Testimony of

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Regarding

"Oversight of the Mutual Fund Industry:

Ensuring Market Stability and Investor Confidence"

Before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

Of the

Committee on Financial Services

United States House of Representatives

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Thank you, Chairman Garrett, Ranking Member Waters, and members of the Subcommittee for permitting me to testify before you today regarding "*Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence*". My name is Andrew J. Donohue. I am a partner in the law firm of Morgan, Lewis & Bockius LLP and was the Director of the Division of Investment Management of the U.S. Securities and Exchange Commission (the "SEC") from May 2006 until November 2010. Prior to joining the SEC I held senior positions in the investment company industry most recently as Global General Counsel for Merrill Lynch Investment Managers. I also was recently elected to the Board of the Mutual Fund Directors Forum, a non-profit organization for independent mutual fund directors. The views I express today are my own and do not represent those of my firm, my firm's clients or any other organization.

When I entered the fund industry in 1975 there were less than 500 funds with about $45 billion in net assets. Today, some 35 years later, the fund industry has grown to over 10,000 funds (including open-end funds, closed-end funds and exchange-traded funds) with over $ 13 trillion in net assets owned by over 90 million shareholders in over 51 million households. Funds own over 25% of U.S. stocks, 33% of municipal securities, 45% of commercial paper and 10% of U.S. government securities. Funds represent the investment of choice for almost one-quarter of household financial assets and for over $4.5 trillion of IRA and defined contribution plan assets.

I do not cite these statistics to praise funds, the fund industry or their federal regulators. Rather, I want to emphasize the critical role that funds play in our economy and in the investment of the American people's hard earned money for their savings and retirement.

I will limit my remarks today to my personal reflections and observations on investment company regulation, the performance of funds during the financial crisis (including short-term bond funds, auction rate preferred securities, money market funds and securities lending pools), the potential designation of mutual fund complexes or asset managers as systemically important financial institutions, the challenges facing funds and their investors, the role of the SEC, and some areas for consideration to enhance the competitiveness of funds in the U.S. and globally.

Investment Company Regulation

Funds are subject to regulation under the Investment Company Act of 1940 (the "1940 Act") as well as the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), Sarbanes-Oxley Act of 2002 ("SOX") and Subchapter M of the Internal Revenue Code of 1986 ("Subchapter M"). Funds are also subject to state corporate or trust laws, as is typical for ordinary operating companies. Investment advisers to funds must be registered with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act") and fund underwriters must be broker-dealers subject to the Exchange Act and members of FINRA.

This regulatory regime is quite comprehensive, and is designed to protect investors and insure that the fund is operated for the benefit of the fund's investors. These laws and the regulations adopted by the SEC and the IRS and FINRA's rules provide for, among others:

- Prospectus disclosure to investors of the important information regarding the fund (recently improved by the SEC with the adoption of the Summary Prospectus);
- Annual and semi-annual shareholder reports with annual reports audited by PCAOB registered and inspected independent auditors;
- Investment diversification requirements and limitations on the use of leverage;
- Limitations on transactions with affiliates;
- Advertising standards;
- Inspections and examinations of funds, their investment advisers and underwriters by the SEC (and FINRA for underwriters);
- Enforcement by the SEC for violations;
- Requirements for a comprehensive compliance program for the fund and its investment adviser including the appointment of a chief compliance officer;
- Requirements for daily valuation and liquidity;
- Limitations on fund issuance of multiple classes of securities and on the issuance of senior securities;
- Sales practices requirements;
- Fund shareholder vote requirement for certain fund changes;
- Required fund distribution of income and capital gains; and

- Custody requirements.

A key additional requirement under the 1940 Act and the SEC rules addresses the critical role of independent fund directors. Independent directors act as watchdogs for fund investors, and among other things, oversee potential conflicts of interest, oversee valuation, and approve fund investment advisory and underwriting agreements.

The authority that 1940 Act gives to the SEC to exempt funds from certain prohibitions has been a critical factor in providing flexibility to adapt the 70 plus year old statute to address changing markets and instruments and encourage innovation (such as money markets funds and exchange-traded funds).

This regulatory structure has served investors well and has played a critical role in the success of the fund industry.

The Performance of Funds during the Financial Crisis:

While funds and their investors were subject to many of the same challenges that other institutions faced during the financial crisis, funds performed quite well during this period. With a few notable exceptions, funds were able to price their portfolio securities, invest their assets and meet redemptions in a timely manner. This was due, I believe, in no small part to the comprehensive regulatory regime described above.

The areas that exhibited strain during the financial crisis were the following:

Short-term Bond Funds: A few short-term bond funds had exposure to mortgage backed securities and other instruments that suffered significant unexpected losses;

Auction Rate Preferred Securities: Closed-end funds used a type of security often referred to as *auction rate preferred securities* or *ARPS* to provide leverage to their portfolios. In 2005 for the over $275 billion in closed-end fund assets $60 billion was represented by *ARPS*. *ARPS* were securities that were re-auctioned at periodic intervals providing *ARPS* investors with liquidity and an adjusted market rate of return for their investment. *ARPS* had worked well for many years benefiting the funds, the fund's common shareholders and the fund's *ARPS* holders. In February 2008 *ARPS* auctions began to fail. This failure resulted in a significant decrease in liquidity and value for the ARP*S*. Recently available information indicates that of the $33 billion in *ARPS* issued by taxable closed-end funds $28 billion had been redeemed or had their redemption pending. Of the $31 billion in *ARPS* issued by tax-exempt closed-end funds, $15 billion had been so redeemed.

Money Market Funds**:** In the late summer of 2007 money market funds, which represented about $3 trillion in assets and which strive to maintain a steady value of $1.00 per share, started to encounter difficulties with the commercial paper owned by some of them.

These securities were issued by certain structured investment vehicles ("*SIVs*"). Several funds encountered credit and liquidity challenges arising from their *SIV* investments that required the financial assistance of the fund's adviser or its affiliate. In September 2008 with the bankruptcy of Lehman the Reserve Fund "*broke the buck*" and there was a run on certain institutional money market funds. With the assistance of several government programs, including the Treasury Temporary Guarantee Program for Money Market Funds, The Federal Reserve Board Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and financial assistance provided by many investment advisers to their own money market funds only the Reserve Fund "*broke the buck*" and no losses were incurred by the government in its programs. I understand that Reserve Fund investors may ultimately suffer a 1% loss on their investment receiving back $0.99 for each share they owned. During this period money market fund advisers from some 25 plus complexes provided financial support to over 100 money market funds to provide them with necessary liquidity or to keep them from "*breaking the buck*".

In early 2010 the SEC amended its money market fund rule, rule 2a-7. Among other things, these amendments: (1) reduced money market fund portfolios exposure to interest rate risk by decreasing the maximum weighted average maturity ("*WAM*") from 90 days to 60 days, and imposing a new weighted average life requirement ("*WAL*") of 120 days; (2) decreased money market fund portfolio exposure to credit risk by decreasing the permissible exposure to Second Tier Securities; (3) reduced the money market funds dependence on the market for liquidity by adopting minimum liquidity requirements of 10% a day and 30% a week; (4) enabled fund directors to close a money market fund immediately if it was in danger of "breaking the buck"; (5) mandated periodic stress testing and monthly disclosure of portfolio information for investors and the SEC along with publication of the "*shadow nav*" and (6) expanded the ability of affiliates of money market funds to purchase distressed assets from money market funds in order to protect the fund from losses. These amendments significantly enhanced the regulatory regime for money market funds.

In October 2010 the *Report of the President's Working Group on Financial Markets Money Market Reform Options* was issued (the "*PWG Report*"). The *PWG Report* explored a number of potential options for reform including:

- Floating *nav*;
- Private emergency liquidity facility;
- Mandatory "Redemption in Kind";
- Money market fund insurance;
- Two tier system of money market funds with enhanced protections for stable *nav*;
- Two tier system of money market funds with stable *nav* for retail investors only;

- Regulating stable *nav* money market funds as "*Special Purpose Banks*"; and
- Enhanced constraints on unregulated money market fund substitutes.

The *PWG Report* provided a well balanced assessment of the potential options for money market reform. The SEC sought comments on the *PWG Report* and received a number of comment letters suggesting potential avenues for further reform. The SEC held a *Roundtable on Money Market Funds and Systemic Risk* on May 10, 2011 along with other members of the Financial Stability Oversight Council ("*FSOC*"). On May 16, 2011 the Investment Company Institute held a *2011 Money Market Funds Summit* which explored a number of topics relating to money market funds.

There does not appear to be a unified approach from the money market fund industry regarding the next step in money market reform. Approaches advanced in comment letters from firms varied and ranged from:

- do nothing
- institute a private emergency liquidity facility
- impose a mandatory reserve "buffer" in the fund
- require money market funds to be managed by special purpose entities with reserve requirements

Groups from outside the industry have proposed requiring:

- a floating *nav*
- special purpose bank for stable *nav* funds
- a mandatory "buffer" in the form of committed capital

The next step in money market reform is extraordinarily important as the wrong choice might have considerable unforeseen consequences for the money market funds, the investors and the capital markets. Yet not doing anything might leave money market funds vulnerable to runs and the increased potential for "*breaking the buck*". I believe that commentators have provided the SEC with a wide range of choices from which an optimum solution might be crafted. One possibility is for there to be a required "buffer" provided by the manager assuring that there are assets dedicated to maintaining the stable *nav*. That "buffer" could be in the form of a special share class ("*Capital Shares*") funded by the adviser that must be maintained at a certain prescribed level and which is designed to absorb any realized or unrealized losses or gains to enable the other share class (the "*Income Shares*") to maintain a stable *nav*. This approach could be augmented with requirements for greater transparency from omnibus accounts and a limit on the maximum fund ownership by any one investor or group of investors (such as 5%). This approach might make explicit the implicit guarantee that investors and the industry seem to operate under and the increased transparency and ownership limits would enable money market funds to better assess and manage their vulnerability to runs.

The money market fund industry, the SEC and money market fund investors should have a common goal. No one wants to see a repeat of what occurred during the financial crisis. The approach outlined above is but one possible approach for consideration by the SEC. I am confident that the SEC and the industry participants will be able to craft an approach that significantly lessens the likelihood of a run on a money market fund or of a money market fund "*breaking the buck*" while still preserving the benefits market funds have historically provided to investors.

***Securities Lending Pools*:** While I am not aware of any securities lending pools registered with the SEC as money market funds (or otherwise) that encountered difficulties during the financial crisis (other than as discussed above for money market funds), some funds did utilize other pooled investment vehicles for the investment of the cash collateral they received from lending securities. I understand that certain of these pooled investment vehicles did encounter some challenges relating to the financial crisis leading to loses in those pools and the possible loss of liquidity to the funds.

Potential Designation of Mutual Fund Complexes or Asset Managers as Systemically Important Financial Institutions

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") provides the Financial Stability Oversight Council (the "FSOC") the authority to require that a nonbank financial company be supervised by the Board of Governors of the Federal Reserve System ("Board of Governors") and be subject to the prudential standards in accordance with Title 1 of the Dodd-Frank Act if FSOC determines that material financial distress at such a firm, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the firm, could pose a threat to the financial stability of the United States. The Dodd-Frank Act provides that in making that determination, FSOC shall consider:

- The extent of leverage of the company;
- the extent and nature of the off-balance-sheet exposure of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

- the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, inter-connectedness, and mix of the activities of the company;
- the degree to which the company is already regulated by 1 or more financial regulatory agencies;
- the amount and nature of the financial assets of the company;
- the amount and types of liabilities of the company, including the degree of reliance on short-term funding; and
- any other risk-related factors that the *FSOC* deems appropriate.

While mutual funds and mutual fund complexes are important participants in the U.S. financial system and provide many benefits to their investors, I believe that the nature of mutual funds, their operations and the comprehensive regulatory regime within which they operate argue quite forcefully for them not being considered *systemically important financial institutions ("SIFIs")* absent extraordinarily unusual circumstances. Mutual funds have regulatory requirements on the degree of leverage they can employ, the diversification and concentration of their portfolios, where and under what conditions their assets are held in custody, the valuation of their assets on a daily basis at market value, the requisite liquidity of their investments and limitations on transactions with affiliates. The enduring strength of this regulatory regime was demonstrated most recently during the recent financial crisis as well as during other financial crises that have occurred since the adoption of the Investment Company Act in 1940.

The one subset of mutual funds which some might believe appropriate for *FSOC* to review whether *SIFI* consideration might be appropriate is money market funds. I believe, however, that *FSOC* should conclude that money market funds should not be considered for designation as *SIFIs* in light of the important steps the SEC, as their primary regulator, has taken and is considering to significantly improve the regulatory regime money market funds are subject to.

For somewhat different reasons I do not believe that asset managers should be designated as *SIFIs* either. Asset managers, while themselves subject to a somewhat less rigorous regulatory regime than mutual funds, manage other people's money. They are often also subject to the regulatory regime applicable to the client or the assets being managed. (mutual funds, pension assets, etc). The asset management industry is quite different from that of other financial institutions and those differences should militate against asset managers being considered *SIFIs*. Asset managers do not put their balance sheet at risk, do not guarantee returns and their clients bear the risk of the investment of the client's assets. While there are some significant participants in the asset management arena, the asset management industry is not concentrated, is quite competitive, and assets can be moved by clients quite freely from manager to manager. For these and other reasons I believe that a careful consideration of the characteristics of an asset manager, the asset management industry and of the factors enumerated in the Dodd-Frank Act will, except in an exceptional case, lead to a determination by *FSOC* that the asset manager does not pose a threat to the financial stability of the United States.

Challenges Facing Funds and Their Investors:

Despite the success they have enjoyed, funds and their investors are facing a number of challenges. While some of these challenges are inherent in the fund structure or the types of securities in the funds invest in, I believe it is important to be mindful of them.

Pricing and nav Determination: As funds invest in an increasing array of more sophisticated investments the ability of the fund to accurately value its investments every day within the tight time frames required becomes more challenging.

Use of Derivative Instruments and Complex Financial Instruments: The comprehensive regulatory regime described earlier was not designed with derivatives and complex financial instruments in mind. The SEC is currently studying how best to address this area and has provided some guidance to the fund industry regarding disclosure obligations in prospectuses and shareholder reports for these instruments. While I am confident that the SEC, with industry input, will provide appropriate guidance in this area it will still be a challenge for funds to be able to craft meaningful, understandable disclosures for fund investors regarding the fund's use of these instruments.

The IRA and 401k Retirement Market and Advice**:** The IRA and 401k retirement market is one that has been extremely important to the fund industry and its investors. $4.7 trillion of fund assets consist of money invested by IRA and 401k participants. As 401k plan participants and IRA owners increasing devote their resources towards their retirement goals it is important that they have access to the funds as an investment option and advice from qualified professionals to assist them in achieving their goals. This area is subject to an array of requirements from the Department of Labor, the Internal Revenue Service and the SEC and these can present quite a challenge.

Distribution Practices**:** Funds are encountering a range of challenges relating to the distribution of their shares through the various distribution channels. Many of these challenges are not new but they do need to be considered. These challenges range from *revenue sharing* payments (which I understand has been a particular challenge for small fund complexes) to operating within the current strictures of rule 12b-1 under the 1940 Act. In addition, Section 22(d) of the 1940 Act currently acts as an impediment to increased competition in the pricing of shares of funds for investors. The SEC has proposed amendments to its rule 12b-1 that address some of these challenges but change, even if beneficial to investors and the industry in the longer term, can be a challenge in the near term.

***The Role of the SEC*:**

The SEC has played a critical role in comprehensive regulatory regime for funds. It has utilized the flexibility provided to it in the 1940 Act to facilitate many innovations in the fund industry including money market funds and exchange-traded funds. It also has used that authority to permit funds to engage in certain actions or transactions otherwise prohibited by the 1940 Act but conditioned such permission on substantive requirements (often involving the independent directors' oversight) that achieve the purpose of the restriction. The SEC has improved disclosures to fund investors with the recently adopted Summary Prospectus and I am hopeful they can improve the usefulness of shareholder annual and semi-annual reports in a similar manner. The SEC has also played a critical role in its inspection and examination program of funds as well as its enforcement actions against those that abuse their positions. The SEC has not traditionally had the role of a merit regulator for funds. I believe that is the correct approach.

I am concerned that budgetary constraints may compromise the SEC's ability to continue the critical role it has played for funds in the past. By way of example, let's look at the ability of the SEC to keep pace in its inspections and examinations of funds. In 1985 the SEC examined 23% of the funds, in 1990 28%, in 1995 51%, and in 2000 32%. In 2010 the SEC examined 10% of the funds and the target for 2011 and 2012 is only 15%. This is certainly not intended as a criticism of the SEC or the inspection staff as I know how difficult their jobs are but rather recognition that without adequate resources to conduct examinations of funds the comprehensive regulatory regime which has benefited funds and fund investor alike may be compromised. In a similar vein, the resources for the Division of Investment Management and for the Commission as a whole may not keep pace with the regulatory challenge of continually adapting the seventy plus year old statute to the modern world.

I am confident, however, that given the proper level of resources, the SEC and my former colleagues in the Division of Investment Management are more than capable of doing the job.

***Competitiveness of Funds*:**

Worldwide mutual fund assets are about $25 trillion with the US representing about $12 trillion of that amount. Accordingly, the US continues to have the preeminent fund regulatory regime. The US fund industry has grown some 33% over the past five years about the same pace that European funds have. The Far East, however, grew 58% during that same period. The European regulatory regimes *UCIT*s have been quite active in promoting the use of *UCIT*s in the Far East and have been meeting some success. US funds have not able to compete effectively there (or elsewhere outside the US) primarily because of US tax law. I doubt these tax laws generate any tax revenue since investors outside the US merely select an investment vehicle outside the US to invest in. I would really like to see the funds in the US able to compete for foreign investors on a level playing field with *UCITs* in the Far East and elsewhere.

Inside the US, funds have been subject to increased competition from private funds that are not subject to all the strict regulatory requirements of the 1940 Act. Now I think that competition from differing structures and products can be quite healthy for everyone. I do believe, however, that it would be worthwhile to explore what impediments there may be to importing some of the successful private fund strategies into the fund regulatory regime that might be addressed without compromising investor protection.

Conclusion:

I want to thank you for this opportunity to testify today regarding mutual funds. Mutual funds have provided significant benefits to investors and the markets. It is incumbent on us all to insure that they continue to do so.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

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

1. Name:	2. Organization or organizations you are representing:
Andrew J. Donohue	While I am representing myself I am affiliated with: Morgan, Lewis & Bockius LLP and Mutual Fund Directors Forum

3. Business Address and telephone number:

[redacted]

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

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Andrew J Donohue

Please attach a copy of this form to your written testimony.