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CONGRESSIONAL HEARINGS ON LATE TRADING, MARKET TIMING AND REFORM OF THE MUTUAL FUND INDUSTRY

[16744] November 6, 2003 TO: BOARD OF GOVERNORS No. 59-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 88-03 DIRECTOR SERVICES COMMITTEE No. 21-03 FEDERAL LEGISLATION MEMBERS No. 21-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 95-03 PUBLIC INFORMATION COMMITTEE No. 37-03 SEC RULES MEMBERS No. 152-03 SMALL FUNDS MEMBERS No. 63-03 UNIT INVESTMENT TRUST MEMBERS No. 40-03 RE: CONGRESSIONAL HEARINGS ON LATE TRADING, MARKET TIMING AND REFORM OF THE MUTUAL FUND INDUSTRY This week, the Institute's President, Matthew P. Fink, and its Chairman, Paul G. Haaga Jr., testified before subcommittees of the Senate Governmental Affairs Committee and the House Committee on Financial Services on abusive mutual fund trading practices and possible industry reforms. The following other witnesses testified at one or both of the hearings: Representative Richard H. Baker (R-LA); John C. Bogle, Founder, The Vanguard Group; Mercer E. Bullard, Founder and President, Fund Democracy, Inc.; Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission; William Francis Galvin, Secretary of the Commonwealth of Massachusetts; Charles Leven, Vice President and Secretary/Treasurer, AARP Board of Directors; Arthur Levitt, former Chairman, U.S. Securities and Exchange Commission; Don Phillips, Managing Director, Morningstar, Inc.; Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission; Mary L. Shapiro, NASD Vice Chairman and President, Regulatory Policy and Oversight; Eliot L. Spitzer, Attorney General, Office of New York Attorney General; and Eric W. Zitzewitz, Assistant Professor of Economics, Stanford Graduate School of Business. The written testimony of the witnesses and a statement by the Chairman of the Senate subcommittee are summarized below.1 1 Prepared statements and testimony for the Senate hearing is available at http://www.senate.gov/~gov_affairs/index.cfm?Fuseaction=Hearings.Detail&HearingID=124 and, for the House hearing, at http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=268. 2 Congressional Statements In his opening statement, Senator Peter G. Fitzgerald (R-IL), Chairman of the Governmental Affairs Subcommittee on Financial Management, the Budget and International Security, noted that the hearing was intended to address not only the impact of abusive trading practices but also to identify possible statutory and regulatory reforms to protect fund investors.2 Senator Fitzgerald stated that, in light of current problems in the mutual fund industry and the industry's rapid growth in the past 20 years, "it's time for a wholesale re- examination of how mutual funds are organized and managed." In addition to steps to prevent market timing and late trading, Senator Fitzgerald recommended several additional reforms, including: (1) requiring at least 75% of

a fund's directors, including its chairman, to be independent; (2) requiring a fund to seek competitive bids on its investment advisory contract; and (3) consideration of whether to facilitate the creation of mutual funds that are truly "mutual" in nature (i.e., the Vanguard model). Representative Richard H. Baker (R-LA), Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, testified at the Senate hearing that he views passage of H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act of 2003, as an important first step toward improving the accountability and integrity of the mutual fund industry.3 Representative Baker stated that, in light of the recent events affecting the industry, he intends to modify H.R. 2420 in several areas, including: (1) reinstating a provision requiring that the chairman of a fund's board be independent; (2) prohibiting a portfolio manager from simultaneously managing a mutual fund and a hedge fund; and (3) requiring not only the appointment of a chief compliance officer but also that such officer report directly to a fund's independent directors. With regard to market timing, Representative Baker advocated: (1) requiring a fund to adopt a fundamental policy indicating whether the fund permits or prohibits market timing; (2) raising the limitation on redemption fees to at least 4%; and (3) having the SEC clarify the requirements as to fair value pricing. Institute Testimony In his testimony before the Senate subcommittee, Mr. Fink expressed his outrage at the "shocking betrayal of trust" by some members of the mutual fund industry and acknowledged that the ongoing investigations by regulators raise serious questions as to the industry's integrity. He stressed that the Institute and its members are "completely committed to answering every one of those questions." Testifying before the House subcommittee, Mr. Haaga described the conduct of some fund officials and others as "shocking and abhorrent" and stated that "the abuses we have learned about are inconsistent with our fiduciary obligations, incompatible with our duties to shareholders and intolerable if we are to serve individuals as effectively in the future as we have in the past." 2 Senator Fitzgerald's statement is available at http://fitzgerald.senate.gov/currentnews/current4.htm. 3 See Institute Memorandum 16346, dated July 25, 2003 (describing H.R. 2420 as approved by the House Financial Services Committee). 3 Messrs. Haaga and Fink stressed that "everything is on the table" in terms of reform. They asserted that action will be needed in three areas to restore investor confidence in mutual funds: (1) government officials must identify and sanction everyone who violated the law; (2) shareholders who were harmed must be made right; and (3) strong and effective regulatory reforms must be put in place to ensure that these abuses never happen again. Mr. Haaga pledged the Institute's cooperation and leadership in restoring everyone involved with mutual funds to the founding principle underlying the Investment Company Act: investors come first. In their written testimony, Messrs. Haaga and Fink discussed the Institute's recent recommendations for fundamental reforms to combat the abusive trading practices revealed at some fund companies.4 These recommendations include a firm 4:00 pm deadline for all trades to be reported to mutual funds or their transfer agents and a mandatory minimum redemption fee of 2% on shares held for five days or less. They also stated that the Institute generally supports other regulatory initiatives that would serve to protect investors and restore their confidence in the fund industry, including: (1) an SEC staff recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940; (2) the SEC's rule proposal regarding mutual fund compliance programs; (3) the SEC's rule proposal on portfolio holdings and expense disclosures; and (4) the NASD's proposal on point-of-sale disclosure requirements for broker-dealers selling mutual fund shares. SEC Testimony Mr. Cutler testified that the SEC has undertaken an aggressive agenda to identify and address problems in the mutual fund industry. He described the SEC's enforcement component of the agenda as having four areas of priority: (1) late trading and market timing; (2) sales practices, such as revenue sharing arrangements; (3) sales of Class B shares; and (4) failure to provide investors with breakpoint discounts. Mr. Cutler described the recent enforcement actions initiated by the SEC relating to late trading and market timing and stated that the agency is working in close coordination with state regulators. Mr. Cutler testified that the SEC's examination staff continues to analyze the information it received in response to information requests it sent to the country's largest mutual fund complexes and broker-dealers immediately following the announcement of Mr. Spitzer's settlement with Canary Capital Partners, LLC. Preliminary results indicate that: (1) 50% of the 88 responding mutual fund complexes appear to have had one or more arrangements with market timers that may be inconsistent with their policies or prospectus disclosures; (2) many persons proposing special timing arrangements with one or more funds offered to invest "sticky" assets in other funds in the complex; (3) more than 30% of responding fund complexes appear to have made selective disclosures of portfolio information; (3) more than 25% of the 34 responding broker-dealers reported instances of late trading by their customers; (4) the staffs of three fund complexes approved late-trading arrangements with investors; and (5) almost 30% of responding broker-dealers assisted market timers in some way (e.g., breaking up customer orders to avoid detection, creating special accounts for customers to facilitate timing activities). Mr. Cutler stated that some firms' responses have warranted 4 An Institute statement on these recommendations is available at http://www.ici.org/issues/mrkt/arc- sec/03_nyag_sum.html. 4 aggressive follow-up and that others have already been referred to enforcement staff for further investigation. Mr. Roye testified with regard to the regulatory component of the SEC's agenda. He discussed SEC Chairman Donaldson's request that the SEC staff submit recommendations this month for rulemaking initiatives addressing the problems of late trading and market timing. As directed by Chairman Donaldson, the staff will recommend explicit disclosures in fund offering documents of market timing policies and procedures and the adoption of procedures to assure compliance with such disclosures, and will consider whether additional requirements are needed to prevent the selective disclosure of portfolio holdings information. Mr. Roye indicated that the recommendations will address issues relating to market timing by portfolio managers and may include additional tools to prevent market timing, such as higher redemption fees or allowing funds to retain gains from short-term trading. He noted that Chairman Donaldson believes the SEC, in connection with this rulemaking, should reiterate its views on fair value pricing and emphasize the obligation of fund directors to evaluate the adequacy and effectiveness of a fund's market timing policies and procedures. Mr. Roye also reported on the status of other regulatory initiatives affecting the mutual fund industry. NASD Testimony Ms. Shapiro testified that NASD examination and enforcement efforts relating to mutual funds have focused on the following: the suitability of the mutual funds that brokers are selling, broker sales practices, disclosures to investors, compensation arrangements between funds and brokers, and breakpoint discounts. She described NASD's recent enforcement cases and rulemaking in these areas and noted that NASD is currently conducting an examination sweep to determine how funds pay for inclusion on a broker-dealer's preferred list or why funds receive favored promotional or selling efforts. In her House testimony, Ms. Shapiro stated that the NASD strongly supports H.R. 2420 and has already begun the rulemaking process to implement some of the principles embodied in the legislation. She noted in particular the NASD's pending proposal to require disclosure regarding revenue sharing and differential compensation arrangements. Ms. Shapiro testified that NASD requested information relating to late trading and market timing from approximately 160 of its member firms. Ms. Shapiro reported that numerous firms disclosed that they did accept and enter late trades, or "probably" had done so, and that those firms will be subject to further investigation and possible disciplinary action. She stated that NASD also will pursue indications of poor internal controls and recordkeeping by these firms. Ms. Shapiro further reported that a number of firms appear to have facilitated a customer's market timing strategy in mutual funds or variable annuities, had employees who agreed with a mutual fund or variable annuity to market time the issuer's shares or had an affiliate involved in market timing of mutual funds or variable annuities. She stated that NASD will investigate whether any of these activities were impermissible under NASD rules or applicable statutes. Testimony of Eliot L. Spitzer Mr. Spitzer began his testimony by asserting that too many mutual funds have permitted and fostered an environment that promotes the interests of fund managers at the 5 expense of fund shareholders. He stated that a large part of the problem, and hence an issue that must be addressed in formulating solutions, is the conflict of interest facing mutual fund directors. Mr. Spitzer contends that fund directors were on notice that their funds were being mismanaged but that they failed to protect shareholders because they were "beholden" to fund managers. In Mr. Spitzer's view, there are some "striking parallels" between the current investigations into the mutual fund industry and the earlier probe by his office involving Wall Street analysts. Mr. Spitzer indicated that, as with the settlement of that probe, he believes any resolution of the current investigation should involve structural reform of the industry that would "realign" the interests of funds and their shareholders. He offered several suggestions for reform, including: (1) requiring funds to maintain "truly independent" boards, including a chairman who is not affiliated with the management company; (2) requiring a board of directors to demonstrate that it has negotiated the fund's advisory fees in the best interests of shareholders by, for example, seeking competitive bids or obtaining a third party appraisal; (3) requiring that a fund's advisory contract contain a most-favored nation clause, so that the fund is not charged fees in excess of those paid by pension plans; and (4) requiring a fund to provide its directors with the staff and data necessary to protect shareholder interests, which could include moving the compliance function from the management company to the fund. Testimony of William Francis Galvin Mr. Galvin testified that the common theme underlying the problems now under investigation is that the mutual fund industry is putting its own interests ahead of investors. He stated that industry self-policing has failed because of the "willingness of the entire industry to quietly tolerate known market abuses" and, further, that regulators have failed to enforce the law aggressively and promptly. Much of Mr. Galvin's testimony described his office's ongoing investigation into mutual fund trading practices, which he said has revealed that special opportunities exist for certain investors at the expense of the vast majority. Mr. Galvin defended the role of state securities regulators, saying that they are often the first to identify and act on investment-related problems. He contended that any effort to restrict or preempt state enforcement is anti-investor. Mr. Galvin further testified that H.R. 2420 is a positive response to problems facing fund investors but that it could be improved, particularly by requiring that fund investors receive disclosure of the actual costs and expenses they are paying and by banning soft dollar arrangements. Testimony of John C. Bogle Mr. Bogle testified that the current investigations into the mutual fund industry will ultimately benefit investors by illuminating the inherent conflict of interest between fund managers and fund investors. He contends that there is much more market timing than the industry acknowledges but that there is a straightforward solution to the problem: a 2:30 pm deadline for orders at the fund level, together with a mandatory redemption fee of 2% for shares held less than 30 days. Mr. Bogle also suggested that firms like Morningstar should report on the redemption rates of individual funds. 6 Mr. Bogle endorsed H.R. 2420 as a good first step to serious reform of the mutual fund industry. He stated that the legislation should mandate personalized disclosure of the effect of mutual fund fees and full disclosure of soft-dollar arrangements and portfolio turnover rates. Mr. Bogle testified that other reforms are necessary to address the industry's conflicts of interest problem, including: (1) requiring that fund board chairmen be independent, limiting fund managers to a single board seat and enabling fund boards to retain their own staffs;

(2) full disclosure of all compensation, including the share of the fund manager's profits that is paid to senior executives and portfolio managers; (3) amendment of the Investment Company Act to specify that fund directors have a fiduciary duty to put the interests of fund shareholders first; and (4) an economic study of the industry that details the revenues and expenses of management companies. Testimony of Mercer E. Bullard Mr. Bullard testified that the recent allegations of fraud involving mutual funds related to activities that were open, notorious and violated express legal requirements. In his view, each of the alleged frauds could have been prevented through the enforcement of "minimal" compliance standards. Mr. Bullard also stated that fund directors failed to satisfy minimum standards of compliance oversight. He asserted that the allegations reflect a "systemic compliance failure" that necessitates both a strong response from Congress and creation of a mutual fund oversight board financed by assessments on mutual fund assets. Mr. Bullard called upon Congress to adopt several measures aimed at strengthening the independence and authority of non-interested directors, including: (1) requiring that the chairperson of a fund board be independent and that independent directors comprise at least 75% of a fund's board; (2) preventing a director from being deemed independent unless he or she is elected by shareholders at least once every five years; and (3) requiring that independent directors make annual findings, after reasonable inquiry, as to whether their fellow independent directors have relationships with the fund or its service providers that would impair their independence. Mr. Bullard also recommended that Congress eliminate "major gaps" in mutual fund fee disclosures. With regard to his proposal for a mutual fund oversight board, Mr. Bullard stated that the SEC's staff has too many responsibilities and not enough resources to provide adequate oversight of fund boards. He recommends that an oversight board have examination and enforcement authority over fund boards and that it be responsible for identifying potential problems in the industry and ensuring that fund boards are actively addressing such problems. In his testimony before the House subcommittee, Mr. Bullard offered his views on the Institute's call for a 4:00 pm deadline for orders at the fund level and imposition of a mandatory 2% redemption fee on shares held for 5 days or less. He stated that the proposed 4:00 pm deadline, while well-intentioned, could impose costs on fund investors that would outweigh its benefits. Mr. Bullard suggested that both proposals show a "fundamental misunderstanding" of the recent allegations, which stem from a failure of compliance and not of existing legal requirements. 7 Testimony of Charles Leven Mr. Leven testified in support of H.R. 2420, which he stated would provide an "overdue upgrade" in investor protection. He stated that the reforms embodied in the legislation, already warranted by the continuing evolution in market practices and the growth in market choices, are now more urgently required. Mr. Leven expressed strong support for the current provisions in H.R. 2420 that would strengthen the role and independence of boards of directors, and he recommended that the legislation be further enhanced by requiring fund boards to have a supermajority of independent directors and an independent chairman. Testimony of Arthur Levitt Mr. Levitt began his testimony by reminding regulators and lawmakers to "remember that mutual funds represent the best vehicle from which the individual investor can access our markets." That said, however, Mr. Levitt called for meaningful change in the administration and governance of mutual funds. He stated that investors are misled into buying funds on the basis of past performance, that the effect of fees and expenses is hidden and that fund directors as a whole exercise scant oversight with regard to management. Mr. Levitt offered several suggestions for reform, including: (1) allowing no more than one interested director per fund board, requiring that the board's chairperson be independent and limiting a director to service on a "reasonable number" of fund boards; (2) requiring fund directors to solicit competitive bids for investment advisory services; (3) a ban on revenue sharing arrangements; and (4) imposing a fiduciary duty on directors to ensure that funds are organized and operated in

the interests of their investors. Testimony of Don Phillips In the view of Mr. Phillips, the mutual fund industry has a good long-term record of serving investors and does not need a major structural overhaul. He suggested, however, that industry problems in recent years are attributable to fund executives having “lost sight of the spirit” of the Investment Company Act and its central premise that the interests of investors come first. Mr. Phillips testified that the adoption of a strengthened version of H.R. 2420 would go a long way in providing better protection for mutual fund investors. He also offered a possible roadmap for restoring public confidence in mutual funds: (1) require funds to disclose compensation, trading and fund holdings information for fund executives and portfolio managers, as is currently required for operating companies; (2) enhance the visibility of fund directors and strengthen their role through requirements such as mandating that the chairperson of the board be an independent director; (3) require more specific disclosures relating to costs and expenses so that investors know how their money is being spent; and (4) ensure fair treatment for all investors through such mechanisms as fair-value pricing policies and, as suggested by the Institute, a 4:00 pm deadline for orders at the fund level. Testimony of Eric W. Zitzewitz Professor Zitzewitz, the author of three studies relating to late trading and market timing, testified that a “complete solution” to these issues would have the following components: (1) expanded use by mutual funds of fair-value pricing, preferably using a model that updates the most recent market price for recent changes in market indicators on a security- 8 by-security basis; (2) tools to permit fund directors, regulators and shareholders to monitor trading activity in mutual funds (e.g., disclosure of daily inflows and outflows, with a two- month lag to alleviate front-running concerns); and (3) the adoption of measures to enhance the independence of fund boards (e.g., require 75% of a fund’s directors to be independent). He stated that short-term trading fees are not substitutes for fair value pricing and that boards with more independent directors appear to perform better in limiting arbitrage. Rachel H. Graham Assistant Counsel

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