STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON H.R. 2420
MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

EXECUTIVE SUMMARY

- Consistent with the industry's longstanding support of efforts to provide real, meaningful help to mutual fund investors, we stand ready to work constructively and respectfully with members of the Subcommittee and officials at the SEC and GAO to identify the best ways to accomplish our common goals of restoring investor confidence and helping individuals make well-informed investment decisions.

- H.R. 2420 was introduced shortly after the release of a detailed report by the staff of the SEC, which found no significant shortcomings in mutual fund regulation. The report recommends, however, a series of policy changes and also identifies areas warranting further study. In large part, the industry agrees with the SEC staff's recommendations. We clearly recognize the need, especially in the current environment, to re-examine our regulatory system in order to determine if it is working as intended, and – even if it is – to determine whether there are ways to make it even stronger.

- We believe that many of the provisions in H.R. 2420 would be beneficial to mutual fund investors. These include steps to:

    - further enhance the independence of fund boards;
    - further enhance the independence of fund audit committees;
    - clarify the role of fund directors and advisers with respect to soft dollar and directed brokerage arrangements; and
    - require the SEC to adopt rules mandating additional disclosure in certain areas including the structure of portfolio manager compensation, revenue sharing arrangements and fund brokerage practices.

- Many of the important policy changes in H.R. 2420 could be swiftly and effectively implemented even in the absence of legislation, through either regulatory action by the SEC or the adoption of best practices by the mutual fund industry. Similarly, the review of soft dollar practices required by the bill – which we strongly support – could be undertaken by the SEC long before legislation is enacted directing the SEC to do so.

- Certain parts of the bill, however, are unnecessary and in fact could be harmful to mutual fund shareholders.

    - *Independent Chair* – It is neither necessary nor appropriate to require mutual funds to have an independent chairman of the board. In many cases, a person needs to be intimately familiar with the operations of a company in order to be an effective chairman, and a management representative is often in the best position to do this. In addition, the combination of regulatory mandates and industry corporate governance best practices make an independent chair unnecessary.

    - *Location of Disclosure* – The specifics of how certain items should be disclosed, and in which document they should appear should not be dictated by legislation. We are particularly concerned with the legislation's presupposition that prospectus

disclosure is not sufficient for any of the items covered. Under the securities laws, the prospectus is the legal document required to include all of the important information that is necessary to assist an investor in making an investment decision including. Congress should not inadvertently discourage investors from viewing the prospectus as the most important disclosure document.

- *Estimated Operating Expenses* – The provision in the bill relating to fund operating expenses seems to contemplate disclosure of expenses on an individualized basis. The SEC's report noted that there were serious problems with this approach, including significant costs and logistical complexity, lack of comparability and lack of an effective context for investors to evaluate the expenses shown. While a requirement to disclose *estimated* fund expenses might reduce the costs and complexities associated with individualized cost disclosure, albeit to a relatively small extent, it would run the risk of confusing and misleading investors by including an imprecise number in a document that otherwise contains very exact and precise numerical data. And, it still would result in disclosure of information that would make it difficult for investors to make meaningful comparisons.

- *Board Oversight of Revenue Sharing* – While the Institute believes that it is entirely appropriate for directors to review soft dollar and directed brokerage arrangements, we do not believe that it is necessary or appropriate for boards to review revenue sharing arrangements. These payments are, by definition, not made by the fund. They are made by a fund's underwriter or adviser out of its own resources to compensate financial intermediaries who sell fund shares. In addition, fund directors are not permitted to take distribution expenses into account when determining whether a fund's advisory fee is reasonable.

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I. Introduction

My name is Paul G. Haaga, Jr. I appreciate the opportunity to appear before the Subcommittee today to discuss H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act."

I am appearing before you today, as I did in March, as chairman of the Investment Company Institute's Board of Governors.[1] My testimony is offered on behalf of the Institute and its members. My own firm is the investment adviser to the American Funds, which manages $350 billion on behalf of about 12 million mutual fund investors. We are the third largest mutual fund family in the United States, and – of particular significance today given several provisions in H.R. 2420 – we are the largest mutual fund company that sells exclusively or primarily through financial intermediaries. Before I joined the American Funds in 1985, I was a securities attorney in private practice in Washington, DC and, prior to that, was on the staff of the Securities and Exchange Commission.

When I testified three months ago I said that mutual fund companies view strict regulation under the federal securities laws as a valuable asset, not a liability. I believe that point is sufficiently important that it bears repeating today.

Mutual funds are not recent converts to the cause of reinforcing investor confidence. Our support for comprehensive regulation and increased resources for the SEC is not a

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,688 open-end investment companies ("mutual funds"), 556 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.475 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

temporary post-Enron public relations strategy. In fact, our views on these matters have been at the heart of how we serve 95 million shareholders. We have embraced the critical principles of integrity, transparency, accountability and competition – in both word and deed – for decades.

In 1940, Congress enacted the Investment Company Act. The Act is a comprehensive, strict and detailed statute that governs nearly all aspects of a mutual fund's organization, structure and operations. Unlike the other major securities laws, the Investment Company Act was supported – not opposed – by the industry it was intended to regulate. Indeed, the Act was drafted with input from the SEC and full cooperation from the fund industry, a fact President Roosevelt highlighted when he signed the bill. The manner in which the Investment Company Act became law is more than just our common history. It is, in my judgment, our common legacy.

Today's hearing brings SEC representatives, mutual fund leaders, industry observers and members of Congress together again. Our charge is to determine whether a common set of initiatives can be devised that would provide real, meaningful help to mutual fund investors. All of us are acutely aware that this effort occurs at a time when investor confidence in our equity markets has declined during the second worst bear market in the last century. Consistent with the tradition established with the enactment of the Investment Company Act, we hope to work constructively and respectfully with members of this Subcommittee and officials at the SEC and GAO to identify the best ways to accomplish our common goals of restoring investor confidence and helping individuals make well-informed investment decisions.

II. General Views on H.R. 2420

H.R. 2420 was introduced shortly after the release of a detailed report by the staff of the Securities and Exchange Commission that was requested by Chairman Baker.[2] The SEC Report addresses a broad array of complex issues.

We believe that the SEC Report is thorough, thoughtful and balanced. Among other things, the report discusses recent steps taken by the SEC, as well as pending proposals, designed to enhance disclosure to, and further the protection of, fund investors. The ICI has expressed the mutual fund industry's support of most of these initiatives, including rule amendments to enhance the independence of fund directors and proposals to improve disclosure of fees and other matters in mutual fund shareholder reports and to reform the rules governing mutual fund advertising.

The SEC Report also recommends a series of additional policy changes and identifies areas warranting further study. In large part, the industry agrees with the SEC staff's recommendations and is committed to working constructively and expeditiously with the Commission if it and the Congress determine to go forward with them.

Provisions in H.R. 2420 address several matters that are covered in the SEC Report; in particular, enhancements to disclosure and corporate governance requirements. We believe it is

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[2] *See* Memorandum to SEC Chairman William H. Donaldson from Paul F. Roye, Division of Investment Management, re Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (June 9, 2003) (the "SEC Report").

especially important for public understanding and for informed debate to point out that the SEC Report did not find significant shortcomings in either area. For example, with respect to mutual fund fees, the SEC Report notes that prospective mutual fund investors currently "receive significant disclosure about fund fees and expenses."[3] The SEC Report also notes that its pending proposal to enhance disclosure of fees "would go beyond the disclosure provided by other financial service providers," including banks and mortgage companies.[4] More generally, the SEC Report notes that there is evidence of "significant competition based on costs in the fund industry."[5] With respect to mutual fund corporate governance, the SEC Report states that "one of the principal reasons the mutual fund industry has avoided the scandals that have plagued other segments of the securities industry is the presence of independent directors."[6]

These and similar conclusions in the SEC Report affirm our belief that the mutual fund industry continues to adhere to extremely high ethical and business standards, is strictly and effectively regulated by an active and vigorous independent agency, and is highly competitive in a manner that promotes service and responsiveness to individuals saving for the future. While we are proud of all of this, we also clearly recognize the need, especially in the current environment, to re-examine our regulatory system in order to determine if it is working as intended, and – even if it is – to determine whether there are ways to make it even stronger and more responsive to investor needs.

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[3] SEC Report at 9.

[4] *Id.* at 17.

[5] *Id.* at 5.

[6] *Id.* at 48.

H.R. 2420 would impose several significant new disclosure requirements upon mutual funds. It also contains provisions relating to the structure and duties of mutual fund directors. In some instances, the bill's provisions echo recommendations in the SEC Report; in other cases, the bill proposes a different approach, or would constrain the SEC's flexibility in responding to its directives.

We believe that the new requirements and policy changes envisioned by many of the provisions in H.R. 2420 would be beneficial to mutual fund investors. These include steps to:

- further enhance the independence of fund boards;
- further enhance the independence of fund audit committees;
- clarify the role of fund directors and advisers with respect to soft dollar and directed brokerage arrangements; and
- require the SEC to adopt rules mandating additional disclosure in certain areas.

We believe it is important for the Subcommittee to recognize that most, if not all, of these policy changes could be swiftly and effectively implemented even in the absence of legislation, through either regulatory action by the SEC or the adoption of best practices by the mutual fund industry. Similarly, the review of soft dollar practices required by the bill – which we strongly support – could be undertaken by the SEC for the Subcommittee long before legislation is enacted directing the SEC to do so.

At the same time, however, as I will explain in further detail below, we believe that some parts of the legislation are unnecessary and potentially harmful. These include certain

aspects of the additional disclosure requirements and the requirement that fund boards have independent chairpersons. We do not believe that these proposed changes would be beneficial to fund shareholders.

I now turn to a more detailed discussion of the provisions of H.R. 2420.

III. Soft Dollars

The Institute believes that one of the most important issues addressed by H.R. 2420 is soft dollars. The SEC has been very active in this area for some time, including issuing an extensive report on inspections[7] and proposing new disclosure requirements for investment advisers.[8] Nevertheless, we believe the time has come for a top to bottom re-examination by the SEC of soft dollar arrangements. We agree with the discussion in the SEC Report, which states that soft dollar arrangements may involve the potential for conflicts on the part of investment advisers, including – but certainly not limited to – advisers to mutual funds. The SEC Report notes that, in the case of mutual funds, these types of potential conflicts are generally managed by fund boards of directors and that mutual funds (and pension plans) are subject to stricter standards and more oversight regarding their adviser's soft dollar practices than other accounts.[9] The issues surrounding soft dollars are extremely complicated, have significant policy dimensions, raise a host of practical concerns and have been the subject of

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[7] The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (September 22, 1998).

[8] Investment Advisers Release No. 1862 (April 5, 2000).

[9] SEC Report at 36-39.

intense debate for decades. Therefore, we concur that it is prudent for the SEC to first undertake another careful analysis of the relevant issues. One particular area that we believe is ripe for re-examination by the SEC is whether the definition of "research" for purposes of the soft-dollar safe harbor is overly broad.

IV. Audit Committee Requirements

The Institute agrees that it would be appropriate for audit committees of mutual funds to follow standards that are similar to those required by Section 301 of the Sarbanes-Oxley Act of 2002.[10] While most provisions of the Sarbanes-Oxley Act apply equally to mutual funds and operating companies,[11] Section 301 applies only to companies that are listed on an exchange. This includes closed-end funds and most exchange-traded funds, but does not include mutual (open-end) funds.

With respect to the audit committee standard, members of the Subcommittee might want to note that many funds already have chosen voluntarily to implement, or are currently considering voluntarily implementing, most of the requirements of Section 301. In a recent speech, Paul Roye, Director of the SEC's Division of Investment Management, stated that these requirements "represent 'best practices' worthy of consideration by all mutual fund boards of

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[10] The SEC recently adopted Rule 10A-3 under the Securities Exchange Act of 1934 to implement Section 301 of the Sarbanes-Oxley Act. SEC Release No. IC-26001 (April 9, 2003).

[11] For example, pursuant to Sections 302 and 906 of the Act, periodic reports of funds must be certified by the fund's principal executive officer and principal financial officer; pursuant to Section 307 of the Act, rules regarding attorney conduct apply to attorneys representing funds; pursuant to Section 406 of the Act, funds must disclose whether they have a code of ethics that applies to senior financial officers; and pursuant to Section 407 of the Act, funds must disclose whether they have a "financial expert" on their audit committees. In addition, fund auditors are subject to the various provisions of the Act relating to auditor independence (*e.g.*, Section 206).

directors."[12] We believe that it makes sense for mutual funds to follow the strict standards for audit committees established under Section 301 of the Sarbanes-Oxley Act. In the absence of legislation, we would commit to urging the mutual fund industry to adopt them as a best practice.

V. <u>Super-Majority of Independent Directors</u>

The Investment Company Act currently requires that at least 40 percent of a fund's board consist of individuals who are not "interested persons" of the fund or certain affiliates. In addition, when mutual fund shares are offered through an affiliate of the fund's investment adviser, which is quite common, the Investment Company Act requires a majority of the mutual fund's board to be independent.

These statutory provisions establish baseline requirements with respect to the composition of mutual fund boards. But there are additional requirements that reinforce and strengthen the role and responsibilities of independent directors on mutual fund boards. For example, in 2001, the SEC adopted rule amendments that require funds that rely on any of ten key exemptive rules to have a majority of independent directors.[13] As almost all funds rely on one or more of these rules, the effect of these amendments is to require virtually all mutual funds to have a majority of independent directors.

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[12] *See* "A New Era of Accountability in Fund Regulation," Remarks by Paul F. Roye, Director, SEC Division of Investment Management, at the Investment Company Institute's 2003 Mutual Funds and Investment Management Conference, March 31, 2003.

[13] SEC Release No. IC-24816 (January 2, 2001). The rule amendments also require, for funds relying on these exemptive rules, that the independent directors select and nominate other independent directors and that any legal counsel for the independent directors be "independent legal counsel" as defined by the SEC.

H.R. 2420 would amend the Investment Company Act to require at least *two-thirds* of the directors of all investment companies to be independent directors. We note that a two-thirds standard would be consistent with existing mutual fund industry practices. In June 1999, an Advisory Group on Best Practices for Fund Directors established by the Institute and on which I served recommended that at least two-thirds of the directors of all investment companies be independent directors.[14] The Advisory Group concluded that having a super-majority of independent directors on fund boards would enhance the authority of independent directors. It is the Institute's understanding that most fund boards have adopted this best practice and currently have a super-majority of independent directors.[15]

We also think it bears mentioning that the super-majority standard in the bill exceeds the standard currently being considered for public operating companies. For example, currently pending proposals of the New York Stock Exchange, Nasdaq and the American Stock Exchange would require listed companies to have a *majority* of independent directors.

VI. <u>Qualification as an Independent Director</u>

Section 4(b) of the bill would give the Commission additional authority to define, by rule, categories of persons who should not be treated as independent directors for purposes of the Investment Company Act. The Institute agrees that there may be types of family, business

[14] *Report of the Advisory Group on Best Practices for Fund Directors, Enhancing a Culture of Independence and Effectiveness*, June 24 (1999) ("Best Practices Report") at 10. The Best Practices Report recommended fifteen best practices for enhancing the effectiveness and independence of fund boards. It was issued by an advisory group of independent and management fund directors.

[15] If it is deemed appropriate to mandate that *all* funds adopt this standard, this could be implemented through SEC rulemaking.

and professional relationships – in addition to those currently enumerated in Section 2(a)(19) of the Act – that, both for appearances sake and as a matter of fact, should disqualify persons from serving as independent directors of a mutual fund.

The Act broadly defines those persons who are considered "interested persons" of a fund or its affiliates and thus disqualified from independent status. Nevertheless, the current definition technically would allow persons such as former executives of the fund's adviser and persons with certain family relationships to senior officers of the adviser, underwriter or their affiliates (*e.g.*, aunts and uncles) to be considered independent directors.[16] While the Institute believes that such situations are rare, when they come to light, they risk undermining public confidence in the system of fund governance.

For this reason, the Institute supports the concept of making the strict standards for independence under the Investment Company Act even stricter. We note that the Advisory Group on Best Practices for Fund Directors recommended that "former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund."[17] While recognizing that such persons may be valuable board members because of their extensive knowledge of the industry, the fund complex and the operations of the adviser or underwriter, the Advisory Group concluded that their prior service may affect the directors' independence, both in fact and appearance. Accordingly, the Advisory Group recommended that such persons should not be considered *independent* directors if they

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[16] The Act considers "immediate family" members of such persons to be "interested persons." Immediate family members are defined as any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and they include step and adoptive relationships.

[17] Best Practices Report at 12.

serve on fund boards. Family relationships not specifically covered by Section 2(a)(19) may raise similar concerns over independence. In the absence of legislation, it would therefore seem appropriate to adopt a best practice similar to that adopted for former executives that would have the effect of extending the exclusion from the definition of "disinterested director" to additional family members, as well as business or professional associates.

VII. Board Oversight of Soft Dollars, Directed Brokerage and Revenue Sharing

H.R. 2420 would impose requirements on fund directors to: (1) supervise the investment adviser's direction of the fund's brokerage arrangements and soft dollar arrangements, and to determine that the direction of such brokerage is in the best interests of the fund's shareholders; and (2) supervise any "revenue sharing arrangements" to ensure compliance with the Investment Company Act and rules thereunder and to determine that such arrangements are in the best interests of investors.

The Institute believes it is entirely appropriate for investment advisers to report to fund boards on soft dollar and directed brokerage arrangements, and for directors to review those arrangements. Soft dollars and brokerage are fund assets, and these arrangements involve the potential for conflicts between the interests of the fund and those of the adviser or its affiliates. As such, these matters fall squarely within the purview of fund director oversight responsibilities. As noted in the SEC Report, these matters already are overseen by fund boards of directors in connection with their obligation to request and review such information as may reasonably be necessary to evaluate the terms of the contract between the fund and its

investment adviser.[18] Nevertheless, we would have no objection to making the duties of fund advisers and fund directors in this area more explicit.[19] The SEC currently has the authority to do so, even in the absence of legislation, through rulemaking and/or an interpretive release.

By contrast, so-called "revenue sharing" arrangements involve payments by a fund's principal underwriter or investment adviser out of its own resources to compensate financial intermediaries who sell fund shares. These payments are, by definition, not made by the fund.[20] In addition, the SEC has taken the position that fund directors should not take distribution expenses into account when determining whether a fund's advisory fee is reasonable, and courts have applied the same standard.[21] For these reasons, it would be unnecessary and perhaps even inappropriate for fund boards to review such payments. As is discussed further below, the principal investor protection concern that is raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. For this reason, we have long advocated additional disclosure of these payments directly to investors in order to put them on notice of these potential conflicts.

VIII. Disclosures by Mutual Funds

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[18] SEC Report at 26-27. The SEC Report explains, for example, that research and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because such services otherwise would have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser.

[19] Directors should not, however, serve in the role of "supervising" the investment adviser's soft dollar and directed brokerage activities. This term suggests a degree of board involvement that could improperly transform the board's oversight role into one of direct management.

[20] As the SEC Report notes, if such payments are made directly or indirectly by a fund, they must be in accordance with Rule 12b-1 under the Investment Company Act. SEC Report at 77.

[21] *See, e.g.,* SEC Release No. IC-11414 (October 28, 1980); *Schuyt v. T.Rowe Price Prime Reserve Fund*, 663 F.Supp. 962 (S.D.N.Y. 1987), *aff'd,* 835 F.2d 45 (2d Cir. 1987), *cert. denied,* 485 U.S. 1034 (1988).

Section 2 of the bill would require the SEC to adopt rules to require mutual funds to provide investors with additional disclosures on various matters. These new disclosures would be required to be set forth in a document other than the fund's prospectus, although presumably the SEC could require that the disclosure also be in the prospectus.

As a preliminary matter, the Institute strongly shares the Subcommittee's commitment to full disclosure. Because mutual funds are the investment vehicles of choice for millions of Americans, it is imperative that they communicate with investors as clearly and effectively as possible. Therefore, it is important that information be provided to investors in a format that is easy to understand and does not inadvertently mislead investors. In addition, it is important that regulators carefully consider the costs associated with different disclosure requirements, because ultimately all costs borne by a fund reduce investor returns.

All of the disclosures that would be required under H.R. 2420 concern matters that are discussed in the SEC Report. The Report contains a detailed analysis of disclosure of fund operating expenses, portfolio transaction costs, portfolio manager compensation, soft dollars, and revenue sharing. We believe the SEC staff's discussion provides a sound basis on which to proceed in enhancing disclosure in these areas. Moreover, as the agency charged with administering the securities laws, we believe that the SEC should be accorded deference and granted discretion in determining in what form and in what document any new disclosures should be made. The SEC and its staff have the requisite expertise and experience to make these determinations, and to do so, after seeking public comment, based on a complete analysis of benefits and costs to funds and their shareholders.

Other more specific thoughts on this section of the bill are set forth below.

A. <u>Location of Disclosure</u>

As a general matter, we believe that funds should be permitted to include several of the proposed disclosures exclusively in the prospectus if the SEC so determines. The fund's prospectus is the document under the securities laws that is required to provide investors in mutual funds (and all issuers of securities) with all material information that is likely to be relevant to an investment decision. In 1998, the SEC substantially revised the mutual fund prospectus to simplify it and make it easier to read and understand. Key information that is necessary to assist an investor in making an investment decision should be contained in the prospectus. In addition, some of the specific disclosures need to be in the prospectus in order to put them in proper context. For example, fund prospectuses are required to disclose various information about the fund's portfolio manager. It would seem appropriate, therefore, to have any disclosure about how that person is compensated in the same document. Similarly, fund prospectuses must describe the fund's investment strategies; brokerage practices can be an important element of these strategies. Finally, including material information in a document other than the prospectus could have the perverse effect of causing investors to view that information as being more important than the prospectus disclosure. This could result in an investor, for example, focusing on disclosure relating to a fund's directed brokerage arrangements but not on the disclosure in the prospectus discussing the risks of investing in the fund.

B. Specific Disclosure Items

Estimated Dollar Amount of Operating Expenses – Section 2 would require funds to disclose the estimated dollar amount of operating expenses that are borne by each shareholder. This seems to contemplate disclosure of expenses on an individualized basis. We question both the practicability and the necessity of this requirement. As the SEC Report discusses, mutual fund investors currently receive significant disclosure about fund fees and expenses.[22] The Report describes, in particular, the fee table that is included in the front of every fund prospectus and discloses to investors all of the costs of owning the fund – both initial and ongoing – in a standardized format that is intended to facilitate cost comparisons among funds. It discloses the fund's overall expense ratio and includes a numerical example that illustrates the effect of all fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare two or more funds because it presents an "all-in" figure that takes into account both sales charges and annual fees and is expressed as a dollar amount.

In December 2002, the SEC proposed additional disclosure to enhance investors' understanding of the ongoing expenses they incur when they invest in a fund. Under the SEC's proposal, funds would have to disclose in their semi-annual and annual reports to shareholders the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the period.

The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment return.

[22] SEC Report at 9.

Because the disclosure would be based on a standardized investment amount ($10,000), it would also assist them in comparing the expenses of different funds. In addition, including this information in fund shareholder reports alongside key information about the fund's operating results, including management's discussion of the fund's performance, would allow investors to place the information in context.

The SEC Report stated that as an alternative to the proposed approach above, the SEC also considered the GAO's recommendation in its June 2000 report.[23] The GAO recommended that the SEC require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement. The SEC Report noted that there were serious problems with the GAO's alternative, including costs and logistical complexity, lack of comparability and lack of an effective context for investors to evaluate the expenses shown.

The Institute believes that the SEC should proceed with its proposal, and that Congress should study the effectiveness of the new fee disclosure initiatives in development before mandating yet another related and costly disclosure requirement. In addition, we wish to point out that requiring funds to provide only an estimate of an investor's share of the costs would only reduce the costs associated with individualized cost disclosure to a relatively small extent.[24] Also, if it were required to be disclosed in account statements, it would run the risk of

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[23] United States General Accounting Office, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition" (June 2000).

[24] A survey of industry participants conducted by the Institute in late 2000 with the assistance of an industry task force and PricewaterhouseCoopers LLP found that the aggregate costs to survey respondents associated with calculating and disclosing the actual dollar amount of fund operating expenses attributable to each investor on quarterly account statements would be $200.4 million in initial implementation costs and $65 million in annual, ongoing costs. ICI Survey on GAO Report on Mutual Fund Fees (January 31, 2001). The survey found that the costs of providing an estimate of fund operating expenses attributable to each investor would be $189.4 million in annual costs and $58.3 million in annual, ongoing costs. Because the survey respondents included only a sample of affected

confusing and misleading investors, by including an *imprecise* number in a document that otherwise contains very exact and precise numerical data, *e.g.*, number of shares owned, value of an investor's holdings. And, it still would result in disclosure of information that would make it difficult for investors to make meaningful comparisons.

Transaction Costs – Under Section 2, funds would be required to disclose transaction costs "in a manner that facilitates comparisons." The SEC Report includes a lengthy discussion of this issue, noting that that while shareholders could benefit from a better understanding of a fund's trading costs, quantitative disclosure of such costs is highly problematic. For example, the SEC Report notes that while commissions are the only type of trading cost that can be measured directly, disclosure of commissions alone would be misleading as they do not capture all trading costs, including spreads, market impact, and lost opportunity, and thus would make it difficult for investors to compare costs.[25] However, including these other costs would result in funds being forced to speculate about costs that are not quantifiable and could mislead investors, particularly when they attempt to compare costs among funds using different methods of estimation.[26] The potential benefits of complicated new disclosure requirements

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organizations, the total costs incurred by mutual funds, service providers, financial intermediaries and ultimately fund investors under either approach likely would be significantly higher.

[25] SEC Report at 28-29.

[26] The Report states that implementation shortfall may be the most all-inclusive way to measure transaction costs. *Id.* at 30. Implementation shortfall measures transaction cost as the difference between the price of each trade that was actually made and the price that prevailed in the market when the decision to trade was made. The Report acknowledges that the practical difficulties of constructing the implementation shortfall would be daunting because funds would need to collect and analyze enormous quantities of information throughout the trading process, and develop objective and verifiable criteria for determining when a trading decision has actually been made, determining when the decision has been modified or revised and selecting the figure that represents a security's market price at each of these times. In addition, determining the extent to which the fund's actual trading activity has varied from its intention would be difficult, even if new recordkeeping requirements relating to the motivations of the trade were mandated.

must be weighed against the costs – including potential unintended consequences – of providing them.

Notwithstanding these difficulties, the SEC Report identifies and evaluates several possible approaches for improving disclosure of portfolio transaction costs, including (1) giving greater prominence to the portfolio turnover ratio, (2) requiring disclosure in the prospectus of the impact the fund's management style would have on portfolio transaction costs, (3) moving information on brokerage costs from the statement of additional information to the prospectus and (4) reinstating some form of average commission rate per share disclosure. The Institute believes that these ideas are worthy of serious consideration by the SEC. The Report also states that the staff will consider whether to recommend that the SEC issue a concept release on this matter. The Institute supports the issuance of a concept release in this area in order to explore whether it is feasible to construct a transaction cost measure that is accurate, verifiable and comparable, and not overly burdensome for funds.

*"**Revenue-Sharing**"* – As explained in the SEC Report, there is competition among funds for the services of selling broker-dealers, who frequently demand compensation, or expense-sharing, for distributing fund shares and servicing shareholders beyond the amounts they receive through sales charges and fees paid from fund assets under a Rule 12b-1 plan. Thus, it is common practice in the fund industry for fund principal underwriters and/or investment

advisers to pay additional compensation to selling broker-dealers out of their own resources.[27] The bill would require disclosure concerning these payments.[28]

Disclosure concerning these additional payments to broker-dealers already is required in fund prospectuses, and the Institute agrees that general prospectus disclosure is appropriate to alert investors to the existence of the payments so that they can request additional information from their sales professionals if they so wish.

According to the SEC Report, the SEC staff is considering whether also requiring point-of-sale disclosure by broker-dealers would be appropriate. Consistent with our longstanding position on this issue,[29] the Institute believes that it would.

The NASD has previously raised the concern that these payment arrangements "may provide point-of-sales incentives that could compromise proper suitability determinations or otherwise create a perception that a [broker-dealer's] interests might not, in some circumstances, be fully aligned with the interests of customers."[30] General point-of-sale disclosure by broker-dealers of the existence of payments by fund advisers would help investors assess and evaluate recommendations to purchase fund shares.

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[27] *See id.* at 77.

[28] Specifically, Section 2(a)(5) would require disclosure of "[i]nformation concerning payments by any person other than a fund itself that are intended to facilitate the sale and distribution of the fund's shares."

[29] *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 October 15, 1997.

[30] NASD Request for Comment 97-50 (August 1997) at 409.

Breakpoint Discounts – Section 2(a)(6) of the bill would require disclosure of information concerning discounts on front-end sales loads for which investors may be eligible, including the minimum purchase amounts required for such disclosure. This requirement is intended to address concerns raised by recent regulatory examinations that found significant failures by broker-dealers to deliver such discounts to eligible investors.[31]

The Institute and its members have been working with the broker-dealer community on several levels to examine the causes for these problems and develop and implement appropriate solutions. A task force convened by the NASD that consists of regulators and representatives from the broker-dealer and fund industries, and on which I serve, is in the process of studying this issue and formulating recommendations for both regulatory and voluntary industry measures that would minimize the potential for future problems in this area. The task force is expected to issue its recommendations very shortly, and it is likely that those recommendations will include additional disclosure concerning front-end sales charge discount privileges. This is intended to help ensure that fund investors will be aware of discounts for which they may be eligible and of the need to communicate relevant information to their sales professional. We would urge Congress to review the recommendations of the task force before moving legislation to specify additional disclosure requirements.

C. Timing of Rulemaking

[31] *See* Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003). The report noted that these failures did not appear to involve intentional misconduct.

The bill would require the SEC to adopt final rules within 270 days after enactment of the legislation. This means that the entire process of studying the issues involved, developing proposed rules, soliciting public comment, analyzing the comments, making any appropriate modifications and issuing final rules would have to be completed within that period. The Institute is concerned that such a compressed time period imposes an unreasonable burden on the SEC and will likely curtail opportunities for meaningful public comment. Given the importance and complexity of the issues involved, Congress should provide a longer time period that would allow for a thorough and deliberate process rather than a rushed one. We note that, by contrast, the bill would provide an 18-month period for the SEC to conduct a study of soft dollars. It is unclear why it would be necessary to accelerate the completion of all of the stages of formal rulemaking proceedings that will involve considering and addressing several diverse topics, in half the time allotted for an agency study of one issue.[32]

IX. Independent Chair of Fund Boards

As noted above, the Institute supports appropriate measures, such as requiring two-thirds of a fund's board to be independent and making the standards for independence stricter, to further enhance the strong system of corporate governance already in place in the mutual fund industry. We do not believe, however, that requiring all fund boards to have an independent chair is necessary or appropriate.

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[32] Indeed, given the importance of the issues raised by soft dollar practices, the Committee may wish to consider setting an earlier deadline for the completion of that report.

To begin with, having an independent chair might be counterproductive and impractical. For example, a management representative, due to his or her knowledge of the details of a fund's operations, will often be a more effective chair. It is likely that, for reasons such as this, an independent chair has not been among the many corporate governance reforms that are currently under consideration by the major securities self-regulatory organizations. We can think of no reasons why different considerations should apply in the case of mutual funds.

Indeed, if anything, the concerns that proponents of requiring an independent chair seek to address are *already* addressed in an effective manner by existing legal requirements and industry practices that bolster the independence and authority of fund independent directors. For example, the Investment Company Act requires a separate vote of the independent directors to approve certain important decisions, such as the 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.

Moreover, best practices followed by many boards further reinforce the independence and authority of the independent directors. As noted above, while virtually all funds are required to have a majority of independent directors, many boards actually have a super-majority of independent directors. In addition, many have meetings of the independent directors separately from management on a regular basis, and many have a lead independent director.[33] As noted in the SEC Report, "a lead director can coordinate the activities of the independent directors, act as a spokesperson for the independent directors in between meetings

[33] Each of these practices was recommended by the Advisory Group on Best Practices for Fund Directors. *See* Best Practices Report at 10 (super-majority), 24 (separate meetings of independent directors), and 25 (lead independent director or directors).

of the board, raise and discuss issues with counsel on behalf of the independent directors and chair separate meetings of the independent directors."[34] We believe that this combination of regulatory mandates and industry best practices, which go beyond those of operating companies, make an independent chair unnecessary.

X. Conclusion

The Institute appreciates the opportunity to testify before the Subcommittee. We fully support all appropriate initiatives to promote investor confidence in mutual funds. We stand ready to work with the Subcommittee and the SEC to achieve this shared goal.

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[34] SEC Report at 51.