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MUTUAL FUND INDUSTRY Y2K PREPAREDNESS SUBJECT OF SENATE SPECIAL COMMITTEE HEARING

1[10338] September 30, 1998 TO: BOARD OF GOVERNORS No. 64-98 FEDERAL LEGISLATION MEMBERS No. 24-98 OPERATIONS COMMITTEE No. 38-98 PRIMARY CONTACTS - MEMBER COMPLEX No. 86-98 PUBLIC INFORMATION COMMITTEE No. 44-98 SEC RULES COMMITTEE No. 95-98 RE: MUTUAL FUND INDUSTRY Y2K PREPAREDNESS SUBJECT OF SENATE SPECIAL COMMITTEE HEARING

____ On September 17, the Institute and several mutual fund industry representatives testified before the Senate Special Committee on the Year 2000 Technology Problem regarding the Year 2000 preparedness of the mutual fund and pension industries. Witnesses from the Securities and Exchange Commission, the Pension and Welfare Benefits Administration, the Securities Industry Association and other companies also testified. Copies of the opening statements of Chairman Robert Bennett (R-UT) and Vice-Chairman Christopher Dodd (D-CT) and the testimony of the Institute, the SEC and other mutual fund industry witnesses are available upon request. The hearing was one in a series held by the Special Committee to determine the Year 2000 preparations of government and business. In his opening statement, Chairman Bennett said the Committee focused this hearing on mutual funds because they represent the primary vehicles through which most Americans invest in the stock market. He emphasized the seriousness of the Y2K risks for participants in the financial services industry—from bank customers to stock market investors. Chairman Bennett also said it is important for investors to receive useful information about the Y2K readiness of the financial services industry and the businesses in which they invest. In addition, the Chairman spent significant time questioning the witnesses on the impact of the Year 2000 on the global securities market and on how fund managers address the potential Y2K risks of companies in which they invest. Institute Testimony Institute President Matthew P. Fink testified that Year 2000 compliance is a very high priority for mutual fund firms and emphasized that the industry’s continued success depends on maintaining investor confidence. Fund firms have been engaged for some time in internal efforts to identify and remedy Y2K problems and many fund firms have dedicated Y2K staffs, separate Y2K budgets and a program of regularly updating fund boards on Y2K compliance. The Institute testified that when considering the Year 2000 issue in the context of the mutual fund industry, it is important to bear in mind three points: 2! The existing stringent regulatory structure for mutual funds. The Investment Company Act of 1940 requires mutual funds to set their prices and be prepared to buy back shares from investors every business day. Thus, while all businesses may jeopardize customer relationships because of Y2K, mutual funds additionally run the risk of failing to comply with extensive legal requirements if they are not prepared for Y2K. ! The fund industry's extensive experience with computer operations. The fund industry, as a matter of regular business, has extensive experience dealing with large-scale computer operations modifications. ! The arrival of Y2K will have no impact on the protections afforded to mutual fund investors. Fund-related Y2K problems, if any, would likely be minor and in the nature of delayed statements or other temporary administrative glitches. The testimony also details funds' internal and industrywide efforts to become Y2K compliant, including private testing of interfaces with service providers and "street-wide" testing coordinated by the Securities Industry Association and the National Securities Clearing Corporation. The testimony also cites the industry's disclosure efforts with investors and regulators, particularly through prospectuses, websites, newsletters and brochures, and by telephone. Finally, the Institute applauded the strong leadership of Senator Bennett and the Senate Special Committee on the Year 2000 Technology Problem and the SEC's efforts to promote meaningful Y2K disclosure by securities issuers. SEC Testimony Laura Unger, Commissioner of the Securities and Exchange Commission, testified that the mutual fund industry is well aware of the potential problems that Y2K presents and is preparing to meet the challenge in a timely manner. Unger said, "Funds and advisers appear to be expending the effort and resources necessary to ensure Year 2000 compliance." She also detailed recent Commission initiatives to address the Y2K issues that pertain to the mutual fund industry, including guidance on disclosure obligations, nationwide examinations focused on Y2K compliance and various other regulatory measures. At the end of September, Unger said, the Commission expects to take final action on a proposed rule that would require all registered investment advisers, including investment advisers to mutual funds, to report on the funds' and the advisers' Y2K readiness. TIAA-CREF Testimony James A. Wolf, Executive Vice President of TIAA-CREF, described his company's Y2K efforts, which involve a five-step process of awareness, assessment, renovation, validation and implementation. He said TIAA-CREF's preparations began in 1996, encompassing internal and external system interfaces under the supervision of the firm's trustees, senior management and internal auditors. Mr. Wolf told the Committee that his firm's focus has now turned to external interfaces with vendors, ensuring services and products are Y2K compliant. Most recently, a test using simulated Year 2000 data proved successful—it included processing monthly retirement income benefits payments, one of the firm's most critical aspects of readiness for customers. 3The testimony also detailed the importance with which TIAA-CREF views its communications with individual and institutional customers and its employees on its Y2K efforts. Fidelity Investments Testimony Bert E. McConnell, Senior Vice President of Fidelity Investments and head of the Fidelity Year 2000 program, said that the process of ensuring Y2K compliance involves extensive testing internally as well as with external vendors. He detailed Fidelity's efforts, noting that the firm has more than 500 dedicated Y2K staff representing every Fidelity business unit and a devoted budget of more than $300 million. He reported that his firm was well on the way to meeting a goal of seamless processing for all Fidelity applications, including uninterrupted business operations and services to customers into the Year 2000. Mr. McConnell also detailed Fidelity's three-phase plan for testing, which he said is the main challenge in Y2K preparations, and he focused on the company's global efforts. Mr. McConnell agreed with the Institute's testimony that Year 2000 is critical not only for financial services firms, but also for those companies in which mutual funds invest. He said that a mutual fund's overriding obligation when choosing investments is maximizing shareholder value consistent with the fund's investment objective. Fidelity seeks to identify and evaluate all factors having an impact on a company's value, including Y2K preparations. Nonetheless, McConnell said Fidelity believes it inappropriate to impose specific Year 2000 obligations on fund managers when assessing investment risk. State Street Corporation Testimony John R. Towers, Executive Vice

President for Global Operations at State Street Corporation, focused on the services his firm provides to the mutual fund industry as a custodian and investment manager. State Street's day-to-day support of the mutual fund industry depends upon a technology infrastructure with state-of-the-art processing and backup systems. Since State Street and similar global financial firms must constantly upgrade and recode software to accommodate shifting customer and market needs, technological challenges like Y2K are basic to their business. Regarding whether investment management firms should consider Y2K preparations of a company in which they intend to invest, Mr. Towers said proposed legislation or regulation that focuses exclusively on Y2K might obscure or subordinate other risks to the detriment of all. He said, for example, where a fiduciary does not have investment discretion—such as with a 401(k) or index mutual fund—a specific Year 2000 obligation may be inconsistent with the purpose of the investment or outside the fiduciary's discretion. State Street believes that guidance recently issued by the Federal Financial Institutions Examination Council (FFIEC) should serve as a model for governmental response to the Y2K risks of fiduciaries. The FFIEC guidance recognizes that a fiduciary's responsibilities are determined by applicable law, such as ERISA, and the particular goals of a retirement fund or trust instrument. Mr. Towers closed by praising legislators and regulators for raising the nation's awareness of Y2K, and supported efforts designed to encourage cooperation and openness among all parties, such as "The Year 2000 Information Disclosure Act" and an SEC interpretive release providing safe harbors to businesses engaged in Y2K information sharing. The Capital Group Companies Testimony 4Thomas M. Rowland, Senior Vice President-Central Services Group of The Capital Group Companies, Inc., said the fund industry's recent success has led to significant investment in new technology that is less susceptible to Year 2000 issues and gives the industry an advantage in dealing with the problem. Mr. Rowland also detailed Capital Group's Y2K efforts, saying his firm plans to complete internal Y2K compliance by December 31, 1998. He emphasized the breadth of the issue, pointing out that even office facilities—including building security systems, clock-controlled lighting and temperature controls, elevators and power grids—used by Capital Group Companies are being examined for possible Year 2000 problems. After internal compliance is assured at the end of 1998, the company plans to shift its primary focus to outside vendors and contingency plans. Capital Group's testimony emphasized the interconnections and interdependencies inherent to the fund industry and the need to anticipate external events, particularly on the global level. Mr. Rowland noted that despite careful planning, there may be no way to eliminate these concerns entirely, so companies such as Capital Group must develop solid contingency plans to maintain certain business functions. In some cases, Capital Group is replacing vendors in advance of potential problems. With respect to the Y2K readiness of companies in the Capital Group's client portfolios, Mr. Rowland stated that research analysts and portfolio counselors are reviewing public disclosures and making inquiries of management. He noted that Capital Group seeks to invest in well-managed companies with good prospects for the future and that such companies are more likely to address Y2K issues in a responsible and effective manner. It would be inappropriate, in the Capital Group's view, to consider statements about Y2K to the exclusion of other, equally pertinent investment considerations. DST Systems Testimony Michael A. Waterford, Group Vice President of DST Systems, Inc., detailed the wide range of products and services—especially shareholder recordkeeping—that his firm provides to mutual funds and other financial services companies. Over the past decade DST has invested hundreds of millions of dollars in its infrastructure and systems to address the growing needs of mutual funds. In 1989, DST initiated Y2K preparations and the process has gained momentum in the intervening years. In his testimony, Mr. Waterford said DST's internal Y2K readiness should be completed by December 31, 1998, a deadline set partially because the firm expects testing with clients, the fund industry and other third parties will occupy much of 1999. To DST, the Y2K preparation is more of a logistical problem than a technological one: it lies in coordinating and sequencing all projects across a large organization and beyond. DST expects to continue testing with clients and other third parties well into 1999. So far, said Mr. Waterford, the testing has been encouraging and few problems have occurred. He said that DST believes that Y2K readiness will require significant management attention and resources at least through early 2000. * * * * * The Senate Special Committee on the Year 2000 Technology Problem will hold two more hearings before the Congress adjourns, examining the general preparations of the business community and government. We will keep you informed as these issues continue to develop. 5Matthew P. Fink President Note: If you would like to obtain copies of the testimony referred to in this memo, please call the Institute's Library Services Division at (202)326-8304, and ask for this memo's attachment number: 10338.