Mutual Fund Reform

Statement of

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Before the Committee on Banking, Housing, and
Urban Affairs of the United States Senate

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I. Introduction and Background

Thank you for asking me to testify on the important question of mutual fund reform. My views are my own and not those of any group or entity. I am currently a Professor of Law at Northwestern University School of Law, where I teach securities law. I was Chairman of the United Securities and Exchange Commission from 1987 to 1989 and was a member of the Board of Governors of the National Association of Securities Dealers, Inc. from 1990 to 1993. While a member of the NASD Board, I was chairman of a committee that reviewed securities industry practices in and promulgated a report on the topic "Inducements for Order Flow"[1], sometimes known as "payment for order flow."

Currently, I serve as Chairman of the Mutual Fund Directors Forum, a not-for-profit corporation, whose mission is to improve fund governance by promoting the development of vigilant and well-informed directors. We do so by offering continuing education programs to independent directors, providing opportunities for independent directors to discuss matters of common interest, and serving as advocates on behalf of independent directors.

[1] National Association of Securities Dealers, Inc. (1994)

The Forum is a membership corporation whose members are all independent directors of mutual funds. Their dues are paid by their funds, but their memberships are individual. The Forum is entirely independent of the mutual fund advisory industry.

In November of 2003, Securities and Exchange Commission Chairman William H. Donaldson asked the Forum to develop guidance and best practices in five areas where directors oversight and decisions are critical for the protection of fund shareholders. In our view, Chairman Donaldson's choice of the Forum to develop guidance and best practices in critical mutual fund areas demonstrates the SEC's confidence in the Forum's capability and independence.

Finally by way of background, I am currently serving as the Independent Compliance Consultant for the Strong Financial Corporation, which manages approximately $37 billion in assets and is the adviser to more than 50 mutual funds. My task is to recommend compliance procedures at Strong, including the areas of market timing, late trading, portfolio valuation, and disclosure of portfolio holdings.

II. The Role of the Mutual Fund

A mutual fund provides a vehicle through which the pooled resources of investors can be managed by professional money managers ("investment advisers" or "advisers.") Through mutual funds investors are able to achieve the benefits of diversification and to seek above average returns by investing in funds with special characteristics, such as growth funds, income funds, or sector funds.

In addition to offering diversification and special investment vehicles, mutual funds provide other advantages to investors. Individual investors are unlikely to be able to gather the information necessary to make good investment decisions, and they do not have the experience or judgment enabling them to outperform professional managers. Mutual funds provide them with the opportunity to compete with the professionals.

Equally important, the discipline of regular investing in mutual funds, with an expectation of long-term investment profit, creates saving habits that are beneficial to investors.

III. Directors as Monitors

When a mutual fund investor entrust funds to an investment adviser, conflicts inevitably arise. The adviser seeks to maximize their profits, while the fund shareholders want the adviser to charge the lowest fees possible. Conflicts also exist because the adviser who has control over investors' money may engage in transactions with the fund that are to the advantage of the adviser and to the detriment of investors.

The Investment Company Act of 1940, as administered by the SEC, recognizes these conflicts by laws and rules designed to prevent conflicts of interest and by placing special governance responsibilities on mutual fund boards of directors.

The most important approach to increasing the protection of mutual fund investors is to enhance the power of independent fund directors and to motivate those directors to perform their duties responsibly.

IV. The Unique Form of Mutual Fund Organization

As presently constituted, the mutual fund industry has a unique form of organization. In an industrial corporation the primary function of the board of directors is to supervise the management of the corporation. The board has the ability to hire and fire the corporate chief executive officer, as well as other officers, and has the power to set corporate policy. The board has the power to tell the corporate officers how to manage the business.

In contrast, in the typical mutual fund, the board of directors is not dealing with a CEO or other officers charged with management of the corporation, but with an entity – a mutual fund adviser whose obligations to the fund are determined by contract. Typically the fund board does not have a separate office or a staff. The CEO of the fund will be an employee of the adviser, and the CEO's allegiance typically will lie primarily with the adviser.

Given the separation between the fund board and the adviser, the important question to be asked is:

> What organization and powers will best assist a fund board in protecting the interests of the fund and its shareholders?

I will examine this question, and will also examine some specific current areas of concern in the mutual fund area.

In deciding what corporate governance structure is desirable, Congress and the SEC need to understand that for the most part fund directors are well informed, dedicated, and active in their supervision of the adviser. Any reform in the mutual fund governance area should be aimed toward improving the powers of fund directors to perform their supervisory functions.

To say that most fund directors are well informed, dedicated, and active does not mean that all fund directors share these qualities Historically mutual funds have been created by investment advisers that are extremely knowledgeable about the securities industry and the intricacies of mutual fund management. In many cases, the independent fund directors have been chosen by the adviser. Some fund directors charged with supervising the adviser may at times be unwilling to challenge an adviser who has the advantage of superior knowledge and resources. The SEC has stated:

> Our concern is that in many fund groups…the fund adviser exerts a dominant influence over the board. Because of its monopoly over information about the fund and its frequent ability to control the board's agenda, the adviser is in a position to attempt to impede the directors from exercising their oversight rule. In some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers; in other cases, boards may have lacked the information or organizational structure necessary to play their proper role.[2]

There are some directors who are not meeting high standards as supervisors of fund activities, because they are new to a complex industry, because they have not taken the time to become fully informed, or because they are friendly to the adviser. Some directors do not meet supervisory standards because they are not sufficiently assertive in carrying out their duties.

Our primary tasks at the Mutual Fund Directors Forum are to assist independent directors to become better educated and to be more active in overseeing management of their funds by advisers.

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[2] Proposed Rule: Investment Company Governance, Rel. IC-26323 (January 15, 2003) p.3.

In assessing director performance, it is important to recognize that the mutual fund industry is complex. Mutual fund boards are ultimately responsible for supervising many fund functions, including:

1. Advisory fees and fees of other entities providing services,
2. Compliance with representations made in documents distributed to prospective investors and fund shareholders,
3. Performance of the fund portfolio,
4. Quality and cost of portfolio executions,
5. The manner and cost of the distribution of fund shares,
6. The custody of the fund's securities, and
7. Administration of individual investor accounts.

These functions will be carried out by the adviser and by other entities, sometimes collectively called "service providers." The term "service providers" includes not only advisers and sub-advisers who manage fund portfolios, but also underwriters who sell fund shares, administrators of customer accounts, and transfer agents who record transfers of shares in customer accounts. Custodians who hold fund portfolio securities both in the United States and abroad, fund accountants, and third party pricing services may also be considered to be "service providers."[3]

In order to monitor the adviser the fund directors need to understand the fund's operations, have the power to assure that the fund operations are being carried out honestly and efficiently, and have the will to exercise these powers for the protections of shareholders. They must bargain with the adviser regarding

[3] See Note 28 in SEC Releases IA-2204 and IC-26299 (December 17, 2003)

the costs of its services and regarding the cost of arrangements made by the adviser to have others perform services.

V. An Overview of Needed Regulation

Recent events have revealed that there are serious problems in the mutual fund industry. Advisers have facilitated late trading, market timing, and improper disclosure of mutual fund portfolio holdings. Advisers have used fund portfolio execution revenues and their own resources to pay brokers to advocate purchase of funds managed by the adviser, without adequate disclosure to investors.

The recent problems are being addressed by both state regulatory authorities and the Securities and Exchange Commission. The SEC been charged by Congress with regulating the complicated investment company industry since 1940, and it has performed that regulation well, given its limited resources. Nonetheless, some of the recent scandals have caught the Commission by surprise. In reaction, the Commission has recently been vigorous in its enforcement activities, has imposed numerous reforms through new rules governing the activities of funds and advisers, and is preparing additional rules.[4]

As noted earlier, the mutual fund industry is highly complex. Detailed regulation is best left to the discretion of the agency that has expertise regarding the mutual fund industry and can regulate in a manner that will reflect changing

[4] See e.g. SEC Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds. Releases 33-8358; 34-49148; IC-26341 (January 29, 2004)

industry patterns and technology in both the mutual fund industry and in the securities industry generally. **I believe Congress should be very cautious in addressing mutual fund reform by legislation. I urge Congress to recognize that for the most part needed regulatory steps are being taken by the SEC through its rule making and enforcement powers under the Investment Company Act, the Investment Advisers Act, the Securities Act, and the Securities and Exchange Act.**

VI. Corporate Governance Reforms

The Mutual Fund Directors Forum recently conducted a policy conference on Critical Issues for Mutual Fund Directors. At that conference it was my pleasure to listen to numerous independent directors express their desire to increase their oversight of the advisers. My recommendations for reform are designed to increase the oversight powers of fund directors and to help independent directors be more assertive when they deal with fund advisers.

A. Independence

The first criteria for exercise of independent oversight is that a sufficient number of directors be independent of the adviser.

1. **At least three fourths of each fund board of directors should be independent of the adviser.** The SEC has proposed this requirement.[5]

2. **Director independence standards should be tightened by the SEC.** The Investment Company Act's definition of "interested person" does not sufficiently address problems of indirect relationships, such as former employment with the adviser, family relationships, and other matters.

[5] Proposed Rule: Investment Company Governance, Rel. IC-26323 (January 15, 2003)

B. An Independent Chairman of the Fund Board

The chairman of the board of each fund should be independent of the adviser. An independent chairman can control the board agenda, can control the conduct of board meetings so that important discussions are not truncated, and can provide important and direct liaison with the adviser between board meetings. The SEC has proposed this requirement.[6]

C. An Independent Committee Structure

At the urging of the SEC, the New York Stock Exchange and the Nasdaq Stock Market now require that the Board Nominating, Compensation, and Audit Committees be composed entirely of independent directors. Similar committees and other committees composed entirely of independent directors are important to assuring good fund governance. The SEC should urge or perhaps mandate that various committees exist, taking into account that funds are different in size and objectives. Some fund boards, particularly in smaller funds, may choose to deal with some matters solely at the board level.

I recommend that fund boards in the larger complexes function with the following committees.

1. **A Nominating Committee**

A Nominating Committee composed entirely of independent directors should have exclusive power to nominate directors, thereby helping to assure that new independent directors of each fund will not be chosen by the adviser.

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[6] Id.

2. **An Audit Committee**

An Audit Committee composed entirely of independent directors should have responsibility to oversee the audit function and the power to hire, terminate, and set the compensation of the auditor.

3. **A Compliance Committee**

A fund board may wish to create a Compliance Committee composed entirely of independent directors. The Committee should have the primary responsibility for overseeing the compliance policies and procedures of advisers and service providers, and should be responsible for overseeing the content of their ethics codes. The committee should monitor the fund's compliance functions, including the activities of the chief compliance officer.

4. **An Investment Committee**

Although practices in each fund complex may differ, some funds may choose to create an Investment Committee composed entirely of independent directors, charged with the review of investment performance and fund fees and costs.

5. **Other Committees**

Other committees, such as a valuation committee, should be established as deemed desirable by the fund board.

D. Independent Counsel and Staff

Since most mutual funds are "externally" managed by the adviser, it is important that the board of directors have independent counsel and staff.

1. Independent Counsel

In 2001, the SEC required any legal counsel to the independent directors of funds relying on certain exemptions to be independent from the adviser.[7] As a result, many independent fund directors now have legal counsel who can provide independent advice to the fund board regarding board governance matters and the entire range of fund operations. A fund board should be sure that its counsel is in fact independent and is acting independently. **The SEC should require that the independent directors have an independent legal counsel.** In the absence of SEC action, all independent directors should strongly consider retaining their own independent counsel.

2. Independent Staff

The Sarbanes-Oxley Act mandated that the Audit Committee of each company registered with the SEC have the power to hire independent staff. The stock exchanges have recommended that the nomination and compensation committees be empowered to hire independent staffs. **Mutual fund boards should be able to hire an independent staff on a permanent basis or on an as needed basis. They should be able to hire independent advisers to advise the board in areas such as fund fees and costs, the quality of portfolio executions, and the valuation of fund securities.**

[7] Role of Independent Directors of Investment Companies, Rel. IC-24816 (January 2, 2001)

E. <u>A Chief Compliance Officer</u>

Each investment adviser should be required to hire a chief compliance officer (CCO), charged with supervising the compliance functions of the adviser and its service providers. The CCO should report to the fund board, as well as to the adviser. The fund boards should have the right to hire, fire and set the compensation for the chief compliance officer. Mutual fund advisers typically provide investment advice not only to mutual funds, but also to other clients, such as high net worth individuals, 401(k) retirement plan advisers, and institutions such as pension plan sponsors. The adviser's chief compliance officer should report to the fund board regarding adviser compliance in all aspects of the adviser's operations that are likely to impact the fund's operations, including the adviser's supervision of sub-advisers and service providers. The chief compliance officer should be well paid, have high ranking officer status within the adviser, and have his or her own staff.

My recommendations are not new. The SEC has adopted rules requiring chief compliance officers at both advisers and funds.[8] Rules under the Investment Advisers Act will require each adviser to have a chief compliance officer, meeting the criteria I have set forth. Similar rules under the Investment Company Act will require mutual funds to have a chief compliance officer. The SEC's new Investment Company Act rule adds important additional levels of detail:

[8] Investment Advisers Act Rule 206 (4)-7 and Investment Company Act Rule 38a-1. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Rel. IA-2204; Rel. IC 26299 (December 17, 2003).

1. The chief compliance officer must annually provide a written report to the fund board regarding operation of the fund's policies and procedures, as well as those of the fund's service providers.

2. The chief compliance officer must meet with the fund board in executive session as least once each year.

3. The chief compliance officer must oversee the fund's service providers, including their compliance officers, and should keep the fund board aware of compliance matters and needed changes at the service providers.[9]

F. Policies and Procedures

Advisers and funds should adopt and implement written compliance policies and procedures. The SEC's recently adopted Investment Advisers Act rule[10] will require the adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser. The rule specifies a number of areas that should be addressed, including portfolio management, trading practices, proprietary trading, the accuracy of disclosures, the safeguarding of client assets, and portfolio valuation procedures.

The SEC has also adopted a similar rule under the Investment Company Act[11] requiring fund boards to adopt written policies and procedures reasonably designed to prevent the funds from violating the federal securities laws. As with the adviser rule, the Investment Company Act rule also specifies a number of

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[9] Rule 38a-1, Id.
[10] Investment Advisers Act Rule 206(4)-7, Id.
[11] Investment Company Act Rule 270.38a-1, Id.

areas that must be addressed. In the corporate governance area, the SEC's investment company rules require funds to have policies and procedures designed to oversee compliance by the adviser and service providers, including principal underwriters, administrators of shareholder accounts and transfer agents. The rule specifies areas that should be addressed, including the areas identified for fund advisers, as well as pricing of portfolio securities and fund shares, processing of fund shares, and compliance with fund governance requirements. The latter requirements include board approval of the fund's advisory contracts, underwriting agreements, and distribution plans.

G. Certification

The Sarbanes-Oxley Act and SEC rules now require chief executive officers and chief financial officers of industrial corporations to certify in disclosure documents that the issuer's financial statement fairly present the company's financial condition and that the company's internal controls and procedures are effective.

Some have suggested that fund directors or the fund board chairman be required to certify to shareholders regarding oversight activities. I do not believe that such a certification requirement is needed or advisable. Such a requirement is not needed because fund board's are increasingly becoming more active in supervising advisers and service providers and will be even more active under new SEC rules. A certification requirement for fund directors is not advisable because it would deter qualified individuals from serving as directors.

H. A Mutual Fund Oversight Board

Some have suggested a mutual fund oversight board be established for the purpose of overseeing the mutual fund industry in a manner similar to the oversight regarding the activities of accountants now being performed by the Public Company Accounting Oversight Board. **I do not believe such a mutual fund oversight board is necessary. The SEC has full authority to exercise such oversight, is increasing its oversight and rule making activities, and has recently been given additional resources that will help it to perform its oversight functions.**

VII. Areas Needing Attention

In evaluating possible legislation Congress should be aware of the complexity of the issues faced by mutual fund directors in monitoring the activities of advisers and the funds service providers. I will address several areas of particular current concern.

A. Advisory Fees

As noted earlier, a fundamental conflict exists between the mutual fund directors, who should be seeking the lowest fees from advisers consistent with good performance and the adviser, who will be seeking the highest profits for its services.

In reviewing advisory fees, the fund board should consider portfolio performance, the quality of the adviser oversight of service providers, the levels of volume breakpoints that provide reduced fees to the funds based upon fund size, compensation received by the adviser through its affiliates or from directing portfolio brokerage, and other factors.

Criticisms of mutual fund fee levels have been made by a number of well informed persons. These critics contend that mutual fund boards have too readily acceded to management's recommendations. They also challenge fee levels in index funds and some debt funds that do not require judgments regarding the likely future value of particular securities.

Accepting the proposition that fund directors can be more active in attempting to reduce advisory fees, I believe the proper way to achieve better control over advisory fees is to improve the corporate governance environment for independent directors, to increase director education as we are attempting to do through the Mutual Fund Directors Forum, to encourage directors to be more assertive and energetic in challenging adviser recommendations, and to mandate increased disclosure regarding the fee setting process.[12]

I strongly believe that neither the U.S. government nor state governments should attempt to set mutual fund advisory fees. Government price setting is inadvisable and wrong in the exceedingly complex and competitive mutual fund industry.

B. <u>Best Execution and Directed Brokerage</u>

One difficult task for a fund board is to assure that the fund is receiving best execution in fund portfolio transactions. All fund boards are concerned with execution practices and will normally insist that the adviser demonstrate that it is

[12] See SEC Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies. Rel. IC-26350 (February 11, 2004)

achieving best execution in portfolio transactions. The adviser will present details and comparisons regarding best execution to fund boards on a regular basis. Statistical analysis by third party consultants is sometimes provided.

Although best execution is a goal, the definition of best execution is highly subjective. The definition is frequently said to mean the achievement of the most favorable price under the circumstances, including commissions, market conditions, and the desire for prompt execution.

Mutual fund portfolio transactions almost always involve transactions in large numbers of shares. In highly liquid markets some large transactions can be accomplished without causing market price movements. However, mutual fund transactions are frequently so large in size that the execution must be accomplished confidentially and carefully so that the transaction does not unduly affect price. Some of the more difficult transactions are conducted by brokers who are highly skilled at executing large size transactions without revealing the size of the order or by electronic communications networks that have the ability to use computers to execute orders in stages without revealing size.

Substantial competition exists among executing brokers for the right to execute transactions. These brokers will be compensated based primarily upon a per share commission charge, which now is said to vary between approximately 3 and 6 cents per share for large transactions.

The competitive environment for portfolio execution commissions has caused many executing brokers to offer cash payments or equivalent payments in kind for the execution privilege. These payments are sometimes called "directed brokerage" payments and are sometimes used to pay for the costs of adviser research, to pay distribution costs incurred by advisers for fund shares, and to pay service providers for costs owed to entities providing services for funds.

I believe that directed brokerage is the property of the funds, who should receive the benefit of these payments. I believe payment to service providers on behalf of the funds meets this objective, but that payments that benefit advisers, such as soft dollar payments and payment for distribution costs do not, unless these payments are quantified and utilized by fund boards to reduce advisory fees. **I believe the SEC should adopt a rule requiring all directed brokerage to be used for the benefit of funds, not the benefit of fund advisers.**

C. <u>Soft Dollars</u>

Directed brokerage payments used to pay research or brokerage costs of fund advisers are called "soft dollars." Section 28(e) of the Securities and Exchange Act protects the adviser against liability or administrative action for payment of an excess amount of commissions for effecting a securities transaction if the adviser "determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage or research services received" by the adviser[13].

The value of research services received for soft dollars is often difficult to measure, so that soft dollar payments often lack transparency. Additionally, as soft dollar practices have developed, the SEC has by release expanded the allowable use of soft dollars to pay for services that seem to me to be far

[13] Securities and Exchange Act, Section 28(e)

removed from research or brokerage[14]. For instance, services sometimes include costs of computers. Provision of these and other services often creates record keeping problems because of the need to separate services applicable to research and brokerage from services that are not applicable to these functions. It is also important to monitor soft dollar payments to see that the funds generating commission dollars are receiving appropriate credit. Even if allocated properly, the amount of soft dollar payments made to the adviser should be revealed to and approved by the fund directors.

I believe that protection given to soft dollar payments by Section 28(e) is wrong and creates unnecessary complications. Congress should repeal Section 28(e), and the SEC should deal with soft dollar payments by rule.

D. Use of Directed Brokerage for Distribution

Recently the SEC brought and settled administrative proceedings with Morgan Stanley DW, Inc.[15] based upon alleged violations of SEC rules by Morgan Stanley when it accepted payments from mutual fund advisers in return for rewarding its sales personnel for selling shares of funds sponsored by those advisers rather than the shares of funds sponsored by non-paying advisers. The advisers' motive in paying Morgan Stanley was to increase the amount of assets under management and therefore their advisory fees. The Commission asserted that by accepting these payments for "shelf space" without disclosing them to

[14] SEC Rel. 34-23170 (April 23, 1986)
[15] In the Matter of Morgan Stanley DW, Inc. Securities and Exchange Act Rel. 48789 (November 17, 2003)

investors Morgan Stanley violated SEC anti-fraud rules prohibiting misrepresentations to investors.

The Commission's action also noted that a portion of the payments to Morgan Stanley amounted to the use of directed brokerage by the investment advisers to pay for distribution costs. This practice of using revenues from fund brokerage to pay third parties for the benefit of the adviser is similar to the advisers' receipt of soft dollars from directed brokerage. Unless the use of directed brokerage by the adviser to pay for the distribution of fund shares is revealed to and approved by fund directors, this practice is unacceptable. Adviser acceptance of directed brokerage to pay for its distribution costs is not protected by Section 28(e).

I believe the Commission should adopt a rule requiring the adviser to use all directed brokerage revenues for the benefit of the funds. It may be that if the adviser chooses to forgo all directed brokerage revenue, best execution of fund shares will be improved.

E. Rule 12b-1

In 1980 the Commission promulgated Investment Company Act Rule 12b-1[16] which permits mutual fund assets to be used to pay for the distribution of fund shares. The theory underlying the rule is that the use of fund assets to pay for distribution is justified because as assets increase, advisory fees as a percentage of assets will decrease. The assertion is that when certain levels, called break points, are reached advisory fee levels will decrease.

[16] SEC Inv. Co. Act Rel. 16431 (1980)

Rule 12b-1 requires fund board approval for the use of fund assets to pay for fund distribution costs. Some have suggested that at the very least the use of directed brokerage revenues to pay for fund distribution costs should be included as a 12b-1 fee, which must be approved by the fund directors. My view is that the advisers should pay all of the costs of fund distribution and that therefore Rule 12b-1 should be repealed by the SEC. If that rule is not repealed, use of directed brokerage to pay for fund distribution costs should be included as part of 12b-1 fees, subject to approval by the fund directors.

With regard to inclusion of directed brokerage in 12b-1 fees, as with other aspects of directed brokerage revenues, I believe Congress should refrain from legislation, and await SEC action.

F. Late Trading and Market Timing

New York Attorney General Spitzer's investigation involving the Canary hedge fund and subsequent SEC inquires and actions have raised important concerns in the areas of late trading and market timing.

Late Trading

Late trading is the practice by which a fund allows orders to buy or sell fund shares to be placed after the time at which the fund determines its net asset value (NAV), which in turn determines the per share net asset value used to price purchases and sales of fund shares. Late trading allows an investor to buy or sell shares at prices that will differ from the next day's prices to the advantage of the investor. The investor may profit if it is in possession of information that will cause the NAV to change on the following day. The practice of late trading is unlawful under SEC Investment Company Act Rule 22c-1, which prohibits an investment company from selling or redeeming fund securities except at a price based on the current net asset value of the security next computed after the order is placed. Late trading has the effect of allowing securities to be valued at a NAV computed before the order is placed.

Late trading activities have been aided by fund transfer agent practices allowing submission of orders by third party fund distributors after the NAV pricing time. The distributors are usually brokerage firms that receive customer fund orders during the day and submit so called omnibus orders aggregating smaller customer orders into large buy and sell orders. Industry practice has been to allow these orders to be submitted as late as 7:00 p.m. or 9:00 p.m. Eastern time, or even later. Use of these omnibus accounts raises the possibility that the orders were actually received after the NAV pricing time in violation of the late trading prohibitions.

The SEC has attempted to meet the late submission problem by proposing a “hard close” of 4:00 p.m. Eastern time, requiring that all purchase and redemption orders be received by the fund no later than the time the fund prices it securities.[17] **Since late trading is already illegal and since the SEC is addressing late trading practices, no legislation is needed.**

Market Timing

Market timing is the practice of engaging in short term trading of fund shares in order to take advantage of situations in which the fund’s net asset

[17] Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares. Release IC-26288 (December 11, 2003).

values will not reflect the real value of the fund's shares. This practice allows the market timers to take advantage of information learned prior to the time at which the fund values its assets at the end of the day, but which will not be reflected in the NAV. The most frequently used illustration of this practice involves the pricing of foreign securities when foreign markets have closed many hours before NAV pricing. If events occur during the intervening period that will be likely to cause changes in the prices of the foreign securities, the market timer can buy or sell the fund shares on the day the events occur, taking advantage of the fact that the fund shares will not reflect the changed values of the foreign securities. Market timing is not illegal, but a fund allowing market timing to exist may be violating representations in the fund's prospectus that market timing will not be allowed.

Both late trading and market timing activities injure the funds and their investors because the funds lose money to the arbitrage activities of the traders and because the funds often will have to retain additional cash in order to be able to pay these traders when they sell their shares.

The SEC has urged funds to enhance their compliance procedures regarding market timing, and is pursuing market timing enforcement actions.[18] It has proposed amendments to the registration form used by mutual funds to register securities for sale that would require funds to disclose risks to them of market timing and to disclose fund policies and procedures designed to prevent

[18] E.g. In the matter of Putnam Investment Management, LLC. Investment Advisers Act Rel. 2192 (November 13, 2003)

market timing.[19] It has also recently required funds to adopt policies and procedures dealing with market timing.[20] Some funds are attempting to meet market timing problems by adopting special valuation procedures for foreign securities, and the SEC has proposed that funds disclose their fair value procedures.[21] **No legislation is needed in the market timing area at this time. The SEC should adopt its proposed disclosure rules and should consider rules requiring third party distributors to monitor market timing practices.**

Prospectus Disclosures

Sales of fund shares to investors are regulated by the Securities Act of 1933, which mandates disclosures when selling securities to investors. Since sales of mutual fund shares are continually being made, the SEC allows the fund prospectuses to be amended on a continuous basis, so that they are always current.

Prospectus disclosures must be complete and truthful. By describing the types of portfolio securities that will be purchased by the fund, the use of leverage, the methods of distributions of fund shares, and costs to investors the funds are essentially making a series of promises to investors regarding fund operations.

Oversight of the adviser by the fund directors includes oversight of the adviser's responsibility to see that its activities conform to the representations

[19] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Release 33-8343, IC-26287 (December 11, 2003)
[20] Final Rule: Compliance Programs of Investment Companies and Investment Advisers. Rel. IC-26299 (December 17, 2003)
[21] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosures of Portfolio Holdings. Rel. 33-8343, IC-26287 (December 11, 2003)

made in each fund's prospectus. The SEC's recent rules requiring compliance policies and procedures and emphasizing the enhanced role of the chief compliance officer will provide the fund boards with tools for meeting these responsibilities.

VIII. Conclusion

In conclusion, I believe that Congress should rely upon the Securities and Exchange Commission to remedy problems in the mutual fund industry, particularly by measures designed to enhance the power of independent fund directors. Congress should not take any legislative action, except for repealing Section 28(e) of the Securities and Exchange Act.