American Banker

October 24, 2007

SECTION: Pg. 10 Vol. 172 No. 205 ISSN: 0002-7561

ACC-NO: 170188537

LENGTH: 991 words

HEADLINE: Mutual Fund Execs Prepare For Regulatory Clampdown.

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BODY:

Ominous indicators of increased Securities and Exchange Commissionsurveillance and a tougher enforcement regime for mutual funds are visible on the horizon, according to a report that was released by SEIInvestments in Oaks, Pa.

"It's important for managers to know and understand the SEC's hot-button issues," said Jim Volk, the chief compliance officer for investment manager services at SEI and a co-author of the report.

Compliance officers and other executives should pay close attention to the SEC's informal signals, prepare for more intensive exams, improve risk assessments, and fill in compliance gaps when they are identified, the report said.

SEI identified six areas of concern for regulators and mutual fundcompanies' compliance chiefs: use of nonpublic information, hidden fee arrangements, soft dollars, brokerage relationships, alternative investment management activities, and securities lending.

Mr. Volk said that, though mutual funds have shored up their compliance programs since the trading-abuses scandal broke four years ago,challenges remaining for them are to do more with the information they collect and to be able to show a rock-solid compliance pathway.

SEC officials have indicated that 40% of the compliance programs they reviewed last year were deficient. Taken together with SEI's assertion that, "in the last six to nine months, the SEC has been going out of its way to make sure the industry knows what's on its mind," some sleepless nights may be in store for mutual fund managers.

SEI argues that with the commission's greater outreach will come increased expectations when it asks companies for data.

But before industry executives reach for the tranquilizers, they should note that observers have reacted to the report by adding qualifiers to its conclusions. Brian Regan, a partner in the Washington lawfirm Sutherland Asbill & Brennan, said it is not surprising the SEC is finding more deficiencies - because it is doing more target exams,.

Niels Holch, the head of the Coalition of Mutual Fund Investors inWashington, said it is important to distinguish between material andtechnical violations when thinking about the 40% deficiencies.

Another way to judge the impact of the assertedly high percentage of deficiencies in 2006 SEC exams is that fines declined from a totalof $1.5 billion in 2005 to $975 million last year.

However, Mr. Volk said the level of fines has nothing to do with changes in the commission's reporting requirements. Those attending anApril SEI conference agreed, he said, that in the face of the SEC's move toward a risk-based strategy, it had become harder to manage compliance.

Risk-based regulation takes a principles-based regulatory approach, as exemplified by the Financial Services Authority in the United Kingdom.

The SEC has indicated that it will move away from its traditional rules-based approach, which emphasizes specific guidelines, to a principles-based approach. This looks like a clear consequence of the formation of the SEC Office of Risk Assessment in 2004 to uncover emerging forms of fraud and illegal activity.

Another take on the commission's posture comes from Jeff Keil, theprincipal at Keil Fiduciary Services in Littleton, Colo., an industry consulting firm that works with mutual fund board members.

From Mr. Keil's perspective, an important question is, what shouldthe summary of a complicated compliance program for board members look like? Overall, he said, most large mutual funds have taken effective steps to beef up compliance regimes since the scandals of recent years.

The commission's concern about the use of nonpublic information typically arises when information leaks in advance of large customer orders. This variation on illegal insider trading must be staunched by funds.

The soft-dollar issue was ticked off by Mr. Volk as a good exampleof how potential conflicts can be managed. Funds are reluctant to abandon the practice, he said, because it is a good mechanism for keeping execution costs low. He recommended disclosure and monitoring by compliance officers as one approach to ensure that they are managing the soft-dollar issue effectively.

With securities lending, a problem may arise for mutual funds if they cannot get the security back before they are faced with a proxy vote in which they have a vested interest. If the security cannot be retrieved, the fund may be unable to vote its proxy.

Yet on the whole, Mr. Volk said, securities lending is a beneficial revenue generator for funds. The risks associated with it are minor, he said.

Concerning brokerage relationships, the report suggested that elimination of Rule 12-b-1, which lets funds pay for distribution from their asset pools, is less likely than it once seemed to be. A compromise is more likely than outright elimination of the rule, according toSEI.

Still, Tim Levin, a partner at Morgan, Lewis & Bockius in Philadelphia, advises fund executives to continue monitoring the SEC's posture on this issue.

On the question of investments in alternative assets, such as derivatives, Mr. Volk said it is important for fund managers to understand the securities they are investing in. This is crucial as more mutual funds adopt hedge-fund-like strategies and invest in additional asset classes.

Mr. Volk urged compliance executives to stay abreast of what is onthe commission's radar since its most prominent issues today differ from its top concerns six months ago. And even if most of the issues do not apply to a given fund, managers can be sure that a few will doso.

But as to whether there is a trend toward less rulemaking by the commission, Mr. Regan, the Washington lawyer, said that the industry will just has to wait and see.

Mr. Shearer is a senior editor at Money Management Executive, a SourceMedia publication, where this story first appeared.

LOAD-DATE: October 30, 2007