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ICI AND SEC OFFICIALS' REMARKS AT THE 2003 SECURITIES LAW DEVELOPMENTS CONFERENCE

[16881] December 15, 2003 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 110-03 COMPLIANCE ADVISORY COMMITTEE No. 109-03 INTERNAL AUDIT ADVISORY COMMITTEE No. 10-03 INVESTMENT COMPANY DIRECTORS No. 25-03 SEC RULES MEMBERS No. 186-03 TRANSFER AGENT ADVISORY COMMITTEE No. 113-03 UNIT INVESTMENT TRUST COMMITTEE No. 24-03 RE: ICI AND SEC OFFICIALS' REMARKS AT THE 2003 SECURITIES LAW DEVELOPMENTS CONFERENCE Institute General Counsel Craig S. Tyle gave welcoming remarks, Paul F. Roye, Director of the SEC's Division of Investment Management, delivered a keynote address, and SEC Commissioner Harvey J. Goldschmid spoke at a luncheon at the Institute's recent 2003 Securities Law Development Conference.1 The speakers focused on the various regulatory initiatives and other measures to address the recent scandals in the mutual fund industry and restore investor confidence. Their remarks are briefly summarized below. Craig Tyle's Remarks In his remarks, Mr. Tyle provided his thoughts on measures to appropriately address the late trading and market timing scandals that recently came to light. At the outset, Tyle stressed the necessity of maintaining tough enforcement of the securities laws. In this regard, he discussed the importance of punishing wrongdoers, the deterrent effect that enforcement actions provide, and the response of fund complexes in conducting internal investigations to uncover any wrongdoing. Tyle then noted that steps are necessary to enhance the SEC's oversight of mutual funds, including for example, possible enhancements to the SEC's inspection program, and added that the recent scandals underscored the need for SEC oversight of hedge funds. Tyle next stated that improvements are needed in the way that information is shared between fund companies and intermediaries. He added that inadequate information sharing may be one of the reasons why some mutual fund investors failed to receive correct breakpoint discounts, and that it also can hamper a fund's ability to deter short-term trading activity that it 1 Copies of Mr. Roye's and Commissioner Goldschmid's remarks are available from the SEC's website at www.sec.gov. A copy of Mr. Tyle's speech is attached. 2 believes may not be in the best interests of its shareholders. He noted the Institute's strong support for the efforts of the NASD omnibus account task force that SEC Chairman Donaldson has proposed. Tyle next discussed the importance of forward pricing and noted that "late trading is – and should be – flatly prohibited." Commenting on how fair valuing portfolio securities can help deter trading activity that can harm fund shareholders, Tyle was quick to point out that because fair valuation is an inherently subjective process and, consequently, has its limitations, it cannot by itself, be the complete "solution" to problematic short-term trading. Nevertheless, because of its importance, all funds should have procedures in place that

cover when and how fair valuation of securities will occur. Next, Tyle stated that funds should have specific, well thought out policies and procedures in place that address potential conflict situations, which, as a general matter, should involve fund directors. Such procedures can serve to protect both fund shareholders and fund managers. Tyle then noted that legislators and regulators should avoid the trap of fighting the last war, and that, unlike the Enron and Worldcom scandals, which involved a failure of corporate governance, not every problem is a corporate governance problem. He also cautioned against blaming directors for not ferreting out deficiencies that were not brought to their attention. While noting that the SEC's new compliance rule should give directors additional tools to carry out their oversight responsibilities, Tyle warned against incorporating other proposals into pending legislation, adding that fund directors are not supposed to be managing funds, but rather are responsible for providing general oversight and guidance against conflicts of interest. Similarly, Tyle cautioned against using the recent scandals as a pretext for wholly unrelated changes to the system of mutual fund regulation, noting that any such actions could drastically change the economics of the mutual fund business, resulting in a less diverse, less competitive, less innovative industry, which would be a disservice to the investing public. In closing, Tyle reminded the audience of the need to place the interests of the average mutual fund investor first and that by the industry making it a practice of approaching each issue by asking whether it is fair to the average investor, the industry can regain the confidence of fund investors. Paul Roye's Remarks Mr. Roye began his remarks by noting that the conduct unearthed by the recent scandals, which put the management company or fund personnel's interests above fund investors, would have several significant and wide-ranging costs and impact on the industry. In summarizing these costs, Mr. Roye noted that: (i) there is the cost to those individuals who were foolish enough to compromise their integrity in order to line their pockets with, what in many cases, was a relatively small amount of profit; (ii) there is the cost to those fund management companies that have lax compliance procedures or that looked the other way when anti-investor activities were occurring; (iii) there is the cost to those innocent individuals at fund management companies who were not in a position to stop, or even aware of, the abuses but may lose their jobs in the layoffs that inevitably will result from the loss of assets under management, as disillusioned investors pull their investments from suspect fund management companies; (iv) there is the cost to the industry as a whole in terms of loss of credibility, as investors question whether mutual funds are safe places for their investments or whether they are being ripped off through hidden and unscrupulous practices; and (v) there is 3 the cost to investors of feeling betrayed by the fund management companies in whom they placed their investment dollars and their trust. Mr. Roye next discussed the Commission's recently adopted compliance policies and procedures rules. He characterized these rules as "one of the core enhancements the Commission is making to the mutual fund regulatory regime in light of the recent abuses…." According to Mr. Roye, the Commission believes that the policies and procedures required under the rule include policies and procedures to guard against late trading, abusive market timing and selective disclosure of non public portfolio holdings information. He also indicated that the adopting release will include a "clear and unambiguous" Commission statement regarding fund's fair value pricing obligation. He emphasized the important role of the chief compliance officer that each fund and adviser will be required to designate under the new rules. Mr. Roye then discussed the Commission's proposal to amend Rule 22c-1 under the Investment Company Act of 1940, which would require that orders to buy or redeem fund shares be received by the fund or certain other specified entities by 4:00 p.m. each day in order to receive that day's price (the so-called "hard 4:00 p.m. close").2 Mr. Roye also briefly discussed the Commission's disclosure proposal, which would require funds to disclose their policies and procedures related to market timing, fair valuation and disclosure of portfolio holdings.3

Finally, recognizing that the Commission's actions in this area to date are a first step toward an improved regulatory framework, Mr. Roye then summarized the package of further reforms called for by Chairman Donaldson that the staff will be focusing on in the coming months. Such reforms include the following: (i) studying additional measures to combat problematic market timing activity, including requiring a mandatory redemption fee imposed on short-term traders, and developing a solution to the problem of market timers' trading through omnibus accounts; (ii) coordinating with the Mutual Fund Directors Forum and the NASD on their respective projects to prepare best practices for independent directors and to examine and make recommendations regarding omnibus accounts; (iii) considering a series of fund governance measures, including requiring an independent chairman of each fund's board of directors, increasing the percentage of independent directors from a majority to three-fourths, and requiring fund boards to perform an annual self-evaluation of their effectiveness; (iv) considering rulemaking to require "dollars and cents" disclosure to shareholders, coupled with more frequent disclosure of portfolio holdings information; (v) considering a proposal to require disclosure to mutual fund investors regarding the availability of sales load breakpoints; (vi) issuing a concept release on ways to provide fund investors better information on portfolio transaction costs; and (vii) preparing a new mutual fund confirmation statement that will highlight the incentives that brokers have in recommending particular funds, including specific information regarding revenue sharing arrangements and other incentives. Commissioner Goldschmid's Remarks Commissioner Goldschmid's remarks focused on ways to improve corporate governance and noted that in the mutual fund area much work needs to be done. He discussed the central role played by mutual fund directors and suggested several basic steps that must be taken to strengthen fund boards' independence and their ability to effectively fulfill their fund 2 See Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, SEC Release No. IC-26288 (December 11, 2003). The release is available from the SEC's website. 3 See Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Release Nos. 33-8343 and IC-26287 (December 11, 2003) 4 governance responsibilities. First, Commissioner Goldschmid stressed the importance of strengthening the information flows and the loyalty of gatekeepers, like auditors, lawyers, and compliance officers, to independent directors. Second, he recommended extending the public company audit committee listing rules, which presently apply to closed-end funds, to mutual funds, which would further strengthen the loyalty of auditors to independent directors and enhance the effectiveness of mutual fund audit committees. Third, he supported initiatives that would require fund directors to establish effective programs and procedures to assist them in their decision-making and monitoring roles, adding that the Commission's recently adopted compliance rules would do just that by requiring funds and their advisers to adopt policies and procedures reasonably designed to prevent securities law violations. Fourth, in recognition of the critical role that fund directors play, Commissioner Goldschmid recommended increasing the percentage of independent directors on fund boards to at least 75 percent, and opined that the fund's chair should always be an independent director. Commissioner Goldschmid next discussed the roles of compliance officers and lawyers. He stressed the importance of having "reporting up" mechanisms that would pull "bad" mutual fund news to the top, which would facilitate the ability of independent directors to fulfill their oversight role. He again mentioned the recently adopted compliance officer rule (i.e., Rule 38a-1 under the Investment Company Act of 1940), and noted that the rule, among other things, requires funds to designate a chief compliance officer who will report directly to the board. Comparing this rule to the attorney conduct rules, which impose a similar "reporting up" responsibility, Commissioner Goldschmid stated that these rules are designed to enhance the flow of material information to independent directors, thus improving their ability to resolve key securities

law and conflict of interest issues. Turning to other areas in which reform is needed, Commissioner Goldschmid noted that one of his priorities is to address mutual fund disclosure issues. He stressed the importance of providing investors with accurate, understandable, and easy to apply and compare fee, sales load, and expense information, and called upon the Commission to finalize its proposal for more frequent portfolio disclosure. He also noted the importance of developing new disclosures related to broker-dealer “preferred lists,” portfolio manager personal trading, breakpoint discounts, Rule 12b-1 fees, and revenue sharing arrangements. Commissioner Goldschmid then reported that the Commission is in the process of revising its guidance on Rule 12b-1 plans (related to the payment of brokerage commissions to broker-dealers that sell fund shares) and will soon propose amendments to Rule 10b-10 under the Securities Exchange Act of 1934, which would require additional, comprehensible disclosure on fund confirmations. He added that the entire “soft dollar” area needs a critical reexamination, and that vigorous prosecutions for sales practice and advertising abuses should continue. Finally, he noted that the involvement of Canary Capital Partners in the recent scandals further illustrates the need to require the registration of hedge fund advisers. Barry E. Simmons Associate Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 16881, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16881. Attachment (in .pdf format)
