On June 9, 2003, William H. Donaldson, the Chairman of the Securities and Exchange Commission (the "SEC"), forwarded to Congressman Richard H. Baker, Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, a 120-page memorandum (the "Memorandum") prepared by the SEC's Division of Investment Management (the "Division") that responded to a series of questions posed by the Congressman. Congressman Baker immediately introduced a bill (the "Bill") to amend the federal securities laws, including the Investment Company Act of 1940 (the "1940 Act").[1] While substantial portions of the Memorandum summarize existing law and regulations, the following observations by the Division are significant:

- The Division said that "step-outs" used to reward brokers selling fund shares represent a use of fund assets for sales and are required to be covered by a distribution plan under Rule 12b-1 under the 1940 Act.

- The Division stated that it believes advisers "must provide" information about soft dollar practices and fund directors "must assess" the use of soft dollars when evaluating the amount of the adviser's compensation.

- The Division affirmed that bundled fees, such as platform fees, can be allocated by fund directors between distribution and non-distribution expenses.

- The Division generally favored more prospectus disclosure as a solution for apparent investor confusion concerning brokerage and other costs.

- The Division asserts that quantifying transaction costs is "problematic" and "daunting" and that existing methodologies lack the important attributes of "uniformity, reliability and verifiability." Interestingly, the Bill ignores these concerns and mandates promulgation of regulations requiring disclosure, in a new document, of all transaction costs "in a manner that facilitates comparison."

- The Division stated that it believes fund directors "should oversee the administration of [sales load] breakpoint discounts" and expects boards "to review the adequacy of their funds' policies and procedures" and "obtain assurances" from the fund's underwriter.

- The Division explained that boards dissatisfied with fund performance have several options short of terminating an advisory contract, since termination "may not necessarily be in the best interest of the fund" given "potential costs and disruption."

These matters and other highlights of the Memorandum and the Bill are summarized below:

1. Expenses. In response to the Congressman's suggestion that there had been an upward trend in mutual fund fees, the Division stated that it was "not clear" that there had been an increase in the overall costs of owning mutual fund shares (as measured both by reference to expense ratios and on an all-in basis

[1] The Bill is called the "Mutual Funds Integrity and Fee Transparency Act of 2003."

that includes sales loads). The Memorandum notes competition both within the mutual fund industry and outside, including competition from wrap accounts and on-line trading accounts. The Division pointed to empirical evidence suggesting there is "significant competition based on costs in the fund industry," but conceded that broker-dealers with large retail networks have "significant leverage" because of the limited number of fund share distribution systems.

The Bill calls for SEC regulations mandating disclosure by mutual funds of the estimated dollar amount of operating expenses that are borne by each shareholder.

2. Costs of Trading. The Division agreed with the premise of Congressman Baker's inquiry that shareholders need a better understanding of mutual fund trading costs, but concluded that quantitative disclosure of trading costs is "problematic." The Division characterized the practical difficulties as "daunting" and said that while quantitative disclosure is "attractive in theory," it was unfeasible given that estimates of certain elements of transaction costs "lack the attributes of uniformity, reliability and verifiability."

The Memorandum includes a helpful description of four different kinds of trading costs: (i) commission costs, which are the per-share charges that a broker collects for acting as agent; (ii) spread costs, reflecting the difference between bid and asked prices paid by a buyer or seller in a principal transaction; (iii) market impact costs, which are the changes in security prices as a result of efforts to purchase or sell; and (iv) opportunity costs, representing the costs of delayed or missed trades.

In this connection, the Division did note that consultants and academics have derived estimates of total costs by comparing actual transaction prices with market prices prevailing sometime before or after the transaction. The Division observed, however, that spread costs, market impact costs and opportunity costs could "only be roughly estimated." The Division concluded that "additional numerical disclosure of trading costs would result either in a number that would be comparable and verifiable, but incomplete [if it included only commission costs], or a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund [if it attempted to included spread, market impact and opportunity costs]."

The Division also said that it would consider recommending that the SEC issue a concept release on approaches to shareholder disclosure of brokerage expenses, including possible qualitative self-categorization by mutual funds in their prospectuses (e.g., "very high, high, average, low or very low" transaction costs).

The Division indicated that it would consider recommending enhanced disclosure in mutual fund prospectuses, including: (i) moving information on brokerage costs from the Statement of Additional Information (the "SAI") to the prospectus; (ii) requiring a discussion of transaction costs and portfolio turnover in the prospectus; (iii) moving the portfolio turnover rate from the SAI to the prospectus; and (iv) reinstating the requirement that a fund disclose its average brokerage commission rate per share. As most of these items were previously required under Form N-1A or are currently required to be disclosed in the SAI, any changes in this area would represent the latest example of so-called "prospectus creep."

The Bill calls for the SEC to adopt regulations requiring disclosure of "transaction costs . . . including commissions . . . set forth in a manner that facilitates comparison among [funds]."

3. Soft Dollars and Related Conflicts. The Division noted that by suspending fiduciary principles and other applicable law, the safe harbor in Section 28(e) of the Securities and Exchange Act of 1934 (the "1934 Act") shifts the responsibility to advisory clients, including fund boards, to supervise their money managers' use of soft dollars and the resulting conflicts of interest. The Division discussed the role of fund directors in overseeing brokerage and, based on the reciprocal obligations of investment advisers and the board under Section 15(c) of the 1940 Act, concluded that "mutual fund advisers that have soft dollar arrangements must provide their funds' boards with information regarding their soft dollar practices" and that directors "must assess the fund adviser's use of soft dollars when evaluating the amount of the adviser's compensation." The Memorandum does not detail the kind of information that "must" be provided, but refers to a 1998 SEC report describing the results of an industry-wide inspection. The Bill would amend Section 15 of the 1940 Act to impose on fund directors a fiduciary duty to supervise the adviser's direction of the fund's brokerage transactions, including directed brokerage and soft dollar arrangements, and to determine that the direction of such brokerage is in the best interests of shareholders of the fund. The Bill also calls for the SEC to adopt regulations requiring that funds disclose their policies and practices with respect to the payment of brokerage commissions under soft dollar arrangements.

The Memorandum describes existing disclosure obligations as well as rules pending under the Investment Advisers Act of 1940 that would require additional disclosure by registered investment advisers.2 The Division concluded, however, that disclosure alone is not enough and called for congressional reexamination of Section 28(e) of the 1934 Act. In that context, the Division also noted that the United Kingdom's Financial Services Authority had released a study in April, 2003 that recommended that money managers not be able to purchase with client commissions "goods and services for which demand is reasonably predictable." The Bill calls for a study of Section 28(e) and mandates that the SEC submit a report to Congress within 18 months of the enactment of the Bill.

4. Rule 12b-1 Distribution Issues. The Memorandum highlights a number of changes in marketing and distribution practices that did not exist when Rule 12b-1 was adopted, including the existence of multiple class arrangements, fund supermarkets, the financing of 12b-1 fees by distributors and the compensation of broker-dealers' distribution activities with portfolio brokerage. The Memorandum suggests that, in some instances, these practices could lead to (i) permanency of 12b-1 plans, (ii) difficulty in distinguishing between distribution and non-distribution related services in the fund supermarket context, (iii) negating a board's ability to terminate a 12b-1 plan when future 12b-1 fees have been pledged to a third party and/or (iv) a need to reflect in 12b-1 distribution plans the payment of brokerage commissions used to compensate broker-dealers for distribution activities. The Division reiterated that, in the case of bundled fees (e.g., fund platform fees), the directors "can" scrutinize the arrangements to allocate the portion of the fee "that is for distribution and thus is includable in a 12b-1 plan." The Memorandum notes that although the Division has provided guidance on distribution expenses, questions still remain on how to determine whether a particular activity is primarily intended to result in the sale of fund shares. The Memorandum notes that in December 2000, the SEC's Staff recommended reviewing and amending the requirements of Rule 12b-1 and states that the Division will continue to assess the issues raised by Rule 12b-1, including the changes in fund distribution practices over the last twenty years.

Importantly, the Memorandum states the Division's belief that certain arrangements under which funds direct brokerage commissions that they pay on portfolio transactions to compensate brokers for distribution of

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[2] See Investment Advisers Act Release No. 1862 (April 5, 2000).

fund shares should be reflected in Rule 12b-1 plans. The Division gave as an example of such an arrangement, a so-called "step-out" transaction, in which the fund instructs the executing broker to pay a portion of the commission to a broker-dealer that sells the fund's shares, but performs no execution-related services in connection with portfolio transactions. The Memorandum states the Division's intent to recommend that the SEC take action to clarify the circumstances under which "the use of brokerage commissions to facilitate the distribution of fund shares should be reflected in a [R]ule 12b-1 plan."

5. Revenue-Sharing Payments. The Memorandum discusses "revenue-sharing" payments by investment advisers from their own resources to finance the distribution of fund shares and warns that shareholders may bear the costs of revenue-sharing payments through higher advisory fees. In the SEC's view, any allowance made in a fund's investment advisory fee to provide resources to finance the distribution of fund shares would involve an indirect use of fund assets to finance distributions requiring compliance with Rule 12b-1. Alternatively, revenue-sharing payments do not involve an indirect use of a fund's assets if the payments are made from the profits of an investment advisory fee that are "legitimate." According to the Division, a fund's board must determine whether revenue-sharing payments constitute an indirect use of fund assets and, if so, whether they are made in accordance with Rule 12b-1.

The Memorandum states that the SEC has recognized that fund prospectuses are "not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue-sharing payments to meet the requirements of Rule 10b-10 under the 1934 Act." It notes that the SEC Staff has been directed to make recommendations regarding improvements in disclosure and is considering the appropriateness of disclosure at the "point-of-sale" and in subsequent "periodic filings."

The Bill would address the disclosure side of the revenue-sharing issue through the requirement of "improved disclosure" in the quarterly statements, shareholder reports or other "appropriate disclosure documents" (specifically excluding the prospectus and SAI) concerning "payments by any person other than the . . . [fund] that are intended to facilitate the sale and distribution of the . . . [fund's] shares." The Bill would also amend Section 15 of the 1940 Act to impose on fund directors a fiduciary duty to supervise revenue-sharing arrangements.

6. Substantive Board Oversight. The Memorandum briefly summarizes fund directors' fiduciary duties of care and loyalty, as well as the business judgment rule. In describing fund directors' responsibilities in overseeing advisory relationships, the Memorandum adopts the Gartenberg standard, i.e., whether the adviser's compensation "is so disproportionately large that it bears no reasonable relationship to the services rendered, and could not have been the product of arms' length bargaining." The Memorandum states that fund directors "must continue to exercise vigilance in monitoring the fees and expenses of the funds they oversee and ensure that an appropriate portion of the cost savings achievable from economies of scale is passed along to fund shareholders." The Memorandum notes that the Division is considering whether Staff review of board contract review functions would be facilitated by record-keeping requirements relating to information used to evaluate fund fees and expenses, as well as transaction costs and other costs not reflected in a fund's expense ratio.

With respect to the Division's experience with SAI discussion of the factors the fund's directors considered in approving a fund's advisory agreement, the Division stated that the better disclosure addressed which specific factors were most significant, discussed the quality of specific services provided, including the adviser's performance, and provided a "non-cursory" comparison of the fund's advisory fees to those of other similar funds (without naming them).

While the Memorandum acknowledges that advisory agreements are infrequently terminated by fund directors, it notes that fund directors can and do frequently employ means short of termination to benefit funds and their shareholders. The Memorandum states that if the fund's directors are not satisfied with the investment adviser's performance, "termination of the contract is not the only course of action," and "may not necessarily be in the best interests of the fund." The Memorandum also states that, in deciding whether to terminate an advisory agreement, a fund's directors should consider whether the benefits of termination outweigh the potential costs and disruption associated with termination, and notes that the SEC and the courts have traditionally avoided substituting their judgment for that of fund directors with respect to the approval of advisory agreements. Steps short of termination mentioned by the Division included: renegotiating the terms of the advisory agreement by adjusting the fee structure or including a performance fee component; requiring the adviser to take appropriate steps to improve performance, such as hiring a new portfolio manager, adopting a team approach to portfolio management or increasing investment research capacity; retaining a sub-adviser; merging or liquidating a fund; or closing a fund to new investors.

As noted elsewhere in sections 3, 4, 5 and 7 of this Client Alert, the Memorandum also discusses board oversight in the specific context of fund brokerage and other transaction costs; sales load breakpoints; distribution expenses and revenue sharing; and portfolio brokerage as a reward for fund sales.

7. Role of Directors Regarding Sales Load "Breakpoint" Discounts. The Division acknowledged the practical limitations on the ability of fund organizations to police dealer practices. Nonetheless, the Memorandum asserts that directors have "oversight" responsibilities concerning front-end sales loads ("FESLs") and breakpoint discounts. Directors' fiduciary responsibilities include an obligation to become involved in overseeing operational matters where problems have been identified. The Division believes that, accordingly, "fund boards should oversee the administration of breakpoint discounts." The Memorandum states that the Division "expect[s] . . . boards to review the adequacy of their funds' policies and procedures relating to FESLs" and that "it would seem appropriate" for boards to obtain assurances – through the funds' underwriters – that selling dealers have adequate policies and procedures in place to ensure that shareholders receive their discounts. The Division recommended that the SEC consider requiring that fund disclosure of breakpoint discounts be moved from the SAI to the prospectus.

The Bill would address this issue through the requirement of "improved disclosure" of information concerning discounts in the quarterly statements, shareholder reports or other appropriate disclosure documents (other than the prospectus or SAI).

8. Board Governance. The Memorandum notes that Congress could consider amending Section 10(a) of the 1940 Act to require that a majority of a fund directors not be "interested persons" of the fund, thereby giving independent directors control of the fund's "corporate machinery." The Bill would require that at least two-thirds of the directors of a fund be independent. The Memorandum also requests that Congress consider a revision to Section 2(a)(19) of the 1940 Act that would give the SEC rulemaking authority to classify as "interested persons" additional classes of directors whose relationships suggest a lack of independence from fund management, such as former executives of the fund's adviser and more remote relatives (in addition to "immediate family" members) of fund managers. The Bill would give the SEC rulemaking authority to expand the definition of interested persons to include any class of natural persons

that the SEC determines is unlikely to exercise an appropriate degree of independence as a result of (i) a material business relationship with the fund or any affiliated person thereof or (ii) a close familial relationship with any natural person who is an affiliated person of the fund. The Bill would delete references to broker-dealers and lenders from the definition of "interested persons" but would permit the SEC, through rulemaking authority, to amend the definition of "interested persons" to include persons with such material business relationships.

The Division questioned the need to mandate that a fund's chairman be independent, given that almost all fund boards currently have at least a majority of independent directors, and many have already designated one or more "lead" independent directors. The Bill would prohibit any interested person of a fund from serving as chairman of its board.

In discussing the audit committee requirements of Section 301 of the Sarbanes-Oxley Act of 2002 (e.g., giving the committee power to retain auditors and other experts), which currently apply only to "listed issuers," including most closed-end funds, the Memorandum states the Division's belief that extending those requirements to mutual funds could benefit fund investors. The Bill would amend Section 32 of the 1940 Act to impose audit committee requirements similar to those of Section 301 of the Sarbanes-Oxley Act of 2002.

9. Fund Performance and Incubation. The Memorandum addresses concerns regarding investors' heavy emphasis on past performance when selecting mutual fund investments. It notes that mutual funds disclose as much, if not more, information about their performance than other types of financial products and services. The Division did express concern with several aspects of fund performance disclosure, including unusual circumstances that contribute to fund performance, the shelf life of performance information and the selective use of performance data. In May 2002, the SEC proposed amendments to its mutual fund advertising rules to address these concerns. The proposed amendments, which the Division expects the SEC to adopt shortly, (i) re-emphasize that fund advertisements are subject to the anti-fraud provisions of the federal securities laws, (ii) require funds that advertise performance information to make available total returns that are current to the most recent month-end and (iii) require improved explanatory information.

The Memorandum acknowledges the potential for an adviser to defraud its clients by preferring incubator funds in IPO allocations and references the Van Kampen and Dreyfus enforcement proceedings.

10. Portfolio Manager Compensation/Fund Holdings. The Memorandum suggests that disclosure regarding the structure of a portfolio manager's compensation might assist shareholders in discerning a manager's alignment with fund shareholders' interests. Specifically, the Memorandum mentions that the compensation structure could shed light on a manager's incentive to manage with a short- or long-term horizon and to maximize pre- or after-tax profits. The Memorandum also notes that disclosing a portfolio manager's fund share holdings could provide shareholders with insight into the manager's level of confidence in the fund. The Bill calls for the SEC to adopt regulations requiring funds to disclose the structure of, or method used to determine, the compensation of fund portfolio managers.

11. Proxy Voting. The Memorandum discusses the procedural history of the recently adopted rules requiring mutual funds to disclose proxy votes and proxy voting policies. The Division identified three modifications made to the final rule to address concerns expressed by the industry. These modifications

include (i) the filing of an annual, rather than semi-annual, proxy voting record; (ii) the ability for a fund to make its proxy voting record available to shareholders on its website, rather than mailing the record to shareholders; and (iii) the elimination of the proposed requirement that a fund disclose in its annual and semi-annual reports proxy votes that are inconsistent with the fund's proxy voting policies and procedures.

12. Fair Valuation. The Memorandum outlines existing guidelines governing the fair valuation of a fund's portfolio securities.