Testimony Concerning
Mutual Fund Rulemaking

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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

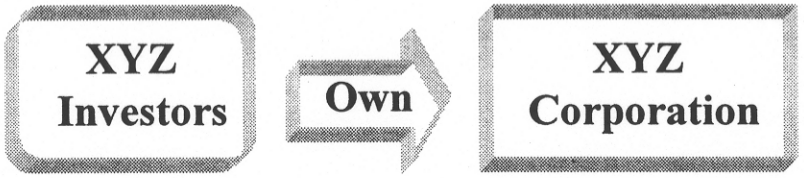
Donaldson has stated that he believes it is time to step back and take a top-to-bottom assessment of our mutual fund disclosure regime. He has asked the staff to carry out a comprehensive review of the mutual fund disclosure regime and how we can maximize its effectiveness on behalf of fund investors. 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