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MUTUAL FUND LEGISLATION INTRODUCED IN THE U.S. SENATE

[16837] December 3, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 50-03 BOARD OF GOVERNORS No. 68-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 101-03 FEDERAL LEGISLATION MEMBERS No. 27-03 INVESTMENT COMPANY DIRECTORS No. 21-03 OPERATIONS MEMBERS No. 37-03 PENSION MEMBERS No. 49-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 106-03 PUBLIC INFORMATION COMMITTEE No. 43-03 SEC RULES MEMBERS No. 171-03 SMALL FUNDS MEMBERS No. 75-03 UNIT INVESTMENT TRUST MEMBERS No. 47-03 RE: MUTUAL FUND LEGISLATION INTRODUCED IN THE U.S. SENATE Senators Jon Corzine (D-NJ) and Christopher Dodd (D-CT), members of the Senate Committee on Banking, Housing, and Urban Affairs, recently introduced S.1971, the "Mutual Fund Investor Confidence Restoration Act" ("Act").1 The bill is summarized below. TITLE I – ENHANCING COST, FEE, AND OTHER DISCLOSURES TO SHAREHOLDERS Transparency of Mutual Fund Costs The bill would direct the SEC, within 180 days of enactment of the Act, to adopt rules requiring a mutual fund to disclose the following: • The actual dollar amount, borne by each shareholder, of the expenses of the mutual fund; • The structure of, method used to determine, and the total amount of compensation of individuals employed by the mutual fund's investment adviser to manage the fund's portfolio and the ownership interest of such persons in the fund's securities, including when they have no ownership interest in the fund; 1 A copy of S.1971 is available at http://www.corzine.senate.gov/priorities/mutualfundbilltext.pdf. The bill is co- sponsored by Senator Joseph I. Lieberman (D-CT), the Ranking Member of the Senate Committee on Governmental Affairs. 2 • Whether the chairman of the mutual fund's board of directors or any directors of the fund's investment adviser employed to manage the fund's portfolio do not own any securities of the fund; • The estimated total annual dollar amount of fees, costs, expenses, taxes, and any other payments by the mutual fund for any purpose, excluding only pro rata distributions to shareholders, and set forth in a manner that facilitates comparison;2 • Information concerning soft dollar and directed brokerage policies and practices; • Information concerning revenue sharing arrangements; and • Information concerning breakpoint discounts on front-end sales loads. The foregoing disclosures would have to be included in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document, and could not be made exclusively in the mutual fund's prospectus or statement of information. The bill would provide an exception from this requirement for the disclosures concerning: (1) portfolio manager compensation and holdings of the mutual fund's shares, (2) holdings of the fund's shares by the chairman of the fund's board and any directors of the fund's investment adviser employed to manage the portfolio of the fund, and (3) soft dollar and directed brokerage policies and practices. Obligations Regarding Certain Distribution and Soft Dollar Arrangements The bill would require each investment adviser to a registered fund annually

to submit a report to the fund's board of directors on (1) revenue sharing arrangements, (2) directed brokerage arrangements, and (3) soft dollar arrangements. The bill would impose a fiduciary duty on fund directors to (1) review the adviser's direction of the fund's brokerage transactions (including directed brokerage and soft dollar arrangements) and determine that the direction of fund brokerage adheres to the fund's stated policies and is in the best interests of fund shareholders, and (2) review revenue sharing arrangements to ensure compliance with the Investment Company Act and determine that such arrangements adhere to the fund's stated policies and are in the best interests of fund shareholders. The bill would direct the SEC to adopt implementing regulations, which would have to require that a fund's annual report to shareholders contain a summary of the most recent report submitted to fund directors under this provision. 2 The bill would direct the SEC to issue rules defining "fees, costs, expenses, taxes, and any other payments made by the [mutual fund]" and to include in such definition any management fees, transfer agency expenses, custodial fees, shareholder servicing fees, portfolio transaction costs (including commissions, market impact, spread, and opportunity costs), 12b-1 fees, and other distribution expenses, directors' fees, and registration fees. The bill also would direct the SEC to issue rules defining "manner that facilitates comparison among [mutual funds]" and to include in such definition definitions of functional categories of fees, costs, expenses, taxes, and other payments disclosed in the required estimate that will not be based on the contract under which or with whom the services are provided, and will instead be based on the nature of the services provided. The bill would require the SEC to issue both sets of rules within 180 days of enactment of the Act. The bill would further direct the SEC to issue rules within 90 days of enactment of the Act to require the independent audit of the required estimate and certification by the mutual fund's investment adviser and chairman of the fund's board of directors. 3 Definition of No-Load Mutual Fund The bill would require the adoption of SEC or self-regulatory rules, within 180 days of enactment of this Act, to (1) clarify the definition of "no-load" as used by funds that impose Rule 12b-1 fees and (2) require disclosure to prevent investors from being misled by use of this term by the fund or its adviser or principal underwriter. Disclosure of Incentive Compensation and Mutual Fund Sales The bill would require a broker to provide customers who purchase mutual fund shares with disclosure concerning the incentive and other compensation that the broker receives for selling such shares. The bill would direct the SEC, within one year of enactment of the Act, to adopt rules establishing standards for the required disclosures. TITLE II – MUTUAL FUND GOVERNANCE Director Independence The bill would require: (1) three-fourths of a fund's board to be independent, (2) the fund's directors to be elected by shareholders at least once every five years, and (3) a majority of the fund's independent directors to determine annually, after reasonable inquiry, that each independent director does not have any material business or familial relationship with the fund, a significant service provider to the fund, or any entity controlling, controlled by or under common control with such service provider, that is likely to impair the director's independence.3 The bill also would expand the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to include the following: (1) a person serving as legal counsel to the fund, its investment adviser or principal underwriter since the beginning of the last five completed fiscal years (up from the current two fiscal years); (2) a person serving, within the last 10 fiscal years, as an officer, director or employee of the fund's investment adviser or principal underwriter or of any entity controlling, controlled by or under common control with the adviser or underwriter; (3) a person serving, within the last 10 fiscal years, as an officer, director or employee of (a) an entity that has been a significant service provider to the fund within the last five fiscal years or (b) an entity controlling, controlled by or under common control with such service provider; and (4) a person belonging to a class of persons that the SEC determines by rule is unlikely to exercise an appropriate degree of

independence by reason of certain specified relationships or for any other reason as determined by the SEC.4 3 The bill would require the SEC, within 180 days of enactment of the Act, to issue final rules defining "significant service provider," which must include, at a minimum, a fund's investment adviser and principal underwriter. 4 The relationships would include: (1) a material business relationship with the fund, an affiliated person of the fund, the fund's investment adviser or principal underwriter, or an affiliated person of the adviser or underwriter, and (2) a close familial relationship with any natural person who is an affiliated person of the fund or of its investment adviser or principal underwriter. This rulemaking authority would be in place of the SEC's current authority under Section 2(a)(19) to determine, by order, that a natural person is an interested person by reason of having had certain specified relationship(s). 4 Independent Chair, Nominating Committee, Financial Expert The bill would require fund boards to have independent chairs. In addition, funds would be required to have nominating committees comprised solely of independent directors. Such committees would have to be responsible for: (1) selecting persons to be nominated for election as director; and (2) adopting qualification standards for the nomination of directors, which standards would have to be disclosed in the fund's registration statement. Each fund board would be required to have at least one "financial expert," as defined by the SEC in rules issued within 180 days of enactment of the Act.5 Audit Committee Requirements The bill would apply to funds audit committee 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 1934.6 Informing Directors of Significant Deficiencies The bill would require a fund to provide to its board of directors the report of any SEC inspection that identifies significant deficiencies in the operations of the fund or its investment adviser or principal underwriter. In addition, the bill would require the SEC annually to review all fund inspection reports and publicly disclose the 10 most common deficiencies cited in those reports. Certifications by Chairman, Chief Compliance Officer Title III of the bill (described below) would amend Section 17(j) of the Investment Company Act, which authorizes the SEC to adopt rules to prevent fraud, deception, and manipulation. Rules established under amended Section 17(j) would have to require that the chairman of a mutual fund's board of directors certify in the periodic report to shareholders or other appropriate disclosure document that: • Procedures are in place for verifying that the determination of the mutual fund's current net asset value complies with the Investment Company Act and rules thereunder, and that the fund is in compliance with those procedures; • Procedures are in place for the oversight of the flow of funds into and out of the mutual fund, and that the fund is in compliance with those procedures; • Procedures are in place to ensure that investors are receiving any applicable sales charge breakpoint discounts; 5 The bill would require the SEC, in defining "financial expert," to consider certain specified factors that are substantially similar to those set forth in Section 407 of the Sarbanes-Oxley Act of 2002. 6 The bill would require the SEC, within 180 days of enactment of the Act, to issue implementing regulations as well as rules establishing (1) a program of incentives to encourage the filing of meritorious complaints regarding accounting, internal accounting controls or auditing matters, and (2) appropriate penalties for the willful filing of materially false complaints. 5 • In the case of a mutual fund with multiple classes of shares, procedures are in place to ensure that such classes are designed in the interests of investors and could reasonably be an appropriate investment option for an investor; • Procedures are in place to ensure that information about the mutual fund's portfolio securities is not disclosed in violation of the securities laws or the fund's code of ethics; • The independent directors have reviewed and approved the compensation of the mutual fund's portfolio manager in connection with their consideration of the investment advisory contract under Section 15(c) of the Investment Company Act; • The mutual fund has established and enforces a code of ethics as required by amended Section 17(j) of the

Investment Company Act; • The mutual fund is in compliance with the requirements in amended Section 17(j) relating to implementation and periodic review of compliance policies and procedures and the appointment of a chief compliance officer; and • The adviser's annual report to the fund's board regarding revenue sharing, directed brokerage and soft dollar arrangements is complete and accurate, and the board has fulfilled its fiduciary obligations with respect to review of that report. The bill also would direct that rules established under amended Section 17(j) would have to require the following additional certifications, on an annual basis: • By the mutual fund's chief compliance officer, that (1) appropriate internal controls are in place for the review required by the chairman's certification, as outlined above, and (2) the chief compliance officer has reviewed such internal controls and determined that they reasonably achieve their stated purpose; and • By both the chairman of the mutual fund's board and the fund's chief compliance officer, that the fund's advisory contract and associated management fees have been negotiated and are in the best interests of the fund.7 TITLE III – PREVENTING ABUSIVE MUTUAL FUND PRACTICES Prevention of Fraud; Internal Compliance and Control Procedures The bill would amend Section 17(j) of the Investment Company Act by expanding it to cover fraudulent, deceptive or manipulative acts, practices, or courses of business in connection with purchases or sales by certain persons, not only of any security held or to be acquired by a fund (as is currently the case), but also of any security issued by the fund or an affiliated fund. The SEC would have to adopt rules requiring: (1) a fund and its investment adviser and principal underwriter to adopt codes of ethics and (2) a fund to disclose (a) such codes of ethics and any changes therein in the periodic report to shareholders and (b) such codes and any waivers and material violations thereof on 7 The bill would direct the SEC, within 90 days of enactment of the Act, to prescribe implementing regulations and minimum standards for compliance with the certification requirements. 6 a readily accessible electronic public information facility of the fund and in such other form and manner as the SEC shall require. In addition, funds and registered investment advisers would be required to: (1) adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws and certain other designated laws, and (2) review the policies and procedures annually for their adequacy and the effectiveness of their implementation. A fund also would be required to appoint a chief compliance officer to oversee its compliance policies and procedures. The chief compliance officer, whose compensation would have to be approved by a fund's independent directors, would be required to report directly to the independent directors at least annually, in private if the directors so request. These reports would have to include any violations or waivers of, or other significant issues arising under, the compliance policies and procedures. Funds also would be required to adopt policies and procedures reasonably designed to protect their officers, directors, employees, contractors, subcontractors, or agents from retaliation for providing information to assist in an investigation relating to conduct that the person reasonably believes constitutes a violation of either the securities laws or the fund's code of ethics. The bill would require the SEC to prescribe rules implementing all of the foregoing requirements within 90 days of enactment of the Act. Ban on Joint Management of Mutual Funds and Hedge Funds The bill would prohibit an individual from serving as the portfolio manager or investment adviser of both a mutual fund and an unregistered fund or other category of company as prescribed by the SEC in order to prevent conflicts of interest. The SEC would be permitted to make exceptions to the joint management prohibition when necessary to protect the interest of investors, but any rule, regulation or order doing so would have to require: (1) enhanced disclosure by the mutual fund to investors of any conflicts of interest raised by the joint arrangement; and (2) fair and equitable policies and procedures for allocating securities to the portfolios of the jointly managed companies, as well as certification by the mutual fund's independent directors in

the periodic report to shareholders or other appropriate document that such policies and procedures are fair and equitable. The bill would direct the SEC to prescribe implementing rules within 90 days of enactment of the Act. Restrictions on Short-Term Trading and Mandatory Redemption Fees The bill would prohibit certain persons8 from engaging in "short-term transactions," as defined by the SEC, in securities issued by a fund or an affiliate of the fund. Excepted from the prohibition would be money market funds, other funds whose investment policy expressly permits short-term transactions, or other categories of funds as specified by the SEC. The bill would direct the SEC to prescribe implementing rules within 180 days of enactment of the Act. 8 These persons are any officer, director, partner, or employee of a registered investment company, any affiliated person, investment adviser, or principal underwriter of such company, or any officer, director, partner, or employee of such an affiliated person, investment adviser, or principal underwriter. 7 The bill also would direct the SEC, within the same time period, to adopt rules requiring any fund that does not allow market timing to charge a redemption fee upon the short-term redemption of its shares. Elimination of Stale Prices The bill would direct the SEC, within 180 days of enactment of the Act, to prescribe standards concerning the obligations of mutual funds to apply and use fair value methods of net asset value (NAV) determination in order to prevent dilution of the interests of long-term investors or as necessary in the other interests of investors. The SEC would have to identify, in addition to significant events, the conditions or circumstances from which the obligation to use fair value will arise and the methods by which fair value methods will be applied. Policies and Procedures Related to Fair Value Pricing, Market Timing The bill would direct the SEC, within 180 days of enactment of the Act, to adopt rules requiring each fund and registered investment adviser to: • Establish formal policies relating to (1) compliance with the SEC's fair value pricing standards and (2) market timing and short-term trading, including the circumstances under which such practices will be permitted; • Review the policies on an ongoing basis; • Publicly disclose the policies to shareholders (in the case of the market timing policies, in any prospectus delivered by the fund or adviser); • Adopt internal procedures to ensure compliance with the policies; and • Certify annually that the fund or adviser is adhering to the policies.9 The bill would prohibit a fund or adviser from altering its fair value pricing policies without the prior approval of a majority of its shareholders. Prevention of Late Trades The bill would direct the SEC, within 180 days of enactment of the Act, to issue rules to prevent transactions in mutual fund securities in violation of Section 22 of the Investment Company Act, including transactions that are executed at a price based on an NAV that was determined as of a time prior to the actual execution of the transaction ("after-hours trades"). The rules would have to permit execution of after-hours trades that are provided to a mutual fund by a "permitted intermediary," which the bill defines as an intermediary having late trading and detection policies and procedures that are subject to SEC inspection. The bill also would direct the SEC to require each 9 The certification as to the fair value pricing policies would have to be made by the chief executive officer of the fund or adviser. The certification as to the market timing policies would have to be made by the chief executive officer in the case of the adviser and, for the fund, by the chairman of the fund's board and the fund's chief compliance officer. 8 permitted intermediary to: (1) certify that it has policies and procedures in place to prevent and detect late trades and has adhered to such policies, and (2) submit an independent annual audit verifying that its policies and procedures do not permit the acceptance of late order trading. Disclosure of Insider Transactions Within 180 days of enactment of the Act, the SEC would have to adopt rules requiring: (1) advance disclosure by a senior executive officer of a mutual fund of any intended purchases or sales of securities issued by any other mutual fund having the same investment adviser, and (2) the senior executive officer to hold such securities for not less than 6 months. TITLE IV – STRENGTHENING MUTUAL FUND

INDUSTRY OVERSIGHT Study of Mutual Fund Oversight Board The bill would require the General Accounting Office (“GAO”) to study the feasibility and the benefits (if any) to shareholders, mutual fund governance, and mutual fund oversight of establishing a Mutual Fund Oversight Board that would: (1) have inspection, examination, and enforcement authority over mutual fund boards of directors; (2) be funded by assessments against mutual fund assets or management fees; (3) have members selected by the SEC; and (4) have rulemaking authority. Within one year of enactment of the Act, the GAO would be required to submit a report to Congress on the study. Study of Coordination of Enforcement Efforts The bill would require the GAO to study the coordination of enforcement efforts between the SEC (both its headquarters and its regional offices) and appropriate state regulatory and law enforcement entities (such as state attorney generals and the North American Securities Administrators Association) related to allegations of misconduct by mutual funds. Within one year of enactment of the Act, the GAO would be required to report to Congress on the study. Review of SEC Resources The bill would require the SEC to study the allocation and adequacy of SEC supervision and enforcement resources that are dedicated to the oversight of mutual funds. The SEC would have to report to Congress on the study within one year of enactment of the Act. Study of Soft Dollar Arrangements The bill would require the SEC to study the use of soft dollar arrangements by investment advisers and to submit a report to Congress on the study within one year of enactment of the Act. Report on Adequacy of Regulatory Response to Late Trading and Market Timing Within 180 days of enactment of the Act, the SEC would be required to submit a report to Congress on market timing and late trading of mutual funds, which would have to include: (1) the economic harm of market timing and late trading of mutual funds on long-term shareholders; (2) the findings of the SEC’s Office of Compliance Inspections and Examinations and the actions taken by the 9 SEC’s Division of Enforcement regarding illegal late trading practices, illegal market timing practices, and market timing practices that are not in violation of prospectus disclosures; (3) when the SEC became aware that the use of market timing practices was harming long-term shareholders and the circumstances surrounding the SEC’s discovery of that activity; (4) the steps the SEC has taken to protect long-term fund investors since that time; and (5) any additional legislative or regulatory action that is necessary to protect long-term mutual fund shareholders against the detrimental effects of late trading and market timing practices. Study of Arbitration Claims The bill 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 of enactment of the Act. TITLE V – PROMOTING SHAREHOLDER LITERACY The bill would require the SEC to conduct a study of the financial literacy of mutual fund investors and to submit a report to Congress on the study within one year of enactment of the Act. Rachel H. Graham Assistant Counsel

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