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Committee on Financial Services

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"Mutual Funds: A Review of the Regulatory Landscape"

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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); s*ee, 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).