

MEMO# 16600

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SEC CHAIRMAN TESTIFIES BEFORE CONGRESSIONAL COMMITTEE ON THE STATE OF THE SECURITIES INDUSTRY

[16600] October 1, 2003 TO: BOARD OF GOVERNORS No. 52-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 76-03 FEDERAL LEGISLATION MEMBERS No. 19-03 PUBLIC INFORMATION COMMITTEE No. 34-03 SEC RULES MEMBERS No. 129-03 SMALL FUNDS MEMBERS No. 52-03 UNIT INVESTMENT TRUST MEMBERS No. 31-03 RE: SEC CHAIRMAN TESTIFIES BEFORE CONGRESSIONAL COMMITTEE ON THE STATE OF THE SECURITIES INDUSTRY On September 30th, Securities and Exchange Commission Chairman Donaldson testified before the Banking, Housing, and Urban Affairs Committee of the U.S. Senate on the state of the securities industry. In large part, Chairman Donaldson's testimony focused on the Commission's "aggressive agenda" to identify and address challenges in the mutual fund industry. 1 His testimony was divided into three areas: actions recently taken by the Commission to ensure that mutual fund investors have the information they need to make investment decisions; future initiatives of the Commission relating to mutual funds; and updates on current issues involving hedge funds and mutual funds. His remarks in each of these areas are summarized below. Actions Recently Taken by the Commission With respect to the actions the Commission has recently taken to better inform investors regarding their investment decisions, Chairman Donaldson highlighted the following: • Amendments to the Advertising Rules Governing Mutual Funds – the Chairman noted that, during the week of September 22nd, the Commission adopted amendments to modernize the rules governing fund advertisements. In part, these amendments will require additional information in fund advertisements including information about a fund's investment objectives and risks, a statement that investors should consider a fund's fees before investing, and the fact that other important information about the fund is available in the fund's prospectus. 1 A copy of Chairman Donaldson's written testimony is available on the Commission's website at: <http://www.sec.gov/news/testimony/ts093003whd.htm>. 2 • Fund of Funds – The Chairman next discussed new rules proposed by the Commission last week under the Investment Company Act that would broaden the ability of one fund to acquire shares of another fund. According to the Chairman, this proposal would improve the transparency of the expenses charged by the acquired funds by requiring that such expenses be aggregated and included in the fee table of the acquiring funds. • Proxy Voting – the Chairman summarized for the Committee the rules adopted by the Commission in January of this year that require mutual funds to disclose their proxy voting records as well as the policies and procedures they use to determine how to vote proxies related to portfolio securities. He noted that funds have already begun complying with these new requirements. • Sarbanes-Oxley Requirements – Chairman Donaldson also summarized the corporate governance requirements of the Sarbanes-Oxley Act and noted that the

Commission has applied them to both operating companies and mutual funds, “with some tailoring for the unique aspects of mutual funds.” Future Mutual Fund Activity According to Chairman Donaldson, the Commission has various initiatives in its pipeline. These initiatives, which relate to disclosure, internal compliance, and fund governance, are as follows:

- **Breakpoint Disclosure** – Chairman Donaldson stated that he has directed the Commission’s staff to draft a rule for Commission consideration that is consistent with recommendations of the Joint NASD/Industry Task Force Report on Breakpoints, which was issued in July, to help ensure that investors receive the appropriate discounts in the future. He additionally noted that the SEC and the NASD intend to continue to investigate and bring enforcement actions, where warranted, in this area.
- **Shareholder Report Disclosure of Operating Expenses** – Chairman Donaldson noted that the SEC has proposed additional disclosure to increase investors’ understanding of the expenses they incur when investing in a mutual fund. As proposed, mutual funds would be required to disclose in their shareholder reports the dollar amount of fund expenses paid by shareholders on a prescribed amount, based on both the fund’s actual expenses and return for the period based on an assumed return of 5% per year.
- **Highlighting Broker Incentives and Conflicts of Interest** – Another issue being considered by the Commission is how to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives being considered by the Commission in this area include a comprehensive revision of mutual fund confirmation form requirements that, as envisioned by Chairman Donaldson, would require disclosure of revenue sharing arrangements, incentives for selling in-house funds, and other inducements for brokers to sell fund shares “that may not be immediately transparent to fund investors.”
- **Mutual Fund Compliance Rule** – Chairman Donaldson noted that, in February, the Commission published for comment proposed rules that would mandate that funds and investment advisers maintain comprehensive compliance policies and procedures that are reasonably designed to prevent violations of the federal securities laws. According to Donaldson’s testimony, while the proposal does not include specific elements funds must include in their compliance programs, the Commission “would expect funds to have policies and procedures to address pricing of portfolio securities and fund shares; processing of fund shares on a timely basis; portfolio management processes, including allocation of investment opportunities among clients; the accuracy of disclosures made to investors in fund prospectuses (disclosures that would include representations regarding market timing policies and procedures); and processes to value client holdings and assess fees based on those valuations.” He expects the Commission to consider adoption of these requirements “later this fall.”
- **Director Nomination Rules** – Chairman Donaldson next discussed rule changes the Commission proposed last month to strengthen disclosure requirements relating to the nomination of directors and shareholder communications with directors. He noted that these proposals that apply to both operating companies and mutual funds. According to the Chairman, these rules will benefit fund shareholders by improving the transparency of the nominating process and board operations, as well as by increasing shareholders’ understanding of the funds in which they invest. Chairman Donaldson further indicated that he expects the Commission to propose rules shortly that would allow shareholders to nominate directors in certain circumstances, and that these rules will apply “with equal force” to mutual funds.

Updates on Other Issues Chairman Donaldson then provided updates to the Committee on the following topics:²

- **Hedge Fund Report** – Chairman Donaldson noted that, earlier this week, the Commission released a staff report that outlines the staff’s factual findings concerning the current system of hedge fund regulation and oversight. The report identifies concerns with the current system and discusses other action that may be taken to improve it. The staff’s primary recommendation is that the Commission should consider revising its rules to require that

hedge fund advisers register under the Advisers Act. Chairman Donaldson reiterated his own view that the Commission needs to have a means of examining hedge funds and how they operate and noted that registration of hedge fund advisers would accomplish this. He said that the next step is for the Commission to consider the staff's recommendations and determine how it wishes to proceed.

- **Canary Investigation** – Under this heading in his testimony, Chairman Donaldson updated the Committee on the SEC's enforcement and regulatory initiatives relating to recent allegations involving a hedge fund's late trading of mutual funds and questions concerning funds permitting market timers to arbitrage the funds:
- **The Commission's Enforcement Efforts** – Chairman Donaldson noted that the Commission has filed a civil action against a salesperson who was the hedge fund's primary contact at one of the firms implicated in this matter. According to Chairman Donaldson, the Commission will aggressively pursue those who have injured investors as a result of illegal late-trading and/or market-timing activity and, where possible, seek recompense for those investors in connection with mutual fund transactions. He noted that the Commission has sent detailed information requests to registered prime brokerage firms, other large broker-dealers, transfer agents, and 2 In addition to those topics listed below, Chairman Donaldson also discussed, under the heading of "NYSE/Corporate Governance," the critical need for sound governance practices by self-regulatory organizations. 4 the 80 largest mutual fund complexes in the country seeking information on their policies and procedures relating to market timing and late trading, and has sought information from mutual funds "susceptible to market timing" regarding their use of fair value pricing procedures to combat this activity.
- **The Commission's Regulatory Efforts** – Chairman Donaldson noted that, in addition to its enforcement efforts, the Commission is determining whether it should pursue additional regulatory measures to thwart abusive activity. In particular, the staff is studying whether the Commission needs to take additional steps to: (1) pursue measures to prevent the circumvention of forward-pricing requirements for fund shares and market timing restrictions; (2) require funds to have written policies and procedures to address short-term trading in their shares; (3) require improved disclosure regarding market timing procedures; (4) provide funds with additional tools to deter market timing activity; and (5) address concerns related to the selective disclosure of fund portfolio information. Following the hearing, the Institute's Chairman and President each issued a statement commending Chairman Donaldson for his efforts to protect investors and ensure that mutual funds continue to serve investors effectively in the years ahead.³

Tamara K. Salmon Senior Associate Counsel 3 A copy of these statements may be found on the Institute's website at: http://www.ici.org/statements/nr/03_news_donaldson_tmny.html#TopOfPage