

**MEMO# 16869**

December 11, 2003

## **MUTUAL FUND LEGISLATION INTRODUCED BY SENATOR KERRY**

[16869] December 11, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 55-03 BOARD OF GOVERNORS No. 73-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 107-03 FEDERAL LEGISLATION MEMBERS No. 30-03 INVESTMENT COMPANY DIRECTORS No. 23-03 OPERATIONS MEMBERS No. 41-03 PENSION MEMBERS No. 52-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 110-03 PUBLIC INFORMATION COMMITTEE No. 47-03 SEC RULES MEMBERS No. 181-03 SMALL FUNDS MEMBERS No. 81-03 UNIT INVESTMENT TRUST MEMBERS No. 52-03 RE: MUTUAL FUND LEGISLATION INTRODUCED BY SENATOR KERRY On November 25, 2003, Senator John Kerry (D-MA) introduced S.1958, the "Mutual Fund Investor Protection Act" ("Act").<sup>1</sup> The bill is summarized below.

**TITLE I - REGULATORY IMPROVEMENTS**

**Pricing of Mutual Fund Shares** The bill would add to the Investment Company Act of 1940 a new Section 11A entitled "Pricing of Securities." Under that section, a purchaser of mutual fund shares would have to "place an order to purchase such securities prior to the time at which the [mutual fund] sets the price of the securities for that day in order to purchase the securities at that price." Increased Penalties; RICO Enforcement The bill would increase various penalties for securities law violations relating to the offer, sale, and pricing of mutual fund shares. Specifically, the bill would:

1 The bill is co-sponsored by Senator Edward Kennedy (D-MA). A copy of S. 1958 is available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108\\_cong\\_bills&docid=f:s1958is.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s1958is.txt.pdf).

2 • Increase the maximum penalty to \$1 million, 20 years' imprisonment, or both for: (1) violations of Section 17(a) of the Securities Act of 1933 with respect to the offer and sale of mutual fund shares; or (2) violations of Section 22(a) of the Investment Company Act.<sup>2</sup> (The maximum penalty for other violations of the two Acts would remain \$10,000, 5 years' imprisonment, or both).

• Increase the maximum penalty to \$10 million for individuals / \$50 million for companies, 25 years' imprisonment, or both for: (1) violations of Section 10(b) of the Securities Exchange Act of 1934 with respect to the offer and sale of mutual fund shares; or (2) violations of Section 17(a) of the Securities Act.<sup>3</sup> (The maximum penalty for other violations of the Exchange Act would remain \$5 million for individuals / \$25 million for companies, 20 years' imprisonment, or both).

• Impose a mandatory lifetime ban from participation in any offer or sale of securities on an individual found to have violated: (1) Section 10(b) of the Exchange Act with respect to the offer and sale of mutual fund shares; or (2) Section 17(a) of the Securities Act.<sup>4</sup>

The bill also would add the following offenses to the Racketeer Influenced and Corrupt Organization (RICO) provisions of the Organized Crime Control Act of 1970: (1) violations of Section 17(a) of the Securities Act with respect to the offer or sale of mutual fund shares; (2) violations of Sections 10(b) and 17(a) of the Exchange Act with respect to the purchase or sale of mutual fund shares; and (3) violations of Section 22(c) of the Investment Company Act with respect to the valuation of mutual fund shares. Adding these offenses to RICO effectively would increase the

penalties that could be imposed on persons committing such offenses. Disclosure of Market Timing Policies The bill would require a mutual fund's prospectus to disclose: (1) the mutual fund's policies with respect to the timing of the pricing of its shares; and (2) the steps taken by the mutual fund to prevent the abuse of such pricing policies. Fund Directors:

Independence; Fiduciary Duty The bill would require: (1) three-fourths of a fund's board of directors to be independent; and (2) each fund board to have an independent chairman, who will be entitled to "access to all information, including but not limited to any outside advisory, management, marketing, or investment service fees paid by the investment company." The bill also would 2 It appears that the bill was intended to refer to violations of Section 22(c) of the Investment Company Act and not Section 22(a). A press release by Senator Kerry's office ("Press Release") states that the bill increases penalties and jail time for violating, among other provisions, "Section 22(c) of the Investment Company Act, which requires underwriters and dealers to sell and redeem fund shares at a price based on current Net Asset Value." A copy of the Press Release is available at

<http://kerry.senate.gov/bandwidth/cfm/record.cfm?id=214426>. 3 It appears that the bill was intended to refer to Section 17(a) of the Exchange Act. The Press Release states the bill increases penalties and jail time for violating, among other provisions, "Section 17(a) of the Exchange Act for failing to keep current and appropriate records of brokerage transactions." 4 See id. 3 expand the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to include any 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: (1) a material business or professional relationship with the fund or an affiliated person of the fund; or (2) a close familial relationship with any natural person who is an affiliated person of the fund.5 The bill also would direct the SEC, within 270 days of enactment of the Act, to publish rules imposing upon a fund's board of directors a fiduciary duty to:

- Demonstrate that the fund's negotiated advisory, management, marketing, and investment service fees are reasonable and in the best interests of fund shareholders.

Under the bill, this could be accomplished by: (1) obtaining multiple bids; (2) obtaining an independent evaluation or appraisal; (3) including a "most favored nation" clause in all fee contracts; or (4) any other means practicable to ensure that shareholders are not overcharged for any services provided to the fund. • Report to the SEC on any significant or material business or professional relationship with any advisory, management, marketing, investment, or other service provided to the [fund] to ensure that such services are provided in the best interests of their shareholders. Improved Transparency of Fund Costs

The bill would direct the SEC, within 270 days of enactment of the Act, to adopt rules to require a fund to disclose the following:

- The estimated amount, in dollars, of the operating expenses of the fund, including any advisory, management, marketing, and investment service fees, that are borne by the shareholders, and the amount borne by each shareholder of the fund, based on the investment of each shareholder in the fund.
- 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 and the ownership interests of such persons in the fund's securities.
- The portfolio turnover rate of the fund, 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.

5 The bill would strike from the definition of "interested person" any person or affiliated person of a person (other than a registered fund) that, during the preceding 6 months, has: (1) executed any portfolio transactions for, engaged in any principal transactions with, distributed shares for, or loaned money or other property to (a) the fund or any other fund having the same adviser or principal underwriter, or (b) any fund holding itself out to investors as related to any such fund for purposes of investment or investor services; (2) executed any portfolio transactions for, engaged in any principal transactions with, or

distributed shares for any account over which the fund's adviser has brokerage placement discretion; or (3) loaned money or other property to any account for which the fund's adviser has borrowing authority. 4 • Information concerning: (1) soft dollar and directed brokerage payments; (2) revenue sharing payments; and (3) breakpoint discounts on front-end sales loads. The foregoing disclosures would be required in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document, but could not be made exclusively in a prospectus or statement of additional information. The bill would provide an exception from this requirement for the disclosures concerning (1) portfolio manager compensation and holdings and (2) soft dollar and directed brokerage payments. The bill would require the SEC to issue a concept release to examine: (1) portfolio transaction costs incurred by funds; (2) advisory, management, marketing, and investment service fees paid by funds; and (3) how such costs may be disclosed to investors in a manner that will enable them to compare such costs among funds. The bill would direct the SEC to report its findings to Congress no later than 270 days after enactment of the Act. In addition, the bill would direct the SEC to adopt, within 270 days of enactment of the Act, a rule requiring that periodic account statements contain a statement informing shareholders: (1) of "what amount of fees they have paid on each \$1,000 of their investments over the past 365 days;" (2) that such fees have been deducted from the amounts shown on the statements; and (3) where they may find additional information regarding the amount of these fees. In prescribing rules to implement the above requirements, the SEC would have to consider to methods for reducing the burdens on small funds of making this disclosure, consistent with the public interest and the protection of investors.

**Prohibition on Short-Term Trading by Interested Persons** The bill would prohibit certain persons<sup>6</sup> from engaging in "short-term transactions" (to be defined by SEC rule) in securities issued by a fund or its affiliate, other than money market funds, other funds whose investment policy expressly permits short-term transactions, or other categories of funds specified by SEC rule.

**Fund Compliance Officer** The bill would direct the SEC, within 270 days of enactment of the Act, to adopt rules requiring each fund to appoint a compliance officer, who would report solely to the fund's independent directors.

**TITLE II – MUTUAL FUND OVERSIGHT BOARD** The bill would establish a Mutual Fund Oversight Board ("Board"), which would be modeled largely on the Public Company Accounting Oversight Board established by the 6 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. 5 Sarbanes-Oxley Act of 2002. The Board would "oversee the conduct of mutual funds and related matters, in order to protect the interests of investors." **Administrative Provisions** **Composition.** The Board would consist of four members and a chairman, each of whom would have "a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial services offered by registered mutual funds." The bill would require the SEC, within 90 days of enactment of the Act, to appoint the initial Board members after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. **Each Board member:** (1) would be required to serve full-time; (2) could not be employed by any other person or engaged in any other professional or business activity while serving on the Board; and (3) would be limited to serving no more than two five-year terms. Under the bill, no Board member would be permitted to "share in any of the profits of, or receive payments from" a mutual fund or any other person as the SEC determines by rule. The bill would give the SEC the authority to remove a Board member for good cause shown. **Duties.** Under the bill, the Board would be responsible for, among other things: (1) registering mutual funds; (2) establishing internal auditing, quality control, ethics, independence, and other standards relating to the

conduct of mutual funds; (3) conducting inspections of mutual funds; (4) conducting investigations and disciplinary proceedings concerning mutual funds and their associated persons; and (5) performing such other duties and functions as the Board deems necessary and appropriate to promote high professional standards among, and improve the quality of services offered by, mutual funds.

**Organizational Timeframe.** The bill would direct the Board to hire staff, propose rules, and take other necessary or appropriate actions so that the SEC could determine, no later than 270 days after enactment of the Act, that the Board has the capacity to enforce compliance with the Act by registered mutual funds and their associated persons (“SEC Determination”).

**Annual Report.** The bill would direct the Board to submit an annual report to the SEC, which in turn would be required to transmit a copy to Congress.

**Registration with the Board Beginning 180 days after the SEC Determination (i.e., within 15 months of enactment of the Act),** a mutual fund would have to be registered with the Board in order to conduct business. To register, a mutual fund would be required to submit, as part of its application and in such detail as the Board specifies: (1) the fund’s policies regarding, and the fund’s efforts to eliminate, late trading practices and market timing practices; (2) the annual fees received by the fund; (3) such other current financial information for the fund’s most recently completed fiscal year as the Board may reasonably request; (4) a statement of the fund’s quality control policies; (5) information relating to criminal, civil, or administrative action or disciplinary proceedings pending against the mutual fund or its associated persons in connection with the fund; and (6) other information as specified by Board or SEC rule as necessary or appropriate in the public interest or for the protection of investors. The bill would direct the Board to approve or otherwise act on a completed application no later than 45 days after receiving it.

**6** The bill would require each registered mutual fund to submit an annual report to the Board. Under the bill, funds may be required to report more frequently in order to update the information in their applications or to provide such additional information as the Board or the SEC may specify by rule. The bill would direct that a mutual fund’s application and reports be made publicly available (subject to Board rules, SEC rules, or applicable confidentiality laws), provided that the Board protects from public disclosure any information that the fund reasonably identifies as proprietary. The bill also would direct the Board to collect fees from mutual funds to cover the costs of processing and reviewing applications and annual reports.

**Auditing, Quality Control, and Independence Standards and Rules** The Board would be required to establish internal auditing and quality control standards, as well as ethics standards to be used by registered mutual funds in conducting their business. The bill would direct the Board to convene such expert advisory groups as may be appropriate (“Advisory Groups”), which may include representatives of the mutual fund industry and of other interested groups, to make recommendations concerning the content of the required standards. The bill would further direct the Board to cooperate on an ongoing basis with the Advisory Groups in examining the need for changes in such standards. The Board also would be required to establish rules to ensure compliance with Section 10 of the Investment Company Act, which concerns affiliations or interests of fund directors, officers, and employees.

**Inspections of Registered Mutual Funds** The bill would require the Board to conduct an inspection program to “assess the degree of compliance” of each registered mutual fund and its associated persons with, and to identify any act or omission to act by such persons that may violate: (1) the Act; (2) rules of the Board; (3) SEC rules; (4) the fund’s quality control policies; or (5) professional standards. The Board would be required, if appropriate, to: (1) report any such acts or omissions to the SEC or state regulators; or (2) begin a formal investigation or take appropriate disciplinary action with respect to any such violation. Under the bill, the Board could require by rule that registered mutual funds retain records for inspection purposes. The bill would require the Board to inspect each mutual fund annually or according to such other schedule as set by Board rule. The Board would be

required, by rule, to give the fund the opportunity to review and respond to a draft report on the Board's inspection. Any response by the fund, redacted to protect information reasonably identified by the fund as confidential, would have to be made part of the final inspection report. The final report, in appropriate detail, would be: (1) transmitted to the SEC and each appropriate state regulatory authority; and (2) made publicly available, except that no portion of the report criticizing the fund's quality control systems would be made public if the fund addresses those criticisms to the Board's satisfaction within 12 months of the date of the report. The bill would require the SEC to adopt rules permitting a fund to seek SEC review if: (1) the fund, after responding to the Board's draft inspection report, disagrees with assessments contained in the final report; or (2) the fund disagrees with the Board's determination that the fund did not satisfactorily address criticisms of its quality control systems within the required 12-month timeframe.

### 7 Investigations and Disciplinary Proceedings

The bill would direct the Board to adopt procedures governing the investigation and discipline of registered mutual funds and their associated persons. The Board's investigative authority would extend to any act, practice, or omission to act that may violate: (1) the Act; (2) the rules of the Board; (3) provisions of the securities laws relating to mutual funds; or (4) professional standards. Among other things, the Board's rules could allow for: (1) the Board to request testimony and documents from any person, including a mutual fund client, that the Board considers relevant or material to its investigation; and (2) procedures for the Board to seek issuance of an SEC subpoena to compel such testimony or production of documents. Under the bill, any disciplinary hearing by the Board against a registered mutual fund or associated person would be open to the public, unless otherwise ordered by the Board for good cause shown. The bill would authorize the Board to impose a range of sanctions if the Board finds that the fund or associated person has acted or omitted to act in violation of: (1) the Act; (2) the rules of the Board; (3) provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including SEC rules issued under the Act; and (4) professional standards. The bill would provide that any application to the SEC for review (or institution by the SEC of review) of a Board disciplinary action would operate as a stay of the Board's action.

### SEC Oversight of the Board

Under the bill, the SEC would have oversight and enforcement authority over the Board. No Board rule would become effective without prior SEC approval, which would be required upon a finding by the SEC that the rule is consistent with the requirements of the Act and the securities laws, or is necessary in the public interest or for the protection of investors. The SEC also would have the authority to review final disciplinary sanctions imposed by the Board, in much the same way that the SEC reviews disciplinary sanctions imposed by a self-regulatory organization.

### Funding

The bill would authorize the Board to establish, with SEC approval, a reasonable "annual support fee" to cover the Board's annual budget, which also would be subject to SEC approval. The bill would require the Board's rules to provide for the equitable allocation, assessment, and collection of the support fee among mutual funds, allowing for "differentiation among classes of mutual funds, as appropriate." Under the bill, the support fees charged to a particular mutual fund (or class) would be based upon its average monthly equity market capitalization over the 12-month period immediately preceding the beginning of the Board's fiscal year as against the average monthly equity market capitalization for all mutual funds over the same period.

### 8 No Preemption of State Securities Actions

Under the bill, an action by the Board would not preempt: (1) any state securities investigation or enforcement action; or (2) any state law, regulation, order, interpretation, or other action of general applicability relating to corporate governance or antitrust.

### Arbitration of Investor Claims in Independent Forum

The bill would direct the SEC, within 270 days of enactment of the Act, to prescribe rules under the various federal securities laws for adoption by the SEC, any self-regulatory organization or both, to require

that persons bringing claims under those laws be given the option of having any arbitration of such claim held in an independent arbitration forum of the person's choosing. Rachel H. Graham Assistant Counsel

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