

MEMO# 16788

November 20, 2003

SENATE HEARINGS ON CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY

[16788] November 20, 2003 TO: BOARD OF GOVERNORS No. 63-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 94-03 FEDERAL LEGISLATION MEMBERS No. 24-03 INVESTMENT COMPANY DIRECTORS No. 19-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 102-03 PUBLIC INFORMATION COMMITTEE No. 40-03 SEC RULES MEMBERS No. 159-03 SMALL FUNDS MEMBERS No. 68-03 UNIT INVESTMENT TRUST MEMBERS No. 43-03 RE: SENATE HEARINGS ON CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY On November 18, the Institute's President, Matthew P. Fink, testified before the Senate Committee on Banking, Housing and Urban Affairs on the current investigations and regulatory actions regarding the mutual fund industry. Also testifying before the Committee were William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, and Marc E. Lackritz, President, Securities Industry Association. The oral and written testimony of Mr. Fink and the written testimony of Messrs. Donaldson and Lackritz are summarized below.¹ The Committee has scheduled a second hearing for today. The witnesses at today's hearing are: Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission; Robert Glauber, Chairman and CEO, NASD; and Eliot L. Spitzer, Attorney General, Office of New York Attorney General.² Institute Testimony In his testimony before the Committee, Mr. Fink stated that the Institute is "truly horrified at the betrayal of shareholders that occurred at some mutual fund companies" and is committed to working with the Committee and other policymakers to "rebuild trust, renew confidence, and reinforce our previous history of putting the interests of investors ahead of everything else." He called for severe sanctions on all persons who acted willfully against the interests of fund shareholders and for "zero tolerance" of arrangements that violate "perhaps the most fundamental principle underlying mutual funds - that all shareholders must be treated alike." Mr. Fink stressed that strong and effective reforms are needed and that such reforms should build upon the Investment Company Act of 1940, which he noted is far more restrictive than the other federal securities laws and the only such law to be passed by Congress unanimously. In his written testimony, Mr. Fink discussed the Institute's recent recommendations for fundamental reforms to combat the abusive trading practices

1 Testimony for the November 18th hearing is available on the Committee's website at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=78>. 2 Testimony for the November 20th hearing likely will be available on the Committee's website at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=80>.

revealed at some fund companies.³ These recommendations include a firm 4:00 pm deadline for all trades to be reported to mutual funds or their transfer agents and a mandatory minimum redemption fee of 2% on shares held for five days or less. He also stated that the Institute generally supports other regulatory initiatives that would serve to protect investors and restore their confidence in the fund industry, including: (1) an SEC staff recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940; (2) the SEC's rule proposal regarding mutual fund compliance programs; (3) the SEC's rule proposal on portfolio holdings and expense disclosures; and (4) the NASD's proposal on point-of-sale disclosure requirements for broker-dealers selling mutual fund shares.

Testimony of SEC Chairman Donaldson Mr. Donaldson began his testimony by outlining what, in his view, are the fundamental rights to which every mutual fund investor is entitled. First on his list are the rights to: (1) an investment industry that is committed to the highest ethical standards and that places investors' interests first, and (2) equal and fair treatment by mutual funds and brokers. Other more specific rights identified by Mr. Donaldson include the right to: (1) assurances that fund assets are being used for the benefit of investors; (2) clear disclosure of fees, expenses, and conflicts arising from arrangements with brokers regarding the sale of fund shares; and (3) effective and comprehensive compliance programs by mutual funds and brokerage firms. Mr. Donaldson then discussed the SEC's "plan of execution" to ensure that these rights are realized for mutual fund investors.

Late Trading and Market Timing Abuses. Mr. Donaldson announced that, at an open meeting scheduled for December 3rd, the SEC will consider a staff recommendation to require that purchase or redemption orders for fund shares must be received by the fund or its designated agent – and not an intermediary such as a broker-dealer – before the fund prices its shares in order for the investor to receive that day's price. Mr. Donaldson testified that, with respect to market timing, the SEC will consider the following staff recommendations at the December 3rd meeting: (1) that a fund have additional, more explicit disclosure in its offering documents of the fund's market timing policies and procedures; and (2) that the fund be required to have specific procedures to comply with those disclosures. Mr. Donaldson stated that the recent allegations relating to market timing have 3 See http://www.ici.org/issues/mrkt/arc-sec/03_nyag_sum.html. 3 involved issues of: (1) abusive trading by portfolio managers in shares of their own funds, and (2) selective disclosure of a fund's portfolio holdings to curry favor with large investors. He indicated that the staff recommendations for the December 3rd meeting would address these issues. Mr. Donaldson further expects that the SEC will emphasize the obligation of funds to fair value their securities in order to avoid stale pricing. Mr. Donaldson promised that the SEC will "explore the full range of [its] authority" to address market timing abuses. He stated that he has asked the staff to study additional measures for SEC consideration, including a mandatory redemption fee on short-term trades (e.g., a roundtrip trade over a 3-5 day period).

Trading in Omnibus Accounts. Mr. Donaldson stated that mutual fund shares are often purchased and redeemed through omnibus accounts with intermediaries, making it difficult for funds to fulfill certain obligations to their shareholders. He noted, for example, that many of the market timing abuses identified by the SEC took place through trading in omnibus accounts. Mr. Donaldson stated that he has directed the NASD to head an Omnibus Account Task Force to study issues relating to omnibus accounts and to provide the SEC staff with information and recommendations. The task force will consist of representatives from the fund and brokerage industries and from other intermediaries.

Fund Governance. Mr. Donaldson testified that recent problems in the mutual fund industry call for "enhanced effectiveness" by independent directors. He offered several ideas for reform, which he has asked the staff to develop for SEC consideration in January. They are: (1) requiring that a fund's board of directors have an independent chairman; (2) increasing the percentage of independent directors under SEC rules from a majority to three-fourths;

(3) providing independent directors the authority to retain staff as they deem necessary; (4) requiring a fund board to perform an annual self-evaluation of its effectiveness, which would include consideration of the number of funds the directors oversee and the board's committee structure; and (5) requiring a fund's board to focus on and preserve documents and information that the directors use to determine the reasonableness of fees relative to performance, quality of service and stated objectives, including a focus on the need for breakpoints or reductions in advisory fees and comparisons with fees and services charged to other clients of the adviser. Mr. Donaldson stated that he has called upon independent directors to be "active participants in the reform effort." He also has called for the development of guidance and best practices with regard to issues such as director decision-making, compliance oversight, and valuation and pricing of fund portfolio securities and fund shares.

Disclosure. Mr. Donaldson testified that he expects the SEC to consider the following disclosure initiatives in December: (1) the issuance of a proposal to improve disclosure regarding the availability of sales load breakpoints; (2) the issuance of a concept release to solicit views on how the SEC should proceed in fashioning disclosure of portfolio transaction costs; and (3) the issuance of a proposal setting forth a new mutual fund confirmation statement that would provide investors in load funds with quantified information about sales loads and other charges, revenue sharing arrangements, differential compensation for proprietary funds, and other broker incentives that may not be readily apparent.

4 Mr. Donaldson stated that he expects the SEC will consider, in January, the adoption of rules to require "dollars and cents" fee disclosure to shareholders and more frequent disclosure of portfolio holdings information. He indicated that he also has instructed the staff to consider rules that would better highlight for investors the bases upon which the directors of a fund have approved management and other fund fees.

Compliance and Oversight. Mr. Donaldson stated that the SEC, at its December 3rd meeting, would consider adopting rules to ensure that funds and investment advisers have strong compliance programs. The rules would require funds and advisers to: (1) adopt and implement written policies and procedures reasonably designed to prevent and detect violations of the federal securities laws; (2) review these policies and procedures annually for their adequacy and the effectiveness of their implementation; and (3) designate a chief compliance officer to be responsible for administering the policies and procedures and, in the case of funds, to report directly to the fund's board of directors. Mr. Donaldson noted that the SEC will continue to explore other possible approaches for having funds assume greater responsibility for compliance with the federal securities laws, including whether funds and advisers should periodically undergo an independent third party compliance audit. After outlining the SEC's "plan of execution," Mr. Donaldson defended recent settlements of certain SEC enforcement cases. He described the agency's partial settlement with Putnam Investments as both offering "immediate and significant protections" for current investors in the company's mutual funds and enhancing the agency's ability to obtain meaningful sanctions for the alleged wrongdoing. With respect to the SEC's settlement of charges against Morgan Stanley, Mr. Donaldson observed that the abuses addressed in the case are significant and are not necessarily limited to the firm. Specifically, he stated that the SEC is conducting an examination sweep of 15 broker-dealers regarding "shelf space" payments by funds to brokers selling their shares and that the agency is looking at potential disclosure failures and breaches of trust by both the funds and the brokers involved. Finally, Mr. Donaldson outlined for the Committee a new risk management initiative at the SEC that will help the agency to analyze risks across its various divisions and to focus on early identification of fraudulent, illegal, or questionable behavior or products. Mr. Donaldson stated that this initiative will be coordinated by a new Office of Risk Assessment, whose director will report directly to him, and a Risk Management Committee, which will be tasked with reviewing the implications of identified

risks and recommending appropriate courses of action. Mr. Donaldson described this effort as one of his top priorities since becoming SEC Chairman. Testimony of Marc E. Lackritz Mr. Lackritz testified that the current problems identified in the mutual fund industry “must be addressed swiftly and comprehensively by tough regulatory enforcement action where wrongdoing has occurred, thoughtful regulatory revisions to make sure that these problems cannot recur, and legislation to fill in existing ‘gaps’ in the law.” He cautioned, however, that it is “equally important” that regulatory or legislative solutions should not create new problems or other unintended consequences. 5 Mr. Lackritz stated that the SIA is “greatly distressed” by the number of instances of late trading in mutual funds and supports regulatory action to eliminate future opportunities for such trading. With respect to calls for a “hard close” at the mutual fund, Mr. Lackritz stated that the SIA believes such a requirement would have some significant drawbacks for investors and also may have some major operational difficulties. In particular, he asserted that a hard close at the mutual fund would likely create a two-tiered market, to the detriment of both individual fund investors desiring the services of broker-dealers or other intermediaries and the 36 million families who invest through employer-sponsored retirement plans. Rather, said Mr. Lackritz, the SIA believes that a proposal to develop a centralized time stamp facility at the NSCC, which would require receipt of fund orders to the NSCC by 4 pm but permit the submission after the close of other data needed to complete the transactions, appears to pose a much less daunting operational challenge. Mr. Lackritz stated that another alternative, which the SIA has proposed, is to permit a hard close at the intermediary, which he called “the most attractive of the three [proposals] from the standpoint of investor fairness.” He stated that an intermediary receiving fund orders until the close would be required to have: (1) an electronic order capture system, with verifiable order entry time aligned with an atomic clock; (2) written policies and procedures to ensure compliance; (3) senior management approval as to the adequacy of those procedures; and (4) an annual external audit to measure compliance with, and the effectiveness of, the procedures. With respect to market timing, Mr. Lackritz expressed support for: (1) expected action by the SEC to require disclosure of a fund’s policies and procedures on market timing and procedures to assure compliance with that disclosure; (2) an SIA proposal to require that intermediaries provide to funds (subject to customer privacy rights) sufficient trade-level customer detail on trades submitted to the fund on an aggregated basis; (3) a mandatory redemption fee on fund shares that are redeemed within 5 days of purchase; and (4) SEC action to address the issue of stale pricing. As to a mandatory redemption fee, Mr. Lackritz suggested that the SEC provide a narrow exemption for cases in which an investor can demonstrate in writing that the transaction was necessary to meet an unanticipated personal financial hardship. In his testimony, Mr. Lackritz discussed the SIA’s support for enhanced transparency with regard to revenue sharing arrangements and differential compensation and listed the elements that should be embodied in any additional disclosure. With regard to soft dollars and directed brokerage, Mr. Lackritz stated that the SIA supports disclosure to investors and fund trustees to ensure that arrangements with broker-dealers are disclosed “fairly and in context.” Rachel H. Graham Assistant Counsel