Statement of Michael S. Miller
Managing Director
The Vanguard Group

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

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

May 10, 2005
Washington, D.C.

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

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

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

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

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

I. The Vanguard Group

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

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

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

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

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

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

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

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

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

III. A Foundation of Mutual Respect

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

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

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

IV. Meaningful Dialogue

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

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

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

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

V. Constructive Engagement and Collaboration

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

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

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

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

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

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

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

VI. Looking Ahead

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

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

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

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

VII. Conclusion

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

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

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

Thank you.