STATEMENT OF PAUL SCHOTT STEVENS

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

"MUTUAL FUNDS: A REVIEW OF THE REGULATORY LANDSCAPE"

MAY 10, 2005

EXECUTIVE SUMMARY

- The Institute applauds the Subcommittee for providing this timely forum to take stock of where we are and consider how to shape mutual fund regulatory policy going forward so that it will continue to serve the interests of fund investors.

- Developments since 2003 are reassuring. Our legal and regulatory system has worked as designed to identify, correct and prevent misconduct, and to hold investors harmless. Strong, corrective market forces have been at work as well. The result has been to sustain the historically high degree of public confidence in mutual fund investing – and thus to preserve to average Americans an indispensable tool to achieve their long-term financial objectives. This objective, assuring that mutual funds remain a vibrant and competitive and effective tool for average investors, is one of utmost importance. But it cannot be taken for granted.

- In considering future regulatory action affecting mutual funds, it is critical that consideration be given to the competitive realities of the marketplace. The SEC in particular must give due consideration to potential unintended consequences of burgeoning regulatory requirements that uniquely affect mutual funds. Individually, these requirements may serve valid and useful purposes. If, however, when taken as a whole, the SEC's regulation (and the associated costs and risks) discourage investment advisers from entering or staying in the fund business, if they discourage portfolio managers from managing mutual funds versus other investment products or if they cause intermediaries to favor less regulated financial products over mutual funds, then the SEC's regulatory regime is not effectively serving the interests of investors.

- The SEC must pursue future rulemaking for mutual funds with a better understanding of the potential consequences, including the costs and the benefits. To do so, the SEC must conduct a more informed and rigorous analysis of the relative costs and benefits of its regulatory requirements. Only in this way can it assure that the costs of new requirements will not outweigh their benefits – or add unnecessarily to a growing and unique regulatory "surcharge" on mutual funds.

- The success of the mutual fund regulatory regime relies, in large part, on a strong and well-run regulator. The Institute has repeatedly supported adequate funding of the SEC, but resources alone are not the answer. The larger challenge is for the SEC to assure the effectiveness of its regulatory and law enforcement efforts. To his great credit, Chairman Donaldson has committed to pursuing internal reforms that will improve the performance of the SEC. As part of the SEC's inward-looking reforms, there are three areas we believe deserve priority attention. They are:

  - better coordination among the different SEC divisions and offices that deal with mutual fund issues;
  - better coordination of, and other improvements to, the inspection process; and
  - improvements to the efficiency and productivity of the Division of Investment Management, especially in processing applications for exemptive relief.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President of the Investment Company Institute, the national association of the U.S. investment company industry. ICI members include 8,512 open-end investment companies, or mutual funds, with total assets of approximately $7.959 trillion (representing more than 95% of all assets of U.S. mutual funds). These funds serve approximately 87.7 million shareholders in more than 51.2 million households. Mutual funds are one of the nation's largest financial intermediaries, and they play an especially important role in Americans' retirement security. As of the end of 2004, mutual funds accounted for 24 percent ($3.1 trillion) of U.S. retirement market assets.

It is no accident that mutual funds are such a popular investment choice for so many people. Mutual fund investing is a powerful proposition. It provides access to professional investment managers, diversification of investments, and a range of valuable services for investors, all at relatively low cost.

In addition to their role as the investment vehicle of choice for millions of Americans, mutual funds and other registered investment companies are major investors in securities and participants in the marketplace. At the end of 2004, investment companies (the bulk of which are mutual funds) held approximately 24 percent of the outstanding stock of U.S. companies, approximately 34 percent of outstanding tax-exempt debt, and about 10 percent of corporate bonds and U.S. Treasury and agency debt. Mutual funds (mostly money market funds) hold approximately 35 percent of outstanding U.S. commercial paper.

I greatly appreciate the opportunity to appear before the Subcommittee to discuss the current regulatory landscape for mutual funds.

Much has transpired since the Institute's former Chairman, Paul Haaga of Capital Research and Management Company, testified before you in November 2003, shortly after the revelations of market timing and late trading abuses involving mutual funds. The Securities and Exchange Commission (SEC) and state authorities have conducted wide-ranging investigations and enforcement actions against fund companies, broker-dealers and others implicated in wrongdoing. The SEC has developed an array of new rules addressing trading abuses as well as governance, disclosure and other practices. Congress, in a series of oversight hearings, has closely followed all of these developments to assure that adequate measures are being taken to protect the interests of fund investors. It is fair to say that the market, too, has followed all these developments closely – it has exacted a heavy toll on fund firms found to violate the trust of their investors; companies with reputations intact clearly have benefited.

From the outset, fund leaders have regarded the trading abuses as the most serious challenge to confront our industry in its modern history. We called for strong law enforcement and new regulatory standards. We have worked hard – and continue to work hard – to implement these new standards and achieve their full potential to safeguard the interests of our shareholders. And we have recognized in the scandal an important need to bolster our commitment to ethical practices and fiduciary principles, for it is upon these that any success in our business depends.

I agree with the Institute's Chairman, Jim Riepe of T. Rowe Price, who recently remarked that we are at a turning point where we need to build on the regulatory safeguards that have been put in place and again focus on ensuring that Americans have opportunities to build for their financial futures.[1] I applaud the Subcommittee for providing this very timely forum to take stock of where we are and consider how to shape mutual fund regulatory policy going forward so that it will continue to serve the interests of fund investors.

As the Subcommittee knows, I joined the Institute as President in June 2004. Prior to that time, I spent much of my career in private law practice, and have served for many years as counsel to mutual funds, independent fund directors, investment advisers, and fund distributors. I attended my first fund board meeting almost twenty-five years ago. From this longer-term perspective, developments since 2003 are reassuring. Our legal and regulatory system has worked as designed to identify, correct and prevent misconduct, and to hold investors harmless. Strong, corrective market forces have been at work as well. The result, I believe, has been to sustain the historically high degree of public confidence in mutual fund investing – and thus to preserve to average Americans an indispensable tool to achieve their long-term financial objectives.

This objective, assuring that mutual funds remain a vibrant and competitive and effective tool for average investors, is one of utmost importance. But it cannot be taken for granted.

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[1] Remarks of James S. Riepe, Chairman, ICI, at the Investment Company Institute First Annual Mutual Fund Leadership Dinner, Library of Congress, Washington, D.C. (May 4, 2005), at 5.

Decisive action in response to the trading abuses was plainly necessary. In my judgment, it is no less imperative to continue to evaluate the broad fabric of fund regulation, in light of recent experience and the industry's growth, in order to assure that mutual funds remain vibrant and competitive and continue to offer middle-income Americans an effective way to reach their long-term saving and investment goals.

As we consider future regulatory action affecting mutual funds, we must take into account the competitive realities of the marketplace. The SEC in particular must give due consideration to potential unintended consequences of burgeoning regulatory requirements that uniquely impact mutual funds. Individually, these requirements may serve valid and useful purposes. If, however, when taken as a whole, the SEC's regulation (and the costs and risks associated therewith) discourage investment advisers from entering or staying in the fund business, if they discourage portfolio managers from managing mutual funds versus other investment products, if they cause intermediaries to favor less regulated financial products over mutual funds, then the SEC's regulatory regime is not effectively serving the interests of investors.

Closely related to this issue is a concern about the escalating cost of compliance with the SEC's mutual fund regulations. The Institute is a long-time advocate of sound regulation and strong compliance. We also believe, however, that the SEC must conduct a far more informed and rigorous analysis of the relative costs and benefits of its regulatory requirements. Only in this way can it assure that the costs of new requirements will not outweigh their benefits – or add unnecessarily to the growing and unique regulatory surcharge on funds and their investors.

My testimony will address these concerns in greater detail. The Institute is likewise a long-time advocate of a well-funded and effective SEC. For this reason, it is important to build on Chairman Donaldson's important and timely initiatives to improve the SEC's efficiency and effectiveness. I would like to share our thoughts in this area with the Subcommittee as well. It is critical that the SEC continue to have sufficient resources and deploy them wisely to provide strong oversight and sensible regulation.

Before turning to these issues, I will take a brief look back at the SEC's recent mutual fund reforms and other significant new regulatory requirements applied to funds in the past several years.

II. STATUS OF RECENT REGULATORY REFORMS

When I took the helm as President of the Institute in June 2004, the industry was in the midst of the most significant regulatory overhaul it has experienced in over 60 years. Under Chairman Donaldson's leadership, and with the careful oversight of this Subcommittee and other Congressional bodies, the SEC embarked upon an extremely ambitious mutual fund regulatory reform agenda. The Institute supported this broad-based reform process and the vast majority of the SEC's specific proposals as the best way to address the abusive trading practices and assure continued investor confidence.

Of the twelve reform proposals issued since September 2003, ten have been adopted and the SEC continues to consider actively the remaining two. These reforms – and the half dozen other new rules adopted or proposed since September 2003 that apply to mutual funds – represent a remarkable body of new regulatory requirements in and of themselves.[2] Yet they follow on the heels of a host of other new regulations impacting mutual funds in recent years. The combined weight of all these new regulations is truly daunting. Leading up to September 2003,

- Congress enacted the Gramm-Leach-Bliley Act in 1999.
- The SEC adopted its privacy rules the next year.
- It approved Chairman Levitt's fund governance reforms in 2001.
- Soon after, the SEC required funds to disclose after-tax returns.
- Congress passed the USA Patriot Act in 2001, with its extensive anti-money laundering compliance obligations.
- President Bush signed the Sarbanes-Oxley Act into law in 2002, with its certification requirements, disclosure controls and procedures, and code of ethics and financial expert provisions.
- The SEC subsequently promulgated a detailed series of rules to implement the Sarbanes-Oxley Act, and elected to apply to mutual funds a host of new provisions enacted primarily for corporate issuers.
- The SEC's proxy voting disclosure rules for mutual funds took effect in 2003.

Many of the new requirements are far-reaching, necessitating fundamental changes to business operating systems and in some cases business culture. These changes cannot happen overnight. It is extremely important, therefore, that the SEC provide funds the "breathing

[2] A list of these rules is set forth in the attached Appendix.

space" to focus on the effective implementation of these new requirements. This implementation period can also provide a valuable opportunity for the industry and the SEC to consider important, "big picture" issues concerning mutual fund regulation and to apply a number of useful lessons that our recent experience has taught us. These issues are discussed below.

III. CONSIDERATIONS FOR FUTURE SEC RULEMAKING

A. Mutual Fund Regulation and the Law of Unintended Consequences

The Institute has always supported strong and effective regulation to protect the interests of fund investors. We continue to do so. At the same time, we believe it is important to recognize that regulatory requirements can and often do have unintended consequences.

Consider the many new requirements for mutual funds mentioned above. We have supported most of the individual proposals. But it is the *totality* of regulatory requirements under which mutual funds operate that gives us cause for concern.

For example, while all firms share the burdens of new regulations, the greatest impact likely falls on smaller firms and new entrants. Unfortunately, there are indications that these burdens may drive some small firms out of the mutual fund business, and that they are likely to discourage others from entering it. This result is regrettable. The costs and burdens of regulation have the potential to reduce the level of competition, diversity and creativity that new and smaller firms historically have contributed to the fund industry. Fund investors will have fewer choices as a result.

Regulatory requirements that single out mutual funds versus other financial products raise additional concerns. It is critical that mutual fund regulators understand the financial marketplace and bear firmly in mind that mutual funds are one product among many that compete for investor dollars. As a consequence of the size and importance of mutual funds and their value to investors, they have been subjected to a host of unique disclosure and substantive regulatory requirements – and the SEC has many new rules being urged upon it. Yet, no competing financial product is subject to more comprehensive disclosure, compliance and governance requirements than mutual funds are.

For example, unlike hedge funds, mutual funds must calculate their performance in accordance with a standardized formula. Unlike wrap accounts, they must disclose their after-tax return. Unlike bank collective investment funds, they must establish the value of their assets on a daily basis. Unlike pension funds, they must disclose the policies and procedures that they use to determine how to vote proxies and disclose their proxy voting records. Unlike any other pooled investment product, they must disclose their portfolio holdings on a quarterly basis and disclose information about their portfolio managers. Unlike the sponsors of competing products, they must comply with strict corporate governance requirements. These latter requirements have continued to become more and more numerous and detailed, with the unfortunate effect of seeming to marginalize the relationship of fund sponsors to the very funds they have created as a vehicle for offering their investment advisory services to the public.

None of these concerns arise in the same way with respect to entities sponsoring wrap accounts, hedge funds, bank collective investment funds, or separately managed accounts, to name a few. We do not mean to suggest that any specific requirement is inappropriate for mutual funds. Nor would we propose that these varied requirements be applied to all competing financial products. We are simply calling attention to what seems to be an ever-expanding body of regulations that apply exclusively to mutual funds and urging caution about the possible unintended consequences.

All financial institutions, without exception, are accustomed to regulations affecting their business, and they all must accept the concomitant costs and risks that such regulations entail. In adopting these regulations, government agencies like the SEC are focused on achieving immediate, foreseen results like expanding the information available to investors, changing specific aspects of a fund's operations, or fashioning new fund governance requirements. At that time, they are not concerned, and often do not consider, further consequences of the regulations they adopt. It is important to recognize, however, that in today's intensely competitive marketplace, there is a wide array of financial services and products. If associated regulations, costs and risks make one of these services or products relatively unattractive, then producers, service providers and sales intermediaries can and likely will turn their attention to others – potentially to the disadvantage of the consumer.

Despite their prodigious success over the last twenty-five years, mutual funds are not exempt from this dynamic. We already have seen the creation of new funds slow down coming off the bear market, and it is possible that the impact of regulatory costs and burdens may be contributing to this trend.[3] We are deeply concerned that similar forces may be at work to discourage skilled money managers from entering the mutual fund business, to impel small and medium-sized fund firms to exit the business, to favor the utilization of collective investment funds over mutual funds as investment options in retirement plans, to make mutual funds far less attractive to the best portfolio management talent, and to establish strong practical incentives for brokers to favor alternative investments over mutual funds for many customers.

It would be highly ironic and unfortunate if, in our zeal to "perfect" mutual funds as a financial tool for millions of average investors, we establish so uneven a "playing field" that mutual funds become less competitive, less innovative, less attractive to talented investment firms and professionals, and less available to investors.

Concerns such as these, widely shared within our industry, are not trivial. Two of the SEC's recent mutual fund reforms illustrate these concerns – first, the new required disclosure concerning mutual fund portfolio managers; and second, the proposed new disclosure by brokers to mutual fund investors at the point of sale. Each is discussed below.

1. Additional Portfolio Manager Disclosure

[3] In 2000, for example, mutual fund sponsors opened about 1100 new funds, compared with just over 400 in 2004. The number of fund mergers and liquidations – another factor affecting the number of available funds – totaled around 500 in both 2000 and 2004. As a net result, mutual fund sponsors introduced about 600 new funds in 2000, compared with reducing the number of funds by about 100 in 2004.

The SEC recently adopted new requirements that added to existing required disclosures about fund portfolio managers.[4] Previously, funds were required to identify and describe the business experience of the individuals who are primarily responsible for the day-to-day management of a fund. If a committee, team, or other group is jointly and primarily responsible for management of the fund, as is commonly the case, the fund was required to provide disclosure to the effect that the fund's investments are managed by that group. Disclosure of the names of or other information about the members of the group was not required. Under the new requirements, funds that are managed by a team of portfolio managers must provide the same information for team members that is required where a fund is managed by a single portfolio manager.[5]

The new requirements also made other significant changes. Funds now must disclose information regarding other accounts managed by fund portfolio managers, including a description of any material conflicts of interest that may arise in connection with a portfolio manager's management of the fund and such other accounts. The SEC has taken the position that this requirement applies to accounts managed in a personal capacity as well as accounts managed in a professional capacity. Funds must disclose the structure of, and method used to determine, the compensation of each portfolio manager. And they must disclose each portfolio manager's ownership of securities in the fund. Before these new requirements were adopted, some had suggested going even further and, for example, prohibiting a fund portfolio manager from simultaneously managing any other account and/or requiring disclosure of the exact

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[4] SEC Release Nos. 33-8458; 34-50227; IC-26533 (Aug. 23, 2005), 69 Fed. Reg. 52804 (Aug. 27, 2004).

[5] Disclosure is required with respect to members of a portfolio management team who are jointly and primarily responsible for the day-to-day management of the fund's portfolio. If there are more than five such individuals, the fund is required to provide the required information for the five persons with the most significant responsibility.

dollar amount of each portfolio manager's compensation. No one familiar with recent trends in mutual fund regulation would dismiss the notion that the SEC might develop still further prohibitions or disclosure obligations affecting mutual fund portfolio managers.

While we agree that many of the new disclosures have merit, it is important to point out that the requirements apply *uniquely* to portfolio managers of mutual funds. Although the same public policy concerns may apply to them, no other pooled investment vehicle is subject to these requirements, nor are the portfolio managers of any pooled investment vehicle subject to these disclosures.

If one starts with the premise that mutual funds represent an important and valuable investment proposition for millions of Americans, it would seem important to consider how these many requirements might impact their ability to recruit and retain the best investment professionals. Presumably, fund investors will not be well served by regulations if the ultimate effect is to provide a disincentive for money managers to enter or stay in the mutual fund business. Likewise, regulations do not serve investors if they impair a fund's ability to attract the best talent. The result will be reduced access for investors of relatively modest means to the best and brightest investment professionals.

These are not theoretical concerns. We have heard from our members that some of their most skilled portfolio managers have expressed a preference not to manage mutual funds because of the new disclosure requirements. At least one large member firm has told us that the burdens of these requirements are causing the firm to consider getting out of the actively managed mutual fund business.

2. Proposed Point of Sale Disclosure

Another example of the need to avoid unintended consequences concerns proposed requirements that we fear will create substantial disincentives for intermediaries to sell mutual funds. Specifically, the SEC has proposed to require brokers to disclose information to investors at the point of sale about the costs and potential conflicts of interest associated with selling mutual funds.[6] The Institute fully supports this concept. Indeed, we have repeatedly called for and supported requiring enhanced disclosure by brokers of so-called "revenue sharing" arrangements, in which fund advisers or underwriters make payments out of their legitimate profits to compensate brokers for selling fund shares.[7] We have advocated enhanced point of sale disclosure in this area to help investors assess and evaluate recommendations to purchase fund shares.

Notwithstanding our longstanding support for enhanced point of sale disclosure, we are deeply concerned that the manner in which the SEC now proposes to effectuate such disclosure will have highly adverse if unintended consequences. Most recently, the SEC has proposed to expand still further the required disclosure by brokers to include not just distribution costs but all fund fees and expenses. An NASD Mutual Fund Task Force has recommended going even

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[6] SEC Release No. 33-8358; 34-49148; IC-26341 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004); *see also* SEC Release Nos. 33-8544; 34-51274; IC-26778 (Feb. 28, 2005), 70 Fed. Reg. 10521 (Mar. 4, 2005).

[7] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Annette L. Nazareth, Director, Division of Market Regulation, and to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 8, 2000.

further and adding information about fund investment strategies, risks and performance.[8] All of this additional information is important, and the best way to communicate it to investors should be considered in the course of a broader review of the mutual fund disclosure regime.

Disclosing this quantum of information at the point of sale is wholly inconsistent with the model by which brokers sell mutual funds – as well as competing financial products that will not be subject to similar requirements. The SEC's proposal would not allow brokers to effect a fund purchase until the investor has received the required information and had an opportunity to determine whether to place an order. In practice, to avoid exposure to unacceptably high liability risks, brokers likely will be compelled to provide the required disclosure in paper form. Because the majority of investors do not conduct business with their brokers in person, the disclosure requirement will stymie a large percentage of fund transactions or delay them for days, or simply predispose brokers and their clients to invest in some other manner.

If the SEC adopts point of sale disclosure requirements that expose brokers to heightened liability risks, complicate the process of selling mutual funds, cause delays in effecting investor transactions, and impose significant programming and compliance costs, the interests of investors will not be served. Instead, the requirements will have unintended consequences. They will destroy a sales model that has worked well for investors and brokers alike. Many brokers are likely to steer their customers to alternative investments that are not subject to these requirements and do not offer the same level of regulatory protection and other benefits (*e.g.*, diversification, liquidity and professional management) that mutual funds do.

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[8] *See* Report of the Mutual Fund Task Force: Mutual Fund Distribution (March 2005).

B. Need for Rigorous and Informed Cost-Benefit Analyses

As the SEC considers future rulemaking for mutual funds, it is important to do so with a full understanding of the potential consequences, including the costs and the benefits. Academic researchers have advocated that rigorous cost-benefit analysis is crucial to an effective regulatory process.[9] We strongly agree. In the future, the Institute intends to become a more active participant in this process by conducting its own cost-benefit research to contribute to the body of learning that informs regulatory policy. This will be a high priority for our Research Department, and we have recently hired a new senior economist to lead this effort.

Congress, through the Paperwork Reduction Act, requires the SEC as a federal agency to conduct an analysis of the time and monetary burdens imposed under a proposed rule that requires a collection of information. Among the considerations that the SEC must weigh for each collection of information is "a specific, objectively supported estimate of the burden imposed."[10] Unfortunately, the SEC's current process is inadequate; it fails to produce realistic assessments of regulatory costs and burdens and appropriately evaluate alternative approaches.[11] Below, I will discuss examples of this problem, focusing in particular on the

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[9] Hahn, Robert W. and Dudley, Patrick, "How Well Does the Government Do Cost-Benefit Analysis?" AEI-Brookings Joint Center for Regulatory Studies (April 2005); Crandall, Robert W., DeMuth, Christopher, Hahn, Robert W., Litan, Robert E., Nivola, Pietro S., Portney, Paul R., "An Agenda for Federal Regulatory Reform," AEI and Brookings Institution (1997).

[10] 44 U.S.C. § 3506(c)(1)(A)(iv).

[11] The Institute has previously raised similar concerns. *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to the attention of Mr. Nathan Knuffman, Desk Officer for the Securities and Exchange Commission, Office of Management and Budget and to Mr. Jonathan G. Katz, Secretary, Securities and

SEC's recently-adopted mutual fund redemption fee rule. In addition, I will discuss the cost-benefit implications of using the Internet as a primary means for disclosing information to fund investors.

1. Examples of Inadequate Cost-Benefit Analyses

The costs reported under the Paperwork Reduction Act section in the SEC's release adopting the new redemption fee rule is just one example of the SEC's failure to conduct rigorous cost-benefit analyses in the mutual fund arena.[12] Unless revisited, the consequence of this failure will be a regulatory surcharge on investors.

Redemption fees can serve as an important tool in protecting long-term fund shareholders from the harmful costs of short-term trading. Thus, this new rule is quite important. The rule levies significant new responsibilities and potential liabilities on funds and poses major new operational challenges, all of which will involve costs far exceeding the SEC's estimates.

Most notably, the rule requires *all* funds, even those that do not impose redemption fees, to enter into written contracts with each and every "intermediary" with which they do business. The term "intermediary" is broadly defined under the rule to include, among other things, any entity that holds shares in nominee name or maintains a participant-directed employee benefit

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Exchange Commission, dated March 13, 2003 (concerning the SEC's burden estimates with respect to the requirement that mutual funds file their complete proxy voting records).

[12] *See* SEC Release No. IC-26782 (Mar. 11, 2005), 70 Fed. Reg. 13328 (Mar. 18, 2005).

plan's participant records. As a result, any account not registered specifically for a natural person potentially could be subject to the contract requirement.

To comply with this requirement, funds will have to first identify the universe of their "intermediaries" and then either modify any existing agreements or enter into new agreements containing the terms required by the rule. The SEC failed to appreciate the enormity of this task. Indeed, just the first step alone of identifying the universe of intermediaries will be substantially greater than the *total* time and cost the SEC estimates. Three large fund complexes estimate that in the aggregate they have over 6.5 million accounts that could be considered to be held by an "intermediary" for purposes of the rule. On this basis, it is clear that the fund industry as a whole will have to evaluate tens of millions of accounts to determine whether they are held by "intermediaries." While many of these accounts may ultimately fall outside the scope of the rule because they are held by entities trading on their own behalf rather than as nominees, every complex will have to evaluate the registration of each account to make that determination. Given the number of accounts that will have to be examined, the SEC's estimate that the entire contract requirement can be satisfied in 4.5 hours of work per fund is completely unreasonable.[13] In fact, one large fund complex estimates that it will spend more than twice the time complying with the contract requirement in the rule than the SEC estimates for the entire industry.

The second step of modifying existing agreements or entering into new ones also imposes extraordinary burdens on funds. While it will be burdensome for funds to modify

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[13] Using this hourly burden, the SEC computes the total cost to the industry to be $745,173. The SEC's actual estimate in its adopting release was $3,353, 278.50. This number, however, was based on an apparent mathematical error. The SEC's analysis also uses an inappropriate methodology for determining the number of funds.

hundreds (and for some complexes, thousands) of existing agreements, this task will be dwarfed by the effort that will be required with respect to the thousands of accounts for which there are no written agreements, unless the rule is appropriately modified. These accounts are typically associated with small retirement plans (*e.g.*, a dentist who maintains a retirement plan for herself, two hygienists and a receptionist), small businesses, limited partnerships, trusts, bank nominees, and other "intermediaries" holding shares on behalf of investors. One major mutual fund complex estimates that it will have to obtain new written agreements with at least 2,200 intermediaries.

In addition to missing the mark with respect to the amount of time that will be required to obtain these contracts, the SEC underestimated, and in some cases overlooked, the costs and technical difficulties in transmitting data from intermediaries to funds as contemplated by the rule.

Funds will need to establish processes for contacting intermediaries regarding data requests to work out the specifics of each transmittal – whether periodic or related to specific circumstances. Until standardized reporting formats and transmission protocols are developed, funds will have to accept data requested from intermediaries in various formats generated from many different systems.[14] Reformatting such data to make it useful will be labor intensive and costly. The Commission estimates the initial capital costs to establish systems for the collection, transmittal, and processing of the information to be $100,000 per fund and $150,000 per financial intermediary for total aggregate capital costs of $1.1 billion. The Commission's

[14] Funds and intermediaries can be expected to move toward standardization, but this effort will take time and certainly will involve substantial start-up costs.

estimate might be reasonable with respect to the hardware that funds will be required to obtain to receive, store, and process the information, but it fails to take into account the substantial software costs that funds will incur to support and translate multiple software platforms.

The Commission's capital cost estimates are only a small portion of the costs funds and intermediaries will incur, and there are a number of sizeable ongoing costs that do not appear to have been contemplated in the cost-benefit analysis. For example, there will be costs associated with maintaining and improving computer systems, collecting and analyzing the data received from intermediaries, reporting the results of that analysis to operations and compliance personnel, and notifying and working with intermediaries as issues arise. The Commission's estimate of ongoing annual costs of $6,640 per fund ($10.7 million in the aggregate) understates the costs of these tasks, which will involve many hours of work and substantial expenditures.

The Commission's cost analysis is further flawed in that it underestimated the hourly labor cost of an attorney in the mutual fund industry by using figures that exclude attorneys based in New York. Major mutual fund complexes are primarily based in large metropolitan cities, such as Boston, New York, San Francisco, Los Angeles, and Chicago where quality legal talent commands more than the $66.31 per hour the SEC assumed in their analysis.

We have expressed these and other concerns about the redemption fee rule in a comment letter filed with the SEC yesterday,[15] and we are hopeful that the SEC will take appropriate steps to address them.

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[15] Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated May 9, 2005.

We believe that the redemption fee rule is merely illustrative of the deficiencies in the SEC's process for analyzing cost-benefit issues. For example, one large complex advises us that its costs to comply with the SEC's new disclosure requirements relating to market timing policies and procedures, "fair valuation" practices, and selective disclosure of portfolio holdings are almost four times the SEC's estimate.[16] In addition, based on informal conversations with our members, it appears that the costs of implementing the mutual fund compliance rule – a rule that the Institute supported and that had its roots in an Institute proposal – have far exceeded the SEC's estimates.

2. Cost-Benefit Implications of Internet Disclosure

Internet technology has very significant potential for striking a cost-benefit balance in the disclosure area, and we believe it deserves the utmost consideration as the SEC develops any new regulation affecting mutual funds. As the SEC itself has recognized, Internet use has expanded greatly, to the point where it can appropriately be the vehicle for required disclosure. According to data cited by the SEC, "75% of Americans have access to the Internet in their homes, and . . . those numbers are increasing steadily among all age groups."[17] The

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[16] *See* SEC Release Nos. 33-8408; IC-26418 (April 16, 2004), 69 Fed. Reg. 22300 (April 23, 2004) at 22310 and 22311.

[17] *See* SEC Release Nos. 33-8501; 34-50624; IC-26649 (Nov. 3, 2004), 69 Fed. Reg. 67392 (Nov. 17, 2004) at n.353. According to a report published by the Commerce Department in 2002, the rate of growth in Internet use in the United States at that time was two million new Internet users per month. U.S. Dept. of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, *A Nation Online: How Americans Are Expanding Their Use of the Internet* (Feb. 2002).

demographic profile of fund investors strongly suggests a higher level of use. Our own survey data show that in 2001, 82 percent of mutual fund shareholders accessed the Internet.[18]

The Internet can facilitate disclosure that is timely, convenient, thorough and flexible. It is well suited to serving a variety of needs and preferences for different levels of information, which is particularly appropriate in the mutual fund context. While the most important purpose of mutual fund disclosure is to inform investors meaningfully and effectively, it also serves many other constituencies, including financial advisers, analysts, regulators, and the media.

Internet disclosure will make it easy for investors to obtain the information they want and to compare information concerning different funds. Use of the Internet also is likely to lower the costs of providing disclosure. For example, it does not involve the printing and mailing costs that paper disclosure entails. In the case of disclosure provided to existing shareholders, those shareholders bear these costs.

As a result of all these features, Internet disclosure offers great promise as a solution to the concerns discussed above with the SEC's point of sale disclosure proposal. It also has the potential to play a central role in the SEC's anticipated mutual fund disclosure reform initiative. The Internet provides a unique tool for addressing concerns that the current mutual fund disclosure system does not function as effectively as it should in promoting investor awareness and understanding of important information about funds. It could be the needed breakthrough

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[18] Investment Company Institute, *2001 Profile of Mutual Fund Shareholders* (Oct. 2001), at 4.

in what has been a repeated cycle of prospectus simplification efforts thwarted by a constant stream of new disclosure requirements.

Through the Internet, for example, funds can readily provide a brief, simple and clear presentation of their most important features, which would be a significant improvement over the lengthy, detailed prospectuses that funds are currently required to provide and that many investors find uninviting and overwhelming. Funds can also provide hyperlinks to additional and more detailed information that may be of interest to certain investors and to the many third parties who perform useful services by analyzing, repackaging and distributing information about funds to the investing public. Given that over 80 percent of mutual fund shareholders who own funds outside of defined contribution retirement plans own fund shares through professional financial advisers,[19] it is especially appropriate to fashion a disclosure system that recognizes and supports the role of these advisers.

We strongly urge the SEC to designate the Internet as the primary vehicle for brokers to provide point of sale disclosure about the costs and potential conflicts of interest associated with the sale of mutual funds. We also recommend that, as part of Chairman Donaldson's plan to conduct a top-to-bottom review of the mutual fund disclosure regime, the SEC carefully study how to take full advantage of the Internet as a means of providing mutual fund disclosure. In both cases, we would support requiring that investors have the option of requesting paper disclosure if they do not have Internet access or otherwise wish to receive disclosure in paper form.

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[19] Investment Company Institute, "Ownership of Mutual Funds Through Professional Financial Advisers," *Fundamentals*, Vol. 14, No. 3, April 2005, at 2.

IV. IMPROVING THE SEC'S EFFICIENCY AND EFFECTIVENESS

The success of the mutual fund regulatory regime relies, in large part, on a strong and well-run regulator. The Institute has repeatedly expressed its support for adequate funding of the SEC,[20] and we are glad that in recent years, the SEC has received increased funding to carry out its many important missions. But as Chairman Donaldson has recognized, resources alone are not the answer. The larger challenge is for the SEC to assure not only the reach but also the effectiveness of its regulatory and law enforcement efforts.

To his credit, Chairman Donaldson has committed to pursuing internal reforms that will improve the performance of the SEC, including the creation of an infrastructure with respect to risk assessment. In describing these reforms, Chairman Donaldson has stated that "[w]ith limited resources in an expanding world of responsibilities and challenges, we are seeking to create an enhanced oversight regime that will equip the Commission to better anticipate, find, and mitigate areas of financial risk, potential fraud, and malfeasance."[21]

In a companion effort, the SEC has created internal task forces that are cross-disciplinary and involve staff from multiple divisions and offices. According to Chairman Donaldson, the task forces, "organized around emerging problems and difficult questions of policy, will bring a

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[20] *See, e.g.,* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable Ted Stevens, Chairman, Committee on Appropriations, United States Senate, dated February 11, 2004.

[21] Remarks from the Conference Board's 2004 Annual Dinner by William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (October 14, 2004), at 4.

new flexibility and resourcefulness to an agency that must be as mobile and nimble as the entities it regulates."[22]

Chairman Donaldson's initiatives are on target, and we support them. As part of the SEC's inward-looking reforms, there are three imperatives that we believe deserve immediate, serious attention. These are (1) better coordination among the different SEC 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 the area of processing applications for exemptive relief.

A. Coordination of Divisions and Offices Responsible for Mutual Fund Issues

From our perspective, it is particularly important for the SEC to develop and employ mechanisms to assure better communication and coordination among the different divisions and offices within the agency that have responsibility for mutual fund issues. More specifically, there is a need for greater coordination between the Division of Investment Management, which has responsibility for mutual fund and investment adviser regulation, and the Division of Market Regulation, which has responsibility for broker-dealer and transfer agent regulation. Ideally, the SEC should take a holistic approach to regulating the mutual fund business, rather than looking at each of various key participants (*e.g.*, funds, advisers, broker-dealers, transfer agents) in isolation. Similarly, the Enforcement Division and the Office of Compliance Inspections and Examinations need to communicate and coordinate their activities with the

[22] *Id.*

Division of Investment Management to ensure appropriate and consistent application of regulatory policy.

B. Improvements to the Mutual Fund Inspection Process

The SEC should continue to consider the best way to structure its examination program for mutual funds and investment advisers. One idea we were glad to learn the SEC is pursuing is the designation of a team of lead examiners for larger fund groups. [23] A designated team will develop a comprehensive knowledge base about the firm, which will facilitate more efficient and well-targeted inspections.

In considering how best to deploy examination resources, we also recommend that the SEC review its use of "sweep" exams, in which the staff focuses on a particular issue. These exams often involve voluminous and sometimes duplicative information requests from different regional offices. They result in a piecemeal look at fund operations, usually without any feedback to the funds. We are concerned that sweep exams are inappropriately diverting finite fund resources that could better be spent on compliance efforts.

Another area that requires prompt attention relates to e-mail production by investment advisers in response to SEC inspection requests. We understand that SEC examiners routinely

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[23] *See* United States Government Accountability Office, Report to the Committee on the Judiciary, House of Representatives, *Mutual Fund Trading Abuses, Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage* (April 2005), at 23.

request that advisers promptly produce all firm e-mail, or all e-mail sent or received by certain individuals, in an electronically searchable format. These requests appear to exceed current requirements as to the records that investment advisers are obligated to retain, and the format in which records can or must be retained. Investment advisers are concerned that in the absence of greater regulatory certainty, their e-mail retention procedures could be deemed deficient if, for example, they do not retain *all* e-mail for five years or routinely convert electronic records on back-up storage drives into a searchable format.

Given the huge and ever-growing volume of business e-mail, investment advisory firms must dedicate substantial resources to developing and maintaining the systems necessary to comply with the inspection staff's record retention and production requirements. It is unfair to require firms to do so without the benefit of clarity as to their legal obligations. Moreover, it is inappropriate for the Office of Compliance Inspections and Examinations to engage in what amounts to *de facto* rulemaking through the inspection process. Due to the significance of these issues and the fact that they have not been the subject of formal SEC rulemaking, the SEC should address e-mail retention and production issues through the public rulemaking process.

C. Improvements to the Exemptive Order Process

The Division of Investment Management has primary responsibility for mutual fund regulation. We recommend that the SEC pursue improvements to the efficiency and productivity of the Division of Investment Management that will benefit funds and their investors. In particular, we recommend changes to improve the Division's process for considering and issuing exemptive relief.

One of the most remarkable features of the Investment Company Act of 1940 is its ability to accommodate evolving practices and innovations in the industry by providing the Commission with broad authority to exempt products or activities from specific regulatory requirements in appropriate circumstances. Unfortunately, the Division of Investment Management's exemptive order process currently imposes a formidable barrier as even routine exemptive relief can take a significant amount of time (*e.g.*, more than a year) to obtain. The Institute has suggested specific ways to improve the current system[24] and we continue to urge the SEC to address the serious problems with delayed action, particularly with respect to routine requests.[25]

In addition, now that the SEC is close to completing its slate of mutual fund reforms, it should turn its attention to adopting rules that codify existing exemptive relief and other routine issues affecting day-to-day fund operations. Codifying exemptive relief will enhance efficiency by obviating the need for funds to file, and the SEC staff to review and process, individual exemptive applications. For example, the SEC should adopt rules governing fund of funds investments and manager of managers arrangements.[26]

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[24] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated March 28, 2002. The Institute recommended, among other things, that the Division of Investment Management establish a "Routine Applications Branch" for expedited review of routine applications, that it make publicly available the status of applications on file, and that it consider requiring the staff to act on applications within a certain specified time period.

[25] Similar delays plague the Division of Investment Management's no-action letter process. As we have recommended previously, the Division should impose concrete deadlines for commenting on no-action requests and should require the Chief Counsel to provide a written explanation to the Division Director if the deadline is not met.

[26] The SEC has already proposed rules in these areas. *See* SEC Release Nos. 33-8297; IC-26198 (Oct. 1, 2003), 68 Fed. Reg. 58226 (Oct. 8, 2003) (concerning fund of funds investments) and SEC Release Nos. 33-8312; 34-48683; IC-26230 (Oct. 23, 2003), 68 Fed. Reg. 61720 (Oct. 29, 2003) (concerning "manager of managers" arrangements).

VI. CONCLUSION

As we move on to the next chapter in the evolution of mutual funds, it is critically important that the rules governing funds continue to be effective in protecting and promoting the interests of fund shareholders. Thorough consideration of the impact of regulatory costs and burdens, as well as the potential benefits of alternative approaches, is necessary to assure that mutual funds remain a vibrant, competitive and effective tool for use by millions of Americans to save and invest. Internal reforms that strengthen the SEC's effectiveness will further enhance the regulatory regime, to the ultimate benefit of investors.

I very much appreciate the opportunity to share the Institute's views with you today. We look forward to working with the SEC and the Subcommittee on these issues.

APPENDIX: SEC RULES AFFECTING MUTUAL FUNDS SINCE SEPTEMBER 2003

Rule	Date Proposed or Adopted
Mutual Fund Reforms	
Compliance programs/CCOs	Adopted December 3, 2003
Hard 4pm close	Proposed December 3, 2003
Confirmation and point of sale disclosure requirements	Proposed January 14, 2004[27]
Fee and expense disclosure in shareholder reports; quarterly portfolio holdings disclosure	Adopted February 11, 2004
Disclosure regarding market timing, fair valuation, and selective disclosure of portfolio holdings	Adopted April 13, 2004
Investment adviser codes of ethics	Adopted May 26, 2004
Enhanced sales charge breakpoint disclosure	Adopted May 26, 2004
Disclosure concerning board approval of fund advisory contract	Adopted June 23, 2004
Fund governance requirements	Adopted June 23, 2004
Directed brokerage prohibition	Adopted August 18, 2004
Redemption fees	Adopted March 11, 2005
Other Rules	
Investment company advertising rule amendments	Adopted September 24, 2003
Security holder director nominations	Proposed October 14, 2003
Disclosure regarding nominating committees and shareholder communications with directors	Adopted November 19, 2003
Limitations on affiliate marketing (Reg. S-AM)	Proposed July 8, 2004
Disposal of consumer report information	Adopted December 2, 2004

[27] The SEC subsequently requested supplemental comment on revised point of sale disclosure.