MEMO# 16280

July 11, 2003

SEC RESPONSE TO CONGRESSIONAL REQUEST FOR ADDITIONAL INFORMATION ON MUTUAL FUND INDUSTRY ISSUES

[16280] July 11, 2003 TO: BOARD OF GOVERNORS No. 35-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 57-03 DIRECTOR SERVICES COMMITTEE No. 13-03 FEDERAL LEGISLATION MEMBERS No. 12-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 54-03 PUBLIC INFORMATION COMMITTEE No. 23-03 SEC RULES MEMBERS No. 89-03 SMALL FUNDS MEMBERS No. 32-03 RE: SEC RESPONSE TO CONGRESSIONAL REQUEST FOR ADDITIONAL INFORMATION ON MUTUAL FUND INDUSTRY ISSUES Last month, the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing on H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003."1 Following the hearing, Subcommittee Ranking Minority Member Paul E. Kanjorski (D-PA) sent a letter to the Securities and Exchange Commission posing questions on several issues discussed at the hearing. The SEC staff recently responded to Congressman Kanjorski's questions. The staff's response is attached and summarized below. Disclosure of Fund Operating Expenses The staff's response first addresses Congressman Kanjorski's questions concerning the estimated cost per fund of (1) the SEC's pending proposal concerning disclosure of fund expenses in shareholder reports and (2) compliance with the full range of disclosures that H.R. 2420 contemplates, including the dollar amount of operating expenses for each shareholder. With respect to the SEC's proposal, the staff estimates annual compliance costs of approximately $3,988 per mutual fund registrant ($1,329 per mutual fund portfolio). The response states that the staff cannot estimate the cost of compliance with the full range of disclosures that H.R 2420 contemplates because it would depend on the specifics of the implementing rules, which are left to the SEC. The response further states that it is unclear whether rules along the lines of those proposed by the SEC would be consistent with Section 2(a)(1) of the bill, or whether that provision would require individualized disclosure of the actual dollar amounts of each investor's share of operating expenses. It notes that an ICI survey 1 See Memorandum to Board of Governors No. 31-03, Director Services Committee No. 11-03, Federal Legislation Members No. 9-03, Primary Contacts – Member Complex No. 50-03, Public Information Committee No. 20-03, SEC Rules Members No. 80-03 and Small Funds Members No. 28-03 [16225], dated June 20, 2003. 2 of industry participants found that the aggregate costs to survey respondents associated with calculating and disclosing each investor's share of operating expenses on quarterly account statements would be $200.4 million in initial implementation costs and $65.7 million in annual, ongoing costs. The response next discusses Mr. Bogle's testimony to the effect that actual dollar disclosures of expenses could be provided cheaply and effectively on account

statements by using an annualized expense ratio multiplied by the investor's balance. The response explains that this would result in a figure that reflects the operating expenses that a fund investor would pay over a year if the expense ratio and the investor's account balance remained constant. It expresses several concerns with the presentation of an estimate on account statements, including that (1) it might be difficult to explain the nature and limitations of the expense estimate without significantly cluttering the account statement, (2) the figure could significantly understate or overstate a investor's actual expenses if the investor's account value fluctuates significantly from the quarter-end balance, and (3) because account statements are distributed quarterly, an investor might mistakenly assume that the expense estimate represents expenses for one quarter (rather than one year). The response also expresses concern about the potential costs of implementing this method of expense disclosure, noting that both mutual funds and broker-dealers would have to make systems modifications, that broker-dealers would have to redesign account statements, and that both funds and broker-dealers would have to train personnel to respond to questions about the estimated expense figure. It states that the staff is concerned "that the benefits that shareholders would receive from the estimated expense figure might not outweigh these costs, which could be considerable." It further notes that the fund's expense ratio is already available in fund prospectuses, and that the SEC's pending expense disclosure proposal would permit investors to compare dollar amounts of fund operating expenses, rather than expense ratios, which some investors may find more difficult to understand than dollar amounts. In addition, in contrast to the SEC's proposal, Mr. Bogle's approach would not permit investors to make comparisons across funds because it would be based on an individual shareholder's quarter end account value. Disclosure of Portfolio Transaction Costs The staff's response then turns to a series of questions about disclosure of portfolio transaction costs. It reiterates the staff's view that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund but that quantitative disclosure of trading costs is problematic for several reasons. The response notes that some mutual fund managers retain independent consultants to review trading costs and report their findings to the manager and to fund directors. It states that while these reports can be useful to fund directors, the staff does not believe the data in such reports would be suitable for inclusion in disclosure documents provided to the investing public unless significant modifications were made. Not only would it be necessary to develop objective and verifiable criteria for measuring transaction costs, but also the staff does not have "sufficient information to evaluate whether methodologies designed to provide estimates for internal analytical purposes or academic research can feasibly be redesigned to provide transaction cost figures that are suitable for disclosure documents that must be attested to by fund management and external auditors." The staff's response further indicates that the staff is unable to estimate the cost per fund of 3 providing transaction cost disclosure without more specific information about the nature and methodology of the disclosure requirement. In light of these issues, the staff plans to recommend that the SEC issue a concept release seeking comment on the feasibility of requiring mutual funds to provide quantitative disclosure of their transaction costs. Independent Chairman The staff's response next addresses a question concerning how many funds that have a majority of independent directors currently have an independent chair. It states that, while the staff knows that almost all funds have a majority of independent directors, the staff does not have data on how many fund boards have elected independent directors as chairmen. It further states that one consultant has estimated that one-third of funds have independent chairmen, but notes that many of these funds may be sponsored by banks that, until the enactment of the Gramm-Leach-Bliley Act in 1999, were prohibited from having directors that were also directors, officers, or employees of the bank. Fund Governance Best Practice Guidelines In response to questions about the effectiveness of best practice guidelines developed by the ICI for corporate governance and other practices within the fund industry, the staff states its belief that fund governance practices have improved over the past few years as a result of several developments, including the 1999 guidelines developed by the ICI's advisory committee and the SEC's 2000 fund governance rules. The staff's response further observes that while many fund boards have adopted excellent governance practices that meet or exceed the advisory committee's recommendations, not all funds have embraced the best practices. For example, some funds continue to have former executives or relatives of the adviser serve as independent directors. For this reason, the staff supports Section 4 of H.R. 2420, which would close "gaps" in the Investment Company Act that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. SEC Rulemaking Concerning Funds and Advisers Since 1998 Congressman Kanjorski's letter asked for a description of the number and type of rules adopted by the SEC since 1998 concerning investment companies and their advisers, as well as the rulemaking proposals currently pending. The staff's response provides a chart categorizing by type of rule the 40 rules that have been adopted and nine that are currently pending. A complete list of these rules is set forth in an appendix to the staff's response. Effectiveness of Prospectus and Other Disclosure Documents The staff's response addresses questions about whether the prospectus is serving as an effective and efficient disclosure document for investors, and whether there are other documents that could be more helpful and accessible for investors. It states that the availability of information that is comprehensive, yet clear and easy to understand, is critical, given the importance of mutual fund investments to millions of Americans. While the prospectus serves an important function as the basic disclosure document for potential fund investors, the staff is concerned that some investors might find it overwhelming. The staff's response identifies a variety of factors that lead the staff to believe it may be appropriate to reexamine the current 4 disclosure regime for mutual funds, and discusses some of the challenges and goals involved. It lists several of the disclosure documents mutual funds currently prepare, and expresses the staff's belief that "it is appropriate to examine the role that each of the existing disclosure documents could play in enhancing the mutual fund disclosure regime, with particular attention to the different needs for information of different investors and the possibilities that technology offers for enhancing the ability of investors to choose the level of information that is helpful to them." Also on the topic of disclosure effectiveness, the staff's response discusses the mutual fund profile. It states that the profile may appear less overwhelming or complicated for investors who prefer a shorter document than the full prospectus, but notes that it is difficult to assess whether investors find the profile more effective than the prospectus because very few funds have chosen to use profiles. While emphasizing that there is no requirement to do so, the staff's response explains that many funds distribute their prospectuses annually to all shareholders because it is simpler than tracking which shareholders purchase additional shares. It indicates that the staff believes it would be useful to examine whether there are more effective means for funds to provide updated disclosure to their existing shareholders who purchase additional shares, such as use of the profile as an updating document, perhaps coupled with availability of a fund's prospectus upon request or at a fund's website. Impact of H.R. 2420 on Small Funds The staff's response acknowledges that regulatory requirements, including any that would be adopted to implement provisions of H.R. 2420, may impose relatively greater costs and burdens on small funds and small fund families because they have smaller asset bases to absorb these costs. It states that the staff considers the potential impact on small funds and small fund families when it makes rulemaking recommendations to the SEC, and also endeavors to minimize the regulatory burden on all funds. The response further states that the staff welcomes the input of small funds and fund families and would be pleased to consider any suggestions that would help them comply with disclosure requirements. It notes, however, that the staff would be concerned about any simplified disclosure regime for small funds or fund families that would compromise investor protection, e.g., by creating the risk that investors would not receive adequate information or impeding investors' ability to make informed comparisons among funds. In evaluating suggestions for reducing the compliance burden for small funds or fund families, the staff stated that it would be guided by the goal of furthering investor protection. Matthew P. Fink President Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 16280, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16280. Attachment (in .pdf format)
