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REMARKS BY INSTITUTE GENERAL COUNSEL, COMMISSION OFFICIALS AT THE INSTITUTE'S SECURITIES LAW DEVELOPMENTS CONFERENCE

[18378] December 31, 2004 TO: BOARD OF GOVERNORS No. 91-04 CEOS CHIEF COMPLIANCE OFFICER COMMITTEE No. 37-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 82-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 108-04 SEC RULES MEMBERS No. 180-04 SMALL FUNDS MEMBERS No. 133-04 UNIT INVESTMENT TRUST MEMBERS No. 44-04 RE: REMARKS BY INSTITUTE GENERAL COUNSEL, COMMISSION OFFICIALS AT THE INSTITUTE'S SECURITIES LAW DEVELOPMENTS CONFERENCE Earlier this month, Institute General Counsel Elizabeth Krentzman delivered opening remarks at the Institute's 2004 Securities Law Developments Conference. Paul Roye, Director of the Securities and Exchange Commission's Division of Investment Management, delivered the keynote address, and Stephen Cutler, Director of the Commission's Division of Enforcement, delivered the luncheon address. Their remarks are briefly summarized below.* Remarks by Ms. Krentzman Ms. Krentzman focused her remarks on how industry members, the Institute, and regulators can strengthen the fund industry and prepare it to meet the challenges ahead. She reminded the conference attendees that mutual funds remain "the best game in town" for average investors, because they offer professional investment advice, diversification and a range of services at relatively low costs. Ms. Krentzman stated that, given the importance of mutual funds, the industry and regulators alike should consider how their actions affect fund shareholders and the overall health of the industry. Specifically, Ms. Krentzman recommended that existing business practices and regulatory requirements be reexamined to ensure that each is achieving its purpose and does * A copy of Ms. Krentzman's opening remarks is available on the Institute's public website at http://www.ici.org/statements/remarks/04_sld_krentzman_spch.html. Copies of Mr. Roye's address, "Mutual Fund Regulation: What Happens Next," and Mr. Cutler's address, "Minding Your Ps: Preventing Another Crisis in the Mutual Fund Industry," are available on the Commission's website at http://www.sec.gov/news/speech/spch120604pfr.htm and http://www.sec.gov/news/speech/spch120604smc.htm, respectively. 2 not have unintended consequences. She likewise called for rigorous scrutiny of new practices and proposed regulations, and for a more careful analysis of whether the benefits of a proposed regulation justify the costs of compliance, which are ultimately borne by fund shareholders. Ms. Krentzman suggested that regulatory actions should be evaluated on a broader scale, rather than solely on how they relate to mutual funds. She noted that the NASD Mutual Fund Task Force recently examined the issue of soft dollars from this kind of perspective

and has recommended, among other things, that compliance with the soft dollar safe harbor be made mandatory for all discretionary investment advisers, whether or not registered with the Commission. Ms. Krentzman strongly encouraged the Commission to act promptly on the Task Force's recommendations. Similarly, Ms. Krenztman suggested that this broader perspective be applied in the area of disclosure, by extending to all investors the same degree of protection that is afforded to mutual fund shareholders. She cited her recent testimony before the Department of Labor's ERISA Advisory Council, in which the Institute called for participants in certain defined contribution plans to receive equivalent disclosure about all pooled investment options under the plan, not just about the mutual fund options. Ms. Krentzman reported that the Advisory Council has developed recommendations that were largely consistent with the Institute's suggested approach. In closing, Ms. Krentzman stated that charting the proper course for the industry's future will require industry members, the Institute, and regulators to think and act proactively and comprehensively. She expressed confidence that a bright future could be achieved by working together and making sure that the interests of investors come first. Remarks by Mr. Roye Mr. Roye began by noting that many of his recent speeches have focused on the abuses that occurred in the mutual fund industry and the Commission's mutual fund regulatory agenda. In this speech, he said, he would answer the question, "Mutual fund regulation – what happens next?" From Mr. Roye's standpoint, the immediate answer is that the fund industry must "robustly implement" the new rules adopted by the Commission. He opined that the fund industry has shown a "desire to clean house" and said that his Division stands ready to assist the industry as it works toward full and meaningful implementation of the new rules. Mr. Roye encouraged industry members to reach out to the Commission staff with questions as to the legal interpretation or practical implications of the rules, because "having an industry that is uncertain about what is required by a specific rule serves no one's interests." Next, Mr. Roye briefly discussed the three remaining items on the Commission's mutual fund reform agenda. With respect to the redemption fee proposal, he stated that the Commission staff is currently weighing a voluntary versus mandatory approach to redemption fees. Mr. Roye further stated that any rule in this area should be structured so that once a fund board determines a redemption fee is necessary, intermediaries will work with the fund to facilitate collection of the fee. He also noted that the staff is considering whether to recommend that the Commission issue guidance on fair value pricing, which the Commission has said is 3 critical to addressing market timing. With regard to the "hard 4" proposal, Mr. Roye reported that the staff continues to review alternative approaches, including technological controls that could be used to guard against late trading. As for the point of sale proposal, he said that the staff is examining how best to provide investors with meaningful information about broker conflicts and compensation without overwhelming them with detail or imposing prohibitive costs on the brokerage and fund industries. Mr. Roye expects the Commission to act on these proposals "in the near future." Mr. Roye devoted the balance of his remarks to discussing the initiatives that he expects the Commission to consider in the coming year. These include: soft dollars; portfolio transaction costs; review of the mutual fund disclosure regime; mutual fund and investment adviser surveillance; Rule 12b-1; and outreach by the Commission and its staff to chief compliance officers ("CCOs"). With regard to soft dollars, Mr. Roye noted that 2005 marks the 30th anniversary of the enactment of the Section 28(e) safe harbor and thus presents an appropriate time for the Commission and its staff fully to reconsider the use of soft dollars, their impact on the securities markets, and whether they further the interests of investors. He stated that the staff task force currently examining the issue will be looking at the recent recommendations of the NASD Mutual Fund Task Force, in particular those relating to: (1) narrowing the definition of "research" for purposes of Section 28(e); and (2) improving disclosure of soft dollar arrangements for both fund boards

and fund investors. Mr. Roye stated that the staff likewise will closely examine the recommendations of the NASD task force with regard to portfolio transaction costs, as part of its effort to develop a recommendation for the Commission on enhanced disclosure of these costs. A “top-to-bottom, full scale review” of the mutual fund disclosure regime is, in Mr. Roye’s opinion, possibly the most important item on the Commission’s upcoming mutual fund agenda. He stated his preference for a comprehensive review, looking not just at the prospectus and Statement of Additional Information but at all disclosure vehicles, including: shareholder reports; fund advertising; point of sale and confirm documentation; account statements; fund websites; profile prospectuses; prospectus stickers; and disclosures made available on the Commission’s website and upon request to investors. Mr. Roye remarked that there is a role for “layered” disclosure – that is, getting critical information to investors when they are making an investment decision, while providing investors, their advisors, and the financial press with access to more detailed information – but that the challenge will be identifying which streamlined disclosures are most helpful to investors and placing them in the most appropriate format and disclosure vehicle. He stated that “creative ideas will be welcomed” and expressed hope that the fund industry could be a “constructive partner” in this effort, given the industry’s knowledge about the types of disclosures that are effective in communicating information to investors. With regard to fund and adviser surveillance, Mr. Roye noted that two Commission task forces are examining how the Commission can improve its oversight capabilities, including how to use technology to obtain useful information easily from funds and advisers. On Rule 12b-1, Mr. Roye remarked that changes in the industry and in the use of 12b-1 fees since the rule’s adoption makes the rule’s future “a topic worthy of a full and thorough review.” He noted that the Commission’s release adopting the ban on directed brokerage asked the staff to 4 explore alternatives to the rule, including deducting distribution costs directly from shareholder accounts. Mr. Roye stated that “it is believed” that an account-based approach would help to address investors’ inadequate understanding of 12b-1 fees, which he said is an ongoing staff concern. On the issue of CCO outreach, Mr. Roye offered his opinion that an effective CCO must reach out to the fund industry in order to understand how new rules are being implemented, what the newest compliance challenges are, and how other CCOs are approaching their role. He stated that the staff can be a “helpful resource” for CCOs and that the staff wants to foster a partnership with CCOs in order to keep the industry free of major compliance lapses in the future. In closing, Mr. Roye cautioned that the fund industry must remain vigilant and forceful in meeting both compliance goals and fiduciary obligations to investors. Remarks by Mr. Cutler Mr. Cutler first discussed the changes that have been instituted to make the Commission’s enforcement program more proactive. These include: greater efforts to draw on the expertise of staff in the Commission’s operating divisions (including the Division of Investment Management); hiring “subject matter experts” to help enforcement staff examine the implications of business practices in different areas of the market; and probing practices that raise less developed concerns, rather than waiting for specific evidence of wrongdoing. Mr. Cutler also said that, in bringing and settling cases, the Enforcement Division is focusing more closely on the role of “gatekeepers” in the industry, including executives of investment management firms, directors, and lawyers. The balance of Mr. Cutler’s remarks concerned the role of the fund industry in protecting fund shareholders and addressing problems that may arise. He stated that success in avoiding another scandal requires focus on the “three Ps” of place, people and process. “Place,” said Mr. Cutler, refers to the culture of the firm, which ideally supports compliance and gives shareholder interests the highest priority. “People,” he said, refers to a firm’s key personnel, who have the ability to create the right tone at the top and are responsible for ensuring that the firm and its employees act consistently with the interests of fund

shareholders. In particular, Mr. Cutler highlighted the responsibilities of senior managers, who must demonstrate their commitment to compliance through actions such as using compensation and promotion decisions to reward ethical behavior and punish ethical lapses; directors, who can be a powerful force in maintaining a culture that places the interests of investors first; and lawyers, who must broadly evaluate a proposed course of conduct and the motivations underlying it in order to assess the legal implications of such conduct. Finally, Mr. Cutler stated that firms must have a well-conceived and thorough process for identifying and addressing compliance problems. In developing such a process, he recommended that firms should: (1) think expansively about potential problems and ways to address them; (2) not be afraid to challenge accepted business practices; and (3) consider issues raised by the interaction of all parts of the business, including service providers and brokers. Rachel H. Graham Assistant Counsel 5
