

MEMO# 17374

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FUND REGULATORS TESTIFY BEFORE SENATE BANKING COMMITTEE; SEC OCIE STAFF ISSUES REPORT ON FUND AND ADVISER EXAMINATIONS

[17374] April 12, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 42-04 RE: FUND REGULATORS TESTIFY BEFORE SENATE BANKING COMMITTEE; SEC OCIE STAFF ISSUES REPORT ON FUND AND ADVISER EXAMINATIONS On March 10, the Senate Banking Committee heard testimony from mutual fund regulators as part of its continuing series of hearings on the current investigations and regulatory actions regarding the mutual fund industry.¹ Testifying at the hearing were: Lori Richards, Director, Office of Compliance Inspections and Examinations (“OCIE”), Securities and Exchange Commission; Paul Royce, Director, Division of Investment Management, SEC; Mary Shapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD; and David Walker, Comptroller General, General Accounting Office. Included in Ms. Richards’ testimony is a comprehensive report by the OCIE staff that describes the SEC’s examination of funds and investment advisers (“OCIE Report”). The written testimony of the witnesses and the OCIE Report are summarized below.² Testimony of Ms. Richards Ms. Richards testified that the size of the mutual fund industry precludes SEC examiners from conducting a comprehensive audit of each registrant’s operations and that consequently routine examinations must focus on areas that may pose the greatest risk to fund investors. She stated that the SEC is making changes to its examination program in order to: (1) improve detection of late trading and abusive market timing; and (2) identify the areas of highest risk to investors and probe those areas effectively, while still providing timely examinations of each 1 For a summary of the written testimony from the Committee’s earlier hearings, see Institute Memoranda to Board of Governors Nos. 63-03 and 19-04, Closed-End Investment Company Members Nos. 94-03 and 14-04, Federal Legislation Members Nos. 24-03 and 7-04, Investment Company Directors Nos. 19-03 and 11-04, Primary Contacts – Member Complex Nos. 102-03 and 23-04, Public Communications Committee Nos. 40-03 and 12-04, SEC Rules Members Nos. 159-03 and 36-04, Small Funds Members Nos. 68-03 and 29-04, and Unit Investment Trust Members Nos. 43-03 and 10-04 [16788 and 17180], dated Nov. 20, 2003 and Mar. 5, 2004, respectively. 2 The written testimony is available on the Committee’s website at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=97>. The OCIE Report is available on the SEC’s website at <http://www.sec.gov/news/extra/apx-ts031004lar.pdf>. . 2 registrant. With respect to detecting market timing abuses, Ms. Richards stated that all routine fund examinations would now include a review of: (1) daily sales and redemption data; and (2) a sample of

fund executives' internal e-mail communications. Ms. Richards described other enhancements to the examination program, which include: (1) increased use of data analysis; (2) more targeted "mini-sweeps" to investigate particular industry practices; (3) more requests to funds and advisers for written reports; (4) greater collaboration with the SEC's enforcement and regulatory staffs; and (5) using the results from comprehensive, "wall-to-wall" examinations of a select number of firms to test the assumptions used in routine, risk-based examinations. She noted that an SEC staff task force will be looking at mutual funds' current reporting to the SEC and developing a new surveillance program that would facilitate the detection of potential problems, both at individual firms and industry-wide. Ms. Richards also noted that additional resources added to the examination program in 2003 will allow the staff to conduct more frequent examinations of both the largest fund firms and those posing the greatest compliance risk. OCIE Report The OCIE Report discusses the SEC's examination program for funds and investment advisers. It outlines in greater detail the enhancements to the examination program that Ms. Richards summarized in her testimony. The OCIE Report also identifies 12 major areas that may be reviewed during fund and adviser examinations and provides a detailed look at the issues that may be probed in each area. The 12 areas are: (1) portfolio management; (2) brokerage arrangements and best execution; (3) allocations of trades; (4) personal trading; (5) pricing of clients' portfolios and calculation of net asset value; (6) information processing and protection (books and records, disclosures, filings); (7) performance advertising, marketing, and fund distribution activities; (8) safety of client and fund assets; (9) fund shareholder order processing; (10) anti-money laundering; (11) corporate governance; and (12) money market funds. A lengthy appendix to the OCIE Report provides a detailed summary of recent SEC enforcement actions involving funds. Testimony of Mr. Roye Mr. Roye testified that the SEC has embarked on a dramatic overhaul of the regulatory framework in which mutual funds operate. He stated that this regulatory agenda is focused on four main goals: (1) addressing late trading, market timing, and related abuses; (2) improving fund oversight by enhancing fund governance, ethical standards, and compliance and internal controls; (3) addressing or eliminating conflicts of interest that are potentially harmful to fund investors; and (4) improving disclosure to fund investors, especially fee-related disclosure. Mr. Roye then discussed in detail each of the SEC initiatives undertaken in respect of these goals. In discussing late trading, Mr. Roye noted that some commenters clearly do not favor the SEC's proposed hard 4:00 p.m. close and that consequently the SEC is seeking to determine if other alternatives would effectively address late trading abuses. On fair valuation, he stated that the SEC staff is gathering information about funds' fair value pricing practices and evaluating whether to recommend additional measures to improve such pricing. With regard to soft dollars, he stated that the SEC's Divisions of Market Regulation and Investment Management are conducting a review of the problems and conflicts inherent in soft dollar 3 arrangements and the scope of the current safe harbor. On the issue of fund governance, Mr. Roye described the SEC's pending fund governance proposal as a significant overhaul of the composition and workings of fund boards that is intended to establish, without ambiguity, the dominant role of independent directors on a fund's board. As an aside, he noted that Commissioners Glassman and Atkins have questioned whether requiring a fund board to have an independent chair would in fact provide a more effective check on management. Testimony of Ms. Shapiro Ms. Shapiro testified that broker-dealer participation in illegal or unethical sales practices in the sale of mutual fund shares is a matter of immediate concern to NASD. She stated that NASD has brought more than 200 cases in the fund area since 2000, most recently dealing with market timing, the failure to deliver appropriate breakpoint discounts on sales of Class A shares, and improper sales of Class B shares. Ms. Shapiro described recent NASD rulemaking initiatives that relate to the sale of fund shares, including: (1)

proposed amendments that would require a fund's performance advertisements to present information about the fund's fees and expenses in a prominent text box; (2) a proposal to prohibit broker-dealers from selling the shares of any mutual fund that considers fund sales as a factor in selecting broker-dealers to execute its portfolio transactions; and (3) proposed disclosure enhancements regarding revenue sharing and differential compensation arrangements. She also discussed the work of NASD's Omnibus Accounting Task Force and the Joint NASD/Industry Task Force on Breakpoints. In concluding her testimony, Ms. Shapiro pledged that NASD will continue its vigorous examination and enforcement focus on mutual fund advertising, the suitability of the mutual fund share classes sold by broker-dealers, compensation practices between funds and broker-dealers, and whether brokers are delivering the appropriate sales charge and pricing discounts to their customers. Testimony of Mr. Walker Mr. Walker offered GAO's views on several of the SEC's pending reform proposals. To address the problem of late trading, he noted that GAO supports "in the short run" the SEC's proposed "hard" 4:00 p.m. close but believes the SEC also should explore other alternatives more fully and develop a strategy for overseeing the processing of mutual fund trades by intermediaries. On market timing, Mr. Walker expressed support for the SEC's redemption fee proposal and its proposal for enhanced disclosures regarding funds' market timing policies and procedures. Similarly, Mr. Walker expressed support for the SEC's proposal to enhance fund governance. He added that having Congress give the SEC additional rulemaking authority to define the term "interested person" clearly seems appropriate. With regard to broker-dealer compensation issues, Mr. Walker commended the SEC for seeking comments on possible revisions to Rule 12b-1 under the Investment Company Act of 1940 and said that GAO believes alternatives to Rule 12b-1 (e.g., deduction of distribution-related costs directly from shareholder accounts) would preserve the flexibility that investors currently enjoy while also increasing the transparency of the fees they pay. He also expressed support for the SEC's proposals to prohibit directed brokerage and to provide greater disclosure of revenue sharing arrangements. Mr. Walker testified that the conflicts of interest created by soft dollar arrangements and enhanced disclosure regarding mutual fund fees and costs are two other areas that require the SEC's continued attention. On soft dollars, he stated that the SEC should consider the merits of 4 narrowing the scope of the current safe harbor or perhaps eliminating soft dollar arrangements altogether. With regard to fund fees, Mr. Walker reiterated several recommendations made in GAO's June 2003 report entitled "Mutual Funds - Greater Transparency Needed in Disclosures to Investors."³ Barry E. Simmons Associate Counsel 3 For a summary of the GAO report, see Institute Memorandum to Board of Governors No. 30-03, Director Services Committee No. 10-03, Primary Contacts - Member Complex No. 49-03, Public Information Committee No. 19-03, SEC Rules Members No. 78-03, and Small Funds Members No. 27-03 [16223], dated June 19, 2003.

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