

MEMO# 16854

December 9, 2003

ADDITIONAL POLICY MATTERS FOR BOARD CONSIDERATION

[16854] December 9, 2003 TO: BOARD OF GOVERNORS No. 70-03 RE: ADDITIONAL POLICY MATTERS FOR BOARD CONSIDERATION In addition to the Board's consideration of the ICI's policy on soft dollars and brokerage for sales, there are three additional matters that the ICI staff believes the Board should consider at its December 12th meeting. Each has been raised, in some form, in proposed legislation. The three matters are: (1) limiting short-term trading in fund shares by fund insiders, (2) requiring fund portfolio managers and officers to disclose their holdings in fund shares, and (3) directing the SEC to adopt rules on potential conflicts of interest that can arise when the same firm manages both mutual funds and hedge funds. Each of these matters is discussed below.

Short-term Trading in Fund Shares Allegations of insider trading in fund shares have led to calls for restrictions on short-term trading by fund insiders. In its settlement with the SEC, Putnam agreed to impose a 90 day holding period on all fund investments by employees of the fund's adviser. Investment personnel would be subject to a one-year holding period. H.R. 2420 would make it unlawful for any director or employee of a fund (or a fund's adviser, underwriter, or affiliate) to engage in "short-term transactions" (to be defined by the SEC) in securities issued by the fund, or any affiliate of the fund. The Corzine-Dodd bill contains an identical provision, as does legislation introduced by Senator Kerry. (The Corzine-Dodd bill also contains a provision requiring "senior executive officers" to hold fund shares for at least six months.) The ICI's best practices on personal investing require disgorgement of profits on purchases and sales of securities within 60 days. However, the best practices do not apply to investment company shares. In October, the ICI recommended that funds amend their codes of ethics to include transactions in fund shares. I believe that the ICI should call for statutory or regulatory action that would impose restrictions on short-term trading by certain fund insiders. The recent allegations involving this type of trading by portfolio managers and others have, perhaps more than any other revelation, discredited mutual funds in the eyes of many. In particular, I would recommend that (1) the restrictions apply to all fund "access persons", as defined under SEC rules, (2) they require 2 disgorgement of profits realized from transactions that occur within a specified period (e.g., 60 days), and (3) they permit the SEC to grant exceptions by rule or order (e.g., to make appropriate allowances for employees who engage in systematic investment plans).

Disclosure of Fund Holdings The allegations of insider trading noted above have also led to calls for increased disclosure of fund holdings by certain fund insiders. Most of the bills pending in Congress would require portfolio managers to disclose their holdings in the funds they manage. The Corzine-Dodd bill also would require senior executive officers to make public disclosure of their intention to purchase or sell fund shares prior to the transaction. I believe that the ICI should respond by endorsing requiring disclosure of fund holdings by both portfolio managers and fund officers. Such disclosure could parallel that required of fund directors,

which requires disclosure within dollar ranges, rather than an exact amount. Joint Management of Mutual Funds and Other Accounts Both H.R. 2420 and the Corzine-Dodd bill would ban the same individual from managing a mutual fund and a hedge fund. While this would not prohibit joint management of a mutual fund and a hedge fund by the same investment advisory firm, some have called for broadening the provision in this manner. In addition, even as presently written, the provision could be troublesome for smaller fund advisers and subadvisers to registered funds that also manage hedge funds. I believe that, in lieu of this type of flat prohibition, the ICI should call for the SEC to adopt rules that would govern potential conflicts involved in the side-by-side management of mutual funds and unregistered funds. These rules could require advisers to such funds to have policies and procedures in place to address specified issues, such as trade allocation, short sales, and sequential transactions. In addition, mutual fund boards could be required to review such policies and procedures, and to receive reports on them from the fund's compliance officer. I believe that rules along these lines would be more effective at addressing potential conflicts, and would avoid the hardships noted above. Matthew P. Fink President

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