The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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HOUSE HEARING ON H.R. 2420, MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

[16225] June 20, 2003 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 SMALL FUNDS MEMBERS No. 28-03 RE: HOUSE HEARING ON H.R. 2420, MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003 On June 18th, the House Financial Services 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." The following witnesses appeared at the hearing: John C. Bogle, Founder, The Vanguard Group; Mercer E. Bullard, Founder and President, Fund Democracy, Inc.; Paul G. Haaga, Jr., Chairman of the Investment Company Institute and Executive Vice President of Capital Research and Management Company (on behalf of the Institute); Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office; Mellody Hobson, President, Ariel Mutual Funds; and Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission. The written testimony of each of the witnesses is summarized below.1 Institute Testimony Mr. Haaga testified that the hearing brings together SEC representatives, mutual fund leaders, industry observers and members of Congress to determine whether a common set of initiatives can be devised that would assist mutual fund investors. He emphasized that it is noteworthy that the mutual fund industry has embraced the critical principles of integrity, transparency, accountability and competition for decades. While being proud of its record, the industry recognizes the need to re-examine the regulatory system to determine if it is working as intended and to determine whether there are ways to make it even stronger. Mr. Haaga stated that many of the provisions of H.R. 2420 would be beneficial to mutual fund investors, including steps to: (1) further enhance the independence of fund boards (by 1 Prepared statements and testimony are available at http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=233&comm=1. 2 requiring at least two-thirds of the directors of all investment companies be independent directors and tightening the definition of "interested persons"); (2) further enhance the independence of fund audit committees (by extending to mutual funds standards that are similar to those required of listed companies under Section 301 of the Sarbanes-Oxley Act of 2002); (3) clarify the role of fund directors and advisers with respect to soft dollar and directed brokerage arrangements; and (4) require the SEC to adopt rules mandating additional disclosure in certain areas, including the structure of portfolio manager compensation, revenue sharing arrangements and fund brokerage practices. Mr. Haaga pointed out that many of these important changes could be effected even in the absence of

legislation through regulatory action by the SEC or the adoption of best practices by the mutual fund industry. Mr. Haaga stated that certain parts of the bill are unnecessary and even could be harmful to mutual fund shareholders. These include the provisions that would: (1) require mutual funds to have an independent chairman of the board; (2) require certain disclosures to be made to fund investors in a document other than a prospectus; (3) require disclosure of the estimated amount of operating expenses borne by each individual shareholder; and (4) require fund boards to "supervise" revenue sharing arrangements. Mr. Haaga concluded by affirming the industry's readiness to work with the Subcommittee and the SEC to promote investor confidence in mutual funds. SEC Testimony Mr. Roye testified in support of the goals of enhancing disclosure and expanding the SEC's authority to define which directors should be considered independent. He noted that the bill would help to address ongoing concerns that fund investors do not understand the nature and effect of recurring mutual fund fees by requiring disclosure in dollars of the estimated amount of a mutual fund's operating expenses that are borne by each shareholder. Mr. Roye also pointed out that the Commission has outstanding a rule proposal that would achieve the same objectives addressed by the bill by requiring certain shareholder cost information in fund shareholder reports. He noted that the SEC staff is reviewing the comments on this proposal and expects to present the Commission with a recommendation in this area expeditiously. Mr. Roye stated that disclosure regarding the structure of an individual portfolio manager's compensation would be useful and that the improved disclosure of fund portfolio transaction costs that the bill would require should provide investors with a better understanding of these costs. He also agreed that fund investors should be provided with better information about soft dollar arrangements and testified in support of a study of such arrangements, including the safe harbor created by Section 28(e) of the Securities Exchange Act of 1934. Mr. Roye testified in support of: the bill's goal of improved information concerning a mutual fund's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of fund shares, improved disclosure with respect to revenue sharing arrangements, and improved disclosure of available breakpoint discounts. While supporting improved disclosures of mutual fund costs and related matters, Mr. Roye asked that the bill preserve the SEC's flexibility to determine the appropriate disclosure document(s) for each of the mandated disclosures and not preclude any particular document. 3 Mr. Roye's testimony also expressed support for requiring each investment adviser to an investment company to submit a report to the fund's board on revenue sharing arrangements, directed brokerage arrangements, and an adviser's use of soft dollar arrangements. Mr. Roye testified in support of the goal of the bill's provision that would require two-thirds of a fund's board to be independent and noted that there might be benefits in having an independent director serve as the chairman of the board. Mr. Roye also noted, however, that by increasing the representation of independent directors on fund boards, the bill would empower independent directors to use their judgment as to who should serve as chairman, including one of their own. Finally, Mr. Roye expressed support for the provisions of H.R. 2420 that would extend to mutual funds certain audit committee requirements similar to those required for listed companies under Section 301 of the Sarbanes-Oxley Act of 2002. GAO Testimony Mr. Hillman's testimony summarized the results of the GAO's recently issued report entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors,2 and commented on provisions in the bill addressing topics covered in the GAO Report. He indicated that, consistent with the bill, the GAO Report recommended that the SEC consider requiring additional disclosures, including: (1) specific disclosure of mutual funds fees in dollars to each investor in quarterly account statements; (2) more disclosure to investors about any revenue sharing payments their broker-dealers are receiving; and (3) disclosure to fund directors and investors about the adviser's use of soft dollars. With respect to fee

disclosure, Mr. Hillman pointed out that the GAO Report also discussed less costly alternatives that could prove beneficial to investors and spur increased competition among mutual funds. For example, one alternative would be to require quarterly statements to include the dollar amount of a fund's fees based on a set investment amount (which is the information that the SEC has proposed to be required in mutual fund shareholder reports). Mr. Hillman also noted that the bill would require funds to disclose more information about portfolio transaction costs. He indicated that the GAO Report found that although additional information about such costs could be beneficial to investors, determining these costs in a way that allows them to be accurately and fairly compared across funds could prove difficult. Mr. Hillman's testimony further noted that the bill would make certain "sound" corporate governance practices (e.g., fully independent audit committees) that are already in place at many funds, mandatory for all funds, ensuring consistent implementation of practices across the industry. Testimony of John C. Bogle Mr. Bogle testified in support of the bill, especially the provisions calling for disclosure of the estimated dollar amount of annual operating expenses borne by each shareholder, an increase in the required proportion of independent directors to two-thirds of each fund board, and an independent director as chairman of the board. 2 GAO-03-763 (Washington, D.C.: June 9, 2003) ("GAO Report"). The full report can be accessed at www.gao.gov/cgi-bin/getrpt?GAO-03-763. 4 He also asserted that any final legislation should go further in several respects, including: (1) creating in the Investment Company Act of 1940 an express fiduciary duty for fund directors to place the interests of fund shareholders ahead of the interests of fund managers and underwriters; (2) requiring funds to report their estimated portfolio transaction costs to investors; (3) requiring funds to provide the current rate of costs by disclosing the dollar amount each shareholder is incurring (by multiplying the fund's current expense ratio by the asset value of the investor's account each quarter); and (4) requiring disclosure of the actual amount of individual portfolio manager compensation, including the compensation for management teams and managers of multiple funds, the salaries of senior officers, the net income of the investment adviser both before and after taxes, and the amount of profits paid to "major" individuals and corporations that own the investment adviser's shares. Testimony of Mercer E. Bullard Mr. Bullard testified that fund distribution and brokerage practices have changed dramatically but that rules governing fund disclosure and fund director responsibilities have not kept pace. According to Mr. Bullard's testimony, fee disclosure fails to reflect accurately how and how much fund shareholders pay for fund-related services. Also, fund governance rules need to be improved to give independent directors the authority and tools they need to oversee funds' increasingly complex distribution and brokerage services. Mr. Bullard stated that the bill takes an important first step in modernizing mutual fund rules to reflect the way that funds operate today. Mr. Bullard testified in favor of requiring funds to disclose in quarterly statements the dollar amount of operating expenses paid by individual shareholders. With respect to fund portfolio manager compensation, he noted that the source and structure of compensation paid to a fund portfolio manager (or portfolio management team) are highly relevant to an investor because this information may indicate whether the manager's and the shareholders' interests are aligned. In contrast, the total value of a portfolio manager's compensation is not especially relevant. Mr. Bullard testified in favor of requiring funds to disclose portfolio transaction costs – both brokerage commissions and other costs (e.g., spread costs, opportunity costs) that are not as easily quantified. With regard to the adviser's use of soft dollars, Mr. Bullard recommended that the SEC consider requiring the quantification of soft dollar costs in a format that allows meaningful comparison across different funds. Mr. Bullard's testimony also contained several recommendations with respect to disclosure of fund fees and expenses, including the following: (1) the SEC should consider requiring disclosure, in the form of web-based calculators, that illustrates the

relative advantages and disadvantages of different share classes and the effect of breakpoints; (2) the SEC should direct the NASD to take steps to ensure that brokers direct their clients' attention to such disclosure; (3) the SEC should consider eliminating the 12b-1 fee line item from the fee table and replacing it with one or more lines that show the total fund assets spent on distribution; (4) the SEC should consider revising the entire fee table to set forth two categories of information – (a) the costs of investing in the fund (a single expense ratio, plus shareholder expenses such as loads and account fees), and (b) how fund fees are allocated among different types of services (e.g., in the form of a pie chart); and (5) the SEC should consider requiring 5 funds to provide a trade confirmation to investors disclosing how much the broker was paid in connection with the transaction, any incentives the broker may have had to prefer the sale of one fund over another, and a separate box showing the breakpoint schedule and how it was applied to the purchase. Mr. Bullard further testified in favor of requiring fund advisers to report to their directors on revenue sharing, the adviser's use of soft dollars, and directed brokerage and requiring directors to supervise such arrangements. He also supported requiring two-thirds of a fund's board to be independent, fund boards to be chaired by an independent director, providing the SEC with rulemaking authority to deem certain persons to be "interested persons," strengthening the independence of fund audit committees, and requiring the SEC to issue a report regarding soft dollars. Testimony of Mellody Hobson Ms. Hobson's testimony began by noting the volume of recently enacted and currently pending SEC rules for mutual funds and the costliness of these regulations for the fund industry. She expressed her concern with the negative effect this could have on the competitiveness of small mutual fund companies. Ms. Hobson also testified in support of the Institute's approach to the issues addressed by the bill (i.e., recommending regulatory action by the SEC and adoption of best practices by the industry to achieve the goals of the legislation) and urged the Subcommittee to provide sufficient time so that a consensus approach could be developed. In addition, she testified in favor of the "legend" alternative suggested in the GAO Report that would require funds to include a notice on shareholder account statements, reminding investors that they pay fees and to check the fund's prospectus for more information. Matthew P. Fink President

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