108TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPORT
108–351

MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

NOVEMBER 4, 2003.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. OXLEY, from the Committee on Financial Services, submitted the following

R E P O R T

[To accompany H.R. 2420]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 2420) to improve transparency relating to the fees and costs that mutual fund investors incur and to improve corporate governance of mutual funds, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

CONTENTS

	Page
Amendment	1
Purpose and Summary	8
Background and Need for Legislation	9
Hearings	22
Committee Consideration	22
Committee Votes	23
Committee Oversight Findings	23
Performance Goals and Objectives	23
New Budget Authority, Entitlement Authority, and Tax Expenditures	24
Committee Cost Estimate	24
Congressional Budget Office Cost Estimate	24
Federal Mandates Statement	25
Advisory Committee Statement	25
Constitutional Authority Statement	25
Applicability to Legislative Branch	26
Section-by-Section Analysis	26
Changes in Existing Law Made by the Bill, as Reported	32

AMENDMENT

The amendment is as follows:

29–006

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Mutual Funds Integrity and Fee Transparency Act of 2003".

SEC. 2. IMPROVED TRANSPARENCY OF MUTUAL FUND COSTS.

(a) REGULATION REVISION REQUIRED.—Within 270 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940, or any combination thereof, to require, consistent with the protection of investors and the public interest, improved disclosure with respect to an open-end management investment company, in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document, of the following:

(1) The estimated amount, in dollars for each $1,000 of investment in the company, of the operating expenses of the company that are borne by shareholders.

(2) The structure of, or method used to determine, the compensation of individuals employed by the investment adviser of the company to manage the portfolio of the company, and the ownership interest of such individuals in the securities of the company.

(3) The portfolio turnover rate of the company, set forth in a manner that facilitates comparison among investment companies, and a description of the implications of a high turnover rate for portfolio transaction costs and performance.

(4) Information concerning the company's policies and practices with respect to the payment of commissions for effecting securities transactions to a member of an exchange, broker, or dealer who—

(A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;

(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(C) facilitates the sale and distribution of the company's shares.

(5) Information concerning payments by any person other than the company that are intended to facilitate the sale and distribution of the company's shares.

(6) Information concerning discounts on front-end sales loads for which investors may be eligible, including the minimum purchase amounts required for such discounts.

(b) APPROPRIATE DISCLOSURE DOCUMENT.—

(1) IN GENERAL.—For purposes of subsection (a), a disclosure shall not be considered to be made in an appropriate disclosure document if the disclosure is made exclusively in a prospectus or statement of additional information, or both such documents.

(2) EXCEPTIONS.—Notwithstanding paragraph (1), the disclosures required by paragraph (2) and (4) of subsection (a) may be considered to be made in an appropriate disclosure document if the disclosure is made exclusively in a prospectus or statement of additional information, or both such documents.

(c) CONCEPT RELEASE REQUIRED.—

(1) IN GENERAL.—The Commission shall issue a concept release examining the issue of portfolio transaction costs incurred by investment companies, including commission, spread, opportunity, and market impact costs, with respect to trading of portfolio securities and how such costs may be disclosed to mutual fund investors in a manner that will enable investors to compare such costs among funds.

(2) REPORT AND RECOMMENDATIONS REQUIRED.—The Commission shall submit a report on the findings from the concept release required by paragraph (1), as well as legislative and regulatory recommendations, if any, to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, no later than 270 days after the date of enactment of this Act.

(d) ADDITIONAL REQUIREMENT FOR FEE STATEMENT.—

(1) IN GENERAL.—Not later than 270 days after the date of enactment of this Act, the Commission shall prescribe a rule to require, with respect to an open-end management investment company, in the quarterly statement or other periodic report, or other appropriate disclosure document, a statement informing

shareholders that such shareholders have paid fees on their investments, that such fees have been deducted from the amounts shown on the statements, and where such shareholders may find additional information regarding the amount of these fees.

(2) APPROPRIATE DISCLOSURE DOCUMENT.—The statement required by paragraph (1) shall not be considered to be made in an appropriate disclosure document unless such statement is—

(A) made in each periodic statement to a shareholder that discloses the value of the holdings of the shareholder in the securities of the company; and

(B) prominently displayed, in a location in close proximity to the statement of the shares account value.

(e) REDUCING BURDENS ON SMALL FUNDS.—In prescribing rules under this section, the Commission shall give consideration to methods for reducing for small investment companies the burdens of making the disclosures required by such rules, consistent with the public interest and the protection of investors.

SEC. 3. OBLIGATIONS REGARDING CERTAIN DISTRIBUTION AND SOFT DOLLAR ARRANGEMENTS.

(a) REPORTING REQUIREMENT.—Section 15 of the Investment Company Act of 1940 (15 U.S.C. 80a–15) is amended by adding at the end the following new subsection:

"(g) OBLIGATIONS REGARDING CERTAIN DISTRIBUTION AND SOFT DOLLAR ARRANGEMENTS.—

"(1) REPORTING REQUIREMENTS.—Each investment adviser to a registered investment company shall, no less frequently than annually, submit to the board of directors of the company a report on—

"(A) payments during the reporting period by the adviser (or an affiliated person of the adviser) that were directly or indirectly made for the purpose of promoting the sale of shares of the investment company (referred to in paragraph (2) as a 'revenue sharing arrangement');

"(B) services to the company provided or paid for by a broker or dealer or an affiliated person of the broker or dealer (other than brokerage and research services) in exchange for the direction of brokerage to the broker or dealer (referred to in paragraph (2) as a 'directed brokerage arrangement'); and

"(C) research services obtained by the adviser (or an affiliated person of the adviser) during the reporting period from a broker or dealer the receipt of which may reasonably be attributed to securities transactions effected on behalf of the company or any other company that is a member of the same group of investment companies (referred to in paragraph (2) as a 'soft dollar arrangement').

"(2) FIDUCIARY DUTY OF BOARD OF DIRECTORS.—The board of directors of a registered investment company shall have a fiduciary duty—

"(A) to review the investment adviser's direction of the company's brokerage transactions, including directed brokerage arrangements and soft dollar arrangements, and to determine that the direction of such brokerage is in the best interests of the shareholders of the company; and

"(B) to review any revenue sharing arrangements to ensure compliance with this Act and the rules adopted thereunder, and to determine that such revenue sharing arrangements are in the best interests of the shareholders of the company.

"(3) SUMMARIES OF REPORTS IN ANNUAL REPORTS TO SHAREHOLDERS.—In accordance with regulations prescribed by the Commission under paragraph (4), annual reports to shareholders of a registered investment company shall include a summary of the most recent report submitted to the board of directors under paragraph (1).

"(4) REGULATIONS.—The Commission shall adopt rules and regulations implementing this section, which rules and regulations shall, among other things, prescribe the content of the required reports.

"(5) DEFINITION.—For purposes of this subsection—

"(A) the term 'brokerage and research services' has the same meaning as in section 28(e)(3) of the Securities Exchange Act of 1934; and

"(B) the term 'research services' means the services described in subparagraphs (A) and (B) of such section.".

(b) CONTRACTUAL RECORDS.—Within 270 days after the date of enactment of this Act, the Securities and Exchange Commission shall, by rule prescribed pursuant to section 28(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(e)), require that—

(1) if any research services (as such term is defined in section 15(g)(5)(B) of the Investment Company Act of 1940, as amended by subsection (a) of this section)—

(A) are provided by a member of an exchange, broker, or dealer who effects securities transactions in an account, and

(B) are prepared or provided by a party that is unaffiliated with such member, broker, or dealer,

any person exercising investment discretion with respect to such account shall maintain a copy of the written contract between the person preparing such research and the member of an exchange, broker, or dealer; and

(2) such contract shall describe the nature and value of the services provided.

SEC. 4. MUTUAL FUND GOVERNANCE.

(a) DIRECTOR INDEPENDENCE.—Section 10(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–10) is amended by striking "60 per centum" and inserting "one-third".

(b) DEFINITION OF INTERESTED PERSON.—Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(19)) is amended—

(1) in subparagraph (A)—

(A) by striking clause (vi) and redesignating clause (vii) as clause (vi); and

(B) by amending clause (v) to read as follows:

"(v) any natural person who is a member of a class of persons who the Commission, by rule or regulation, determines are unlikely to exercise an appropriate degree of independence as a result of—

"(I) a material business or professional relationship with the company or any affiliated person of the company, or

"(II) a close familial relationship with any natural person who is an affiliated person of the company,"; and

(2) in subparagraph (B)—

(A) by striking clause (vi) and redesignating clause (vii) as clause (vi); and

(B) by amending clause (v) to read as follows:

"(v) any natural person who is a member of a class of persons who the Commission, by rule or regulation, determines are unlikely to exercise an appropriate degree of independence as a result of—

"(I) a material business or professional relationship with such investment adviser or principal underwriter (or affiliated person thereof), or

"(II) a close familial relationship with a natural person who is such investment adviser or principal underwriter (or affiliated person thereof),".

SEC. 5. AUDIT COMMITTEE REQUIREMENTS FOR INVESTMENT COMPANIES.

(a) AMENDMENTS.—Section 32 of the Investment Company Act of 1940 (15 U.S.C. 80a–31) is amended—

(1) in subsection (a)—

(A) by striking paragraphs (1) and (2) and inserting the following:

"(1) such accountant shall have been selected at a meeting held within 30 days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of the members of the audit committee of such registered company;

"(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of the members of the audit committee of such registered company, cast in person at a meeting called for the purpose of voting on such action;"; and

(B) by adding at the end the following new sentence: "The Commission, by rule, regulation, or order, may exempt a registered management company or registered face-amount certificate company subject to this subsection from the requirement in paragraph (1) that the votes by the members of the audit committee be cast at a meeting in person when such a requirement is impracticable, subject to such conditions as the Commission may require."; and

(2) by adding at the end the following new subsection:

"(d) AUDIT COMMITTEE REQUIREMENTS.—

"(1) REQUIREMENTS AS PREREQUISITE TO FILING FINANCIAL STATEMENTS.—Any registered management company or registered face-amount certificate company that files with the Commission any financial statement signed or certified by

an independent public accountant shall comply with the requirements of paragraphs (2) through (6) of this subsection and any rule or regulation of the Commission issued thereunder.

"(2) RESPONSIBILITY RELATING TO INDEPENDENT PUBLIC ACCOUNTANTS.—The audit committee of the registered company, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any independent public accountant employed by such registered company (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing the audit report or related work, and each such independent public accountant shall report directly to the audit committee.

"(3) INDEPENDENCE.—

"(A) IN GENERAL.—Each member of the audit committee of the registered company shall be a member of the board of directors of the company, and shall otherwise be independent.

"(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of a registered company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

"(i) accept any consulting, advisory, or other compensatory fee from the registered company or the investment adviser or principal underwriter of the registered company; or

"(ii) be an 'interested person' of the registered company, as such term is defined in section 2(a)(19).

"(4) COMPLAINTS.—The audit committee of the registered company shall establish procedures for—

"(A) the receipt, retention, and treatment of complaints received by the registered company regarding accounting, internal accounting controls, or auditing matters; and

"(B) the confidential, anonymous submission by employees of the registered company and its investment adviser or principal underwriter of concerns regarding questionable accounting or auditing matters.

"(5) AUTHORITY TO ENGAGE ADVISERS.—The audit committee of the registered company shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

"(6) FUNDING.—The registered company shall provide appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation—

"(A) to the independent public accountant employed by the registered company for the purpose of rendering or issuing the audit report; and

"(B) to any advisers employed by the audit committee under paragraph (5).

"(7) AUDIT COMMITTEE.—For purposes of this subsection, the term 'audit committee' means—

"(A) a committee (or equivalent body) established by and amongst the board of directors of a registered investment company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; and

"(B) if no such committee exists with respect to a registered investment company, the entire board of directors of the company.".

(b) CONFORMING AMENDMENT.—Section 10A(m) of the Securities Exchange Act of 1934 is amended by adding at the end the following new paragraph:

"(7) EXEMPTION FOR INVESTMENT COMPANIES.—Effective one year after the date of enactment of the Mutual Funds Integrity and Fee Transparency Act of 2003, for purposes of this subsection, the term 'issuer' shall not include any investment company that is registered under section 8 of the Investment Company Act of 1940.".

(c) IMPLEMENTATION.—Not later than 180 days after the date of enactment of this Act, the Securities and Exchange Commission shall issue final regulations to carry out section 32(d) of the Investment Company Act of 1940, as added by subsection (a) of this section.

SEC. 6. TRADING RESTRICTIONS.

Subsection (e) of section 22 of the Investment Company Act of 1940 (15 U.S.C. 80a–22(e)) is amended to read as follows:

"(e) TRADING RESTRICTIONS.—

"(1) PROHIBITION AND EXCEPTIONS.—No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for

more than seven days after the tender of such security to the company or its agents designated for that purpose for redemption, except—

"(A) for any period (i) during which the principal market for the securities in which the company invests is closed, other than customary week-end and holiday closings; or (ii) during which trading on such exchange is restricted;

"(B) for any period during which an emergency exists as a result of which (i) disposal by the company of securities owned by it is not reasonably practicable; or (ii) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

"(C) for such other periods as the Commission may by order permit for the protection of security holders of the company.

"(2) COMMISSION RULES.—The Commission shall by rules and regulations—

"(A) determine the conditions under which trading shall be deemed to be restricted;

"(B) determine the conditions under which an emergency shall be deemed to exist; and

"(C) provide for the determination by each company, subject to such limitations as the Commission shall determine are necessary and appropriate for the protection of investors, of the principal market for the securities in which the company invests.".

SEC. 7. DEFINITION OF NO-LOAD MUTUAL FUND.

Within 270 days after the date of enactment of this Act, the Securities and Exchange Commission shall, by rule adopted by the Commission or a self-regulatory organization (or both)—

(1) clarify the definition of "no-load" as such term is used by investment companies that impose any fee under a plan adopted pursuant to rule 12b–1 of the Commission's rules (17 CFR 270.12b–1); and

(2) require disclosure to prevent investors from being misled by the use of such terminology by the company or its adviser or principal underwriter.

SEC. 8. INFORMING DIRECTORS OF SIGNIFICANT DEFICIENCIES.

Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a–41) is amended by adding at the end the following new subsection:

"(f) INFORMING DIRECTORS OF SIGNIFICANT DEFICIENCIES.—If the report of an inspection by the Commission of a registered investment company identifies significant deficiencies in the operations of such company, or of its investment adviser or principal underwriter, the company shall provide such report to the directors of such company.".

SEC. 9. EXEMPTION FROM IN PERSON MEETING REQUIREMENTS.

Section 15(c) of the of the Investment Company Act of 1940 (15 U.S.C. 80a–15(c)) is amended by adding at the end the following new sentence: "The Commission, by rule, regulation, or order, may exempt a registered investment company subject to this subsection from the requirement that the votes of its directors be cast at a meeting in person when such a requirement is impracticable, subject to such conditions as the Commission may require.".

SEC. 10. PROXY VOTING DISCLOSURE.

Section 30 of the Investment Company Act of 1940 (15 U.S.C. 80a–29) is amended by adding at the end the following new subsection:

"(k) PROXY VOTING DISCLOSURE.—Every registered management investment company, other than a small business investment company, shall file with the Commission not later than August 31 of each year an annual report, on a form prescribed by the Commission by rule, containing the registrant's proxy voting record for the most recent twelve-month period ending on June 30. The financial statements of every such company shall state that information regarding how the company voted proxies relating to portfolio securities during the most recent 12-month period ending on June 30 is available—

"(1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; or on or through the company's website at a specified Internet address; or both; and

"(2) on the Commission's website.".

SEC. 11. ETHICS COMPLIANCE BY MUTUAL FUNDS.

Within 270 days after the date of enactment of this Act, the Commission shall, by rule pursuant to the Investment Company Act of 1940 and the Investment Advisers Act of 1940, require each investment company and investment adviser registered with the Commission—

(1) to adopt and implement policies and procedures reasonably designed to prevent violation of the Securities Act of 1933 (15 U.S.C. 78a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b et seq.), the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.), subchapter II of chapter 53 of title 31, United States Code, chapter 2 of title I of Public Law 91–508 (12 U.S.C. 1951 et seq.), or section 21 of the Federal Deposit Insurance Act (12 U.S.C. 1829b);

(2) review those policies and procedures annually for their adequacy and the effectiveness of their implementation; and

(3) appoint a chief compliance officer to be responsible for administering the policies and procedures.

SEC. 12. INCENTIVE COMPENSATION AND MUTUAL FUND SALES.

(a) COMMISSION RULE REQUIRED.—Within 270 days after the date of enactment of this Act, the Commission shall by rule prohibit, as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices, the sale of the securities of an investment company or of municipal fund securities by a broker or dealer or by a municipal securities broker or dealer without the disclosure of—

(1) the amount and source of sales fees, payments by persons other than the investment company that are intended to facilitate the sale and distribution of the securities, and commissions for effecting portfolio securities transactions, or other payments, paid to such broker or dealer, or municipal securities broker or dealer, or associated person thereof in connection with such sale;

(2) any commission or other fees or charges the investor has paid or will or might be subject to, including as a result of purchases or redemptions;

(3) any conflicts of interest that any associated person of the investor's broker or dealer or municipal securities broker or dealer may face due to the receipt of differential compensation in connection with such sale; and

(4) information about the estimated amount of any asset-based distribution expenses incurred, or to be incurred, by the investment company in connection with the investor's purchase of the securities.

(b) BENCHMARKS.—In connection with the rule required by subsection (a), the Commission shall, to the extent practical, establish standards for such disclosures.

(c) DEFINITIONS.—

(1) DIFFERENTIAL COMPENSATION.—For purposes of this section, an associated person of a broker or dealer shall be considered to receive differential compensation if such person receives any increased or additional remuneration, in whatever form—

(A) for sales of the securities of an investment company or municipal fund security that is affiliated with, or otherwise specifically designated by, such broker or dealer or municipal securities broker or dealer, as compared with the remuneration for sales of securities of an investment company or municipal fund security offered by such broker or dealer or municipal securities broker or dealer that are not so affiliated or designated; or

(B) for the sale of any class of securities of an investment company or municipal fund security as compared with the remuneration for the sale of a class of securities of such investment company or municipal fund security (offered by such broker or dealer or municipal securities broker or dealer) that charges a sales load (as defined in section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(35)) only at the time of such a sale.

(2) MUNICIPAL FUND SECURITY.—For purposes of this section, a municipal fund security is any municipal security issued by an issuer that, but for the application of section 2(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(b)), would constitute an investment company within the meaning of section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3).

SEC. 13. COMMISSION STUDY AND REPORT REGULATING SOFT DOLLAR ARRANGEMENTS.

(a) STUDY REQUIRED.—

(1) IN GENERAL.—The Commission shall conduct a study of the use of soft dollar arrangements by investment advisers as contemplated by section 28(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(e)).

(2) AREAS OF CONSIDERATION.—The study required by this section shall examine—

(A) the trends in the average amounts of soft dollar commissions paid by investment advisers and investment companies in the past 3 years;

(B) the types of services provided through soft dollar arrangements;

(C) the benefits and disadvantages of the use of soft dollars for investors, including the extent to which use of soft dollar arrangements affects the ability of mutual fund investors to evaluate and compare the expenses of different mutual funds;

(D) the potential or actual conflicts of interest (or both potential and actual conflicts) created by soft dollar arrangements, including whether certain potential conflicts are being managed effectively by other laws and regulations specifically addressing those situations, the role of the board of directors in managing these potential or actual (or both) conflicts, and the effectiveness of the board in this capacity;

(E) the transparency of such soft dollar arrangements to investment company shareholders and investment advisory clients of investment advisers, the extent to which enhanced disclosure is necessary or appropriate to enable investors to better understand the impact of these arrangements, and an assessment of whether the cost of any enhanced disclosure or other regulatory change would result in benefits to the investor; and

(F) whether such section 28(e) should be modified, and whether other regulatory or legislative changes should be considered and adopted to benefit investors.

(b) REPORT REQUIRED.—The Commission shall submit a report on the study required by subsection (a) to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing and Urban Affairs of the Senate, no later than one year after the date of enactment of this Act.

SEC. 14. STUDY OF ARBITRATION CLAIMS.

(a) STUDY REQUIRED.—The Securities and Exchange Commission shall conduct a study of the increased rate of arbitration claims and decisions involving mutual funds since 1995 for the purposes of identifying trends in arbitration claim rates and, if applicable, the causes of such increased rates and the means to avert such causes.

(b) REPORT.—The Securities and Exchange Commission shall submit a report on the study required by subsection (a) to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate not later than one year after the date of enactment of this Act.

PURPOSE AND SUMMARY

The purpose of H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003, is to (1) improve transparency of mutual fund fees and costs and (2) improve corporate governance and management integrity of mutual funds. Better fee disclosure will promote robust industry competition and will help investors make more informed decisions about which mutual fund is most appropriate.

Better corporate governance of mutual funds will enhance investor protection. The bill strengthens the influence of independent directors, who have a greater inclination to protect the interests of fund shareholders than those directors who are tied to the success of the mutual fund's management company. H.R. 2420 further promotes investor protection by directing the SEC to promulgate rules requiring enhanced disclosure and director scrutiny of directed brokerage, soft dollar and revenue sharing arrangements. The legislation also codifies the SEC rule requiring mutual funds to disclose both policies and procedures with respect to proxy voting and the actual votes cast, thus enabling shareholders to monitor their funds' involvement in the governance of portfolio companies. Finally, the legislation also codifies a pending Commission rule requiring mutual funds to implement internal audit procedures, including appointing a chief compliance officer to administer these procedures.

BACKGROUND AND NEED FOR LEGISLATION

Mutual funds have brought the benefits of professional management, portfolio diversification, and securities ownership to millions of individuals. Today, 95 million individuals, comprising nearly half of all U.S. households, own mutual funds. The majority of these individuals represent households with moderate annual incomes between $25,000 and $75,000.

The primary statute governing mutual funds is the Investment Company Act of 1940 (1940 Act). Its preamble calls for mutual funds to be "organized, operated (and) managed" in the interests of shareholders rather than in the interests of "directors, officers, investment advisers * * * underwriters or brokers." Some critics of mutual fund industry practices have charged that fund management companies and directors have not adequately served the interests of fund shareholders, as required by the 1940 Act.[1] More recently, disturbing allegations have been made involving possible illegal activity harming long-term investors by a number of mutual funds, prompting a criminal investigation by State and Federal authorities.[2]

It is widely recognized that one of the most important variables affecting fund performance is cost. Numerous studies and commentators have noted that equity mutual fund fees have continued to increase while fund returns have lagged those of relevant indexes. Yet, investors often are unaware of these fees. Mr. John C. Bogle, founder and former chief executive officer of The Vanguard Group, testified at a Capital Markets Subcommittee hearing that "investors are largely unaware of the high level of mutual fund costs," and that "since managers have an obvious vested interest sustaining this ignorance * * * we urgently need new SEC rules that require greater cost disclosure."[3] The Securities and Exchange Commission (the SEC or the Commission), in a letter to Subcommittee Chairman Richard H. Baker, cited surveys dem-

---

[1] See, e.g., John C. Bogle, The Emperor's New Mutual Funds, Wall Street Journal, July 8, 2003, at A16 ("I believe that the fund industry has not adequately measured up to its statutory responsibilities of stewardship to mutual fund investors. The express language of the preamble to the Investment Company Act of 1940 calls for mutual funds to be 'organized, operated (and) managed' in the interests of shareholders rather than in the interest of 'directors, officers, investment advisers * * * underwriters or brokers.' Yet since most new funds are organized to bring in assets and generate advisory fees, and operated at cost levels that virtually preclude market-beating returns, it is simply impossible to believe the standards of that preamble are being honored * * *. The present situation, in which the fund adviser is typically the head of the fund's investment adviser, presents an unacceptable conflict of interest in the selection and compensation of fund management companies. Warren Buffett said it well: 'Negotiating with oneself seldom produces a barroom brawl'."); Neil Weinberg and Emily Lambert, The Great Fund Failure; why lousy managers, conflicts of interest and sky-high expenses are way too common in the fund business, Forbes, Sept. 15, 2003 ("* * * the fund business [is] shortsighted, poorly governed, weak on disclosure and riddled with conflicts of interest. This is an industry that pays lip service to helping investors achieve long-term goals while spending a bundle promoting the short-term payoff of hot-for-the-moment funds. It has tossed economies of scale out the window, charging more per dollar invested as fund assets have grown. Investors pay upwards of $100 billion in annual fund costs and fees. What do they get for this? Almost by mathematical necessity, they get, on average, mediocrity.").

[2] Shannon Buggs, Fund Scandal Threatens Very Foundation of Investing, Houston Chronicle, Sept. 8, 2003 ("Mutual funds are supposed to be the no-nonsense, safe and easy way to achieve your financial dreams * * *. That's why it's a gut punch to middle-income America's stomach to find out the companies that fashion themselves as the small investor's champions on Wall Street may be selling them out.").

[3] Hearing on Mutual Fund Industry Practices and Their Effect on Individual Investors Before the House Committee on Financial Services, 108th Cong. 11 (Mar. 12, 2003) (testimony of Mr. John C. Bogle, founder and former Chief Executive Officer, The Vanguard Group) [hereinafter Hearing on Mutual Fund Industry Practices].

onstrating that investors do not understand the nature and effect of ongoing mutual fund fees.[4]

Mutual fund investors would be the direct beneficiaries of greater fee-based competition among mutual funds; more accessible and understandable information about mutual fund fees; stronger oversight by independent fund directors; and enhanced firewalls against a variety of conflicts of interest raised by the way mutual funds are operated and sold. H.R. 2420 would provide all of these reforms for mutual fund investors.

Fee Disclosure

There are several different types of costs associated with mutual funds. The costs that are disclosed in the fund's prospectus include account-based costs, such as sales loads, and ongoing costs, disclosed as the fund's "expense ratio." Sales loads are a one-time fee, generally charged to an investor's account at the time of purchase or, in some cases, at the time of redemption. The expense ratio reflects the fund's annual operating expenses as a percentage of assets and is an ongoing charge. Unlike sales loads, the expenses included in the expense ratio are not charged directly to an investor's account, but are deducted from fund assets prior to earnings distributions to shareholders. The operating expenses include (1) the management or advisory fee, which is used to pay the adviser for managing the fund's investment portfolio, (2) 12b–1 fees, which are used to pay for distribution and marketing of fund shares, and (3) the administrative costs for operating the fund.

A mutual fund's board of directors is responsible for supervising fund fees. The board of directors, which must approve the contracts between the fund and its service providers, has a fiduciary obligation to the fund and must therefore ensure that the shareholders' interests are being served. As Mr. Bogle stated at a hearing before the Subcommittee, "fund costs make the difference: As it turns out, the major reason that the return of the average equity fund lagged the stock market by 3.1 percent during the past twenty years is the costs that investors' funds incur—the management fees, the operating expenses, the out-of-pocket fees, the portfolio transaction costs, the sales charges, and the opportunity cost represented by the significant cash positions typically held by funds."[5] In fact, a recent Standard & Poor's study found that mutual funds with lower fees (as measured by expense ratios) have outperformed their more expensive peers in nearly all fund categories.[6] The study demonstrated that lower-cost funds beat more expensive ones in 8 of the 9 domestic fund style categories over one, 3, 5, and ten years on an annualized basis.

In its 2000 report on mutual fund costs, the U.S. General Accounting Office (GAO) found that mutual funds do not generally compete for investors based on fees.[7] In its 2003 report, the GAO

---

[4] Letter from the Honorable William H. Donaldson, Chairman, Securities and Exchange Commission, to Congressman Richard H. Baker, Chairman, House Committee on Financial Services, Capital Markets Subcommittee, 11–12 (June 9, 2003) [hereinafter SEC Response].

[5] Hearing on Mutual Fund Industry Practices, 7–8 (testimony of Mr. Bogle, the Vanguard Group).

[6] Julie Earle-Levine, Low-fee funds outperform costlier rivals, Financial Times; June 12, 2003, at 21.

[7] United States General Accounting Office, Report to the Chairman, Subcommittee on Finance and Hazardous Materials; and the Ranking Member, Committee on Commerce, House of Rep-

found that the average fees charged by 77 of the largest mutual funds had increased because of higher management fees to investment advisers.[8] Mr. Bogle noted in testimony before the Subcommittee that the expense ratio of the average fund recently stood at 1.36 percent—49 percent higher than in the late 1970s.[9] This data suggests that the fund companies have failed to deliver on their promise of lower fees through economies of scale. In addition, the SEC cited several surveys illustrating that mutual fund investors do not understand the fees they pay. For example, the SEC referred to a recent survey that found that 75 percent of respondents could not accurately define "expense ratio" and 64 percent did not understand the impact of expenses on fund returns.[10] Another academic study in 2002 found that, despite clear evidence to the contrary, 84 percent of investors believe higher fees buy better performance.[11] The 2000 GAO study stated, "[s]tudies and data that others, and we, collected, indicate that mutual fund investors have focused more on fund performance and other factors than on fee levels. In contrast to the consideration they give fees, investors appear more concerned over the level of mutual fund sales charges (loads)."[12] As a result, fund advisers have lowered the loads charged on mutual funds since the 1980s.

H.R. 2420 carries the potential to similarly affect mutual fund fees. The bill makes substantial changes to fund disclosures with regard to fund operating expenses, portfolio turnover, directed brokerage, revenue sharing, soft dollar arrangements and breakpoint discounts, among other things, in an effort to enhance transparency of fees and costs associated with mutual funds.

The SEC recently proposed a new rule that would require disclosure in a fund's semi-annual and annual report to include (1) a dollar example of the fees an investor would have paid on a hypothetical $10,000 investment, using the actual expenses incurred by the fund and the actual return achieved by the fund; and (2) the same dollar example, using the actual expenses incurred, but assuming a 5 percent return over the period so funds could be compared against each other. Currently, funds must provide similar disclosures (a dollar example of the fees an investor would pay on a hypothetical $10,000 investment in the fund based on expected, not actual fees, and assuming a 5 percent annual return) but this disclosure is only included in the fund's prospectus. H.R. 2420 generally codifies the pending SEC proposal, but includes two important changes: first, the dollar example in the annual report must be based on a hypothetical $1,000 investment. The Committee believes that using $1,000 as the example will make it easier for investors to calculate the amount of fees paid. Second, the legislation includes a requirement that account statements include a legend prominently stating that (1) the investor has paid fees on the mutual fund investments, (2) those fees have been deducted from the amount shown on the statement, and (3) the investor can find more

resentatives, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition, at 62 (June 2000) [hereinafter, 2000 GAO study].

[8] United States General Accounting Office, Report to Congressional Requesters, Mutual Funds: Information on Trends in Fees and their Related Disclosure, 6–9 (March 12, 2003).

[9] Hearing on Mutual Fund Industry Practices, 1, 3, Exhibit 1 (testimony of Mr. Bogle, the Vanguard Group).

[10] SEC Response, at 12.

[11] Weinberg and Lambert, supra note 1.

[12] 2000 GAO study, at 66.

information by referring to documents disclosing the amounts of those fees.

Portfolio Transaction Expenses

Portfolio transaction expenses are the costs funds incur when they buy and sell securities. These costs can be enormously significant, and in some cases, exceed the fund's operating expenses. According to some estimates, in 2002 the mutual fund industry paid brokers about $6 billion in commissions.[13] It has been estimated that between $1 billion and $4 billion was paid for something other than simple trade execution.[14] Trading costs can easily double the annual expense of a mutual fund. Mr. Gary Gensler, former Under Secretary of the Treasury and co-author of The Great Mutual Fund Trap, has stated that "[r]ight now the average annual expense ratio for a mutual fund is about 1.3 percent, but when you add up trading costs and all the other fees, you can get up to 3 percent in annual costs."[15]

Yet mutual fund transaction costs are not disclosed to investors in a useful way. Funds are required to include their commission costs, in dollars, in the Statement of Additional Information (the "SAI"), a dense disclosure document that investors must request from the fund. Many believe this information is of limited utility to investors because (1) it is relatively inaccessible, (2) it does not include portfolio execution costs such as bid/ask spreads, which can be as high or higher than commission costs, and (3) the dollar format does not permit comparison against other funds as easily as percentages would.

In testimony before the Subcommittee, Mr. John Montgomery, founder and President of Bridgeway Funds, cited a hypothetical example of a fund with an average trading cost of 1 percent (which he called "probably conservative") and a turnover rate of 100 percent, meaning the fund buys and sells the equivalent of the entire fund in one year's time. This fund, he noted, would have a total trading cost of 2 percent (purchases plus sales), which is significantly higher than the entire operating expense ratio of those funds. For small company funds, the trading costs are roughly twice as much. To "beat the market," he concluded, the portfolio manager would have to add back value equal to the operating expense ratio of the fund (1.4 percent, on average), plus 2 percent in trading costs—"a huge performance hurdle to overcome and [one that] highlights the need for some way to provide shareholders with information on its magnitude."[16]

Similarly, Mr. Mercer Bullard, founder and chief executive officer of Fund Democracy, Inc., citing numerous studies, testified that "portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided by the prospectus."[17]

---

[13] Julie Creswell, Dirty Little Secrets; The mutual fund industry has been playing fast and loose with your dollars. Will the SEC finally take action?, Fortune, Sept. 1, 2003, at 133.

[14] Id.

[15] Id.

[16] Hearing on Mutual Fund Industry Practices, 5 (testimony of Mr. John Montgomery, founder and President, Bridgeway Funds).

[17] Hearing on H.R. 2420 the Mutual Funds Integrity and Fee Transparency Act of 2003 Before the House Committee on Financial Services, 108th Cong. 6–7 (June 18, 2003; Serial No. 108–XX) (testimony of Mr. Mercer Bullard, founder and CEO, Fund Democracy, Inc.) [hereinafter Hearing on H.R. 2420].

He, and several other witnesses, stated that providing more meaningful disclosure for some types of transaction costs would be easier than for others. Commission costs, which are currently required to be included in a fund's SAI in dollar amounts, might be a more useful measure if disclosed "per average net assets," and included in a document, such as the semi-annual report to shareholders, that is more accessible than the SAI.[18] Other transaction costs, such as spread costs, market impact and opportunity costs, are more difficult to measure and there are no standardized methods for calculating these costs. There are, however, a number of private companies that do provide fund advisers with this information, for self-evaluative and board review purposes.

Recognizing that developing an agreed-upon standard for valuing these costs will be a complicated, yet necessary, undertaking, the Committee directs the Commission in H.R. 2420 to promulgate a "concept release" seeking input on this issue, for purposes of establishing rules that will provide more useful information to investors about these significant, but currently hidden, mutual fund costs.

The legislation also directs the Commission to use a proxy for fund transaction costs, in the form of portfolio turnover, to provide investors more immediately with a useful tool with which to judge the potential transaction costs incurred by a fund. H.R. 2420 requires mutual fund companies to improve the portfolio turnover disclosure that funds currently provide, by including this disclosure in a document that is more widely read than the prospectus or SAI, and by requiring a textual explanation of the impact of high portfolio turnover rates on fund expenses and performance.

Portfolio Manager Compensation and Holdings

Mutual funds are not required to disclose the compensation or structure of compensation of portfolio managers. Mr. Montgomery testified that "When we invest in individual companies, we have the right to know the compensation of the company leaders. When we invest in mutual funds, we are in the dark * * * we believe that investors should know the actual compensation and structure of that compensation as it relates to the fund's management * * * compensation structure and level may strongly affect portfolio manager incentives and the decisions he or she makes on behalf of a fund."[19] The SEC staff stated:

> [D]isclosure regarding the structure of an individual portfolio manager's compensation might * * * be useful in supplementing existing disclosure of the advisory fee. It could provide fund shareholders with information that would be helpful in assessing the incentives of the individuals who are managing the fund. For example, disclosure that a manager is compensated based on the fund's performance for a particular period, e.g., 3 months, 1 year, or 5 years, may shed light on the manager's incentives to maximize short-term or long-term performance. Similarly, disclosure of whether a portfolio manager's compensation is based on a fund's pre-tax or after-tax returns may be

[18] Hearing on Mutual Fund Industry Practices, 8 (testimony of Mr. Montgomery, Bridgeway Funds).
[19] Id. at 6.

useful in assessing whether a fund is an appropriate investment for a taxable or tax-deferred account.[20]

Accordingly, H.R. 2420 directs the Commission to issue rules requiring disclosure of the structure of fund manager compensation.

Additionally, the legislation addresses the issue of fund manager investments in the fund he or she manages. Currently, funds are required to disclose fund ownership by officers and directors, but not individual portfolio managers. Mr. Montgomery and other commentators have argued for disclosure by portfolio managers as well, because it would help investors assess the confidence level of the portfolio manager. Similarly, the Commission staff noted that "disclosure of a portfolio manager's holdings of fund shares could provide some indication of his or her alignment with the interests of fund shareholders * * * [and] could also provide investors with some insight into the level of confidence that a manager has in the investment strategy of the fund."[21] Accordingly, the legislation directs the Commission to require that fund managers disclose their holdings in the funds they manage.

Breakpoint Discounts

Many mutual funds sell funds with front-end loads that may be reduced based on the amount of an investor's holdings ("breakpoint discounts"). Many investors, however, are unaware that they may be eligible for the discounts, and have overpaid front-end sales loads when they were actually entitled to a reduced rate pursuant to the fund's breakpoint policy. The staffs of the New York Stock Exchange and NASD recently conducted examinations of 43 broker-dealers that sell funds with front-end sales loads to determine whether investors were receiving the promised breakpoint discounts. These regulators found significant failures by the broker-dealers to deliver the discounts to eligible customers, and recently issued a report recommending improved disclosure.[22] H.R. 2420 requires the Commission to mandate improved disclosure to help investors determine whether they are eligible for a discount. The Committee recognizes that it is the obligation of intermediaries such as brokers to ensure that their customers are given the breakpoint discounts that apply to a fund. The Committee also notes that it is the obligation of the fund's board of directors, which oversee the fund's operations generally, to ensure that appropriate mechanisms are in place so that fund shareholders receive the benefits of breakpoint discounts and other provisions that are disclosed in the fund's prospectus.

Revenue Sharing Arrangements

Under a revenue sharing arrangement, the adviser of a fund uses its own profits to pay a broker or other party to sell shares of the fund. Revenue sharing is generally not disclosed to investors, thus leaving investors unaware of the incentives a broker may have for

[20] SEC Response, at 43.
[21] Id. at 44–45.
[22] Joint SEC/NASD/NYSE Report of Examinations of Broker/Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, at 14–16 (Mar. 11, 2003). The report found that most of the 43 broker/dealers examined failed to provide the appropriate breakpoint discount to customers in a significant number of cases. The group of firms examined did not provide breakpoints in about one-third of the breakpoint-eligible transactions analyzed—the average dollar amount of the discount not provided was $364.

recommending one fund over another. SEC Chairman Donaldson at a Subcommittee hearing on May 22, 2003, testified that he believed that an investor should be informed of the incentives and the compensation that a broker or branch manager receives in promoting or selling a fund to an investor. Chairman Donaldson stated, "A prospective buyer, in my view, has a right to know what incentives lie behind a recommendation."[23] According to Donaldson, the SEC's "bottom line goal is to assure that a potential mutual fund investor through an investment banking firm is aware of all the compensation or inducements that are being paid to the broker that is selling them."[24]

Mr. Paul Roye, Director of the Commission's Division of Investment Management, echoed Chairman Donaldson's views on mutual fund revenue-sharing arrangements in his June 18, 2003, Subcommittee testimony. Mr. Roye declared that broker compensation is an area where disclosure can be improved. According to Mr. Roye, "the investor ought to understand the incentives and the compensation that that broker has in promoting the fund or trying to sell the fund to you."[25]

In addition, revenue sharing arrangements may be used in ways that constitute a violation of the 1940 Act, if an adviser is actually using fund assets, disguised as its own profits, to pay for distribution. As the Commission staff pointed out in its June 9, 2003, letter to Subcommittee Chairman Baker:

> Revenue-sharing payments may * * * affect funds and their shareholders. Investment advisory fees may be higher than they otherwise would be if no revenue-sharing payments were made * * *. In addition, an investment adviser that makes revenue-sharing payments for an existing fund may be less willing to agree to a reduction of its investment advisory fee because its profit already is reduced from making the payments. Thus, in some instances, funds and their shareholders may be effectively bearing the costs of the revenue-sharing payments made by the funds' investment advisers.[26]

Accordingly, the legislation requires fund directors to review these arrangements, consistent with their fiduciary duty to the fund. In seeking to enhance the mutual fund board's oversight of revenue sharing and other arrangements, the Committee recognizes the different roles of the board and the adviser. Directed brokerage and soft dollar activities potentially involve the assets of the fund and its shareholders, and therefore must be reviewed by the board under an exacting fiduciary duty standard. Revenue sharing arrangements, to the extent they involve 12b–1 plans, also involve fund assets and its shareholders and deserve comparable scrutiny by the board. The Committee recognizes that some revenue sharing arrangements involve the adviser's use of its legitimate profits, rather than fund assets. Because of the concerns highlighted by the

---

[23] Hearing on The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk Before the House Committee on Financial Services, 108th Cong. 35 (May 22, 2003) (statement of Chairman Donaldson, Securities and Exchange Commission).

[24] Id.

[25] Hearing on H.R. 2420, 41 (testimony of Mr. Paul Roye, Director, Division of Investment Management, Securities and Exchange Commission).

[26] SEC Response, at 81–82.

Commission staff, the Committee believes it is important for the fund board to be aware of these revenue sharing arrangements when it assesses the fund's contract with the adviser, as part of its fiduciary obligation to the fund and its overall assessment of whether the adviser is charging fees to the fund that are reasonable in the aggregate in relation to the services provided by the adviser.

Directed Brokerage Arrangements

Directed brokerage arrangements are also not clearly disclosed to investors. The Commission staff noted in its June 9 response that funds have increasingly used a portion of the brokerage commissions that they pay on their portfolio transactions to compensate broker-dealers for distribution of fund shares. Certain of these arrangements, the staff observed, "result in the use of fund assets to facilitate distribution and should be reflected in rule 12b–1 distribution plans."

Accordingly, the bill directs the Commission to require enhanced disclosure of these arrangements, as well as enhanced oversight by the board of these arrangements, consistent with the board's fiduciary obligations to the fund.

Soft Dollar Arrangements

A soft dollar transaction is one in which an investment adviser directs client brokerage transactions to a broker and, in exchange, receives research or other services from the broker or a third party. These transactions are permitted pursuant to a "safe harbor" provided by section 28(e) of the Securities Exchange Act of 1934. Soft dollar arrangements have been subject to criticism because of the potential for conflicts of interest between a fund and the investment adviser. Mr. Harold Bradley, Senior Vice President of American Century Investments, testified:

> Client[s] * * * pay [for] products and services as part of the brokerage commissions charged to [an] account * * * present[ing] an obvious temptation to the manager to buy items that benefit [him]self rather than the client, or items, such as general research reports, quotations services and computer hardware and software, that other managers consider their own responsibility under their basic management fee. The money manager may also pay too much in commissions or engage in unnecessary trading so as to generate more commissions and thus more soft dollars.[27]

According to another witness, the problem with soft dollar arrangements is that there is an "inadequate incentive for the adviser to keep trading costs low."[28] He argues that shareholders should only pay for the benefits of soft dollar arrangements through management fees because the shareholder hires the adviser to manage the portfolio, which includes stock-picking tools.[29]

---

[27] Hearing On Mutual Fund Industry Practices, 8–9 (testimony of Mr. Harold S. Bradley, Senior Vice President, American Century Investment Management).

[28] Id. at 4 (testimony of Mr. Montgomery, Bridgeway Funds).

[29] Id.

The Commission staff, discussing concerns about soft dollar arrangements, stated:

> We are * * * concerned about the growth of soft dollar arrangements and the conflicts they may present to money managers, including fund advisers * * *. The effect of section 28(e) is to suspend the application of otherwise applicable law, including fiduciary principles, and to shift responsibility to advisory clients (including fund boards) to supervise their money manager's use of soft dollars and the resulting conflicts of interest, based on disclosure that the clients receive from the money manager.[30]

H.R. 2420 addresses the inherent conflicts of interest with respect to soft dollar arrangements. First, the legislation requires the Commission to issue rules mandating disclosure of information about soft dollar arrangements.

Second, the legislation requires fund advisers to submit to the fund's board of directors an annual report on these arrangements, and requires the fund to provide shareholders with a summary of that report in its annual report to shareholders.

Third, the legislation imposes a fiduciary duty on the fund's board of directors to review soft dollar arrangements, consistent with their obligations to the fund.

Fourth, the legislation directs the Commission to issue rules to require enhanced recordkeeping of soft dollar arrangements. When soft dollar research services are provided in connection with a fund's transactions, the person exercising investment discretion with respect to the fund must maintain a copy of the written contract relating to those arrangements. The contract must describe the nature and value of the services provided. The Committee notes that the Commission staff stated that "we * * * expect to ask the Commission to propose changes to the record-keeping rule under the Advisers Act to require advisers to keep better records of the products and services they receive for soft dollars * * *"[31]

Finally, the legislation orders the Commission to conduct a study of soft-dollar arrangements, including: the trends in the average amounts of soft dollar commissions paid by investment advisers and funds; the types of services provided through these arrangements; the benefits and disadvantages of the use of soft dollar arrangements including the impact of soft dollar arrangements on investors' ability to evaluate and compare the expenses of different mutual funds; the potential or actual conflicts of interest created by these arrangements and the effectiveness of the board of directors in managing these conflicts; the transparency of soft dollar arrangements; and whether the "safe harbor" should be modified.

The Committee is aware that securities regulators in other jurisdictions are also reviewing soft dollar arrangements.[32] The Committee believes that regulations addressing soft dollar arrangements in other jurisdictions may not necessarily be appropriate for the United States, given the particular features of U.S. markets,

[30] SEC Response, at 37–38 (citing Section 28(e)(2) of the Securities and Exchange Act of 1934, which authorizes the Commission to require disclosure of an adviser's soft dollar policies and practices).

[31] SEC Response, at 41.

[32] See, e.g., Bundled Brokerage and Soft Commission Arrangements, Consultation Paper 176, the United Kingdom Financial Services Authority (April 2003).

including the importance of mutual funds as an investment vehicle and the diverse nature of U.S. providers of brokerage and research services.

Independent Fund Directors

Mutual fund management companies (i.e., fund advisers) are distinct from the funds themselves and have their own profits and, sometimes, shareholders to consider. Mutual funds themselves are, in fact, owned by their investors, not their advisers. While investors have the ability to "vote with their feet" by redeeming their shares of a fund if they are dissatisfied with the fund's performance (or for any other reason), and have occasional opportunities to vote in board elections, on changes in certain contractual fees, and other matters, in practice, mutual fund investors have very little power over the company they own. The Commission has noted that mutual funds are effectively dominated by their advisers.[33] Mutual funds are set up by advisers, not by individual investors. Generally, all of the research, trading, money management and customer support staff actually work for the fund's adviser, distributor, or other service providers. While shareholders vote on the fund's directors, the adviser initially selects the directors, who rely on the adviser's staff for information. Furthermore, fund companies often set up a pooled structure, whereby fund directors serve on all of the fund boards in a fund complex.

As Mr. Montgomery observed in his testimony:

> Over the years, I have examined the record of some of the consistently worst-performing funds and wondered, "Where are the boards of directors?" Unlike the boards of privately held firms, non-profit organizations, or even publicly traded companies with multiple constituencies, a mutual fund's board really exists only to protect the interest of its shareholders. Nevertheless, 5 mutual funds declined by more than 20 percent per year over the last 5 years; 3 of these had dismal returns for the 4 or 5 years before this. The average expense ratio of these 5 funds is 11.5 percent, more than the entire average annual return of the stock market. How can these funds hope to make any return for shareholders? Why doesn't someone put them out of their misery? [34]

Similarly, another witness testified that "there is significant evidence suggesting that fund directors generally do not actively pursue fee reduction or changing money managers." [35]

In an effort to address the conflicts of interest inherent in the structure of mutual funds, the 1940 Act establishes specific roles and independence standards for mutual fund directors. As Mr. Bullard has observed, the effective domination of a fund by its adviser "necessarily compromises the control normally exercised under State law by a board of directors. To compensate for this im-

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

[34] Hearing on Mutual Fund Industry Practices, 7 (testimony of Mr. Montgomery, Bridgeway Funds).

[35] Id. at 11 (testimony of Mr. Gary Gensler, former Under Secretary for Domestic Finance, Department of the Treasury).

balance, it follows that additional requirements, beyond those provided under State law, may be necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders."[36]

The 1940 Act imposes those additional requirements, in the form of a requirement that "interested persons"—i.e., non-independent directors—comprise no more than 60 percent of a fund's board. In 2001, the SEC took various actions in an effort to make fund directors more independent of their adviser by raising the required percentage of independent directors from 40 to 50 percent. In practice, though, commentators have argued that fund directors have a difficult time striking a proper balance between working with the adviser and vigorously pursuing investors' interests. Mr. Gary Gensler, former Under Secretary of the Treasury for Domestic Finance, suggested that, "Too often the outcome is simply acquiescence to whatever the adviser proposes."[37] He continued, "many directors view their role as simply auditing the performance of the adviser and making sure there is no malfeasance or accounting problems, rather than acting as investors' vigorous advocates."[38] Clearly, the greater the influence of independent directors on a board, the greater their ability to protect the interests of shareholders against those of the directors whose interests are tied to the success of the management company.

H.R. 2420 strengthens the influence of independent directors on fund boards by requiring that independent directors comprise at least two-thirds of the board. As Mr. Bullard noted:

> [T]he need for fund boards to be independent is much greater than for operating company boards. The conflicts between operating company directors and management are mitigated by the fact that they report to the same shareholders—the shareholders of the company. In contrast, fund directors and management report to different sets of shareholders. Fund directors report to the shareholders of the funds. Fund management reports to the shareholders of the manager.
>
> This unique structural conflict of interest lies at the heart of fund regulation and is the most distinguishing feature of mutual funds in comparison with other types of companies. Congress has long recognized that this conflict of interest necessitates heightened standards of independence to ensure that shareholders' interests are protected.[39]

The Committee notes that the recent allegations, if true, involving criminal activity (permitting late-day trading for favored institutional clients) by numerous large mutual fund companies represent the most recent example of fund directors' failing to meet their fiduciary obligation to the funds they represent.

Audit Committee Requirements

H.R. 2420 extends certain provisions to enhance the independence and authority of mutual funds' audit committees. The bill

[36] Letter from Mr. Bullard to Chairman Baker and Ranking Member Paul E. Kanjorski (July 9, 2003), at 8 [hereinafter Bullard July 9 Letter].
[37] Hearing on Mutual Fund Industry Practices, 6 (testimony of Mr. Gensler).
[38] Id.
[39] Bullard July 9 Letter, at 9.

strengthens the audit committee of a fund by requiring that all of its members be independent. To further the objectivity of financial reporting, the bill charges the audit committee with direct responsibility for the appointment, compensation and oversight of the mutual fund's accountant. The bill also requires the audit committee to establish procedures for handling complaints regarding accounting matters and grants the audit committee the authority to engage and compensate outside advisers to assist it in carrying out its duties. In turn, the mutual fund is required to provide the appropriate funding for the audit committee to compensate the fund's accountant and any outside advisers it engages.

Use of the Term "No-Load"

Under current NASD rules, funds may not call themselves "no-load" if they charge a 12b–1 fee of more than 25 basis points. However, they may use the term if they charge a 12b–1 fee of 25 basis points or less. This may confuse investors, who might think that "no-load" means the fund is not charging any 12b–1 fee at all. The bill directs the Commission to clarify rules relating to the use of the term "no-load" by mutual funds, so investors may better understand what they are actually paying when they choose such a fund. At a minimum, the Commission's rule should require disclosure designed to inform investors that the designation "no-load," when used by a mutual fund, means that investors in the fund are not assessed certain transaction-based charges when purchasing or selling shares of the fund, but does not mean that the fund pays no operating fees or expenses.

Proxy Voting Disclosures

Recent business scandals have created renewed investor interest in issues of corporate governance, underscoring the need for mutual funds to focus on this issue. Despite the fact that millions of American investors own the underlying securities of mutual funds, funds have been extremely reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities. With the overwhelming support of investor advocacy groups, the Commission adopted a rule earlier this year that requires investment companies to disclose their policies and procedures with respect to proxy voting as well as the actual votes cast. By implementing the rule, the Commission sought to increase transparency of proxy voting by mutual funds, thereby enabling fund shareholders to monitor their funds' involvement in the governance of portfolio companies, which could have a dramatic impact on shareholder value in funds. The Committee strongly agrees with the Commission's position and supports this rule. H.R. 2420 codifies the rule, to ensure that all mutual fund investors continue to get this important information.

Informing Directors of Significant Deficiencies

The Commission staff regularly inspects mutual funds. In practice, the staff generally informs the fund's adviser of any significant deficiencies that are discovered. H.R. 2420 includes a new requirement that the fund's board of directors be provided with a report of any deficiencies, to ensure that they will be able to take any necessary corrective action.

Ethics Compliance

H.R. 2420 codifies aspects of a Commission proposal to strengthen the corporate governance practices of mutual funds. In February 2003, the Commission issued a proposed rule that would require investment companies to implement internal audit procedures to promote compliance and detect violations of Federal securities laws.[40] The proposed rule would require investment companies to designate a chief compliance officer to administer the internal audit program. The internal audit program would have to be reviewed annually to evaluate its effectiveness. Imposing routine internal audits on investment companies helps foster early detection of practices harmful to investors and provides a deterrent to unlawful conduct. Moreover, strong internal auditing programs reduce the likelihood of securities law violations and allow companies to correct potential violations early. The Committee notes that the recent allegations, if true, of criminal activity by numerous large mutual fund companies further underscores the pressing need for adoption of these ethics-related provisions.

Sales Practices and Broker Incentive Compensation

H.R. 2420 includes a provision to address undisclosed conflicts of interest created by financial incentives for brokers to sell certain types of funds. The practice of providing financial incentives to brokers and branch managers to sell a particular fund, such as an in-house fund (i.e., a fund that is advised by the broker's employer) or a fund on a "preferred list" (i.e., a fund that has paid the broker for "shelf space"), has been the subject of recent scrutiny by Federal and State regulators, including regulators in Massachusetts and New York as well as the SEC and NASD. Investors are not told that brokers may have a financial incentive to sell a particular fund, which is an obvious conflict of interest that should be disclosed to them. In testimony before the Committee, SEC Chairman Donaldson and Mr. Roye both agreed that disclosure of this information should be required.[41]

Similar concerns have been raised regarding financial incentives, in the form of higher commissions, for brokers to promote a particular class of fund shares. When consumers buy mutual funds, they can choose from (1) Class A shares, which charge a commission upfront but have lower ongoing management fees, (2) Class B shares, which have higher ongoing fees and charge a commission if shares are redeemed before a certain period of time, or (3) Class C shares, which charge no commission but carry the highest ongoing fees. Concerns have been raised about brokers improperly recommending Class B shares, which are designed for long-term investors (because of the deferred sales charge), to short-term investors who would have paid a lower commission had they purchased Class A shares.[42]

H.R. 2420 addresses these concerns by directing the Commission to issue a rule requiring disclosure to mutual fund investors regarding any financial incentives provided to brokers for selling par-

[40] Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 7037 (proposed Feb. 11, 2003).
[41] See—supra notes 23–25 and accompanying text.
[42] See Brooke A. Masters, The Cost of Buying In, Washington Post, July 6, 2003, at F1.

ticular funds, as well as any conflicts of interest that the broker may face due to these financial incentives.

Study of Arbitration Claims Involving Mutual Funds

This provision directs the SEC to study the dramatic increase in arbitration claims involving mutual funds since 1995. Arbitration cases involving mutual funds have increased ten-fold in just the past few years, skyrocketing from 121 in 1999 to 1,249 in 2002.[43] The study will identify the reasons for this troubling trend, and will, therefore, help the Commission and the Committee enact measures to reverse it.

HEARINGS

On March 12, 2003, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing entitled "Mutual Fund Industry Practices and Their Effect on Individual Investors." A number of issues were discussed, including mutual fund fees and the transparency of those fees, mutual fund governance, and other matters affecting fund investors. The Subcommittee heard testimony from Mr. John C. Bogle, founder and former chief executive officer, The Vanguard Group; Mr. Wayne H. Wagner, Chairman, Plexus Group, Inc.; Mr. John Montgomery, founder and President, Bridgeway Funds; Mr. Harold S. Bradley, Senior Vice President, American Century Investments; Mr. Paul Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute; Mr. Gary Gensler, former Under Secretary for Domestic Finance, Department of the Treasury; and Mr. James S. Riepe, Chairman, T. Rowe Price Associates, Inc.

On June 18, 2003, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a legislative hearing on H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act of 2003, a bill introduced by Subcommittee Chairman Baker which addresses concerns raised at the March 12 hearing. The Subcommittee accepted written testimony by Mr. Paul Roye, Director of the Division of Investment Management, U.S. Securities and Exchange Commission; Mr. Richard Hillman, Director, Financial Markets and Community Investment, U.S. General Accounting Office; Mr. John C. Bogle, founder and former chief executive officer, The Vanguard Group; Mr. Mercer Bullard, President, Fund Democracy; Ms. Mellody Hobson, President, Ariel Mutual Funds; and Mr. Paul Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute.

COMMITTEE CONSIDERATION

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises was discharged from the further consideration of H.R. 2420 on July 18, 2003.

On July 23, 2003, the Committee on Financial Services met in open session and ordered H.R. 2420 reported to the House with a favorable recommendation, with an amendment, by a voice vote.

---

[43] http://www.nasdadr.com/statistics.asp.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. No record votes were taken in conjunction with the consideration of this legislation. A motion by Mr. Oxley to report the bill to the House with a favorable recommendation was agreed to by a voice vote.

The following amendments were considered:

> An amendment in the nature of a substitute offered by Mr. Oxley, no. 1, making a number of technical and substantive changes to the bill, was agreed to by a voice vote, as amended.
>
> An amendment to the amendment in the nature of a substitute offered by Mr. Kanjorski, no. 1a, reducing disclosure burdens on small funds, was agreed to by a voice vote.
>
> An amendment to the amendment in the nature of a substitute offered by Mr. Tiberi, no. 1b, striking the independent chairman provision, was agreed to by a voice vote.
>
> An amendment to the amendment in the nature of a substitute offered by Mr. Baker, no. 1c, requiring disclosure of proxy voting, an amendment to the amendment in the nature of a substitute offered by Mr. Baker, no. 1d, requiring each investment company and investment adviser registered with the SEC to have a code of ethics and a chief compliance officer, and an amendment to the amendment in the nature of a substitute offered by Mr. Baker, no. 1e, requiring the portfolio manager disclose any holdings they have in the funds they manage, were agreed to en bloc by a voice vote.
>
> An amendment to the amendment in the nature of a substitute offered by Mr. Baker, no. 1f, requiring brokers disclose to investors whether or not they have received an incentive to sell a particular fund or class of shares, was agreed to by a voice vote.
>
> An amendment to the amendment in the nature of a substitute offered by Mr. Shays, no. 1g, prohibiting any registered investment company from using deceptive or misleading names, was not agreed to by a voice vote.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee made findings that are reflected in this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee establishes the following performance related goals and objectives for this legislation:

The SEC will utilize the authority granted by this legislation to improve the operation of the Nation's securities markets and protect investors by improving the governance of mutual funds and the disclosures made by those funds.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 2, 2003.

Hon. MICHAEL G. OXLEY,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Melissa E. Zimmerman.

Sincerely,

DOUGLAS HOLTZ-EAKIN,
Director.

Enclosure.

H.R. 2420—Mutual Funds Integrity and Fee Transparency Act of 2003

H.R. 2420 would establish new operating policies and federal reporting requirements for the mutual fund industry. The bill would require the Securities and Exchange Commission (SEC) to conduct studies and issue regulations regarding various aspects of a mutual fund's operations, including information about costs, fees, research services, audit committees, trading restrictions, compensation, and compliance with ethics requirements.

Based on information from the SEC, CBO estimates that implementing this bill would cost about $1 million in 2004 and a total of about $2 million over the 2004–2008 period, assuming appropriation of the necessary amounts. Enacting H.R. 2420 would not affect direct spending or revenues.

H.R. 2420 contains no intergovernmental mandates, as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

H.R. 2420 would impose private-sector mandates, as defined in UMRA, on mutual fund companies. Based on information provided by industry and government sources, CBO expects that the direct costs of complying with those mandates would fall below the annual threshold established by UMRA for private-sector mandates ($117 million in 2003, adjusted annually for inflation).

The bill would require the SEC to revise and implement regulations requiring mutual fund companies to disclose certain information to investors. The regulations would require:

- Disclosure of operating expenses for each $1,000 of investment in the company that are borne by shareholders;
- Notification of investors in their brokerage account statements that fees have been deducted;
- Disclosure of portfolio turnover rates, structure of the fund manager's compensation, and where shareholders can find additional information;
- New reporting and record keeping of so-called soft dollar transactions;
- Directors to be informed of any significant deficiencies in the operation of a mutual fund discovered in a SEC inspection;
- Each fund to have a code of ethics and chief compliance officer;
- Disclosure of any holdings managers have in the funds they manage; and
- Disclosure to investors whether brokers received extra financial incentives to sell a particular fund or class of shares.

The bill also would require such companies to make summaries of reports on fund distribution arrangements available to the public, revise audit committee responsibilities, and impose fiduciary duties on board of directors to review revenue-sharing arrangements.

The CBO contacts for this estimate are Melissa E. Zimmerman (for federal costs) and Paige Piper/Bach (for the impact on the private sector). This estimate was approved by Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.

FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

CONSTITUTIONAL AUTHORITY STATEMENT

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds that the Constitutional Authority of Congress to enact this legislation is provided by Article 1, section 8, clause 1 (relating to the defense and general welfare of the United States), and clause 3 (relating to the power to regulate foreign and interstate commerce).

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of section 102(b)(3) of the Congressional Accountability Act.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short Title

This section provides the short title of the bill, the "Mutual Funds Integrity and Fee Transparency Act of 2003".

Section 2. Improved Transparency of Mutual Fund Costs

Section 2(a) requires that the Securities and Exchange Commission, within 270 days after enactment of the bill, to revise regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940 Investment Company Act to require improved disclosure with respect to an open-end management investment company of: (1) The estimated amount, in dollars for each $1,000 of investment in the company, of operating expenses that are borne by shareholders; (2) the structure of, or method used to determine, the compensation of portfolio managers and the portfolio managers' ownership interest in securities; (3) portfolio turnover rate, set forth in a manner that facilitates comparison among investment companies, and a description of the implications of a high turnover rate for portfolio transaction costs and performance; (4) information concerning the company's policies and practices with respect to certain so-called "soft dollar arrangements," specifically, the payment of brokerage commissions to a broker who provides research services; and information concerning the company's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the company's shares; (5) information concerning so-called "revenue sharing," i.e., payments by any person other than the company that are intended to facilitate the sale and distribution of the company's shares (e.g., payments by the company's investment adviser or an affiliate of the adviser to a broker that sells fund shares); and (6) information concerning so-called "breakpoint" discounts on front-end sales loads for which investors may be eligible, including the minimum purchase amounts required for those discounts.

With respect to "soft dollar arrangements," the research services covered are: (1) Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or (2) furnishing analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts. These are the same research services included in the definition of "brokerage and research services" in sections 28(e)(3)(A) and (B) of the Exchange Act, for purposes of the safe harbor for certain "soft dollar arrangements" in section 28(e).

This subsection also requires that the improved disclosure be made in the quarterly statement, a periodic report to shareholders, or other appropriate disclosure document. Subsection (b) permits

the Commission to require that the disclosure be made in a prospectus or SAI, so long as that disclosure is also provided in another appropriate disclosure document. The Commission may consider whether a disclosure of information concerning portfolio managers' compensation and ownership interest in securities and disclosure of "revenue sharing" payments made exclusively in a prospectus, SAI, or both, is made in an appropriate disclosure document.

Section 2(c) requires the Commission to issue a concept release on portfolio transaction costs with respect to trading portfolio securities and how costs can be disclosed to investors to allow cost comparison among mutual funds. Within 270 days of enactment, the Commission must also submit a report on the findings from the concept release and make legislative and regulatory recommendations to the House Financial Services Committee and the Senate Banking Committee.

Subsection (d) requires the Commission to issue a rule within 270 days of enactment of the legislation, requiring that investors be informed that they have paid fees to their mutual fund companies. Investment companies should provide a statement, in a quarterly statement or periodic report, prominently stating that the investor has paid fees on the mutual fund investments, and that those fees have been deducted from the amount shown on the statement, and further directing the investor to documents disclosing the amounts of the fees.

Finally, subsection (e) requires that the Commission consider methods of reducing the burden of making the requisite fee disclosures on small investment companies.

Section 3. Obligations Regarding Certain Distribution and Soft Dollar Arrangements

Section 3 amends section 15 of the Investment Company Act to require each investment adviser to a registered investment company to annually provide the company's board of directors with a report on: (1) Payments made by the adviser (or its affiliated person) to promote the sale of shares of the company (revenue sharing); (2) services provided to the company or paid for by brokers executing securities transactions for the company (or its affiliated person) (directed brokerage); and (3) research services obtained by the adviser (or its affiliated person) from a broker as a result of securities transactions effected on behalf of the company (soft dollar arrangements).

The Committee contemplates that, in exercising this authority, the Commission may adopt rules differentiating among different types of payments. The Committee believes, for example, that it would be consistent with the legislation for the Commission to require disclosure of information relating to payments made by mutual fund advisers to obtain preferential treatment, in offering or selling shares of the funds or in including the funds among those that are marketed more actively by financial intermediaries and their sales forces than other funds sold by the intermediaries (e.g., preferred lists). The Committee also believes it would be consistent with the underlying purpose of Section 2(a)(5) to mandate a different type of disclosure for payments made by fund advisers, dis-

tributors and their affiliates for shareholder services, administrative services or other non-distribution services.

The section also establishes a fiduciary duty on the part of the board to review the adviser's direction of the company's brokerage transactions and to determine that the direction of fund brokerage is in the best interests of the shareholders of the investment company, and requires the board to review revenue sharing payments to ensure consistency with the provisions of the legislation, such as ensuring that they are not disguised payments from fund assets, and determining that those agreements are in the best interest of the shareholders of the investment company.

This section also requires that an investment company's annual report include a summary of the most recent report submitted to the board of directors and gives the Commission rulemaking authority to implement the section.

Finally, section 3 requires that within 270 days of enactment of this bill, the SEC must prescribe a rule (pursuant to the Securities Exchange Act) requiring that an investment manager maintain a copy of a written contract between a person providing research services if the person preparing or providing the research service is not affiliated with the investment manager.

Section 4. Mutual Fund Governance

Section 4(a) amends section 10(a) of the Investment Company Act to decrease the maximum allowable percentage of directors on fund boards who are interested persons from 60 percent to ⅓.

Section 4(b) amends section 2(a)(19) of the Investment Company Act, which defines the term "interested person," to give the Commission authority to expand the definition to include natural persons who are unlikely to exercise an appropriate degree of independence as a result of: (1) A material business relationship with the company, its investment adviser, or principal underwriter (or any of their affiliated persons), or (2) a close familial relationship with any natural person who is an adviser or principal underwriter to the company (or any of their affiliated persons).

Section 4(b) also deletes from section 2(a)(19) references to broker-dealers and lenders as interested persons to permit the Commission to include persons with material business relationships as interested persons in a rule adopted pursuant to its new authority.

Section 5. Audit Committee Requirements for Investment Companies

Section 5 extends to registered management companies and registered face-amount certificate companies certain audit committee requirements similar to those required by section 301 of the Sarbanes-Oxley Act of 2002 and codified in section 10A(m) of the Exchange Act for listed companies. Section 10A(m) required the Commission, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with enumerated audit committee requirements.

Section 5(a)(1) amends sections 32(a)(1) and (2) of the Investment Company Act to make the audit committee of a registered management company or registered face-amount certificate company, rather than the independent members of the full board of directors, re-

sponsible for selection of the auditor. This conforms the Investment Company Act to the approach of section 301 of the Sarbanes-Oxley Act, which currently applies to investment companies that are listed for trading on an exchange, and section 202 of the Sarbanes-Oxley Act, which requires an issuer's audit committee to preapprove all auditing services and which applies to most investment companies because they are "issuers" under the Sarbanes-Oxley Act. This section allows the SEC to exempt investment companies in certain situations from the requirement that votes by members of the audit committee be cast in person.

Subsection (a)(2) adds new section 32(d) to the Investment Company Act. Section 32(d)(1) of the Investment Company Act makes it unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant unless the company is in compliance with certain audit committee requirements and Commission rules and regulations. The audit committee requirements, which are similar to those enumerated in section 301 of the Sarbanes-Oxley Act, are the following:

Section 32(d)(2) of the Investment Company Act requires the audit committee to be directly responsible for the appointment, compensation, and oversight of auditors, and requires auditors to report directly to the audit committee.

Section 32(d)(3) of the Investment Company Act requires each member of the audit committee to be an "independent" member of the board of directors. Section 32(d)(3)(B) of the Investment Company Act provides that, in order to be considered "independent," a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the company or any affiliated person of the company; or (ii) be an "interested person" of the company, as that term is defined in section 2(a)(19) of the Investment Company Act. This definition of "independent" differs from the definition in section 301 of the Sarbanes-Oxley Act in that (i) the prohibition on the acceptance of fees has been broadened to affiliated persons of the company in recognition of the fact that investment companies typically are externally managed, with most services rendered to the company by its investment adviser or another third party; and (ii) the long-standing "interested person" standard of the Investment Company Act has been substituted for the "affiliated person" test of section 301, in recognition of the fact that the "interested person" standard is tailored to the particular circumstances of registered investment companies.

Section 32(d)(4) of the Investment Company Act requires the audit committee to establish procedures for (i) the receipt, retention, and treatment of complaints regarding accounting, internal controls, or auditing matters; and (ii) the confidential, anonymous submission by employees of the company and its affiliated persons of concerns regarding accounting or auditing matters. Section 32(d)(4)(B) of the Investment Company Act requires that the audit committee establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters not only by employees of the company, but also by em-

ployees of the company's affiliated persons. This is broader than section 301 of the Sarbanes-Oxley Act, again to recognize the fact that investment companies typically are externally managed.

Section 32(d)(5) of the Investment Company Act requires the audit committee to have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

Section 32(d)(6) of the Investment Company Act requires the company to provide appropriate funding, as determined by the audit committee, for payment of compensation to the auditors and any advisers employed by the audit committee.

Section 32(d)(7) of the Investment Company Act defines "audit committee" to mean (i) a committee of the board of directors that oversees the accounting and financial reporting processes of the company and audits of its financial statements; and (ii) if no such committee exists, the full board of directors.

Section 5(b) of the bill adds new section 10A(m)(7) to the Exchange Act, which exempts registered investment companies from the requirements of section 10A(m) (the codification of section 301 of the Sarbanes-Oxley Act) effective one year after enactment of the legislation. Because all registered management companies and registered face-amount certificate companies are covered by new section 32(d) of the Investment Company Act, it is no longer necessary that registered investment companies that are listed on an exchange be covered by section 10A(m) of the Exchange Act. This exemption does not, however, preclude a national securities exchange or national securities association from imposing audit committee requirements on listed investment companies in appropriate circumstances. In the event that the rules promulgated pursuant to this Section become effective prior to one year after enactment, the Commission may use its exemptive authority under the Exchange Act to exempt listed investment companies that are subject to the provisions of 10A(m) from those provisions so they will not be subject to two inconsistent regulatory requirements.

Finally, section 5(c) requires the Commission to issue final regulations to carry out new section 32(d) of the Investment Company Act not later than 180 days after the date of enactment.

Section 6. Trading Restrictions

Section 6 amends section 22(e) of the Investment Company Act to prohibit an investment company from suspending or postponing the right of redemption of a redeemable security for more than 7 days after the security has been tendered, except for periods when the securities market is closed or trading is restricted (aside from weekends and holidays), or when an emergency exists and disposal of securities is not reasonably practical. The Commission has the authority to determine when trading is restricted and when an emergency exists.

Section 7. Definition of No-Load Mutual Fund

Section 7 requires that within 270 days of enactment of the bill, the Commission, or a self-regulatory organization, or both, must adopt a rule clarifying the definition of the term "no-load" as used by mutual funds, so investors may better understand the use of the term. The Committee intends that nothing in this section impair,

interfere, or prevent a bank from effecting transactions as part of a program for the investment or reinvestment of deposit funds into any investment company registered under the 1940 Act that holds itself out as a money market fund as permitted under Section 3(a)(4)(B)(v) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)).

Section 8. Informing Directors of Significant Deficiencies

Section 8 amends section 42 of the Investment Company Act to require that if a report of a Commission inspection identifies significant deficiencies in a company's operations or in the operation of its investment adviser or principal underwriter, the company must provide the report to the company's board of directors.

Section 9. Exemption From In Person Meeting Requirements

Section 9 amends section 15(c) of the Investment Company Act by allowing the Commission to issue a rule, regulation, or order to exempt an investment company from the requirement that votes cast by directors take place at an in person meeting when the requirement is impracticable. The Commission has the discretion to determine when those conditions exist.

Section 10. Proxy Voting Disclosure

Section 10 amends section 30 of the Investment Company Act by requiring that every investment company (excluding small businesses) file an annual report with the Commission containing the company's proxy voting record for the 12 month period ending on June 30. The report must be filed on or before August 31 of each year. Company financial statements must state how the company voted proxies relating to portfolio securities. Companies must also make the information available free of charge upon request by a telephone number, through the company's website, and on the Commission's website.

Section 11. Ethics Compliance By Mutual Funds

Section 11 requires that within 270 days of enactment of this bill, every investment company must adopt and implement policies and procedures designed to prevent violation of the federal securities laws. Investment companies are required to review the policies and procedures annually and appoint a chief compliance officer to administer the policies and procedures in place.

Section 12. Incentive Compensation and Mutual Fund Sales

Section 12 requires that within 270 days of enactment, the Commission must issue a rule prohibiting the sale of mutual funds by a broker dealer who has not disclosed inducements that he or she receives to facilitate the sale and distribution of a particular mutual fund. In addition, a broker dealer must disclose his or her commission, fees an investor has or will pay as a result of a future purchase or redemption, and any conflicts of interest associated with the sale of a mutual fund.

The Committee contemplates that this disclosure may be a "point of sale" disclosure, or an after-the-fact disclosure, such as in a "confirm" that is provided to investors after execution of the transaction. Requiring brokers to disclose their commissions and incen-

tives for selling particular funds will help inform investors about the costs involved in purchasing a particular fund or class of fund and permit them to better evaluate their broker's investment advice.

Section 13. Commission Study and Report Regulating Soft Dollar Arrangements

Section 13(a) directs the Commission to conduct a study of the use of soft dollars by investment advisers. The section requires the Commission, in preparing the report, to examine trends in soft dollar use during the preceding 3 years, the types of services provided, the benefits and disadvantages of the use of soft dollars, including the extent to which use of soft dollars impairs the ability of investors to evaluate and compare expenses of investment companies; the potential or actual conflicts of interest created by soft dollar arrangements, the transparency of those arrangements; and the extent to which enhanced disclosure is necessary to enable investors to understand the impact of theses arrangements. Finally, the study must address the Commission's view of whether section 28(e) of the Securities Exchange Act, which provides a "safe harbor" for soft dollar arrangements, should be modified, or whether other regulatory or legislative changes should be considered and adopted to benefit investors.

Subsection (b) directs the Commission to submit a report on the soft dollar study to the Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs no later than 18 months after enactment of the bill.

Section 14. Study of Arbitration Claims

Section 14(a) directs the Commission to study the increased rate of arbitration claims and decisions involving mutual funds since 1995.

Section 14(b) requires the Commission to submit a report on the increased rate of arbitration claims and decisions involving mutual funds to the House Financial Services Committee and the Senate Banking Committee within one year of enactment of this legislation.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INVESTMENT COMPANY ACT OF 1940

TITLE I—INVESTMENT COMPANIES

* * * * * * *

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

(1) * * *

* * * * * * *

(19) “Interested person” of another person means—

(A) when used with respect to an investment company—

(i) * * *

* * * * * * *

⟦(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

⟦(I) the investment company;

⟦(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

⟦(III) any account over which the investment company’s investment adviser has brokerage placement discretion,

⟦(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

⟦(I) the investment company;

⟦(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

⟦(III) any account for which the investment company’s investment adviser has borrowing authority,⟧

(v) any natural person who is a member of a class of persons who the Commission, by rule or regulation, determines are unlikely to exercise an appropriate degree of independence as a result of—

(I) a material business or professional relationship with the company or any affiliated person of the company, or

(II) a close familial relationship with any natural person who is an affiliated person of the company,

⟦(vii)⟧ *(vi)* any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any

other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) * * *

* * * * * * *

[(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

[(I) any investment company for which the investment adviser or principal underwriter serves as such;

[(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

[(III) any account over which the investment adviser has brokerage placement discretion,

[(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

[(I) any investment company for which the investment adviser or principal underwriter serves as such;

[(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

[(III) any account for which the investment adviser has borrowing authority,]

(v) any natural person who is a member of a class of persons who the Commission, by rule or regulation, determines are unlikely to exercise an appropriate degree of independence as a result of—

(I) a material business or professional relationship with such investment adviser or principal underwriter (or affiliated person thereof), or

(II) a close familial relationship with a natural person who is such investment adviser or principal underwriter (or affiliated person thereof),

【(vii)】 *(vi)* any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagaph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this title or for any other purpose for any period prior to the effective date of such order.

* * * * * * *

AFFILIATIONS OF DIRECTORS

SEC. 10. (a) No registered investment company shall have a board of directors more than 【60 per centum】 *one-third* of the members of which are persons who are interested persons of such registered company.

* * * * * * *

INVESTMENT ADVISORY AND UNDERWRITING CONTRACTS

SEC. 15. (a) * * *

* * * * * * *

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the direc-

tors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f). *The Commission, by rule, regulation, or order, may exempt a registered investment company subject to this subsection from the requirement that the votes of its directors be cast at a meeting in person when such a requirement is impracticable, subject to such conditions as the Commission may require.*

* * * * * * *

(g) OBLIGATIONS REGARDING CERTAIN DISTRIBUTION AND SOFT DOLLAR ARRANGEMENTS.—

(1) REPORTING REQUIREMENTS.—Each investment adviser to a registered investment company shall, no less frequently than annually, submit to the board of directors of the company a report on—

(A) payments during the reporting period by the adviser (or an affiliated person of the adviser) that were directly or indirectly made for the purpose of promoting the sale of shares of the investment company (referred to in paragraph (2) as a "revenue sharing arrangement");

(B) services to the company provided or paid for by a broker or dealer or an affiliated person of the broker or dealer (other than brokerage and research services) in exchange for the direction of brokerage to the broker or dealer (referred to in paragraph (2) as a "directed brokerage arrangement"); and

(C) research services obtained by the adviser (or an affiliated person of the adviser) during the reporting period from a broker or dealer the receipt of which may reasonably be attributed to securities transactions effected on behalf of the company or any other company that is a member of the same group of investment companies (referred to in paragraph (2) as a "soft dollar arrangement").

(2) FIDUCIARY DUTY OF BOARD OF DIRECTORS.—The board of directors of a registered investment company shall have a fiduciary duty—

(A) to review the investment adviser's direction of the company's brokerage transactions, including directed brokerage arrangements and soft dollar arrangements, and to determine that the direction of such brokerage is in the best interests of the shareholders of the company; and

(B) to review any revenue sharing arrangements to ensure compliance with this Act and the rules adopted thereunder, and to determine that such revenue sharing arrangements are in the best interests of the shareholders of the company.

(3) SUMMARIES OF REPORTS IN ANNUAL REPORTS TO SHAREHOLDERS.—In accordance with regulations prescribed by the Commission under paragraph (4), annual reports to shareholders of a registered investment company shall include a summary of the most recent report submitted to the board of directors under paragraph (1).

(4) REGULATIONS.—The Commission shall adopt rules and regulations implementing this section, which rules and regulations shall, among other things, prescribe the content of the required reports.

(5) DEFINITION.—For purposes of this subsection—

(A) the term "brokerage and research services" has the same meaning as in section 28(e)(3) of the Securities Exchange Act of 1934; and

(B) the term "research services" means the services described in subparagraphs (A) and (B) of such section.

* * * * * * *

DISTRIBUTION, REDEMPTION, AND REPURCHASE OF REDEEMABLE SECURITIES

SEC. 22. (a) * * *

* * * * * * *

[(e) No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption, except—

[(1) for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;

[(2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

[(3) for such other periods as the Commission may by order permit for the protection of security holders of the company.

The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection.]

(e) TRADING RESTRICTIONS.—

(1) PROHIBITION AND EXCEPTIONS.—No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agents designated for that purpose for redemption, except—

(A) for any period (i) during which the principal market for the securities in which the company invests is closed, other than customary week-end and holiday closings; or (ii) during which trading on such exchange is restricted;

(B) for any period during which an emergency exists as a result of which (i) disposal by the company of securities owned by it is not reasonably practicable; or (ii) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

(C) for such other periods as the Commission may by order permit for the protection of security holders of the company.

(2) COMMISSION RULES.—The Commission shall by rules and regulations—

(A) determine the conditions under which trading shall be deemed to be restricted;

(B) determine the conditions under which an emergency shall be deemed to exist; and

(C) provide for the determination by each company, subject to such limitations as the Commission shall determine are necessary and appropriate for the protection of investors, of the principal market for the securities in which the company invests.

* * * * * * *

PERIODIC AND OTHER REPORTS; REPORTS OF AFFILIATED PERSONS

SEC. 30. (a) * * *

* * * * * * *

(k) PROXY VOTING DISCLOSURE.—Every registered management investment company, other than a small business investment company, shall file with the Commission not later than August 31 of each year an annual report, on a form prescribed by the Commission by rule, containing the registrant's proxy voting record for the most recent twelve-month period ending on June 30. The financial statements of every such company shall state that information regarding how the company voted proxies relating to portfolio securities during the most recent 12-month period ending on June 30 is available—

(1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; or on or through the company's website at a specified Internet address; or both; and

(2) on the Commission's website.

* * * * * * *

ACCOUNTANTS AND AUDITORS

SEC. 32. (a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

⟦(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company;

⟦(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested

persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;]

(1) such accountant shall have been selected at a meeting held within 30 days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of the members of the audit committee of such registered company;

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of the members of the audit committee of such registered company, cast in person at a meeting called for the purpose of voting on such action;

* * * * * * *

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3), the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled, at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 16(c), no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in section 16(c) in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal, the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filed within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (42) of section 2(a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection. *The Commission, by rule, regulation, or order, may exempt a registered management company or registered face-amount certificate company subject to this subsection from the requirement in paragraph (1) that the votes by the members of the audit committee be cast at a meeting in person when such a requirement is impracticable, subject to such conditions as the Commission may require.*

* * * * * * *

(d) AUDIT COMMITTEE REQUIREMENTS.—

(1) REQUIREMENTS AS PREREQUISITE TO FILING FINANCIAL STATEMENTS.—Any registered management company or registered face-amount certificate company that files with the Commission any financial statement signed or certified by an independent public accountant shall comply with the requirements of paragraphs (2) through (6) of this subsection and any rule or regulation of the Commission issued thereunder.

(2) RESPONSIBILITY RELATING TO INDEPENDENT PUBLIC ACCOUNTANTS.—The audit committee of the registered company, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any independent public accountant employed by such registered company (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing the audit report or related work, and each such independent public accountant shall report directly to the audit committee.

(3) INDEPENDENCE.—

(A) IN GENERAL.—Each member of the audit committee of the registered company shall be a member of the board of directors of the company, and shall otherwise be independent.

(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of a registered company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

(i) accept any consulting, advisory, or other compensatory fee from the registered company or the investment adviser or principal underwriter of the registered company; or

(ii) be an "interested person" of the registered company, as such term is defined in section 2(a)(19).

(4) COMPLAINTS.—The audit committee of the registered company shall establish procedures for—

(A) the receipt, retention, and treatment of complaints received by the registered company regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the registered company and its investment adviser or principal underwriter of concerns regarding questionable accounting or auditing matters.

(5) AUTHORITY TO ENGAGE ADVISERS.—The audit committee of the registered company shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(6) FUNDING.—The registered company shall provide appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation—

(A) to the independent public accountant employed by the registered company for the purpose of rendering or issuing the audit report; and

(B) to any advisers employed by the audit committee under paragraph (5).

(7) AUDIT COMMITTEE.—For purposes of this subsection, the term "audit committee" means—

(A) a committee (or equivalent body) established by and amongst the board of directors of a registered investment company for the purpose of overseeing the accounting and

financial reporting processes of the company and audits of the financial statements of the company; and

(B) if no such committee exists with respect to a registered investment company, the entire board of directors of the company.

* * * * * * *

ENFORCEMENT OF TITLE

SEC. 42. (a) * * *

* * * * * * *

(f) INFORMING DIRECTORS OF SIGNIFICANT DEFICIENCIES.—If the report of an inspection by the Commission of a registered investment company identifies significant deficiencies in the operations of such company, or of its investment adviser or principal underwriter, the company shall provide such report to the directors of such company.

* * * * * * *

SECTION 10A OF THE SECURITIES EXCHANGE ACT OF 1934

SEC. 10A. AUDIT REQUIREMENTS.

(a) * * *

* * * * * * *

(m) STANDARDS RELATING TO AUDIT COMMITTEES.—

(1) * * *

* * * * * * *

(7) EXEMPTION FOR INVESTMENT COMPANIES.—Effective one year after the date of enactment of the Mutual Funds Integrity and Fee Transparency Act of 2003, for purposes of this subsection, the term "issuer" shall not include any investment company that is registered under section 8 of the Investment Company Act of 1940.

○