

MEMO# 15809

March 27, 2003

CONGRESSIONAL REQUESTS FOR FOLLOW-UP INFORMATION FROM SEC ON MUTUAL FUND INDUSTRY ISSUES

[15809] March 27, 2003 TO: BOARD OF GOVERNORS No. 16-03 DIRECTOR SERVICES COMMITTEE No. 4-03 FEDERAL LEGISLATION MEMBERS No. 5-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 29-03 PUBLIC INFORMATION COMMITTEE No. 8-03 SEC RULES MEMBERS No. 37-03 RE: CONGRESSIONAL REQUESTS FOR FOLLOW-UP INFORMATION FROM SEC ON MUTUAL FUND INDUSTRY ISSUES As we previously indicated, on March 12, the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing on "Mutual Fund Practices and Their Effect on Individual Investors."1 At the hearing, Subcommittee Chairman Richard H. Baker (R-LA) announced his plan to send a letter to the Securities and Exchange Commission following the hearing to solicit the SEC's views on various mutual fund issues. Chairman Baker sent such a letter to the SEC yesterday. The letter requests the SEC's response by June 11, 2003. Later in the day, Subcommittee Ranking Minority Member Paul E. Kanjorski (D-PA) and Congressman Robert W. Ney (R-OH) sent a separate letter to the SEC requesting information on mutual fund issues. Their letter requests that the SEC respond no later than June 4, 2003. Both letters are attached and summarized below. Letter from Chairman Baker Chairman Baker's letter states that one of the highest priorities of the Subcommittee is to help restore confidence in the securities markets and that an essential component of that goal is the Subcommittee's ongoing review of mutual funds and its efforts to promote transparency, accountability, integrity and competition in the fund industry. The letter requests the following information from the SEC. 1 See Memorandum to Board of Governors No. 13-03, Director Services Committee No. 3-03, Primary Contacts - Member Complex No. 25-03, Public Information Committee No. 6-03 and SEC Rules Members No. 32-03, dated March 13, 2003; Memorandum to Federal Legislation Members No. 3-03, dated March 21, 2003. 2

Transparency of fees and costs • What steps might help promote greater transparency of fees for investors and greater fee-based competition among funds, and an assessment of the relative utility of information provided on shareholder statements and semi-annual reports versus the prospectus and statement of additional information. • An analysis of how trading costs could be better disclosed to investors, including an analysis of the relative utility of including commissions and other trading costs in the fund's expense ratio or as a separately disclosed cost item. • How soft dollar arrangements create undisclosed conflicts of interest and whether enhanced transparency and disclosure of actual execution costs would benefit investors. Portfolio manager information • Whether disclosing the structure of portfolio manager compensation might benefit investors. • Whether investors would benefit from having information about portfolio managers' holdings of fund shares. Mutual fund governance • An analysis of: the current definition of independent directors under the

Investment Company Act, including a discussion of the adequacy of that definition; whether directors are adequately serving shareholders' interests, including oversight of fund fees; and the impact of requiring the chairman of the board of a fund to be disinterested. • The SEC's expectations regarding the role of fund directors with respect to sales charge breakpoints. • The frequency of rejection of management contracts by fund directors in the past ten years. • The legal standard that applies to the fiduciary obligations of fund directors and advisers with respect to approval of management contracts, and issues relating to the utility of that standard; the effectiveness of new rules requiring disclosure in the statement of additional information of the board's rationale for approving management contracts and possible alternative venues for disclosing this information to investors. • Whether mutual fund investors would benefit from corporate governance reforms similar to a provision of the Sarbanes-Oxley Act under which stock exchanges are required to prohibit the listing of any security of a public company that does not have an audit committee meeting certain criteria.

3 Fund distribution issues

- The obligations of fund directors regarding approval of fund distribution arrangements under Rule 12b-1 and otherwise, and whether Rule 12b-1 should be updated in light of the evolution of fund distribution since the rule's adoption.
- How "revenue-sharing" arrangements between investment advisers and broker-dealers work, the impact of these expenses on investors, the legal issues raised by such arrangements with respect to Rule 12b-1, directors' obligations with respect to these arrangements, and the transparency of these arrangements and their associated costs.

Performance information

- What steps can be taken to help educate investors on the issue of investing in funds based on past performance and improve the utility of information on which investors base their investment decisions; how fund advertising contributes to this phenomenon.
- Whether shareholder reports, on average, adequately disclose the factors affecting fund performance.
- The practice of steering hot IPOs to "incubator" funds and then using those funds' performance data as a marketing tool.

Mutual funds and IPOs

- The legal and policy implications of potential use of mutual funds by their broker-dealer affiliates to prop up prices of IPOs in the secondary market.

Proxy voting

- An analysis of whether the benefits to investors of disclosure of mutual fund proxy voting merit the burdens and costs to industry, and an estimation of what those burdens and costs will be.

Valuation

- The issues raised by portfolio security valuation methodologies and the relevant rules relating to those methodologies including, for example, the rules applicable to, and issues raised by, valuation of private securities as well as those relating to fair value pricing of securities for which a market price is available.

Letter from Congressmen Kanjorski and Ney

The letter to the SEC from Congressmen Kanjorski and Ney notes that the Subcommittee heard a variety of testimony about mutual fund issues at its recent hearing. In light of the importance of maintaining investor confidence in the U.S. capital markets, the letter seeks the SEC's expert views. It acknowledges that mutual funds are subject to a variety of disclosure and governance requirements developed and enforced by the SEC and states that therefore, "we would like to know whether changes to existing regulatory structures would help investors in making better and more informed investment decisions." The letter then addresses several specific topics and poses a series of related questions, as described below.

Fund expenses

- Is the recent increase in expenses for equity funds and decline for bond funds a result of the fact that mutual fund expense ratios generally decline as the amount of fund assets increase, or are other factors involved?
- Does the SEC believe that additional disclosure of fund expenses would increase price competition?
- What were the SEC's reasons for rejecting recommendations to disclose fund fees in dollar terms on account statements in the past; what would be the costs of complying and the likely effect on fund expenses and competition; what would be the likely effects of such disclosure on investors' decision making; are similar cost disclosures provided for other financial and securities products; and would providing too much information deter

investors' ability to quickly understand the performance of a mutual fund? • To what extent does the investor's choice of distribution method influence the fund expenses the investor pays; are there differing concerns regarding expense disclosure or competitiveness depending on distribution method; and to what extent do fund sponsors, as opposed to fund distributors, effectively control, set, or receive loads and 12b-1 expenses? Transaction costs • What transaction costs are currently required to be disclosed to investors; are all funds presently required to review transaction costs with their directors and is there an agreed-upon method of calculating transaction costs for various types of funds; and would investors benefit from the standardized disclosure of transaction costs? • How are brokerage commissions disclosed; what is the rationale for treating commissions and other transaction costs as capital items rather than as expenses; and would investors benefit from accounting for commissions differently? • Should disclosures of soft dollars are currently required of mutual funds be expanded; what obligations are placed on mutual fund directors to review soft dollar practices; are the present safeguards against the misuse of soft dollars sufficient; how does soft dollar regulation differ between mutual funds and other SEC-regulated entities; and are the requirements substantially different for entities such as hedge funds or pension funds? • What are the SEC's plans regarding possible additional regulations regarding the practice of using fund commissions to compensate brokers that have sold mutual fund shares; and should such uses of commissions be regulated under Rule 12b-1? 5 Mutual fund governance • Should additional aspects of the Sarbanes-Oxley Act corporate governance standards be applied to mutual funds or are there aspects from which funds should be exempted? • Does the infrequency with which fund directors terminate fund management contracts suggest that independent directors are not being sufficiently forceful in representing shareholders' interests; and how does the frequency of termination of management contracts in the past ten years compare to the frequency of other changes to management contracts, such as increases or decreases in fund fees? Payments for distribution • Are changes to Rule 12b-1 warranted at this time; what are the advantages and disadvantages to investors of paying for distribution and marketing via a 12b-1 fee versus a front-end load; and has Rule 12b-1 increased or decreased price competition? • What are the typical sources of "revenue sharing" payments, and are they subjected to the controls of Rule 12b-1; are the current disclosures by the payor and recipient of such payments adequate; what services do funds, fund shareholders and fund sponsors typically obtain for such payments; and do these payments stimulate or inhibit price competition? Fund performance information • Do investors have too much or too little performance data available to them; how does the performance disclosure required for mutual funds compare to the disclosure required for other financial products; and what additional information presented in a standardized format could help to improve investors' decisions? • Does the SEC regulate or require specific disclosures regarding "incubator funds"? Does the SEC require or permit funds to disclose performance on a complex-wide basis, and does "survivor bias" influence the results; to what extent is survivor bias a product of mutual fund practices versus a product of how mutual fund returns are reported by third-party fund tracking entities; and what is the effect of incubator funds and survivor bias on investors' perceptions of fund performance? * * * We will keep you informed of further developments. Matthew P. Fink President Attachments (in .pdf format) Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (<http://members.ici.org>) and search for memo 15809, or call the ICI Library at (202) 326-8304 and request the attachments for memo 15809.

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