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THE FINANCIAL SERVICES ROUNDTABLE

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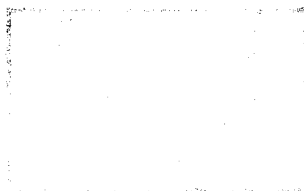

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: "Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings," SEC Rel. Nos. 33-8343; IC-26287 S7-26-03

The Financial Services Roundtable[1] is pleased to offer its comments on the above-captioned amendments proposed by the Securities and Exchange Commission (the "Commission" or the "SEC"). The Roundtable believes that mutual fund investors deserve protection from abusive short-term trading. Such trading can reduce funds' efficiency and result in lower returns to investors.

Roundtable members support vigorous additional efforts by the Commission to guard against market timing. As discussed below, the Roundtable supports the enhanced disclosure by funds of their market timing policies and practices proposed by the Commission. In general, the Roundtable believes it is better to present investors with greater information regarding funds' market timing policies than to enforce new "one size fits all" rules on this issue. The Roundtable also supports the Commission's proposals on the wider use of fair value pricing and on disclosure of that issue and of disclosure to selected parties of fund portfolio holdings.

I. Introduction

Mutual funds have become the investment vehicle of choice for Americans investing toward long-term financial goals. Whether directly or through retirement plans and other media, American investors have turned to mutual funds in order to save and build wealth. Nearly three-quarters of all mutual fund shares are owned by individuals.

Retaining investor confidence is crucial to maintaining this level of participation by retail investors. As mutual fund managers and distributors, Roundtable members recognize that recent instances of market timing have the potential to weaken investor

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[1] The Financial Services Roundtable unifies the leadership of large integrated financial services companies. Its membership includes nearly 100 firms from the banking, securities, investment and insurance sectors. In addition to communicating the benefits of integrated financial services to the American public, the Roundtable is a forum in which financial services industry leaders address critical public policy issues.

confidence in mutual funds and the U.S. markets as a whole. Roundtable members care deeply about restoring investor trust and the comments below are offered in the hope of achieving that goal.

Recent investigations have brought to light potential violations associated with market timing. The Roundtable is certain that regulators will identify and punish violators. At the same time, the Commission must ensure that harmful practices such as market timing have no place in the mutual fund industry and that funds and their investors are not overly burdened by inefficient or ineffective regulation.

II. Enhanced Prohibitions Against Market Timing

A. Current Prohibitions Against Market Timing

"Market timing" refers to a form of trading mutual fund shares in which investors seek to profit from a perceived arbitrage between the last calculated price of a fund's own shares and the value of the fund's portfolio holdings. Under Investment Company Act Rule 22c-1(a),[2] a mutual fund must set a price for sales and redemptions of its shares at least once a day. Funds typically set this price based on their net asset value ("NAV") as of 4:00 p.m. Eastern time, the closing time of the major U.S. securities exchanges. In some cases, the closing price of a portfolio security as of 4:00 p.m. Eastern time may not reflect its current market value. For example, an event may occur or news may be released after 4:00 p.m. that can reasonably be expected to have an impact on a security's price when trading resumes. The opportunities for arbitrage may be greatest when mutual funds invest in less liquid securities, such as small-cap stocks and securities that trade overseas. In the latter case, many hours may elapse between the close of trading in an overseas market and the calculation of the fund's NAV.

Market timers seek to reap quick profits in mutual fund shares from these arbitrage opportunities. A market timer seeks to purchase a fund's shares based on events occurring before the fund's NAV calculation. For example, a market timer might guess that rising prices in the U.S. securities markets indicate likely higher prices in overseas markets the next day. The market timer would purchase mutual fund shares that reflect stale closing prices in overseas markets. The market timer would then redeem the fund's shares the next day, when the fund's next NAV calculation would reflect the presumably higher prices in overseas markets. The market timer seeks to make a quick and relatively risk-free profit.

While not illegal, many mutual funds discourage market timing because the arbitrageur's profits come at the expense of the fund's long-term shareholders. When a fund sells its shares at an artificially low price based on stale information, the ownership interest of existing shareholders is diluted in favor of the purchasers. Similarly, when a fund redeems its shares at an artificially high price based on stale information, the interest of remaining shareholders is diluted in favor of the sellers. Market timing might also lead a fund's portfolio manager to keep more of the fund's assets in cash or to sell portfolio

[2] 17 CFR 270.22c-1.

securities in order to meet redemptions. This increases a fund's brokerage costs and likely reduces its returns, to the detriment of long-term shareholders.

Mutual funds are required to disclose in their prospectuses any restrictions they impose on redemptions of fund shares. This disclosure must also include any redemption charges, including in what circumstances such charges will be waived and the circumstances in which a fund may delay redeeming a shareholder's shares for a certain time after his investment. Mutual funds are not required to disclose the specific steps they will take to identify, deter or punish market timers.

B. Proposed Enhancements to Protections Against Market Timing

1. Disclosure regarding market timing

The Commission has proposed a number of amendments to the registration form for mutual funds. These would require a fund to provide additional disclosure identifying steps taken to prevent market timing. First, a fund would be required to disclose in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders. A fund's prospectus would also disclose whether or not the fund board has adopted policies and procedures with respect to frequent purchases and redemption. If not, the prospectus would state the specific basis for the view of the board that it is not appropriate. A fund prospectus would also describe any policies and procedures for deterring and detecting frequent purchases and redemptions, including through intermediaries, and any arrangements to permit frequent purchases and redemptions. The Commission proposes that the description must be specific and would include any restrictions on shareholder purchases and redemptions within a given time period; any redemption fees; and any minimum holding period. The Commission has proposed requirements similar to those described above to the registration forms for insurance company separate accounts that issue variable annuities and variable life insurance policies.

2. Disclosure regarding and use of fair value pricing

The Commission has proposed amendments to the instructions to the registration statements for mutual funds (other than money market funds) and managed separate accounts that offer variable annuities. These amendments would require a fund to explain in its prospectus the circumstances under which it will use fair value pricing and the effects of using it. Funds would be required to use fair value pricing any time price quotations are not readily available or are not reliable.

3. Selective disclosure of portfolio securities

Finally, the Commission has proposed amendments to the registration statements for mutual funds and managed separate accounts that issue variable annuities that would require them to disclose in their Statement of Additional Information ("SAI") any policies and procedures with respect to the disclosure of the fund's portfolio securities to any person and any ongoing arrangements to do so. Prospectuses would be required to state that a description of the policies and procedures regarding selective disclosure of portfolio securities is available in the SAI and on a website if applicable. The description

would include frequency of disclosure; how policies and procedures apply to different categories of investors; any conditions placed on the use of the information; persons who may authorize disclosure; and the manner in which the board exercises oversight of disclosure.

C. Comments on the Proposed Enhancements

1. Disclosure regarding market timing

The Roundtable supports enhanced disclosure by mutual funds of their market timing policies and practices. Roundtable members believe the Commission has identified the appropriate items for disclosure. Of these, Roundtable members feel that restrictions on the volume or number of transactions that a fund shareholder may make in a given time period and any exceptions under which a fund will not impose restrictions are particularly important to shareholders. It is important to disclose, as the Commission would require, any polices to accommodate market timing as well as policies to discourage market timing. In addition, the Roundtable believes that the prospectus is the proper venue for this disclosure. The Commission might consider requiring disclosure in the SAI of policies and practices to detect, as opposed to deter, market timing.

The Roundtable supports the Commission's focus on disclosure rather than on mandating that all funds use the same tools to combat market timing. Roundtable members would not support mandating the use of redemption fees or establishing uniform holding periods to avoid imposition of redemption fees. Fund advisers and directors must make their own determination about how best to use such tools to prevent market timing. Once the information required to be disclosed by the Commission's proposal is available, investors would be able to evaluate a fund's commitment to opposing market timing in making their investment decisions. The Roundtable would support allowing for, but not requiring, imposition of redemption fees greater than the current 2% ceiling.

It is important to note that insurance company separate accounts that issue variable products are subject to State law as well as the Federal securities laws. Any changes in policy forms made to effectuate enhanced disclosure requirements adopted by the Commission must be approved by State regulatory authorities. In addition, separate account variable contracts may include portfolios offered by unaffiliated mutual fund complexes as well as funds affiliated with the sponsor of the separate account. In this case, it will be difficult to have identical policies and procedures among all of the investment options. Disclosure should focus on the different obligations of the separate account and the underlying funds and on the complementary policies they may develop.

2. Disclosure regarding and use of fair value pricing

The Roundtable supports allowing wider use of fair valuation of portfolios. As the Commission has correctly observed,[3] fair valuation of portfolios may reduce arbitrage opportunities and thus the attractiveness and frequency of market timing. Roundtable members believe the SEC has identified the appropriate conditions for the use of fair

[3] SEC Rel. No. 33-8343 (December 11, 2003) at 11.

valuation. The disclosure items identified by the Commission are appropriate; additional disclosures, such as the methodology of fair value pricing, might even help market timers. The Roundtable believes that the location of the disclosure should depend on the type of the fund. For funds where market timing may be a greater possibility, such as international funds, disclosure should be made in the prospectus. For other funds where market timing may be less likely, disclosure might be made in the SAI.

3. Selective disclosure of portfolio securities

The Roundtable supports the disclosure of information proposed by the Commission as well as the location of the disclosure. As the Commission has observed, selective disclosure of portfolio holdings may provide arbitrageurs an opportunity to trade, to the detriment of long-term fund shareholders.[4] Restricting selective disclosure of fund portfolio holdings, as the proposed disclosures are likely to do, should reduce these opportunities. Roundtable members appreciate that the Commission recognizes that there may be legitimate business reasons for disclosing portfolio holdings to selected third parties. The examples identified by the Commission, including disclosure for due diligence purposes and for use by a rating agency in developing a rating, are instances where it would be justifiable for a fund to disclose its portfolio holdings.

IV. Conclusion

Allegations of market timing in mutual funds have tested investors' confidence. While the Roundtable is confident that securities regulators will identify and prosecute violations of law associated with market timing, more can be done to protect mutual fund shareholders from this abuse. The proposals articulated by the Commission – to enhance disclosure of funds' market timing policies and practices, to allow wider use of fair valuation, and to enhance disclosure of use of fair valuation and of selective disclosure of fund portfolio holdings – should significantly reduce the incentives and opportunities to engage in market timing. The Roundtable supports these proposals and looks forward to working with the Commission to ensure that all mutual fund investors are treated fairly.

Best regards,

Steve Bartlett

[4] SEC Rel. No. 33-8343 (December 11, 2003) at 6.