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CORRESPONDENCE MEMORANDUM

DATE: April 28, 2004

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Mutual Fund Industry Investigation Update

This memo provides an update on events and changes resulting from investigations by the New York Attorney General (NY AG), the U.S. Securities and Exchange Commission (SEC) and other organizations into the mutual fund industry. Staff at the Department of Employee Trust Funds (ETF) and Nationwide Retirement Solutions (NRS) continues to monitor the ongoing investigations and proposed regulatory changes.

Background

On September 3, 2003, New York Attorney General Eliot Spitzer announced the start of an investigation into trading practices in the mutual fund industry. This investigation was prompted by the New York Attorney General's settlement with Canary Capital Partners, a hedge fund that apparently engaged in after-market trading and market timing. The SEC and other regulatory agencies have also opened investigations.

WDC Program Implications

To help determine the implications and consequences of reported inappropriate trading practices on the Wisconsin Deferred Compensation (WDC) Program, the Board requested information from each of the firms providing mutual fund options through the WDC Program. Staff mailed a letter with detailed questions to all firms providing WDC investment options. The attached memo summarizes the responses of the investment providers.

Overall, the firms in the WDC core spectrum responding to the letter indicated they have or are in the process of conducting internal reviews. They are supportive of fair treatment for investors and regulators' efforts to eliminate any improper trading that harms other investors. Since the delivery of their responses, two mutual fund firms in the WDC core spectrum have announced results from their investigations:

- *Federated Investors*: Federated reports that an investigation conducted by Cornerstone Research uncovered one instance of frequent trading, some instances of late trading (but no pattern or collusion with Federated workers), and at least one instance where a Federated employee regularly placed orders after the funds' closing times. The firm has taken steps to address the findings of the review and has established a $7.6 million restitution fund.

Reviewed and approved by Pam Henning, Office of Strategic Services

Signature ____________________ Date __________

- *Janus Capital Group* announced in a letter to Janus shareholders on April 27, 2004, that it had reached a settlement with the attorneys general of New York and Colorado and the Colorado Division of Securities. They have also reached an agreement in principle on monetary terms with the SEC, which is subject to approval by the SEC commissioners. Under the terms of the settlement, Janus will:

  - provide $50 million for investor restoration;
  - pay $50 million in civil penalties, some of which may also be used for investor restoration;
  - make $1.2 million in other settlement-related payments to the state of Colorado; and
  - reduce or forego management fees by approximately $25 million per year for the next five years.

  Regulators and Janus trustees are developing a plan for how and when restoration to impacted fund investors will occur. Janus trustees are also reviewing fee reduction requirements to determine how to apply them and to which funds to apply the reduction. Janus anticipates the management fee reductions will commence on July 1, 2004.

  Janus has also experienced major changes in its executive management. Mark Whitson, the Chief Executive Officer and a member of the Janus board of directors, resigned his positions at Janus effective April 20, 2004. He was replaced by Steve Scheid, who will also continue to be the Janus board chair. Whitson will remain at Janus in a "consulting" role for transition purposes until the end of 2004. Other new executives at Janus include Chief Investment Officer Gary Black, who started April 26, 2004, and Chief Operating Officer Girard Miller, who started at Janus in July of 2003. In addition to these changes, the executive vice president in charge of institutional services, Lars Soderberg, was recently placed on a leave of absence as a result of the firm's review of activities related to the mutual fund trading scandal. Richard Garland, the head of Janus' international business, resigned his position in November 2003 after documentation released by the NY AG's office connected him to trading arrangements with Canary Capital Partners.

Regulatory Proposals
In an effort to curb market timing, late trading and other perceived abuses, the SEC has proposed many reforms and new regulations, including:

- Market Timing Regulations and Fair Value Pricing
  In mid-April, the SEC unanimously approved regulations requiring mutual funds to clearly disclose their market timing policies. Under the regulations, mutual funds must clearly state their policies that prohibit market timing in their prospectuses, or if they don't prohibit it, why not. Funds must also explain their policies for disclosing portfolio holdings as well as how and when they use fair market value pricing. These rules take effect December 5, 2004.

  Adopting "fair value pricing" of securities held by international funds to reflect an adjusted price to account for market events that occur after foreign markets close is another proposal by the SEC. The SEC approved fair value pricing in 1981 but never required funds to use them. In March 2004, the SEC disclosed results from a September 2003 survey that showed that near a third of the mutual funds queried hadn't done any fair value pricing in the last twenty months. The September 2003 survey also revealed that the funds that didn't use any fair value pricing had high levels of share turnover, which can be a sign of market timing.

The SEC believes that the use of fair value pricing coupled with redemption fees could effectively eliminate most market timing.

- <u>Hard Close 4 p.m. Deadline</u>
  The SEC has proposed a hard close 4 p.m. Eastern Time deadline for submitting mutual fund trades. Any trades not received by the deadline would be priced at the next day's close. This proposal has received many comment letters from plan sponsors, mutual fund firms and intermediaries such as record keepers. This measure has been controversial. It would require record keepers such as NRS to not only place all orders before the 4 p.m. close but also to settle all trades before market close. This means that NRS would likely need to impose an earlier cutoff time for all WDC participant trades that are now accepted up until the market close at 4 p.m. Eastern Time. If enacted, this proposal could put participants in the WDC and other similar plans at a disadvantage compared to people dealing directly with a mutual fund. As a result of numerous letters commenting on this proposal and how it may adversely impact investors in section 457 and 401(k) programs, including comments from members of Congress, as of April 20, 2004, it appears that the SEC may adopt alternatives to the original 4 p.m. hard close proposal.

- <u>Redemption</u>
  The SEC has proposed that mutual funds charge a two-percent redemption fee on shares sold within five days of purchase. Money market mutual funds and exchange-traded funds would be exempt from this requirement, and the rule would be waived for financial emergencies. This measure is likely to pass. It is not clear how this redemption fee would be levied on investors in retirement or deferred compensation plans such as the WDC.

- <u>12(b)-1 Fee Elimination</u>
  The SEC is looking at tightening restrictions on how 12(b)-1 fees are used, including a proposal that would ban fund companies from using 12(b)-1 fees to pay for direct brokerage expenses. Rule 12(b)-1 was introduced in 1980 and the fees collected under it were intended to be temporary measures to help fund companies recoup costs associated with sales, such as printing, mailing and advertising. Most fund companies now use 12(b)-1 fees to defray costs associated with selling their funds through intermediaries. There are numerous proposals out on this measure; the House would bar 12b-1 fees on funds that are closed to new investors, while the Senate would prohibit all asset-based distribution charges. Either the SEC or Congress are likely to require improved disclosure of how 12b-1 charges are used to pay securities firms and individual brokers.

- <u>Independent Chairmen</u>
  In mid-January, the SEC proposed that seventy-five percent of directors and board chairman be independent of the fund management company. This proposal is highly controversial and has been hotly debated. It is uncertain if the measure will pass.

- <u>Soft Dollars</u>
  "Soft Dollars" are a largely unseen expense for most investors. The term refers to the practice by which mutual funds and other institutional investors agree to pay higher commissions in exchange for a variety of services and products, such as research reports. A bill approved by the House would require greater disclosure of soft-dollar arrangements and orders the SEC to study soft-dollar practices. While there is not yet consensus on how to change the soft-dollar system, it is likely that something will change with this system.

The SEC has already made changes in the compliance rules for mutual fund companies. Most of these new requirements have an effective date of February 5, 2004, and a compliance deadline date of October 5, 2004. The changes primarily relate to compliance and require registered advisers and investment companies to appoint a chief compliance officer who will oversee the adoption of specific compliance policies and procedures.

<u>Other Notable Developments</u>

- In November 2003, the House of Representatives approved the Mutual Funds Integrity and Fee Transparency Act (HR 2420). Among other things, this bill authorizes the SEC to adopt rules to prohibit fraud, deception and manipulation and directs the SEC to develop rules to prevent after-hours trading (with an exemption for retirement plan procedures and legitimate third-party intermediaries).

  On April 23, 2004, the Chair of the Senate Banking Committee said that for now, he will defer to the SEC efforts to institute mutual fund reform before he would consider legislation.

- Nearly 100 federal class-action lawsuits alleging trading abuses at six mutual fund companies, including those naming Janus Capital Group, Inc., will be heard at the U.S. District Court in Baltimore, Maryland.

- The Department of Labor has been asked to consider issuing guidance to clarify that plan fiduciaries may restrict activities of participants who engage in market timing, plan sponsors may rely on a fund's determination that trading activity is harmful to participants, and that a plan sponsor may apply fund trading restrictions to plan participants.

- North Carolina, California and New York issued "Mutual Fund Protection Principles" on January 15, 2004, with the goal of influencing the marketplace by requiring mutual funds doing business in state to follow their guidelines.

Attachments:

1. Mutual Fund Investment Firm Responses to November 2003 WDC Query
2. Janus CEO Steve Scheid Letter to Janus Institutional Clients, Janus Capital Group April 27, 2004
3. Q&A Regarding Janus' Agreements with Regulators, Janus Capital Group April 27, 2004
4. "Janus Reaches Agreements in Principle with Regulators, Announces First Quarter 2004 Results" Janus Capital Group Press Release, April 27, 2004
5. "Janus Settles Up" *PlanSponsor.com NewsDash* April 27, 2004
6. "Janus CEO Steps Down" *PlanSponsor.com NewsDash* April 20, 2004
7. Janus CEO Mark Whitson Letter to Institutional Clients, Janus Capital Group April 20, 2004
8. "Janus Capital Group Announces Management Change" Janus Capital Group Press Release, April 20, 2004
9. "Mutual Funds' Scandal Spawns New SEC Rules" *Wall Street Journal* April 14, 2004
10. "Federated Fund Directors' Letter to Fund Shareholders" Feb. 3, 2004
11. "Analysis of the Proposed SEC Rules Re: Mutual Fund Trading Practices" Nationwide Retirement Education Institute Panel of Advisors, January 20, 2004
12. "Update from the Independent Trustees of the Janus Funds" Dec. 2003