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ROYE AND FINK REMARKS AT 2001 MUTUAL FUNDS CONFERENCE

[13325] April 2, 2001 TO: BOARD OF GOVERNORS No. 15-01 DIRECTOR SERVICES COMMITTEE No. 3-01 PRIMARY CONTACTS - MEMBER COMPLEX No. 25-01 SEC RULES MEMBERS No. 27-01 RE: ROYE AND FINK REMARKS AT 2001 MUTUAL FUNDS CONFERENCE Paul F. Roye, Director of the Securities and Exchange Commission's Division of Investment Management, and Institute President Matthew P. Fink each delivered a keynote address at the 2001 Mutual Funds and Investment Management Conference. Copies of their speeches are attached, and they are summarized below. Paul Roye's Address In his address, Mr. Roye focused on: (i) recent Commission actions impacting the mutual fund industry, such as the fund governance rules, the Division of Investment Management's fee study and disclosure of after-tax returns; (ii) issues the Division hopes to address during the next year, including shareholder communications, providing flexibility in the affiliated transactions area and revising the rules governing fund advertising; and (iii) various Commission initiatives, such as monitoring hedge funds, new products and technologies, and reviewing the Division's processes. Recent Actions With respect to the fund governance rules, Mr. Roye expressed the view that the Commission's initiatives give fund directors the tools, access and power they need "to fulfill their legal duty and moral mandate as shareholder representatives." He noted that "there are limits to what SEC rules can and/or should do" and thus encouraged fund groups to review their fund governance framework and "embrace the ICI's best practice recommendations for fund governance." Mr. Roye then briefly summarized the findings and recommendations in the Division's fee study. He highlighted the staff's recommendation that the Commission review the requirements of Rule 12b-1, stating that "modifications to Rule 12b-1 may be needed to reflect changes in the manner in which funds are marketed and distributed." In addition, the Commission should consider whether to give additional or different guidance to fund directors 2with respect to their review of Rule 12b-1 plans, "including whether the factors suggested by the 1980 adopting release are still valid." Mr. Roye encouraged the industry and others "to weigh in and provide thoughts and ideas as to how Rule 12b-1 should be modified." On the topic of after-tax disclosure, Mr. Roye detailed the Commission's various reasons for standing firm on the use of the highest federal tax bracket for the after-tax return calculation. He also emphasized that using the short-term capital gains rate for the one-year after-tax return number is relevant to inform investors of the tax consequences of short-term trading, and that "the most logical place" for the disclosure of after-tax numbers is alongside the fund's pre-tax returns. Current Issues Mr. Roye reported that the staff is continuing to study how to improve shareholder reports and financial statement presentations. With regard to the recent focus on the disclosure of portfolio holdings, Roye acknowledged that "there are costs, burdens and risks that must be considered," and stated that a better alternative to more frequent disclosure to all shareholders "might be to provide the information more

frequently only for those shareholders that request it, or to use technology such as the Internet to meet the needs of shareholders who want this additional information." Regarding affiliated transactions, Mr. Roye described recent no-action letters whereby the staff has attempted to provide flexibility in this area. Roye noted that the staff is continuing its review of the need for rules that would permit certain other affiliated transactions to proceed without the need for exemptive relief, including proposed amendments to expand the scope of Rule 17a-8, which involves fund mergers, and a rule that would codify exemptive relief given to permit funds to invest cash in affiliated money market funds. Mr. Roye indicated that the Division expects to recommend that the Commission propose amendments to Rule 482 "to enhance funds' ability to provide investors with better and timelier information in fund advertising," and eliminate the requirement that the substance of the information contained in advertisements be included in the statutory prospectus. Roye stated that Rule 482 revisions also "will serve as an occasion to remind funds that technical compliance with the rule may nevertheless run afoul of the antifraud prohibitions of the federal securities laws." In connection with this proposed rulemaking, Roye stated that the staff has been "exploring how to promote the use of more current performance information," with the ultimate goal of seeking to promote balance and responsibility in fund advertising. Prior to this rulemaking, Roye confirmed, the staff plans to publish a legal bulletin "that will remind funds that their advertisement should not mislead investors and that mere compliance with Rule 482 is not the end of the analysis." Commission Initiatives Mr. Roye acknowledged the Institute's concerns regarding inappropriate hedge fund activities, and informed attendees that the Commission is monitoring carefully (i) the conflict of interest issues and the potential for abuse involved with fund managers sponsoring and advising hedge funds and other alternative investments, and (ii) "those mutual funds that are using hedge fund type strategies, such as short selling, and the aggressive use of leverage and derivatives." Roye also announced that the staff is working on a concept release regarding actively managed exchange traded funds ("ETFs"). The staff's goal is "to gain a better 3understanding of the various perspectives on the issues surrounding actively managed ETFs," to enable them to better evaluate any proposals for these types of products as they are presented through the exemptive process on a case-by-case basis. Roye also emphasized the Commission's dedication to fighting Internet securities fraud, and discussed OCIE's current sweep of Internet advisers that is aimed at gaining a better understanding of how these advisers operate, and monitoring their compliance with the federal securities laws. In addition, Roye reported that the staff is currently analyzing whether "so-called web-based baskets of securities … are appropriately regulated and how they fit within the federal securities laws." In conclusion, Mr. Roye announced that the Division's Deputy Director is undertaking a review of the Division's systems and procedures "to make recommendations as to how we can improve the way in which we service registrants, respond to investors and fulfill our responsibilities" – in short, to enhance the staff's ability to "work smart." Matt Fink's Address In his address, Mr. Fink shared his views on what the industry and its regulators must do to maintain the industry's tradition of trust and excellence and continue to be, in the words of President Theodore Roosevelt, "wise on time" for investors. Based on the theory that "we can't focus only on perfecting mutual fund regulation without considering the larger universe of investment management products and services in which mutual funds operate," Mr. Fink focused his remarks on hedge funds, Internet advisory services, and disclosure. He also spoke about needed reform in the Commission's administration of the self-dealing prohibitions of Section 17 of the 1940 Act. Mr. Fink stated that the fallout from the collapse of unregulated hedge funds, such as Long Term Capital Management, affects all investors, not just those sophisticated investors who knowingly accept such risks. He noted that some hedge fund advocates are suggesting that hedge funds have "outgrown" their offering and advertising

restrictions, leading to plans for an on-line hedge fund supermarket and suggestions that broad-based marketing of hedge funds would not put small investors at risk. Mr. Fink also mentioned “ominous reports that some individual sales personnel are trying to circumvent the law by pooling the assets of small investors to meet the financial thresholds for hedge fund investing.” Calling for the application of “basic, common sense controls” of hedge funds, Mr. Fink recommended two things the industry must do to be “wise on time” for investors in this area: (i) require adequate disclosure of hedge fund operations, and (ii) ensure that the safeguards established by Congress in 1940 and 1996 are not “leached away through mass advertising of risky pools that are unsuitable for all investors.” Mr. Fink remarked that, while technology “is a tremendous boon for investors” it also creates “significant dangers for the unwary.” He therefore urged the SEC to consider a review of how technology is changing the ways Americans obtain investment advice and review online services to see if the Commission needs to modify its rules or seek additional statutory authority to address investor protection concerns. While specifically not advocating that every element of Advisers Act regulation be applied to all on-line advisory services, or that every Investment Company Act regulation be immediately imposed on all discretionary advisory programs, Mr. Fink encouraged taking a “hard look” at whether technological developments 4are leading to the creation of products and services that, “when examined functionally, implicate the vital policy concerns at the heart of these two statutes.” On the topic of disclosure, Mr. Fink pointed out that a variety of managed investments, such as commingled retirement funds, wrap accounts, variable insurance accounts and individually managed accounts, all essentially offer investors the same services, although “the content and the frequency of the disclosure received by investors varies from product to product.” Mr. Fink therefore cautioned that being “wise on time” for investors requires that “all investors, not just those who invest in mutual funds, receive full and fair disclosure.” With respect to Section 17(a), Mr. Fink noted that dedication to the 1940 Act’s core principles and ongoing opposition to efforts to repeal Section 17(a) should not “translate into inflexible adherence to archaic, technical restrictions if they no longer fit the reality of modern markets.” Mr. Fink therefore encouraged the staff to change certain restrictions on affiliated transactions that no longer make sense, in order to better serve investors. Doretha VanSlyke Zornada Assistant Counsel Attachments Note: Not all recipients receive the attachments. To obtain copies of the attachments to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachments for memo 13325. ICI Members may retrieve this memo and its attachments from ICINet (http://members.ici.org). Attachment no. 1 (in .pdf format)
