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BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ON

"MUTUAL FUNDS: TRADING PRACTICES AND ABUSES THAT HARM INVESTORS"

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EXECUTIVE SUMMARY

- The bedrock principle of the mutual fund industry is that the interests of investors always come first. Consequently, the industry has reacted with shock and outrage to recent allegations of abusive mutual fund trading practices.

- Forceful steps must be taken immediately to restore and reinforce investor confidence. SEC Chairman Donaldson has laid out a blueprint for regulatory reform. The Institute has formed task forces to provide the SEC with a range of possible options to address the alleged abusive mutual fund trading practices.

- ***Late Trading***. The Institute believes that the most effective solution to protect against the possibility of late trading would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time the fund prices its shares (*e.g.*, 4:00 p.m. Eastern time). This approach would significantly limit opportunities for late trading and enhance compliance oversight by funds and regulators.

- ***Market Timing.*** Market timing is not inherently illegal or improper, but because it can be disruptive to portfolio management and can increase trading and administrative costs, funds often employ methods to deter such activity. It has been alleged that some funds were not applying their market timing policies fairly and consistently, and even worse, that some fund insiders may have engaged in market timing, reaping personal benefits at the expense of other shareholders.

  - The SEC is considering various regulatory measures in this area, including (1) requiring funds to have more formalized market timing policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under certain circumstances and (3) reinforcing board oversight of market timing policies and procedures. The industry supports all of these measures.

  - With respect to personal trading activities of senior fund personnel, the Institute is urging its members to clarify or amend their codes of ethics to require oversight of trades by such persons in any mutual funds offered or sponsored by the company.

  - Funds and their shareholders also would benefit if funds had additional "tools" to combat harmful market timing activity. These could include redemption fees higher than the 2% limit currently imposed by the SEC staff and measures that would enable funds to better enforce their market timing restrictions on short-term trading activity within omnibus accounts, such as a mandatory minimum 2% redemption fee on fund shares redeemed within a minimum of 5 days of their purchase.

- ***Selective Disclosure.*** It also has been alleged that some funds may have provided information about their portfolio holdings to certain investors to enable those investors to trade ahead of the funds. One way to address this conduct would be to require funds to adopt board-approved, written policies in this area and to publicly disclose those policies.

- ***Other Initiatives.*** Other current initiatives also will reinforce the protection and the confidence of mutual fund investors, including a proposal to require funds to have compliance programs, changes to the fund advertising rules, proposals concerning portfolio holdings and expense disclosure, measures to ensure that investors benefit from sales charge discounts to which they are entitled and proposed disclosure of revenue sharing arrangements. The industry supports these initiatives.

- The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

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I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 8,664 open-end investment companies ("mutual funds"), 601 closed-end investment companies, 106 exchange-traded funds and 6 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about $6.967 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

I appreciate the opportunity to appear before the Subcommittee today to discuss the issues of late trading and market timing of mutual funds, and the industry's commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

The bedrock principle of the mutual fund industry is that the interests of mutual fund investors always come first. Consequently, the industry has reacted with shock and outrage to the allegations of late trading and market timing in the New York Attorney General's complaint in the Canary case[1] and other recent allegations of abusive mutual fund trading practices. There can be no excuse for knowingly permitting the buying and selling of fund shares at old prices after the market has closed. And while restricting market timing may be easier said than done,

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[1] *State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd., and Edward J. Stern* (NY S. Ct. filed Sept. 3, 2003) (undocketed complaint) ("Canary Complaint").

silently selling to a select few the right to trade fund shares is deeply troubling. Even more abhorrent is the notion that, in some instances, fund insiders themselves may have engaged in market timing to reap personal benefits at the expense of other fund shareholders. The industry commends the New York Attorney General's office and the Securities and Exchange Commission for their investigative efforts and forceful responses to these alleged practices. It is imperative that the ongoing investigations by the SEC and others of these allegations are thorough and successful in rooting out trading activities that have compromised or harmed the interests of individual mutual fund shareholders.

We cannot wait until those investigations are complete, however, to take the steps necessary to restore and reinforce investor confidence in mutual funds. Investor confidence is every mutual fund's most precious asset. The industry earned the confidence of millions of Americans by serving their interests above all other considerations. Unfortunately, the business practices that have been alleged are inconsistent with this principle and are intolerable if mutual funds are to serve individual investors as effectively in the future as they have in the past. Forceful action will be the key to restoring and reinforcing investor confidence. The broad elements of what must be done to reassure investors are as follows:

- First, government officials must identify everyone who violated the law. Forceful and unambiguous sanctions must be delivered swiftly wherever punishment is warranted.
- Second, if shareholders were harmed because of illegal or deceptive business arrangements, these wrongs must be made right.
- Third, any gaps in the otherwise strict system of mutual fund regulation must be identified and effectively addressed.

With respect to the last point, SEC Chairman Donaldson has announced plans to propose tough new regulatory requirements addressing the late trading and abusive short-term trading of mutual fund shares.[2] The SEC also will consider whether additional requirements are necessary to address the issue of selective disclosure of portfolio holdings information. The industry pledges its full support of the SEC in whatever course of action it determines will best protect mutual fund shareholders.

To help advance this objective, the ICI's Board of Governors established two separate task forces to identify specific options to address the issues of late trading and abusive short-term trading involving mutual fund shares. The findings of the task forces are being provided to the SEC and other regulators and government officials.

Mutual funds themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have initiated internal investigations, hired independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards and shareholders. In addition, some fund boards have retained independent third parties to conduct investigations. As a result of these investigations, several funds have terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. These actions reinforce that funds take very seriously their obligations under the federal securities laws and the fulfillment of their responsibility to make sure that investors' interests always come first.

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[2] *See* SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003-136 (Oct. 9, 2003) ("Donaldson Statement").

The remainder of my testimony will focus on the issues of late trading and abusive short-term trading of mutual fund shares. I also will discuss the practice of selectively disclosing information about fund portfolio holdings to shareholders, and oversight of hedge funds. Finally, I will discuss other initiatives to reinforce the protection and confidence of mutual fund investors.

II. LATE TRADING

A basic tenet of mutual fund investing is the concept of "forward pricing." Mutual funds are required to price their shares at least once each day, at a time or times designated by the fund's board of directors and disclosed in the fund's prospectus. Most funds price their shares as of 4:00 p.m. Eastern time, the close of regular trading on the New York Stock Exchange. All purchase and redemption orders received by a fund or its agents before 4:00 p.m. must receive that day's price. All orders received after 4:00 p.m. must receive the next day's price. The requirement that a purchase or redemption order be priced based on the fund's net asset value (NAV) next computed after receipt of the order is known as the "forward pricing" rule. The SEC adopted this rule in 1968 because it recognized that "backward pricing" (purchases and sales of fund shares at a previously determined NAV) could lead to dilution of the value of fund shares and could be susceptible to abuse in that it could allow speculators to take advantage of fluctuations in the prices of the fund's portfolio securities that occurred after

the fund calculated its NAV.[3] Unfortunately, the recent allegations of late trading appear to bear this out.

Under current SEC rules and staff interpretations, funds may treat the time of receipt of an investor's order by a person designated by the fund (such as a dealer) as the relevant time for determining which price the order will receive.[4] Thus, it is common industry practice for intermediaries such as broker-dealers, banks and retirement plan administrators to transmit their clients' purchase and redemption orders that were accepted before 4:00 p.m. to a fund for processing after 4:00 p.m. at that day's price.

Given the alleged abuses that recently have come to light, the Institute believes that existing regulations should be tightened to better protect against the possibility of late trading. The most effective solution to this problem would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (*e.g.*, 4:00 p.m. Eastern time).[5] While such a requirement could have a significant impact on the many investors who own mutual funds through financial intermediaries,[6] the recent abuses indicate that the strongest possible measures are necessary to ensure investor protection. A 4:00 p.m.

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[3] *See* Investment Company Act Release No. 5519 (October 16, 1968).

[4] *See, e.g.,* Investment Company Act Release No. 5569 (December 27, 1968).

[5] As noted above, most funds price their shares as of 4:00 p.m. Eastern time. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders before that time.

[6] Institute data show that the vast majority (approximately 85-90 percent) of mutual fund purchases are made through such intermediaries, including both financial advisers and employer-sponsored retirement plans. *See* Investment Company Institute, 2003 Mutual Fund Fact Book, at 38. A 4:00 p.m. cut-off time at the fund will require intermediaries to apply an earlier cut-off time to the mutual fund orders they receive. This, in turn, will compress the time period during which investors conducting fund transactions through intermediaries could receive same-day prices. The precise impact likely will vary among different types of intermediaries, and among individual firms. In many cases, investors may no longer have the ability to obtain same-day prices.

cut-off time at the fund would significantly limit opportunities for late trading by narrowing the universe of entities responsible for applying a 4:00 p.m. cut-off time to funds and their transfer agents. In addition to limiting the number of entities involved, it would restrict them to SEC-regulated entities. This would simplify both funds' compliance oversight responsibilities and regulators' examination and enforcement efforts with respect to potential late trading. In doing so, it would likely enhance compliance.

We note that Chairman Donaldson has specifically asked the SEC staff to examine the feasibility of such a requirement.[7] The Institute believes that applying order cut-off requirements to funds and their transfer agents is the best way to address late trading abuses at this time.[8] We urge the SEC to proceed expeditiously to adopt this approach.[9]

III. MARKET TIMING

The ongoing investigations by the SEC and other governmental officials also involve issues relating to "market timing" of mutual funds. It is important to note that "market timing" is not a precisely defined term. Generally speaking, the term refers to a trading strategy involving frequent purchases and sales of mutual funds in an effort to anticipate changes in market prices. There is nothing inherently illegal or improper about such activity.

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[7] Donaldson Statement, *supra* note 2.

[8] In the future, advances in technology may make it possible to devise systems (e.g., a system for "time stamping" mutual fund orders in a way that cannot be altered) that provide a high level of assurance regarding the time of receipt of an order by an intermediary. Nothing would prevent the SEC from revisiting this issue in that event.

[9] We note that a reasonable period of time will be needed to allow all affected entities to make the necessary systems changes to implement new cut-off requirements.

At some level, however, frequent trading activity can be disruptive to the management of a fund's portfolio. For example, frequent trading may compel portfolio managers either to hold excess cash or to sell holdings at inopportune times in order to meet redemptions. This can adversely impact a fund's performance, and increase trading and administrative costs. For this reason, many fund groups have sought to employ a number of methods to try to deter market timing, such as imposing redemption fees, limiting frequent trading, and restricting exchange privileges. Many funds disclose in their prospectus that they do not permit market timing or that they may take steps to discourage it.

Different types of funds are affected differently by short-term trading, and higher turnover of smaller accounts has little effect on portfolio management. Funds also may seek to serve different types of investors; some funds are designed specifically to accommodate short-term trading. Thus, there is no "one size fits all" solution with respect to market timing generally.

The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been alleged that some funds were not applying their market timing policies fairly and consistently. A number of different steps can be taken to address these concerns, which are discussed below.

A. Written Policies and Procedures

SEC Chairman Donaldson has outlined various regulatory measures that the SEC staff is considering to address the alleged practice of funds allowing certain investors to engage in market timing activities in a manner inconsistent with their policies.[10] These measures include new rules and form amendments to (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. The industry fully supports these measures.

While many funds already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area will ensure that they have a system in place designed to address abusive market timing activity. Such a requirement will provide funds with an effective mechanism to implement and police compliance with their policies by, among other things, eliminating (except when expressly permitted) any discretion in dealing with market timers.

Another element of Chairman Donaldson's regulatory action plan is to reinforce the obligation of fund directors to consider the adequacy and effectiveness of fund market timing policies and procedures.[11] For example, fund boards could be required to receive regular reports on how these programs have been implemented. We strongly support reinforcing board oversight in this area.

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[10] Donaldson Statement, *supra* note 2.

[11] *Id.*

Fund shareholders also will benefit from additional prospectus disclosure about a fund's market timing policies by gaining an understanding of how the fund will protect their interests from abusive market timing activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting market timers to the fund's policies.

Additional steps are needed to address alleged abusive market timing activity by fund insiders. As noted above, this conduct, if true, is especially reprehensible. Thus, with respect to personal trading in fund shares by portfolio managers or a fund's senior executives, the Institute is urging all mutual funds to clarify or amend their codes of ethics to require oversight of personal trading activity by these persons in any funds offered or sponsored by the company.

B. Fair Valuation

An issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. Some market timing activity appears to be motivated by a desire to take advantage of fund share prices that are based on closing market prices established some time before a fund's net asset value is set. It has been suggested that one way to address this concern is to require funds to fair value their portfolio securities more often. As part of Chairman Donaldson's regulatory action plan to address detrimental market timing activity, the SEC staff is considering rules that would "emphasize the obligation

of funds to fair value their securities under certain circumstances to minimize market timing arbitrage opportunities."[12]

The Investment Company Act establishes standards for how mutual funds must value their holdings. Funds are required to use market prices when they are available. This is in recognition of the fact that market prices generally are objective and accurate reflections of a security's value. When market prices are not available, funds must establish a "fair value" for the securities they hold. The Investment Company Act places primary responsibility for fair valuation on a fund's board of directors. There is no definition of "fair value" provided in the Act, nor an established or required uniform method for fair value pricing inasmuch as it necessarily calls for professional judgment and flexibility.

In 2001, the SEC staff issued guidance that, among other things, discussed situations in which funds might need to utilize fair value pricing of foreign securities, even where those securities had closing prices in their home markets. In particular, the SEC staff said that, in certain circumstances, a significant fluctuation in the U.S. market (or a foreign market) may require a fund to fair value those securities.[13]

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[12] *Id.*

[13] Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001 ("2001 Valuation Letter").

The rationale underlying the SEC staff's position is the same as that underlying the forward pricing rule discussed earlier in my testimony. To the extent that prices of foreign securities are correlated with changes in the U.S. market, a significant change in the U.S. market that occurs after the time that a foreign market closes can indicate that the closing prices on the foreign market are no longer an accurate measure of the value of those foreign securities at the time the U.S. market closes (*i.e.*, 4:00 p.m., Eastern time). Certain investors may attempt to exploit this situation by engaging in market timing activity. For example, a market timer might purchase shares of an international fund on days when the U.S. market is up significantly, and redeem shares of such a fund on days when the U.S. market is down significantly. Like late trading activity, this can hurt other shareholders in the fund by diluting their interests.

Unfortunately, knowing when and how to fair value foreign securities in these types of circumstances is not an exact science, as there is no way to know for sure at what price those securities would be traded as of 4:00 p.m. Eastern time. Consequently, funds must exercise their best judgment in valuing these securities. If funds fair value these securities too often, they may introduce too much subjectivity into the valuation process. If they don't fair value often enough, they run the risk of exposing their shareholders to losses from market timing activity of the type described above.[14]

In order to appropriately balance these concerns, funds must have in place rigorous, board-approved policies and procedures concerning fair valuation. Some fund groups have developed detailed fair value pricing methodologies in-house; others are utilizing third-party

[14] The potential for these losses can be mitigated by imposing restrictions on market timing.

service providers to assist them in valuing foreign and other securities. Either way, fair value policies and procedures can, and should, be updated as needed; as the 2001 SEC staff letter states, "funds should regularly evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale."[15] The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and to ensure that fund share prices are fair to purchasing, redeeming and existing shareholders.[16]

It is important to note that, while fair valuation can reduce harmful market timing activity, it cannot completely eliminate it. Accordingly, as mentioned above and discussed further below, funds often employ additional methods to deter market timing activity.

C. Tools to Deter Market Timing

The government and regulatory investigations referred to above involved situations where funds allegedly granted exceptions from, or did not enforce, policies against market timing. It is important to note that many funds that are susceptible to market timing have devoted significant resources to efforts to combat such activity. Frequently, however, the various means that funds have employed to deter harmful market timing activity have not proved effective. Funds and their shareholders would benefit if funds had additional "tools" to restrict trading activity that they determine to be harmful to their shareholders. Last year, the

[15] 2001 Valuation Letter, *supra* note 13, at 7.

[16] *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

SEC staff responded favorably to an Institute request to permit funds to delay exchange transactions, in an effort to deter some market timing activity.[17] There are additional methods for combating market timers that the SEC staff should consider permitting funds to employ. One such method would be to permit funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2% limit currently imposed by the staff.

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.,* a broker-dealer or a retirement plan recordkeeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts. The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies en masse. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account."[18]

Steps clearly need to be taken to enable mutual funds to better enforce restrictions they establish on short-term trading when such trading takes place through omnibus accounts. One possible approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request. Another approach would be to require most funds, at a minimum, to impose a 2% redemption fee on any redemption of fund shares

[17] Investment Company Institute, 2002 SEC No-Act. LEXIS 781 (November 13, 2003).

[18] Canary Complaint, *supra* note 1, at par. 46.

within 5 days of purchasing them. If most funds had a minimum redemption fee along these lines, it might be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those redemption fees.[19]

We look forward to working with the SEC and other regulators and industry groups on these matters.

IV. SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

The SEC and other regulators are investigating allegations concerning the selective release by funds of their portfolio holdings to some but not all of a fund's shareholders. In particular, it has been alleged that some funds may have provided information about their portfolio holdings to certain investors in order to enable those investors to trade ahead of the fund, to the potential detriment of the other shareholders. Such conduct, if true, is deplorable. The industry is committed to working with the SEC to determine the best approach to deal with this matter.

One possible way to address this issue would be to require funds to adopt formal written policies in this area. The SEC could require that the policies be approved by the fund's

[19] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees or longer minimum holding periods. As noted above, different types of funds are affected differently by short-term trading; hence, flexibility remains important. In addition, certain types of funds (*e.g.*, money market funds and funds that are designed specifically for short-term trading) should not be required to assess redemption fees.

board and that reports of instances when the information was released be provided to the board on a regular basis. In addition, funds could be required to publicly disclose their policies for releasing portfolio information. This approach would have many benefits. Similar to market timing, requiring funds to adopt formal policies would ensure that they have a system to prevent disclosure that is not in the best interests of shareholders and to police compliance. Board oversight and public disclosure would further enhance compliance with the policies. At the same time, this approach would preserve some flexibility in how funds release information. This is important because many funds release portfolio information for purposes that benefit investors. For example, they may provide it to independent services that analyze mutual funds and to certain intermediaries that provide professional assistance to help investors make decisions such as which funds to invest in and how to allocate their assets among investments.

V. HEDGE FUND OVERSIGHT

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The SEC recently issued a staff report on hedge funds[20] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. The Institute supports this

[20] Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003) ("Staff Report").

recommendation. As the Staff Report indicates, by requiring hedge fund advisers to register, the Commission would be able to more comprehensively and effectively observe the trading activities of the funds managed by such advisers. As a result, the Commission would be in a better position to detect improper or illegal trading practices.[21]

VI. OTHER INITIATIVES

While the regulators have been actively involved in investigating and bringing enforcement actions relating to abusive mutual fund trading practices, as well as considering new regulatory requirements to prevent such practices in the future, it bears noting that these efforts are not the only current regulatory initiatives on behalf of fund investors. Other regulatory reforms, as well as voluntary industry actions, that are underway or have recently been completed also form an important part of overall efforts to reinforce the protection and the confidence of mutual fund investors.

Current initiatives include the following:

Fund Compliance Programs. In February, the SEC proposed a rule to require mutual funds to have compliance programs.[22] Generally speaking, the proposal would require (1) written compliance policies and procedures, (2) identification of persons responsible for administering the policies and procedures, (3) regular review of the policies and procedures,

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[21] *Id.* at 92-95.

[22] *See* Investment Company Act Release No. 25925 (February 5, 2003).

and (4) board oversight of funds' compliance programs. Requirements along these lines could provide an effective way to enhance protections against late trading, abusive short-term trading, and selective disclosure. The Institute generally supports this proposal.[23]

Mutual Fund Advertisements. The SEC recently adopted amendments to the mutual fund advertising rules to require enhanced disclosure in fund advertisements, particularly advertisements containing performance information.[24] Under the new rules, fund performance advertisements will have to provide a toll-free or collect telephone number or a website where an investor may obtain more current performance information (current as of the most recent month-end). In addition, fund advertisements will be required to advise investors to consider the investment objectives, risks, and charges and expenses of the fund carefully before investing and that this and other information about the fund can be found in the fund's prospectus.

Portfolio Holdings and Expense Disclosure. The SEC is expected to adopt soon a proposal that would require funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and that would improve disclosure in fund shareholder reports.[25] As part of this proposal, funds would be required to disclose in their shareholder reports the dollar amount of expenses paid on a $10,000 investment in the fund during the period covered by the report. This disclosure, which would supplement the detailed fee disclosure currently required

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[23] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 17, 2003. In our letter we suggested certain modifications to ensure that the proposed requirement accommodates existing, effective compliance structures. In order for the proposal to achieve its objective of enhancing fund compliance, it is critical that the SEC have the benefit of the input from industry experts and other interested persons.

[24] *See* Investment Company Act Release No. 26195 (September 29, 2003).

[25] *See* Investment Company Act Release No. 25870 (December 18, 2002).

in fund prospectuses, would serve to remind investors about the impact of fund expenses and assist them in comparing the expenses of different funds. The Institute supports this proposal.

Sales Charge Breakpoints. Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which broker-dealers did not give investors the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to several important initiatives, including the formation of a Joint Industry/NASD Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Joint Industry/NASD Breakpoint Task Force recently issued a report making a series of recommendations designed to ensure that processes are in place to ensure that investors receive applicable discounts.[26] The recommendations include additional required disclosure concerning breakpoint discounts. The Institute is working with its members, other securities industry participants and regulators on the implementation of the Breakpoint Task Force's recommendations and is committed to resolving the problems that have been identified for the benefit of mutual fund investors.

Revenue Sharing Arrangements. "Revenue sharing" arrangements involve payments by a fund's investment adviser or principal underwriter out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these

[26] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. Disclosure concerning revenue sharing payments is already required in fund prospectuses, and the Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[27] The NASD recently proposed new point-of-sale disclosure requirements in this area.[28] The NASD proposal also addresses differential cash compensation arrangements, in which a broker-dealer firm pays its registered representatives different rates of compensation for selling different funds. The Institute supports the NASD proposal.[29]

Fund Governance. The recent disturbing revelations have caused some to question the effectiveness of the fund governance system. We do not believe it is fair to place blame upon directors, or the fund governance system. Directors cannot be expected to unearth every instance of wrongdoing, especially if such wrongdoing took place at an unrelated entity. At the same time, it seems apparent that steps need to be taken to enhance the ability of directors to exercise their oversight responsibilities, and some of those steps are discussed above.

Overall, we continue to believe that the system of mutual fund corporate governance has served investors very well through the years. It has even served as a model for reforming the governance of corporate America. In recent years the fund governance system has

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[27] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[28] NASD Notice to Members 03-54 (September 2003).

[29] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated October 17, 2003.

undergone several enhancements. For example, in June 1999, an Institute advisory group composed of investment company independent and management directors recommended a series of fifteen best practices – that went beyond legal and regulatory requirements – to enhance the independence and effectiveness of investment company directors.[30] Subsequently, the SEC adopted rule amendments designed to further strengthen the independence and effectiveness of investment company directors.[31] Last month, at the behest of the Institute's Executive Committee, the Institute's Board of Governors adopted a resolution recommending that Institute member companies adopt additional best practices with respect to (1) the treatment of close family members of persons associated with a fund or certain affiliates as independent directors and (2) the standards for investment company audit committees. The resolution also recommended that Institute members, to the extent they have not already done so, adopt the best practices set forth in the 1999 Best Practices Report.

VII. CONCLUSION

The alleged abusive late trading and market timing activities recently uncovered by the New York Attorney General and the SEC are deplorable. Swift and forceful responses are necessary to make clear that there is no place in the mutual fund industry for those who would put their own interests before those of fund shareholders. The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

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[30] Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) ("Best Practices Report").

[31] SEC Release No. IC -24816 (January 2, 2001).