The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 16346**

July 25, 2003

# AMENDED MUTUAL FUND LEGISLATION APPROVED BY HOUSE COMMITTEE ON FINANCIAL SERVICES

[16346] July 25, 2003 TO: BOARD OF GOVERNORS No. 38-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 62-03 DIRECTOR SERVICES COMMITTEE No. 15-03 FEDERAL LEGISLATION MEMBERS No. 14-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 58-03 PUBLIC INFORMATION COMMITTEE No. 25-03 SEC RULES MEMBERS No. 97-03 SMALL FUNDS MEMBERS No. 37-03 UNIT INVESTMENT TRUST MEMBERS No. 23-03 RE: AMENDED MUTUAL FUND LEGISLATION APPROVED BY HOUSE COMMITTEE ON FINANCIAL SERVICES As you may know, on Wednesday, July 23, 2003, the House Committee on Financial Services approved a substantially amended version of H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003."1 The Committee approved the bill by a voice vote after considering several amendments. The Institute notes that several of the provisions we opposed have been substantially improved or eliminated, including2: • The requirement that mutual funds have an independent chairman of the board was deleted; • The requirement to disclose expenses on an individualized basis was changed to require disclosure of the estimated amount of the operating expenses borne by shareholders based on a standardized investment of $1,000; and • The requirement to disclose portfolio transaction costs was deleted and replaced with a requirement that the SEC issue a concept release. The provisions of the bill as approved by the Committee are summarized below, with changes to the original bill highlighted.3 Most significantly, the Committee approved an amendment in the nature of a substitute introduced by Committee Chairman Michael Oxley (R- OH) ("manager's amendment"). It contains the following provisions: 1 See Institute Memorandum [16192] dated June 11, 2003. 2 See Institute Memorandum [16308], dated July 16, 2003; Institute Memorandum [16271], dated July 8, 2003. 3 The version of the bill approved by the Committee is not yet available. 2 Transparency of Mutual Fund Costs The manager's amendment 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 for each $1,000 of investment in the company, of the operating expenses of the company that are borne by shareholders [note: the original bill appeared to require individualized expense disclosure]; • the structure of, or method used to determine, the compensation of individuals employed by the fund's investment adviser to manage the fund's portfolio; • the portfolio turnover rate of the company, set forth in a manner that facilitates comparison among investment companies, and a description of the implications of a high turnover rate for portfolio transaction costs and performance [note: the original bill would have required disclosure of portfolio transaction costs, including commissions, set forth in a manner that facilitates comparisons among funds]; • information concerning soft dollar and directed

brokerage policies and practices; • information concerning revenue sharing payments; and • information concerning breakpoint discounts on front-end sales loads. Like the original bill, the manager's amendment would require this disclosure in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document, but it would not allow the disclosure to be made exclusively in a prospectus or statement of additional information. However, the bill now provides an exception from this requirement for the disclosures concerning portfolio manager compensation and soft dollar and directed brokerage policies and practices. The original bill would have required disclosure of portfolio transaction costs. However, the manager's amendment requires the SEC to issue a concept release to examine the issue of portfolio transaction costs and how such costs may be disclosed to investors in a manner that will enable them to compare such costs among funds. The SEC would be required to report its findings to Congress no later than 270 days after enactment of the Act. A significant concern with the original bill was that it appeared to favor disclosure of fees in account statements. Instead, the manager's amendment includes a new account statement "legend" requirement. Specifically, the bill would now require the SEC to adopt a rule within 270 days of enactment requiring that periodic account statements contain a statement informing shareholders that they have paid fees on their investments, that such fees have been deducted from the amounts shown on the statements, and where shareholders may find additional information regarding the amount of these fees. The SEC is directed to give 3 consideration to methods for reducing the burdens to small investment companies of making this disclosure, consistent with the public interest and the protection of investors.4 Obligations Regarding Certain Distribution and Soft Dollar Arrangements Like the original bill, the manager's amendment would amend Section 15 of the Investment Company Act to require each adviser to a registered investment company to annually provide the fund's board of directors with a report on (1) revenue sharing arrangements, (2) directed brokerage arrangements and (3) soft dollar arrangements. It would impose a fiduciary responsibility on fund directors to "review" these arrangements [the original bill would have required fund directors to "supervise" these arrangements ] and to determine that the direction of fund brokerage is in the best interests of fund shareholders and that revenue sharing arrangements are consistent with the Investment Company Act and in the best interests of fund shareholders. The SEC would be given rulemaking authority to implement these requirements. In a change from the original bill, the manager's amendment provides that the SEC's implementing regulations would have to require that annual reports to shareholders contain a summary of the reports submitted to fund directors under this provision. The SEC also would have to adopt a rule within 270 days of the bill's enactment requiring that if research services are provided by a member of an exchange, broker, or dealer who effects securities transactions in an account and are provided by a party that is unaffiliated with such exchange member, broker, or dealer, any person exercising investment discretion with respect to the account must maintain a copy of the written contract between the exchange member, broker, or dealer and the person preparing the research, and the contract must describe the nature and value of the services provided. Mutual Fund Governance At the mark-up, the Committee approved an amendment to delete the independent chair requirement. Like the original bill, the manager's amendment would amend Section 10(a) of the Investment Company Act to require two-thirds of a fund's board to be independent. The manager's amendment made no change to provisions that 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 affiliated person of the fund. Audit Committee Requirements Like the original bill, the manager's amendment would apply 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 to open-end investment companies. Changes were 4 The Committee approved an amendment offered by Paul Kanjorski (D-PA), the ranking minority member of the House Capital Markets Subcommittee, that extends this requirement to all of the disclosure requirements in this section of the bill. 4 made to address technical issues with the independence criteria for audit committee members and the provision for submission of employee complaints to the audit committee. Trading Restrictions The manager's amendment includes a new provision that would amend Section 22(e) of the Investment Company Act, which currently prohibits a registered investment company from suspending redemptions of fund shares for more than seven days after they are tendered for redemption except, among other circumstances, for any period during which the New York Stock Exchange is closed other than customary week-end and holiday closings or during which trading on the NYSE is restricted. Under the amendment, a fund could suspend redemptions "for any period during which the principal market for the securities in which the [fund] invests is closed or trading restricted, other than customary week-end and holiday closings." The SEC would have rulemaking authority to provide for the determination by each fund, subject to limitations established by the SEC, the principal market for the securities in which the fund invests. Definition of No-Load Mutual Fund The manager's amendment includes a new provision requiring the adoption of SEC or self-regulatory organization rules to (1) "clarify the definition of 'no-load'" as used by funds that have 12b-1 fees and (2) require disclosure to prevent investors from being misled by the use of this term by the fund or its adviser or principal underwriter. Informing Directors of Significant Deficiencies The manager's amendment would amend Section 42 of the Investment Company Act to require that if a report of an SEC inspection of a fund identifies significant deficiencies, the fund must provide that report to its directors. Exemption from In-Person Meeting Requirement The manager's amendment would amend Section 15(c) of the Investment Company Act to authorize the SEC to exempt a fund from the in-person meeting requirement in that section, "when such a requirement is impracticable, subject to such conditions as the [SEC] may require." SEC Study and Report on Soft Dollar Arrangements Like the original bill, the manager's amendment would call for an SEC study of the use of soft dollar arrangements by investment advisers.5 Some revisions were made to the areas that the study would have to cover. For example, the study would no longer specifically be required to consider whether Section 28(e) of the 1934 Act should be repealed. 5 See fn. 6 below. 5 Study of Arbitration Claims The manager's amendment would require the SEC to conduct a study of the increased rate of arbitration claims and decisions involving mutual funds since 1995, for the purpose of identifying trends in claim rates and, if applicable, the causes of such increased rates and the means to avert such causes. The SEC would be required to submit a report to Congress on the study within one year from date of the bill's enactment. Fund Name Rule An amendment offered by Chris Shays (R-CT) to modify the fund name rule was defeated. The amendment would have prohibited funds from including terms such as "federal," "government," or other similar terms in their names, unless they invest at least 80% of their assets in securities that are direct obligations of the United States, or that are expressly guaranteed as to principal or interest by, or backed by the full faith and credit of the United States. Other Provisions At the mark-up, four amendments offered by Richard Baker (R-LA), Chairman of the House Capital Markets Subcommittee, were approved. These include the following: • an amendment to the provision relating to disclosure of portfolio managers compensation to also require disclosure of a portfolio manager's ownership of shares of the fund; • a provision directing the SEC to adopt rules requiring disclosure concerning incentive and other compensation paid to broker-dealers for selling mutual funds;6 • a provision amending Section 30 of the Investment Company Act to make the disclosure by mutual funds of their proxy votes a

statutory requirement; and • a provision directing the SEC to adopt rules requiring funds and investment advisers to adopt and implement compliance policies and procedures, review those policies and procedures annually and appoint a chief compliance officer to administer the policies and procedures. Two additional amendments were proposed, but not offered because of opposition from Members of the Committee: • a provision directing the SEC to adopt rules to require disclosure, in the semi- annual report or other appropriate document, of the fund's fees and performance, set forth in a way that compares the fund to a relevant index, and 6 In the amendment as drafted, this provision would replace Section 10 of the manager's amendment, which is the SEC study of soft dollars. The deletion of the soft dollar study was not discussed at the Committee mark-up. Therefore, it is unclear whether this was intended and whether this provision will be restored. 6 • a provision directing the SEC to adopt rules requiring that whenever a fund advertises its performance, it must also disclose information about its fees. The Institute's position remains that the SEC can, through its current rulemaking authority, accomplish most of the policy objectives contained in the legislation. In other areas, such as audit committee standards and who is qualified to serve as an independent director of a mutual fund, the industry can adopt best practices. The Institute and its members will continue to work to improve the legislation by proposing alternatives to provisions that are problematic. I want to thank the many Institute members who helped to effect the changes in the legislation. We will keep you posted on any further significant developments. Matthew P. Fink President

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