that is what that rule is all about.

Mrs. MCCARTHY. And I appreciate that, because I will say that when you are working with your broker—and obviously there has to be some sort of relationship because they will call you and say hey, we think you should get out of this and go into it, and hopefully you will say fine, I mean, they are the ones that actually know why would we have it. I mean, I don't have time to start looking at what I am supposed to do with it.

So I hope that we can have some rules up there. I mean, I happen to trust the guys that take care of my funds——

Mr. EISENBERG. Trust, but verify.

Mrs. MCCARTHY. But I am in Congress, so they might be looking out for my investments, I have no idea. Thank you. No further questions.

Chairman BAKER. I thank the gentlelady. And Ms. Biggert.

Mrs. BIGGERT. I thank the Chairman. I would like to come back, I think Mr. Castle had talked a little bit about the Hard 4 close. And I know that we had a hearing a couple of years ago that the question came up, and there was a feeling by people who testified that that would mean that in some time zones, it would be like 12 noon that they would have to stop trading the mutual funds. And I believe that there has been some development of some technology

to have a time stamp technology that is now capable of doing that. Would that solve the problem, or are there other alternatives that you need to look into?

Mr. EISENBERG. I did refer to that, I believe, in the testimony that yes, that there are technological advances which would have tamper proof stamps. But it is more complicated than that because there are some intermediaries which bundle the orders, and they are not subject to commission regulation. So that is the reason why there should be some arrangement, in addition to just the time stamping, because there is nothing that is foolproof, there has to be some arrangement where those intermediaries would report and would have to disaggregate those late traders. I mean, the late trading was so harmful and the sticky assets that the quick fix was the Hard 4 close. And I believe it is more complicated than that.

Mrs. BIGGERT. And I believe it is more complicated than that. I understand that. I wonder if that technology has been put into place.

Mr. EISENBERG. It may go a significant way in solving the problem; it may not solve the problem altogether. And that is what is being examined right now.

The Chairman has indicated—the Commission has indicated that they are interested in, one, the technological fix, and two, whatever we have to do in terms of the intermediaries.

Mrs. BIGGERT. Well, certainly the SEC has had a lot of criticism for failing to spot the late trading in the market timing scandals. But what is happening currently?

Mr. EISENBERG. What is happening currently, that is, under active consideration, is that the hard close—the question of whether the hard close is really the solution. And we would need to work with the industry and with tech people to determine whether that——

Mrs. BIGGERT. You said that that would probably be finalized by the—in this area, later this year?

Mr. EISENBERG. Yes, I think it is important that we do that. And to a large extent, the fair value of the securities, to some extent, would help as well.

But those of us who were in the industry, I think, were pretty surprised at the late trading. I mean, market timing, you can say, well, some of it was legal. A lot of it was illegal.

Late trading was pretty clearly illegal, and a lot of people just did not know that these kinds of shady deals were going on.

Mrs. BIGGERT. If I could just turn to another issue that—there was a settlement, the global settlement. And part of that was a direction for $52.5 million to set up the Investor Education Plan, and the investor education entity.

I am very interested in this, because of the financial literacy that we are working on here in Congress, and with the U.S. Treasury and the Commission. But is that up and running?

Mr. EISENBERG. I do not have up-to-date information about that. I would be happy to get back to you on that question.

Mrs. BIGGERT. I would appreciate it. I think that the board was set up, but there have been resignations. So I do not——

Mr. EISENBERG. That is right. And my understanding is, they are going to fill those vacancies and that they are going to review the

work of that body. It got held up because of, apparently, disagreements within the board. But further than that, I really cannot say.

Mrs. BIGGERT. Thank you.

Chairman BAKER. Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman.

I appreciate the testimony, Mr. Eisenberg. I thought I would try to touch on a couple of areas that have not been explored so far.

I have read Mr. Steven's testimony. And he warns about, I think appropriately, some of the cumulative regulatory burdens placed on the industry, especially small mutual fund companies who will bear a disproportionate brunt of regulations if we go too far overboard. And he suggests at one point that, for example, treating mutual funds differently from other financial products has some problems.

With respect to the independence of the board, it seems to me that we have got a very different story here, because in a typical corporation, including financial products, the role of the board of directors is primarily to protect the shareholders of the company. In this case, it is not only the shareholders of the company, but the customers of the company who consume the product.

One of the concerns I had, as opposed to just simply the typical definition of an independent board member, is that with some mutual fund companies, we have got members of the boards serving on four or five or six or eight different types of family funds; and these are often fairly lucrative positions with some significant benefits to them.

Has anything that the SEC has done looked into the propensity or the incentives to the board member that is serving on, let's say, five or eight funds in a particular family to essentially become a rubber stamp for management in return for the ability to serve on multiple boards?

Mr. EISENBERG. The multiple board question is something that I am familiar with, and that we have looked into. There are boards who administer 100 different funds. And they often tend to meet longer and more often than boards with smaller amounts.

That does not mean that they cannot be effective. What those boards basically do is they divide up the funds into categories, and a subcommittee of the board will deal with those categories. They will interview the portfolio managers and the management with respect to what is going on.

Say you have an international sector, you have a bond sector, you have an aggressive growth sector, and an index sector. And what they will do is divide that up, and then they will meet together on the fees and on those other issues.

I would hesitate to say that a member, a board member, could not serve on multiple boards so long as it was effective and so long as they were not rubber stamps.

One of the things that I think would prevent that is that the regime now is where you do have certain—you have the independent counsel and the audit committee and all of that, an independent chair, that they have the incentive to ask the right questions; and if they don't get those answers, they will inquire further.

And I think also the industry recognizes that it is in their interests to restore confidence. I do not think that banning somebody

from serving on more than 10 mutual fund boards is something that we are about to do.

I mean, you are not going to believe this, but there is a limit on what the Government ought to do. And if that really becomes a problem, then I think we will have to act. But before we do that, we will do what we did with the independent chair and the 75 percent. You look to see what is happening, you see what abuses are occurring, and you try to do something about it.

Mr. FEENEY. I have got two more questions. I see my time is running out. Would the Chair entertain a motion for unanimous consent to give me an additional minute?

Chairman BAKER. I do not see that anybody is going to object. Why do not you just take off?

Mr. FEENEY. At the most, I could offend three of my colleagues. That is—I have done a lot more than that on occasion.

The second question I have concerns the disparate fees that are often charged by funds between large institutional investors and small individual investors. Sometimes the cost to the individual investor is as much as 3-, 4-, 500 percent more. It seems to me that there is some inherent unfairness, whether I am managing a dollar for a client that has invested a hundred million dollars with me, or a dollar for somebody who has got his or her 401(k) invested with me, you know, the marginal costs cannot be that great in my view.

And while I am not inclined to limit fees, that is against my instincts, I am inclined—despite the warnings about 80-page disclosures, I am inclined to tell people that there are other customers that are getting an 80 percent discount, for example, to what they are paying, because I think it would have the ultimate effect of bringing some more balance and fairness in the fee structures.

Mr. EISENBERG. Are you talking about the difference between what an institution or a fund pays for a stock?

Mr. FEENEY. No. I am talking about what the management fees are that customers are charged in—you know, per dollar managed, large institutions sometimes—well, individual investors are paying 4-, 500 percent more per share or per dollar than a large institutional investor in that mutual fund is paying.

Mr. EISENBERG. When an individual invests in a fund, there are break points in terms of when his load, if it is a load fund, when the load goes down, so that, depending on how much the person is investing, you may get charged a full load or a partial load or very little.

I think the whole question of whether or not there are economies of scale, which I take your question to be, that where there are in fact economies of scale, that there really ought to be significant break points for that service. And I think that the disclosure pretty much makes that—should make that clear.

Now, the other—the question which you may be getting at is that while there are different advisory organizations that charge a load, there are some that charge no load, there are some that have a contingent deferred sales load—you pay 5 percent; you stay in for an extra year, it is 4; and if you stay in for 5 years there is no commission whatsoever.

So there are different commission schemes that they have and they need to disclose what those are.

Mr. FEENEY. Well, I was under the impression, maybe wrongfully, that the annual management fee was at times treated differently between institutional investors and individual investors, and I may be wrong about that.

Mr. EISENBERG. Because the institution is a much larger customer and it costs less per dollar to manage a large institution if you have a billion dollars or half a billion dollars. If you have someone that comes in with $100,000 or $10,000, and you have to pay individual attention to that person's objectives and policies, then that costs more.

Also, you have the difference—you have wrap fees.

I am afraid I am not answering your question.

Mr. FEENEY. Maybe—because I may not be able to stay for the bulk of the rest of the testimony, maybe some of the other witnesses could address that if they are able.

Mr. EISENBERG. It would be nice if you can ask them that.

Mr. FEENEY. I have just done so.

Then finally with respect to 12b-1 fees, my understanding was that the theory, at least in part, behind allowing 12b-1 fees for advertisement and recruiting new investors is that if I can take my fund from, say, $100 million of management to $1 billion, if I can multiply it tenfold, the marginal costs per share, or per dollar, of doing research declines. So the marginal cost to the individual to manage the fund, to do things like research, would decline.

In other words, the original investor, the guy who has got shares when the fund is worth 100 million would be better off when the fund grows, because the marginal cost per share of doing research declines and, essentially, their management fees should decline.

But, in fact, some of these funds have now closed. And I would like to know the status of what the SEC is doing to review the appropriateness of 12b-1 funds in general and for closed funds in particular.

Mr. EISENBERG. I can try and answer that quickly.

There is currently, right now, an ongoing review of 12b-1 fees. 12b-1 fees are fees that come from the fund to facilitate distribution. And what you are saying is that with—well, if there is no distribution when it is closed, why do you need a 12b-1 fee at all?

I think that is a legitimate question. It is one which the Commission is interested in. But we are reviewing 12b-1 fees in general, because 12b-1 fees originally just were to facilitate distribution, to pay for advertising and that kind of thing. They have become, to some extent, a substitute for a load, so people—for a commission.

The role of 12b-1 fees is much different today than it was in 1981 when they started. And that is really an area that needs to be looked at. I agree with you, sir.

Chairman BAKER. There being no further members to bring matters to your attention, I would like to, just for the record, acknowledge that some members, who did have to leave, have questions for you. We will submit them in writing, and a couple of points of clarification, we will follow up with you on subsequent to the close of the hearing today.

But we express our appreciation to you for coming forward and continuing to work with us as we try to bring about an appropriate regulatory regime for this important sector of the economy. Thank you, sir.

Mr. EISENBERG. I think it is important that we do work with you, with your staff, and with the committee. We will certainly respond to any questions. Thank you very much.

Chairman BAKER. Thank you, sir.

And as appropriate, I will ask the members of our second panel to come forward.

I want to welcome each of you to the Capital Markets Subcommittee this afternoon. As you are each very much aware, your official statement will be made part of the record. We request that you make your oral presentation, as best you can, within the 5-minute period.

And our first witness this afternoon will be Mr. Paul Schott Stevens, President of the Investment Company Institute.

Welcome, sir.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Mr. Chairman, and good afternoon.

The subcommittee is aware that mutual funds are one of the largest financial intermediaries, and, of course, they play an important role in American's retirement security.

The Institute has the privilege of serving as the national association of U.S. mutual funds, and our members have total fund assets approaching $8 trillion. They serve approximately 87 million shareholders.

At the end of 2004, mutual fund assets accounted for nearly one-quarter of all retirement market assets in the United States. The importance of mutual funds is unquestionable, and I certainly commend the subcommittee for providing this timely forum to take stock of where we are and to consider mutual fund regulatory policy going forward, so that it will continue to serve in the best possible way the interests of fund investors.

Now, I am personally very honored to have this, my first opportunity as the president of the ICI, to testify before the subcommittee, so ably led by you, Chairman Baker, my fellow Louisianan. Under your leadership and that of Ranking Member Kanjorski, the subcommittee truly has been active across an exceptionally broad range of important issues affecting not just mutual funds, but all of our capital markets.

Prior to joining the Institute as its president, I spent much of my career in private law practice and served for many years as counsel to mutual funds, to independent fund director and fund boards, to investment advisors, and to fund distributors. Indeed, I attended my first mutual fund board meeting almost 25 years ago.

From this longer-term perspective, I believe that our collective response to the market timing and late trading abuses that first came to light in 2003 is reassuring. Our legal and regulatory system has worked as designed to identify, correct and prevent misconduct, as has the congressional oversight process. Strong corrective market forces have been at work as well.

As an industry, I believe we have recognized the seriousness of these abuses and worked very hard to implement the comprehensive reforms developed by the SEC under the leadership of Chairman Donaldson. The result has been to sustain the traditionally very high degree of public confidence in mutual fund investing and, thus, to preserve for average Americans an indispensable tool to achieve their long-term financial objectives.

This goal, assuring that mutual funds remain a vibrant and competitive and effective tool for average investors, is one of utmost importance, but it cannot be taken for granted. In considering future regulatory action affecting mutual funds, I believe it is critically important to bear in mind, in addition to the protection of investors, which is paramount, certain business and competitive realities in the financial services marketplace.

The SEC, in particular, must give due consideration to potential unintended consequences of burgeoning regulatory requirements that uniquely affect mutual funds. My written testimony analyzes two specific instances, one related to disclosure concerning fund portfolio managers and a second concerning proposed point-of-sale disclosures concerning mutual funds.

Now, individually, these and numerous other requirements may serve valid and useful purposes, but if, however, when taken as a whole, the SEC's uniquely applied mutual fund regulations and the associated costs and risks discourage investment advisors from entering or staying in the fund business. If they discourage portfolio managers from managing mutual funds as opposed to other investment products, or if they cause intermediaries to favor less regulated financial products over mutual funds, then the SEC's regulatory regime is not effectively serving the interests of American investors.

Now, closely related to this issue is a concern about the escalating costs of compliance with the SEC's mutual fund regulations. To be clear, the Institute and its members firmly support sound regulation and strong compliance. It is necessary in crafting regulations for mutual funds, however, that the SEC have a full understanding of the potential consequences, including the actual cost implications of different regulatory approaches and their impact on funds, fund managers and fund distributors. To do so, we believe the SEC must conduct a substantially more informed and rigorous cost-benefit analysis of its proposed regulatory requirements.

Now, we for our part pledge to assist the SEC in this process, by conducting our own cost-benefit research to contribute to the body of learning that informs mutual fund regulatory policy. Only in this way, working together, can we assure that the costs of new requirements will not outweigh their benefits or add unnecessarily to the growing and unique regulatory surcharge applicable to funds.

Now, we also recognize that success of the mutual fund industry relies in large part on a strong and well-managed regulator. An effective SEC is essential to help sustain the high level of trust and confidence that investors have in mutual fund investing. Toward this end, for many years, the ICI supported adequate funding for the Commission.

As Chairman Donaldson has recognized, however, more money and more staff are not the whole answer. The larger and more difficult challenge is for the SEC to assure the effectiveness of its regulatory and law enforcement efforts. To his credit, Chairman Donaldson has committed to pursuing internal reforms that will improve the performance of the SEC. As part of these internal reforms, there are three areas we believe deserve priority attention.

They are better coordination among the different SEC divisions and offices that deal with mutual fund issues, better coordination of and other improvements to the inspection process regarding funds, and improvements to the efficiency and productivity of the Division of Investment Management, especially in processing applications for exemptive relief.

To ensure the success of any future regulatory initiatives, it is important that the industry and the regulators move forward collaboratively, and to that end, maintain an open, ongoing and constructive dialogue. Such an approach will inevitably yield the best results for investors.

I greatly appreciate the opportunity to testify on these important issues. The Institute looks forward to working closely with you, Chairman Baker, with the subcommittee, with Chairman Donaldson and all at the SEC to achieve our shared objective, a strong mutual fund regulatory regime that protects fund investors and helps ensure that mutual funds remain a vibrant and effective tool for them to achieve their financial goals.

Chairman BAKER. Thank you very much, Mr. Stevens.

[The prepared statement of Paul Schott Stevens can be found on page 80 in the appendix.]

Chairman BAKER. Our next witness is Mr. Barry P. Barbash, partner, Shearman & Sterling. Welcome.

STATEMENT OF BARRY P. BARBASH, PARTNER, SHEARMAN & STERLING LLP

Mr. BARBASH. Chairman Baker, thank you for inviting me here today to discuss the costs and benefits of the SEC's recent regulatory initiatives in the mutual fund area. I commend the subcommittee for its desire to assess at this early juncture the effects of the SEC's recent actions.

I see myself as bringing to the discussion today a fairly unique perspective in the fund industry, as I have had, within the last decade, the privilege of working on both sides of the regulatory process. I feel compelled to note that Mike Eisenberg has the same background, just in the name of full and fair disclosure. I served as the division director of the Division of Investment Management at the SEC for 5 years before I joined the law firm of Shearman & Sterling, where I head up the asset management practice group.

My practice is broad and diverse, representing all of the relevant constituencies in the asset management industry. I represent no particular client or clients in speaking with you today. My views are mine and mine alone.

In my practice I have witnessed firsthand the costs and complex undertakings involved in complying with the new mutual fund regulations adopted by the Commission over the last 2 years. At the same time, my prior experience as division director enables me to

appreciate the challenges regulators face and the great responsibility they bear in responding to improper conduct and in crafting rules to protect the interests of investors.

I will speak briefly today about three areas that in my judgment have been affected significantly by the Commission's initiatives: mutual fund disclosure, the role of mutual fund independent directors, and the development of novel and innovative investment management products and services.

Many of the SEC's recent regulatory measures have resulted in more material about more subjects appearing in mutual fund prospectuses and statements of additional information. This bulking up of these disclosure documents runs counter to what mutual fund investors, fund sponsors and sellers of mutual fund shares all agree must be a fundamental principle of fund disclosure. That principle is, what works best for fund investors is straightforward disclosure on the basic topics that are central to investing in a fund: performance, fees, expenses, risks and key objectives and strategies.

I agree with high-level policymakers at the SEC, including Chairman Donaldson, that the time is again ripe for a renewed effort to make prospectuses a more useful tool for investors. To my mind, a new and enhanced mutual fund prospectus should have two core components. It should be short, addressing only the most important factors about which typical fund investors care in making investment decisions, and it should be supplemented by additional information available electronically, specifically through the Internet, unless an investor chooses to receive the additional information through other means.

In seeking to make prospectuses more useful, the Commission and its staff should, in my judgment, also carefully consider when and in what form the prospectus should be delivered to prospective fund investors. These were topics that we did not consider in the late 1990s when I headed a review of mutual fund prospectuses.

The question often asked by those of us involved with the mutual fund industry is, for what are the independent directors of a mutual fund responsible? Many independent directors, with whom I deal regularly, see the SEC's new rules and recent actions by the SEC staff as answering the question by four words: Everything the fund does.

I believe that answer is inconsistent with the long-accepted notion that fund directors best serve as overseers and not micromanagers of business. I suggest that the subcommittee consider supporting those who serve as funds' independent directors, by asking that the SEC reevaluate all of its rules contemplating action by those individuals.

The goal of such a reevaluation would be to center the efforts of directors on matters of overarching importance to the interests of fund shareholders, such as conflicts of interest faced by the fund investment advisors, distributors, or other service providers.

The SEC's resources in regulating the investment management business over the recent past seems to have been principally devoted to rules proscribing or limiting activities of mutual funds, compliance matters and enforcement. Although all of these activities have clearly been of critical importance, they appear to have

caused the Commission and its staff to spend less of their resources facilitating innovative opportunities for the investing public.

Innovation in investment management products and services often necessitates obtaining exemptive relief from provisions of the Investment Company Act of 1940. The SEC staff's consideration of that type of relief appears to have bogged down of late, resulting in some industry participants abandoning their efforts to develop new products and services.

How can the SEC enhance its efforts in supporting innovation in the investment management industry? I believe two actions are crucial. First, the Commission should strongly embrace what Commissioner Cynthia Glassman recently described as the Commission's mission; that mission, according to the commissioner, is to strike an appropriate balance between two goals—shielding investors from harm and maintaining the integrity of the securities markets on the one hand, and not unduly interfering with investor choice or impeding market innovation on the other, a balance that seems to be missing of late and needs to be reestablished.

Second, the Commission should dedicate staff with special expertise in markets and products to the Division of Investment Management exemptive review process. Just as the Commission has sought to keep abreast of potential problems in the financial markets and the securities and investment businesses by forming a risk management unit, it needs to encourage creative development in the investment management business by organizing a new product review unit.

In closing, I appreciate this opportunity to assist the subcommittee in its review of the SEC's recent mutual fund regulatory activity. I hope that by sharing my perspectives and experiences with you, I have been able to illuminate some unintended but troublesome consequences arising out of the SEC's regulatory activity. The subcommittee's thoughtful reconsideration of the cumulative effects of the new fund regulations should help to ensure that the interests of mutual fund shareholders are furthered and not impaired by that regulation. Thank you.

Chairman BAKER. Thank you, sir.

[The prepared statement of Barry P. Barbash can be found on page 38 in the appendix.]

Chairman BAKER. Our next witness is Mr. Michael S. Miller, managing director, Planning and Development, for The Vanguard Group.

Welcome, sir.

STATEMENT OF MICHAEL S. MILLER, MANAGING DIRECTOR, PLANNING & DEVELOPMENT, THE VANGUARD GROUP

Mr. MILLER. Thank you, Chairman Baker. As you know, my name is Michael Miller. I am a managing director of The Vanguard Group, based in Valley Forge, Pennsylvania.

An important part of my responsibilities involves providing oversight of our firm's compliance functions. I am also responsible for a number of other areas, including corporate planning and strategy, portfolio review, which includes new fund initiatives and research, and shareholder communications.

Vanguard is the world's second largest fund company with more than 18 million shareholder accounts, and approximately $830 billion invested in our U.S. Funds. We have a unique mutual ownership structure at Vanguard where our mutual funds, and therefore, indirectly, the fund shareholders own The Vanguard Group, which provides the funds with all management services at cost. Under this structure, all profits are returned to our fund shareholders in the form of reduced expenses.

Investor trust and confidence in the fund industry have been tested over the past 20 months, and the relationship between regulators and regulated firms has been strained. Amid an atmosphere that at times could be characterized as mutual mistrust, interactions between regulated firms and regulatory officials at times has been somewhat a game of gotcha or regulatory one-upsmanship.

In the face of intense public pressure, new rules have been proposed and adopted at a record pace, failing in some cases to allow for accurate study by the Commission or the industry to evaluate the practical impact of the measures. I believe that we are now at a turning point.

Nearly 2 years after the market timing and late trading problems at some firms, investors continue to regain confidence in mutual funds. No doubt investors in the markets have been reassured by the swift enforcement actions by regulators. The marketplace, too, has been swift and unforgiving in delivering punishment to firms that betrayed investors' trust.

As we turn to the next chapter in the evolution of mutual fund regulation, the Commission and the industry must work together to ensure that the regulatory framework that governs our industry fully serves the millions of investors who rely on mutual funds to build their financial futures.

In the wake of an extraordinary period of regulatory activity, adjustments and some fine tuning will be necessary, and the SEC will surely be asked to interpret new rules and regulatory requirements. The Commission and the fund industry share responsibility for getting these interpretations right.

Hippocrates once advised physicians to declare the past, diagnose the present, foretell the future, and to make a habit of two things—to help or, at least, to do no harm. We would do well to follow his teachings today. That some misguided or unprincipled people at hedge funds, distributors and mutual fund companies engaged in abusive business practices has been well documented, and the regulators have responded.

Today, fund company legal and compliance staffs are dealing with at least 25 new regulatory requirements that have been proposed and/or adopted in the past 4 years alone. With so many new requirements, fund companies are facing difficult resource allocation issues. At times it seems that these new demands on operating budgets and senior management time and attention unduly strain financial resources and leave little time to develop new and better ways to serve investors' needs.

And I am speaking on behalf of the industry's second largest firm. I can only imagine the difficulties and tough decisions that many smaller firms must be facing. A regulatory system that is in

overdrive can create undesirable and unintended consequences, ultimately punishing everyone in an effort to address the abuses of the few.

After we have a chance to step back and review the events of the past 20 months, I think we will find that some of the new rules adopted in haste may not serve investors well. All of this regulatory activity has been well intended, but actual experience must be taken into account. If new requirements are helpful in some measure, but exact a cost in human and capital resources that far exceeds the benefits to investors, we—and I refer here to both regulators and the regulated—have failed in our obligation to strike an effective cost-benefit balance for investors.

To operate collaboratively, we must maintain mutual respect and an open dialogue. Unfortunately, the events of the last 2 years have led to a breakdown in the constructive communications that had existed between the industry and the regulators. We must reestablish these lines of communication.

In large part, the fund industry owes its success to the legacy of good rulemaking and sound and reasonable interpretation of the law by the SEC over the years. Recently, the fund and securities industries have worked with the NASD, with the SEC staff participating on many issues, including sales charge break points, transaction costs, distribution arrangements and point-of-sale disclosures.

There is so much sense to putting our heads together to develop solutions to our most challenging issues. The search for simple answers in a complex world is difficult and may not always be possible. Fund firms have become increasingly complex as they seek to meet the needs of investors.

Mutual funds appeal to a wide range of investors, from individuals saving for retirement to Fortune 500 companies. Funds and fund operations have evolved to adapt to the varied needs of these different investors. Regulators and fund companies must therefore engage in thoughtful and constructive dialogue to pursue and achieve a disciplined process to developing effective rules that protect all investors.

There will not be unanimous support within the industry for every specific rule change or proposal. It would be naive to expect otherwise. But there must be an open dialogue and rigorous debate if we are to achieve an effective outcome for the benefit of fund investors.

Working collaboratively, we can ensure that regulatory measures are designed with a thorough understanding of the intricacies of the business. Working together, we can also avoid the pitfalls too often faced by regulatory efforts.

A regulatory response that is disproportionate or poorly tailored to the problem it seeks to solve can do more damage than good. And no amount of regulation will ever replace a commitment from the industry to integrity and high ethics.

But over-regulation does not prevent bad people from doing bad things. There will always be people who figure out how to evade the rules. Such individuals should be subjected to strong and swift enforcement actions.

We must be wary of changing the rules without providing adequate time for the industry and the regulators to consider the ramifications of the changes. Recently with the regulatory system in overdrive, the fund industry has too often been given too little time to consider and comment on regulatory changes. Less than 60 days simply is not enough time to digest all of a proposed rule's operational and other implications.

We need not look too far in the future to see some opportunities to become reengaged. In recent testimony before the U.S. Senate, SEC Chairman Donaldson described two issues that offer opportunities for us to join in productive dialogue: mutual fund disclosure reform and mutual fund distribution. Advances in technology and the high adoption rate of the Internet by mutual fund shareholders create new avenues for better disclosure and distribution to shareholders.

We also hope regulators and the industry will take more time to reengage in new business development, work where the SEC plays a critical role. Just as fund firms have been coping with the weight of new regulations, so too has been the SEC. As a result, firms trying to develop new offerings that could provide greater flexibility and lower costs to investors have encountered delays and bottlenecks.

The pace of new product review and evaluation needs to be reexamined. Many of our new regulations seek to achieve similar objectives. As a result, at times we now have multiple and sometimes redundant solutions pursuing a single problem. We should look at all of these solutions closely and in concert with each other. We should consider what works well and what does not, then take the best of it and leave the rest.

Vanguard has always been willing and eager to come to the table with our regulators to discuss any issue at any time. And I am confident that any serious and responsible firm in our business would make this same representation.

We are willing to share the expertise of all of our experts, all of our people, for the benefit of this industry and, more importantly, for the investors we serve.

Thank you, Mr. Chairman, for this opportunity to testify.

[The prepared statement of Michael S. Miller can be found on page 70 in the appendix.]

Chairman BAKER. Thank you, Mr. Miller. I will start with you.

With regard to your analysis of perhaps unwarranted rulemaking or unjustified rulemaking. One of the reasons for the hearing is to get from industry perspectives on the modifications made and the consequences of the rulemaking environment for us to assess what could be done to make the market efficient while ensuring transparency.

If there are specific actions that you have identified from a Vanguard perspective, that you could make known to the committee at some future point, as to the consequences of a particular action and why it was, in your corporate view, not warranted, those are the examples of rulemaking which we would like to assess.

But let me quickly add, as Mr. Eisenberg indicated in his comment earlier, it cannot be simply a cost-benefit analysis that makes

a rule justifiable or not; it is the context in which the cost-benefit is engaged.

And perhaps there are two classes of rules that I see. One is the practical impairment to business process—the 4 o'clock hard rule comes to mind, that that merely geographically or technologically precludes someone from engaging in the same business enterprise that others are engaged in, and is prejudicial merely by where you happen to be. That is something that obviously has need of repair.

The other issue with regard to point-of-sale disclosure is on the other end of the extreme, which is a business judgment to require certain ethical conduct to ensure the investor is, presumably, made an informed investor by this disclosure, needs to be looked at in the context of what does it cost that investor for you to prepare that analytical, get it in his hands, in relation to the overall earnings of the fund. That is what troubles me there.

If you can be more specific about the points at which you have found the process not to be balanced or where the timeliness given to a particular consideration was not sufficient, that is really where we want to go with this, to make sure that we are getting it between the sidelines as well.

Mr. MILLER. Maybe, Mr. Chairman, I can give you an answer that is a broad answer, but I think it goes directly to what you are asking. And that is, let us step back; Mr. Eisenberg talked about this, and Mr. Stevens and Mr. Barbash also talked about this.

If we consider the entire disclosure regime that we are facing today, I think we all concede that there is too much paper. There is too much disclosure. We want investors to be aware, we want investors to be knowledgeable, but we want investors to read the information that we give them. They won't read it when we make it so weighty and so overwhelming that they are deterred from picking it up and giving it a read.

I think that what we need today—and we have to look at this in the context of the last couple of years—I am very sympathetic to the SEC. I am very sympathetic to the industry and the pressures that have built up over these last couple of years, the pressures to do more and more, enact more and more rules; and the pace of activity has been at times frantic.

It has been a record pace. I think someone told me that in a given year, a normal year, if we had such a year, you would have two or three rules of substance that would be proposed for comment by the SEC and perhaps adopted.

Over the last few years, as I indicated in my testimony, we have had 25-plus rules proposed or adopted. It is just an overwhelming burden that the SEC has had to manage, the industry has had to manage.

I think today, if we can somehow take a breath, step back, look overall at this disclosure regime and work with the SEC, work with the Commission staff to find a way to make a more manageable set of information that we provide to investors, that would serve investors well, it would serve the industry well.

Really, it is a win-win-win. It is a win for the SEC, it is a win for the industry, it is a win for investors.

So it is not a specific answer, but it goes to this whole aura of disclosure. We all know that we need to have disclosure, we all

know that disclosure is good, but if we do not make it workable and manageable, as an industry, we suffer. I think the Commission suffers. I know the investor suffers.

Chairman BAKER. Well, I think to a great extent the Congress has played a role in encouraging the SEC's actions, with the awareness of the business practices that were discussed over 2 years ago; and certainly the Agency has been trying to catch up in a regulatory sense to the world as it has passed them by. Principally, the mutual fund industry was, I think, one of the last places anyone was going to look for any misconduct; their reputations had been so good for so long. There were a lot of other arenas that were getting the headlines until the unfortunate news broke, perhaps to explain the Agency's intense actions.

But I leave the door open for any specific things that you might want to bring to our attention.

Mr. Barbash, you talk a little bit about the appropriateness of the disclosure regime today, and suggest that a more prospective reporting—perhaps I should use the word "forward-looking" statement—might more appropriate and helpful to investors. I have used the example on the public operating company side; the current paper-based, rules-based reporting system gives you information that it is at least 90 days old, maybe over that, and tells you where the company was and not where they are going.

You seem to be indicating there might be value in not requiring that, but perhaps having more focus on what the investment strategy is, going forward. Was I understanding you properly in your written testimony?

Mr. BARBASH. Well, I call for—what I call for would be a document that gets to the basic points. It is shorter, goes to the point about what are the key investment objectives and policies of an investment company, and then would take advantage of the Internet to provide additional information to others who would want more information.

So a shorter document would be the fundamental prospectus, and then it would be supplemented by other material that would be electronically available, so that interested parties would have mutual fund prospectuses and other information available; there would be access to a range of other information that would be on file with the SEC.

Chairman BAKER. There is a parallel reason for asking the question.

In the financial institution world, within the FDIC, there is a software capability that operates behind the screen, the user doesn't know is there, Extensible Business Reporting Language, XBRL in the trade, and you enter your data, and then on the other side of the screen, whether it is a regulator, a competitor, a shareholder, or an analyst, they can get access to their data in real-time, in the format to which they are entitled.

One of the things that seems to be difficult in this industry is comparability and having the average investor sit down with three different mutual fund annual reports and figure out who really did better. There has got to be a way, using technology, to provide for that kind of comparability, not only peer to peer, but peer to sector, however you want to compare it.

I think that is what the typical investor—all he wants to know is, I am putting up $10,000; what happened to it, and how can I find out whether I can do better elsewhere?

Is there a technology comparable to XBRL in the mutual fund world?

Mr. BARBASH. I can't really speak to technology, because I am technologically challenged. If I said otherwise, you would hear from all kind of constituencies complaining about what I said.

But when we were looking at the prospectus back in the 1990s, one of our goals was greater comparability. We recognize what you recognize, which is that investors do want comparable information.

The biggest change, frankly in the last 6 years, is technological. There is so much more information that is available that can be used. And I would hope, as the SEC goes forward, it looks hard at technology and sees what is available and what can be done.

I think there is a very technologically savvy industry, the industry can also provide insight on that.

Mr. STEVENS. Mr. Chairman, I think it is a very key question. It seems to me the Internet is the way out of a real dilemma that the Commission has had for a long time. If you think historically, how we got where we are, there is, over time, more and more disclosure, which has quite appropriately been expected of mutual funds. It grew so large at one point we cut the prospectus in two, we created what we know as the prospectus, then there was the SAI.

It continued to grow, and we put a summary in the first part of that, the prospectus, and now it is continuing to grow further, and with it increasing frustration. I think the industry and the SEC and commentators, and members of this subcommittee obviously, believe that we are wandering very far from what is a useful disclosure format for most investors.

The Internet will allow, I think, for precisely what you described at the beginning of this hearing, will allow the SEC to focus on quality information that is concise, that is delivered to an investor, but also provide for the marketplace generally, for analysts, for commentators, for investment advisors, and for the do-it-yourself investor, a quantum of information on the Internet which can be maintained, which is current, and as I understand the technologies, is subject to a kind of search engine so that you can go to five different Web sites and pull down exactly the same information about five different families of funds.

Now, I would tell you that if you look at mutual fund investors, it is going to be the exception rather than the rule that people are going to want to have that. Most are going to want to have that clear and concise document.

Indeed, 80 percent of funds are purchased with the help of financial advisors. And it is their role to do most of that sifting and finding out. It is the exception, not the rule, where someone wants to look at three different prospectuses and make the choice for themselves.

Chairman BAKER. It is really innoculatory. It is for when things go bad. As long as the industry is returning 15 percent ROE, nobody is going to ask any questions. But it is when your fund, or

the industry generally, has a downturn that everybody starts calling lawyers and finding out, well, why did you not tell me this?

Maybe the answer is to have access to a point, a data point, where you can go find out anything you want, but the two-pager, as I requested, already up to four pages as a result of our testimony this morning, it tells you this is not a complete recitation of your rights and responsibilities, go to SEC.gov, or whatever it is, and there we will give you all that you want. So that you are not telling everybody, you have been fully informed, you have been given only the meaningful and minimal in order to get you in the game, if you want to go this route.

Mr. STEVENS. I believe that the key issue that will be before the SEC is, when we have reached the point of Internet familiarity and facility across a broad investor population, that the rule can switch, that is to say, that for an individual, the presumption will be, they can access that information over the Web, it would be delivered and available to them that way. But if they want to opt out, if they want to get the paper information, if they want to have it delivered in some other fashion, they can so indicate and the system can work for them.

That sort of reverses what is currently the presumption, that everyone wants the paper and that minimizes utilization of the Internet. So I think that is a very important issue.

And, of course, it has cost-benefit implications of significant degree not only in terms of our ecosystem—think of all of the trees me might spare—but also the effort that goes into producing disclosure documents which must be, to the industry's regret and the SEC's, I think, never opened in too many cases and never read.

Chairman BAKER. You raised one area I wanted to ask you about; that is the cost-benefit thing again. I am hesitant to say that it is the only measure by which a rule's effectiveness should be judged, but I think it is a component which should not be ignored. And going forward, as the rules are developed, should there be impacts that the Congress should be made aware of in our new communicative role here?

In the post-Sarbanes-Oxley world, the committee feels responsibility to oversee and assess the effectiveness of the rules environment in which the market now functions, so if there are specific things or actions which have been taken which do not yield appropriate public benefit, we are reliant on those stakeholders and the industry to bring those to our attention—and, of course, with public explanation as to why these rules should be reevaluated.

I certainly respect the work the SEC has done over a very difficult 2-year period. But it is not likely that everything that has been done is necessarily in the consumer's best interest. And to again state the obvious, that higher regulatory costs comes off the investor's return; it does not magically appear from the industry. You have the right and ability to pass it on to your investor community, and you do.

So we have to look at this from sufficient information for a reasonable man to make a sound judgment, but at the same time, not taking $5 of his $10 investment to put it in regulatory costs. Therein is the problem.

I hope you will take advantage of that opportunity to communicate with the committee as we go forward, because this is going to be an ongoing and difficult road, I am sure.

Mr. STEVENS. May I respond?

As I look at cost-benefit analysis, you want to look at the benefits, too. I agree with Mr. Eisenberg. Some very simple things can have enormous benefits. They might even have very substantial costs, but the benefits could clearly outweigh them. It is the balancing of both of those.

Some of them can be quantitative and tangible, some of them are going to be intangible, if you will, and are subject to more normative judgments. What I think is important, though, is that the Commission at least try its best to look at what the quantitative implications are. And I would say, in that regard, that that is an area where it is going to need assistance.

I think commenters on rules, like the Investment Company Institute, have an obligation to come forward with that kind of analysis. To the extent we have not in particular cases, it seems to me that that is a defect that we need to remedy in our own input to our regulator.

Indeed, it is now a priority for our research department. We have hired a new senior economist at the ICI that is going to be doing, as a priority, cost-benefit analysis of rulemaking.

But I think, to be candid on the other side as well, if you look at the way that they have calculated costs in specific instances—and the redemption fee rule is a terrific example—the analysis is simply inadequate by any measure. And when that is the case, I wonder if the Commission really has had sufficient information to consider, from a public policy perspective, is this the best way to go or might there be better alternatives for us to consider?

Now, the issue of requiring funds to enter into contracts with every one of their intermediaries as a way of resolving the problem of market timing and imposing redemption fees was not one that had been proposed in an earlier rule; they simply asked questions, Gee, is that a good approach? And we at the Institute had told them, No, it is not a good approach, it is not promising, but it is the one that they have finally arrived at in the rule that they have adopted.

We are working to communicate our views to the Commission in that regard. I offer it simply as an example of where the analysis of the costs and benefits in relative terms can fall down in a substantial way.

Chairman BAKER. I appreciate that.

Mr. MILLER. Chairman Baker, I also—I am going to step back again and—I think we should respond to your specific request. But I think it is also, again, important to step back and look at the entire regime, the entire regulatory landscape.

When I hear about cost-benefit analysis, when I think what that means to the industry, I think in terms of everything that has been enacted, all of the rules that been proposed that have gone into effect, everything that the fund companies have to do today to comply with those rules. Some of those rules are good, but again I think that taken in the context of the overall picture, taken in the context of what is the cost of all of those things, it is people.

I mean, there are more lawyers, there are more compliance people working today, that is clear. It is technology; I suggest, probably millions of dollars are being spent at Vanguard today on technology that in some ways is there in response to new rules that have been enacted, the PATRIOT Act, things that happened before the scandals of a couple of years ago.

So all of those things in context. It is postage, it is paper, it is more and more communications to the fund shareholders. And, again, my hope would be that if we could step back, if we could work jointly with the Commission, the industry and the Commission hand in hand, have that dialogue, step back—maybe it is a blue ribbon panel; I do not know what it is precisely—but a way that we can look at these issues together, so that at the end of the day, hopefully, we have a more orchestrated regime from a compliance standpoint across the industry. Perhaps a few less rules, but no less in the way of the governance of the industry and investors, no less protection for investors. Then, I think, at the end of the day, again we have that win-win-win for the Commission, for the industry, for the investor.

Chairman BAKER. Well, it is a certainty that we have entered into a new economic arena in most financial service sectors, clearly in the mutual fund industry, and we cannot go back. We now have an overwhelming number of congressional constituents who are direct investors in your industry. That brings about a clear political accountability. So, unfortunately for the industry, the Congress is certainly not going to go away.

On the flip side of that, with renewed assurances that the regulatory structure is adequate—and I suspect your view is, it is more than adequate today—that a confidence comes back to consumers to again place their money in your hands. That is a good thing. It is a good thing not only for the investor, but for the economy generally. And the balancing act going forward will be to ensure that the regulatory inhibitions do not forestall someone making a good investment decision or, worse yet, takes part of their investment dollar and needlessly spends it on regulatory compliance when they are not reading the documents in the first place.

So it will continue to be a balancing act for us. And I hope that communication you talked about with the SEC from each of your perspectives will also be sent in our direction so we can do a better job of public policy analysis going forward, because this is an important part of our economic performance. It is a key, pivotal part of our growth going forward, and it is too important to idle off into a bureaucratic morass.

So for those reasons alone, I am sure other members of the committee will join in supporting whatever steps might be taken from a Commission or from an industry perspective to ensure we reach the right balance.

I just want to express my appreciation to each of you for your participation. Your remarks will be an important part of our work going forward. I am certain, as members indicated to me that they had other obligations, there will be written questions from other members coming to your desk in the next few days.

Chairman BAKER. Thank you for your courtesies, and our meeting stands adjourned.

[Whereupon, at 4:00 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 10, 2005

Testimony of Barry P. Barbash
Partner, Shearman & Sterling LLP

before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

"Mutual Funds: A Review of the Regulatory Landscape"

May 10, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

Thank you for inviting me today to discuss the costs and benefits of the Securities and Exchange Commission's recent regulatory initiatives in the mutual fund area. I commend the Subcommittee for its desire to assess at this early juncture the effects -- both positive and negative -- of the SEC's recent actions, which some have called the most significant changes in the mutual fund regulatory landscape since the landmark 1970 amendments to the Investment Company Act of 1940.

I see myself as bringing to the discussion today a fairly unique perspective on the fund industry, as I have had, within the last decade, the privilege of working on both sides of the regulatory process. I served as the Director of the Division of Investment Management at the SEC for five years before I joined the law firm of Shearman & Sterling LLP in 1998, where I

head up the Asset Management practice group. My practice is broad and diverse. I represent mutual fund advisers and sponsors, mutual fund independent directors and trustees, and mutual funds themselves. I also represent financial services companies that sell shares of mutual funds and a variety of institutional investors that invest in mutual funds. Finally, I represent a number of the new product development units of financial services firms that seek to offer shares of novel types of funds or that seek to offer products and services designed to provide alternatives to traditional mutual funds. I represent no particular client or clients in speaking with you today; my views are mine and mine alone.

In my practice, I have witnessed firsthand the costs and complex undertaking involved in complying with the new mutual fund regulations adopted by the Commission over the last 18 months to two years. At the same time, my prior experience as Division Director enables me to appreciate the challenges regulators face, and the great responsibility they bear, in responding to improper conduct and in crafting rules to protect the interests of investors.

I will speak briefly on three topics today, the first of which is mutual fund disclosure. During my tenure at the Commission, an issue of principal focus was the need for clearer and more useful disclosure for mutual fund investors. I am proud to have had an active role for close to three years in prospectus disclosure reform, as well as the development of the fund profile. Many of the SEC's recent regulatory measures have resulted in more material about more subjects appearing in mutual fund prospectuses and statements of additional information. This bulking up of these disclosure documents runs counter to what mutual fund investors participating in focus groups, fund sponsors and sellers of fund shares all agree must be a fundamental principle of fund disclosure -- that fund investors want and should be given straightforward disclosure on the basic topics that are central to investing in a fund: fees,

expenses, performance, risks and key objectives and strategies. The paramount need of these investors for a concise and easy-to-use disclosure document is one of the topics I will discuss today.

The second topic I will address is the role of mutual fund directors and trustees, particularly independent or non-interested[1] directors and trustees, and the extent to which the SEC's recent mutual fund regulations have placed excessive burdens of time and responsibility on those directors and trustees. A question often asked by those of us involved with the mutual fund industry is: "For what are the independent directors and trustees of a mutual fund responsible?" Many independent directors and trustees read the SEC's new fund rules as answering the question with four words: "Everything the fund does." I believe that answer is inconsistent with the long-accepted notion that fund directors and trustees are overseers and not micromanagers.

The last of my three topics is a cost to the fund industry and the investing public arising out of the recent reform efforts that may be less apparent than other costs and may not be strictly quantifiable. The SEC's resources in the investment management area in recent years have principally been devoted to rules prescribing or limiting activities of mutual funds, mutual fund and adviser compliance matters and enforcement of suspected violations of the federal securities laws by funds and advisers. Although all of these activities have clearly been of critical importance, they appear to have caused the Commission and its staff to spend less of its resources facilitating innovative opportunities for the investing public.

Disclosure

Mutual fund disclosure was at the top of the agenda of the Division of Investment Management during my tenure as the Division Director and is of central importance to virtually

all of my fund clients. While I was the Director, the Commission significantly revised the mutual fund prospectus, seeking to follow the adage "less is more."[2] At the core of the revisions was an attempt to provide essential information about a fund to assist a typical fund investor in deciding whether to invest in the fund.[3]

Seven years have passed since the SEC's last major overhaul of the disclosure requirements for mutual funds. Perhaps reflecting explicit regulatory requirements, fear of SEC, state or NASD enforcement action, or potential plaintiffs' litigation,[4] mutual fund prospectuses have become overly complicated once again, becoming liability protection plans and not investor assistance documents.[5] The disclosure philosophy of at least some funds seems now to have become "more is safe" and "everything is essential."[6] We must again ask ourselves: Are current prospectuses helping investors? It is again time to evaluate prospectuses and determine what kind of disclosure works for investors, what does not, and consider new options moving forward.

If the Subcommittee were to consider mutual fund disclosure, a starting point of inquiry might be to ask a question we at the SEC did not ask when we looked closely and comprehensively at mutual fund prospectuses in the late 1990s -- whether the disclosure regime of the Securities Act of 1933 should apply to mutual funds.[7] The 1933 Act and its rules generally are intended to provide a purchaser of securities issued by a company with information about both the securities and the operations of the company; after all, the operations of the company have a clear bearing on the value of the securities. Although a mutual fund is a company -- typically a corporation or a business trust -- the value of an investor's interest in the shares of a mutual fund depend on the value of the portfolio of investments held by the fund and not generally on the operation of the mutual fund as a company. This distinction would seem to suggest that the statutory framework applicable to a mutual fund prospectus be amended to

center on the prospective investments of the fund and the costs and risks of investing in the fund. Disclosure relating to the operations of the fund -- such as the identity of its directors or trustees, its policies on matters such as market timing and the like, and the manner in which the portfolio manager having day-to-day responsibility over the fund's investments is compensated -- should appear in other disclosure documents on file with the SEC and continuously available to investors through the Internet.

Whether the Subcommittee needs to be the driving force behind an initiative to reform mutual fund disclosure appears debatable at this time. Key SEC policymakers, most notably SEC Chairman Donaldson, have spoken about the Commission undertaking such an initiative.[8] Chairman Donaldson has said that mutual fund investors participating in focus groups, fund sponsors and sellers of fund shares all agree, as a fundamental principle, that fund investors want and should be given straightforward disclosure on the basic topics that are central to investing in a fund: fees, expenses, performance, risks and key objectives and strategies.[9] My hope would be that, to the extent the SEC undertakes a reevaluation of mutual fund disclosure, it draws heavily on the significant hard work done by the SEC staff during the late 1990s. Much of what the staff found at that time about the attitudes of fund investors, for example, remains as relevant today as it was then.[10]

I agree with high level policy makers at the SEC that the time is ripe for a renewed effort to make prospectuses a more useful tool for investors. To my mind, a new and enhanced mutual fund prospectus should have two core components:

- It should be short, and address only the most important factors about which typical fund investors care in making an investment decision; and

- It should be supplemented by additional information available electronically -- specifically through the Internet -- unless an investor chooses to receive the additional information through other means.

In seeking to make prospectuses more useful, the Commission and its staff should, in my judgment, also carefully consider when and in what form the prospectus should be delivered to prospective fund investors.

By embracing the Internet and other advances in technology that have occurred over the last seven years, the SEC and other regulators would help to avoid the fate of one of the novel elements of the Commission's last mutual fund prospectus initiatives, the "fund profile."[11] The profile was intended to respond to mutual fund investors who asked for a short, straightforward disclosure document providing a snapshot of a particular mutual fund's core components, including fees, expenses, performance, risks and principal strategies.[12]

Over the past seven years, the profile has been used only sporadically by a handful of mutual fund sponsors. My clients' explanations are virtually uniform that fund companies do not use profiles for fear of potential liability they could face by a shareholder complaining that he or she purchased shares of a particular fund on the basis of the fund's profile, which did not incorporate the level of detail set out in the fund's prospectus. This type of concern could be alleviated by a disclosure regime contemplating an investor receiving a profile-like document describing a fund and being deemed to have also been given information about the fund electronically.[13]

My bottom line on mutual fund disclosure continues to be that from a typical investor's standpoint, shorter is better. I believe that the concept underlying the "Profile Plus," an initiative developed and recently described publicly by the NASD's Mutual Fund Task Force, is a step in

the right direction in terms of the level of disclosure and use of technology.[14] The Profile Plus would be a two-page disclosure document available over the Internet that would allow a potential fund investor to review as much or as little detail about the fund as desired and to compare easily all funds offered by a particular broker-dealer. Technology would, under the Task Force's proposal, be available to allow this streamlined disclosure to be paired with links to a more traditional prospectus for investors seeking this more detailed information. I would hope that the SEC moves forward quickly on a short-form fund prospectus contemplating greater use of the Internet.

My recommendation on fund disclosure is far from revolutionary; the fundamental principles appear to have been accepted by the SEC and other regulators.[15] Most importantly, fund investors themselves have consistently told us that they agree with these principles.[16] Investors want short, clear information about what matters to them in investing in fund shares. They do not necessarily want what regulators or fund commentators think investors should want.

The Role of Mutual Fund Directors and Trustees

I would now like to turn to the appropriate priorities of mutual fund non-interested directors. Their role is being significantly increased by rulemaking and, indirectly, by enforcement actions that relate to other fund boards. Their direct responsibility is tending toward management of everything the fund does. Under federal and state laws, directors have long been assigned the role of overseers, not micromanagers. A reevaluation of the role of fund independent directors and trustees is in order.[17]

While Director of the Division of Investment Management, and during my time in private practice, I have had occasion to talk and work with a host of mutual fund independent directors. I have found typical directors to be intelligent, conscientious, and hard-working, and they are

strong advocates for fund investors. My experience of more than twenty years as an investment management lawyer and regulator is simply at significant odds with the less than flattering picture of fund directors drawn by some industry commentators and detractors. Many, if not most, of the fund directors with whom I deal are eager to take on the active role with respect to the funds they oversee, as contemplated by new SEC rules. I fear, however, that the sheer quantity of new regulations may result in an unfortunate shift of focus away from directors' core duties under the Investment Company Act of 1940, such as monitoring conflicts of interest, and instead mire directors in a sea of details pertaining to mundane and routine approvals best reviewed or summarized by management. In meeting the rule requirements, directors must consider an ever-increasing number of items at every board meeting and, frequently, between regularly scheduled meetings. This, to my mind, has lessened boards' flexibility to take initiative or closely examine potential conflicts.[18] Perhaps most striking, the extremely high volume of data provided to typical board members is, in my over two decades of experience of dealing with fund directors, simply unprecedented.

The pressures faced by fund board members by a demanding workload have been exacerbated by informal statements made by some members of the SEC staff suggesting that the Commission should and will increase the number of enforcement actions against independent directors of funds.[19] As a former member of the staff, I can surely appreciate the appropriateness of the Commission's instituting a proceeding against independent directors who engage in conduct in violation of the securities laws. Nonetheless, I believe strongly that the interests of fund shareholders demand that boards retain the discretion to act, not out of fear of regulatory or enforcement action, but rather based on their understanding of the needs of the funds they oversee. It is time for the Commission to assess whether the governance machinery it recently

created produces benefits to shareholders that exceed the costs associated with the added burdens on directors.

That fund boards should focus most closely on certain discrete, yet central, matters has long been accepted. In a 1992 report of the Division of Investment Management, this notion was articulated in a manner that, I continue to believe, sets the appropriate standard:

> [I]ndependent directors perform best when required to exercise their judgment in conflict of interest situations. ... We believe that independent directors are unnecessarily burdened, however, when required to make determinations that call for a high level of involvement in day-to-day activities. ... [I]n order to allow directors to devote their time and attention to truly important matters, we believe that provisions that require directors to conduct reviews and [make detailed] findings that involve more ritual than substance should be eliminated.[20]

This standard of responsibility for directors has been endorsed by courts and an impressive array of SEC Commissioners and officials, including former Chairman Arthur Levitt, former Commissioner Richard Roberts and Paul Roye, who last month stepped down from the position of Director of the Division of Investment Management.[21] When adopting a number of fund governance rules over the past two years, the Commission has indicated that its purpose was not to articulate a new standard, but to provide fund directors the wherewithal to fulfill their oversight role more effectively. Nonetheless, the breadth of the Commission's new governance rules together with statements of certain SEC staff members about the need for independent board members to be involved in what seems to be countless areas have, in my experience, led to the perception among many directors that they should be intimately involved in all areas of their funds' operations. This perception has been reinforced by the common practice of the Commission's inspections staff to notify directors of the results of examinations of their funds, as well as informal statements by other members of the staff raising the possibility of directors' becoming the subject of enforcement actions should the directors not act diligently enough in

carrying out their responsibilities. Believing that their positions and reputations can be on the line if they are not involved in all aspects of a fund's business, many board members, in my experience, routinely request detailed reports about those operations, including information about the fund's various service-providers, that go well beyond directors' traditional roles.

I completely agree with the Commission's view that independent directors need to be strong, aggressive, and active in fulfilling their legal obligations. At the same time, I submit that the best way to make directors effective shareholder watchdogs is not to deluge them with reports on all of a fund's operations and those of the fund's service-providers. My experience leads me to conclude that a board will act more effectively in the interests of its fund and the fund's shareholders if the board focuses on matters of overarching concern, such as addressing or eliminating conflicts of interest faced by the fund's investment adviser, distributor or other service-providers. I am far from alone in this conclusion. At a recent industry conference, for instance, another former Director of the Division of Investment Management, citing directors' increased responsibilities under new rules told the audience that the SEC needs to reevaluate the duties of fund independent directors. As that Director said: "[A] lot of this stuff [required of directors] is so routine it really could be better done by management. ... Right now there's just so much detail it's crazy."[22]

The increase in substantive responsibilities of mutual fund directors layered on the already extensive number of duties to which directors historically have been subject, has caused some highly qualified directors I know to talk seriously of resigning from their positions. Losing qualified directors is hardly beneficial to fund shareholders. And finding qualified replacements, if my recent experiences are any indication, is a daunting task.

I suggest that the Subcommittee support those who serve as fund independent directors by asking the Commission to reevaluate its rules contemplating action by independent directors. In making this evaluation, the Commission should focus the efforts of directors on matters of overarching importance to the interests of a fund's shareholders, and seek to identify those tasks for which independent directors are best qualified to accomplish.

Development of Novel and Innovative Products and Services

Finally, I would like to discuss a less quantifiable, but no less important, cost arising out of the SEC's recent reform efforts. In my judgment, an indirect and unintended consequence of the Commission's recent spate of regulations in the mutual fund area has been to bog down the efforts of the SEC staff in approving new investment management products and services. Many of those products and services raise issues, sometimes of a highly technical nature, under the Investment Company Act of 1940 and necessitate the obtaining of an exemptive order issued by the Commission under Section 6(c) of the 1940 Act.[23] Regardless of whether the product is entirely new to the marketplace or based on existing products, the process of obtaining an exemptive order is time-consuming, and can be a significant disincentive to product development. Obtaining an order relating to a novel product or service, for example, can take eighteen months or more.[24] Nothing frustrates my clients, and I submit the clients of other practitioners, more than the time needed to obtain exemptive orders.

My five years as the Director of the Division of Investment Management makes me appreciate fully that the granting of Section 6(c) exemptive orders is one of, if not the, most difficult functions of the Division. Recommending that such an order be granted requires the staff to conclude that the order would be necessary or appropriate in the public interest and consistent with the protection of investors.[25] Reaching that conclusion can and should take time,

particularly when the product or service has not previously been considered by the staff and Commission.

Responsible investment industry participants not only recognize the need for the staff to take its time evaluating requests for exemptive relief, but also appreciate the additional level of due diligence effectively provided by the staff's review of novel products and services. What frustrates industry participants at this time, however, is the lack of urgency those participants perceive to be reflected in the staff's consideration of many applications for Section 6(c) exemptive relief.

Any effort to improve the exemptive order review process would, in my view, be significantly enhanced if the process reflected what Commissioner Cynthia Glassman recently described as the Commission's "mission" -- striking an appropriate balance between two goals: shielding investors from harm and maintaining the integrity of the securities markets on the one hand and, on the other, "not unduly interfering with investor choice or impeding market innovation."[26] I believe, with the SEC's recent rulemaking, that some of that balance has been lost.

A case that illustrates the current concerns of developers of investment management products and services is the staff's consideration of exemptive orders relating to certain exchange traded funds, widely known by their acronym "ETFs." ETFs, which are funds that blend characteristics of mutual funds and closed-end funds, have been hailed by many investment management commentators and participants as furthering the interests of fund investors.[27] Paul Roye, former Director of the Division of Investment Management, joined a chorus of supporters when he noted in a 2002 speech that ETFs have a "bright future" and that "investors continue to

praise these products for their tax efficiency, their liquidity, their modest fees and their ease of trading."[28]

The hybrid nature of ETFs necessitates their obtaining exemption from certain provisions of the 1940 Act.[29] The Commission granted the first such exemption in 1992 and has granted over 20 other exemptions covering approximately 300 ETFs over the last thirteen years.[30] Many, if not most, of the later exemptions differ principally from one another only in terms of the index whose performance the ETF seeks to track.[31]

ETF exemptive requests relating principally to the index to be tracked have been under consideration by the Division staff for what strikes many industry participants as an inexplicably long time in light of the issues raised by the requests. For example, industry participants see high-yield fixed income ETFs as not raising serious business or legal issues. Those ETFs operate in the same manner as many existing ETFs and invest in securities held by countless mutual funds and closed-end funds. Despite this, a number of ETF sponsors have been seeking relief for ETFs tied to high-yield fixed income indices for close to two years. The delay in issuance of exemptions is seen by many in the fund industry as simply denying fund investors the ability to invest in high-yield income securities through alternative means that have certain benefits to investors. In short, innovation in the fund business has been short-circuited.

I am not alone in my concerns about the Division of Investment Management's handling of exemptive orders under Section 6(c) of the 1940 Act. Paul Roye, in one of his last appearances as Director of the Division, suggested that the Division is in the process of drafting a rule under which Section 6(c) requests that are virtually identical to those for which relief has been previously granted by the Commission will be dealt with on an expedited basis.[32] Although

I applaud the staff's goal underlying the initiative, I seriously question the extent to which it will help industry participants seeking relief for products or services that raise novel legal issues.

To my mind, a possible solution to expedite the handling of novel 1940 Act exemptive orders would be for the Commission to dedicate staff with special expertise in markets and products to the exemptive review process. Such a dedicated staff that focuses on reviewing new products and services should have a greater appreciation as to how a new product or service differs from an existing one and be more aware of the current direction of new product and service developments. A dedicated staff that could work alongside the industry in the area of innovative products would help the Commission accomplish the laudatory balancing mission suggested by Commissioner Glassman.

Conclusion

I appreciate this opportunity to assist the Subcommittee in its review of the SEC's recent regulatory activity in the mutual fund industry. I hope that by sharing my perspective and experiences with you, I have been able to illuminate some unintended, but troublesome, consequences arising out of that activity. The Subcommittee's thoughtful reconsideration of the cumulative effects of this regulation should help to ensure that the interests of mutual fund shareholders are furthered by the regulation.

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[1] The Investment Company Act of 1940 (the "1940 Act") does not actually employ the term "independent director." Rather, the provisions of the 1940 Act and the rules under the Act that relate to independent directors refer to directors who are "not interested persons." "Interested person" is defined in Section 2(a)(19) of the Act.

[2] *See* Final Rule: Registration Form Used by Open-End Investment Companies, Investment Company Act Release No. 23064 (Mar. 13, 1998) ("1998 Amendments Adopting Release"). Before these amendments,

the prospectus was found to be "unintelligible, tedious and legalistic." The amendments sought to "unclutter" the prospectus by focusing its disclosure on essential information about a fund, while continuing to assure that fund information was available to those interested in reviewing it. One of the principal revisions was to move certain disclosure items about fund organization and legal requirements from the prospectus to the Statement of Additional Information. *Id.*

3 The SEC staff continued to express its commitment to this principle during Paul Roye's term as Director of the Division of Investment Management from 1998 to 2005. *See, e.g.*, Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the Securities Law Procedures Conference, Investment Company Institute (Dec. 7, 1998) *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch238.htm.

4 Concerns over enforcement actions initiated by state and/or federal regulators, or over plaintiff's litigation, are heightened among industry participants given the regulatory and enforcement environment since September 2003.

5 The view of the prospectus as a "liability document" is not without precedent. Former SEC Commissioner Isaac C. Hunt, Jr. has said, for example, that "[o]ver the past several decades, many of us have lost sight of the fact that the disclosure documents that are filed with the SEC every year are not only liability documents - but are intended to be one of the primary ways that the corporate community communicates with investors." Remarks Before the First Annual Institute on Mergers and Acquisitions: *Plain English: A Work in Progress* (Feb. 6, 1997).

6 The SEC has recognized, on at least one occasion, that it is aware of concerns over potential "information overload" that may come as a result of recent disclosure initiatives. *See* Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the ICI 2004 Securities Law Development Conference: *Mutual Fund Regulation: What Happens Next* (Dec. 6, 2004) *available at* http://www.sec.gov/news/speech/spch120604pfr.htm.

7 The idea that there should be a systematic re-examination of the process by which mutual fund investors receive disclosure and the quality of the prospectus disclosure they receive, including revisions to the application of the disclosure concepts of the 1933 Act, was discussed by Thomas P. Lemke in *Mutual Fund Disclosure Revisited,* published in the PRACTISING LAW INSTITUTE 1989 COURSEBOOK ON INVESTMENT COMPANIES.

8 *See, e.g.*, Chairman William H. Donaldson, U.S. Securities and Exchange Commission, Remarks Before the 2005 Mutual Fund and Investment Management Conference (Mar. 14, 2005) ("Donaldson 2005 Speech").

9 *See id.* In his remarks, Chairman Donaldson talked about his request for the staff to carry out a "top-to-bottom review" of current mutual fund disclosure requirements, adding that, when improving mutual fund disclosure, "no good idea will be off the table." *Id.*

10 *Compare* Alexander, Gordon J., et al., *Report on the OCC/SEC Survey of Mutual Fund Investors*, Washington, D.C., U.S. Securities and Exchange Commission and Office of the Comptroller of the Currency (Jun. 26, 1996), *with* Donaldson 2005 Speech, *supra* note 8. The findings from the 1996 Survey provided the basis for some of the disclosure reform initiatives undertaken at the time. *See* Barry P. Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission, and Eugene A. Ludwig, Comptroller of the Currency, Testimony Before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services of the U.S. House of Representatives (Jun. 26, 1996).

11 The "profile" was introduced simultaneously with the 1998 amendments to the rules governing prospectus disclosure. *See* Final Rule: New Disclosure Option for Open-End Management Investment Companies, Investment Company Act Release No. 23065 (Mar. 13,1998).

12 *See id.*

13 Most in the industry welcomed the concept of short-form disclosure and expressed their support for the profile. It could be argued that a primary reason why the SEC's short form profile has not been embraced

by the industry is fear of liability. *See. e.g.*, Comment letter from Lawrence H. Kaplan, Chairman, Securities Industry Association (Jun. 6, 1997). At the time the profile was proposed, the SEC was not comfortable incorporating by reference into a fund's profile the full disclosure set out in the fund's prospectus. *See* Proposing Release: Proposed New Disclosure Option for Open-End Management Investment Companies, Investment Company Act Release No. 22529 (Feb. 27, 1997). As a result, the fund industry has taken the view that the profile may expose funds to liability by concluding that, because the profile is not the full prospectus, it by definition omits material information that the fund is obligated to disclose under the current regulatory regime.

14 *See* Report of the Mutual Fund Task Force: Mutual Fund Distribution (Apr. 4, 2005) *available at* http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013690.pdf. A model of the proposed Profile Plus is available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013691.pdf.

15 These disclosure principles were outlined in an SEC Release in 1998, and include, among others, a belief that funds should design disclosure documents, particularly their prospectuses, first and foremost to communicate information to investors effectively; a belief that funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision; and a belief that prospectus disclosure requirements should not lead to lengthy disclosure that discourages investors from reading the prospectus or obscures essential information about an investment in a fund. *See* 1998 Amendments Adopting Release, *supra* note 2. Regulators outside the United States, including the Financial Services Authority, have embraced fully the concept of simpler disclosure to investors. *See* Implementation of the Simplified Prospectus Requirements in the UCITS Management Company Directive, FSA Consultation Paper 04/18 (Nov. 2004).

16 *See supra* note 12 and accompanying text.

17 Some mutual funds are organized as business trusts under state law and refer to their board members as "trustees." References to "directors" in the 1940 Act have equal application to "trustees."

18 The burdens on fund directors are illustrated by the devotion of fund chairmen, in some large fund complexes, of over 600 hours per year to their funds. Bonnie Bauman, *More Time, More Money for Directors in 2004*, BOARD IQ (May 3, 2005). Both the number of board meetings and the length of those board and committee meetings have measurably increased. *Id.* While these statistics may not seem noteworthy at first glance, they represent a significant burden, given the fact that most fund directors are employed full-time by unrelated companies in executive or senior management positions.

19 *See, e.g.*, Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks Before the 2004 Investment Company Institute Securities Law Developments Conference: *Minding Your Ps: Preventing Another Crisis in the Mutual Fund Industry* (Dec. 6, 2004) *available at* http://www.sec.gov/news/speech/spch120604smc.htm ("We have ... made some important changes in how we bring and settle our enforcement actions to maximize their effectiveness and deterrent effect. ... You can ... expect to see, over the next year, a continued focus on whether independent directors have lived up to their role as guardians of the interests of the shareholders they serve."); Kara Scannell and Deborah Solomon, *Your Fault: Directors' Payback Deal Shows Corporate Boards Aren't Safe*, WALL ST. J. at CI (Jan. 7, 2005) (discussing the Enforcement Division staff's focus on holding individuals accountable and citing evidence of an increase in caution among candidates for independent director positions).

20 U.S. Securities and Exchange Commission, *Report of Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation* at 266 (May 1992).

21 The U.S. Supreme Court, in a landmark case describing the role of mutual fund directors, named the independent directors as the funds' "watchdogs," and confirmed that these directors are vested with safeguarding the interests of a fund's shareholders by "furnish[ing] an independent check upon management" of investment companies, particularly with regard to conflicts of interest. *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quotations and citations omitted). The Supreme Court, of course, did not find that independent directors should effect management themselves. The Court observed, "the structure and purpose of the Investment Company Act indicate that Congress entrusted to the independent directors of

investment companies ... the primary responsibility for looking after the interest of the funds' shareholders." *Id.* at 486. About a decade ago, then-U.S. Securities and Exchange Commission Chairman Arthur Levitt told the mutual fund industry:

> The SEC believes effective governance lies not in micro-management, but in meaningful oversight. In less ritual and more substance in the boardroom. Not just active, but pro-active involvement. What is pro-active involvement? Does it mean asking to replace management's judgment with the judgment of independent directors? No. But it does mean being critically supportive of management. It does mean kicking the tires of management's operations. And it does mean boards should be alert, informed and involved throughout the process.

Remarks at the Mutual Funds and Investment Management Conference: *Mutual Fund Directors: On the Front Line For Investors* (Mar. 21, 1994). Former Commissioner Richard Y. Roberts said ten years ago that mutual fund directors "should not and cannot micromanage the day-to-day operations of the fund." Remarks Before the IDS Mutual Fund Conference: *The Watchdog Role and Responsibilities of Mutual Fund Directors* (Feb. 10, 1994), *in* INVESTMENT LAWYER, Vol. 1, No. 2 (May 1994). Former Division of Investment Management Director Paul Roye quoted the film *Dirty Harry* five years ago in emphasizing: "A man's got to know his limitations." Director Roye told independent directors of mutual funds: "You are not and should not try to be a full-time, day-to-day manager of the fund's operations. The fund's investment adviser is paid to do that. You are responsible for oversight. You are there to act as a control and check on fund management. You cannot micro-manage the fund and also focus on your broad oversight responsibilities." Remarks Before the Investment Company Institute Workshop for New Fund Directors: *What Does It Take to Be an Effective Independent Director of a Mutual Fund?* (Apr. 14, 2000) *available at* http://www.sec.gov/news/speech/spch364.htm.

22 Beagan Wilcox, *Time to Reassess Directors' Duties,* BOARD IQ (Mar. 22, 2005) *quoting* Kathryn McGrath, Director of the Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the ICI 2005 Mutual Funds and Investment Management Conference (Mar. 14, 2005).

23 Section 6(c) of the 1940 Act provides that the Commission "may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions [of the Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." 15 U.S.C. 80a-6(c).

24 U.S. GENERAL ACCOUNTING OFFICE, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES, REPORT TO CONGRESSIONAL REQUESTERS, GAO-02-302 (Mar. 2002) at 16, *citing* U.S. Securities and Exchange Commission, Inspector General, *Applications for Exemptive Relief,* Audit Report No. 230 (Mar. 1996) (noting that novel exemptive applications often take a year or longer to be reviewed by the staff and citing an example of one application for which the staff did not render a decision for over 5 years).

25 *See supra,* note 23 and accompanying text.

26 Commissioner Cynthia A. Glassman, U.S. Securities and Exchange Commission, Remarks at the Thirteenth Annual Public Fund Boards Forum: *The Challenges of Striking Regulatory Balance* (Dec. 6, 2004) *available at* http://www.sec.gov/news/speech/spch120604cag.htm.

27 An exchange traded fund, or ETF, is an open-end investment company or a unit investment trust registered under the Investment Company Act of 1940 whose investment objective is to achieve the same return as a particular market index. An ETF will hold a portfolio of securities that is intended to provide investment results that, before fees and expenses, generally correspond to the price and yield performance of the underlying benchmark index. ETFs receive certain exemptive relief from the SEC to allow secondary market trading in ETF shares. *See* Investor Information: Exchange-Traded Funds (ETFs) *available at* http://www.sec.gov/answers/etf.htm. *See also* SEC Concept Release: *Actively Managed Exchange-Traded Funds*, Investment Company Release No. 25258 (Nov. 8, 2001).

28 Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the American Stock Exchange Symposium on Exchange Traded Funds: *Regulatory Issues*

Involving Exchange Traded Funds (Jan. 14, 2002) *available at* http://www.sec.gov/news/speech/spch534.htm.

29 ETF applications typically seek exemptions from several provisions of the 1940 Act and its rules: Section 2(a)(32), 4(2) and 5(a)(1), which require open-end investment companies to issue redeemable shares; Section 22(d) and Rule 22c-1, which require open-end investment company shares to trade at a price based on net asset value; and Sections 17(a) and 17(b), which prohibit an affiliated person of a fund from selling any security to, or purchasing any security from, the fund. Some ETFs additionally seek exemption from Section 24(d), which requires the delivery of the fund's prospectus to investors.

30 *See* SPDR Trust, Series 1, Investment Company Act Release Nos. 18959 (Sep. 17, 1992) (Notice) and 19055 (Oct. 26, 1992) (Order). *See, e.g.*, Vanguard Funds, Investment Company Act Release No. 24789 (Dec. 12, 2000); UBS Global Asset Management (US) Inc and Fresco Index Shares Funds, Investment Company Act Release No. 25767 (Oct. 11, 2002); Rydex ETF Trust, et al., Investment Company Act Release No. 25970 (Mar. 31, 2003)

31 *See* Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference: *The Exciting World of Investment Company Regulation* (Jun. 14, 2001); *see, e.g.*, The CountryBaskets Index Fund, Inc., Investment Company Act Release Nos. 21736 (Feb. 6, 1996) (Notice) and 21802 (Mar. 5, 1996) (Order); The Foreign Fund, Inc., Investment Company Act Release Nos. 21737 (Feb. 6, 1996) (Notice) and 21803 (Mar. 5, 1996) (Order); Barclays Global Fund Advisors, et al., Investment Company Act Release Nos. 25594 (May 29, 2002) (Notice) and 26626 (Oct. 5, 2004) (Order).

32 Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks Before the Mutual Fund and Investment Management Conference (Mar. 15, 2005).

TESTIMONY
OF

MEYER EISENBERG, ACTING DIRECTOR
DIVISION OF INVESTMENT MANAGEMENT
AND DEPUTY GENERAL COUNSEL
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
MUTUAL FUNDS: A REVIEW OF THE REGULATORY LANDSCAPE

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MAY 10, 2005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Testimony Concerning
Mutual Fund Rulemaking

Meyer Eisenberg
Acting Director
Division of Investment Management
and Deputy General Counsel
U.S. Securities and Exchange Commission

Before the U.S. House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Hearing Entitled "Mutual Funds: A Review of the Regulatory Landscape"

May 10, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I. Introduction

I am Meyer Eisenberg, Acting Director of the Division of Investment Management and Deputy General Counsel of the Securities and Exchange Commission. Thank you for inviting me to testify before the Subcommittee today on the status of the Commission's mutual fund rulemaking reforms. I am pleased to be here on behalf of the Commission to provide an overview of the regulatory reforms the Commission has adopted in response to the recent unfortunate spate of mutual fund industry scandals that involved some of the best known names in the industry and sharply dramatized the need for additional measures to deal with conflicts of interest inherent in the organizational structure of mutual funds (see attached chart), restore public confidence in the fund industry and better safeguard the interests of investors in the future. I also would like to outline some additional regulatory initiatives that the Commission has undertaken in this area that may be of interest to the Subcommittee.

Before I begin, however, I would like to take this opportunity on behalf of the Commission to thank you, Chairman Baker, for your leadership on the issue of mutual fund reforms. Many of the reforms ultimately adopted by the Commission addressed the important concepts underlying the Mutual Funds Integrity and Fee Transparency bill that you introduced. I also wish to thank Committee Chairman Oxley, Subcommittee and Committee Ranking Members Kanjorski and Frank, as well as all Members of the Subcommittee and Committee for the leadership that they have provided during this disappointing chapter in the history of the investment company industry. Millions of Americans (indeed now over 91 million) rely on these products to safeguard and grow their savings so they can achieve dreams of a home, an education, and a comfortable retirement. Your support has been vital to their protection and to the restoration of confidence in this important sector of the financial services industry.

Last year, in the wake of the mutual fund late trading, market timing and revenue sharing scandals, the Commission implemented a series of mutual fund reform initiatives. The reforms were designed to (1) improve the oversight of mutual funds by enhancing fund governance, ethical standards, and compliance and internal controls; (2) address late trading, market timing and other conflicts of interest that were too often resolved in favor of fund management rather than in the interest of fund shareholders; and (3) improve disclosures to fund investors, especially fee-related disclosures. It is the Commission's expectation that, taken together, these reforms will minimize the possibility of the types of abuses we have witnessed in the past 20 months from occurring again. I would like briefly to review for you the significant steps the Commission has taken to strengthen and improve the mutual fund regulatory framework.

II. Enhancing Internal Oversight

Fund Governance Reforms: With respect to enhancing mutual fund governance and internal oversight, a centerpiece of the Commission's reform agenda was the fund governance initiative. In July 2004, the Commission in a 3-2 vote adopted reforms providing that funds relying on certain exemptive rules must have an independent chairman, and 75 percent of board members must be independent. In addition, the independent directors to these funds must engage in an annual self-assessment and hold separate "executive sessions" outside the presence of fund management. The Commission also clarified that these independent directors must have the authority to hire staff to support their oversight efforts. These fund governance reforms will enhance the critical independent oversight of the transactions permitted by the exemptive rules. Funds must comply with these requirements by January 16, 2006.

The fund governance reforms were designed to carry out the Congressional instruction in the Investment Company Act that the resolution of conflicts of interest be in the interest of fund shareholders rather than the interest of fund managers. Our fund governance reforms are also designed to facilitate the effective implementation of other mutual fund initiatives that we have adopted. In reviewing these questions, we need to step back and recall the statutory direction in the policy provision of section 1(b) of the 1940 Act:

> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions

enumerated in this section which adversely affect the national public interest and the interest of investors.

Compliance Policies and Procedures and Chief Compliance Officer Requirement: One of the most important of the Commission's initiatives, adopted in December 2003, requires that funds and their advisers have comprehensive compliance policies and procedures and appoint a chief compliance officer. In the case of a fund, the chief compliance officer is answerable to the fund's board and can be terminated only with the board's consent. The chief compliance officer must report to the fund's board regarding compliance matters on at least an annual basis. Funds and advisers were required to comply with these new requirements beginning October 5, 2004. The Commission believes that making these changes to the mutual fund compliance infrastructure, and the increased focus on compliance that comes from the new chief compliance officer requirement will help to minimize the kinds of compliance weaknesses that led to the mutual fund scandals.

Code of Ethics Requirement: In July 2004, the Commission adopted a new rule that requires registered investment advisers, including advisers to funds, to adopt a code of ethics that establishes the standards of ethical conduct for each firm's employees. The code of ethics rule represents an effort by the Commission to reinforce the fundamental importance of integrity in the investment management industry. Investment advisers were required to comply with the new code of ethics requirement as of February 1, 2005.

III. Addressing Late Trading, Abusive Market Timing and Directed Brokerage for Distribution

Late Trading/Hard 4:00 Proposal: To address the problems associated with late trading (which involves purchasing or selling mutual fund shares after the time a fund prices its shares-typically 4:00-but receiving the price that is set before the fund prices its shares), the Commission, in December 2003, proposed the so-called "hard 4:00" rule. This rule would require that fund orders be received by the fund, its designated transfer agent or a clearing agency by 4:00 p.m. in order to be processed that day.

We have received numerous comments raising concerns about this approach. In particular, we are concerned about the difficulties that a hard 4:00 rule might create for investors in certain retirement plans and investors in different time zones. Consequently, the staff is focusing on alternatives to the proposal that could address the late trading problem, including various technological alternatives. The technological alternatives could include a tamper-proof time-stamping system and an unalterable fund order sequencing system. These technological systems could be coupled with enhanced internal controls, third party audit requirements and certifications.

The staff has been gathering information from industry representatives to better understand potential technological solution that could be used to address the late trading problem. Chairman Donaldson has instructed the staff to take the time necessary to fully understand the technology issues associated with any final rule. The Commission likely will consider a final rule in this area later this year.

Market Timing/Redemption Fee Rule: In March 2005, the Commission adopted a "voluntary" redemption fee rule, which permits (but does not require) funds to impose a redemption fee of up to 2%. The rule requires that fund boards consider whether they should impose a redemption fee to protect fund shareholders from market timing and other possible abuses. The voluntary rule represents a change from the "mandatory" approach originally proposed by the Commission. Many commenters opposed a mandatory redemption fee rule because of concerns that investors would inadvertently trigger the fee's application and because a 2% redemption fee may not be appropriate in all cases.

When the Commission adopted the new rule, it also requested comment on whether to require that any redemption fee imposed by a fund conform to certain uniform standards. This standardization may facilitate imposition and collection of redemption fees throughout the fund industry. Chairman Donaldson has indicated that he is hopeful that the Commission will quickly reach a decision on this part of the rule, after we process the comments we received. The comment period closed yesterday.

The new rule also mandates that funds enter into written agreements with intermediaries operating omnibus accounts that enable funds to access information from those intermediaries, so that funds can identify shareholders in those accounts who may be violating a fund's market timing policies. Under these arrangements, the intermediaries and funds would share responsibility for enforcing fund market timing policies. I should also note that fair value pricing remains critical to eliminating arbitrage opportunities for market timing. I anticipate that the Commission will be providing additional guidance on this issue.

Directed Brokerage Ban: In September 2004, the Commission adopted amendments to rule 12b-1 under the Investment Company Act to prohibit mutual funds from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. The Commission's concern was that this practice may well compromise best execution of portfolio trades, increase portfolio turnover, conceal actual distribution costs and inappropriately influence broker-dealer recommendations to investors through, for example, using fund brokerage to secure preferred treatment ("shelf space") for the fund complex directing the brokerage. In adopting the ban, the Commission determined that directing brokerage for distribution represented the type of conflict that was too significant to address by disclosure alone. The directed brokerage ban went into effect December 13, 2004.

IV. Improving Disclosures to Fund Investors

Improved mutual fund disclosure--particularly disclosure about fund fees, conflicts and sales incentives--has been a stated priority for the Commission's mutual fund program throughout Chairman Donaldson's tenure, even before the mutual fund scandals came to light. As such, disclosure enhancements have been an integral part of our reform initiatives. As part of our mutual fund reform agenda, we have adopted the following disclosure reforms, all of which have become effective.

Shareholder Reports: In February 2004, the Commission adopted significant revisions to mutual fund shareholder reports. These revisions include dollar-based expense disclosure, quarterly disclosure of portfolio holdings and a streamlined

presentation of portfolio holdings in shareholder reports. These requirements became effective in August 2004.

Disclosure Regarding Market Timing, Fair Valuation and Selective Disclosure of Portfolio Holdings: In April 2004, the Commission adopted amendments requiring funds to disclose (1) market timing policies and procedures, (2) practices regarding "fair valuation" of their portfolio securities and (3) policies and procedures regarding the disclosure of their portfolio holdings. Each of these disclosures specifically addresses abuses that came to light in the mutual fund scandals. These requirements became effective in May 2004.

Breakpoint Discounts: In June 2004, the Commission adopted rules requiring mutual funds to provide enhanced disclosure regarding breakpoint discounts on front end sales loads, in order to assist investors in understanding the breakpoint opportunities available to them. This initiative addresses the failure on the part of many broker-dealers to provide sales load discounts to mutual fund investors who were entitled to them. The requirement became effective in July 2004.

Board Approval of Investment Advisory Contracts: Also in June 2004, the Commission adopted rules requiring that shareholder reports include a discussion of the reasons for a fund board's approval of its investment advisory contract. The disclosure is intended to focus directors' and investors' attention on the importance of the contract review process and the level of management fees. This requirement became effective in August 2004.

Disclosure Regarding Portfolio Manager Conflicts and Compensation: In August 2004, the Commission required that funds provide additional information regarding portfolio manager conflicts and compensation, including information about other investment vehicles managed by a fund's portfolio manager, a portfolio manager's investment in the funds he or she manages and the structure of the portfolio manager's compensation. These requirements became effective in October 2004.

Point of Sale/Fund Confirmations: In addition to these adopted reforms, the Commission recently requested additional comment on a proposal requiring brokers to provide investors with enhanced information regarding costs and broker conflicts associated with their mutual fund transactions. The proposal would require disclosure at two key times - first at the point of sale, and second at the completion of a transaction in the confirmation statement. The proposal was tested with investor focus groups, and based on the feedback we received from these focus groups, the Commission issued the request for additional comment. The Commission was sensitive to the concerns expressed by certain brokerage industry commenters about the costs associated with the original proposal. The staff is examining the possibility of using more cost-effective methods of providing investors with the disclosures they need. Chairman Donaldson has stated that he is hopeful that the Commission can move quickly on this initiative after we have an opportunity to review the comments that respond to the recent request. Comments were due April 4th.

V. Upcoming Mutual Fund Initiatives

Having outlined the Commission's progress on the mutual fund reform agenda, I would like to briefly highlight some additional mutual fund related initiatives that Chairman Donaldson has indicated are on the horizon.

Portfolio Transaction Costs Disclosure: In December 2003, the Commission issued a concept release requesting comment on measures to improve disclosure of mutual fund transaction costs. In many cases, investors do not understand how the costs associated with the purchase and sale of a mutual fund's portfolio securities affect their bottom-line investment in the fund. These transaction costs can include the payment of commissions and spreads as well as costs associated with soft dollars and other reciprocal brokerage arrangements that are undisclosed or only vaguely disclosed. Using feedback that the Commission received in response to the concept release, the staff is currently preparing a proposal to improve disclosure of mutual fund transaction costs.

Soft Dollars for Research: Chairman Donaldson has stated that he believes it is necessary to examine the nature of the conflicts of interest that can arise from soft dollars, which involve an investment adviser's use of fund brokerage commissions to purchase research and other products and services. He has placed a high priority on resolving these issues. Consequently, he has formed a Commission Task Force that is actively reviewing the use of soft dollars, the impact of soft dollars on our nation's securities markets and whether allocations of soft dollar payments further the interests of investors. In addition, the Task Force is reviewing whether we can improve disclosure to better inform investors about the use of soft dollars and whether there are enhanced disclosures

that can be made to fund boards to enable them to better evaluate funds' use of soft dollars. The Task Force also is examining the definition of "research" (that is the scope of the exemption) as used in section 28(e) of the Securities Exchange Act of 1934. It should be emphasized that soft dollar arrangements present many of the same concerns irrespective of whether research is provided on a proprietary basis, or by an independent research provider, and I expect that any recommendations from the staff would accord similar treatment to both types of arrangements.

Rule 12b-1: When the Commission proposed to ban directed brokerage for distribution under rule 12b-1, it also requested comment on the broader question of whether rule 12b-1 (which allows mutual fund assets to be used to promote the sale of fund shares) should be revised or even eliminated. The Commission received numerous comments on this issue. The Commission adopted rule 12b-1 over 20 years ago, and the mutual fund industry has evolved significantly since then. Part of the Commission's original rationale in adopting rule 12b-1 was to allow the fees to provide resources for advertising and marketing purposes on the theory that growing fund assets would create economies of scale for the benefit of investors. In recent years, however, rule 12b-1 fees have, in some cases, become a substitute for a sales load, with less transparency to the investor. In light of these changes in the industry and in the use of 12b-1 fees, Chairman Donaldson has stated that the future of rule 12b-1 is a topic that should receive a thorough and reasoned review.

Mutual Fund Disclosure Reform: As I outlined above, the Commission has adopted a number of new mutual fund reform initiatives designed to improve the disclosures made to fund investors. In addition to these needed reforms, Chairman

Donaldson has stated that he believes it is time to step back and take a top-to-bottom assessment of our mutual fund disclosure regime. He has asked the staff to carry out a comprehensive review of the mutual fund disclosure regime and how we can maximize its effectiveness on behalf of fund investors. The staff also will examine how we can make better use of technology, including the Internet, in our disclosure regime. Throughout this review process, we will solicit input from mutual fund investors.

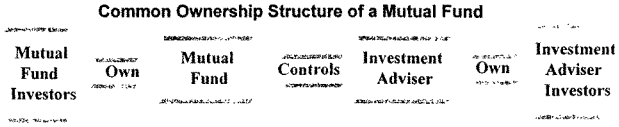
VI. Conclusion

In conclusion, Mr. Chairman, let me again thank you for your support and leadership in the area of mutual fund reform. Under your leadership, this Subcommittee was at the forefront of recognizing the necessity for that reform and initiating serious consideration regarding what needed to be done to restore investor confidence in this industry.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions you may have.

Common Ownership Structure of a Corporation

Common Ownership Structure of a Mutual Fund



Statement of Michael S. Miller
Managing Director
The Vanguard Group

Before the Capital Markets, Insurance and Government-Sponsored Enterprises Subcommittee of the U.S. House Financial Services Committee

Oversight Hearing on
"Mutual Funds: A Review of the Regulatory Landscape"

May 10, 2005
Washington, D.C.

Chairman Baker, Ranking Member Kanjorski, and Members of the Committee, my name is Michael Miller. I am a Managing Director at The Vanguard Group, based in Valley Forge, Pennsylvania. An important part of my responsibilities involves providing oversight to our firm's compliance functions and our efforts to meet applicable regulatory requirements. I am also responsible for a number of other areas, including corporate planning and strategy, portfolio review—which includes new fund initiatives and research—and shareholder communications. I am grateful to have this opportunity to appear before the Committee to discuss the regulatory climate for mutual funds, and to share some ideas about the future direction of regulatory oversight of the fund industry.

To be sure, investor trust and confidence in this industry have been tested over the past 20 months, following the revelations by the SEC and New York Attorney General Spitzer that began in September 2003 about problems at some hedge funds, distributors and fund companies. Moreover, the relationship between regulators and regulated firms has been strained. Amid an atmosphere that at times could be characterized as mutual

mistrust, interactions between regulated firms and regulatory officials came to resemble a game of "gotcha" or regulatory one-upsmanship instead of a cooperative joint endeavor in the interest of investors. In the face of intense public pressure, new rules have been proposed and adopted at a record pace, failing, in some cases, to allow for adequate study by the Commission or the industry to evaluate the practical impact of the measures. And while the industry itself brought forth many thoughtful comments and suggestions about how best to address these regulatory challenges, there were times, quite frankly, when these comments were brushed aside amid the pressure to move forward quickly.

I believe, though, that we are now at a turning point. Nearly two years after the market-timing and late-trading problems at some firms first surfaced, it is gratifying to see that investors continue to retain confidence in mutual funds as an investment vehicle and, in important respects, the investment vehicle of choice. No doubt, investors and the markets have been reassured by the swift enforcement actions by regulators to right wrongs and punish wrongdoers. The marketplace, too, has been swift and unforgiving in delivering punishment to firms that betrayed investors' trust.

As we turn to the next chapter in the evolution of mutual fund regulation, the Commission and the industry must work together to ensure that the regulatory framework that governs our industry fully serves the millions of investors who rely on mutual funds to build their financial futures. We expect that fine tuning will be needed in the wake of an extraordinary period of regulatory activity. Inevitably, adjustments will be necessary and the SEC will be called upon to interpret new rules and regulatory requirements. We believe that this should be a shared responsibility between the Commission and the fund industry if the effort is, in the long run, to serve the best interests of investors who seek the rewards of investing in a fair, transparent, and cost effective market. We hope, too, that the Commission will focus renewed attention on supporting innovative ways to serve investors, with respect to new product development, service and disclosure improvements, technological advancements, and operational efficiencies.

I. The Vanguard Group

The Vanguard Group is the world's second-largest mutual fund family, with more than 18 million shareholder accounts and approximately $830 billion invested in our U.S. mutual funds. Vanguard offers 129 funds to U.S. investors and more than 40 additional funds in foreign markets. The Vanguard Group has a unique structure within the mutual fund industry. At Vanguard, the mutual funds, and therefore indirectly the fund shareholders, own The Vanguard Group, Inc., which provides the funds with all management services "at cost." Under this structure, all "profits" of The Vanguard Group are returned to our fund shareholders in the form of reduced expenses.

Given Vanguard's mutual ownership structure, all of our management policies, practices, and personal incentives are designed to ensure the growth, safety, and well being of our fund shareholders' assets. In addition, Vanguard has long maintained a philosophy of fair dealing with our shareholders, and we believe that our current investment, business, and disclosure practices are designed to protect their interests. As an industry leader, we are pleased to contribute to the discussions about current and proposed fund initiatives, and we support appropriate and meaningful reforms at the federal level to maintain investor trust in mutual funds.

II. "To Help, or At Least To Do No Harm"

Hippocrates advised physicians to "Declare the past, diagnose the present, foretell the future...(and to) make a habit of two things—to help, or at least to do no harm." We would do well to follow his teachings today.

That some misguided and unprincipled people at hedge funds, distributors and fund companies engaged in abusive business practices has been well documented, and regulators have responded. Today, fund company legal and compliance staffs are dealing with at least 25 new regulatory requirements for fund firms that have been proposed and/or adopted in the past four years alone. When confronted with so many new

requirements, it's inevitable that organizations must face difficult resource-allocation issues. At times, it seems that these new demands—on operating budgets and senior management time and attention to review, analyze, and implement the new regulatory requirements—unduly strain financial resources and leave little time for senior management to develop new and better ways to serve investors' needs . . . and I'm speaking on behalf of the industry's second-largest firm. I can only imagine the difficulties and tough decisions that many smaller firms are facing. One has to wonder not whether—but to what extent—the increased compliance burdens have led organizations to hold off on operational improvements and service enhancements and other innovations—to the potential detriment of fund investors.

A regulatory system that is in overdrive for an extended period can create undesirable and unintended consequences, ultimately punishing everyone in an effort to address the abuses of the few. I think that after we have a chance to step back, catch our breath, and review the events and activities of the past 20 months or so, we'll find that some of the new rules, adopted in haste, may not serve investors well, while others may prove to be a disservice to investors. Let me stress that I believe all of this regulatory activity has been well-intended, but actual experience may contravene those good intentions. If, for example, new requirements are helpful in some measure but exact a cost in human and capital resources that far exceeds the benefits to investors, we—and I refer to both regulators and the regulated—have failed in our obligation to strike an effective cost/benefit balance for investors.

As Hippocrates advised, we should help, or at least do no harm.

But, how do we do so? We believe the best approach begins with mutual respect and meaningful dialogue, which will lead to constructive engagement and collaboration for the benefit of all fund shareholders.

III. A Foundation of Mutual Respect

The mutual respect between regulators and regulated entities that is necessary for a productive and constructive engagement has long existed between the fund industry and its regulators, and it remains intact, even after the challenges of the last couple of years.

Indeed, this industry owes its success to the legacy of good rulemaking, beginning with the passage of the Investment Company Act of 1940, which we consider to be a brilliant piece of legislation that has stood, virtually intact, for more than 60 years. We also recognize that the SEC's work in interpreting the law and applying it with reasoned judgment over the years has been a vital factor in the effectiveness of our regulatory system. Over the years, the fund industry has consistently called for more resources for the SEC and for more regulation where it serves investors' interests. Though there is room for honest debate on the ways and means to accomplish a particular objective—and we must encourage and have such debate—we are committed to working with regulatory authorities to protect investors.

We know that good regulation helps tremendously to make our industry reputable—and, ultimately, that's a vital factor in earning and maintaining the trust of investors and ensuring the long-term viability of our business.

IV. Meaningful Dialogue

If we are going to operate collaboratively, as we should, we must maintain an open dialogue. Unfortunately, one casualty of the events of the last two years has been a breakdown in the constructive communication that had existed between the industry and the regulators. We must re-establish communications so that the engaged, interested parties—fiduciaries and regulators alike—can work hand in hand to accomplish the shared objective of maintaining investor protections and trust.

There have been many examples in the past where we have seen how well an identified issue can be addressed through swift, cooperative efforts. Most recently, the fund and securities industries have worked with the NASD, with the SEC staff participating, on many issues, including sales-charge breakpoints, transaction costs, distribution arrangements and point-of-sale disclosures. These have been worthwhile endeavors with broad participation from both the industry and the regulators. There is so much sense to putting our heads together to develop solutions to our most challenging issues.

The search for simple answers in a complex world is difficult, and may not always be possible. Fund firms have become increasingly complex as they seek to meet the needs of an ever-widening variety of investors. Because mutual funds are an outstanding long-term, low-cost, investment vehicle, they appeal to a wide range of investors—from individuals saving for retirement, to small businesses, to Fortune 500 companies. This diversity has been a great strength of the industry—attracting a strong and stable asset base which has spurred innovation and growth and economies of scale for the benefit of all investors. Because funds and fund operations have evolved to adapt to varying investor needs, regulatory solutions to identified problems must often address multiple fund-offering platforms and operating systems. Regulators and fund companies therefore need—more than ever—to engage in thoughtful and constructive dialogue and pursue a disciplined process to developing rules that can be effective in protecting investors.

We certainly recognize that there won't always be unanimous support within the industry for some specific proposals—indeed, it would be naïve to expect regulators and regulated firms to be in complete agreement on every issue. But even though a constructive engagement—one in which there is mutual respect, open dialogue, and often rigorous debate—may not lead to complete agreement, it will lead to a more effective outcome for the benefit of fund investors and the fund industry.

V. Constructive Engagement and Collaboration

In a constructive engagement between regulators and the regulated, the rulemaking process should be collaborative, not adversarial. We believe that the regulatory process works best when regulators and the firms that they regulate work collaboratively to design rules to protect investors. Together, we can ensure that regulatory measures are designed with a thorough understanding of the intricacies of the business, whether they involve mutual funds, brokers, exchanges, or other market participants.

Working together, we can also avoid the pitfalls any regulatory effort faces. As we all know, a regulatory response that is disproportionate or poorly tailored to the problem it seeks to solve can do more damage than good. And no amount of regulation will ever replace a commitment from the industry itself to integrity and high ethics. But over-regulation doesn't prevent bad people from doing bad things. There will always be people who figure out how to evade rules. Such individuals should be subject to strong and swift enforcement actions.

We must be wary of changing the rules without providing adequate time for the industry and the regulators to consider the ramifications of the changes. During this recent period, with the regulatory system in overdrive, the fund industry has too often been given less than 60 days to consider and comment on regulatory changes. That simply isn't enough time to obtain and digest all of the operational and other implications, which can often be quite complex and require an iterative process to evaluate properly. Efforts to make changes to proposed rules in response to public comments are commendable, but it is essential that any such changes must also be subject to further comment and consideration if we are to identify the best possible way to effect the change. This is the foundation of the notice and comment process of administrative rulemaking—and with good reason. Failure to give adequate notice and opportunity to consider a rule can result in failure to achieve an important and necessary regulatory objective.

The recently adopted rule relating to mutual fund redemption fees is an instructive example.[1] Although the rule was first proposed as a mandatory requirement, numerous comments from outside the industry, including firms not regulated by the Commission, persuaded the Commission that the rule should not be mandatory and, as a result, whether or not to impose redemption fees was left to the discretion of each fund board, on a fund by fund basis. During the comment period, concerns were expressed by the fund industry about the ability to enforce redemption fee requirements with respect to shares held in omnibus accounts, such as those held by brokerage firms and retirement plan administrators. These difficult operational and regulatory questions led the Commission to impose a new requirement for every fund, whether or not it carried a redemption fee, to enter into a contract with all intermediaries and to require certain contractual provisions to assist the fund in enforcing its market-timing policies. Although well intended, the practical and cost implications of the contractual requirements were not well understood when the final rule was adopted, and there was no opportunity for formal comment by the industry. As a result, funds may find it virtually impossible to comply with the final rule as written. We are hopeful that the long compliance period established for this rule (effective October 2006) and a supplemental comment period will afford the industry and the staff an opportunity to resolve these issues.

I have been involved in the securities industry for much of my career, and during that time I have observed how well the partnership between regulators and regulated firms *can* work when we are constructively engaged with each other and on multiple levels. At Vanguard, we truly appreciate the interest that our regulators have in learning about our business and consulting with us on broad regulatory issues of mutual interest. It's a give and take that we find to be extremely worthwhile—and eye-opening. Some of our best give and take on regulatory issues has occurred with experienced and knowledgeable staff members who have worked with us to explore practical, workable solutions to complex regulatory issues. It's important for all of us to make an effort to understand each other's perspectives so that we can most effectively accomplish our shared objective—protecting investors.

[1] "Mutual Fund Redemption Fees," SEC Release No. IC-26782, 70 Fed. Reg. 13328 (March 18, 2005).

When things work that way, there are net gains for both sides. Regulated firms gain because we're looking at an issue with fresh eyes, and, of course, we feel a sense of urgency about solving a potential problem. At the same time, regulators who want to identify where the gaps are and figure out how to close them need the input of the firms they regulate in order to succeed.

VI. Looking Ahead

In the future, as in the past, regulated companies that want to prosper and grow will need to understand how to comply with regulations as they launch new products, expand their services, and integrate new technologies into their businesses. Regulators will need to work together with each other and with the companies they regulate in order to keep apace with new developments.

We need not look too far into the future to see some opportunities to become re-engaged. SEC Chairman Donaldson recently testified before the Senate on the state of the securities industry. He outlined areas of focus for the SEC in the coming months with regard to mutual funds. Two areas of focus he mentioned were mutual fund disclosure reform and mutual fund distribution—issues that offer a terrific opportunity for us to join in a productive dialogue. Advances in technology and the high adoption rate of new technology by mutual fund shareholders create new avenues for better disclosure and distribution to shareholders. As we tackle these two topics, we also hope regulators and the industry will make more time to re-engage on new business developments—an area that has suffered somewhat as we've all devoted considerable attention and resources to new compliance and disclosure initiatives.

The SEC plays a critical role here, serving as the gate-keeper of new products and services. However, just as fund firms were coping with the weight of new regulations, so, too, was the SEC. As a result, firms that attempted to continue developing new offerings—offerings that could provide greater flexibility and lower costs to investors—encountered delays and bottlenecks that seemed endless. We would suggest one prime

area for improvement is new product review. I'm not suggesting that new offerings should not undergo careful consideration before being made available to investors. They should. However, the pace of new product review and evaluation needs to be examined, so that investors can be better served with new products that are responsive to their needs.

VII. Conclusion

One of the great strengths of the financial services industry has been the ability to adapt and evolve. Due in part to the flexible and forward-looking provisions of the legislation that empowers us, the SEC has been a great partner with the industry in helping to launch new investment products and services in a manner that serves the investing public.

As we look forward, we should collaboratively and thoughtfully take stock of the work that we have done these past several years. Many of our new regulations—the compliance rules, enhanced code of ethics requirements, redemption fees, and expanding disclosures about the potential harm and remedies for market timing, to name a few—seek to achieve similar objectives. So, we have multiple and sometimes redundant solutions pursuing a single problem. We should look at all of these solutions closely and in concert with each other. We should consider what works well and what doesn't, then take the best of it and leave the rest.

In closing, I would like this Committee to know that Vanguard has always been willing and eager to come to the table with our regulators to discuss any issue at any time. While I am speaking for Vanguard, I'm confident that any serious and responsible firm in the financial services industry would agree with me on this point. The industry is fortunate to have in its employ many fine, ethical, and talented people—individuals who work every day in operations, investment management, shareholder services, legal, communications, compliance, and research. We are willing to share their expertise, for the betterment of this industry and, more importantly, for the investors we serve.

Thank you.

STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

"MUTUAL FUNDS: A REVIEW OF THE REGULATORY LANDSCAPE"

MAY 10, 2005

EXECUTIVE SUMMARY

- The Institute applauds the Subcommittee for providing this timely forum to take stock of where we are and consider how to shape mutual fund regulatory policy going forward so that it will continue to serve the interests of fund investors.

- Developments since 2003 are reassuring. Our legal and regulatory system has worked as designed to identify, correct and prevent misconduct, and to hold investors harmless. Strong, corrective market forces have been at work as well. The result has been to sustain the historically high degree of public confidence in mutual fund investing – and thus to preserve to average Americans an indispensable tool to achieve their long-term financial objectives. This objective, assuring that mutual funds remain a vibrant and competitive and effective tool for average investors, is one of utmost importance. But it cannot be taken for granted.

- In considering future regulatory action affecting mutual funds, it is critical that consideration be given to the competitive realities of the marketplace. The SEC in particular must give due consideration to potential unintended consequences of burgeoning regulatory requirements that uniquely affect mutual funds. Individually, these requirements may serve valid and useful purposes. If, however, when taken as a whole, the SEC's regulation (and the associated costs and risks) discourage investment advisers from entering or staying in the fund business, if they discourage portfolio managers from managing mutual funds versus other investment products or if they cause intermediaries to favor less regulated financial products over mutual funds, then the SEC's regulatory regime is not effectively serving the interests of investors.

- The SEC must pursue future rulemaking for mutual funds with a better understanding of the potential consequences, including the costs and the benefits. To do so, the SEC must conduct a more informed and rigorous analysis of the relative costs and benefits of its regulatory requirements. Only in this way can it assure that the costs of new requirements will not outweigh their benefits – or add unnecessarily to a growing and unique regulatory "surcharge" on mutual funds.

- The success of the mutual fund regulatory regime relies, in large part, on a strong and well-run regulator. The Institute has repeatedly supported adequate funding of the SEC, but resources alone are not the answer. The larger challenge is for the SEC to assure the effectiveness of its regulatory and law enforcement efforts. To his great credit, Chairman Donaldson has committed to pursuing internal reforms that will improve the performance of the SEC. As part of the SEC's inward-looking reforms, there are three areas we believe deserve priority attention. They are:

    - better coordination among the different SEC divisions and offices that deal with mutual fund issues;
    - better coordination of, and other improvements to, the inspection process; and
    - improvements to the efficiency and productivity of the Division of Investment Management, especially in processing applications for exemptive relief.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President of the Investment Company Institute, the national association of the U.S. investment company industry. ICI members include 8,512 open-end investment companies, or mutual funds, with total assets of approximately $7.959 trillion (representing more than 95% of all assets of U.S. mutual funds). These funds serve approximately 87.7 million shareholders in more than 51.2 million households. Mutual funds are one of the nation's largest financial intermediaries, and they play an especially important role in Americans' retirement security. As of the end of 2004, mutual funds accounted for 24 percent ($3.1 trillion) of U.S. retirement market assets.

It is no accident that mutual funds are such a popular investment choice for so many people. Mutual fund investing is a powerful proposition. It provides access to professional investment managers, diversification of investments, and a range of valuable services for investors, all at relatively low cost.

In addition to their role as the investment vehicle of choice for millions of Americans, mutual funds and other registered investment companies are major investors in securities and participants in the marketplace. At the end of 2004, investment companies (the bulk of which are mutual funds) held approximately 24 percent of the outstanding stock of U.S. companies, approximately 34 percent of outstanding tax-exempt debt, and about 10 percent of corporate bonds and U.S. Treasury and agency debt. Mutual funds (mostly money market funds) hold approximately 35 percent of outstanding U.S. commercial paper.

I greatly appreciate the opportunity to appear before the Subcommittee to discuss the current regulatory landscape for mutual funds.

Much has transpired since the Institute's former Chairman, Paul Haaga of Capital Research and Management Company, testified before you in November 2003, shortly after the revelations of market timing and late trading abuses involving mutual funds. The Securities and Exchange Commission (SEC) and state authorities have conducted wide-ranging investigations and enforcement actions against fund companies, broker-dealers and others implicated in wrongdoing. The SEC has developed an array of new rules addressing trading abuses as well as governance, disclosure and other practices. Congress, in a series of oversight hearings, has closely followed all of these developments to assure that adequate measures are being taken to protect the interests of fund investors. It is fair to say that the market, too, has followed all these developments closely – it has exacted a heavy toll on fund firms found to violate the trust of their investors; companies with reputations intact clearly have benefited.

From the outset, fund leaders have regarded the trading abuses as the most serious challenge to confront our industry in its modern history. We called for strong law enforcement and new regulatory standards. We have worked hard – and continue to work hard – to implement these new standards and achieve their full potential to safeguard the interests of our shareholders. And we have recognized in the scandal an important need to bolster our commitment to ethical practices and fiduciary principles, for it is upon these that any success in our business depends.

I agree with the Institute's Chairman, Jim Riepe of T. Rowe Price, who recently remarked that we are at a turning point where we need to build on the regulatory safeguards

that have been put in place and again focus on ensuring that Americans have opportunities to build for their financial futures.[1] I applaud the Subcommittee for providing this very timely forum to take stock of where we are and consider how to shape mutual fund regulatory policy going forward so that it will continue to serve the interests of fund investors.

As the Subcommittee knows, I joined the Institute as President in June 2004. Prior to that time, I spent much of my career in private law practice, and have served for many years as counsel to mutual funds, independent fund directors, investment advisers, and fund distributors. I attended my first fund board meeting almost twenty-five years ago. From this longer-term perspective, developments since 2003 are reassuring. Our legal and regulatory system has worked as designed to identify, correct and prevent misconduct, and to hold investors harmless. Strong, corrective market forces have been at work as well. The result, I believe, has been to sustain the historically high degree of public confidence in mutual fund investing – and thus to preserve to average Americans an indispensable tool to achieve their long-term financial objectives.

This objective, assuring that mutual funds remain a vibrant and competitive and effective tool for average investors, is one of utmost importance. But it cannot be taken for granted.

Decisive action in response to the trading abuses was plainly necessary. In my judgment, it is no less imperative to continue to evaluate the broad fabric of fund regulation, in light of recent experience and the industry's growth, in order to assure that mutual funds

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[1] Remarks of James S. Riepe, Chairman, ICI, at the Investment Company Institute First Annual Mutual Fund Leadership Dinner, Library of Congress, Washington, D.C. (May 4, 2005), at 5.

remain vibrant and competitive and continue to offer middle-income Americans an effective way to reach their long-term saving and investment goals.

As we consider future regulatory action affecting mutual funds, we must take into account the competitive realities of the marketplace. The SEC in particular must give due consideration to potential unintended consequences of burgeoning regulatory requirements that uniquely impact mutual funds. Individually, these requirements may serve valid and useful purposes. If, however, when taken as a whole, the SEC's regulation (and the costs and risks associated therewith) discourage investment advisers from entering or staying in the fund business, if they discourage portfolio managers from managing mutual funds versus other investment products, if they cause intermediaries to favor less regulated financial products over mutual funds, then the SEC's regulatory regime is not effectively serving the interests of investors.

Closely related to this issue is a concern about the escalating cost of compliance with the SEC's mutual fund regulations. The Institute is a long-time advocate of sound regulation and strong compliance. We also believe, however, that the SEC must conduct a far more informed and rigorous analysis of the relative costs and benefits of its regulatory requirements. Only in this way can it assure that the costs of new requirements will not outweigh their benefits – or add unnecessarily to the growing and unique regulatory surcharge on funds and their investors.

My testimony will address these concerns in greater detail. The Institute is likewise a long-time advocate of a well-funded and effective SEC. For this reason, it is important to build on Chairman Donaldson's important and timely initiatives to improve the SEC's efficiency and

effectiveness. I would like to share our thoughts in this area with the Subcommittee as well. It is critical that the SEC continue to have sufficient resources and deploy them wisely to provide strong oversight and sensible regulation.

Before turning to these issues, I will take a brief look back at the SEC's recent mutual fund reforms and other significant new regulatory requirements applied to funds in the past several years.

II. STATUS OF RECENT REGULATORY REFORMS

When I took the helm as President of the Institute in June 2004, the industry was in the midst of the most significant regulatory overhaul it has experienced in over 60 years. Under Chairman Donaldson's leadership, and with the careful oversight of this Subcommittee and other Congressional bodies, the SEC embarked upon an extremely ambitious mutual fund regulatory reform agenda. The Institute supported this broad-based reform process and the vast majority of the SEC's specific proposals as the best way to address the abusive trading practices and assure continued investor confidence.

Of the twelve reform proposals issued since September 2003, ten have been adopted and the SEC continues to consider actively the remaining two. These reforms – and the half dozen other new rules adopted or proposed since September 2003 that apply to mutual funds – represent a remarkable body of new regulatory requirements in and of themselves.[2] Yet they follow on the heels of a host of other new regulations impacting mutual funds in recent years.

[2] A list of these rules is set forth in the attached Appendix.

The combined weight of all these new regulations is truly daunting. Leading up to September 2003,

- Congress enacted the Gramm-Leach-Bliley Act in 1999.
- The SEC adopted its privacy rules the next year.
- It approved Chairman Levitt's fund governance reforms in 2001.
- Soon after, the SEC required funds to disclose after-tax returns.
- Congress passed the USA Patriot Act in 2001, with its extensive anti-money laundering compliance obligations.
- President Bush signed the Sarbanes-Oxley Act into law in 2002, with its certification requirements, disclosure controls and procedures, and code of ethics and financial expert provisions.
- The SEC subsequently promulgated a detailed series of rules to implement the Sarbanes-Oxley Act, and elected to apply to mutual funds a host of new provisions enacted primarily for corporate issuers.
- The SEC's proxy voting disclosure rules for mutual funds took effect in 2003.

Many of the new requirements are far-reaching, necessitating fundamental changes to business operating systems and in some cases business culture. These changes cannot happen overnight. It is extremely important, therefore, that the SEC provide funds the "breathing space" to focus on the effective implementation of these new requirements. This implementation period can also provide a valuable opportunity for the industry and the SEC to consider important, "big picture" issues concerning mutual fund regulation and to apply a

number of useful lessons that our recent experience has taught us. These issues are discussed below.

III. CONSIDERATIONS FOR FUTURE SEC RULEMAKING

A. Mutual Fund Regulation and the Law of Unintended Consequences

The Institute has always supported strong and effective regulation to protect the interests of fund investors. We continue to do so. At the same time, we believe it is important to recognize that regulatory requirements can and often do have unintended consequences.

Consider the many new requirements for mutual funds mentioned above. We have supported most of the individual proposals. But it is the *totality* of regulatory requirements under which mutual funds operate that gives us cause for concern.

For example, while all firms share the burdens of new regulations, the greatest impact likely falls on smaller firms and new entrants. Unfortunately, there are indications that these burdens may drive some small firms out of the mutual fund business, and that they are likely to discourage others from entering it. This result is regrettable. The costs and burdens of regulation have the potential to reduce the level of competition, diversity and creativity that new and smaller firms historically have contributed to the fund industry. Fund investors will have fewer choices as a result.

Regulatory requirements that single out mutual funds versus other financial products raise additional concerns. It is critical that mutual fund regulators understand the financial

marketplace and bear firmly in mind that mutual funds are one product among many that compete for investor dollars. As a consequence of the size and importance of mutual funds and their value to investors, they have been subjected to a host of unique disclosure and substantive regulatory requirements – and the SEC has many new rules being urged upon it. Yet, no competing financial product is subject to more comprehensive disclosure, compliance and governance requirements than mutual funds are.

For example, unlike hedge funds, mutual funds must calculate their performance in accordance with a standardized formula. Unlike wrap accounts, they must disclose their after-tax return. Unlike bank collective investment funds, they must establish the value of their assets on a daily basis. Unlike pension funds, they must disclose the policies and procedures that they use to determine how to vote proxies and disclose their proxy voting records. Unlike any other pooled investment product, they must disclose their portfolio holdings on a quarterly basis and disclose information about their portfolio managers. Unlike the sponsors of competing products, they must comply with strict corporate governance requirements. These latter requirements have continued to become more and more numerous and detailed, with the unfortunate effect of seeming to marginalize the relationship of fund sponsors to the very funds they have created as a vehicle for offering their investment advisory services to the public.

None of these concerns arise in the same way with respect to entities sponsoring wrap accounts, hedge funds, bank collective investment funds, or separately managed accounts, to name a few. We do not mean to suggest that any specific requirement is inappropriate for mutual funds. Nor would we propose that these varied requirements be applied to all competing financial products. We are simply calling attention to what seems to be an ever-

expanding body of regulations that apply exclusively to mutual funds and urging caution about the possible unintended consequences.

All financial institutions, without exception, are accustomed to regulations affecting their business, and they all must accept the concomitant costs and risks that such regulations entail. In adopting these regulations, government agencies like the SEC are focused on achieving immediate, foreseen results like expanding the information available to investors, changing specific aspects of a fund's operations, or fashioning new fund governance requirements. At that time, they are not concerned, and often do not consider, further consequences of the regulations they adopt. It is important to recognize, however, that in today's intensely competitive marketplace, there is a wide array of financial services and products. If associated regulations, costs and risks make one of these services or products relatively unattractive, then producers, service providers and sales intermediaries can and likely will turn their attention to others – potentially to the disadvantage of the consumer.

Despite their prodigious success over the last twenty-five years, mutual funds are not exempt from this dynamic. We already have seen the creation of new funds slow down coming off the bear market, and it is possible that the impact of regulatory costs and burdens may be contributing to this trend.[3] We are deeply concerned that similar forces may be at work to discourage skilled money managers from entering the mutual fund business, to impel small and medium-sized fund firms to exit the business, to favor the utilization of collective investment funds over mutual funds as investment options in retirement plans, to make mutual funds far

[3] In 2000, for example, mutual fund sponsors opened about 1100 new funds, compared with just over 400 in 2004. The number of fund mergers and liquidations – another factor affecting the number of available funds – totaled around 500 in both 2000 and 2004. As a net result, mutual fund sponsors introduced about 600 new funds in 2000, compared with reducing the number of funds by about 100 in 2004.

less attractive to the best portfolio management talent, and to establish strong practical incentives for brokers to favor alternative investments over mutual funds for many customers.

It would be highly ironic and unfortunate if, in our zeal to "perfect" mutual funds as a financial tool for millions of average investors, we establish so uneven a "playing field" that mutual funds become less competitive, less innovative, less attractive to talented investment firms and professionals, and less available to investors.

Concerns such as these, widely shared within our industry, are not trivial. Two of the SEC's recent mutual fund reforms illustrate these concerns – first, the new required disclosure concerning mutual fund portfolio managers; and second, the proposed new disclosure by brokers to mutual fund investors at the point of sale. Each is discussed below.

1. Additional Portfolio Manager Disclosure

The SEC recently adopted new requirements that added to existing required disclosures about fund portfolio managers.[4] Previously, funds were required to identify and describe the business experience of the individuals who are primarily responsible for the day-to-day management of a fund. If a committee, team, or other group is jointly and primarily responsible for management of the fund, as is commonly the case, the fund was required to provide disclosure to the effect that the fund's investments are managed by that group. Disclosure of the names of or other information about the members of the group was not required. Under the new requirements, funds that are managed by a team of portfolio managers must provide the

[4] SEC Release Nos. 33-8458; 34-50227; IC-26533 (Aug. 23, 2005), 69 Fed. Reg. 52804 (Aug. 27, 2004).

same information for team members that is required where a fund is managed by a single portfolio manager.[5]

The new requirements also made other significant changes. Funds now must disclose information regarding other accounts managed by fund portfolio managers, including a description of any material conflicts of interest that may arise in connection with a portfolio manager's management of the fund and such other accounts. The SEC has taken the position that this requirement applies to accounts managed in a personal capacity as well as accounts managed in a professional capacity. Funds must disclose the structure of, and method used to determine, the compensation of each portfolio manager. And they must disclose each portfolio manager's ownership of securities in the fund. Before these new requirements were adopted, some had suggested going even further and, for example, prohibiting a fund portfolio manager from simultaneously managing any other account and/or requiring disclosure of the exact dollar amount of each portfolio manager's compensation. No one familiar with recent trends in mutual fund regulation would dismiss the notion that the SEC might develop still further prohibitions or disclosure obligations affecting mutual fund portfolio managers.

While we agree that many of the new disclosures have merit, it is important to point out that the requirements apply *uniquely* to portfolio managers of mutual funds. Although the same public policy concerns may apply to them, no other pooled investment vehicle is subject to these requirements, nor are the portfolio managers of any pooled investment vehicle subject to these disclosures.

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[5] Disclosure is required with respect to members of a portfolio management team who are jointly and primarily responsible for the day-to-day management of the fund's portfolio. If there are more than five such individuals, the

If one starts with the premise that mutual funds represent an important and valuable investment proposition for millions of Americans, it would seem important to consider how these many requirements might impact their ability to recruit and retain the best investment professionals. Presumably, fund investors will not be well served by regulations if the ultimate effect is to provide a disincentive for money managers to enter or stay in the mutual fund business. Likewise, regulations do not serve investors if they impair a fund's ability to attract the best talent. The result will be reduced access for investors of relatively modest means to the best and brightest investment professionals.

These are not theoretical concerns. We have heard from our members that some of their most skilled portfolio managers have expressed a preference not to manage mutual funds because of the new disclosure requirements. At least one large member firm has told us that the burdens of these requirements are causing the firm to consider getting out of the actively managed mutual fund business.

2. Proposed Point of Sale Disclosure

Another example of the need to avoid unintended consequences concerns proposed requirements that we fear will create substantial disincentives for intermediaries to sell mutual funds. Specifically, the SEC has proposed to require brokers to disclose information to investors at the point of sale about the costs and potential conflicts of interest associated with selling mutual funds.[6] The Institute fully supports this concept. Indeed, we have repeatedly called for

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fund is required to provide the required information for the five persons with the most significant responsibility.

[6] SEC Release No. 33-8358; 34-49148; IC-26341 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004); *see also* SEC Release Nos. 33-8544; 34-51274; IC-26778 (Feb. 28, 2005), 70 Fed. Reg. 10521 (Mar. 4, 2005).

and supported requiring enhanced disclosure by brokers of so-called "revenue sharing" arrangements, in which fund advisers or underwriters make payments out of their legitimate profits to compensate brokers for selling fund shares.[7] We have advocated enhanced point of sale disclosure in this area to help investors assess and evaluate recommendations to purchase fund shares.

Notwithstanding our longstanding support for enhanced point of sale disclosure, we are deeply concerned that the manner in which the SEC now proposes to effectuate such disclosure will have highly adverse if unintended consequences. Most recently, the SEC has proposed to expand still further the required disclosure by brokers to include not just distribution costs but all fund fees and expenses. An NASD Mutual Fund Task Force has recommended going even further and adding information about fund investment strategies, risks and performance.[8] All of this additional information is important, and the best way to communicate it to investors should be considered in the course of a broader review of the mutual fund disclosure regime.

Disclosing this quantum of information at the point of sale is wholly inconsistent with the model by which brokers sell mutual funds – as well as competing financial products that will not be subject to similar requirements. The SEC's proposal would not allow brokers to effect a fund purchase until the investor has received the required information and had an opportunity to determine whether to place an order. In practice, to avoid exposure to unacceptably high liability risks, brokers likely will be compelled to provide the required

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[7] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Annette L. Nazareth, Director, Division of Market Regulation, and to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 8, 2000.

[8] *See* Report of the Mutual Fund Task Force: Mutual Fund Distribution (March 2005).

disclosure in paper form. Because the majority of investors do not conduct business with their brokers in person, the disclosure requirement will stymie a large percentage of fund transactions or delay them for days, or simply predispose brokers and their clients to invest in some other manner.

If the SEC adopts point of sale disclosure requirements that expose brokers to heightened liability risks, complicate the process of selling mutual funds, cause delays in effecting investor transactions, and impose significant programming and compliance costs, the interests of investors will not be served. Instead, the requirements will have unintended consequences. They will destroy a sales model that has worked well for investors and brokers alike. Many brokers are likely to steer their customers to alternative investments that are not subject to these requirements and do not offer the same level of regulatory protection and other benefits (*e.g.*, diversification, liquidity and professional management) that mutual funds do.

B. Need for Rigorous and Informed Cost-Benefit Analyses

As the SEC considers future rulemaking for mutual funds, it is important to do so with a full understanding of the potential consequences, including the costs and the benefits. Academic researchers have advocated that rigorous cost-benefit analysis is crucial to an effective regulatory process.[9] We strongly agree. In the future, the Institute intends to become a more active participant in this process by conducting its own cost-benefit research to contribute

[9] Hahn, Robert W. and Dudley, Patrick, "How Well Does the Government Do Cost-Benefit Analysis?" AEI-Brookings Joint Center for Regulatory Studies (April 2005); Crandall, Robert W., DeMuth, Christopher, Hahn, Robert W., Litan, Robert E., Nivola, Pietro S., Portney, Paul R., "An Agenda for Federal Regulatory Reform," AEI and Brookings Institution (1997).

to the body of learning that informs regulatory policy. This will be a high priority for our Research Department, and we have recently hired a new senior economist to lead this effort.

Congress, through the Paperwork Reduction Act, requires the SEC as a federal agency to conduct an analysis of the time and monetary burdens imposed under a proposed rule that requires a collection of information. Among the considerations that the SEC must weigh for each collection of information is "a specific, objectively supported estimate of the burden imposed."[10] Unfortunately, the SEC's current process is inadequate; it fails to produce realistic assessments of regulatory costs and burdens and appropriately evaluate alternative approaches.[11] Below, I will discuss examples of this problem, focusing in particular on the SEC's recently-adopted mutual fund redemption fee rule. In addition, I will discuss the cost-benefit implications of using the Internet as a primary means for disclosing information to fund investors.

1. Examples of Inadequate Cost-Benefit Analyses

The costs reported under the Paperwork Reduction Act section in the SEC's release adopting the new redemption fee rule is just one example of the SEC's failure to conduct rigorous cost-benefit analyses in the mutual fund arena.[12] Unless revisited, the consequence of this failure will be a regulatory surcharge on investors.

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[10] 44 U.S.C. § 3506(c)(1)(A)(iv).

[11] The Institute has previously raised similar concerns. *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to the attention of Mr. Nathan Knuffman, Desk Officer for the Securities and Exchange Commission, Office of Management and Budget and to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 13, 2003 (concerning the SEC's burden estimates with respect to the requirement that mutual funds file their complete proxy voting records).

[12] *See* SEC Release No. IC-26782 (Mar. 11, 2005), 70 Fed. Reg. 13328 (Mar. 18, 2005).

Redemption fees can serve as an important tool in protecting long-term fund shareholders from the harmful costs of short-term trading. Thus, this new rule is quite important. The rule levies significant new responsibilities and potential liabilities on funds and poses major new operational challenges, all of which will involve costs far exceeding the SEC's estimates.

Most notably, the rule requires *all* funds, even those that do not impose redemption fees, to enter into written contracts with each and every "intermediary" with which they do business. The term "intermediary" is broadly defined under the rule to include, among other things, any entity that holds shares in nominee name or maintains a participant-directed employee benefit plan's participant records. As a result, any account not registered specifically for a natural person potentially could be subject to the contract requirement.

To comply with this requirement, funds will have to first identify the universe of their "intermediaries" and then either modify any existing agreements or enter into new agreements containing the terms required by the rule. The SEC failed to appreciate the enormity of this task. Indeed, just the first step alone of identifying the universe of intermediaries will be substantially greater than the *total* time and cost the SEC estimates. Three large fund complexes estimate that in the aggregate they have over 6.5 million accounts that could be considered to be held by an "intermediary" for purposes of the rule. On this basis, it is clear that the fund industry as a whole will have to evaluate tens of millions of accounts to determine whether they are held by "intermediaries." While many of these accounts may ultimately fall outside the scope of the rule because they are held by entities trading on their own behalf rather than as nominees, every complex will have to evaluate the registration of each account to make that

determination. Given the number of accounts that will have to be examined, the SEC's estimate that the entire contract requirement can be satisfied in 4.5 hours of work per fund is completely unreasonable.[13] In fact, one large fund complex estimates that it will spend more than twice the time complying with the contract requirement in the rule than the SEC estimates for the entire industry.

The second step of modifying existing agreements or entering into new ones also imposes extraordinary burdens on funds. While it will be burdensome for funds to modify hundreds (and for some complexes, thousands) of existing agreements, this task will be dwarfed by the effort that will be required with respect to the thousands of accounts for which there are no written agreements, unless the rule is appropriately modified. These accounts are typically associated with small retirement plans (*e.g.*, a dentist who maintains a retirement plan for herself, two hygienists and a receptionist), small businesses, limited partnerships, trusts, bank nominees, and other "intermediaries" holding shares on behalf of investors. One major mutual fund complex estimates that it will have to obtain new written agreements with at least 2,200 intermediaries.

In addition to missing the mark with respect to the amount of time that will be required to obtain these contracts, the SEC underestimated, and in some cases overlooked, the costs and technical difficulties in transmitting data from intermediaries to funds as contemplated by the rule.

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[13] Using this hourly burden, the SEC computes the total cost to the industry to be $745,173. The SEC's actual estimate in its adopting release was $3,353, 278.50. This number, however, was based on an apparent mathematical error. The SEC's analysis also uses an inappropriate methodology for determining the number of funds.

Funds will need to establish processes for contacting intermediaries regarding data requests to work out the specifics of each transmittal – whether periodic or related to specific circumstances. Until standardized reporting formats and transmission protocols are developed, funds will have to accept data requested from intermediaries in various formats generated from many different systems.[14] Reformatting such data to make it useful will be labor intensive and costly. The Commission estimates the initial capital costs to establish systems for the collection, transmittal, and processing of the information to be $100,000 per fund and $150,000 per financial intermediary for total aggregate capital costs of $1.1 billion. The Commission's estimate might be reasonable with respect to the hardware that funds will be required to obtain to receive, store, and process the information, but it fails to take into account the substantial software costs that funds will incur to support and translate multiple software platforms.

The Commission's capital cost estimates are only a small portion of the costs funds and intermediaries will incur, and there are a number of sizeable ongoing costs that do not appear to have been contemplated in the cost-benefit analysis. For example, there will be costs associated with maintaining and improving computer systems, collecting and analyzing the data received from intermediaries, reporting the results of that analysis to operations and compliance personnel, and notifying and working with intermediaries as issues arise. The Commission's estimate of ongoing annual costs of $6,640 per fund ($10.7 million in the aggregate) understates the costs of these tasks, which will involve many hours of work and substantial expenditures.

The Commission's cost analysis is further flawed in that it underestimated the hourly labor cost of an attorney in the mutual fund industry by using figures that exclude attorneys

[14] Funds and intermediaries can be expected to move toward standardization, but this effort will take time and certainly will involve substantial start-up costs.

based in New York. Major mutual fund complexes are primarily based in large metropolitan cities, such as Boston, New York, San Francisco, Los Angeles, and Chicago where quality legal talent commands more than the $66.31 per hour the SEC assumed in their analysis.

We have expressed these and other concerns about the redemption fee rule in a comment letter filed with the SEC yesterday,[15] and we are hopeful that the SEC will take appropriate steps to address them.

We believe that the redemption fee rule is merely illustrative of the deficiencies in the SEC's process for analyzing cost-benefit issues. For example, one large complex advises us that its costs to comply with the SEC's new disclosure requirements relating to market timing policies and procedures, "fair valuation" practices, and selective disclosure of portfolio holdings are almost four times the SEC's estimate.[16] In addition, based on informal conversations with our members, it appears that the costs of implementing the mutual fund compliance rule – a rule that the Institute supported and that had its roots in an Institute proposal – have far exceeded the SEC's estimates.

2. Cost-Benefit Implications of Internet Disclosure

Internet technology has very significant potential for striking a cost-benefit balance in the disclosure area, and we believe it deserves the utmost consideration as the SEC develops any new regulation affecting mutual funds. As the SEC itself has recognized, Internet use has

[15] Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated May 9, 2005.

[16] *See* SEC Release Nos. 33-8408; IC-26418 (April 16, 2004), 69 Fed. Reg. 22300 (April 23, 2004) at 22310 and 22311.

expanded greatly, to the point where it can appropriately be the vehicle for required disclosure. According to data cited by the SEC, "75% of Americans have access to the Internet in their homes, and . . . those numbers are increasing steadily among all age groups."[17] The demographic profile of fund investors strongly suggests a higher level of use. Our own survey data show that in 2001, 82 percent of mutual fund shareholders accessed the Internet.[18]

The Internet can facilitate disclosure that is timely, convenient, thorough and flexible. It is well suited to serving a variety of needs and preferences for different levels of information, which is particularly appropriate in the mutual fund context. While the most important purpose of mutual fund disclosure is to inform investors meaningfully and effectively, it also serves many other constituencies, including financial advisers, analysts, regulators, and the media.

Internet disclosure will make it easy for investors to obtain the information they want and to compare information concerning different funds. Use of the Internet also is likely to lower the costs of providing disclosure. For example, it does not involve the printing and mailing costs that paper disclosure entails. In the case of disclosure provided to existing shareholders, those shareholders bear these costs.

As a result of all these features, Internet disclosure offers great promise as a solution to the concerns discussed above with the SEC's point of sale disclosure proposal. It also has the

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[17] *See* SEC Release Nos. 33-8501; 34-50624; IC-26649 (Nov. 3, 2004), 69 Fed. Reg. 67392 (Nov. 17, 2004) at n.353. According to a report published by the Commerce Department in 2002, the rate of growth in Internet use in the United States at that time was two million new Internet users per month. U.S. Dept. of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, *A Nation Online: How Americans Are Expanding Their Use of the Internet* (Feb. 2002).

[18] Investment Company Institute, *2001 Profile of Mutual Fund Shareholders* (Oct. 2001), at 4.

potential to play a central role in the SEC's anticipated mutual fund disclosure reform initiative. The Internet provides a unique tool for addressing concerns that the current mutual fund disclosure system does not function as effectively as it should in promoting investor awareness and understanding of important information about funds. It could be the needed breakthrough in what has been a repeated cycle of prospectus simplification efforts thwarted by a constant stream of new disclosure requirements.

Through the Internet, for example, funds can readily provide a brief, simple and clear presentation of their most important features, which would be a significant improvement over the lengthy, detailed prospectuses that funds are currently required to provide and that many investors find uninviting and overwhelming. Funds can also provide hyperlinks to additional and more detailed information that may be of interest to certain investors and to the many third parties who perform useful services by analyzing, repackaging and distributing information about funds to the investing public. Given that over 80 percent of mutual fund shareholders who own funds outside of defined contribution retirement plans own fund shares through professional financial advisers,[19] it is especially appropriate to fashion a disclosure system that recognizes and supports the role of these advisers.

We strongly urge the SEC to designate the Internet as the primary vehicle for brokers to provide point of sale disclosure about the costs and potential conflicts of interest associated with the sale of mutual funds. We also recommend that, as part of Chairman Donaldson's plan to conduct a top-to-bottom review of the mutual fund disclosure regime, the SEC carefully study how to take full advantage of the Internet as a means of providing mutual fund

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[19] Investment Company Institute, "Ownership of Mutual Funds Through Professional Financial Advisers," *Fundamentals*, Vol. 14, No. 3, April 2005, at 2.

disclosure. In both cases, we would support requiring that investors have the option of requesting paper disclosure if they do not have Internet access or otherwise wish to receive disclosure in paper form.

IV. IMPROVING THE SEC'S EFFICIENCY AND EFFECTIVENESS

The success of the mutual fund regulatory regime relies, in large part, on a strong and well-run regulator. The Institute has repeatedly expressed its support for adequate funding of the SEC,[20] and we are glad that in recent years, the SEC has received increased funding to carry out its many important missions. But as Chairman Donaldson has recognized, resources alone are not the answer. The larger challenge is for the SEC to assure not only the reach but also the effectiveness of its regulatory and law enforcement efforts.

To his credit, Chairman Donaldson has committed to pursuing internal reforms that will improve the performance of the SEC, including the creation of an infrastructure with respect to risk assessment. In describing these reforms, Chairman Donaldson has stated that "[w]ith limited resources in an expanding world of responsibilities and challenges, we are seeking to create an enhanced oversight regime that will equip the Commission to better anticipate, find, and mitigate areas of financial risk, potential fraud, and malfeasance."[21]

In a companion effort, the SEC has created internal task forces that are cross-disciplinary and involve staff from multiple divisions and offices. According to Chairman Donaldson, the

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[20] *See, e.g.*, Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable Ted Stevens, Chairman, Committee on Appropriations, United States Senate, dated February 11, 2004.

task forces, "organized around emerging problems and difficult questions of policy, will bring a new flexibility and resourcefulness to an agency that must be as mobile and nimble as the entities it regulates."[22]

Chairman Donaldson's initiatives are on target, and we support them. As part of the SEC's inward-looking reforms, there are three imperatives that we believe deserve immediate, serious attention. These are (1) better coordination among the different SEC divisions and offices that deal with mutual fund issues, (2) better coordination of, and other improvements to, the inspection process, and (3) improvements to the efficiency and productivity of the Division of Investment Management, especially in the area of processing applications for exemptive relief.

A. Coordination of Divisions and Offices Responsible for Mutual Fund Issues

From our perspective, it is particularly important for the SEC to develop and employ mechanisms to assure better communication and coordination among the different divisions and offices within the agency that have responsibility for mutual fund issues. More specifically, there is a need for greater coordination between the Division of Investment Management, which has responsibility for mutual fund and investment adviser regulation, and the Division of Market Regulation, which has responsibility for broker-dealer and transfer agent regulation. Ideally, the SEC should take a holistic approach to regulating the mutual fund business, rather than looking at each of various key participants (*e.g.*, funds, advisers, broker-dealers, transfer

[21] Remarks from the Conference Board's 2004 Annual Dinner by William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (October 14, 2004), at 4.

[22] *Id.*

agents) in isolation. Similarly, the Enforcement Division and the Office of Compliance Inspections and Examinations need to communicate and coordinate their activities with the Division of Investment Management to ensure appropriate and consistent application of regulatory policy.

B. Improvements to the Mutual Fund Inspection Process

The SEC should continue to consider the best way to structure its examination program for mutual funds and investment advisers. One idea we were glad to learn the SEC is pursuing is the designation of a team of lead examiners for larger fund groups.[23] A designated team will develop a comprehensive knowledge base about the firm, which will facilitate more efficient and well-targeted inspections.

In considering how best to deploy examination resources, we also recommend that the SEC review its use of "sweep" exams, in which the staff focuses on a particular issue. These exams often involve voluminous and sometimes duplicative information requests from different regional offices. They result in a piecemeal look at fund operations, usually without any feedback to the funds. We are concerned that sweep exams are inappropriately diverting finite fund resources that could better be spent on compliance efforts.

[23] *See* United States Government Accountability Office, Report to the Committee on the Judiciary, House of Representatives, *Mutual Fund Trading Abuses, Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage* (April 2005), at 23.

Another area that requires prompt attention relates to e-mail production by investment advisers in response to SEC inspection requests. We understand that SEC examiners routinely request that advisers promptly produce all firm e-mail, or all e-mail sent or received by certain individuals, in an electronically searchable format. These requests appear to exceed current requirements as to the records that investment advisers are obligated to retain, and the format in which records can or must be retained. Investment advisers are concerned that in the absence of greater regulatory certainty, their e-mail retention procedures could be deemed deficient if, for example, they do not retain *all* e-mail for five years or routinely convert electronic records on back-up storage drives into a searchable format.

Given the huge and ever-growing volume of business e-mail, investment advisory firms must dedicate substantial resources to developing and maintaining the systems necessary to comply with the inspection staff's record retention and production requirements. It is unfair to require firms to do so without the benefit of clarity as to their legal obligations. Moreover, it is inappropriate for the Office of Compliance Inspections and Examinations to engage in what amounts to *de facto* rulemaking through the inspection process. Due to the significance of these issues and the fact that they have not been the subject of formal SEC rulemaking, the SEC should address e-mail retention and production issues through the public rulemaking process.

C. Improvements to the Exemptive Order Process

The Division of Investment Management has primary responsibility for mutual fund regulation. We recommend that the SEC pursue improvements to the efficiency and productivity of the Division of Investment Management that will benefit funds and their

investors. In particular, we recommend changes to improve the Division's process for considering and issuing exemptive relief.

One of the most remarkable features of the Investment Company Act of 1940 is its ability to accommodate evolving practices and innovations in the industry by providing the Commission with broad authority to exempt products or activities from specific regulatory requirements in appropriate circumstances. Unfortunately, the Division of Investment Management's exemptive order process currently imposes a formidable barrier as even routine exemptive relief can take a significant amount of time (*e.g.*, more than a year) to obtain. The Institute has suggested specific ways to improve the current system[24] and we continue to urge the SEC to address the serious problems with delayed action, particularly with respect to routine requests.[25]

In addition, now that the SEC is close to completing its slate of mutual fund reforms, it should turn its attention to adopting rules that codify existing exemptive relief and other routine issues affecting day-to-day fund operations. Codifying exemptive relief will enhance efficiency by obviating the need for funds to file, and the SEC staff to review and process,

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[24] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated March 28, 2002. The Institute recommended, among other things, that the Division of Investment Management establish a "Routine Applications Branch" for expedited review of routine applications, that it make publicly available the status of applications on file, and that it consider requiring the staff to act on applications within a certain specified time period.

[25] Similar delays plague the Division of Investment Management's no-action letter process. As we have recommended previously, the Division should impose concrete deadlines for commenting on no-action requests and should require the Chief Counsel to provide a written explanation to the Division Director if the deadline is not met.

individual exemptive applications. For example, the SEC should adopt rules governing fund of funds investments and manager of managers arrangements.[26]

VI. CONCLUSION

As we move on to the next chapter in the evolution of mutual funds, it is critically important that the rules governing funds continue to be effective in protecting and promoting the interests of fund shareholders. Thorough consideration of the impact of regulatory costs and burdens, as well as the potential benefits of alternative approaches, is necessary to assure that mutual funds remain a vibrant, competitive and effective tool for use by millions of Americans to save and invest. Internal reforms that strengthen the SEC's effectiveness will further enhance the regulatory regime, to the ultimate benefit of investors.

I very much appreciate the opportunity to share the Institute's views with you today. We look forward to working with the SEC and the Subcommittee on these issues.

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[26] The SEC has already proposed rules in these areas. *See* SEC Release Nos. 33-8297; IC-26198 (Oct. 1, 2003), 68 Fed. Reg. 58226 (Oct. 8, 2003) (concerning fund of funds investments) and SEC Release Nos. 33-8312; 34-48683; IC-26230 (Oct. 23, 2003), 68 Fed. Reg. 61720 (Oct. 29, 2003) (concerning "manager of managers" arrangements).

APPENDIX: SEC RULES AFFECTING MUTUAL FUNDS SINCE SEPTEMBER 2003

Rule	Date Proposed or Adopted
Mutual Fund Reforms	
Compliance programs/CCOs	Adopted December 3, 2003
Hard 4pm close	Proposed December 3, 2003
Confirmation and point of sale disclosure requirements	Proposed January 14, 2004[27]
Fee and expense disclosure in shareholder reports; quarterly portfolio holdings disclosure	Adopted February 11, 2004
Disclosure regarding market timing, fair valuation, and selective disclosure of portfolio holdings	Adopted April 13, 2004
Investment adviser codes of ethics	Adopted May 26, 2004
Enhanced sales charge breakpoint disclosure	Adopted May 26, 2004
Disclosure concerning board approval of fund advisory contract	Adopted June 23, 2004
Fund governance requirements	Adopted June 23, 2004
Directed brokerage prohibition	Adopted August 18, 2004
Redemption fees	Adopted March 11, 2005
Other Rules	
Investment company advertising rule amendments	Adopted September 24, 2003
Security holder director nominations	Proposed October 14, 2003
Disclosure regarding nominating committees and shareholder communications with directors	Adopted November 19, 2003
Limitations on affiliate marketing (Reg. S-AM)	Proposed July 8, 2004
Disposal of consumer report information	Adopted December 2, 2004

[27] The SEC subsequently requested supplemental comment on revised point of sale disclosure.

DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

May 13, 2005

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Baker:

In my testimony before the Subcommittee on May 10, I should have noted that my comments concerning the cost-benefit analyses performed in connection with Commission rulemakings reflected my own views and not necessarily those of the Commission. I included these comments in my prepared oral testimony, in anticipation of remarks on the subject that I learned shortly before the hearing would be made by subsequent panelists and that there would be no opportunity to respond. I would appreciate it if the record would include a statement to the effect that these were my own views.

Thank you for your consideration of this request.

Sincerely,

Meyer Eisenberg
Acting Director

cc: Ms. Lois Richerson
Clerk
Committee on Financial Services

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