

**MEMO# 16858**

December 9, 2003

## **STATUS OF LEGISLATIVE AND REGULATORY INITIATIVES AFFECTING INVESTMENT COMPANIES**

[16858] December 9, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 51-03 BOARD OF GOVERNORS No. 71-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 105-03 FEDERAL LEGISLATION MEMBERS No. 28-03 OPERATIONS MEMBERS No. 38-03 PENSION MEMBERS No. 50-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 108-03 PUBLIC INFORMATION COMMITTEE No. 44-03 SEC RULES MEMBERS No. 178-03 SMALL FUNDS MEMBERS No. 78-03 UNIT INVESTMENT TRUST MEMBERS No. 49-03 RE: STATUS OF LEGISLATIVE AND REGULATORY INITIATIVES AFFECTING INVESTMENT COMPANIES As the first session of the 107th Congress concludes, I am writing to give you an update on the legislative and regulatory environment in Washington and a sense about events that seem likely to occur in 2004. I hope you will have a chance to seriously consider the various matters described below. Mutual fund companies are facing a major crisis of public confidence. We need your best thoughts about how to restore confidence in mutual funds as sound investments and fund companies as trusted guardians of a large portion of the nation's long-term savings. Please contact a member of the ICI staff with your thoughts about Institute priorities and positions regarding the legislative and regulatory proposals described below.

**Legislative and Regulatory Environment** The late trading and market timing scandals that surfaced in early September intensified the legislative and regulatory scrutiny of mutual funds that began in 2003. In the past three months, Committees in both Houses of Congress have held hearings at which the Institute testified, the House of Representatives has passed legislation and the SEC and NASD have either proposed or adopted rules addressing aspects of mutual fund practices. The most significant initiatives are summarized below:

- **House of Representatives** – On November 19, 2003, the House passed H.R. 2420, the “Mutual Funds Integrity and Fee Transparency Act of 2003.” This legislation would, among other things, impose a fiduciary duty on fund directors to determine that 2 certain distribution and soft dollar arrangements are in the best interest of fund shareholders, ban joint management of mutual funds and hedge funds by the same individual, and require (a) investment companies to significantly expand disclosure regarding costs; (b) that two-thirds of a fund's board be independent; (c) mutual funds and their advisers to adopt compliance procedures to prevent fraud; (d) independent directors to certify that procedures related to various aspects of a mutual fund's business, such as calculation of the daily NAV and application of the proper sales charge breakpoints, are in place. For a full description of this legislation, please see ICI Memorandum number 16786 on the Institute's member website, [members.ici.org](http://members.ici.org).
- **Senate** – In November, two bills were introduced in the Senate, the “Mutual Fund Transparency Act of 2003” and the “Mutual Fund Investor Confidence Restoration Act.” Both bills include numerous provisions dealing

with mutual fund disclosure, fund governance and certification of various mutual fund procedures by the fund's independent directors. In many cases the provisions of these bills are similar in nature to the bill passed by the House. However, some provisions, especially those included in the Confidence Restoration Act, are more extensive. Please see ICI Memorandum numbers 16751 and 16837 on the Institute's member website, [members.ici.org](http://members.ici.org) for a complete summary of the Senate bills. It should be noted that neither the Chairman of the Senate Banking Committee (the Senate Committee with primary jurisdiction over mutual funds), Senator Shelby (R - AL), nor the ranking Democratic member, Senator Sarbanes (D - MD), have introduced legislation to date.

- SEC - On December 3, 2003 the SEC adopted a rule that will require mutual funds and their advisers to have compliance policies and procedures that are reviewed annually, and to designate a chief compliance officer who must report to the fund's board of directors. The Commission also proposed rules requiring that orders to buy or redeem fund shares be received by the fund or certain other specified entities by 4:00 p.m. and that funds disclose their policies and procedures related to market timing, fair valuation and disclosure of portfolio holdings. The SEC has not yet released the text of these rules. We expect the rules will be posted to the SEC's website, [www.sec.gov](http://www.sec.gov), shortly. In addition, SEC Chairman Donaldson outlined a series of Commission meetings that will be held in December, January and February to consider a wide range of proposals related to late trading, market timing, selective disclosure of portfolio holdings, mutual fund governance and disclosure of mutual fund fees and expenses. The full text of Chairman Donaldson's statement can found at <http://www.sec.gov/news/speech/spch120303whd.htm>
- NASD - in September, the NASD proposed amendments to Rule 2830 that would require broker-dealer point-of-sale disclosure of revenue sharing and differential cash compensation arrangements relating to the distribution of investment company securities. Please see ICI Memoranda 16566 and 16683 on the Institute's member website, [members.ici.org](http://members.ici.org), for a description of the proposed Rule and for ICI's comment letter on the proposed Rule.

3 Institute Activities Since September, the Institute has testified before Congress several times and called for a number of actions to respond to the trading scandals and to strengthen investor protections, including:

- A requirement that orders to buy or redeem fund shares be received by the fund or its transfer agent by 4:00 p.m. in order to address late trading.
- A minimum mandatory 2% redemption fee on all short-term trades in most mutual fund shares and the ability to assess a higher redemption fee where such a fee is supported by the fund's costs to combat market timing.
- A call for mutual fund advisers to clarify or amend their codes of ethics so that all transactions by affiliated personnel in shares of mutual funds sponsored by the adviser are covered by the code.

The Institute has also supported the SEC's compliance rule that was adopted last week and several actions yet to be taken, including the SEC staff recommendation that hedge fund advisers register with the SEC, the SEC rule proposal on portfolio holdings and expense disclosure and the NASD proposal for point-of-sale disclosure requirements by broker-dealers selling mutual fund shares.

Expected Actions in Early 2004 When Congress returns in late January, we expect that additional mutual fund hearings will be scheduled in the Senate. We expect that the Institute will be asked to testify. Final legislation, addressing the trading scandals and other areas, is quite probable in 2004. The scope of legislation will be influenced by many factors, including new developments related to the scandals and actions taken by the SEC. As Chairman Donaldson's recent statement indicates, the SEC intends to propose a number of rules in the coming months. Working through the various member committees, the Institute will analyze and comment upon each proposal. Several principles will guide the Institute's positions on legislative and regulatory proposals.

- Severe sanctions should be taken against all persons who acted willfully against the interests of fund shareholders. There can be no tolerance for arrangements that violate the most fundamental principle underlying

mutual funds – that all shareholders must be treated alike. • Strong and effective reforms are needed to restore investor confidence and strengthen investor protections. Such reforms should build upon the Investment Company Act of 1940, which is far more restrictive than other federal securities laws. 4 • Mutual fund regulation should remain centered in the SEC. Regulatory fragmentation would be harmful to investors. • Mutual fund directors need better tools, such as those included in the SEC’s compliance rule, to fulfill their primary role, which is to police conflicts of interest. However, fund director certification requirements are not appropriate. • Shareholder disclosure should be improved by providing investors with meaningful standardized information to help them make informed investment decisions. Member Involvement The SEC’s rule proposals will affect fundamental aspects of mutual fund structure and practices. I encourage all members on Institute committees to carefully evaluate the proposals and provide input to committee deliberations. If you are unable to attend committee meetings please contact the Institute staff member responsible for coordinating the committee’s activities to ensure that your perspective is included in the formation of industry responses. We will be writing you in the near future to ask for your help in contacting Members of Congress to express your views on proposed legislation. The Institute’s Government Affairs Department will coordinate these activities. \*\*\*\*\* The Investment Company Act of 1940 was enacted in response to abuses that took place in the 1920s and 1930s. The Act was fashioned by a cooperative effort of the SEC, Congressional leaders and representatives from industry. After the Act was unanimously passed by Congress, the SEC asked mutual fund leaders to form a group to work with the Commission to ensure that administration of the Act remained responsive to investor needs. The group that was formed became the Investment Company Institute. Since 1940, the Institute has consistently called for strong regulation and strict enforcement to protect shareholders. During the past sixty-three years the Institute has cooperated with the SEC to see to it that the Act is administered in the interests of fund investors. I encourage you to evaluate the various legislative and regulatory proposals and participate in the efforts to ensure that whatever laws or regulations are ultimately approved serve the best interests of mutual fund shareholders. Matthew P. Fink President