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before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

on

The Mutual Funds Integrity and Fee Transparency Act of 2003

June 18, 2003

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified on legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site.

## I. Introduction

More than 95 million Americans are shareholders of mutual funds, making mutual funds America's investment vehicle of choice. These shareholders have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative. This will continue to be true, however, only as long as mutual fund rules keep pace with changes in fund practices. In significant respects, fund rules have not kept pace with developments in the fund industry. H.R. 2420 is necessary to update fund rules to ensure that mutual funds remain the best possible alternative for investors.

The mutual fund industry owes much of its success to the requirements of the Investment Company Act of 1940 and the body of regulatory law that has developed around it. The Act provides liquidity by requiring that mutual funds be redeemable on demand at a price based on the value of their net assets. Fund rules provide safety by prohibiting transactions between funds and their affiliates and by limiting the amount of leverage that funds can use. Transparency and standardization are assured by rules regarding the use of standardized investment performance and fee disclosure. These rules are buttressed by the presence of an independent board of directors that oversees fund operations to ensure that funds are operated in the best interests of their shareholders and not fund affiliates.

Mutual funds offer liquidity, safety, transparency and standardization at a reasonable price – again, partly as a result of effective regulation. The fee information provided in the fund prospectus provides investors with standardized costs that can be used to compare different funds. This information also can be easily disseminated through the information channels that investors use when making investment decisions. The transparency of fund fees promotes price competition and has resulted in the availability of a wide variety of low cost fund options.

Fund regulation also has been successful in adapting to changing business practices. Many of the fundamental characteristics of funds owe their existence to regulatory reforms, including the fee table, standardized investment performance, 12b-1 fees, and multiclass funds. The Vanguard Group, America's second largest fund complex, exists and operates only by reason of a series of exemptions granted by the SEC.[1] Exchange-traded funds, which are similarly a creation of innovative regulation,[2] did not exist ten years ago. They now hold approximately $100 billion in assets.

In some respects, however, fund regulation has failed to adapt to changing business practices. Fund distribution and brokerage practices have changed dramatically over the last twenty years, but rules governing fund disclosure and fund directors' responsibilities have not kept pace. The true cost of investing in mutual funds has become obscured by fee disclosure that fails to reflect accurately how and how much shareholders pay for fund-related services. Fund governance rules need to be improved to give independent directors the authority and tools they need to oversee funds' increasingly complex distribution and brokerage practices. H.R. 2420 takes an important first step in modernizing mutual fund rules to reflect the way that funds operate today.

H.R. 2420 will update fund disclosure rules to provide investors with needed information about fund costs. It will provide investors with a clearer understanding of the impact of fees by requiring that they be disclosed in dollar amounts. Fee disclosure will be required to incorporate all fees, including portfolio transaction costs, and to identify all distribution expenses, including those paid outside of 12b-1 plans. Improved disclosure of compensation paid to portfolio managers and retail brokers will enable shareholders to

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[1] See, e.g., In the Matter of Wellington Fund, Inc., Investment Company Act Release Nos. 8644 (Jan. 17, 1975) (notice) & 8676 (Feb. 18, 1975) (order) (permitting operation of Vanguard as internally managed mutual fund).

[2] See, e.g., The Select SPDR Trust, Investment Company Act Rel. Nos. 23492 (Oct. 20, 1998) (notice of exemptive application) & 23534 (Nov. 13, 1998)(order).

evaluate the extent to which these persons' economic interests are aligned with their own. In addition, H.R. 2420 will strengthen the role of independent directors and further focus their energies where conflicts of interest between the fund adviser and fund shareholders are greatest.

The remainder of this testimony discusses separately each section of H.R. 2420.

## II. Section 2: Improved Transparency of Mutual Fund Costs

### a. Individualized Dollar Fee Disclosure

Section 2(a)(1) of H.R. 2420 will require, through SEC rulemaking, funds to disclose in dollars the amount of operating expenses paid by individual shareholders.[3]

The disclosure of expenses in dollars will benefit shareholders in two principal respects. First, it will illustrate expenses in a more direct, concrete form than currently provided in the prospectus. The prospectus includes a fee table and a hypothetical fee sample. The fee table shows expenses as a percentage of assets (the expense ratio). The fee sample shows the hypothetical expenses in dollars that would be incurred by a $10,000 account. Section 2(a)(1) will be more concrete than the expense ratio by requiring disclosure of a dollar amount, and more direct than the hypothetical fee sample by requiring disclosure of the actual amount paid by each investor.

Second, individualized dollar fee disclosure will provide special benefits to investors for whom current disclosure rules are not effective communication tools. For price conscious investors who already are aware of the importance of fund fees, current disclosure may be adequate. In contrast, individualized dollar fee disclosure has the potential to raise the fee awareness of less price sensitive investors.

[3] On December 18, 2002, the Commission proposed to require funds to provide dollar fee disclosure in the semiannual report. See Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Rel. No. 25870.

Unfortunately, Section 2(a)(1)'s potential to raise investors' fee awareness may not be fully realized, as the Commission's current intention is to require disclosure not of each shareholder's actual expenses, but rather of a hypothetical shareholder's expenses, and to require disclosure not in a document that less price sensitive shareholders are likely to review, but in the semiannual report.[4] This approach provides essentially the same information already provided in the fee sample in the prospectus and is likely to provide minimal added benefit to shareholders.[5]

Ideally, all shareholders would carefully consider the expense information in the prospectus and assiduously review semiannual reports, but they do not. And the shareholders who are least likely to exercise such diligence are the ones who most need to have their attention affirmatively directed to the costs of investing. The SEC's proposal would benefit only price sensitive investors, but common sense necessitates that effective disclosure rules reflect the characteristics of the intended audience of less price conscious investors.

Section 2(a)(1)'s purpose can best be realized by requiring disclosure that less price sensitive shareholders will actually use. For this reason, the Government Accounting Office, Fund Democracy and the Consumer Federation of America have argued for providing individualized dollar fee disclosure on quarterly statements.[6] Quarterly statements are the documents that less price sensitive shareholders are most likely to review, as these documents show changes in the value of their accounts and any account activity. Dollar fee disclosure would be particularly appropriate in quarterly statements

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[4] Memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, at 13-17 (June 9, 2003) ("SEC Report").

[5] See generally, Letter from Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan Katz, Secretary, Securities and Exchange Commission, at Section IV (Feb. 14, 2003), at http://www.sec.gov/rules/proposed/s75102/mbullard1.htm.

[6] Id.; Government Accounting Office, Mutual Funds: Information On Trends In Fees And Their Related Disclosure (March 12, 2003).

because it would juxtapose the dollar amount of fees deducted from the account with the dollar value of the account.

b. Fund Portfolio Manager Compensation

Section 2(a)(2) of H.R. 2420 will require, through SEC rulemaking, disclosure of the structure of the compensation of persons employed to manage a mutual fund's portfolio.

The structure and source of compensation paid to a fund's portfolio manager or portfolio management team ("portfolio manager" hereinafter includes the portfolio management team) are highly relevant to an investor's evaluation of a fund. As noted by the SEC staff, whether a portfolio manager's compensation is based on short-term or long-term performance, or pre-tax or after-tax performance, may indicate whether the manager's and the shareholders' interests are aligned.[7] Whether a portfolio manager is compensated for services provided to other mutual funds or other fund or non-fund clients, or for providing other outside services generally, is also highly relevant to shareholders who wish to evaluate the manager's commitment to a fund and the presence of conflicts of interest that the manager may have as a result of outside duties.[8]

In contrast, the total value of the portfolio manager's compensation is not especially relevant.[9] The total fees paid by fund shareholders is a direct function not of the portfolio manager's compensation, but of the adviser's total compensation. While the total compensation paid to the portfolio manager indirectly bears on the total fees paid by shareholders, and therefore disclosure of this information could help some shareholders

[7] SEC Report at 43.

[8] See Remarks by Paul Roye, Director, Division of Investment Management, before the ALI/ABA Investment Company Regulation and Compliance Conference (June 14, 2001)("As many mutual fund managers look to generate revenues by expanding into other areas of the investment management business such as offering private accounts or sponsoring and advising hedge funds and other alternative investment vehicles, they should be mindful that certain of these new opportunities raise conflict of interest issues and the potential for abuse.").

[9] Accord, SEC Report at 42-43.

to evaluate fund fees, there is a risk that identifying the portfolio manager's total compensation would distract shareholders from the more fruitful exercise of evaluating the fund's and the adviser's total fees as disclosed in the fee table in the prospectus.

c. Fund Portfolio Transaction Costs

Section 2(a)(3) of H.R. 2420 will require, through SEC rulemaking, funds to set forth information about their portfolio transaction costs, including commissions, in a manner that facilitates comparisons across funds.

As stated by the Commission, "fund trading costs incurred in a typical year can be substantial."[10] The Commission cites studies that estimate that brokerage commissions alone cost about 0.30% of equity funds' net assets.[11] Other studies estimate that market spread, or the amount by which the price of a security is marked up or marked down, costs about 0.50% of equity funds' net assets, and that "opportunity costs may amount to 0.20% of value."[12]

Another study found that the mean brokerage and market spread costs for a sample of equity funds was 0.75% of assets – almost three-quarters of the mean expense ratio of 1.09%.[13] The brokerage and spread costs constituted an even larger percentage of the total costs of funds with the highest trading costs, with mean brokerage and spread costs equaling 1.54% of assets and the mean expense ratio equaling only 1.24%.[14]

[10] Id. at 19.

[11] Id. at 22.

[12] Id.

[13] Chalmers, Edelen & Kadlee, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management (Dec. 29, 2001)

[14] Id.

Thus, portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided in the prospectus. Section 2(a)(3) takes the first step in ensuring that investors are made aware of transaction costs and that they can consider these costs when making investment decisions. Transaction costs vary greatly among funds, and full disclosure of these expenses will help hold fund advisers accountable for their trading practices.

Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices. In short, transaction cost disclosure will subject fund expenditures on soft dollar services to market forces, and thereby provide a practical solution to the problem of regulating soft dollar practices. This benefit is addressed further in the next part of this testimony.

For some transaction costs, fashioning disclosure rules will be a relatively easy task. Fund brokerage commissions already are disclosed in the Statement of Additional Information as a dollar amount. Converting this dollar amount to a percentage of assets and including it with other expenses in the expense ratio in the fee table would be simple and inexpensive.[15]

Providing disclosure regarding other types of transaction costs will be more difficult, but no less necessary. There are no standardized methods for calculating spread costs, market impact or opportunity costs. Nor are these concepts, unlike fund brokerage, generally understood by the investing public. Nonetheless, the Commission has been able to develop effective, standardized, quantitative disclosure tools in other contexts, such as funds' investment performance and expense ratios. There are a number of private companies that already provide fund advisers with quantitative assessments of their funds' transaction costs for self-evaluative and board review purposes.[16] The SEC's inspection staff routinely considers these quantitative assessments when evaluating a fund

[15] Accord, SEC Report at 28.

[16] Id. at 21-22

adviser's obligation to obtain best execution of fund transactions. It should not be difficult, over time, to develop quantitative tools to measure fund transaction costs and disclosure formats that will provide this information in a way that helps investors understand these costs.

The Commission has objected to the disclosure of fund portfolio transaction costs on the grounds that the disclosure of brokerage commissions, while easily comparable and verifiable, would be incomplete, and the disclosure of other components of transaction costs, while completing the transaction cost picture, would not lack comparability.[17] This objection misunderstands the purpose of fee disclosure rules and is not consistent with Section 2(a)(3).

The purpose of fee disclosure rules is to ensure that investors have the information they need to make informed investment decisions. Thus, the issue is not whether the disclosure is theoretically perfect or complete, but rather whether it provides information that facilitates better investment decisions.

For example, Commission-mandated standardized investment performance is imperfect and incomplete in a number of ways. It is calculated net of fees, notwithstanding that this does not accurately portray a fund adviser's pure stock picking ability before expenses. It arbitrarily measures performance at 1-, 5-, and 10-year intervals, and not periods in-between. It is based on only one of a number of different methods of calculating an internal rate of return. In advertisements, it is permitted to show the returns of a single class, even though the performance of other classes may have been different.

Similar observations could be made about imperfections in the fee table. Indeed, one drawback of the expense ratio is that it is incomplete, and including commissions would make it a more complete measure of the cost of fund investing. Both standardized

[17] Id. at 20-22 & 28-35.

performance and the fee table have provided an undisputed net benefit to shareholders, notwithstanding their theoretical inadequacies.[18]

The fact that there is more than one way to calculate the different components of fund transaction costs is not a reason to deprive shareholders of useful information about these costs. The Commission has suggested enhanced disclosure of funds' turnover ratios as an alternative to disclosure of actual transaction costs. Using the turnover ratio as a proxy for transaction costs, itself an imperfect measure, would be an inferior and inadequate substitute for disclosure of actual transaction costs.[19]

d. Soft Dollar Disclosure

Section 2(a)(4)(A) & (B) of H.R. 2420 will require, through SEC rulemaking, improved disclosure of funds' soft dollar arrangements. (Section 2(a)(4)(C) is addressed in the next part of this testimony.)

The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded $1 billion in 1998.[20] An executive with American Century Investment Management recently testified before this Subcommittee that the research

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[18] Indeed, the same observations could be made about the SEC's preference for turnover rates as a proxy for portfolio transactions costs. Chalmers, supra note 13 (demonstrating that fund turnover is not a reliable proxy for fund trading expenses). If an imperfect, indirect measure of transaction costs such as portfolio turnover is to be used, it is unclear why a direct measure, such as commissions, spread costs, market impact or opportunity costs would not be preferable.

[19] Id.

[20] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998) ("Section 28(e) Report").

component of soft dollar commissions costs six times the value of the execution component.[21]

Soft dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for themselves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft dollar benefits.[22]

Soft dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.[23] Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio.

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[21] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (Mar. 12, 2003).

[22] See id. at 2 (the statutory safe harbor permitting soft dollars arrangements "encourages investment managers to **use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager**." (emphasis in original)).

[23] See Investment Company Act Section 17(e); SEC Report at 38.

Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

Section 2(a)(4)(A) & (B) will help reduce adviser conflicts and fund costs by subjecting soft dollars to the disciplining effect of public disclosure and market competition. To the extent that shareholders are able to compare soft dollar expenditures of different funds, they will have a more complete picture of the relative costs of investing in different funds.

One way to achieve this objective would be to require the quantification of soft dollar expenses. The Commission has previously proposed requiring such disclosure, but has relented under the weight of arguments that the benefits of soft dollars to a particular fund could not be quantified.[24] The Commission also has argued that the oversight of soft dollar arrangements is best left to fund directors. It is unclear, however, how fund directors are able to provide such oversight if it is not possible to measure the cost of soft dollars (or why director oversight should preclude providing more information to shareholders). The Commission should revisit the possibility of requiring the quantification of soft dollar costs in a format that allows meaningful comparison across different funds.

The Commission also should consider requiring that commissions be included in fund expense ratios, as discussed in the immediately preceding part of this testimony. This solution would indirectly subject soft dollars to price competition without the necessity of separately quantifying their cost. The SEC staff has argued that "greater transparency of brokerage costs is unlikely to help an investor evaluate a fund adviser's conflicts in using

[24] SEC Report at 40.

soft dollars."[25] But directly educating investors about the conflicts inherent in using soft dollars is only one way to address such conflicts. Greater transparency of brokerage costs would address such conflicts by ensuring, at a minimum, that the cost of the conflicts can be considered by the marketplace.

e. Disclosure of Distribution Expenses

Sections 2(a)(4)(C), (5) & (6) of H.R. 2420 will require, through SEC rulemaking, improved disclosure of: the use of fund brokerage to compensate brokers for selling fund shares, payments for fund distribution made by someone other than the fund, and breakpoints on front-end sales loads.

These provisions of H.R. 2420 will help improve investors' understanding of fund distribution costs and brokers' compensation, each of which is addressed separately below.

1. Fund Distribution Costs

Under current disclosure rules, the treatment of fund distribution expenses is inadequate in a number of respects. Although the disclosure of the amount of sales loads and breakpoints in the prospectus is relatively straightforward and clear, there is no required disclosure of the advantages and disadvantages of different selling arrangements or investment amounts. Thus, while an investor may be able to easily determine the amount of his sales load, he will not be able to easily determine whether he has invested in the optimal fund class or invested the optimal amount.[26]

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[25] Id. at 37.

[26] See Lauricella, Mutual-Fund Investors Take Quiz: A, B or C?, Wall Street Journal (Mar. 7, 2003).

The suitability of a particular fund class may depend on the length of the investor's expected holding period or the amount invested.[27] In addition, the choice of fund class or the optimal allocation of assets among different investments may depend on the amount at which commission breakpoints are triggered.

The Commission should consider requiring disclosure, in the form of web-based calculators for example, that illustrates the relative advantages and disadvantages of different share classes and the effect of breakpoints based on different investment amounts. The Commission also should direct the National Association of Securities Dealers ("NASD") to take steps to ensure that brokers direct their clients' attention to such disclosure.

The 12b-1 fee is set forth in a separate line in the fee table in the prospectus. The purpose of this information is not to help investors understand the total cost of investing in the fund, because the 12b-1 fee is already included in the fund's expense ratio. Rather, the 12b-1 fee line item purports to provide investors with a functional understanding of how much of the fund's assets are spent on distribution. Indeed, many shareholders use the 12b-1 fee as a screening tool to eliminate funds that pay for distribution.

In fact, 12b-1 fees are not the only distribution fees that the fund shareholders pay. Fund advisers routinely use some of their fee revenues to make payments to brokers for selling fund shares. Retail brokers also are routinely compensated for selling fund shares in the form of fund brokerage. This use of fund assets to pay for distribution, unlike 12b-1 fees, is not disclosed in the fee table or anywhere else in the prospectus. These payments are disclosed only in the Statement of Additional Information, a document that is provided to shareholders only upon request.

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[27] See Lauricella, Morgan Stanley Faces Inquiry into Fund Sales, Wall Street Journal (Apr. 2, 2003); Lauricella, Morgan Stanley is Sued on 'Break Points,' Wall Street Journal (Mar. 5, 2003).

Current disclosure rules lead investors to believe that the absence of a 12b-1 fee in the fee table means that the fund is not spending their money on distribution.[28] In fact, a shareholder in a 12b-1 fee fund may actually pay less for distribution than a shareholder in a fund that does not charge a 12b-1 fee but whose adviser makes payments to brokers for selling fund shares out of the adviser's own pocket or compensates brokers in the form of fund brokerage. To remedy this confusion, the Commission should consider eliminating the 12b-1 fee line item from the fee table and replacing it with one or more lines that show the total fund assets spent on distribution or types of distribution.

The Commission should consider extending this approach to other types of expenses. For example, the Commission could revise the entire fee table to set forth two categories of information: (1) the costs of the investing in the fund (a single expense ratio, plus shareholder expenses such as loads and account fees), and (2) how fund fees are allocated among different types of services. The first category could continue to be provided in the form of a fee table, and the second category could be provided in the form of a pie chart. This approach would make it easier for investors to evaluate how much it will cost them to invest in the fund and, for those who are interested in this information, how their money will be spent.

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[28] In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "the idea that investors ought to prefer the funds that don't tell what they're spending on distribution over the ones that do is nonsense. You know, if you're spending money on distribution, say it. If you're not spending money on distribution don't say it; but don't pretend that there are no expenses there for a fund that doesn't have a 12b-1 plan." Conference on the Role of Investment Company Directors, Washington, D.C. (Feb. 23 & 24, 1999)(Haaga was not ICI Chairman at this time).

### 2. Brokers' Compensation

The purpose of prospectus disclosure is to inform investors about the cost of investing in a fund. In contrast, the purpose of point-of-sale disclosure is to inform investors about the economic motives of the person (referred to herein as the "broker") recommending the fund. Rule 10b-10 under the Securities Exchange Act accordingly requires that brokers disclose, to purchasers of securities, "the source and amount of . . . remuneration received or to be received by the broker in connection with the transaction." This disclosure is known as the "trade confirmation" or "confirm." The Commission has taken the position that Rule 10b-10 does not apply to sales of mutual fund shares.[29]

As noted above, the prospectus does not disclose all of the compensation that may be paid to brokers for selling fund shares. Even the compensation that is disclosed has no necessary relationship to the amount paid to a broker in a particular transaction. For example, the prospectus for two different mutual funds may show that an investor will pay the same front-end load of $500 on a $10,000 investment, but the broker selling the funds may be paid more for selling one fund than another.[30] The broker payout for both of these funds may be lower than for a fund with a 1.00% 12b-1 fee, for which brokers often receive a flat, upfront payment substantially in excess of the amount of 12b-1 fees that the shareholder will pay in the course of a single year. The broker also may receive payments directly from the fund adviser or compensation in the form of fund portfolio brokerage commissions.

If an investor buys shares of IBM or Dell, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. If an investor buys shares in a mutual fund, the confirm is not required to provide this information. The Commission should rescind its position that Rule 10b-10 does not apply to sales of fund shares and consider whether disclosure in addition to that required by the rule is

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[29] SEC Report at 80.

[30] See Lauricella, Investment Firm's Portfolios Get Priority Despite Rules: 'The Home Field Advantage,' Wall Street Journal (May 22, 2003).

necessary to direct investors' attention to any incentives that a broker may have to prefer the sale of one fund over another. Further, in light of the Commission's recent discovery that brokers routinely fail to credit investors with commission breakpoints,[31] it should consider whether fund confirms should include a separate box that shows the breakpoint schedule and how it was applied to the purchase.

## III. Section 3: Obligations Regarding Certain Distribution and Soft Dollar Arrangements

Section 3 of H.R. 2420 will require that fund advisers provide reports to their funds' directors on revenue sharing, soft dollar, and directed brokerage arrangements, and will provide that the directors shall have a fiduciary duty to supervise such arrangements to ensure that they are in the best interests of the funds' shareholders.

As discussed above, revenue sharing, soft dollar, and directed brokerage arrangements create significant conflicts of interest between a fund's adviser and its shareholders. One way to control these conflicts is through disclosure that enables investors to evaluate these conflicts and that subjects these arrangements to the forces of market competition.

Another way to control these conflicts is to provide fund directors with the tools they need to evaluate whether revenue sharing, soft dollar, and directed brokerage arrangements benefit shareholders. Some might argue, erroneously, that because fund directors already have a duty to conduct such evaluations, and fund advisers already have a duty to provide the information necessary thereto, Section 3's reporting requirements will be superfluous.

Granted, the reporting requirement may be unnecessary for fund complexes in which the advisers are fully forthcoming about these arrangements and the directors are aggressively questioning the information they receive. In some cases, however, these

[31] SEC Report at 52-53.

arrangements may not benefit shareholders, and the adviser accordingly will be less willing to provide information about these arrangements to the directors. These are the situations in which a full evaluation of revenue sharing, soft dollar, and directed brokerage arrangements is most needed. Section 3's formal reporting requirement provides a structure that advisers will be less able to circumvent and that directors will be able to use to elicit more and higher quality information than they might otherwise receive.

Similarly, assigning fund directors a formal supervisory role with respect to such arrangements, as provided in Section 3, will further enhance the protection of shareholders who need it most.

IV. Section 4: Mutual Fund Governance

Section 4 of H.R. 2420 will require that fund boards be two-thirds independent and be chaired by an independent director, and authorize the Commission to deem to be non-independent certain persons who, by reason of business or family relationships, are unlikely to exercise an appropriate degree of independence.

a. Structure of Fund Boards

As often noted by the Commission, a mutual fund is effectively dominated by its adviser,[32] and this fact necessarily compromises the control normally exercised under state law by a board of directors. To compensate for this imbalance, it follows that additional requirements, beyond those provided under state law, may be necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders.

These additional requirements have become especially important in light of recent state law developments. Ironically, while Congress has acted to strengthen the accountability

[32] See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082, at Part I (Oct. 15, 1999) ("investment advisers typically dominate the funds they advise").

of corporate executives and directors, states have weakened the independence of fund boards. The three states in which the vast majority of mutual funds are domiciled – Massachusetts, Maryland and Delaware – have enacted legislation that requires courts to treat a federally independent director as independent for all purposes under state law, even if that director has a direct conflict of interest with respect to the matter on which he is exercising his responsibilities.[33] As stated by the Commission, there are gaps in the definition of a federally independent director "that have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management."[34] The effect of these state law amendments has been to dilute the state law duties of care and loyalty that frame the federal regulation of mutual funds.[35]

Fortunately, recent Commission rulemaking materially strengthened the role of independent directors,[36] and Section 4(a) of H.R. 2420 will further this process. In its rulemaking, the Commission effectively required that only a majority of directors be independent. By increasing the minimum to two-thirds, Section 4(a) will ensure that the independent directors will be able to exercise the independence necessary to protect shareholders, especially when dealing with matters where the interests of shareholders and the adviser conflict.

Section 4(a)'s requirement that fund boards be chaired by an independent director will further ensure that the fund boards will be able to exercise independent judgment and control the operational aspects of fund governance. The Commission staff has suggested that this step is unnecessary because the independent directors already can "influence the

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[33] See generally, Testimony of Mercer Bullard, Founder and President, Fund Democracy, before the Committee on Economic Matters, Maryland House of Delegates (Mar. 28, 2001); Tamar Frankel, The Different Design of Corporate Governance under State Law and Federal Law and the Aftermath of the Strougo Case, 7 The Investment Lawyer 3 (Feb. 2000).

[34] SEC Report at 47.

[35] See id. at 56 (discussing directors' state law duties of care and loyalty); Frankel, supra note 33.

[36] See SEC Report at 8; Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001).

agenda and the flow of information to the board."[37] It is not enough, however, that the independent directors "influence" the information they receive; nor is the staff's position consistent with the principle underlying the directors' affirmative statutory duty to "request and evaluate" the information necessary to evaluate the advisory contracts.[38] Indeed, the staff's suggestion that fund boards designate a "lead independent director" acknowledges the need for independent directors to exercise authority beyond that afforded by their numerical superiority. Formally appointing an independent director as chairman would better fill that need.

There is an inherent conflict between the board's duty to evaluate the adviser's conflicts of interest on the one hand, and the appointment of an employee of the adviser as the board's chairman on the other. Requiring that the chairman be independent will remove this conflict and ensure that the fund's independent directors have complete control over the board.

b. Definition of Interested Person

It is generally accepted that the definition of "interested person" in the Investment Company Act fails to cover many persons who have conflicts that may impair their independence.[39] The Commission has only limited authority to deem persons to be "interested persons," and that authority may be exercised only on a case-by-case basis by individual order.[40]

Section 4(b) of H.R. 2420 will authorize the Commission to fill important gaps in the definition of "interested person" in the Investment Company Act. These gaps permit

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[37] SEC Report at 50.

[38] See Investment Company Act Section 15(c).

[39] See, e.g., Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute, at Part III.2 (recommending that former officers and directors of a fund's adviser not serve on the fund's board as an independent director).

[40] Investment Company Act Sections 2(a)(19)(A)(vii) & (B)(vii).

persons to serve as independent directors notwithstanding, for example, their prior employment by the adviser or familial relationship with executives of the adviser. Section 4(b) will authorize the Commission to fill these gaps by rulemaking, rather than the more cumbersome process of issuing an order in each case.

## V. Section 5: Audit Committee Requirements for Investment Companies

Section 5 of H.R. 2420 will extend certain provisions of the Sarbanes-Oxley Act, as applicable to company audit committees, to mutual funds.

Many of the provisions of the Sarbanes-Oxley Act already apply to mutual funds, including some that are related to audit committees and auditors. For example, mutual funds are subject to Sarbanes-Oxley's audit committee pre-approval, auditor rotation and reporting requirements.[41] Sarbanes-Oxley provisions regarding audit-related employment restrictions, the improper influencing of audits, and attorney conduct also apply in the mutual fund context.[42]

It also is important to note that, as a general matter, mutual fund rules regarding accounting, independent auditors, employees' personal trading practices, affiliated transactions and other areas have generally exceeded and continue to exceed the standards applicable to other industries and other financial services products. For example, had Enron been subject to mutual fund rules, the special purpose entities that contributed to its demise could not have been created, much less used to steal from shareholders. The mutual fund industry has generally been free of the kinds of abuses that prompted the Sarbanes-Oxley Act.

Nonetheless, there have been instances in which mutual fund affiliates have engaged in wrongful conduct that a stronger, more independent audit committee would have been in

[41] Sarbanes-Oxley Act Sections 202, 203 & 204.

[42] Id. at Sections 206, 303 & 307.

a better position to detect and prevent. For example, the Commission, NASD and New York Stock Exchange recently conducted examinations "that found significant failures by broker-dealers to deliver breakpoint discounts to eligible customers."[43] Earlier this year, the SEC staff tentatively decided to recommend that the Commission initiate enforcement proceedings against an investment adviser for mispricing private equity holdings.[44] In late 2000, two municipal bond funds lost 70% and 44% of their value in a single day due to the mispricing of their portfolios.[45]

Section 5 will help reduce the likelihood of this type of wrongdoing going undetected. This provision strengthens the independence of the audit committee by requiring that all of its members be independent and establishing that the committee will have direct responsibility for overseeing the fund's accountant. It also ensures that the independent directors can retain and pay for independent advisers that it needs to determine whether the fund's securities are being priced accurately, and whether the fund's shareholders are paying the correct amount of fees, sales charges and other expenses.

## VI. Section 6: Commission Study and Report Regulating Soft Dollar Arrangements

Section 6 of H.R. 2420 requires that the Commission report to Congress regarding soft dollar trends, services, conflicts of interest, and transparency, and how soft dollar arrangements affect investors' ability to compare mutual fund fees. Section 6 also asks the Commission to consider whether Section 28(e) of the Securities Exchange Act should be repealed or modified.

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[43] SEC Report at 53.

[44] Van Wagoner Funds, Inc., Attachment 77E to Form NSAR-B, at http://www.sec.gov/Archives/edgar/data/1002556/000094040003000110/van77.txt.

[45] The funds were placed into receivership on March 21, 2001. See generally, SEC v. Heartland Group, Inc., Litigation Rel. No. 16938 (Mar. 22, 2001). The Commission has yet to take any enforcement action against the fund's independent directors or adviser.

The soft dollar report will provide an opportunity for the Commission to update its understanding of how soft dollars are being used and provide the basis for further improvement in the regulation of soft dollar arrangements. When the Commission staff last evaluated soft dollar arrangements, it concluded that additional guidance was needed in a number of areas.[46] For example, the staff found that many advisers were treating basic computer hardware – and even the electrical power needed to run it – as research services qualifying under the Section 28(e) safe harbor.[47] The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars.

The soft dollar report also will improve the SEC's understanding of how mutual fund rules regarding soft dollars affect price competition in the fund industry. As discussed above, current disclosure rules provide an incentive to use soft dollars to purchase services, the cost of which would otherwise be included in the expense ratio in the fee table. These rules also enable the investment adviser to receive undisclosed compensation in addition to its management fee. The cost of soft dollar arrangements is invisible to the marketplace and therefore is immune to the disciplining forces of price competition.

Finally, the soft dollar report should benefit mutual fund shareholders by focusing their attention on how Section 28(e) affects their interests. Section 28(e) affects mutual funds differently from other advisory clients because without this provision the soft dollar benefits received by the adviser would be a prohibited affiliated transaction. Thus, Section 28(e) conflicts with the foundation of mutual fund regulation, which is built on a set of rules that prevent the kinds of conflicted transactions that historically have led to the greatest abuses in our financial markets.

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[46] See Section 28(e) Report, supra note 20.

[47] Id. at Section V.C.4.

There is reason for concern, however, regarding the direction of the soft dollar report. The Commission's most recent interpretive position on soft dollar arrangements suggests that it favors ***expanding*** the scope of the Section 28(e) safe harbor. In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions." This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that section 28(e) "does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."[48] The Commission staff has stated that it may be appropriate "to ***narrow*** the scope of this safe harbor."[49] The first step toward such narrowing would be for the Commission to withdraw its ultra vires expansion of Section 28(e)'s scope.

[48] Investment Advisers Act Release No. 1469 (February 14, 1995).

[49] SEC Report at 41 (emphasis added).