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HOUSE SUBCOMMITTEE HEARING ON THE MUTUAL FUND REGULATORY LANDSCAPE

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18850] May 13, 2005 TO: BOARD OF GOVERNORS No. 22-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 27-05 FEDERAL LEGISLATION MEMBERS No. 2-05 INVESTMENT COMPANY DIRECTORS No. 12-05 PRIMARY CONTACTS - MEMBER COMPLEX No. 20-05 PUBLIC COMMUNICATIONS COMMITTEE No. 5-05 SEC RULES MEMBERS No. 61-05 SMALL FUNDS MEMBERS No. 43-05 UNIT INVESTMENT TRUST MEMBERS No. 9-05 RE: HOUSE SUBCOMMITTEE HEARING ON THE MUTUAL FUND REGULATORY LANDSCAPE Earlier this week, Institute President Paul Schott Stevens testified before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services at a hearing entitled "Mutual Funds: A Review of the Regulatory Landscape." Also testifying at the hearing were: Meyer Eisenberg, Acting Director, Division of Investment Management, and Deputy General Counsel, Securities and Exchange Commission; Barry P. Barbash, Partner, Shearman & Sterling LLP; and Michael S. Miller, Managing Director, The Vanguard Group. The written testimony of each witness is summarized below.* Institute Testimony Mr. Stevens briefly discussed several developments since revelations of late trading and market timing abuses involving mutual funds first came to light. He commented that these developments suggest that our legal and regulatory system and strong, corrective market forces have worked to sustain the historically high degree of public confidence in mutual fund investing. He stated that the objective of assuring that mutual funds remain a vibrant and competitive and effective tool for average investors is of utmost importance but cannot be taken for granted. *The written testimony is available on the Committee's website at <http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=382&comm=1>. 2 Mr. Stevens urged that, in considering future mutual fund rulemaking, the SEC give due consideration to the potential unintended consequences of burgeoning regulatory requirements that uniquely affect mutual funds. He explained that the SEC's regulatory regime is not effectively serving investors if, when taken as a whole, it discourages investment advisers from entering or staying in the fund business, discourages portfolio managers from managing mutual funds, or causes intermediaries to favor less regulated products. Mr. Stevens stated that the SEC must pursue future rulemaking for mutual funds with a better understanding of the potential consequences, including by conducting a more informed and rigorous analysis of the relative costs and benefits. He discussed the inadequacy of the SEC's current process, focusing on the recently adopted redemption fee rule. He also described the favorable cost-benefit implications of using the Internet as a

primary vehicle for mutual fund disclosure. Mr. Stevens noted that the success of the mutual fund regulatory regime relies, in large part, on a strong and well-run regulator. He pointed out, however, that resources alone are not the answer. He credited Chairman Donaldson for pursuing internal reforms to improve the SEC's effectiveness, and recommended that the SEC give priority attention to (1) better coordination among the different 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 processing applications for exemptive relief.

Testimony of Meyer Eisenberg Mr. Eisenberg provided an overview of the SEC's mutual fund reform initiatives. He first addressed reforms designed to enhance internal oversight, including the fund governance reforms, the fund compliance rule, and the investment adviser code of ethics requirement. He next discussed initiatives addressing late trading and abusive market timing, and the prohibition on use of directed brokerage for distribution. He noted that the staff is studying possible alternatives to the so-called "hard 4:00" proposal, and indicated that the Commission likely will consider a final rule in this area later this year. He also stated that he anticipates that the Commission will be providing additional guidance on fair value pricing. Mr. Eisenberg then turned to the topic of improving disclosures to fund investors. He described revisions to fund shareholder reports to require dollar-based expense disclosure and quarterly disclosure of portfolio holdings. He briefly outlined new disclosures concerning market timing, fair valuation, and selective disclosure of portfolio holdings; breakpoint discounts; board approval of investment advisory contracts; and portfolio manager conflicts and compensation.

Regarding the SEC's point of sale disclosure proposal, Mr. Eisenberg said that the staff "is examining the possibility of using more cost-effective methods of providing investors with the disclosures they need." According to Mr. Eisenberg, Chairman Donaldson has stated that he is hopeful that the Commission can move quickly on this initiative after the staff has an opportunity to review the comments it received in response to its recent request for additional comments. Mr. Eisenberg provided an update on additional mutual fund initiatives that are in the works or on the horizon, including improved disclosure of mutual fund transaction costs, 3 consideration of issues related to the use of soft dollars, a "thorough and reasoned review" of the future of Rule 12b-1, and a comprehensive review of the mutual fund disclosure regime. With respect to the latter, the staff will examine how to make better use of technology, including the Internet.

Testimony of Barry P. Barbash Mr. Barbash's testimony focused on three topics: mutual fund disclosure; the role of mutual fund directors and trustees; and the development of novel and innovative products and services. With respect to disclosure, Mr. Barbash noted that mutual fund prospectuses have become overly complicated again during the past seven years since the SEC's last major overhaul of fund disclosure requirements. He stated that he agrees 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. He recommended that a new and enhanced mutual fund prospectus have two core components: (1) it should be short; and (2) it should be supplemented by additional information available through the Internet (unless the investor chooses to receive the additional information through other means). Mr. Barbash called for a reevaluation of the role of fund independent directors and trustees. He expressed his fear that "the sheer quantity of new regulations may result in an unfortunate shift of focus away from directors' core duties . . . , 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." He indicated that recent Commission and staff actions and statements have led to a perception among directors that they should be intimately involved in all areas of their funds' operations. He recommended that the Subcommittee ask the Commission to reevaluate its rules contemplating action by independent directors

and suggested that the Commission focus directors' efforts on matters of overarching importance to the interests of fund shareholders. Mr. Barbash next discussed the SEC's exemptive order process, expressing his view that an indirect and unintended consequence of the recent spate of mutual fund regulations has been to bog down the staff in approving new investment management products and services. As a possible solution, he recommended that the Commission dedicate staff with special expertise in markets and products to the exemptive review process. Testimony of Michael S. Miller Mr. Miller testified that the Commission and the industry need to work together to ensure that the regulatory framework governing the fund industry fully serves the millions of investors who rely on mutual funds to build their financial futures. Noting that at least 25 new regulatory requirements for fund firms have been proposed and/or adopted in the past four years alone, Mr. Miller commented that 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." He discussed the importance of mutual respect between regulators and regulated entities, and the need to maintain an open dialogue. He emphasized that the rulemaking process should be collaborative, not adversarial, because "[w]hen things work that way, there are net gains for both sides." 4 Mr. Miller cited two issues that offer the opportunity for the industry and the SEC to re-engage in a constructive dialogue going forward – mutual fund disclosure reform and mutual fund distribution. He also recommended that the SEC examine the pace of new product review and evaluation so that investors can be better served with new products that are responsive to their needs. Frances M. Stadler Deputy Senior Counsel