

MEMO# 3731

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SEC RESPONDS TO INQUIRIES REGARDING MUTUAL FUND FEES, "HUB AND SPOKE" FUNDS AND PROXY REFORM

April 23, 1992 TO: BOARD OF GOVERNORS NO. 25-92 SEC RULES MEMBERS NO. 17-92 RE: SEC RESPONDS TO INQUIRIES REGARDING MUTUAL FUND FEES, "HUB AND SPOKE" FUNDS AND PROXY REFORM _____ SEC

Chairman Richard Breeden recently sent three letters to House Energy and Commerce Committee Chairman John Dingell in response to Chairman Dingell's requests for information regarding mutual fund fees, "hub and spoke" funds and proxy reform initiatives. Copies of Chairman Dingell's letters of inquiry and Chairman Breeden's responses are attached. Mutual Fund Fees In a March 19 letter to Chairman Breeden, Chairman Dingell requested a report on "what action, if any, the Commission proposes to take to address the issues raised by run away mutual fund fees." The letter cited recent press reports that (1) mutual fund fees have continued to increase over the past decade despite the achievement of economies of scale and (2) the staff has been studying the effects of 12b-1 fees for five years but has not yet recommended any changes to the Commission, nor has the Commission acted on the NASD's 1990 proposal to cap 12b-1 fees. Chairman Breeden's response includes a memorandum prepared by the Division of Investment Management which concludes that increases in mutual fund fees "have resulted from a variety of factors and are not necessarily cause for concern." The memorandum describes certain developments within the fund industry that should be taken into account in examining fund expense ratios. For example, according to the staff: . . . there has been a proliferation of both new, small funds and international funds that are more costly to operate and tend to increase fund expenses. [Also], the industry has emphasized improving existing shareholder services and adding new services, such as sweep accounts, telephone redemption and exchange privileges, check or wire redemption, and automated provision of yield quotations. These services may require relatively large expenditures for sophisticated computer, telephone, and shareholder accounting systems. These expenditures may have offset any expense savings resulting from increased industry assets. The memorandum further indicates that fee level increases have varied among types of funds and types of fees. For example, front-end sales loads have declined but this decline has been offset by increases in 12b-1 fees. The memorandum notes that certain press articles have failed to recognize, among other things, that front-end sales loads, unlike 12b-1 fees, are not an annual fund expense and thus are not factored into the expense ratio. The memorandum states that the NASD proposal to limit 12b-1 fees is "a significant step" which the Division generally endorses, and notes that the Division and the Division of Market Regulation

intend to submit a joint recommendation on the NASD proposal to the Commission shortly. The memorandum further indicates that the staff's report on reform of the regulation of investment companies will be published next month and will include certain relevant recommendations, including: (1) repeal of Section 22(d) of the Investment Company Act (regarding retail price maintenance) and 2) the introduction of a new type of open- end investment company, featuring a single fee out of which the sponsor would pay all fund expenses other than brokerage and extraordinary expenses. According to the staff's memorandum, these recommendations are intended to improve investor understanding of mutual fund fees and enhance price competition within the industry. "Hub and Spoke" Funds In a March 4 letter to Chairman Breeden, Chairman Dingell stated that the House Energy and Commerce Committee was "looking into disclosure and regulatory issues raised by so-called 'hub and spoke' funds," and requested a report from the Commission on what issues such funds raise under the federal securities laws and what the Commission is doing to ensure that investors are adequately protected. Chairman Breeden's response includes a report from the Division of Investment Management discussing in detail the two- tier structure, various regulatory provisions that protect shareholders against potential abuses, shareholder voting rights and the liability of responsible parties for securities law violations. The report concludes that "with adequate disclosure and certain structural safeguards for investors, these arrangements can offer benefits to both investors and the mutual fund industry without any significant risk to investors," and states that the staff will continue to monitor developments in this area. Proxy Reform By letter dated March 31, Chairman Dingell inquired about the status of the Commission's review of the proxy rules and its timetable for further action, noting that the Subcommittee on Telecommunications and Finance intends to hold hearings on this topic later this year. In response, Chairman Breeden assured Chairman Dingell that the Commission's decision to repropose amendments to the proxy rules was based on the need to evaluate the voluminous and divergent public comments received (over 900 letters), and did not reflect a decrease in the Commission's commitment to facilitating shareholder communications and reducing costs involved in the solicitation process. Chairman Breeden's response letter further states that the Commission expects to consider repropose proxy rule amendments in the near future, and that the reproposal will include provisions to enhance current disclosure requirements applicable to executive compensation. We will keep you informed of developments. Frances M. Stadler Assistant General Counsel Attachments