INVESTMENT COMPANY INSTITUTE

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SEC CHAIRMAN TESTIFIES AT SENATE MUTUAL FUND HEARINGS

[17372] April 13, 2004 TO: BOARD OF GOVERNORS No. 30-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 25-04 FEDERAL LEGISLATION MEMBERS No. 11-04 INVESTMENT COMPANY DIRECTORS No. 21-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 37-04 PUBLIC COMMUNICATIONS COMMITTEE No. 16-04 SEC RULES MEMBERS No. 55-04 SMALL FUNDS MEMBERS No. 41-04 UNIT INVESTMENT TRUST MEMBERS No. 15-04 RE: SEC CHAIRMAN TESTIFIES AT SENATE MUTUAL FUND HEARINGS On April 8, 2004, SEC Chairman William H. Donaldson testified before the Senate Banking Committee regarding the regulation of the mutual fund industry. Chairman Donaldson's written testimony is summarized below.1 Chairman Donaldson testified that the Commission has embarked on an aggressive regulatory and enforcement agenda to combat the "current ills plaguing" the mutual fund industry. Chairman Donaldson discussed the Commission's (1) rulemaking agenda to tackle late trading and market timing abuses and to address broader structural problems in the mutual fund regulatory framework; (2) inspection and enforcement efforts; and (3) restructuring of its overall internal functions and operations to better assess and anticipate risk. Chairman Donaldson also touched on his concerns about the hedge fund industry. Chairman Donaldson testified that he does not believe that mutual fund legislation is necessary at this time, although the Commission will immediately seek assistance from Congress if there are critical issues that it does not have the ability to address. Commission's Rulemaking Initiatives Chairman Donaldson described various initiatives on the Commission's regulatory agenda to combat late trading, market timing and related abuses. He also discussed the Commission's proposals regarding fund governance, ethical standards for investment advisers, conflicts of interest between funds and those who distribute fund shares, and disclosure regarding portfolio managers. Chairman Donaldson emphasized that, although it is important 1 The written testimony is available at, http://www.sec.gov/news/testimony/ts040804whd.htm. 2 that the Commission consider the adoption of these proposals in an expeditious manner, it is equally important that the Commission give interested parties an opportunity to comment and for the staff to consider fully possible unintended consequences and vet alternative approaches so that the final rules best address the problems that the Commission seeks to solve. With respect to the "hard 4:00 p.m." proposal to halt late trading, Chairman Donaldson stated that the Commission has received more than 1,000 comment letters, many of which raised concerns about how the proposal might adversely impact certain fund investors. He noted that the staff was analyzing the comments to determine whether there is an effective alternative to the hard 4:00 rule proposal that would not disadvantage certain investors and would not distort competition in the marketplace. On the Commission's proposal for a mandatory redemption fee, Chairman Donaldson testified that if the Commission moves forward with adopting the proposal, he believes that it must contain certain exceptions, including

exceptions for individual investors who have suffered an unforeseen hardship and for money market funds and funds that specifically cater to market timers. Chairman Donaldson also testified on improved fund disclosures. He stated that the Commission recently adopted a requirement that shareholder reports include dollar-based expense information, which it considered to be the better course over individualized account information. Chairman Donaldson testified that he believes that the rule should be given a good chance to operate before the Commission contemplates changing it. Inspections and Enforcement Efforts Chairman Donaldson testified that the detection and enforcement piece of the Commission's agenda relating to mutual funds is focused primarily on four types of misconduct: (1) late trading and abusive timing of mutual fund shares; (2) mutual fund sales practices, including fee disclosure issues in connection with the sale of mutual funds; (3) sale of different classes of mutual fund shares; and (4) failure of firms to give customers the discounts available on front-end loads for large purchases of Class A shares. Chairman Donaldson stated that the Commission's Examination staff is continually on the look out for additional mutual fund practices that may be vulnerable to or ripe for abuse, including examining the status of funds closed to new investors that continue to charge rule 12b-1 fees, the portfolio pricing practices of high yield bond funds, the role of pension consultants in pension plans' selection of particular money managers, the use of fair value pricing, the use of affiliated service providers, and the fees charged by certain index funds. Chairman Donaldson emphasized that the Commission also would intently focus on the roles and conduct of mutual fund directors with respect to all these issues. Internal Restructuring Chairman Donaldson testified that, following a thorough internal review of how the Commission deals with risk, it has initiated a new risk management program and laid the groundwork for the new Office of Risk Assessment and Strategic Planning. Chairman Donaldson stated that the new Office of Risk Assessment will work in coordination with the 3 internal risk teams for each major program area and will push the Commission to identify proactively potential problem areas within the mutual fund and broker-dealer industries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable activities. In addition to the new office, Chairman Donaldson testified that multi-divisional task forces have been created to bring together staff from various divisions and offices to brainstorm, evaluate and develop strategies to undertake proactively issues of potential concern in protecting the nation's securities markets. He stated that four of these task forces will tackle mutual fund issues: the Chairman's Task Forces on Soft Dollar Arrangements, College Savings Plans (or 529 plans), Enhanced Mutual Fund Surveillance, and Disclosure Regime. With respect to the Task Force on Soft Dollar Arrangements, Chairman Donaldson was of the view that the Commission, at the very least, should through the rulemaking process consider narrowing the definition of qualifying "research" under the safe harbor so that only "real" research that has valid, intellectual content qualifies. He testified that he expects the Task Force to consider whether the costs of research and execution should be quantified and other ways in which the costs of research could be made more transparent. He was of the view, however, that the Commission should not draw a distinction between third-party research and proprietary research. Chairman Donaldson stated that the Task Force also will consider whether Section 28(e) of the Securities Exchange Act should be repealed. For college savings plans, Chairman Donaldson stated that he has asked the task force to review disclosure and transparency for investors, the extent of the Commission's oversight and whether the costs and fees associated with these plans outweigh the tax advantages of these plans for families saving for their children's educations. For the Task Force on Enhanced Mutual Fund Surveillance, the chairman has asked the task force to look at both the frequency of reports made by mutual funds to the Commission and the categories of information to be reported. Finally, the Task Force on Disclosure will examine the value of various disclosures provided by mutual funds, brokers and issuers to investors as required by the Commission’s rules and regulations. He stated that the Task Force also will explore what types of disclosures best serve investors, the timing of the disclosures, delivery versus access to the disclosures and how best to harness technological advances in assisting investors. Chairman Donaldson testified that the Task Force will analyze whether there is data that the Commission should collect and publish on a periodic basis that would be useful to investors in making comparisons among the various investment options available to them. Hedge Funds Chairman Donaldson testified that he believes that the issues surrounding hedge funds are an excellent example of how the Commission can be proactive and work to enhance enforcement in problem areas before they spread. He was of the view that, although other governmental entities are responsible for monitoring potential systemic risks and the safety and soundness issues raised by the structure of hedge funds, any regulatory action the Commission ultimately takes will focus on the protection of investors. Chairman Donaldson was of the view that hedge funds raise investor protection issues because hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors with a significant impact not only on those investors but on the operation of the U.S. securities markets. He stated that hedge 4 funds are being purchased by intermediaries on behalf of millions of ultimate smaller investor beneficiaries through their pension plans or funds of hedge funds, making it critical for investors that the Commission have basic information and insight on how many hedge fund managers are deploying assets under management, how they handle conflicts of interest, how they account for results and value their investments, and most importantly, what impact their market activities have on other participants of the equity markets. Chairman Donaldson testified that he is troubled that the Commission is limited in its ability to gather information on hedge funds and believes that the Commission has a legitimate interest in obtaining information and imposing appropriate recordkeeping and other regulatory requirements if needed to protect investors. To this end, Chairman Donaldson stated that he has asked the staff to move forward with a rulemaking proposal that would enhance the Commission’s ability to prevent, detect, and deter abusive, fraudulent conduct in the hedge fund industry. Jennifer S. Choi Associate Counsel

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