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MUTUAL FUND LEGISLATION INTRODUCED BY SENATORS FITZGERALD, LEVIN, AND COLLINS

[17112] February 17, 2004 TO: ACCOUNTING/TREASURERS MEMBERS No. 6-04 BOARD OF GOVERNORS No. 14-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 11-04 FEDERAL LEGISLATION MEMBERS No. 5-04 INVESTMENT COMPANY DIRECTORS No. 10-04 OPERATIONS MEMBERS No. 10-04 PENSION MEMBERS No. 13-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 17-04 PUBLIC COMMUNICATIONS COMMITTEE No. 10-04 SEC RULES MEMBERS No. 26-04 SMALL FUNDS MEMBERS No. 20-04 UNIT INVESTMENT TRUST MEMBERS No. 9-04 RE: MUTUAL FUND LEGISLATION INTRODUCED BY SENATORS FITZGERALD, LEVIN, AND COLLINS On February 10, Senators Peter Fitzgerald (R-IL), Carl Levin (D-MI), and Susan Collins (R-ME) introduced S. 2059, the "Mutual Fund Reform Act of 2004" ("Act"). The bill, which has been referred to the Senate Committee on Banking, Housing and Urban Affairs, is summarized below.1 TITLE I – FUND GOVERNANCE Independent Directors (Section 110) The bill would amend Section 10(a) of the Investment Company Act of 1940 to require that 75% of a fund's board be independent and that the board's chairman also be independent. In addition, no person would be able to serve as an independent director of a fund unless: (1) he or she is approved or elected by fund shareholders at least once every 5 years; and (2) a majority of the independent directors make an annual finding that the director does not have any material business or familial relationship with the fund, a "significant service provider" to the fund (to be defined by the Securities and Exchange Commission), or a person who controls, is 1 A copy of S. 2059 is available on the website of the Government Printing Office at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s2059is.txt.pdf. 2 controlled by, or is under common control with such service provider, that is likely to impair the director's independence. In addition, a fund's independent directors would be required to form a committee, comprised solely of independent directors, with responsibility for: (1) selecting nominees for election to the board; (2) adopting qualification standards for nominees; and (3) determining the compensation to be paid to directors. The qualification standards would have to be disclosed in the fund's registration statement. The bill would expand the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to include the following: • any person, or partner or employee of any person, who has acted as legal counsel for a fund, its investment adviser or principal underwriter since the beginning of the last five completed fiscal years (rather than two years, as is currently the case); • any person who, within the preceding 10 fiscal years, has served as an officer, director or employee of the fund's investment adviser or principal underwriter or an entity that controls, is controlled by, or is under common control with the adviser or underwriter; • any person who, within the preceding 10 fiscal years, has served as an

officer, director or employee of an entity that has served as a “significant service provider” to the fund at any time within the preceding five fiscal years, or of any entity that controls, is controlled by, or is under common control with such service provider;2 and • any person who is a member of a class of persons that the SEC, by rule or regulation, determines is unlikely to exercise an appropriate degree of independence as a result of (1) a material business relationship with the fund, an affiliated person of the fund, the fund’s investment adviser or principal underwriter, or an affiliated person of the adviser or underwriter; (2) a close familial relationship with any natural person who is an affiliated person of the fund, its investment adviser or principal underwriter; or (3) any other reason determined by the SEC.3 Study of Director Compensation and Independence (Section 111) The bill would direct the SEC to study whether any limits should be placed upon the compensation paid by a fund or fund affiliate to a director thereof. The SEC would also have to study whether an independent director should “lose” his or her independence by virtue of service on multiple fund boards or the receipt of substantial compensation from the investment adviser of any such fund. The SEC would have to report to Congress on the study within one year of enactment of the Act. 2 The SEC would be required to define the term “significant service provider,” which definition would be required to include a fund’s investment adviser and principal underwriter. 3 Current law authorizes the SEC, by order, to determine that a person is an interested person by reason of having had, at any time since the beginning of the last two fiscal years, a material business or professional relationship with (1) the fund, (2) the fund’s principal executive officer, (3) any other fund with the same investment adviser or principal underwriter, (4) the principal executive officer of such other fund, (5) the fund’s investment adviser or principal underwriter or (6) the principal executive officer of the adviser or underwriter. 3 Fiduciary Duties of Directors (Section 112) The bill would amend Section 10(a) of the Investment Company Act to state that fund directors have a fiduciary duty to act with loyalty and care, in the best interests of fund shareholders. The bill also would require the SEC to issue rules to clarify the scope of this fiduciary duty, which must require at a minimum that fund directors: • determine the extent to which independent and reliable sources of information are sufficient to discharge director responsibilities; • negotiate management and advisory fees with due regard for the actual cost of such services, including economies of scale; • evaluate the totality of fees with reference to the interests of shareholders, as well as the quality, comprehensiveness, and clarity of disclosures to shareholders regarding costs; • evaluate the quality of fund management and potentially superior alternatives; • evaluate any distribution or marketing plan of the fund, including its costs and benefits; • evaluate the size of the fund’s portfolio and its suitability to the interests of shareholders; • implement and monitor policies to ensure compliance with applicable securities laws; and • implement and monitor policies with respect to predatory trading practices. Fiduciary Duty of Investment Adviser (Section 113) The bill would amend Section 36 of the Investment Company Act to provide that an adviser’s fiduciary duty: (1) may require reasonable reference to the adviser’s actual costs and economies of scale with respect to any compensation received by the adviser; and (2) includes a duty to supply such material information as is necessary for a fund’s independent directors to review and govern the fund. Termination of Fund Advisers (Section 114) The bill would require the SEC to issue such rules as it determines necessary in the public interest or for the protection of investors to facilitate the process through which a fund’s independent directors may terminate the services of the fund’s adviser, in the good faith exercise of their fiduciary duties and without undue exposure to financial or litigation risk. Independent Accounting and Auditing (Section 115) The bill would apply to mutual funds audit committee standards similar to those imposed on listed companies by Section 301 of the Sarbanes-Oxley Act of 2002 and Rule 10A-3 under the Securities Exchange Act of 1934. 4 Prevention of Fraud; Internal Compliance and Control Procedures (Section 116) The

bill would amend Section 17(j) of the Investment Company Act by expanding it to cover fraudulent, deceptive or manipulative acts, practices, or courses of business in connection with purchases or sales by certain persons, not only of any security held or to be acquired by a fund (as is currently the case), but also of any security issued by the fund or an affiliate. The SEC would have to adopt rules requiring: (1) a fund and its investment adviser and principal underwriter to adopt codes of ethics; (2) the fund to disclose its code and any changes to such code in its periodic reports to shareholders; and (3) the fund to disclose its code and any waivers and material violations of such code on a readily accessible electronic public information facility of the fund and as otherwise required by the SEC. The bill would direct the SEC to issue rules requiring funds and registered advisers to: (1) adopt and implement policies and procedures reasonably designed to prevent violations of the federal securities laws and certain other designated laws; and (2) review the policies and procedures annually for their adequacy and the effectiveness of their implementation. Each fund would have to appoint a chief compliance officer ("CCO") to oversee its compliance policies and procedures. The CCO, whose compensation would be subject to approval by the fund's independent directors, would have to report directly to the independent directors at least annually, and in private as the directors so request. These reports would have to include any violations or waivers of, or other significant issues arising under, the compliance policies and procedures. The SEC also would have to issue rules requiring each senior executive officer (or such officers designated by the SEC) of a fund's adviser to certify in each shareholder report that: (1) procedures are in place for verifying that the determination of the fund's current net asset value ("NAV") complies with this Act and rules thereunder,4 and the fund is in compliance with such procedures; (2) procedures are in place to ensure that, if the fund has multiple classes, they are designed in the interests of investors and could reasonably be an appropriate investment option for an investor; (3) procedures are in place to ensure that information about the fund's portfolio securities is not disclosed in violation of the securities laws or the fund's code of ethics; (4) the independent directors have reviewed and approved the compensation of the fund's portfolio manager; and (5) the fund has established and enforces a code of ethics. The bill would prohibit a fund, its investment adviser or principal underwriter, or any significant service provider to the fund (or any officer, employee, contractor, or agent of such entity) from retaliating against an employee because of any lawful act by such employee. TITLE II – FUND TRANSPARENCY Cost, Consolidation, and Clarity (Section 210) The bill would direct the SEC to develop a standardized method by which funds would have to calculate: (1) an expense ratio that accounts for as many operating costs to fund 4 It appears that this provision of the bill may have intended to refer to the Investment Company Act and the rules thereunder. 5 shareholders as is practicable;5 and (2) a transaction cost ratio that predictably and fairly accounts for actual costs to fund shareholders including, at a minimum, brokerage commissions and bid-ask spread costs. The two ratios would have to be disclosed, both separately and together as a ratio of total investment cost, in the fee table contained in the fund's prospectus and in annual reports to shareholders. The bill would direct the SEC to issue rules requiring prominent disclosure in shareholder account statements, on at least an annual basis, of the actual dollar amount of projected annual costs of each shareholder based on the shareholder's asset value at the time of disclosure. The bill would direct the SEC to define by rule all specific, allowable categories of fees and expenses that may be borne by fund shareholders. No other fee or expense could be borne by fund shareholders unless the SEC finds that it fairly reflects the services provided to, or is in the best interests of the shareholders of: (1) a particular fund; (2) specific types of funds; or (3) funds in general. The bill also would direct the SEC to issue rules requiring: (1) disclosure in fund prospectuses and any reports filed with the SEC of all types of fees, expenses, and costs borne by fund shareholders; (2) a clear definition of each such fee,

expense, and cost; and (3) information as to how shareholders can learn more about such fees, expenses, and costs. The bill would direct the SEC to issue such rules as are necessary to: (1) promote the standardization and simplification of disclosure of funds' cost structures; and (2) ensure that fund shareholders receive all material information regarding such costs in a manner that is not misleading and in a manner to facilitate (to the extent practicable) comprehension and comparison of such costs. Adviser Compensation and Ownership of Fund Shares (Section 211) The bill would direct the SEC to issue rules requiring funds to disclose: (1) the amount and structure of, or method used to determine, the compensation paid by the fund to its portfolio manager or portfolio management team; and (2) the ownership interests of such persons in the fund. This information would have to be disclosed in fund registration statements and in any other filings designated by the SEC. The fund's portfolio manager(s) also would be required to disclose all of their transactions in fund shares to the fund's board of directors. Point of Sale and Additional Disclosure of Broker Compensation (Section 212) The bill would direct the SEC to issue rules requiring brokers to disclose in writing to each person purchasing fund shares the source and amount of compensation that the broker will receive in connection with the transaction. The disclosure would have to be made at or before the time of the transaction. The bill specifies that the disclosure may not be made exclusively in a fund's registration statement or any fund filing with the SEC. 5 If the SEC determines that inclusion of certain costs in the expense ratio would lead to significant risk of confusing or misleading investors, the SEC would have to develop separate standardized methods for the calculation and disclosure of such costs. 6 Breakpoint Discounts (Section 213) The bill would direct the SEC to issue rules requiring a fund to disclose, in its periodic reports filed with the SEC, information concerning discounts on front-end sales loads for which shareholders may be eligible, including the minimum purchase amounts required for such discounts. Portfolio Turnover Ratio (Section 214) The bill would direct the SEC to issue rules requiring a fund to disclose prominently, in its prospectus and in periodic reports filed with the SEC, the fund's portfolio turnover ratio and an explanation of the ratio's meaning and its implications for cost and performance. Proxy Voting Policies and Record (Section 215) The bill would make the disclosure by mutual funds of their proxy votes and their proxy voting policies a statutory requirement. Such disclosure is currently required by SEC rule. Customer Information from Account Intermediaries (Section 216) The bill would direct the SEC to issue rules requiring account intermediaries to provide a fund with such information about each account that the intermediary services as is necessary for the fund to enforce its investment, trading, and fee policies. The information provided would have to include, at a minimum: (1) the name under which the account is opened; (2) the taxpayer identification number and mailing address for such person; and (3) individual transaction data for all purchases, redemptions, transfers, and exchanges by or on behalf of such person. The bill states that the information and its use would be subject to all federal and state laws concerning privacy and proprietary information. Advertising (Section 217) The bill would direct the SEC to issue such rules as it determines necessary with respect to fund advertising regarding: (1) unrepresentative short-term performance; (2) performance based on an undisclosed or improbable event; and (3) performance based on incomplete or misleading data. The bill also would direct the SEC to issue rules requiring funds to disclose dollar- weighted returns and time-weighted returns for each of the preceding one-, five- and ten-fiscal year periods and for the life of the fund. The disclosures would have to be included in a fund's prospectus and its annual report. The SEC would have the discretion to: (1) omit or require additional disclosures for such time periods as it deems necessary; and (2) require that any performance advertising by a fund be accompanied by such benchmarks as it deems appropriate. The bill also would direct the SEC to issue rules requiring any fund that publicizes a subsidized yield also to disclose the amount and duration of such subsidy. 7

TITLE III – FUND REGULATION AND OVERSIGHT Prohibition of Asset-Based Distribution Expenses (Section 310) The bill would repeal Rule 12b-1 under the Investment Company Act beginning 180 days after enactment of the Act. The bill also would amend Section 12 of the Investment Company Act to: (1) prohibit funds from paying asset-based fees (as defined by the SEC) to any broker or dealer in connection with the offer or sale of fund shares; and (2) permit distribution expenses incurred by a fund adviser to be paid out of the adviser's management fee. The bill would direct the SEC to issue rules: (1) requiring a fund's adviser to disclose to the fund's board any payments made by the adviser to promote or facilitate the sale of fund shares; (2) requiring that such payments be included and identified in the fund's expense ratio; and (3) authorizing the fund's board to prohibit the adviser from using any compensation received from the fund for distribution expenses that the board determines are not in the best interests of fund shareholders. Prohibition on Revenue Sharing, Directed Brokerage, and Soft Dollar Arrangements (Section 311) The bill would add new Section 12A to the Investment Company Act to prohibit: (1) any revenue sharing arrangement between an adviser and a broker-dealer with respect to fund shares; (2) any directed brokerage arrangement between a fund or any fund affiliate and a broker-dealer; and (3) any soft dollar arrangement between a fund or registered adviser and a broker-dealer. The bill would permit the SEC by rule, however, to tailor these prohibitions to achieve the following purposes: (1) protecting the best interests of fund shareholders; (2) minimizing or eliminating conflicts with the best interests of fund shareholders; (3) enhancing market negotiation for, and price competition in, trade execution services and products and services previously obtained under the prohibited arrangements; (4) ensuring the transparency of transactions for trade executions and products and services previously obtained under the prohibited arrangements, and ensuring that disclosure of costs associated with such executions and products and services is simplified, clear and comprehensible; and (5) providing reasonable safe harbors for conduct otherwise consistent with such purposes. The bill also would direct the SEC to issue rules to narrow the soft dollar safe harbor in Section 28(e) of the Securities Exchange Act in order to promote such parity as the SEC deems appropriate between funds and companies that are not covered by the prohibitions outlined above. Market Timing (Section 312) The bill would direct the SEC to issue rules requiring: (1) funds to disclose their market timing policies and procedures in their registration statements; and (2) any fund that does not adopt restrictions on market timing to disclose that fact in its registration statement and in any advertising or publicly available document as the SEC determines necessary. A fund's market timing policies would be deemed to be fundamental policies for purposes of the Investment Company Act. 8 Elimination of Stale Prices (Section 313) The bill would direct the SEC to prescribe standards concerning a mutual fund's obligations to apply and use fair value methods of NAV determination in order to prevent dilution of the interests of long-term shareholders or as necessary in the public interest or for the protection of shareholders. The SEC would have to identify, in addition to significant events, the conditions or circumstances from which the obligation to use fair value will arise and the ways by which fair value methods shall be applied. Prohibition of Short-Term Trading; Mandatory Redemption Fees (Section 314) The bill would prohibit certain persons6 from engaging in "short-term transactions" (to be defined by SEC rule) in securities issued by a fund or its affiliate, other than money market funds, other funds whose investment policy expressly permits short-term transactions, or other categories of funds specified by SEC rule. The bill would direct the SEC to issue rules requiring any fund that does not allow market timing to charge a redemption fee upon the short-term redemption of its shares. In determining the application of mandatory redemption fees, shares would have to be considered in the reverse order of their purchase (i.e., on a last in, first out basis). The SEC also would be required to revise its rules as necessary to permit a fund to charge

redemption fees in excess of 2 percent upon the redemption of fund shares within such period after their purchase as the SEC specifies. Prevention of After-Hours Trading (Section 315) The bill would direct the SEC to issue rules to prevent transactions in fund shares in violation of Section 22 of the Investment Company Act, including after-hours trades that are executed at a price based on a NAV that was determined as of a time prior to the actual execution of the transaction. The SEC would have to determine the circumstances under which to permit the execution of trades provided to the fund by an intermediary after the time as of which the NAV was determined, which circumstances must include an annual independent audit of such trades. Ban on Joint Management of Mutual Funds and Hedge Funds (Section 316) The bill would amend Section 15 of the Investment Company Act to prohibit an individual from serving as the portfolio manager or investment adviser of both a registered mutual fund and an unregistered investment company (or other category of company prescribed by SEC rule) in order to prevent conflicts of interest. The SEC would be permitted to make exceptions to the joint management prohibition in exceptional circumstances when necessary to protect the interest of shareholders, but any rule, regulation or order doing so would have to require: (1) enhanced disclosure by the mutual fund to shareholders of any conflicts of interest raised by such joint management; and (2) fair and equitable policies and 6 These persons are any officer, director, partner, or employee of a fund, any affiliated person, investment adviser, or principal underwriter of such fund, or any officer, director, partner, or employee of such an affiliated person, investment adviser, or principal underwriter. 9 procedures for allocating securities to the portfolios of the jointly managed companies, as well as certification by the mutual fund's independent directors in shareholder reports or other appropriate documents that such policies and procedures are fair and equitable. Selective Disclosures (Section 317) The bill would direct the SEC to issue such rules as it determines necessary to prevent a fund from selectively disclosing material information about its portfolio securities. Such rules would be required to treat selective disclosures by funds in substantially the same manner as selective disclosures by issuers of securities registered under section 12 of the Securities Exchange Act. TITLE IV – ADDITIONAL STUDIES Adviser Conflicts of Interest (Section 410) The bill would require the SEC to study the consequences of the inherent conflicts of interests confronting fund advisers, the extent to which legislative or regulatory measures could minimize such conflicts, and the extent to which legislative or regulatory measures could incentivize internal management of funds. The SEC would be required to submit a report to Congress on the study within one year of enactment of the Act. Coordination of Enforcement Efforts (Section 411) The bill would require the General Accounting Office ("GAO"), with the cooperation of the SEC, to study the coordination of enforcement efforts between the SEC (both its headquarters and its regional offices) and state regulatory and law enforcement agencies. The SEC would be required to report to Congress on the study within one year of enactment of the Act.7 Commission Organizational Structure (Section 412) The bill would require the GAO, with the cooperation of the SEC, to study the SEC's current organizational structure with respect to fund regulation and whether the organizational structure and resources of the SEC "sufficiently credit the importance of fund oversight" to fund investors. The study also would address whether certain organizational features, such as the separation of regulatory and enforcement functions, are sufficient to promote the optimal understanding of current fund practices. Finally, the study would address whether a separate regulatory entity would improve or impair effective oversight. The GAO would be required to report to Congress on the study within one year of enactment of the Act. Trends in Arbitration Clauses (Section 413) The bill would require the SEC to study the trends in arbitration clauses between brokers, dealers, and investors since 1995, and alternative means to avert the filing of claims in 7 It appears that this provision of the bill may have intended to require the GAO (not the SEC) to report to Congress on the

study. 10 federal or state court. The SEC would be required to submit a report to Congress on the study within one year of enactment of the Act. Hedge Fund Regulation (Section 414) The bill would require the SEC to study whether additional regulation of alternative investment vehicles, such as hedge funds, is appropriate to deter the recurrence of trading abuses, the manipulation of funds by unregistered investment companies, or other distortions that may harm fund investors. The SEC would be required to report to Congress on the study within one year of enactment of the Act. Investor Education and the Internet (Section 415) The bill would require the SEC to study: (1) how to enhance the role of the Internet in educating investors and providing timely information regarding laws, regulations, enforcement proceedings, and individual funds; (2) the feasibility of requiring each fund to maintain a website on which it would post its SEC filings and any other material information related to the fund; and (3) how to ensure that the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system is user-friendly and facilitates the expeditious location of material information. The SEC would be required to report to Congress on the study within one year of enactment of the Act. Rachel H. Graham Assistant Counsel

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