The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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MUTUAL FUNDS LEGISLATION INTRODUCED; HEARING ANNOUNCED

[16192] June 11, 2003 TO: BOARD OF GOVERNORS No. 28-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 49-03 DIRECTOR SERVICES COMMITTEE No. 8-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 45-03 SEC RULES MEMBERS No. 71-03 RE: MUTUAL FUNDS LEGISLATION INTRODUCED; HEARING ANNOUNCED House Capital Markets Subcommittee Chairman Richard H. Baker today introduced H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003" (the "Act"), which is intended "to improve transparency relating to the fees and costs that mutual fund investors incur and to improve corporate governance of mutual funds." Chairman Baker announced that the Capital Markets Subcommittee will hold a hearing on the legislation on June 18th. The bill is summarized below.1 Transparency of Mutual Fund Costs The bill would direct the SEC, within 270 days after the date of enactment of the Act, to adopt rules to require an open-end management investment company to disclose the following: • the estimated amount, in dollars, of the operating expenses of the fund that are borne by each shareholder; • the structure of, or method used to determine, the compensation of individuals employed by the investment adviser of the fund to manage the portfolio of the fund; • the portfolio transaction costs of the fund, including commissions paid with respect to the trading of portfolio securities, set forth in a manner that facilitates comparison among funds; • information concerning the fund's policies and practices with respect to soft dollar arrangements, specifically, the payment of brokerage commissions to a broker who provides research services, and information concerning the fund's policies and 1 Copies of the bill and the section-by-section analysis are available at http://financialservices.house.gov/news.asp?FormMode=release&id=343&NewsType=1. 2 practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the fund's shares; • information concerning revenue sharing (i.e., payments by any person other than the fund that are intended to facilitate the sale and distribution of the fund's shares); and • information concerning breakpoint discounts on front-end sales loads for which an investor may be eligible, including the minimum purchase amounts required for such discounts. The bill would require this disclosure in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document. The bill provides that disclosure would not be considered to be made in an appropriate document if it is made exclusively in a prospectus or statement of additional information, or both. The bill would permit the SEC to require that the disclosure be made in a prospectus or SAI, so long as that disclosure is also provided in another appropriate document. The bill also would permit the SEC to consider whether a document provided by a broker or dealer, rather than the fund, may be an appropriate disclosure document, e.g., for disclosure of information concerning revenue sharing payments. Obligations Regarding Certain Distribution and Soft Dollar Arrangements The bill would amend Section 15 of the

Investment Company Act to require each investment adviser to a registered investment company to annually provide the fund's board of directors with a report on: • payments made by the adviser (or an affiliate) to promote the sale of fund shares ("revenue sharing arrangements"); • services provided to the fund or paid for by brokers executing securities transactions for the fund (or its affiliate) ("directed brokerage arrangements"); and • research services obtained by the adviser (or its affiliate) from a broker as result of securities transactions effected on behalf of the fund ("soft dollar arrangements"). The bill would impose a fiduciary obligation on fund directors to supervise these arrangements and to determine that the direction of fund brokerage is in the best interests of the fund's shareholders and that any revenue sharing arrangements are consistent with the Act, e.g., are not disguised payments from fund assets, and are in the best interests of the fund's shareholders. The SEC would be given rulemaking authority under the bill to implement the above requirements. Mutual Fund Governance The bill would amend Section 10(a) of the Investment Company Act to require two- thirds of a fund's board to be independent and to require that the chairman of the board be independent. 3 The bill would amend the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to exclude persons with (1) a material business relationship with the fund, its investment adviser or principal underwriter (or any of their affiliated persons), or (2) a close familial relationship with any natural person who is an adviser or principal underwriter to the fund (or any of their affiliated persons). The bill would delete from Section 2(a)(19) references to broker-dealers and lenders as interested persons to permit the SEC to include persons with such material business relationships as interested persons in a rule adopted pursuant to its new authority provided under the Act. Audit Committee Requirements The bill would amend Section 32 of the Investment Company Act to require the audit committee of a registered management company, rather than the independent directors of the full board, to be responsible for the selection of the auditor. The bill also would amend Section 32 to make it unlawful for any such fund to file with the SEC any financial statement signed or certified by an independent public accountant unless the fund is in compliance with the following standards: • The audit committee must be directly responsible for the appointment, compensation, and oversight of auditors and the auditors must report directly to the audit committee. • Each member of the audit committee must be "independent." In order to be considered "independent," a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (1) accept any consulting, advisory, or other compensatory fee from the fund or any affiliated person of the fund, or (2) be an "interested person" of the fund, as that term is defined in Section 2(a)(19) of the Investment Company Act. • Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the fund and its affiliated persons of concerns regarding questionable accounting or auditing matters. • Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. • Each fund must provide appropriate funding, as determined by the audit committee, for payment of compensation to the auditors and any advisers employed by the audit committee. The bill would amend Section 32 of the Investment Company Act to define "audit committee" to mean (1) a committee of the board of directors that oversees the accounting and financial reporting processes of the fund and audits of its financial statements, an (2) if no such committee exists, the full board of directors. The bill would amend Section 10A(m) of the Securities Exchange Act to exempt registered investment companies from the requirements of Section 10A(m) (the codification of 4 Section 301 of the Sarbanes-Oxley Act) effective one year after enactment of the Act. This exemption would not, however,

preclude one of the exchanges or Nasdaq from imposing audit committee requirements on listed funds in appropriate circumstances. The bill would require the SEC to issue final rules to implement the above requirements within 180 days after enactment of the Act. SEC Study and Report on Soft Dollar Arrangements The bill would direct the SEC to conduct a study of the use of soft dollars by investment advisers. The bill would require the SEC, in preparing the report, to examine trends in soft dollar use during the preceding three years, the types of services provided, the extent to which use of soft dollars impairs the ability of investors to evaluate and compare expenses of investment companies, and the transparency of such arrangements. Finally, the bill would require that the study address the SEC's view of whether Section 28(e) of the Exchange Act should be repealed or modified. The SEC would be required to submit its study to Congress within 18 months of the date of enactment of the Act. Matthew P. Fink President

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