



INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK
PRESIDENT

December 9, 2003

Ms. Paula Dwyer
Business Week
1200 G Street, N.W.
Suite 1100
Washington, D.C. 20005-3802

Dear Ms. Dwyer:

At a time when millions of mutual fund investors are looking for reliable information and guidance, your article of December 15, 2003, "Breach of Trust," instead presents a baseless revisionist theory replete with numerous errors and omissions. The facts simply do not support the article's thesis that the Investment Company Institute "for years overpowered or co-opted most attempts to tighten fund regulation." The truth is that the Institute unequivocally has supported strong, pro-investor regulation. The truth is that this approach long ago led the Institute to adopt a policy of cooperating with, rather than confronting, legislators and regulators charged with protecting investors. The truth is that, while the Institute may at times disagree with government officials or others about whether a specific proposal is reasonably likely to benefit investors, ensuring that the regulatory system effectively serves investors has and always will be at the heart of the Institute's work.

Business Week readers certainly would be forgiven for drawing very different conclusions about the Institute. Based on your article, they would never know that the Institute urged regulators to impose a hard 4 p.m. market close to combat late trading and to require a minimum mandatory redemption fee (payable to the funds' long-term shareholders, not fund managers!) to fight market timing. They wouldn't know these basic facts because the article simply omits them. Your readers also wouldn't know that the Institute said to Congress that mutual fund executives and others "who acted willfully against the interest of fund shareholders should be sanctioned severely. Those found to have violated criminal laws should be sent to prison. The law enforcement message should be loud, clear and memorable." Those are my words, not SEC Chairman Donaldson's, Attorney General Spitzer's or Secretary Galvin's. Would any *Business Week* reader ever have figured that out after reading your caricature of the Institute?

Mentioning the Institute's call for tough medicine like the hard 4 pm close, mandatory minimum redemption fees and jail terms apparently would have been

inconvenient because our advocacy of strong measures to protect mutual fund investors stands in stark contrast to *Business Week's* revisionist thesis. Even worse, the article might have had to acknowledge that these proposals have not been universally embraced by other industry groups or some financial services firms, who have criticized the Institute's proposals as too restrictive and burdensome.

I have been the Institute's President for 12 years, and a *Business Week* reader for decades. It is incredible that you advanced a thesis about the Institute's integrity and veracity based on so many allegations that are just plain wrong. Here are a few particularly egregious examples:

The article alleges that in 1997, SEC official Barry Barbash "capitulated to arguments from fund companies...that market timing was a passing fad and that funds would make adjustments without an SEC mandate." This is preposterous: the Institute never made this argument to Mr. Barbash or anyone else. In fact, when some funds were criticized in the media (including in *Business Week*, see "Funds: A Hidden Trick Investors Should Know About," Nov. 17, 1997, copy enclosed) for making fair value adjustments to mutual fund prices in 1997, the Institute made a point of expressing strong support for the funds' actions.

The article alleges that the Institute "persisted in its efforts to avoid scrutiny" by opposing creation of a "self-regulatory organization" since funds "didn't want intermediaries between themselves and the SEC." This is so wrong it's hard to know where to begin. "Avoid scrutiny?" Mutual funds are the most scrutinized investment product in the world, a fact that we celebrate. Apart from this incorrect premise, the article's assertion that our opposition to the creation of a self-regulatory organization -- and our preference for direct government oversight by the SEC -- is evidence of the mutual fund's hostility to regulation is surreal. Skepticism about the effectiveness of self-regulatory approaches runs deep, and since Enron, the Institute's longstanding doubts about self-regulation are increasingly shared by many legislators, regulators and consumer groups.

Finally, the article alleges that the Institute "made sure key provisions of the [Sarbanes-Oxley] law did not apply to funds. Unlike other companies, funds can't be forced to establish strict internal controls, verified by outside auditors." In fact, the Institute maintained that this provision of Sarbanes-Oxley was not needed for mutual funds only because mutual funds were already required to annually file with the SEC a report, prepared by an independent public accountant, on the fund's system of internal accounting controls.

While purporting to describe past reforms it claims the Institute opposed, *Business Week* conveniently omits mentioning any reform measures the Institute has supported, including those we have long called for. For example:

In 1994, the Institute urged the SEC to adopt a rule requiring mutual funds to have an internal compliance system and a compliance officer. (Earlier this month, the SEC adopted a similar rule).

In 1995, the Institute urged the NASD to require broker-dealers to disclose revenue sharing arrangements at the point of sale. (The NASD recently proposed a similar rule.)

In 1999, the Institute issued best practices for mutual fund directors, many provisions of which have since been incorporated into SEC rules and legislative proposals. These include a requirement that 2/3 of directors be independent, a tough definition of independence that bars any former employee of the fund's adviser from *ever* serving as an independent director, and a requirement that new independent directors only be selected by the fund's current independent directors, not by fund management. At the time we proposed these best practices, a leading proponent of improved corporate governance, the Council of Institutional Investors, called them "far-reaching, extending beyond current legal requirements, industry practices, and in some cases ...surpassing practices currently endorsed by the Council and other groups." (Copy enclosed).

During my 32-year tenure at the Institute, we have consistently supported tough regulation and strict enforcement of the securities laws. We have not been perfect, and have made mistakes. But our efforts have always proceeded in good faith, based on our honest views about what would best serve mutual fund investors.

Business Week is obviously free to express its assessment of the Institute's work. I simply ask that future articles be based on the facts. The December 15th article was not.

Sincerely,

A handwritten signature in black ink, appearing to read "Nath P. F. Q.", written in a cursive style.

Enclosures

cc: Mark Morrison, Managing Editor



November 17, 1997

FUNDS: A HIDDEN TRICK INVESTORS SHOULD KNOW ABOUT

By Geoffrey Smith

Q: When is a stock market crash not a stock market crash?

A: When mutual-fund execs say it's not.

That, in effect, is what some mutual-fund companies said on Oct. 28, when Hong Kong stocks fell 14%. That day, a handful of fund companies decided that in the name of protecting U.S. fund investors, they would dust off an arcane accounting rule known as "fair-value pricing" and use it to erase the decline from their books. In effect, they predicted that Hong Kong stocks would recover the next day, and they adjusted the value of their holdings to reflect the expected gains.

The results were astonishing. Huge disparities appeared the next day in the performance of Asian funds that have many of the same holdings. And some investors who tried to buy on the Asian market drop lost money in at least one Asia fund when its managers suddenly switched to fair-value pricing without warning. The Securities & Exchange Commission has launched a review, and there's little doubt reform should follow -- at least in terms of disclosure.

WIDE LATITUDE. Fair-value pricing, a valuation system sanctioned by the SEC, is an obscure tool that most investors have never heard of. Basically, it gives funds the option of establishing a "fair" price for a security in the event one is not readily available by 4 p.m. EST, when funds set their net asset value (NAV) for the day. Generally, funds use the technique in special circumstances, such as when a fund invests in a private placement. But fund managers have wide latitude in using it -- and they don't have to tell investors when they do.

In the case of the Hong Kong crash, some fund companies chose not to set their Oct. 28 NAV using closing prices in Hong Kong. Instead, they set prices based on what they decided their Hong Kong stocks should be worth at 4 p.m. EST. Fidelity Investments, for one, decided its Hong Kong & China Fund was worth 2 cents a share more than on the 27th. Why? Fidelity Vice-President David B. Jones, who oversees pricing, says the recovery of U.S. stocks and a rise in the Nikkei index on the afternoon of the 28th meant that by the close of trading in the U.S., "Hong Kong prices weren't realistic." So prices for all of Fidelity's Hong Kong holdings were set using outside pricing services, futures prices, and other factors, Jones says.

Over at Colonial Group, Chief Financial Officer Timothy J. Jacoby didn't use fair-value pricing. "We didn't want to run the risk of subjectively trying to predict the market," he says. So while Fidelity's fund rose, the NAV of his Colonial Newport Tiger Fund -- with many of the same top holdings -- fell \$ 1, or 11%, on Oct. 28.

Fidelity bet right: The Hong Kong market did rise. But what matters is whether fund investors were treated fairly -- and many weren't. The inconsistent use of different pricing methods leaves investors in the dark.

"CHEATED"? Consider the case of Dr. Bharat Nathwani, a pathology professor at the University of Southern California who was looking to capitalize on the Asian market turbulence. He says he invested thousands in Fidelity's Hong Kong & China fund at 2 p.m. EST on Oct. 28, expecting to buy at the bottom of the crash. He claims Fidelity said nothing about fair-value pricing, and he was sold shares at a price above Monday's close. "I've been cheated," says Nathwani, adding that he is considering a class action.

Fidelity declines to respond to Nathwani's charges. But it says phone operators can't alert investors to changes in valuation methods because decisions on pricing are made on short notice. Still, Fidelity says it "can do a better job" of explaining pricing methods. Fidelity's concern Oct. 28 was that investors would try to exploit the low Hong Kong prices by buying on Tuesday and quickly selling as Hong Kong recovered, diluting other investors' gains. Gene A. Gohlke, a top SEC compliance officer, favors Fidelity's approach because it prevents such quick trading. "The idea of treating shareholders fairly is the essence of a mutual fund," he says.

No one disagrees. But fund companies should forewarn investors when a fund's prices do not directly reflect market activity. A fund company's obligation is not just to be fair to existing shareholders but to provide accurate information to other investors as well.

Council of Institutional Investors

Research Service Alerts

Volume 4, No. 27

June 28, 1999

SWEEPING NEW INDEPENDENT STANDARDS FOR MUTUAL FUND DIRECTORS were proposed June 24 by an advisory group of the Investment Company Institute, the nation's largest association of mutual funds. The recommendations of ICI's Advisory Group on Best Practices for Fund Directors are far-reaching, extending beyond current legal requirements, industry practices, and in some cases, the Council's governance policies for corporations. The report, Enhancing A Culture of Independence and Effectiveness, follows up on issues discussed at the SEC's Feb. 23-24 Roundtable on the Role of Independent Investment Company Directors. Following the Roundtable, Securities and Exchange Commission chairman Arthur Levitt called on the industry to undertake an initiative to enhance the role of independent directors. At the same time, Levitt announced a "major commission initiative to improve mutual fund governance."

While most of the suggested practices mirror the Council's government policies for corporate boards, the few listed below are leading edge, surpassing practices currently endorsed by the Council and other groups.

- Independent directors should retain independent legal counsel and, as appropriate, they should be authorized to consult with independent auditors and other outside experts. Such outside expertise should ensure that directors understand their responsibilities, ask the right questions and receive the information necessary to carry out their responsibilities, the advisory group said. The Council's policies are silent on this point.

This outside counsel is not prohibited from providing some legal services to the fund's investment adviser. The advisory group decided this is acceptable, provided that the counsel's primary allegiance is to the directors and that the investment adviser understands that any disclosures that makes to counsel are not privileged against disclosure to the independent directors. So that the independent directors may assess the potential for conflicts, the outside counsel should disclose the details of any professional relationship with the investment adviser, the group recommended.

- In addition to requiring that the audit committee consist only of independent directors-a standard identical to the Council's policy for corporate boards-the ICI advisory group recommended that the audit committee meet with the independent auditors at least once a year without management present and that the committee have a written charter spelling out its duties and powers. The advisory group also suggested that the odd committee require the auditor to annually report on its independence from management.
- Independent directors should designate one or more lead directors to coordinate the activities of the independent directors and to raise issues with counsel. The Council's current policies recommend the appointment of a contact director if the chair and CEO roles are combined.
- Boards should adopt tenure or age retirement policies for directors. Council policies do not address this issue.

OTHER COMMITTEE RECOMMENDATIONS ARE SIMILAR to the Council's governance policies for corporate boards. And while many are mainstream for corporate boards, the ICI advisory group's recommendations represent significant enhancements to the mutual fund industry's current practices.

The ICI advisory group recommended that at least two-thirds of the directors be independent—a major shift from current laws which effectively require at least a majority of fund directors to be independent of the adviser/underwriter. The recommended super majority level is "far from universal" and some funds will incur costs to remove affiliated directors or add new independent directors to their boards, the group noted. But, it added that the benefits of the supermajority standard justify the recommendation as an industry best practice.

To add teeth to the definition of independent director, the advisory group recommended that former officers or directors of the fund's investment adviser, principal underwriter or certain affiliates—particularly majority-owned subsidiaries and parent companies that only majority interest—should never qualify as independent. Similar to the Council's policies, there is no grace period after which such a restriction would lapse.

The advisory group also suggested that independent directors complete annual detailed questionnaires on business, family and financial relationships with the fund's adviser, principal underwriter, other service providers and their affiliates—a watered down version of the Council's policy calling on companies to disclose all information necessary for shareholders to assess whether a director qualifies as independent.

A fund's nominating and compensation committee should be composed only of independent directors, the advisory group advised. Fund directors should invest in one or more of the funds on whose boards they serve, and independent directors should meet without management at certain times, particularly in conjunction with the required annual review of the advisory and underwriting contracts.

Fund directors should periodically evaluate the board's overall effectiveness, the advisory group suggested, and all fund directors should keep abreast of industry and regulatory developments.

THE REMAINING GUIDELINES are specific to the mutual fund industry. For example, the group urged boards to obtain adequate D&O insurance coverage and indemnification, particularly for situations in which the fund's independent directors and investment advisers are opposing parties. (Some D&O policies don't provide coverage in these circumstances.) Absence of adequate coverage may discourage directors from acting aggressively in the interests of fund shareholders, the advisory group noted.

In addition, the committee suggested that investment company boards be organized either as a single board for all funds in the complex or cluster boards for groups of funds within a complex. Funds should not have separate boards for each fund, according to the ICI advisory group.

THE RECOMMENDATIONS ARE VOLUNTARY, but with the ICI's backing, they are likely to be adopted throughout the industry. The recommendations were drafted by a six-person advisory panel composed of three experienced independent fund directors—Dawn-Marie Driscoll, Dr. Manuel H. Johnson and Gerald C. McDonough—and three mutual fund company senior executives—John J. Brennan, chair and CEO of The Vanguard Group (and chair of the ICI's board of governors), Paul G. Haaga Jr., executive VP of Capital Research and Management, and William M. Lyons, president and COO