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SEC RESPONSE TO CONGRESSIONAL REQUEST FOR INFORMATION ON MUTUAL FUND INDUSTRY ISSUES

[16181] June 11, 2003 TO: BOARD OF GOVERNORS No. 27-03 DIRECTOR SERVICES COMMITTEE No. 7-03 FEDERAL LEGISLATION MEMBERS No. 7-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 44-03 PUBLIC INFORMATION COMMITTEE No. 15-03 SEC RULES MEMBERS No. 69-03 RE: SEC RESPONSE TO CONGRESSIONAL REQUEST FOR INFORMATION ON MUTUAL FUND INDUSTRY ISSUES Earlier this year, following a hearing on mutual fund practices, Richard H. Baker (R-LA), Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, sent a letter to the Securities and Exchange Commission soliciting the SEC's views on various mutual fund issues.1 The SEC recently sent its response, consisting of a letter from SEC Chairman William Donaldson transmitting a memorandum prepared by the Division of Investment Management, to Chairman Baker (the "SEC Response").2 The SEC Response is summarized below. A. Mutual Fund Fee Trends and Transparency 1. Cost-Based Competition Among Mutual Funds The SEC Response discusses the extent to which cost-based competition currently exists in the fund industry. It notes that while there is some evidence that mutual fund expense ratios have risen over time, it is not clear that the overall costs of owning mutual fund shares has risen. The SEC Response examines the findings of recent SEC staff and U.S. General Accounting Office (GAO) studies of mutual fund fees. It points out that an increase in bond fund investments between 1999 and 2002, coupled with a decline in stock fund assets, may explain the relative stability of mutual fund expense ratios during this period. Noting that the GAO found that the asset-weighted average expense ratio for the 46 large stock funds in its 1 See Memorandum 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 and SEC Rules Members No. 37-03 (15809), dated March 27, 2003. 2 The SEC's response is available on the House Financial Services Committee website at http://financialservices.house.gov/news.asp?FormMode=release&id=338&NewsType=1. 2 study declined between 1990 and 2001, but increased between 1999 and 2001, the SEC Response states that this increase may reflect the decrease in assets of some stock funds in the sample, and also that a portion of the increase may be attributable to the behavior of performance-based fees paid by certain large funds. A decline during this period in the average expense ratio of 30 bond funds studied by the GAO may reflect economies of scale arising from an increase in the assets of bond funds in the sample. The SEC Response cites empirical evidence of competition based on costs in the mutual fund industry. It points to increases since 1990 in (1) the share of total fund assets invested with three fund groups that have been characterized as featuring relatively low costs, and (2) the percentage of

stock fund assets represented by index funds. According to the SEC Response, “[t]hese data suggest that fund groups may effectively compete on the basis of cost for the segment of investors for whom cost is a significant factor in selecting investments.” The SEC Response mentions various competitive pressures both within the industry and from outside the industry. The SEC Response also discusses the significant influence that the choice of distribution channel can have on the amount and type of fund expenses that an investor pays. 2. Fee Disclosure The SEC Response summarizes the current disclosure requirements applicable to mutual fund fees and expenses, noting that “mutual fund investors receive significant disclosure about fund fees and expenses,” and mentions additional efforts to educate investors about fund fees and expenses, which include the SEC’s Mutual Fund Cost Calculator. The SEC Response states that despite existing requirements and educational efforts, the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. The SEC Response then discusses the SEC’s pending proposal to require additional expense disclosure in shareholder reports, and discusses several advantages of this proposal as compared to an alternative approach proposed by the GAO, which would require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement. The SEC Response notes that it is difficult to assess the effects of either proposal on competition in the fund industry, in part because either would go beyond the disclosure provided by other financial service providers. B. Disclosure of Trading Costs The SEC Response expresses agreement with the notion that shareholders need to better understand a fund’s trading costs in order to evaluate the costs of operating a fund. It discusses in detail different types of trading costs, and points out that while commission costs can be easily determined, other types of trading costs (i.e., spread, impact, and opportunity costs) can only be roughly estimated, and there is no generally agreed-upon method for calculating these costs. The SEC Response also describes current requirements with respect to accounting, disclosure, and information to be provided to fund directors. The SEC Response analyzes various proposals that have been made for additional quantitative disclosures of trading costs. It reiterates the staff’s belief that “it would be inappropriate to account for commissions as a fund expense unless spreads, and possibly 3 impact and opportunity costs, were treated in a similar manner,” and goes on to express the view that it is not currently feasible to quantify and record spreads, market impacts and opportunity costs as a fund expense. According to the SEC Response, “[e]ven if a detailed regulatory regime were imposed on the operational procedures that funds use to effect portfolio transactions, the resulting estimates of transaction costs would appear to lack the attributes of uniformity, reliability and verifiability that are the hallmarks for recording operations results in financial statements.” The SEC Response states that the staff will consider whether to recommend that the SEC issue a concept release to elicit views on suggestions that have been made regarding disclosure of transaction costs, and to solicit additional suggestions. The goal of the concept release would be “to obtain comment on whether it is possible to construct a transaction cost measure that would be comparable, verifiable and complete, yet not unduly burdensome to funds and their service providers.” The staff also will consider ways to improve current disclosure of transaction costs. Approaches to be considered will include (1) requiring funds to give greater prominence to portfolio turnover disclosure, (2) requiring a discussion of transaction costs and portfolio turnover in the prospectus, (3) moving information on brokerage costs from the statement of additional information (SAI) to the prospectus and requiring that it be displayed prominently with portfolio turnover information, and (4) reinstating some form of average commission rate disclosure. C. Soft Dollars The SEC Response acknowledges that soft dollar arrangements may involve the potential for conflicts of interest between a fund and its investment adviser but notes that these types of conflicts are generally managed by fund boards of directors. It asserts that independent directors are generally in a better position to monitor the adviser's direction of the fund's brokerage than are fund investors. For this reason, the SEC has not required specific information about use of soft dollars in fund prospectuses and has made clear the responsibilities of fund directors in connection with their oversight of the allocation of fund brokerage. The SEC Response discusses the safe harbor provided by Section 28(e) of the Securities Exchange Act of 1934 and relevant current and pending disclosure requirements applicable to investment advisers. After describing certain obstacles to requiring advisers to provide clients with periodic quantitative information about use of soft dollars, the SEC Response expresses skepticism that enhanced disclosure alone would provide sufficient transparency to permit advisory clients to supervise their money managers' use of soft dollars. It states that the staff will continue its efforts to improve disclosure and also expects to ask the SEC to propose rule changes to require advisers to keep better records of the products and services they receive for soft dollars. In addition, the SEC Response indicates that it may be appropriate to reconsider Section 28(e) or to narrow the scope of the safe harbor. D. Disclosure of Portfolio Managers' Compensation and Fund Holdings The SEC Response discusses current requirements applicable to disclosure of fund advisory fees. It responds to claims that operating companies are held to a higher standard of disclosure because they are required to disclose manager compensation, while funds are not, by 4 explaining that the most direct analogue to the compensation of an operating company's managers is compensation of the fund's investment adviser, which is required to be disclosed. Nevertheless, the SEC Response states that disclosure regarding the structure of an individual portfolio manager's compensation might be useful in supplementing existing disclosure of the advisory fee. The SEC Response identifies some practical issues that would need to be addressed, such as what should be disclosed in the case of funds that are managed by teams or committees or where a portfolio manager manages multiple portfolios. With respect to the possibility of requiring funds to disclose portfolio managers' holdings of fund shares, the SEC Response states that this could provide some evidence of alignment of interests with those of fund shareholders, but that "compensation structure disclosure is probably a more direct indicator of alignment with the interests of fund shareholders." The SEC Response points out that, unlike compensation structure disclosure, disclosure of fund holdings involves some ambiguities as portfolio managers may have a number of reasons for not holding shares of a particular fund. As with compensation structure disclosure, practical issues would arise in the case of funds managed by teams or committees. E. Mutual Fund Governance Issues 1. Definition of Interested Person The SEC Response discusses current requirements regarding board composition and director independence. It cites certain "gaps" in the definition of "interested person" in Section 2(a)(19) of the Investment Company Act of 1940 that "have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management," including former executives of the investment adviser two years after retirement, and the uncle of a fund's portfolio manager. The SEC Response requests that Congress consider amending Section 2(a)(19) to give the SEC rulemaking authority to fill such gaps. 2. Adequacy of Fund Boards While noting that it is difficult to draw any generalized conclusions about the adequacy of fund boards, the SEC Response expresses the staff's belief that "one of the principal reasons the mutual fund industry has avoided the scandals that have plagued other segments of the securities industry is the presence of independent directors." The SEC Response cites recent SEC initiatives to promote effective fund governance, including a 1999 roundtable on the role of independent fund directors, and rule amendments adopted in 2001 that require for most funds that (1) independent directors constitute a majority of the board, (2) independent directors select and nominate other independent directors and (3) any legal counsel for the independent directors qualify as “independent legal counsel.” It states that the rule amendments, along with the attention that they and the roundtable received, “have led to stronger, more independent, fund boards, which today are better equipped to deal with conflicts that arise in the management of funds, including the oversight of fund expenses.” It suggests that Congress could consider amending the 1940 Act to require all funds to have a majority of independent 5 directors, which would codify the standard currently employed by most funds and ensure that all fund boards have the benefit of a board with an independent majority. The SEC Response states that fund directors “must continue to exercise vigilance in monitoring the fees and expenses of the funds they oversee, and ensure that an appropriate portion of the cost savings achievable from any economies of scale are passed along to fund shareholders.” SEC inspections of mutual funds have found that “most boards of directors are obtaining the necessary information to evaluate the various types of fund fees and expenses, as well as costs not reflected in a fund’s expense ratio, such as portfolio transaction costs.” The SEC Response notes that the staff is considering whether recordkeeping requirements in this area would assist the staff’s review of whether fund directors and advisers are fulfilling their obligations under Section 15(c) of the 1940 Act. 3. Independent Chairman The SEC Response addresses the issue of whether it would be beneficial for the chairman of a fund’s board to be an independent director. It notes certain potential benefits of an independent chairman, such as the ability to control the agenda and manage the flow of information to the board, but points out that because almost all funds have a majority of independent directors, “one could question whether there is a need to mandate that a fund’s chairman be independent because independent directors . . . already are in a position to control the board and, if they deemed it appropriate, could already influence the agenda and the flow of information to the board.” The SEC Response also notes that in response to the Institute’s 1999 Report of the Advisory Group on Best Practices for Fund Directors, many fund boards have designated one or more “lead” independent directors who can coordinate the activities of the independent directors, act as their spokesperson in between meetings, raise and discuss issues with counsel on behalf of the independent directors, and chair separate meetings of independent directors. 4. Role of Fund Directors Regarding Sales Charge Breakpoints The SEC Response discusses recent regulatory examinations that found significant failures by broker-dealers to deliver front-end sales charge breakpoint discounts to eligible investors. It states that while the 1940 Act and rules thereunder do not impose any specific obligations on fund boards with respect to the application of front-end sales charges, the staff believes that fund boards should oversee the administration of breakpoint discounts, particularly in light of the problems identified in recent broker-dealer examinations. More specifically, the staff expects fund boards to review the adequacy of their funds’ policies and procedures relating to front-end sales charges, and believes fund boards should “obtain assurances, through the funds’ principal underwriters, that broker-dealers selling their funds’ shares have adequate policies and procedures to ensure that fund investors receive the breakpoint discounts to which they are entitled.” The SEC Response notes that a task force convened by the NASD, comprised of regulators and representatives from broker-dealers, funds, fund administrators and operational personnel, is expected to formulate recommendations for regulatory action and voluntary industry measures that can minimize problems in this area. The SEC Response recommends 6 that the SEC consider requiring that funds disclose breakpoint information in their prospectuses, rather than their SAIs. 5. Director Responsibilities Regarding Management Contracts In response to a question in Chairman Baker’s letter, the SEC Response states that, to the best of the staff’s knowledge, fund directors have infrequently terminated or rejected management or investment advisory contracts during the past ten years. It discusses 1940 Act provisions relating to termination of advisory clients, and certain circumstances in which directors have terminated advisory contracts. The SEC Response also discusses the obligations of directors and investment advisers with respect to the approval of management contracts. In addressing the utility of applicable legal standards, the letter states: “The infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that the legal standards that are applicable to the approval of investment advisory contracts are inadequate, or that independent directors have not been forceful enough in representing shareholders’ interests. Fund directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds,” such as renegotiating the contract or requiring the adviser to take steps to improve its performance. The SEC Response emphasizes that while fund directors have the authority to terminate the advisory contract if they are not satisfied with the adviser’s performance, “termination of the contract is not the only course of action that is available to the directors, and termination may not necessarily be in the best interests of the fund.” The SEC Response responds to a question on the disclosure required in the SAI concerning a fund board’s basis for approving the advisory contract. It reports that much of the disclosure the staff has seen is “satisfactory,” but notes that it has ranged from excellent to poor. The “better” disclosure addressed specific factors that were most significant in the board’s consideration, factors that were not considered or deemed less significant, the quality of services provided to the fund, and the particular experience and performance of the adviser with the particular fund. It also provided a “non-cursory” comparison of the fund’s advisory fee to those of other similarly situated funds. The SEC Response explains the SEC’s reasoning for requiring this disclosure in the SAI rather than in the prospectus or annual report. 6. Application of Section 301 of the Sarbanes-Oxley Act to Mutual Fund Audit Committees The SEC Response discusses whether mutual funds would benefit from the requirements that Section 301 of the Sarbanes-Oxley Act applies to the audit committees of listed companies. It concludes that extending the requirements to mutual funds could benefit them, but should be balanced with the costs to funds and their shareholders. It also notes that certain of the requirements (requiring audit committee members to be independent and requiring that the audit committee appoint, compensate, retain, and oversee the outside auditor) already have been addressed to some extent by other rules applicable to mutual funds. 7 G. Fund Distribution Issues 1. Rule 12b-1 The SEC Response describes the requirements of Rule 12b-1, focusing in particular on the obligations of fund directors under the rule. It refers to the SEC staff’s December 2000 report on mutual fund fees. In that report, the staff recommended that the SEC consider reviewing and amending the requirements of Rule 12b-1, based in part on changes in the manner in which funds have been marketed and distributed, and the experience gained in observing how the rule has operated, since it was adopted in 1980. The SEC Response reviews several important developments since 1980, including the use of 12b-1 plans as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements, the advent of multiple class funds and fund supermarkets, and the use of 12b-1 payment streams as collateral in connection with borrowing to finance fund distribution efforts. Another development cited in the SEC Response is the use by some funds of a portion of brokerage commissions to compensate broker-dealers for selling fund shares. The SEC Response states that the staff believes that certain of these arrangements, e.g., where fund advisers direct broker-dealers that execute fund portfolio transactions to pay a portion of the fund’s brokerage to selling broker-dealers who perform no execution-related services in connection with these transactions, “result in the use of fund assets to facilitate distribution and should be reflected in rule 12b-1 distribution plans.” The staff intends to recommend that the SEC take action to clarify the circumstances in which the use of brokerage to facilitate distribution should be reflected in a 12b-1 plan. In addition, the staff will continue to assess the issues raised by Rule 12b-1 and discuss with the SEC the current status of the rule in light of the staff's 2000 recommendation and the changes in fund distribution practices since the rule's adoption. 2. Revenue-Sharing Payments The SEC Response discusses so-called "revenue-sharing payments," whereby fund advisers compensate selling broker-dealers through payments out of the advisers' own resources. According to the SEC Response, the "primary legal issue" raised by these payments is whether the payments are an indirect use of fund assets to finance distribution and therefore must be made in accordance with Rule 12b-1. The SEC Response states that in the SEC's view, "a fund indirectly finances the distribution of its shares within the meaning of rule 12b-1 if any allowance is made in the fund's investment advisory fee to provide money to finance the distribution of the fund's shares." Conversely, there is no indirect use of fund assets to finance distribution if revenue-sharing payments are made out of the adviser's legitimate profits. The fund's board of directors is primarily responsible for determining whether any revenue-sharing payments implicate Rule 12b-1. The SEC Response reviews current disclosure of revenue-sharing payments by broker-dealers and funds. It notes that the SEC, having recognized that fund prospectuses are not designed to make the particular disclosure about receipt of these payments that broker-dealers must provide to their customers under Rule 10b-10 under the 1934 Act, has directed its staff to make recommendations as to whether additional disclosure should be required or current 8 disclosure further refined. The SEC Response states that the staff "is considering whether disclosure made by the broker-dealer at the point of sale and in subsequent periodic filings would be appropriate mechanisms for this disclosure." According to the SEC Response, revenue-sharing payments generally have no direct impact on fund shareholders because they are not fund expenses. Funds and their shareholders may be impacted, however, if investment advisory fees are higher than they would be if no such payments were made. The SEC Response notes that this "does not necessarily mean" that an adviser has violated its fiduciary duty under Section 36(b) of the 1940 Act, "because the advisory fees paid by the funds to their advisers may not be excessive." H. Performance Information 1. Fund Performance Advertising In response to a question about investor selection of mutual funds based on past performance, the SEC Response reviews the current requirements for mutual fund performance disclosure, as well as current performance disclosure by closed-end funds, unit investment trusts, investment advisers, and hedge funds. It then discusses practices that have raised concerns in recent years, such as instances where the SEC found that funds failed to adequately disclose that unusual circumstances contributed significantly to advertised performance, failed to disclose a significant decline in fund performance since the period reflected in an advertisement, or made selective use of time periods for advertised performance. The SEC Response describes several initiatives to address these concerns, which include pending proposed amendments to the SEC's mutual fund advertising rules and SEC and NASD investor education efforts. The SEC Response briefly discusses a suggestion that fund families be required to disclose the average performance of all of their funds, including funds no longer in existence. It identifies several practical issues that this would raise. 2. Adequacy of Disclosure of Fund Performance in Shareholder Reports The SEC Response explains the staff's process for reviewing the management's discussion of fund performance section in fund shareholder reports and discusses the results of a targeted review of shareholder reports early this year that focused on the quality of this disclosure. The memorandum states that most of the disclosure the staff reviewed "was either of good or average quality," and it contrasts elements of the better disclosures with those of the "poorer quality" disclosures. The SEC Response indicates that the staff will continue to conduct its integrated review program, along with meeting new requirements under the Sarbanes-Oxley Act regarding the review of financial statements and periodic filings. 3. Incubator Funds and Hot IPOs The SEC Response describes the general characteristics of “incubator” funds and notes that such funds may be structured and operated in reliance on exceptions from regulation as an investment company under the 1940 Act, or may register as investment companies but refrain from marketing themselves to the public during their incubation period. With respect to the practice of steering “hot IPOs” to incubator funds, the SEC Response explains an investment adviser’s obligation to allocate investment opportunities among its clients in a manner 9 consistent with the adviser’s fiduciary duties and disclosures to clients and cites several enforcement actions the SEC has instituted against investment advisers for fraudulently allocating hot IPO securities. The SEC Response also discusses the application of the antifraud provisions of the federal securities laws to the use of incubator fund performance information, citing relevant SEC enforcement actions. The SEC Response then discusses the legal and policy implications of the potential use of mutual funds to prop up the prices of IPOs underwritten by an affiliated broker-dealer. It analyzes the application of Sections 10(f) and 17(d) of the 1940 Act, among other relevant considerations. I. Mutual Fund Proxy Voting Disclosure Rules The SEC Response outlines the new SEC rules that require mutual funds to disclose their proxy voting policies and proxy votes. It states that in designing these requirements, the SEC “was extremely sensitive to the potential costs to the fund industry and fund investors and took steps to minimize these costs.” It describes various changes made to the rules as originally proposed in response to comments expressing concerns about costs, and sets forth the cost/benefit analysis from the SEC’s adopting release. It notes that the SEC has asked the staff to monitor the effects of the disclosure and report back to the SEC within two years on the operation of the rule. J. Portfolio Security Valuation The SEC Response discusses the legal and regulatory requirements that govern valuation of fund portfolio securities. It notes that the 1940 Act places the responsibility for fair value pricing portfolio securities on fund boards, but that in practice, most boards delegate day- to-day responsibility for calculating security prices to others, such as the fund’s investment adviser. In response to a question about discounts for large block positions, the SEC Response explains that funds occasionally hold large positions in securities for which market quotations are readily available, and that historically, they have used the market values of those securities, without applying a discount. The SEC Response states that valuing a block position at a discount could understate the value of the position because funds generally seek to liquidate block positions over an extended period of time to obtain the most favorable market prices, rather than selling the entire block at the same time. Matthew P. Fink President