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FINK AND ROYE REMARKS AT 2004 MUTUAL FUNDS CONFERENCE

[17316] March 30, 2004 TO: BOARD OF GOVERNORS No. 24-04 DIRECTORS’ COMMITTEE No. 8-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 31-04 SEC RULES MEMBERS No. 47-04 RE: FINK AND ROYE REMARKS AT 2004 MUTUAL FUNDS CONFERENCE Investment Company Institute President Matthew P. Fink and Paul F. Roye, Director of the Securities and Exchange Commission’s Division of Investment Management, each delivered a keynote address at the 2004 Mutual Funds and Investment Management Conference, held in Palm Desert, California on March 21st – 24th. Both speeches are summarized below.1 PRESIDENT FINK’S ADDRESS President Fink announced to the audience his intention to retire this year and that his remarks would be his final address in his capacity as President of the Investment Company Institute. Fink began his remarks by responding to a recent Wall Street Journal article that incorrectly suggested that during an Institute conference call with members the Institute became aware that some funds may have been facilitating rather than combating market timing and failed to convey this information to the SEC. Calling the article’s suggestions “entirely inaccurate” and “completely untrue,” Fink explained: (i) that the call with members was to identify and discuss effective ways to restrict market timing, not facilitate it; (ii) that during the call members mentioned a number of steps they had implemented to restrict market timers and prevent and deter abusive short-term trading; (iii) that the Institute told the SEC everything that it knew about members’ arrangements to address abusive market timing; and (iv) that several weeks after the call, the Institute sent a draft no-action request to the SEC, requesting that it authorize mutual funds to delay exchanges as a way to combat abusive market timing. Fink emphasized that at no point during the conference call discussion did any Institute staffer or Institute member suggest or otherwise imply that market timing or market timers were being accommodated, or should be accommodated. Fink then turned to his prepared remarks. 1 A copy of Mr. Fink’s speech is available at http://www.ici.org/new/04_mfimc_fink_spch.html. A copy of Mr. Roye’s speech is available at http://www.sec.gov/news/speech/spch032204pfr.htm. 2 Fink discussed the recent scandals and predicted that basic questions, such as: “What went wrong?” and “How did we miss it?” will be the subject of conferences, seminars, articles and books for years to come. He added that at the public policy level, the industry has been faced with analyzing and responding to a “stunning number of legislative and regulatory proposals.” He noted that by one count, there were 106 different mutual fund reform ideas pending before Congress and various regulators, adding that while some of the proposals deal with recent trading abuses, others address areas involving potential conflicts of interest, such as soft dollars, directed brokerage and revenue sharing. Still others involve new disclosures, particularly with respect to fees and expenses, and initiatives to enhance the independence and effectiveness of fund directors. Fink noted that the SEC is undergoing an extensive overhaul of mutual fund regulation and that the Institute has

sought to be a constructive and proactive participant in the reform process. To that end, the Institute has endorsed most of the SEC's proposals and has called for: (i) a 4:00 p.m. reporting deadline to combat late trading; (ii) a mandatory two percent redemption fee to help fight abusive market timing; (iii) a major cutback in the use of soft dollars; (iv) a total ban on directed brokerage; and (iv) actions to prevent fund employees from abusive trading of fund shares. Fink added that one of the most important new rules is the SEC's recently adopted compliance rule, which he predicts will produce the greatest benefits for fund investors. Noting that there is wide disagreement on the precise nature of needed reforms, Fink suggested that each proposal should be evaluated by one standard: "Is the proposal likely to advance the interests of long-term mutual fund shareholders." Fink noted that several recent actions have raised optimism that the industry is well along in the process of improving and strengthening mutual fund oversight, regulation and enforcement in a manner that better serves fund shareholders. First, he noted that the SEC's rule proposals generally have been well thought out and that the Commission has expressed a willingness to adjust its proposals to address issues and alternative approaches raised by commenters. Second, Congress has conducted an extensive series of hearings and examined an exceptional number of issues involving the management, operation and regulation of mutual funds. Third, investors continue to make new investments in mutual funds, while withdrawing money from some of the funds subject to investigations. Lastly, individual fund groups have stepped up quickly and forcefully through such measures as firing executives implicated in the abuses, hiring independent third parties to scrutinize business practices, overhauling internal policies and procedures, pledging restitution to shareholders, and voluntarily disclosing potential problems to government officials. Despite his optimism, Fink expressed two concerns about the reform process. First, he expressed concern that in the understandable urge to stamp out abuse and implement reform, measures may be adopted that may inadvertently, but substantially, harm fund investors. He cited a proposal by certain critics that would have mutual fund portfolio managers disclose their annual compensation and be prevented from managing hedge funds as one example where well-intended policy changes would likely produce much more harm than good. Fink explained that because this proposal would apply only to fund managers – and not to those who manage pension funds, separately managed accounts, hedge funds or other investment products – it is clearly foreseeable that skilled portfolio managers would choose to work in other areas of money management that would not be subject to such regulations. 3 Second, Fink noted that protecting the interests of investors requires much more than adherence to a set of rules, no matter how tough they may be. He added that while it is important to support new rules and policy initiatives that will benefit fund shareholders it is also important to keep a constant eye on what mutual fund companies are doing, whether they are our employers, clients or members. He stressed that if what they are doing is wrong, they must be told to stop, in no uncertain terms, even if the activity is technically legal. According to Fink, "[W]e should always ask not only whether something is legal, but also whether it is the right thing to do for fund shareholders." Noting that this was his last address as ICI President, Fink mentioned that the Institute's Board of Governors has named Paul Stevens as the new President, beginning June 1, 2004. He stated that he could not think of a better qualified person to lead the Institute in the years ahead. Fink also reported that Craig Tyle, the Institute's General Counsel for the past eight years, recently left the Institute for private practice. He added that Craig is a truly outstanding human being, and a brilliant lawyer, whose work has benefited tens of millions of American investors. Fink concluded his remarks by thanking all those who have challenged, supported, advised, inspired, and befriended him over the past 33 years he has represented mutual funds in Washington. DIRECTOR ROYE'S REMARKS Director Roye began his remarks by recounting some of the events that transpired over the past year. He emphasized that integrity and accountability must play an important role in the mutual fund industry. He cautioned those that lost sight of the basic tenet that mutual funds are accountable to their shareholders as they will not only lose the trust and the investment dollars of their shareholders, but also be seriously disciplined by the market and be held accountable by the Commission's enforcement staff. Roye then focused his remarks on summarizing the Commission's rulemaking agenda and reporting on its initiative to reassess its effectiveness as the investors' watchdog. A. The Commission's Rulemaking Agenda Roye noted that the Commission's rulemaking initiatives are premised on four main goals: (1) addressing late trading, market timing and related abuses; (2) improving the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; (3) addressing or eliminating certain conflicts of interest in the industry that are potentially harmful to fund investors; and (4) improving disclosure to fund investors. 1. Initiatives to Address Late Trading, Abusive Market Timing and Related Abuses In the area of late trading, Roye noted that to curtail late trading, the Commission proposed the "hard 4:00" rule, which would require a fund or a certified clearing agency (i.e., NSCC) to receive a purchase or redemption order prior to the time the fund prices its shares (typically 4:00 p.m.) for an investor to receive that day's price.2 Roye noted that the proposal is designed to provide for a secure pricing system that would be highly immune to manipulation 2 Amendments to Rules Governing Pricing of Mutual Fund Shares, SEC Release No. IC-26288 (December 11, 2003). 4 by late traders. He added that because some of the nearly 1,000 comment letters received by the Commission recommended against the rule, the staff is also considering various other alternatives to determine the best approach. In the area of market timing and other related abuses, Roye noted that the Commission has proposed three initiatives, the first of which would require funds to disclose their policies and procedures regarding fair value pricing.3 Roye explained that this would force funds and their boards to be accountable to their shareholders regarding when, how and under what circumstances they are fair valuing their portfolio. He also noted that the Commission has sought public comment on the need for additional guidance or rulemaking in this area, adding that the staff is currently gathering information regarding funds' fair value pricing practices and evaluating whether to recommend additional measures to improve funds' fair value pricing. The Commission's second proposal would require funds to impose a mandatory two percent redemption fee when investors redeem their shares within five business days.4 Roye explained that this proposal is designed to reduce the profitability of abusive market timing. Accordingly, the fee would be payable to the fund, for the direct benefit of fund shareholders, rather than to the management company or any other service provider. The Commission's third proposal would address related abusive activities and require funds to disclose their anti-market timing policies and practices and the circumstances under which they will disclose their portfolio holdings.5 Roye explained that this would force funds to clearly and unambiguously disclose their policies to investors to better enable them to determine whether the fund's policies are in line with their interests. 2. Initiatives to Enhance Fund Oversight Roye next discussed several initiatives the Commission is pursuing to improve fund oversight and compliance, minimize the recurrence of anti-investor activities, strengthen the hand of fund boards, and provide fund directors, particularly the independent directors, with additional tools with which to protect fund investors and reinforce ethical standards. Roye first discussed the Commission's fund director proposal, which, among other things, would require: (i) a board comprised of 75% independent directors; (ii) an independent chairman of the board; (iii) independent director authority to hire, evaluate and fire staff; (iv) quarterly executive sessions of independent directors outside the presence of management; and (v) an annual board self-evaluation.6 Roye clarified that the Commission did not intend for the proposal to "interject directors into day-to-day management of fund operations," as was suggested by some commenters.

Rather, the proposal is intended to enable fund directors to better perform their oversight role. Roye pointed to a provision in the Commission's chief compliance officer rule that requires the compliance officer to report to the board, as well as a 3 Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Release Nos. 33-8343; IC-26287 (December 11, 2003). 4 Mandatory Redemption Fees for Redeemable Fund Securities, SEC Release No. IC-26375A (March 5, 2004). 5 See note 3 supra. 6 Investment Company Governance, SEC Release No. IC-26323 (January 15, 2004). 5 provision in the fund governance rule proposal that grants independent directors authority to retain staff and experts, as measures that will provide fund directors sufficient information to perform their oversight responsibility. Roye then pointed to the Commission's proposal to require all registered investment advisers to adopt codes of ethics as another effort to promote accountability and reinforce the fundamental importance of integrity in the investment management industry.7 He noted that this proposal would set forth standards of conduct for advisory personnel that reflect the adviser's fiduciary duties, as well as codify requirements to ensure that an adviser's supervised persons comply with the federal securities laws, report their transactions (including transactions in mutual funds), and require that supervised persons receive and acknowledge receipt of a copy of the code of ethics. Roye then discussed the Commission's newly adopted compliance policies and chief compliance officer rules.8 He noted that, in his view, the compliance officer would serve not only as the primary architect and enforcer of compliance policies and procedures for the fund, but also as the eyes and ears of the board on compliance matters. As such, he expects these rules will have a far-reaching positive impact on mutual fund operations and compliance programs. 3. Initiatives Aimed at Conflicts of Interest Roye discussed the Commission's proposals to address certain conflicts of interest involving mutual funds and those who distribute fund shares. He mentioned the Commission's proposal to amend Rule 12b-1 under the Investment Company Act to prohibit the use of brokerage commissions to compensate broker-dealers for distribution of a fund's shares.9 He explained that the proposal effectively would ban these types of directed brokerage practices by mutual funds, would force advisers to be more accountable to fund investors about the fees they are paying for distribution, would preclude advisers from masking their distribution payments by using a fund's commission dollars, and would eliminate a practice that potentially could compromise best execution of portfolio trades, increase portfolio turnover, and corrupt broker-dealers' recommendations to their customers. Roye added that because over time Rule 12b-1 has come to be used in ways that exceed its original purposes, the Commission has solicited comment on whether the rule should be further revised or even repealed. Roye next discussed the potential conflicts involving soft dollar arrangements, noting that Chairman Donaldson has made the issue a priority and has directed the staff to explore the problems and conflicts inherent in soft dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. Roye announced that the Divisions of Market Regulation and Investment Management are working together on this review and 7 Investment Adviser Codes of Ethics, SEC Release Nos. IA-2209; IC-26337 (January 20, 2004). 8 Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204; IC-26299 (December 17, 2003). 9 Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC-26356 (February 24, 2004). 6 intend to conduct a thorough analysis to enable the staff to make meaningful and informed recommendations to the Commission on this issue. 4. Initiatives to Improve Fund Disclosure, Including Fee-Related Information Roye noted that Chairman Donaldson has previously identified improved disclosure about fund fees, conflicts, and sales incentives as priorities for the Commission's mutual funds program. He pointed to the Commission's recently adopted rules related to shareholder reports as a "leap forward" in addressing these issues.10 The rules, among other things, require funds to provide periodic disclosure about their costs, portfolio investments, and past performance. Responding to comments made by some industry participants that fund directors are not required to "negotiate" advisory contracts, Roye cited Section 15 of the Investment Company Act, which requires fund directors to annually evaluate the fund's investment advisory contract, and cautioned that if, after reviewing all of the relevant factors – including the adviser's cost and profitability, as well as economics of scale, the board's judgment is that the fee is not reasonable, the directors "indeed should be negotiating a lower fee." He added that "[t]o suggest otherwise lends credence to the perspectives of those who would advocate direct fee regulation or other drastic measures." Roye next discussed the Commission's proposal relating to amendments to the fund confirmation form and a new point of sale document for brokers selling mutual fund shares.11 He explained that this proposal should have the effect of highlighting for customers many of the conflicts that broker-dealers face when recommending certain mutual funds, as well as enhancing the accountability of broker-dealers to their customers when making fund recommendations. Roye then discussed the Commission's recent proposal relating to a portfolio manager's relationship with the fund.12 He explained that the proposal would require funds to disclose the structure of portfolio manager compensation, ownership of shares of the funds that a manager advises, and comprehensive disclosure of specific investment vehicles, including hedge funds and pension funds, that are also managed by the fund's portfolio manager. He added that the proposal would also require funds that are managed by a "team approach" to provide information about the individual members of the team who are primarily responsible for managing the fund's portfolio. Roye briefly mentioned two additional proposals – the Commission's breakpoints disclosure proposal, which would address, in part, the wide-scale failure to provide appropriate 10 Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, SEC Release Nos. 33-8393; 34-49333; IC-26372 (February 27, 2004). 11 Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, SEC Release No. 33-8358; 34-49148; IC-26341 (January 29, 2004). 12 Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, SEC Release Nos. 33-8396; 34-49398; IC-26383 (March 11, 2004). 7 breakpoint discounts on front-end load mutual fund purchases,13 and the Commission's transaction costs concept release, which is intended to solicit comment on methods to calculate and improve the disclosure of funds' portfolio transaction costs.14 B. Reassessment of Commission Effectiveness Roye then turned to the Commission's initiative to restore the Commission's credibility as the investor's watchdog, and announced several Commission decisions. He announced the Commission's decision to undertake a comprehensive review of every division of the Commission. The review would involve assessing current needs, resources, reviewing methodology and installing performance measures. In this regard, Roye added that as a result of a budget increase and this review, the Commission has been able to increase its examination staff by a third to approximately 500 examiners, which, in conjunction with its new examination protocols, have enabled it to enhance its ability to detect violations of the law. Roye then announced the Commission's decision to create a new Office of Risk Assessment, which is focused on early identification of new or resurgent forms of fraudulent, illegal or questionable behavior. He added that, in conjunction with this new office, the Division of Investment Management intends to establish its own risk management group, which will report into and work closely with the Office of Risk Management. Finally, Roye announced the Commission's decision to form a new task force, whose mission is to prepare the outlines of a new mutual fund surveillance program. He explained that the task force will focus on rethinking the mutual fund reporting regime, including the frequency of reporting to the Commission and the types of information that should be reported to facilitate the Commission's oversight of the industry. As part of this process, the task force will also consider how technology can be used to enhance the Commission's ability to carry out its oversight responsibilities. In closing, Roye stressed the importance of honesty and integrity in the mutual fund industry, and challenged industry participants to embrace the spirit of the Commission's reforms to enable the industry to move beyond this unfortunate period in the history of the mutual fund industry. Barry E. Simmons Associate Counsel 13 Disclosure of Breakpoint Discounts by Mutual Funds, SEC Release Nos. 33-8347; 34-48939; IC-26298 (December 17, 2003). 14 Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, SEC Release Nos. 33-8349; 34-48952; IC-26313 (December 19, 2003).