INVESTMENT COMPANY INSTITUTE

MEMO# 10166

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GROWING ATTENTION TO FUND FEES AND EXPENSES AND THE ROLE OF INDEPENDENT DIRECTORS

[10166] July 31, 1998 TO: BOARD OF GOVERNORS No. 48-98 RE: GROWING ATTENTION TO FUND FEES AND EXPENSES AND THE ROLE OF INDEPENDENT DIRECTORS ____ I want to note for you the recent increase in public attention to (1) mutual fund fees and expenses and (2) the role of independent directors in fund governance. 1. Chairman Levitt's Speech at the GMM Chairman Levitt's speech did not break new ground, but it generated a tremendous amount of press coverage. The Chairman said he was "disturbed" and "very concerned" about "the number of investors who don't understand the impact of fees and expenses." He suggested that the industry overemphasized performance in marketing and advertising while "ignor[ing] risk and expenses." According to the Chairman, performance-based advertising that highlights unprecedented recent returns was causing investors to develop unrealistic expectations. He predicted this would lead to "millions of disappointed investors" and "trouble" for the fund industry. Although he was pleased by the industry's important work in promoting investor education, the Chairman said these efforts have not kept pace with the growth of the market. He closed by asking the industry to do more to "keep faith" with "the millions of families who have confidence in [the industry's] judgment" and who depend on its integrity. 2. The SEC-Sponsored Roundtable on Fund Directors During his GMM speech, Chairman Levitt announced that the Commission would sponsor a roundtable on the role of fund directors in October. We have apprised you of developments related to this event, and will continue to do so. The role of fund directors has also attracted increased press attention, most notably in a lengthy New York Times story published in early June. A copy of that story is enclosed as Attachment A. 3. Chairman Levitt's Interview With Bloomberg Chairman Levitt indicated during an interview in June that he intends to meet with dozens of mutual fund directors and executives to discuss fund fee levels. The story also indicated that the Chairman had instructed SEC staff to monitor advertisements -2- to track responsiveness to his concerns. The wire story that resulted from the interview is enclosed as Attachment B. 4. National Press Club Forum On Mutual Fund Fees On July 1, the National Press Club sponsored a Forum entitled "Mutual Fund Fees & Disclosure: Too Much? Too Little?" The forum was moderated by a reporter from Kiplinger's. Panelists included Barry Barbash, Director of the Division of Investment Management at the SEC, Mike Miller from Vanguard, and representatives from the AARP and NAASA. The forum was broadcast live on C-Span. Press coverage of the forum is enclosed as Attachment C. 5. USA Today Editorial On Mutual Fund Fees On July 8, USA Today published an editorial entitled "Industry Doing Poor Job of Explaining Charges." The

Institute was given the opportunity to prepare a response to the editorial, but, as is USA Today's customary practice, the Institute did not see the editorial in advance. While we believe we succeeded in setting forth a strong message, the staff at USA Today edited our response, and declined our request to include a sample fee table. We also sent a follow-up letter pointing out that the editorial's contention that fees are rising is incorrect and is based on flawed research. Copies of the editorial, the ICI response (as submitted to USA Today, and as published), and the ICI letter are enclosed as Attachment D. 6. Senate Appropriations Committee Report Accompanying the SEC Budget In approving a higher budget for the SEC than the Clinton Administration requested, the Senate Appropriations Committee Report expressed concern about whether investors adequately understood the information about mutual fund fees that was disclosed to them. According to the Report: Surveys indicate that while mutual fund investors anticipate returns of over 20 percent per year, only 8 percent completely understand the expenses mutual funds charge. The Committee commends the Chairman of the Commission for his effort to educate investors. The Committee agrees that small investors must be educated on the risk of the stock markets. The SEC's efforts to simplify fund documents provides better communication to all investors. Also, the series of town meetings the SEC has held continues to provide unbiased information to the investor. Finally, the need to provide full disclosure on the cost of mutual fund services is a needed change in the way fund managers work with the small investor. The Committee urges the SEC to continue its work in these efforts. -3- 7. State and Federal Litigation Involving The Role Of Independent Directors There have been a number of different litigation-related developments. Among the most important was the ruling in the Strougo case that directors who sit on multiple boards within a complex and receive relatively high compensation as a result are not "disinterested" under Maryland corporate law. As you may know, legislation was subsequently enacted in Maryland 3that harmonized the state's definition of "disinterested" with the definition that applies under the federal Investment Company Act. Additional cases pressing this issue have been filed. One of these was initiated earlier this month in a Maryland federal court. The case challenges the independence of directors who sit on multiple boards under the federal standard established by the Investment Company Act. 8. Columbia Law Review Note On Independent Directors In mid-1997, Morningstar published an article in which it asserted that there was a direct correlation between high fund expense ratios and high directors' fees. This "study" served as the basis for a March 1998 student article in the Columbia Law Review. The article criticized aspects of the Investment Company Act that set forth the responsibilities of independent directors. The article suggested that the failure of the fund governance process has led to higher mutual fund fees. We will keep you informed of further developments and will report to you at the October Board meeting about related Institute initiatives. Matthew P. Fink President Attachments

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