The Asset Management Industry
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SENATE BANKING COMMITTEE HOLDS MORE HEARINGS ON MUTUAL FUNDS

[17333] April 8, 2004 TO: BOARD OF GOVERNORS No. 29-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 24-04 FEDERAL LEGISLATION MEMBERS No. 10-04 INVESTMENT COMPANY DIRECTORS No. 20-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 36-04 PUBLIC COMMUNICATIONS COMMITTEE No. 15-04 SEC RULES MEMBERS No. 53-04 SMALL FUNDS MEMBERS No. 40-04 UNIT INVESTMENT TRUST MEMBERS No. 14-04 RE: SENATE BANKING COMMITTEE HOLDS MORE HEARINGS ON MUTUAL FUNDS The Senate Banking Committee held additional hearings on reforming the mutual fund industry. The written testimony of the witnesses appearing at the hearing is summarized below. I. March 23, 2004 Hearing on Fund Operations and Governance The witnesses testifying at the hearing were: Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and Assistant Professor, University of Mississippi School of Law; William D. Lutz, Professor, Rutgers University; Robert C. Pozen, Non-executive Chairman, Massachusetts Financial Services Co. and Visiting Professor, Harvard Law School; and Barbara Roper, Director of Investor Protection, Consumer Federation of America.1 Testimony of Mercer E. Bullard In his testimony, Mr. Bullard provided a list of initiatives that he believes Congress should undertake to restore faith in mutual funds. He testified that there are many areas in which Congressional action is needed because the Commission either lacks the necessary authority or opposes mutual fund reforms. The areas that Mr. Bullard focused on include mutual fund governance, fee disclosure, soft dollars, distribution, and fund advertising. 1 The written testimony provided by the witnesses is available on the Committee's website at, http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=99. 2 On fund governance, he advocated the creation of a Mutual Fund Oversight Board (which would have authority over fund directors), the establishment of a federal statutory duty for fund directors requiring that they find that the fund is a reasonable investment, a requirement for an independent chairman, a requirement that fund boards be 75% independent, a prohibition on former directors, officers, and employees of the fund manager from serving as independent directors, and a requirement that independent directors stand for election at least once every five years. With respect to fee disclosure, Mr. Bullard urged Congress to require inclusion of portfolio transaction costs in the total expense ratio, disclosure of the dollar amount of expenses paid by a shareholder in the periodic statement, and disclosure of fees of similarly managed funds and appropriate index funds in the prospectus and to prohibit funds from showing distribution fees as a separate line item in the fee table if that amount does not include distribution expenses paid by the fund manager. Mr. Bullard also recommended a ban on soft dollars. On distribution, Mr. Bullard advised Congress to prohibit funds from using their assets to compensate brokers for sales of fund shares, fund managers from compensating brokers in connection with sales of fund shares, and funds from offering classes of shares that would

not be the best investment option for any rational investor. On fund advertising, he suggested that Congress require funds to include returns for each individual year where such returns differ materially from the fund's one-year performance, performance and expenses of similarly managed funds and an appropriate index fund, and fund expense ratios with equal prominence as performance information. Testimony of William D. Lutz Professor Lutz testified that, although the SEC's proposed point of sale and confirmation disclosures are extremely important in improving disclosure to investors, the proposal does not go far enough in revealing to investors just what they are paying in fees. Professor Lutz argued that both documents only offer "data," which is not "information," and that data must be transformed into information that investors can use. He advocated that the SEC test disclosure documents to ensure that they are communicating the information investors want and need to make informed decisions. Professor Lutz also stated that investors may be paying significant transaction costs that are not revealed in any currently available document for investors. He urged that investors be told that the expenses listed on the disclosure form do not include the transaction costs over the life of the investment and that these costs may significantly affect the return of their investment. Testimony of Robert C. Pozen Mr. Pozen testified that his company, MFS Investment Management, is trying to establish standards of best practice in three important areas to fund shareholders: (1) reduced reliance on soft dollars; (2) individualized expense reports; and (3) enhanced governance structure. Mr. Pozen stated that MFS has eliminated the use of soft dollars to promote sales of mutual funds and stopped using soft dollars to pay for third-party research and market data. He urged the SEC to go back to its initial narrow interpretation of Section 28(e) of the Securities Exchange Act to reduce the reliance on the use of soft dollars. 3 With respect to individualized expense reporting, Mr. Pozen testified that MFS will provide every fund shareholder with an estimate of his or her actual fund expenses in dollar terms on the quarterly statements. He stated that MFS has made this statement cost effective by making one simplifying assumption: that shareholders hold their funds for the whole prior quarter. In addition, Mr. Pozen stated that MFS will disclose in every fund's semi-annual report the total amount of brokerage commissions paid by the fund during the relevant period as well as the fund's average commission rate per share. On fund governance, Mr. Pozen testified that MFS fund boards have a 75% supermajority of independent directors, who elect their own chairman. The chairman leads the executive sessions of independent directors and helps set the board's agenda for the meeting. In addition, Mr. Pozen stated that the independent directors of MFS funds appoint a compliance officer who monitors all compliance activities by MFS, supervises the fund's activities, and reports regularly to the Compliance Committee of the Board, which is composed solely of independent directors. Mr. Pozen testified that, because the SEC and the management firms were making serious efforts to develop higher "behavioral norms" for the mutual fund industry, it might be useful for Congress to monitor these efforts before finalizing a bill on mutual fund reforms. Testimony of Barbara Roper Ms. Roper testified that the SEC has done a good job of developing a strong and credible mutual fund reform agenda. She stated, however, that legislation is "absolutely essential" this year to fill certain significant gaps in the SEC's regulatory response. Ms. Roper was of the opinion that the most serious gap is the SEC's failure to adopt reforms that would introduce vigorous cost competition in the mutual fund marketplace. Ms. Roper testified that legislation is needed to: (1) strengthen the definition of independent director, authorize the SEC to impose its governance directly, and clarify and expand the fiduciary duty of fund directors; (2) give the SEC oversight authority over intermediaries that handle mutual fund transactions to enable the agency to adopt an alternative late trading solution that does not rely on a hard 4 p.m. close; (3) ban soft dollars; and (4) direct the SEC to adopt rules to require that portfolio transaction costs be included in the operating expense ratio, to amend the fee disclosure table to provide

comparative operating cost information, to require that mutual fund investors receive a copy of either the prospectus or the fund profile at the time when a fund purchase is recommended, to require dollar amount cost disclosure on shareholder account statements, and to pre-test those disclosures for effectiveness in conveying key information to investors. Ms. Roper also asked the Committee to ensure that the SEC has adequate funding and to include in legislation a provision requiring a GAO study of whether investors would benefit from the creation of an independent oversight board for mutual funds. She also stated that the SEC's reliance on settlements without an admission of wrongdoing should be further studied. Finally, Ms. Roper focused on a longer-term need to reexamine broker sales practices. 4 II. March 31, 2004 Hearing on Examining Soft Dollar Practices The witnesses testifying at the hearing were: Harold Bardley, Chief Investment Officer, U.S. Growth Equity, American Century Investments; Geoffrey Edelstein, Managing Director and Co-Founder, Westcap Investments; Howard Schilit, Founder and CEO, Center for Financial Research and Analysis; Benn Steil, Senior Fellow and Director of Economics, Council of Foreign Relations; Grady Thomas, President, The Interstate Group; and Joseph Velli, Senior Executive Vice President, The Bank of New York.2 Most of the witnesses cautioned against banning soft dollars but supported requiring additional disclosure. Several witnesses also supported other regulatory measures such as recordkeeping for soft dollars. Several of the witnesses discussed the detrimental effects of banning soft dollars on independent research. One witness advocated the "greater use" of soft dollars while another witness urged that if soft dollars are banned for third-party research, proprietary research also should be unbundled. One witness warned that abolishing soft dollars would create entry barriers for new investment advisory firms, affect adversely smaller investment advisory firms, and diminish the quality and availability of proprietary and third- party research. On the other side of the debate, one witness called for the elimination of soft dollars and suggested that fund managers be obligated to pay trading commissions out of their own assets as recommended by the March 2001 Myners Report, prepared for the UK Treasury. Another witness recommended other measures to address "real and perceived soft dollar abuses," including (1) narrowing the definition of "research" for purposes of the soft-dollar safe harbor, (2) prohibiting fund advisers from taking into account sales of fund shares in allocating fund brokerage, and (3) requiring the SEC to publish an industry execution-only rate for all registered broker-dealers. III. March 31, 2004 Hearings on Fund Costs and Distribution Practices The witnesses testifying at the hearing were: The Honorable Susan M. Collins, Chairman of the Senate Governmental Affairs Committee; The Honorable Peter Fitzgerald; The Honorable Carl Levin; The Honorable Daniel K. Akaka; Paul G. Haaga, Jr., Executive Vice President and Director of Capital Research and Management Company, and Chairman of the Investment Company Institute; Chet Helck, President and Chief Operating Officer, Raymond James Financial; Thomas Putnam, Founder and CEO, Fenimore Asset Management; Edward A. H. Siedle, Founder and President, The Benchmark Financial Services, Inc.; and Mark Treanor, General Counsel and Head of Legal Department, Wachovia Corporation.3 2 The written testimony provided by most of the witnesses is available on the Committee's website at, http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=102. 3 The written testimony provided by most of the witnesses is available on the Committee's website at, http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=103. 5 Senator Susan M. Collins Senator Collins testified that the most important mutual fund reform that can be made is in the area of mutual fund fees and expenses, which she described as being "often opaque and obscure." Senator Collins stated that, although the SEC has made a good start in improving cost disclosure, Congress should go further. Moreover, although the legislation that Senator Collins introduced with Senators Fitzgerald

and Levin4 did not require personalized cost information for investors, Senator Collins believes that such information should be provided to investors to the extent practical. Senator Collins urged the Committee to report mutual fund reform legislation so that reforms can endure regardless of who becomes future members of the SEC. Senator Carl Levin Senator Levin testified that Congressional action was needed because the SEC does not have the authority to undertake certain key mutual fund reforms and Congress should strengthen the hand of the SEC by taking a stand on these issues and placing mutual fund reforms in statutory law. Senator Levin stated that the legislation that he and Senators Fitzgerald and Collins introduced takes the approach of banning rather than simply disclosing certain practices that involve conflicts of interest. He described several practices that the proposed legislation would ban, including revenue sharing and directed brokerage. Senator Levin also stated that the proposed legislation would strengthen the SEC's position on fund governance. Finally, Senator Levin mentioned the importance of enacting legislation establishing a standard for calculating and disclosing mutual fund expenses that incorporates all materials costs, including brokerage commissions. Senator Daniel K. Akaka Senator Akaka commended the SEC for its proposals to improve the corporate governance of mutual funds and to increase the transparency of mutual fund fees and believes that the proposals to require an independent chairman of fund boards and to require 75 percent of fund boards be comprised of independent directors, and the proposal for a confirmation notice are a solid and measured response to the mutual fund scandals. Senator Akaka, however, testified that he continues to believe mutual fund legislation is necessary so that reforms will not be rolled back in the future and to address areas where the SEC needs additional statutory authority to deal with problems and abuses in the mutual fund industry. Senator Akaka also stated that additional legislation may be necessary if disclosure of revenue sharing agreements and portfolio transaction costs are not adequately addressed by the SEC. Senator Akaka described a number of provisions in the mutual fund reform bill he introduced, including investment company board requirements, increased transparency of financial relationships between brokers and mutual funds, and brokerage commission 4 For a summary of the legislation introduced by Senators Collins, Fitzgerald, and Levin, see Institute Memorandum to Accounting/Treasurers Members No. 6-04, Board of Governors No. 14-04, Closed-end Investment Company Members No. 11-04, Federal Legislation Members No. 5-04, Investment Company Directors No. 10-04, Operations Members No. 10-04, Pension Members No. 13-04, Primary Contacts – Member Complex No. 17-04, Public Communications Committee No. 10-04, SEC Rules Members No. 26-04, Small Funds Members No. 20-04, Unit Investment Trust Members No. 9-04 [17112] (Feb. 17, 2004). 6 disclosure.5 Senator Akaka also stated that his bill would require the SEC to conduct a study to assess financial literacy among mutual fund investors that would identify the most useful and relevant information that investors need prior to purchasing shares, methods to increase transparency of expenses and potential conflicts of interest in mutual fund transactions, existing efforts to educate investors, and a strategy to increase the financial literacy of investors that results in positive change in investor behavior. Testimony of Paul G. Haaga Mr. Haaga began his testimony by describing the responses by regulators, investors, Congress, and the industry over the past several months to the revelations of abusive trading practices in the mutual fund industry. Mr. Haaga testified that government authorities have been conducting investigations and have taken forceful action against wrongdoers, the marketplace has sent a powerful message that the trust and confidence of investors can never be taken for granted, Congress has acted quickly and responsibly by holding a series of hearings, and mutual funds have conducted their own investigations and reviews to determine whether any wrongdoing occurred at their firms and to assess the effectiveness of existing policies and procedures. Mr. Haaga also described the significant regulatory enhancements that the Institute has recommended and the SEC's aggressive

and wide-ranging mutual fund regulatory reform agenda. Turning to the various regulatory initiatives, Mr. Haaga first discussed the proposals to address the mutual fund trading abuses and then other proposals to reinforce the protection and enhance the confidence of mutual fund investors. Specifically, Mr. Haaga discussed the Institute's support for SEC's proposals or amendments (1) to tighten existing regulations requiring all fund purchase and redemption orders to be received by a fund (or its transfer agent) by the time of pricing, (2) to require funds to have more formalized short-term trading policies and procedures and to disclose explicitly those policies and procedures, (3) to emphasize the obligation funds have to fair value their securities under appropriate circumstances, and (4) to provide a more effective mechanism for board oversight of short-term trading policies and procedures. Mr. Haaga also discussed other initiatives including fund governance, brokerage allocation practices, 12b-1 fees, revenue sharing arrangements, and other disclosure initiatives. Testimony of Chet Helck Testifying on behalf of the Securities Industry Association and Raymond James, Mr. Helck stated that abuses that undermine investor trust and confidence must be met with tough and firm regulatory action. Mr. Helck was concerned, however, that proposed mutual fund reforms not have unintended consequences that could ultimately degrade the infrastructure that makes it possible for the relationship between client and advisor to thrive to the detriment of the investing public. 5 For a summary of the legislation introduced by Senator Akaka, see Institute Memorandum to Board of Governors No. 60-03, Closed-end Investment Company Members No. 89-03, Federal Legislation Members No. 22-03, Investment Company Directors No. 15-03, Primary Contacts – Member Complex No. 96-03, Public Communications Committee No. 38-03, SEC Rules Members No. 153-03, Small Funds Members No. 64-03, Unit Investment Trust Members No. 41- 03 [16751] (Nov. 10, 2003) 7 Mr. Helck focused on several areas of broker compensation for sales of mutual funds – revenue sharing arrangements, 12b-1 fees, directed brokerage, and soft dollars. Mr. Helck testified that revenue-sharing payments often help reimburse broker-dealers for expenses associated with processing fund transactions, maintaining customer accounts and holding fund education seminars for financial advisers and their clients. He stated that the impact of 12b-1 fees has been positive by allowing funds to reduce front-end sales charges, contributing to development of longer holding periods and a more stable investment profile for clients, and encouraging financial advisors to offer continued service over a period of time. Mr. Helck also stated that eliminating soft dollars would be contrary to investors' interests and affect the ability of smaller, newer companies to obtain financing for their activities. He argued that soft dollars increase competition among money managers, encourage independent research, and give investors more choice. Finally, Mr. Helck offered preliminary suggestions to the SEC's proposals on confirmation and point of sale disclosures – disclosure should be required on websites rather than on paper and transaction-by-transaction breakdown of revenue sharing payments should not be required because of the costs involved. Testimony of Edward A. H. Siedle In his testimony, Mr. Siedle was critical of the mutual fund industry and testified that mutual funds pay excessive management fees because fund boards are failing to fulfill their fiduciary duties. Mr. Siedle recommended that the fiduciary duty of mutual fund directors be strengthened and that a "most favored nation" clause be included in advisory contracts. He argued that this clause would guarantee funds the lowest management fee by requiring fund managers to charge the same management fee to a fund that they would charge to another client for managing the same amount of assets. Mr. Siedle also supported requiring a supermajority of independent directors and an independent chairman on fund boards. Mr. Siedle recommended that the use of commissions for marketing be prohibited and that the practice of soft dollars be restricted. He urged Congress to repeal the safe harbor for soft dollars but if they continued to be permitted, the amount of soft dollars should be disclosed and included in the management fees. Testimony of Thomas O. Putnam The testimony of

Mr. Putnam focused on the role of small fund groups in the mutual fund industry and the impact of regulatory reforms on them. Mr. Putnam described the benefits of small fund groups, including providing greater choice for investors and helping to foster competition. Mr. Putnam testified that he had serious concerns about the possible scope of the changes facing the industry and that small fund groups may find that the considerable costs associated with those changes are prohibitive. Commenting on specific reform proposals, Mr. Putnam stated that requiring all fund groups to have an independent chair would impose an unnecessary, one-size-fits-all approach. Mr. Putnam also testified that many small fund groups are concerned about a ban on joint management of mutual funds and hedge funds, which can drive top portfolio managers out of the mutual fund industry, and have harsh, anti-competitive effects for small investment management firms without the resources to maintain different managers for different types of accounts. Mr. Putnam stated that Rule 12b-1 should be updated but not repealed because it continues to serve an important function by giving investors choice on how to compensate the 8 intermediaries whose assistance they sought in making their investment decisions. He also testified that many small fund groups have been able to remain competitive because they were able to gain access to a wider array of distribution channels than they otherwise would have through traditional sales load structures. Mr. Putnam also supported the SEC's proposal on directed brokerage but recommended that a fund be provided with a safe harbor if it had procedures to ensure that the direction of brokerage was not intended as a reward for fund sales but based solely on a broker's execution capabilities. Although supporting disclosure of revenue-sharing arrangements, Mr. Putnam did not believe that these arrangements should be eliminated or that fund boards should be required to make value judgments about whether such arrangements are in the best interests of fund shareholders. Finally, Mr. Putnam supported narrowing significantly the existing soft dollar safe harbor. Testimony of Mark Treanor On behalf of the Financial Services Roundtable, Mr. Treanor testified that the regulatory process should be allowed to work before any legislative changes are enacted. Mr. Treanor stated that the Roundtable has not yet taken a position on each of the specific SEC proposals on mutual fund distribution but it generally favors disclosure over prohibitions, including prohibitions on specific types of distribution arrangements. On other mutual fund issues, Mr. Treanor stated that aggregate fund brokerage commissions, average commission rate per share and turnover information are useful types of disclosure and that more information also could be disclosed about any services received by a fund in addition to trade execution. Mr. Treanor stated, however, that efforts to require funds or brokers to assign precise dollar values or artificial prices to proprietary services that are not commercially available on an independent basis are likely to be unworkable and unreliable. Mr. Treanor also testified that the Roundtable does not support disclosure of actual dollar amounts of compensation paid to individual portfolio managers but supported disclosure to fund investors of the structure and methodology of portfolio manager compensation. On fund governance, Mr. Treanor testified that the Roundtable supports requiring a supermajority of independent directors on fund boards but not a requirement that the chairman be an independent director. On measures to prevent late trading, Mr. Treanor stated that the Roundtable advocates requiring funds and fund intermediaries to have electronic time stamping systems and abide by associated compliance, certification and independent audit requirements as a condition to be eligible to receive mutual fund orders up to the closing time rather than requiring a "hard close." Finally, Mr. Treanor testified that the Roundtable supports requiring mutual funds to disclose potential conflicts arising out of the joint management of mutual funds and other accounts rather than a blanket ban on such joint management. Jennifer S. Choi Associate Counsel