STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ON

REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY:

FUND COSTS AND DISTRIBUTION PRACTICES

MARCH 31, 2004

EXECUTIVE SUMMARY

- Since allegations of abusive trading practices in the mutual fund industry were first revealed in early September 2003, the industry has been under intense scrutiny from many directions. All share with us the common goal of protecting the interests of fund shareholders.

- Government authorities have been conducting investigations and have taken forceful action against wrongdoers; the marketplace has sent a powerful message that the trust and confidence of investors can never be taken for granted; Congress, including this Committee, has acted quickly and responsibly by holding a series of hearings; and mutual funds themselves have conducted investigations and reviews to determine whether any wrongdoing occurred at their firms and to assess the effectiveness of existing policies and procedures.

- In response to the abuses that have occurred, the Institute has suggested significant regulatory enhancements and the SEC has pursued the most aggressive and wide-ranging mutual fund regulatory reform agenda in recent history, at a record pace.

- ***Late Trading.*** Last October, the Institute called for a tightening of existing regulations to require that all fund purchase and redemption orders be received by a fund (or its transfer agent) by the time of pricing (*e.g.*, 4:00 p.m. Eastern time). The SEC subsequently proposed rule amendments that are consistent with the Institute's recommendation (the SEC's proposal would also allow orders to be received by a registered clearing agency). The Institute supports the SEC's proposal, until such time as the SEC is able to assure itself that effective technological safeguards against late trading exist that would allow other entities to receive fund orders on behalf of a fund for pricing purposes.

- ***Market Timing.*** The Institute supports the various regulatory measures that the SEC has proposed and/or adopted to address abusive market timing activities, including (1) requiring funds to have more formalized short-term trading policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under appropriate circumstances, and (3) providing a more effective mechanism for board oversight of short-term trading policies and procedures.

    - With respect to personal trading activities of senior fund personnel, the SEC has proposed new code of ethics requirements for registered investment advisers, which the Institute supports.

    - Funds and their shareholders would benefit if funds had additional "tools" to combat harmful market timing activity. The Institute recommended, and the SEC recently proposed, requiring most types of funds to impose a 2% redemption fee on any redemption of fund shares within 5 days of purchase.

- ***Fund Governance.*** The recent disturbing revelations suggest management deficiencies at some funds rather than systemic corporate governance problems or serious flaws with the director oversight system. The Institute nevertheless supports reforms that will improve the fund governance system and promote investor confidence, such as the SEC's new mutual fund compliance program rule. Certain other proposals to "improve" fund governance are, however, unwarranted, unrelated to the abuses that have been revealed, and counterproductive. These include mandating that all fund boards have an independent chair and requiring independent directors to make certifications relating to matters outside the scope of what they could reasonably be expected to know.

- ***Brokerage Allocation Practices.*** In order to avoid the appearance of conflicts of interest as well as the potential for actual conflicts, the Institute recommends tightening existing regulations to curtail the use of soft dollars by all investment advisers, including mutual fund advisers, and to ban the practice of directing brokerage to reward broker-dealers for selling fund shares. The Institute is pleased that the SEC recently proposed rule amendments to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.

- ***12b-1 Fees.*** The SEC is conducting a timely and prudent reevaluation of Rule 12b-1. The Institute believes that the rule continues to have merit but that certain changes may be appropriate, and we look forward to providing specific comments to the SEC. The SEC also has proposed new confirmation and point of sale disclosure of 12b-1 fees, which the Institute supports.

- ***Revenue Sharing Arrangements.*** The principal investor protection concern raised by "revenue sharing" (or "cost sharing") arrangements, under which the fund's adviser or principal underwriter makes payments to selling intermediaries out of its own resources, is whether they have the potential to influence the intermediaries' recommendations. For this reason, the Institute has long advocated additional, point of sale disclosure to help investors assess and evaluate recommendations to purchase fund shares. The SEC and the NASD have recently proposed new point of sale disclosure requirements in this area.

- ***Additional Disclosure Initiatives.*** The Institute supports the shareholder report expense disclosure requirements recently adopted by the SEC, under which funds will have to disclose the dollar amount of expenses paid on a $1,000 fund investment during the period covered by the report. We continue to have serious reservations about requiring individualized expense disclosure in quarterly account statements, as some have suggested. If there are other ways to further enhance disclosure of fund fees and expenses at a reasonable cost, we would support pursuing them.

Table of Contents

I. INTRODUCTION

My name is Paul G. Haaga, Jr. I am Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company, the investment adviser to the 29 funds in The American Funds Group, with more than $500 billion in assets under management. The American Funds Group is the third largest mutual fund group in the United States and the largest group distributed exclusively through unaffiliated financial advisors. Before I joined the American Funds in 1985, I was a securities attorney in private practice in Washington, D.C. and, prior to that, was on the staff of the Securities and Exchange Commission. I also serve as the Chairman of the Board of Governors of the Investment Company Institute, the national association of the American investment company industry. My testimony today is offered on behalf of the Institute and its members.[1]

I appreciate the opportunity to appear before the Committee today to discuss ongoing efforts to respond to revelations of abusive mutual fund trading practices and to proffer the industry's continued commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,625 open-end investment companies ("mutual funds"), 611 closed-end investment companies, 124 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.457 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

Since the allegations of late trading, abusive short-term trading and selective disclosure of portfolio holdings were first revealed in early September of last year,[2] the industry has been under intense scrutiny from many directions. All share with us the common goal of protecting the interests of fund shareholders.

The Securities and Exchange Commission and the New York Attorney General's office have been conducting widespread investigations into these alleged abusive practices and have taken forceful action where wrongdoing is found. It is imperative that the ongoing investigations by the SEC and others are thorough and successful in rooting out trading activities that may have compromised the interests of individual mutual fund shareholders.

Notably, the marketplace has already meted out harsh punishment to firms charged with harming their fund shareholders' interests. There is no more powerful way to communicate the message that the trust and confidence of investors can never be taken for granted.

The Congress, including this Committee, has a keen interest in assuring that mutual funds are operated in the interests of investors and has acted quickly and responsibly by holding hearings to elicit the views of experts and interested parties on a range of important issues. The Institute agrees that it is necessary and entirely appropriate for the Committee to engage in a thorough, deliberative process in order to have a well-informed basis for determining what remedial actions may be needed.

---

[2] *See State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd. and Edward J. Stern* (NY S. Ct. filed Sept. 3, 2003) (undocketed complaint) ("Canary Complaint").

Mutual fund sponsors themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have conducted internal investigations, in some cases aided by independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards and shareholders. In addition, some fund boards have retained independent third parties to conduct investigations. As a result of these investigations, several funds have terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. Our responses to shareholders and regulators reinforce that funds take very seriously their obligations under the federal securities laws and the fulfillment of their responsibility to make sure that investors' interests always come first.

In addition to seeking to determine whether any wrongdoing occurred, fund firms have conducted thorough reviews of their policies and procedures in the principal areas that have been the subject of recent enforcement proceedings. These reviews have provided an opportunity to assess whether existing policies and procedures continue to operate effectively or whether enhancements may be needed. Fund boards have been actively involved in overseeing these reviews.

The Institute also has made several recommendations for significant regulatory enhancements to address the specific issues raised by the abuses that have been uncovered, as well as other important issues. Finally, the SEC has pursued, at a record pace, the most aggressive and wide-ranging mutual fund regulatory reform agenda in recent history. These recommendations and regulatory initiatives are discussed below.[3] My testimony will first describe initiatives to address the mutual fund trading abuses referred to above. It will then discuss other initiatives to reinforce the protection and enhance the confidence of mutual fund investors.

II. INITIATIVES TO ADDRESS MUTUAL FUND TRADING ABUSES

A. Late Trading

To address the problem of late trading, the Institute last October called for a tightening of existing regulations to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (generally 4:00 p.m. Eastern time).[4] The Institute recognized that this approach could have a significant impact on many investors who own fund shares through financial intermediaries, but concluded that the recent abuses indicated that the strongest possible measures are necessary to ensure investor protection. In December, the SEC proposed rule amendments that would take an approach consistent with the Institute's recommendation.[5] As noted in the Institute's comment letter on the SEC's proposal, the

---

[3] In order for the SEC to develop appropriate regulatory initiatives to respond to the trading abuses that have occurred, and to successfully carry out its oversight and inspection duties with respect to mutual funds, it is critically important that the SEC have sufficient resources. The industry has consistently supported adequate funding for the SEC, and recently expressed strong support for the Bush Administration's proposed FY 2005 budget for the SEC, which would provide a significant and necessary increase over the record amount appropriated for the current fiscal year. *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable Ted Stevens, Chairman, Committee on Appropriations, United States Senate, dated February 11, 2004.

[4] Most funds price their shares as of 4:00 p.m. Eastern time, the normal close of regular trading on the New York Stock Exchange. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders by that time.

[5] In addition to the fund and its designated transfer agent, the SEC's proposal would allow orders to be received by a registered clearing agency. *See* SEC Release No. IC-26288 (December 11, 2003).

Institute's support for a "hard 4:00 p.m. cut-off" requirement is based, in large part, on the concern that existing technology may not be sufficient both to provide an unalterable date and time stamp for a trade at the time it is actually received by a fund intermediary and to prevent investors from placing trades prior to the time a fund prices it shares, only to cancel such trades once the price is determined by the fund.[6] The Institute's letter encouraged the SEC to consider expanding the list of entities that may receive orders on behalf of a fund for pricing purposes to the extent that the SEC is able to assure itself that technology exists that would enable intermediaries to document, through unalterable means, the precise date and time when they received an order and ensure that orders received prior to the time the fund prices its shares are processed and not cancelled once the fund's share price is determined. We understand that the SEC is now analyzing the hundreds of comment letters submitted in response to the proposal, and are confident that an appropriate solution will be reached.

B. Market Timing

As noted above, the ongoing investigations by the SEC and other governmental officials also involve issues relating to market timing of mutual funds. The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been discovered that certain fund management officials at some funds may have authorized activities that called into question whether the funds were applying their market timing policies fairly and consistently. The Institute has called for and/or endorsed a number of different steps to address these concerns.

---

[6] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004.

1. <u>Written Policies and Procedures; Disclosure</u>

Last fall, SEC Chairman Donaldson outlined various regulatory measures that the SEC staff was considering to address the practice of various individuals at certain funds allowing a few investors to engage in market timing activities in a manner inconsistent with the funds' policies.[7] These measures included new rules and form amendments to (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. Chairman Donaldson also indicated that the SEC would consider measures to reinforce board oversight of market timing policies and procedures. The SEC has recently taken formal action in these areas.[8]

The Institute and its members fully support these measures.[9] While many funds already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area and specifically providing for board oversight will ensure that all funds have tools in place to identify and swiftly respond to potentially abusive activity.

---

[7] SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003-136 (October 9, 2003).

[8] *See* SEC Release No. IC-26287 (December 11, 2003) (proposing amendments to require mutual funds to disclose in their prospectuses both the risks to shareholders of the frequent purchase and redemption of fund shares, and fund policies and procedures with respect to such frequent purchases and redemptions) ("SEC Disclosure Proposals") and SEC Release No. IC-26299 (December 17, 2003) (adopting Rule 38a-1 under the Investment Company Act of 1940 concerning mutual fund compliance programs) ("SEC Compliance Rule Release"). New Rule 38a-1 requires mutual funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including procedures reasonably designed to ensure compliance with disclosed policies regarding market timing. In addition, it requires a fund's chief compliance officer to provide a written report to the fund's board, no less frequently than annually, that addresses, among other things, the operation of the fund's compliance policies and procedures and material compliance matters that occurred since the date of the last report.

[9] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004 (commenting on SEC Disclosure Proposals) ("ICI Comments on SEC Disclosure Proposals").

Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance, because more formal policies likely will limit discretion in dealing with short-term traders. Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests from abusive activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting potential abusers to the fund's policies.[10]

The Institute has called for additional steps to address alleged abusive market timing activity by fund insiders, noting that this conduct, if true, is especially reprehensible. Thus, the Institute has urged all mutual funds and their advisers to clarify or amend their codes of ethics to require oversight of personal trading activity of the funds' portfolio managers and senior executives in shares of the funds. Consistent with the Institute's recommendation, the SEC recently proposed to require registered investment advisers to adopt codes of ethics that, among other things, set forth conduct expected of advisory personnel and require advisory personnel to report their personal securities transactions, including transactions in any mutual funds managed by the adviser.[11] The Institute supports the SEC's proposal.[12]

---

[10] Of course, it will be important for any new disclosure requirements to allow funds to achieve an appropriate balance between providing disclosure that would have these beneficial effects and providing overly specific disclosure that inadvertently could serve as a roadmap for potential abusers to circumvent fund policies.

[11] *See* SEC Release Nos. IA-2209; IC-26337 (January 20, 2004) ("SEC Code of Ethics Proposal").

[12] *See* Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 15, 2004. The Institute recommended certain technical changes to facilitate compliance with the proposed requirements.

2. Fair Valuation

As discussed above, an issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. This is because, when fund share prices are based on closing market prices established some time before a fund's net asset value is set, short-term traders may seek to take advantage of this situation.

The SEC has recently taken steps to minimize the possibility that long-term fund shareholders' interests will be harmed by the activities of arbitrageurs seeking to take advantage of stale prices. The SEC issued a statement regarding fair value pricing requirements in its release adopting the mutual fund compliance program rule.[13] In addition to describing the SEC's position on when funds must use fair value pricing, the release states that the compliance program rule requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. [14] SEC examinations

[13] *See* SEC Compliance Rule Release, *supra* note 8.

[14] *Id.* at 16-17. The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and in ensuring that fund share prices are fair to purchasing, redeeming and existing shareholders. *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

of funds will provide the opportunity further to reinforce and monitor the implementation of applicable requirements in this area.[15]

Fair valuation can reduce the impact of harmful market timing activity, but it is important to recognize that it cannot by itself completely eliminate such trading. Accordingly, funds often employ additional methods to deter market timing activity.

3. Tools to Deter Market Timing

Funds devote significant resources to combating market timing activity. The investigations referred to above all involved situations where fund employees allegedly granted exceptions from stated policies against market timing. However, the various means that funds have employed to deter market timing may not have been fully effective even where enforcement was diligent and no exceptions were made for favored clients. For this reason, the Institute has advocated giving funds additional "tools" to restrict trading activity that they determine to be harmful to their shareholders, such as allowing funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2% maximum level currently permitted by the SEC staff. The Institute has met with the SEC staff several times to discuss these issues. In 2002, in response to an Institute

[15] The SEC also has proposed revisions to clarify prospectus disclosure requirements concerning fair value pricing. The proposal is intended to make clear that all funds (other than money market funds) are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. In addition, the proposed revisions are intended to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable). *See* SEC Disclosure Proposals, *supra* note 8. The proposed revisions should serve as a useful complement to the requirements articulated in the SEC Compliance Rule Release and the proposed disclosure of market timing policies and procedures discussed above.

request, the SEC staff issued a letter clarifying that funds may delay exchange transactions (*e.g.*, until the next business day) in order to deter abusive short-term trading.[16]

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.*, a broker-dealer or a retirement plan record keeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts.[17]

Steps clearly need to be taken to enable mutual funds to enforce more effectively restrictions they establish on short-term trading when such trading takes place through omnibus accounts. The Institute has recommended, and the SEC recently proposed, an approach under which most types of funds would be required, at a minimum, to impose a 2% redemption fee on any redemption of fund shares within 5 days of purchasing them. If funds had a standardized minimum redemption fee along these lines, it would make implementation more cost-effective and thus should encourage intermediaries to establish and maintain the requisite systems to enforce payment of those fees.

---

[16] *See* Investment Company Institute (pub. avail. Nov. 13, 2002) (expressing the SEC staff's agreement that a fund may, consistent with Section 11(a) of the Investment Company Act, make an exchange offer on a specified delayed basis, so long as the offer is fully and clearly disclosed in the fund's prospectus).

[17] The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies <u>en masse</u>. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account." Canary Complaint, *supra* note 2, at par. 46.

C. Selective Disclosure of Portfolio Holdings

The SEC and other regulators are investigating allegations that certain officials at some funds may have provided information about fund portfolio holdings to a few, select shareholders in order to enable them to trade ahead of the fund or to facilitate their abusive trading activities, to the potential detriment of the other shareholders. As the Institute has previously stated, funds and their shareholders would benefit from additional, more specific regulatory requirements in this area.[18]

The SEC has taken several actions toward this end. First, the SEC Compliance Rule Release states that a fund's compliance policies and procedures under the rule should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio.[19] Second, the SEC has proposed to require funds to disclose their policies and procedures with respect to the disclosure of portfolio securities, and any ongoing arrangements to make available information about their portfolio securities.[20] Third, as indicated above, the SEC has proposed to require investment advisers to adopt codes of ethics that, among other things, set forth standards of conduct expected of advisory personnel and safeguard material nonpublic information about client transactions.[21]

---

[18] *See* Statement of Matthew P. Fink, President, Investment Company Institute, on "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry," Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (Nov. 18, 2003) ("Fink Statement"), at 14.

[19] *See* SEC Compliance Rule Release, *supra* note 8, at 19. The rule requires that the fund's board approve the policies and procedures. In addition, it provides for regular reporting to the board on the effectiveness of the policies and procedures, any changes thereto, and material compliance matters.

[20] *See* SEC Disclosure Proposals, *supra* note 8.

[21] *See* SEC Code of Ethics Proposal, *supra* note 11.

Similar to market timing, requiring funds to adopt formal policies should ensure that they have a system to prevent disclosure that is not in the best interests of shareholders (*e.g.*, because it would facilitate front-running or other abusive trading practices) and to police compliance. Board oversight and public disclosure will further enhance compliance with the policies. At the same time, the approach proposed by the SEC would preserve an appropriate degree of flexibility in how funds release information. The Institute supports the SEC's initiatives.[22]

D. Hedge Funds

1. Registration of Hedge Fund Advisers

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the SEC generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets.

---

[22] *See* ICI Comments on SEC Disclosure Proposals, *supra* note 9.

Last fall, the SEC issued a staff report on hedge funds[23] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. As the Staff Report indicates, by requiring hedge fund advisers to register, the SEC would be able to observe more comprehensively and effectively the trading activities of the funds managed by such advisers. As a result, the SEC would be in a better position to detect improper or illegal trading practices.[24] The Institute noted its support for the staff's recommendation in previous testimony before this Committee.[25]

2. Side-by Side Management of Hedge Funds and Mutual Funds

Some have expressed concerns about potential conflicts of interest faced by portfolio managers who manage both mutual funds and hedge funds. Advisers who manage both mutual funds and hedge funds *already* are fully subject to the SEC's jurisdiction, because all advisers to mutual funds must register with the SEC. Consequently, the SEC has the ability to take, and indeed recently has taken, actions that should help address these conflict of interest concerns. In particular, the SEC's new compliance program rule for investment advisers requires advisers to implement policies and procedures that address conflicts arising from management of multiple funds and accounts, such as the allocation of investment opportunities

[23] Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003) ("Staff Report").

[24] *Id.* at 92-95.

[25] *See* Fink Statement, *supra* note 18, at 15.

and the allocation of aggregated trades.[26] In addition, the SEC recently proposed new disclosure requirements concerning conflicts of interest to which a portfolio manager may be subject as a result of managing a mutual fund and other portfolios, such as hedge funds.[27] The Institute believes that the SEC's approach of requiring advisers to adopt specific policies and procedures to deal with conflicts, coupled with disclosure, is an effective way to handle this issue. Importantly, it avoids the many negative consequences that would result if, as some have suggested, a portfolio manager were prohibited from simultaneously managing a mutual fund and a hedge fund. For example, mutual fund investors would have reduced access to the expertise of skilled investment professionals who, if forced to choose, likely would elect to manage other types of investment accounts that do not involve such restrictions. Also, such a prohibition would eliminate important operating efficiencies for investment management firms. It could have harsh, disruptive and anti-competitive effects, especially for smaller investment management firms that have fewer employees and may not have the resources to maintain separate staff for different types of accounts.

E. Fund Governance

The recent disturbing revelations about mutual fund abuses have caused some to question the effectiveness of the fund governance system. What we have learned about the problems that have occurred suggests management deficiencies at several fund groups rather

---

[26] The Institute recently published a paper to inform and assist its members generally with respect to issues relating to the side-by-side management of mutual funds and investment accounts. *See* Investment Company Institute, *Side-by-Side Management of Registered Investment Companies and Investment Accounts* (March 2004).

[27] SEC Release No. IC-26383 (March 11, 2004). The proposal also would require disclosure of the structure of portfolio manager compensation and ownership of shares of the funds that a manager advises, among other things.

than systemic corporate governance problems or serious flaws with the director oversight system. The Institute strongly believes that the fund governance system itself remains fundamentally sound. Nevertheless, the Institute supports reforms that will improve the system and promote investor confidence.[28]

One such reform is the SEC's mutual fund compliance program rule, discussed above. The Institute believes that this rule will greatly assist fund directors in serving effectively in their oversight role by requiring funds to have comprehensive compliance policies and procedures in place and by improving the flow of information about significant compliance issues to the directors. In addition, the SEC has proposed certain new fund governance requirements that should help enhance the independence and effectiveness of fund boards and promote investor confidence.[29] Certain other proposals to "improve" fund governance in the wake of the recent scandals are, however, unwarranted and counterproductive.

---

[28] Consistent with this, in October 2003, the Institute's Board of Governors unanimously adopted a resolution recommending that mutual funds adopt additional governance best practices that would (1) prohibit close family members of persons associated with a fund or certain affiliates from serving as independent directors and (2) apply to mutual fund audit committees standards that are similar to those applicable to the audit committees of operating companies under the Sarbanes-Oxley Act.

[29] The SEC has proposed to require, among other things: that the independent directors meet in separate sessions at least once each quarter; that funds authorize the independent directors to hire their own staff; and that the board perform an annual self-assessment that would include consideration of the board's committee structure and the number of boards on which the directors sit. *See* SEC Release No. IC-26323 (January 15, 2004) ("SEC Fund Governance Proposals"). The Institute supports these measures. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 10, 2004. In addition, the SEC has proposed to require that independent directors constitute at least 75% of each fund board. As indicated in the Institute's comment letter to the SEC, while the Institute supports requiring a supermajority of independent directors, it seems highly unlikely that the marginal benefits, if any, of a 75% requirement would outweigh the disruption involved in imposing that standard rather than codifying the two-thirds supermajority that most fund boards have. The SEC also has proposed to require fund boards to appoint an independent chair which, as discussed in more detail below, the Institute believes should not be mandated for all fund boards.

One such proposal would require mutual fund boards to have an independent chair. While some fund boards may choose to have an independent chair, not all fund boards may find that this structure works best for them.[30] Independent directors constitute at least a majority (and in most cases a supermajority) of a mutual fund's board, meaning that they already have full power to appoint an independent chair if they wish to do so. Existing regulatory requirements and industry practices, as well as the other new fund governance requirements recently proposed by the SEC, also make a requirement to have an independent chair unnecessary. For example, the Investment Company Act requires a separate vote of the independent directors on most important decisions, such as approval of the fund's investment advisory and underwriting agreements, and the use of fund assets to support the distribution of fund shares under a Rule 12b-1 plan. Existing practices in the fund industry – such as a supermajority of independent directors, the appointment of lead independent directors and regular meetings of independent directors in executive session – further reinforce the independence and authority of the independent directors.[31]

More philosophically, it seems counterintuitive to *mandate* such a requirement, instead of allowing the directors to determine in their best judgment who is the most appropriate person to serve as the board's chair. This reasoning is reinforced by the fact that the SEC (and applicable law) already relies heavily on the independent directors' judgment with respect to protecting the interests of shareholders. Also, it is far from clear why mutual fund boards,

---

[30] For example, some funds have found that having an interested director serve as board chair is beneficial in that it promotes administrative efficiencies.

[31] In addition, as noted above, the SEC's pending fund governance proposals would require that fund boards consist of a supermajority of independent directors and that the independent directors meet in separate sessions at least once each quarter. *See* SEC Fund Governance Proposals, *supra* note 29.

alone among all corporate boards, should be deprived of the discretion to choose their chairperson. Finally, it bears noting that some of the funds involved in the recent scandals have independent board chairmen. Thus, there is little empirical or practical evidence that requiring all fund boards to have independent chairs is the answer to the current problems.

There are better ways to assure that independent directors have sufficient avenues for addressing matters of concern to them, including the ability to place items on the board's agenda. For example, as indicated in the Institute's recent comment letter to the SEC, the SEC could require that both a majority of the board and a majority of the independent directors elect the chairman of the board annually. Alternatively, or in addition, the SEC could require funds that do not have an independent chair to appoint a "lead independent director" and/or to submit the agenda to the independent directors for review to ensure that all matters of concern to them are scheduled to be discussed.[32]

Another proposed response to the abusive trading practices would require independent directors, or an independent chair, to make a series of certifications, many of which relate to matters that are outside the scope of what an independent director could reasonably be expected to know (*e.g.,* that the fund is in compliance with certain policies and procedures

---

[32] The appointment of one or more lead independent directors was one of several best practices that an advisory group convened by the Institute in 1999 recommended for adoption by fund boards. *See Enhancing a Culture of Independence and Effectiveness,* Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999). The House Financial Services Committee recently passed legislation that would amend Section 10(a) of the Investment Company Act to require funds that do not have an independent chairman of the board to select a lead independent director having certain minimum powers (including the authority to place items on the agenda for consideration). *See* Section 9 of H.R. 2179, the "Securities Fraud Deterrence and Investor Restitution Act," as passed by the House Financial Services Committee on February 25, 2004.

adopted by the board, such as fair value pricing policies and procedures).[33] Not only would this potentially expose certifying directors to increased liability, but it would not serve the best interests of fund shareholders. Independent directors (or the independent chair) would be faced with the Hobson's choice of either (1) seeking to secure and being forced to rely on a series of sub-certifications from those directly involved in the various matters to be certified (because the directors themselves would not be in a position to have personal knowledge of what they are certifying), or (2) immersing themselves in the day-to-day intricacies of fund operations, thereby inappropriately transforming their role from oversight to management and operational tasks. Both of these results would place the independent directors in an awkward and/or inappropriate position and neither would meaningfully improve investor protection. Finally, imposing a certification requirement on independent directors would create a strong disincentive against serving on fund boards without providing any compensating benefit. In fact, I have heard several directors from various fund groups indicate that they would simply resign from the board if such a requirement were put in place.

III. OTHER INITIATIVES TO PROMOTE INVESTOR CONFIDENCE

A. Brokerage Allocation Practices

In addition to calling for and supporting regulatory changes to protect investors against abusive mutual fund trading practices, the industry has been actively considering other ways to reinforce the protection and confidence of mutual fund investors. The Institute believes that the

[33] *See, e.g.*, Section 201 of H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," as passed by the U.S. House of Representatives on November 19, 2003; Section 301 of S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine and Dodd on November 25, 2003.

time has come for a top to bottom reexamination of mutual fund brokerage allocation practices and the applicable regulatory requirements. Investment advisers, including advisers to mutual funds, may use the brokerage commissions from transactions for client accounts to obtain research products and services from broker-dealers and third parties ("soft dollar arrangements"). Advisers to funds also may take into account a broker-dealer's sales of fund shares in allocating brokerage ("directed brokerage"). While both of these practices are clearly permissible under existing applicable regulations, they can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. The Institute therefore believes that it would be appropriate to tighten regulation in each of these areas.

1. Soft Dollar Arrangements Should Be Significantly Restricted

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor that permits money managers, including advisers to mutual funds, to pay for brokerage and research services with client commissions, subject to various conditions. This section was enacted in 1975 in response to concerns that, with the unfixing of commission rates, money managers might be held liable if they paid more than the lowest possible commission rate and received these services.

Some assert that these arrangements may create incentives for advisers (1) to direct client brokerage to a broker-dealer based on the research services provided to the adviser rather than the quality of execution its clients' accounts will receive and/or (2) to pay too much in commissions or engage in unnecessary trading to generate soft dollars credits to pay for products and services that the manager might otherwise have to pay for from its own assets. To reduce any such potential conflicts, the Institute recommends that the scope of the safe harbor under Section 28(e) be narrowed to exclude the following products and services:[34]

- Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
- Publications, including books, periodicals, newspapers and electronic publications, that are generally available to the public; and
- Third-party research services, *i.e.*, research services that are not produced and provided by the broker-dealer effecting the securities transaction.[35]

This change would (1) ensure that the payment through commissions for products and services that have the attributes of traditional overhead and more routine expenditures of investment managers would fall outside of the safe harbor, and (2) limit the scope of the safe harbor to those research-related products and services that are produced by and provided directly by the broker-dealer receiving the commissions. Narrowing the safe harbor in this manner would be beneficial for investors because it would clarify application of the safe harbor in areas where guidance is needed; would make it easier for investors to understand the costs of

---

[34] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated December 16, 2003 (recommending that the Commission adopt a revised interpretation under Section 28(e) of the Exchange Act to narrow the safe harbor in this manner) ("ICI Soft Dollars and Directed Brokerage Letter"). Some have suggested that Section 28(e) be repealed altogether to prohibit soft dollar arrangements. The Institute agrees that this is an issue that may warrant further study and consideration.

[35] This recommendation does not represent a judgment that proprietary research is somehow "better" than third-party research. It is, rather, based on the Institute's conclusion that there is no inherent reason why research provided by one firm should be bundled with execution services provided by a different firm. In contrast, where both types of services are provided by the same entity, allocating costs between the two can be difficult, particularly since brokerage firms do not typically break out such costs. The Institute believes that it is not necessary or advisable to delay soft dollar reforms that can be implemented relatively quickly while continuing to study the more complex issue of proprietary research. In my own view, to the extent that there already may be instances in which proprietary research and execution services are clearly severable, fund managers should pay for research services in hard dollars.

various investment advisory products, including mutual funds; would reduce incentives for money managers to engage in unnecessary trading; and would interpret Section 28(e) in a manner that is more consistent with its original purpose – a narrowly tailored provision that allows a money manager to take into account the intellectual resources, as well as the execution capabilities, of a brokerage firm in determining how to allocate trades.[36]

2. Directed Brokerage Arrangements Should Be Prohibited

The ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules.[37] The rules provide that a fund can only take a broker's sale of fund shares into account in selecting a broker if it is otherwise receiving best execution. In addition, the rules only permit funds to consider sales in allocating brokerage "after the fact;" conditioning fund sales on the payment of brokerage commissions is expressly prohibited. Notwithstanding the strict nature of these restrictions, this practice can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the complexity of the best execution determination. For these reasons, the Institute urged the SEC to prohibit this practice.[38] The Institute is pleased, therefore, that the SEC recently proposed

---

[36] Because Section 28(e) is a safe harbor, failure to comply with its terms does not, in and of itself, violate any provision of law. For certain advisers, however, using commissions outside of the safe harbor raises serious issues under federal law. These include advisers to mutual funds and to pension plans under ERISA. In contrast, advisers to other types of accounts are not subject to similar substantive limitations. Instead, such advisers are only required to provide disclosure about their use of soft dollars in Form ADV. The Institute recommends that all investment advisers be prohibited from using brokerage commissions outside of the safe harbor to pay for any products or services used by the adviser. This change will extend the protections afforded to mutual funds and ERISA accounts to all investment advisory clients.

[37] *See* NASD Conduct Rule 2830(k).

[38] *See* ICI Soft Dollars and Directed Brokerage Letter, *supra* note 34. As part of its proposal, the Institute recommended that a safe harbor be adopted for funds that use brokers to execute portfolio transactions that also sell

amendments to Rule 12b-1 to address concerns with the use of brokerage commissions to pay broker-dealers for selling fund shares.[39]

B. 12b-1 Fees

In its release proposing amendments to Rule 12b-1 to prohibit directed brokerage arrangements, the SEC also requested comment on whether it should propose additional changes to Rule 12b-1 to address other issues that have arisen under the rule, or even propose to rescind the rule. The Institute agrees that, given the many developments in fund distribution practices since the rule was adopted in 1980, a reevaluation of the rule is timely and prudent. Due to the significance of the rule, its widespread use and related issues, it is important to solicit the views of all interested parties before determining whether further changes to the rule should be proposed. The Institute believes that Rule 12b-1 continues to have merit but that certain changes may be appropriate. We are in the process of developing our specific comments and look forward to providing them to the SEC. The use, disclosure and regulation of 12b-1 fees are discussed below.

1. <u>12b-1 Fees Expand Investor Choice and Align Financial Advisor and Shareholder Interests</u>

---

shares of the fund in those cases where a fund has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation.

[39] *See* SEC Release No. IC-26356 (Feb. 24, 2004). The NASD also has proposed changes to its rules to prohibit directed brokerage. *See* Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions, File No. SR-NASD-2004-027.

Innovations in mutual funds have given investors many choices about how and where they purchase mutual fund shares. Some investors prefer to buy mutual funds directly from the company sponsoring them. Others choose to purchase funds through brokers, financial planners, or other financial professionals who provide assistance and advice in selecting funds to help investors reach their long-term goals, such as retirement and education. The advisory relationship continues through the entire period of ownership, including the critically important withdrawal phase following retirement, during which fund shareholders need personalized advice to avoid either outliving their savings or compromising their lifestyles by under-spending.

Investment professionals traditionally were compensated for their services exclusively by an upfront sales commission, or "load," paid by investors when they purchased mutual fund shares. In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act of 1940. The rule authorizes funds to use their assets to pay distribution costs. Although the rule initially was described by many as a way to help funds increase sales to offset net redemptions, the use of 12b-1 fees has evolved since the rule was adopted. Most significantly, it has provided a method for tying the payment stream to the length of the advisory relationship, rather than compensating the advisor only with a single, upfront payment. Shifting all or a portion of the advisor's compensation from upfront, transaction-based commissions to an ongoing fee for maintaining the relationship aligns the interests of the advisor and the shareholder, eliminating the situation where the only way to get paid is to churn the account, and allows compensation to continue into the critical withdrawal period when no new purchases are being made. Many funds now offer various classes of shares that invest in the same portfolio of securities but provide a variety of different expense and advisor compensation options, allowing choice as to which one best reflects the nature of the relationship.[40] Different classes may be sold through different distribution arrangements (*e.g.*, retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

Most investors use the services of a financial intermediary; thus, most funds have sales charges and ongoing fees to cover these costs. Importantly, investors are well aware of the option of purchasing funds directly without paying for the services of a personal advisor; many choose to do so while the majority prefer to use an advisor. Indeed, Institute data show that among shareholders holding funds outside defined contribution plans, more than 70 percent primarily purchase funds through financial advisors and other intermediaries.[41] In other words, in many cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds; Rule 12b-1 has made it possible for funds to provide investors with a choice of how and when to pay for these services.

The Institute recently undertook a study of mutual fund distribution channels and trends in distribution costs since 1980.[42] The study found that changes in fund distribution over the last 25 years have been accompanied by a significant decrease in the average cost of distribution services incurred by mutual fund buyers. The average annual distribution cost

---

[40] Institute research indicates that each of these options can be optimal for particular investors, depending on the expected time horizon of their investment (including whether they are uncertain about the length of their holding period) and the amount invested. *See* Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, July 2003, at 11-13, available at http://www.ici.org/stats/res/per09-03.pdf. For purposes of the study, distribution costs were defined as charges incurred by mutual fund investors directly through the payment of sales loads or indirectly through 12b-1 fees.

[41] *See* Investment Company Institute, 2001 Profile of Mutual Fund Shareholders, at 68.

[42] *See* Reid and Rea, *supra* note 40.

incurred by buyers of equity funds decreased from 1.49 percent (or 149 basis points) of their initial investment in 1980 to 40 basis points in 2001 – a 73 percent decrease. Similarly, distribution costs of bond funds fell 60 percent, from 82 basis points in 1980 to 33 basis points in 2001.[43]

2. <u>12b-1 Fees Are Fully Disclosed</u>

Assertions that 12b-1 fees are "hidden costs" are completely without merit. All mutual fund fees and expenses are fully disclosed in a standardized fee table that is required to be at the front of a fund's prospectus. If a fund has a 12b-1 fee, it will be clearly identified as a separate line item in the fee table as part of the fund's annual operating expenses. In addition, it is reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table.

Investors also can determine whether a fund charges a 12b-1 distribution fee by reviewing the mutual fund listings published in most newspapers. A newspaper's listings offer information about a fund's fees by using a series of symbols next to the fund's name. A fund that has a 12b-1 fee will have the letter "p" next to its name in the newspaper.

In addition to disclosing the fact that a fund has a 12b-1 fee, such funds are required to include disclosure in the prospectus concerning the impact of this ongoing fee. Specifically, the

---

[43] According to the Institute's study, these declines were due to several developments, including growth in sales through 401(k) plans, which have lower distribution costs, and increased competition from no-load funds. *Id.* at 16-17.

prospectus must disclose that over time, 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges.[44]

The SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors before they purchase mutual fund shares.[45] Such disclosures would include the estimated amount of 12b-1 fees to be paid in the year following purchase, if the fund's net asset value remained constant. The SEC's proposal also would require quantitative disclosure of 12b-1 fees on mutual fund confirmations. The Institute supports requiring such disclosure.

3. Substantive Regulation of 12b-1 Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees, including in particular 12b-1 fees.

First, NASD rules place limits on all mutual fund sales charges, including "asset-based sales charges" (12b-1 fees).[46] In addition, a fund that has a front-end or deferred sales charge, or

---

[44] Additional, more detailed disclosure about a fund's 12b-1 fee is required in the Statement of Additional Information, which is available to fund shareholders free of charge upon request. Such disclosure includes, among other things, a breakdown of the dollar amount of 12b-1 payments made for various activities, such as advertising and compensating broker-dealers.

[45] *See* SEC Release No. IC-26341 (Jan. 29, 2004).

[46] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder

a 12b-1 fee higher than 25 basis points, cannot be referred to as a "no load" fund.[47]

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to any 12b-1 fee.

Any payments by a fund pursuant to Rule 12b-1 must be in accordance with a written plan approved annually by the fund's board of directors, including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.[48]

---

accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales. These limits appropriately treat 12b-1 fees, in effect, as an alternative form of sales charge.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.,* NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000, available at http://www.nasdr.com/rca_summer00_reg.htm#suitability.

[47] NASD rules permit funds with a 12b-1 fee of no more than 25 basis points to be designated as "no load" funds in recognition that the expenses of funds with a low 12b-1 fee tend to more closely resemble those of funds with no sales charges or 12b-1 fees.

[48] Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. According to Institute data, most 12b-1 fees are used to compensate financial advisors for providing assistance to investors in selecting mutual funds or to compensate financial advisors for providing ongoing services to existing fund shareholders. The fact that a fund may have stopped selling shares to new investors is irrelevant to existing shareholders; it does not make it improper or unnecessary for existing shareholders to continue to pay for these services. Also, it would be both disruptive and inappropriate for funds to cease 12b-1 payments in many cases; for example, where a fund underwriter "fronts" money to salespeople with the expectation that these expenditures will be recouped through the 12b-1 fee over time. In these circumstances, the payments compensate the fund's distributor for its past distribution efforts. Finally, as noted above, the NASD imposes limits on 12b-1 fees that are tied to a fund's overall sales of shares. A fund that stops selling shares will eventually reach its "cap" and have to cease imposing asset-based sales charges under Rule 12b-1.

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that shareholders must approve any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise 12b-1 fees, nor may the board alone approve a fee increase.

C. Revenue Sharing Arrangements

As discussed above, mutual fund investors currently have choices in the manner and timing of payments to compensate investment professionals for the services they provide (*i.e.,* through sales charges, 12b-1 fees or, most frequently, a combination). Competition among funds for the services of selling intermediaries (*e.g.,* broker-dealers) has led these intermediaries, however, to seek additional compensation, or cost sharing, for distributing fund shares and providing services to shareholders. Consequently, it is common practice in the fund industry for fund investment advisers or principal underwriters to enter into so-called "revenue sharing" arrangements, under which the adviser or principal underwriter makes payments out of its own resources to intermediaries who sell fund shares. In fact, I believe these arrangements are more accurately described as cost-sharing arrangements.

The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them.[49] Disclosure concerning the payments is already required in fund prospectuses, and the

[49] Legislation currently pending before Congress contains a provision that would impose a fiduciary duty on fund directors to determine that any revenue sharing arrangements are in the best interests of fund shareholders. *See, e.g.,* H.R. 2420 and S. 1971, *supra* note 33. Such a requirement is misguided. The directors are responsible for overseeing uses of the fund's assets. These arrangements, by definition, do not involve the use of fund assets. Indeed, if any payments are made directly or indirectly by a fund, they must comply with Rule 12b-1. H.R. 2420 and S. 1971 would address any possible concern that revenue sharing arrangements may involve an indirect use of fund assets by requiring fund directors to review revenue sharing arrangements to ensure that they comply with the Investment Company Act of 1940. Fund directors play an important role in overseeing the adviser's overall distribution practices but they should not be expected to review individual agreements or arrangements with intermediaries that sell fund shares.

Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[50]

As noted above, the SEC recently proposed new point-of-sale and mutual fund confirmation statement disclosure.[51] The proposed disclosure would address, among other things, payments by fund sponsors for brokers to sell particular funds.[52] Under the SEC's proposal, broker-dealers would be required to disclose to customers, prior to a purchase of mutual fund shares, whether they receive such payments, and whether the broker-dealer pays differential compensation in connection with transactions in shares of the fund.[53] The Institute strongly supports this aspect of the proposal. The SEC's proposal also would encompass other sales-related fees and payments, such as upfront and deferred sales charges and 12b-1 fees. The Institute supports requiring point-of-sale disclosure of such fees and payments.

D. Additional Disclosure Initiatives

Many of the proposed reforms discussed above would involve providing new or enhanced disclosure to investors. The SEC has long recognized the challenge of designing

---

[50] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997.

[51] *See supra* note 45.

[52] *See* SEC Release Nos. 33-8358; 34-49148; IC-26341 (January 29, 2004). The NASD also has recently proposed new point of sale disclosure concerning revenue sharing and differential cash compensation arrangements. *See* NASD Notice to Members 03-54 (September 2003), available at http://www.nasdr.com/pdf-text/0354ntm.txt. The Institute supports the NASD's proposal. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated Oct. 17, 2003.

[53] We note that broker-dealer recommendations to customers to purchase fund shares also must comply with NASD suitability requirements.

disclosure that is comprehensible, informative and useful to the average fund investor. With its 1998 overhaul of mutual fund prospectuses and adoption of "plain English" requirements, both of which the Institute supported, the SEC made significant strides in this direction. These major initiatives transformed fund prospectuses, making them significantly more informative and "user-friendly" than they had been previously.

Nevertheless, it is axiomatic that efforts to improve disclosure of important information to fund investors must be ongoing. The SEC and the industry share a common interest in seeking to assure that investors fully understand their fund investments. As part of its continuing efforts to provide mutual fund investors with useful information, particularly information concerning fund fees and costs, the SEC has recently adopted, proposed, and issued a concept release on new or improved disclosure in the following areas.

1. Portfolio Holdings and Expense Disclosure

Last month, the SEC adopted a proposal that requires funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and makes other changes to disclosure in fund shareholder reports.[54] As part of the new requirements, funds will have to disclose in their shareholder reports the dollar amount of expenses paid on a $1,000 investment in the fund during the period covered by the report. The Institute supports this disclosure, which will supplement the detailed fee disclosure currently required in fund prospectuses. It will serve to remind investors about the impact of fund expenses. Importantly, it will do so in a format that

[54] *See* SEC Release No. IC-26372 (February 27, 2004).

permits investors not only to readily estimate their own expenses but also to compare the expenses of different funds.

In adopting this proposal, the SEC expressed its continued belief that disclosure of current period expenses in fund shareholder reports strikes an appropriate balance between investors' need for this information and the costs and burdens that would be associated with providing the information on an individualized basis (*e.g.*, in quarterly account statements). The SEC noted that its approach avoids the substantial costs and logistical complexity that would be associated with requiring individualized expense disclosure in quarterly account statements. Such costs and complexity result from: (1) the need for funds to make systems changes to compute and disclose individual account expenses for those accounts for which the fund knows the ultimate account owner; (2) the need for funds to make the necessary systems changes to provide to thousands of third-party intermediaries the information they will need to compute and report the expense information for those accounts as to which only the intermediary knows the ultimate account owner (*e.g.,* omnibus accounts); and (3) the need for third-party intermediaries that prepare account statements to implement new systems that would allow them to calculate and report personalized expense information for each fund held in an account in an accurate and timely manner.

In the context of discussions of disclosure of fund expenses, another approach that has been suggested is to provide estimates of individualized expenses in quarterly account statements. The estimated expense amounts would be calculated based on the assumption that the fund holdings of each shareholder remained the same throughout the quarter.

The Institute believes it would be inappropriate to mandate this form of expense disclosure across the entire industry. Importantly, although providing estimated expense information would eliminate some of the costs and complexities noted above by making it unnecessary to calculate expenses at the shareholder account level on a daily basis, accuracy and precision would be sacrificed. It would seem odd if a regulatory regime under which funds must price their shares at a value that is accurate to one penny simultaneously required expense disclosure that could be inaccurate by a significant order of magnitude due to assumptions made to simplify the calculation. Moreover, requiring estimated expense disclosure in account statements would still entail the most significant costs and complexities referred to above, which are those involved in ensuring that the thousands of intermediaries who prepare account statements for fund investors get, and are able to integrate and report, the necessary data from many unrelated fund groups.

The high costs and complexity of implementing the two forms of individualized expense disclosure described above (and the lack of precision of estimated expense disclosure) are not their only drawbacks. Both would sacrifice a key benefit of the approach adopted by the SEC: the ability of investors to compare the expenses of different funds. The Institute agrees with the SEC that the approach it has chosen strikes the best balance and notes that it is the only one that preserves comparability.

The Institute believes that the new expense disclosure in fund shareholder reports should be given a chance to work. Although we continue to have serious reservations about requiring individualized expense disclosure in account statements for the reasons discussed above, if there are other ways to further enhance disclosure of fund fees and expenses at a reasonable cost, we would support pursuing them.

2. Sales Charge Breakpoints

Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which investors did not receive the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to the formation of a Joint NASD/Industry Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Task Force issued a report in July 2003 making a series of recommendations designed to ensure that processes are in place so that investors will receive applicable discounts.[55] These recommendations include additional required disclosure concerning breakpoint discounts. The SEC recently proposed amendments to fund prospectus disclosure requirements to improve disclosure concerning sales charge breakpoint discounts.[56] The Institute supports this proposal.[57]

---

[55] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

[56] *See* SEC Release No. IC-26298 (December 17, 2003).

[57] *See* Letter from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004.

3. Portfolio Transaction Cost Disclosure

In December 2003, the SEC issued a concept release seeking comment on how to improve disclosure concerning funds' portfolio transaction costs.[58] The SEC's release acknowledged the many issues involved in quantifying these costs and providing disclosure that would assist investors in understanding these costs. The Institute filed a comment letter in which it recommended, among other things, enhanced disclosure concerning brokerage commissions, fund flows and portfolio turnover to heighten investors' awareness of portfolio transaction costs and their impact on fund performance.[59] The Institute's letter opposed requiring funds to quantify all portfolio transaction costs and include them in the expense ratio or fee table, due to concerns that such a requirement would call for disclosure that would be misleading, rather than helpful, to investors.[60]

VI. CONCLUSION

I appreciate the opportunity to provide testimony to the Committee on behalf of the Institute on the foregoing matters. The industry remains committed to working with the

---

[58] *See* SEC Release No. IC- 26313 (December 18, 2003).

[59] *See* Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated February 23, 2004. The Institute also recommended enhanced board oversight of portfolio transaction costs.

[60] As noted in the Institute's comment letter, there is no single, agreed-upon measure of transaction costs (nor is there necessarily agreement on what the components of such costs are). Although commissions can be measured directly, other types of transaction costs, such as spread costs and market impact costs, cannot. Existing measures that funds use for internal purposes all have significant limitations that would make them unsuitable for disclosure to investors. For example, some measures do not include all of the components of transaction costs and would therefore present an incomplete picture of these costs to investors.

Committee and regulators to take the steps necessary to make sure that the interests of fund investors are protected and served.