**STATEMENT OF JAMES S. RIEPE**

**VICE CHAIRMAN**

**T. ROWE PRICE GROUP, INC.**

**BEFORE THE**

**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**

**UNITED STATES SENATE**

**ON**

# REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY:

# UNDERSTANDING THE FUND INDUSTRY FROM THE INVESTOR'S PERSPECTIVE

**FEBRUARY 25, 2004**

## EXECUTIVE SUMMARY

- T. Rowe Price operates its mutual fund business in accordance with the fundamental principle that the interests of our fund shareholders are paramount. Consequently, we have been deeply dismayed by the recent revelations of abusive mutual fund trading practices.

- We support appropriate action by government authorities to redress these abuses, and we commend the SEC for its swift and comprehensive regulatory response. As we have urged for a number of years, it is critically important that the SEC receive increased funding to develop appropriate regulatory initiatives and to carry out its mutual fund oversight and inspection duties.

- We also recognize that the challenge of restoring and maintaining investor trust falls not on the regulators but on those of us in the business of managing and distributing funds. T. Rowe Price takes this responsibility very seriously.

- T. Rowe Price has policies, procedures and practices in place that seek to protect Price Fund shareholders against late trading, abusive short-term trading of mutual fund shares, and selective disclosure of fund portfolio holdings. In response to the recent investigations and enforcement proceedings, we have conducted thorough reviews of our policies, procedures and practices in these areas, which has allowed us to confirm their continuing effectiveness and to implement or consider certain enhancements.

- We have, as always, kept the Price Fund Boards fully informed of our actions and they have played an active oversight role. We have also sought to educate fund investors – through communications on our website, in our newsletter and in fund shareholder reports – about the alleged improprieties and how we protect Price Fund shareholders from these types of abuses.

- The efforts of individual firms such as T. Rowe Price to address the concerns raised by the scandal have been significant and are being supplemented by a series of regulatory initiatives.

- ***Late Trading***. To protect against the possibility of late trading, the SEC has proposed rule amendments that would mandate that all purchase and redemption orders be received by a fund, its transfer agent, or a registered clearing agency before the time the fund prices its shares (*e.g.*, 4:00 p.m. Eastern time). T. Rowe Price supports the SEC's proposed approach, until such time as an electronic trade monitoring process is available that would allow other entities to receive fund orders on behalf of a fund for pricing purposes.

- ***Excessive Short-Term Trading.*** T. Rowe Price also supports the various regulatory measures that the SEC has proposed and/or adopted to address abusive market timing activities, including (1) requiring funds to have more formalized short-term trading policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under appropriate

circumstances and (3) providing a more effective mechanism for board oversight of market timing policies and procedures.

  - With respect to personal trading activities of senior fund personnel, the SEC has recently proposed new code of ethics requirements for registered investment advisers, which T. Rowe Price supports.

  - Funds and their shareholders also would benefit if funds had additional "tools" to combat harmful market timing activity, such as a minimum 2% redemption fee on fund shares redeemed within a minimum of 5 days of their purchase. The SEC is expected to propose requiring such minimums for certain categories of funds and we support this approach, but note the need to provide a sufficient time period for implementation.

- ***Fund Governance.*** The recent disturbing revelations do not evidence a failure of the fund governance system but they do indicate that fund directors would benefit from additional tools to assist them in serving effectively in their oversight role. The mutual fund compliance program rule recently adopted by the SEC will have a significant and far-reaching impact on improving the compliance environment and enable fund directors to more readily oversee this important activity. Certain proposals to "improve" fund governance are, however, unwarranted, unrelated to the abuses that have been revealed and counterproductive, such as mandating that all fund boards have an independent chair and requiring independent directors to make certifications relating to matters outside the scope of what they could reasonably be expected to know.

- ***Other Initiatives.*** In addition to internal measures and regulatory changes to protect investors against the abusive mutual fund trading practices that have been the subject of recent investigations and enforcement proceedings, it is appropriate to consider other ways to reinforce the protection and confidence of mutual fund investors. In this vein, the SEC recently proposed, and T. Rowe Price supports, rule amendments to ban the practice of directing fund brokerage transactions to reward broker-dealers who also sell fund shares. In addition, the SEC has embarked on a prudent and timely reevaluation of Rule 12b-1. Finally, the SEC has proposed to require broker-dealers to provide a separate document to mutual fund investors at the point of sale that will help inform them about sales-related fees and payments and alert them to possible conflicts of interest.

- T. Rowe Price is committed to protecting our fund shareholders against abusive mutual fund trading activities. We support those government and industry efforts which are designed to address these issues and other initiatives that will promote investors' interests. We are fortunate that investor confidence in mutual funds generally remains very high, but we must take advantage of the current problems to make improvements that will guard against future breaches of trust and allow our fund shareholders to be confident that their interests come first.

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## I. INTRODUCTION

My name is James S. Riepe. I am Vice Chairman of T. Rowe Price Group, Inc., a Baltimore-based firm that, through its affiliates, provides investment management services to the T. Rowe Price family of no-load mutual funds and to individual and institutional clients. In addition, I am Chief Executive Officer of each of the Price Funds and the Chairperson of all the Price Fund Boards. T. Rowe Price acts as sponsor, investment adviser and distributor of 108 mutual funds and variable annuity portfolios which, as of the end of 2003, exceeded $120 billion in assets. In total, T. Rowe Price manages approximately $190 billion in assets.

I appreciate the opportunity to appear before the Committee today to discuss the ongoing efforts of my firm, and the mutual fund industry as a whole, to respond to abusive mutual fund trading practices by taking concrete and far-reaching actions to protect investors' interests and prevent future abuses. I also note that my comments come from the perspective of having been engaged in the mutual fund business for the last thirty-five years.

T. Rowe Price operates its mutual fund business in accordance with the fundamental principle that the interests of our fund shareholders are paramount. Our fundamental thesis is a simple one: if shareholders prosper then we, as managers, will do likewise; if they do not see value in an investment relationship with us, then our business will do poorly. This principle is applied through formal, documented policies, including a comprehensive Code of Ethics, but, perhaps more importantly, it is also deeply ingrained within the firm's culture. In this context, it is important to understand that one cannot regulate ethical behavior, no matter how extensive the compliance regulations. Ultimately, each of us must create an environment in which the

right decisions are made by our employees. Given our culture, and the industry's previously clean record, my colleagues and I were shocked and deeply dismayed by the allegations of late trading and short-term trading in the New York Attorney General's complaint in the Canary case[1] and subsequent allegations of these and other abusive mutual fund trading practices. It is difficult to fathom that persons associated with our industry – fund managers and intermediaries – would knowingly permit the blatantly illegal buying and selling of fund shares after 4:00 p.m. It is equally troubling that some fund companies allegedly entered into arrangements that authorized short-term market timing in apparent contravention of stated policies in exchange for promises of other benefits to the fund manager. Perhaps most disturbing of all are the revelations that a few fund insiders may have engaged in short-term trading for their own personal benefit, again in contravention of stated policies and potentially at the expense of other fund shareholders.

I commend the Securities and Exchange Commission and the New York Attorney General's office for their investigative efforts and forceful responses to these practices. However, the marketplace impact on the fund companies involved, caused by the disclosure of abuses, has been so severe that it far exceeds the regulatory penalties. This has been a reminder to all of us how important is the implied bond of trust between the investor and the fund manager.

I also commend the SEC for taking swift and sweeping actions on the rulemaking front to address the abusive practices that have been discovered, and to otherwise strengthen mutual

[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).

fund regulation. I believe the SEC's current far-reaching and aggressive mutual fund regulatory reform agenda is unprecedented.

Of course, in order for the SEC to develop appropriate regulatory initiatives to respond to the trading abuses that have occurred, and to successfully carry out its oversight and inspection duties with respect to mutual funds, it is critically important that the SEC have sufficient resources. Consistent with this, I strongly support the Bush Administration's proposed FY 2005 budget for the SEC, which would provide a significant and necessary increase over the record amount appropriated for the current fiscal year. I note that T. Rowe Price, and the fund industry generally, has argued for increased SEC resources for many years. Funds have historically generated SEC registration fees far in excess of the monies spent on regulating and examining fund companies and related entities.

In addition to the important work of the SEC and other government authorities in redressing mutual fund abuses, however, the challenge of restoring and maintaining investor trust falls squarely on the shoulders of the industry itself. T. Rowe Price and other mutual fund firms take this responsibility very seriously. In this regard, we are heartened by the fact that investors have not found fault with the fundamental features of funds – convenience, low cost, diversification and professional management. This is evident in our thousands of conversations with investors each day and by the continued flow of tens of billions of dollars into equity, bond and money market funds.

The remainder of my testimony will (1) describe what T. Rowe Price has done to protect its fund shareholders' interests against late trading, abusive short-term trading of mutual fund

shares, and the practice of selectively disclosing information about fund portfolio holdings to shareholders and (2) discuss regulatory initiatives in these areas. I will also comment on hedge fund oversight and fund governance issues, as well as certain other current initiatives to reinforce the protection and confidence of mutual fund investors.

## II. RESPONSE TO MUTUAL FUND TRADING ABUSES

Since news of the mutual fund trading abuses first broke, T. Rowe Price, like most other firms, has conducted thorough reviews of our firm's policies, procedures and practices in the principal areas that have been implicated in the various enforcement proceedings and investigations that have been announced to date. This has allowed us both to confirm the continuing effectiveness of our existing policies, procedures and practices and to make or consider certain enhancements. Throughout this process, we have kept the Price Fund Boards fully informed of our actions and they have played an active oversight role. Indeed, since the initial revelations, we have held three meetings of the Fund Boards in addition to our regularly scheduled meetings.

In addition to keeping the Fund Boards informed and involved in this process, we believe it is important for investors to understand these improprieties and how we protect Price Fund shareholders from these types of abuses. To this end, we posted a statement on our website last fall emphatically condemning the practices and additional abuses that have been revealed or alleged in these investigations. The statement, which has been continually updated, includes questions and answers about the practices that are under investigation and T. Rowe Price's policies in these areas. We have also updated shareholders on these issues in our

newsletter and in the Chairman's letter included in the funds' most recent annual reports to shareholders. Based on what I have seen and heard, it is my impression that most industry participants have developed communications for their investors.

**A. Late Trading**

Consistent with existing legal requirements, our mutual fund trading policy, delineated in our fund prospectuses, requires that fund transaction orders received prior to 4:00 p.m. Eastern time (the time as of which we price our funds) be executed at that day's share price. Orders received after 4:00 p.m. Eastern time are executed at the following day's price. This policy also applies to shareholders who place their orders through intermediaries such as brokers and retirement plan record keepers (*i.e.*, orders received by intermediaries before 4:00 p.m. will get that day's price). Under current law, these intermediaries are authorized to transmit their customer orders to T. Rowe Price after 4:00 p.m. for processing at that day's closing price, provided that the intermediary received the orders before that time. Our firm has not and will not enter into any arrangements with investors or intermediaries that authorize post-4:00 p.m. trading.

In light of recent revelations of "late trading" of mutual fund shares, our Internal Audit Department conducted a review of our established policies, procedures and practices with respect to the timely receipt of orders to purchase or redeem fund shares and determined that they are sound. This review and the findings were discussed with the Price Fund Boards.

In addition, given the alleged instances of late trading involving transactions conducted through intermediaries, we have taken steps to improve our oversight of intermediaries with whom we conduct business. In particular, we formed an Intermediary Oversight Committee which is charged with:

- overseeing the relationships with intermediaries;
- maintaining and enforcing our policies regarding intermediaries;
- resolving any material issues relating to intermediaries; and
- taking action to terminate intermediaries that fail to meet our compliance standards.

T. Rowe Price has also required each intermediary with whom we have trading agreements (currently over 200) to sign and return a certification that it is complying with all relevant rules and regulations regarding the handling of orders for the Price Funds on a timely basis.

The SEC, for its part, has proposed to address late trading through rule amendments that would tighten existing regulations to require that all purchase and redemption orders be received by a fund, its transfer agent, or a registered clearing agency before the time of pricing (*e.g.*, 4:00 p.m. Eastern time).[2] T. Rowe Price supports the SEC's proposal. Although this approach could have a significant impact on many investors who own fund shares through financial intermediaries, the recent abuses indicate that strong measures are necessary to ensure

[2] *See* SEC Release No. IC-26288 (December 11, 2003).

investor protection. However, it is our expectation that an electronic trade monitoring mechanism will be developed in the near future that will permit trades to be accepted from intermediaries after the closing time. Such a system would create an audit trail that could verify that trade orders were received timely by the intermediaries from customers.

My own view is that, if the SEC expands the list of entities that would be permitted to receive orders on behalf of a fund for pricing purposes under its proposal, it should consider requiring periodic reviews of those entities' internal controls and reports of any material inadequacies (similar to the SAS 70 control review).

**B. Market Timing/Excessive Trading**

For many years, T. Rowe Price has taken an active role in minimizing the potential negative impacts from short-term trading by fund investors on our funds and their long-term shareholders. Our firm has not and will not enter into any arrangements with investors or intermediaries that authorize harmful short-term trading in any of our funds.

Frequent trades driven by short-term market timing have the potential to disrupt the management of a fund and raise its transaction costs. For those investors for whom we maintain individual accounts, we review daily trading activity across the complex at a retail, retirement, and institutional level, and we analyze purchases and sales in the funds to determine if the transactions are within the excessive trading guidelines contained in the prospectus. If we determine that a shareholder has violated our guidelines, action is taken to restrict future excessive trading activity. Over the years, this monitoring process has resulted in

actions up to and including the suspension of purchase privileges for many individuals and a number of intermediaries.

In addition, to discourage excessive trading, a number of Price Funds impose redemption fees ranging from 0.5% to 2.0%. The required holding periods vary and can be as long as two years.

In the wake of the recent scandals, our Internal Audit Department reviewed our established policies, procedures and practices concerning excessive trading, including the imposition of redemption fees, and determined that they remain sound. The review and its findings were discussed with the Price Fund Boards. As a result of this review, we have augmented our monitoring methodologies and will be expanding the number of funds subject to redemption fees.

One issue that the recent trading abuses have highlighted is the difficulty of ensuring that fund policies regarding excessive trading, including the imposition of redemption fees, will be appropriately and consistently applied in the case of investors who own fund shares through intermediaries. With respect to intermediaries, the monitoring process is based on aggregate activity for each intermediary and relies on that entity to provide us with specific sub-account information when excessive trading is suspected. As noted above, we have formed an Intermediary Oversight Committee to help ensure, among other things, that intermediaries meet our compliance standards on an ongoing basis. We are also seeking written certification from intermediaries that they are collecting redemption fees in compliance with the funds' policies.

Last fall, SEC Chairman Donaldson outlined various regulatory measures that the SEC staff was considering to address abusive market timing activities.[3] These measures included 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. Chairman Donaldson also indicated that the SEC would consider measures to reinforce board oversight of market timing policies and procedures. The SEC has recently taken formal action in these areas.[4]

T. Rowe Price supports these measures. While our funds and many others already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area and specifically providing for board oversight will ensure that all funds have systems in place to address abusive activity. Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance because more formal policies likely will limit discretion in dealing with short-term traders. Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests

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

[4] *See* SEC Release No. IC-26287 (December 11, 2003) (proposing amendments to require mutual funds to disclose in their prospectuses both the risks to shareholders of the frequent purchase and redemption of fund shares, and fund policies and procedures with respect to such frequent purchases and redemptions) ("SEC Disclosure Proposals") and SEC Release No. IC-26299 (December 17, 2003) (adopting Rule 38a-1 under the Investment Company Act of 1940 concerning mutual fund compliance programs) ("SEC Compliance Rule Release"). New Rule 38a-1 requires mutual funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including procedures reasonably designed to ensure compliance with disclosed policies regarding market timing. In addition, it requires a fund's chief compliance officer to provide a written report to the fund's board, no less frequently than annually, that addresses, among other things, the operation of the fund's compliance policies and procedures and material compliance matters that occurred since the date of the last report.

from potentially abusive 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 potential abusers to the fund's policies. Of course, it will be important for any new disclosure requirements to allow funds to achieve an appropriate balance between providing disclosure that would have these beneficial effects and providing overly specific disclosure that inadvertently could serve as a roadmap for potential abusers to circumvent fund policies.

Steps also 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 held by intermediaries. One approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request (a practice that some intermediaries already have in place). An additional approach would be to require most types of long-term funds, at a minimum, to impose a 2% redemption fee on any redemption of fund shares within 5 days of purchasing them.[5] If funds had a standardized minimum redemption fee along these lines, it should be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those fees.[6] It is encouraging that the SEC appears willing to consider proposing such a requirement.[7] The administrative implications for

[5] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees and/or longer minimum holding periods. Flexibility is important because different types of funds are affected differently by short-term trading. 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.

[6] At the SEC's request, the NASD formed an Omnibus Account Task Force to consider issues raised by the implementation of mandatory redemption fees in the omnibus account context. *See* NASD, Report of the Omnibus Account Task Force (January 2004), available at http://www.nasd.com/pdf_text/omnibus_report.pdf.

[7] *See* SEC News Digest, February 18, 2004. At the meeting, the SEC also will consider any pertinent recommendations from the NASD's Omnibus Account Task Force.

recordkeepers of such broad-based redemption fees are significant and would have to be examined by the SEC before final approval.

### C. Employee Trading in Fund Shares

In addition to our review of policies, procedures and practices related to excessive trading by fund shareholders, the firm's Internal Audit Department, its Director of Compliance and our Ethics Committee (which is chaired by the firm's Chief Legal Counsel and oversees the administration of the firm's Code of Ethics) have reviewed trading by T. Rowe Price personnel in the Price Funds over the last several years. This review did not uncover the existence of any of the abusive trading practices described in recent enforcement actions relating to fund portfolio managers and senior fund executives. The review and its findings were discussed with the Price Fund Boards.

Although our review did not uncover any such abusive trading, we are exploring how to enhance protections against such conduct at T. Rowe Price. The firm has maintained a comprehensive Code of Ethics since 1973. Each employee must annually sign a compliance verification form attesting to his or her compliance with the Code. We are considering the possibility of instituting additional trading controls relating to employee transactions in Price Fund shares that may be similar to the controls in place for many years for employee trading in stocks and bonds. In addition, each year, we conduct Code of Ethics compliance meetings with all employees at the vice president level and above. These meetings will be expanded to include all employees in 2004.

Consistent with the actions we have been considering on a voluntary basis, the SEC recently proposed to require registered investment advisers to adopt codes of ethics that, among other things, set forth conduct expected of advisory personnel and require such personnel to report their personal securities transactions, including transactions in any mutual funds managed by the adviser.[8] We support this proposal.

### D. Fair Value Pricing

Short-term trading activity, it appears, is often 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. All mutual funds are required to have pricing procedures in place to establish a share price each business day based on the current market values of their portfolio securities. When market prices for portfolio securities are not readily available or are not reliable, funds must determine the fair value of those securities. In accordance with policies and procedures approved by the Fund Boards, T. Rowe Price has utilized fair value pricing for many years and on many occasions to address events affecting the value of a fund's portfolio securities.

We recently conducted a detailed review of our valuation policies and procedures and determined that such policies and procedures are appropriate and are being followed. We have also reviewed our policies and procedures with the Fund Boards.

[8] *See* SEC Release Nos. IA-2209; IC-26337 (January 20, 2004) ("SEC Code of Ethics Proposal").

The SEC has recently taken steps to minimize the possibility that long-term fund shareholders' interests will be harmed by the activities of arbitrageurs seeking to take advantage of stale prices. The SEC issued a statement regarding fair value pricing requirements in its release adopting the mutual fund compliance program rule.[9] In addition to describing the SEC's position on when funds must use fair value pricing, the release states that the compliance program rule requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. [10] SEC examinations of funds will provide the opportunity to further reinforce and monitor the implementation of applicable requirements in this area.[11]

It is important to note that, while fair valuation can reduce the impact of harmful short-term market timing activity, it cannot by itself completely eliminate such trading. Accordingly,

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[9] *See* SEC Compliance Rule Release, *supra* note 4.

[10] *Id.* at 16-17.

[11] The SEC also has proposed revisions to clarify prospectus disclosure requirements concerning fair value pricing. The proposal is intended to make clear that all funds (other than money market funds) are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. In addition, the proposed revisions are intended to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable). *See* SEC Disclosure Proposals, *supra* note 4. The proposed revisions should serve as a useful complement to the requirements articulated in the SEC Compliance Rule Release and the proposed disclosure of market timing policies and procedures discussed above. As in the case of market timing, however, too much specificity about a fund's fair value pricing policies could prove counterproductive by tipping off arbitrageurs and allowing them to circumvent the policies. Thus, it is equally important that new disclosure requirements concerning fair value policies call for disclosure that will be informative to investors but is not so specific as to invite abusive practices.

funds (including the Price Funds) often employ additional methods to deter market timing activity, such as the redemption fees discussed above.

### E. Dissemination of Portfolio Holdings Information

It appears that several fund managers may have provided information about fund portfolio holdings to certain investors in order to enable them or their clients to trade ahead of the fund, to the potential detriment of fund shareholders. For years, the Price Funds have maintained a formal policy relating to providing information about fund portfolio holdings to clients, shareholders, prospective clients, consultants and the public. The policy is intended to ensure that all shareholders are treated in a fair and consistent manner and that the information is not used in inappropriate ways. The policy lists the many pieces of information that may be of interest to shareholders and others (for example, a fund's top ten holdings) and then indicates when that information will be made available (for example, seven days after month end). The policy has been very helpful in managing requests for portfolio holdings information. We have reviewed important aspects of the policy with the Price Fund Boards and are considering modest revisions to ensure that it remains responsive to those with a genuine need for the information while also being protective of shareholders' interests.

The SEC has taken several actions to put in place additional, more specific regulatory requirements in this area. First, the SEC Compliance Rule Release states that a fund's compliance policies and procedures under the rule should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio.[12] Second, the SEC has proposed to require funds to disclose their policies

[12] *See* SEC Compliance Rule Release, *supra* note 4, at 19. The rule requires that the fund's board approve the policies and procedures. In addition, it provides for regular reporting to the board on the effectiveness of the policies and procedures, any changes thereto, and material compliance matters.

and procedures with respect to the disclosure of portfolio securities, and any ongoing arrangements to make available information about their portfolio securities.[13] Third, as indicated above, the SEC has proposed to require investment advisers to adopt codes of ethics that, among other things, set forth standards of conduct expected of advisory personnel and safeguard material nonpublic information about client transactions.[14]

Similar to market timing, requiring funds to adopt formal policies should 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 will further enhance compliance with the policies. At the same time, the approach proposed by the SEC appropriately would preserve some flexibility in how funds release information. T. Rowe Price supports the SEC's initiatives.

### F. Hedge Fund Oversight

The action brought by the New York Attorney General against Canary Capital also underscores the need for some SEC oversight of hedge fund advisers. Last fall, the SEC issued a staff report on hedge funds[15] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. As the Staff Report indicates, by requiring hedge fund advisers to register, the SEC would be able to observe the trading activities of the

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[13] *See* SEC Disclosure Proposals, *supra* note 4.

[14] *See* SEC Code of Ethics Proposal, *supra* note 8.

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

funds managed by such advisers and be in a better position to detect improper or illegal trading practices.[16] T. Rowe Price supports the SEC recommendation to require those advisers to hedge funds that are not otherwise already registered to register under the Investment Advisers Act.

### G. Fund Governance

The recent disturbing revelations about mutual fund abuses have caused some to question the effectiveness of the fund governance system. However, blaming directors, especially independent directors, for failing to uncover the wrongdoing that has occurred is unfair. Independent directors cannot – and should not – be responsible for the day-to-day management of a fund's, adviser's, distributor's or recordkeeper's activities. Indeed, in several cases, the problematic conduct took place at unrelated entities.

The recent incidents do indicate that directors would benefit from additional tools to assist them in serving effectively in their oversight role. The SEC's mutual fund compliance program rule, discussed above, should serve as a useful vehicle for this purpose by requiring funds to have compliance policies and procedures reasonably designed to prevent violation of the federal securities laws and by improving the flow of information about the policies and procedures, as well as significant compliance issues, to the directors. In addition, the SEC has proposed several new fund governance requirements that should help enhance the independence and effectiveness of fund boards.[17] However, certain other proposals to

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

[17] The SEC has proposed to require, among other things: that the board perform an annual self-assessment that would include consideration of the board's committee structure and the number of boards on which the directors sit; that the independent directors meet in separate sessions at least once each quarter; and that funds authorize the

"improve" fund governance in the wake of the recent scandals are unwarranted, counterproductive and would not improve the substantive oversight of the board.

One such proposal would require mutual fund boards to have an independent chair. While some fund boards may choose to have an independent chair – as a number now have – not all fund boards may find that this structure works well for them.[18] It seems counterintuitive to *mandate* such a requirement, instead of allowing the directors to determine in their best judgment who is the most appropriate person to serve as the board's chair. This reasoning is reinforced by the fact that the SEC (and applicable law) already relies heavily on the independent directors' judgment with respect to protecting the interests of shareholders. Furthermore, the independent directors already constitute at least a majority (and in most cases a supermajority) of a mutual fund's board, and therefore have full power to appoint an independent chair if they wish to do so. In the case of T. Rowe Price, fund directors some years ago appointed a "lead independent director" and believe that approach has served them and

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independent directors to hire their own staff. *See* SEC Release No. IC-26323 (January 15, 2004) ("SEC Fund Governance Proposals"). T. Rowe Price supports these measures, although our fund directors view themselves as already having authority to hire staff if appropriate. In addition, the SEC has proposed to require that independent directors constitute at least 75% of each fund board. While we support requiring a supermajority of independent directors, we question whether the marginal benefits, if any, of a 75% requirement would outweigh the disruption involved in imposing that standard rather than codifying the two-thirds supermajority that most fund boards have. The SEC also has proposed to require fund boards to appoint an independent chair which, as discussed in more detail below, T. Rowe Price believes should not be mandated for all fund boards. We recently sent a letter to the SEC staff setting forth T. Rowe Price's views on these important matters. *See* Letter from Henry H. Hopkins, Chief Legal Counsel, T. Rowe Price Associates, Inc., to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated January 13, 2004.

[18] For example, some funds have found that having an interested director serve as board chair is beneficial in that it promotes administrative efficiencies.

the funds' shareholders well. With a supermajority of independents, they believe they are able to take any action needed.[19]

Also, it is far from clear why mutual fund boards, alone among all corporate boards, should be deprived of the discretion to choose their chairperson. Existing regulatory requirements and industry practices, as well as the other new fund governance requirements recently proposed by the SEC, make a requirement to have an independent chair unnecessary.[20] Finally, it bears noting that some of the funds involved in the recent scandals have independent board chairmen. Thus, it would be folly to suggest that requiring all fund boards to have independent chairs is in any way an answer to the current problems.

Another misguided "solution" to the abusive trading practices we have seen would require independent directors, or an independent chair, to make a series of certifications, many of which relate to matters that are outside the scope of what an independent director – who serves in an oversight capacity – could reasonably be expected to know (*e.g.*, that the fund "is in compliance" with certain policies and procedures, such as fund share pricing policies and

[19] For example, several years ago the T. Rowe Price funds' audit committee expressed a desire, for reason of the appearance of a conflict, to have different independent accountants than those who served the funds' adviser. The full boards supported this recommendation and, as a result, the adviser replaced its auditors.

[20] For example, the Investment Company Act requires a separate vote of the independent directors on virtually all important decisions, such as approval of the fund's investment advisory and underwriting agreements, and the use of fund assets to support the distribution of fund shares under a Rule 12b-1 plan. Existing practices in the fund industry – such as a supermajority of independent directors, the appointment of lead independent directors and regular meetings of independent directors in executive session – further reinforce the independence and authority of the independent directors. The Price Fund Boards follow all of these practices. In addition, as noted above, the SEC recently issued a proposal that would require, among other things, that independent directors constitute at least 75% of fund boards and that the independent directors meet in separate sessions at least once each quarter. *See* SEC Fund Governance Proposals, *supra* note 17.

procedures).[21] Not only would this potentially expose those certifying directors to increased liability, but also it would not serve the best interests of fund shareholders. Independent directors (or the independent chair) would be faced with the Hobson's choice of either (1) seeking to secure and being forced to rely on a series of sub-certifications from those directly involved in the various matters to be certified (because the directors themselves would not be in a position to have personal knowledge of what they are certifying), or (2) immersing themselves in the day-to-day intricacies of fund operations, thereby inappropriately transforming their role from "oversight" to "management." Both of these results would place the independent directors in an awkward and/or inappropriate position and neither would improve investor protection. On the contrary, an independent director certification requirement could give investors a false sense of security. It most assuredly would also discourage many qualified persons from serving as independent directors of mutual funds.

## III. OTHER INITIATIVES TO PROMOTE INVESTOR CONFIDENCE

In addition to internal measures and regulatory changes to protect investors against the abusive mutual fund trading practices that have been the subject of the recent investigations and enforcement actions, it is appropriate to consider other ways to reinforce the protection and confidence of mutual fund investors. Certain current initiatives are discussed below.

### A. Directed Brokerage

[21] *See, e.g.*, Section 201 of H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," as passed by the U.S. House of Representatives on November 19, 2003; Section 204 of S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine and Dodd on November 25, 2003.

Under current law, a mutual fund manager is permitted to take sales of fund shares into account in allocating brokerage, subject to various conditions including that the broker must provide best execution. As a directly marketed fund complex, T. Rowe Price has never engaged in this practice for its own mutual funds. Although such "directed brokerage" is strictly regulated, prohibiting this practice may be the most effective way to address the conflict of interest issues it raises. The industry, through the Investment Company Institute, recently urged the SEC (and/or NASD) to adopt new rules for this purpose.[22] Consistent with the Institute's recommendation, the SEC recently proposed amendments to Rule 12b-1 under the Investment Company Act that would prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.[23]

**B. Rule 12b-1**

In addition to proposing amendments to Rule 12b-1 to prohibit the use of fund brokerage commissions to pay broker-dealers for selling fund shares, the SEC is soliciting comments on whether it should make other changes to Rule 12b-1. Given the many developments in fund distribution practices since the rule was adopted in 1980, a reevaluation of the rule is appropriate and timely. Due to the significance of the rule, its widespread use and related issues, it is important to solicit and consider the views of all interested parties before determining whether further changes to the rule should be proposed. Intermediaries who are

[22] Letter to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, from Matthew P. Fink, President, Investment Company Institute, dated December 16, 2003. The Institute also urged the SEC to curtail the use of soft dollars by all investment advisers, including mutual fund managers. T. Rowe Price supports the Institute's recommendations.

[23] *See* SEC Press Release 2004-16 (February 11, 2004), available at http://www.sec.gov/news/press/2004-16.htm.

selected by investors to assist them in making decisions about fund investments, and monitoring those investments, deserve to be compensated. The amounts and methods of compensation, and the disclosure of such to the investor, should all be part of this review. T. Rowe Price looks forward to studying the SEC's release and participating in this process.

### C. Point-of-Sale Disclosure of Broker Incentives

Another issue that has been the focus of much attention recently involves so-called "revenue sharing" arrangements in which a fund's investment adviser or principal underwriter makes payments out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. Disclosure concerning certain types of revenue sharing arrangements already is required in fund prospectuses, and the industry has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[24] Both the SEC and the NASD have recently proposed new point-of-sale disclosure requirements in this area.[25]

The SEC's proposal also would encompass other sales-related fees and payments, such as front-end and deferred sales charges and 12b-1 fees. T. Rowe Price strongly supports requiring point-of-sale disclosure concerning such fees and payments (as well as revenue sharing and differential compensation). Requiring broker-dealers to provide to investors who are considering purchasing mutual funds a separate disclosure document at the point of sale (as contemplated by the SEC's proposal) would help educate investors about the costs they are

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[24] *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.

[25] *See* SEC Release Nos. 33-8358; 34-49148; IC-26341 (January 29, 2004) and NASD Notice to Members 03-54 (September 2003). Both proposals also would require disclosure concerning differential compensation paid to salespersons that could provide an incentive to favor one fund over another.

incurring in connection with the use of the broker who is assisting them, while also alerting them to any potential conflicts of interest.

## IV. CONCLUSION

T. Rowe Price has been and continues to be committed to acting in our fund shareholders' interests. We believe most fund companies seek to do the same. The recent revelations of fund trading problems have highlighted to us and others responsible for fund investor assets the risks of doing otherwise. Many of the far-reaching regulatory changes proposed by the SEC and industry will assist fund managers, distributors, recordkeepers, and directors in fulfilling their objective of serving investor interests. At the same time, they will help eradicate inappropriate or illegal practices.

We are fortunate that investor confidence in mutual funds generally remains very high. But we must take advantage of the current problems to improve our policies and procedures so that we do not experience similar breaches of trust in the future. Our fund shareholders need to be confident that their interests do indeed come first.