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Mutual Fund Reform Bills: A Side-by-Side Comparison

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Summary

The current mutual fund scandal began in September 2003, when New York Attorney General Eliot Spitzer brought charges against a few mutual funds, brokers, and hedge funds. Since then, the New York investigation has widened, and the Securities and Exchange Commission (SEC) has intensified its scrutiny of mutual funds. A number of illegal or unethical practices are under investigation: the common theme is that fund managers and insiders have permitted favored customers, including hedge funds, to engage in highly profitable short-term trading strategies that reduce the investment returns of millions of long-term investors. The number of firms and individuals charged to date is fairly small, but growing. The SEC has reported (in testimony before the Senate Governmental Affairs Committee on November 3, 2003) that preliminary investigations indicate that trading practices that appear to be abusive (but not in all cases illegal) are widespread in the industry.

The congressional response to the mutual fund investigations has included several hearings and bills. Legislative proposals include H.R. 2420 (Representative Baker), which passed the House on November 19, 2003; S. 1822 (Senator Akaka), introduced November 5, 2003; S. 1958 (Senators Kerry and Kennedy), introduced November 25, 2003; and S. 1971 (Senators Dodd and Corzine), also introduced on November 25, 2003.

All four bills would require mutual funds to provide more information to investors about the fees they charge and about the funds' financial relationships with stockbrokers and investment advisers. The bills would also require that funds' governing boards contain majorities of independent directors with no financial or family ties to fund management. S. 1958 would create a new mutual fund regulator to carry out registration, inspections, and disciplinary proceedings, and to make rules promoting mutual fund ethics and independence.

This report compares the provisions of these legislative proposals. It will be updated as the bills are amended, or as new bills are introduced.

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Mutual Fund Reform Bills: A Side-by-Side Comparison

The mutual fund scandal began in September 2003, when New York Attorney General Eliot Spitzer brought civil and criminal charges against a few mutual funds, brokers, and hedge funds. Since then, the New York investigation has widened, and the Securities and Exchange Commission (SEC) has intensified its scrutiny of mutual funds. Several illegal or unethical practices are under investigation: the common theme is that fund managers and insiders have permitted favored customers, including hedge funds, to engage in highly profitable short-term trading strategies that reduce the investment returns of millions of long-term investors. The number of firms and individuals charged to date is fairly small, but growing. The SEC reported (in testimony before the Senate Governmental Affairs Committee on November 3, 2003) that preliminary investigations indicate that trading practices that appear to be abusive (but not in all cases illegal) are fairly widespread in the industry.

Congressional response to the mutual fund investigations has taken the forms of hearings and proposed legislation. On November 19, 2003, the House passed a mutual fund reform bill, H.R. 2420, by a vote of 418-2. In the Senate, three bills have been introduced – S. 1822, S. 1958, and S. 1971 – but none has yet seen committee action.

All the bills would require mutual funds to make more extensive disclosure of the fees and charges that investors pay. Financial relationships among mutual funds, brokers, and investment advisers would also have to be disclosed. Under three of the bills, brokers selling mutual funds would have to disclose how their compensation was structured, including any incentives for selling particular funds.

The proposals would all require mutual funds' boards of directors to contain majorities of independent directors – those not affiliated with the funds or its advisers. The bills also include various provisions to enhance the oversight role of the board, in matters such as auditing, nomination of directors, and supervision of ethical and legal compliance.

S.1958 would establish an independent regulator for mutual funds, to operate under the oversight of the SEC.

Finally, the proposals call for a number of reports or studies on subjects including the creation of an independent regulator for mutual funds, the SEC's enforcement record, "soft dollar" arrangements (financial links among brokers, advisers, and funds), transaction costs, arbitration in mutual fund disputes, fund advertising, and the financial literacy of mutual fund investors.

Table 1. Side-by-Side Comparison of Mutual Fund Reform Legislation in the 108th Congress

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Short Title	Mutual Funds Integrity and Fee Transparency Act of 2003	Mutual Fund Transparency Act of 2003	Mutual Fund Investor Protection Act of 2003	Mutual Fund Investor Confidence Restoration Act of 2003
New Regulatory Structure.				
New mutual fund regulator	No provision.	SEC shall study and report to Congress on the creation of an entity with inspection and enforcement authority over mutual fund boards of directors, funded by assessments on mutual funds, and appointed by the SEC. (Sec. 3(e))	Establishes a Mutual Fund Oversight Board to register mutual funds and establish ethical, quality control, internal auditing, independence, and other standards. The Board will conduct inspections and investigations of mutual funds, and may impose a range of sanctions, including civil fines. The Board will have five members, appointed by the SEC to five year terms. The SEC will have oversight authority, including the right of prior approval (or modification) of all the Board’s rules. The Board’s budget (to be subject to SEC approval) will be funded by an annual assessment upon registered mutual funds. (Title II)	GAO is directed to study the feasibility and benefits (if any) to shareholders of establishing a Mutual Fund Oversight Board with inspection, examination, and enforcement authority over mutual fund boards of directors. (Sec. 401)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Disclosure of Mutual Fund Fees and Costs.				
<p>Improved disclosure of mutual fund fees and costs</p>	<p>Directs the SEC to require periodic disclosure of: (1) the estimated amount, in dollars per \$1000 invested, of operating expenses borne by shareholders; (2) how the fund pays investment advisers, and those advisers' investments in the fund; (3) the rate at which the fund turns over its portfolio; (4) how the fund pays commissions to brokers who provide investment advice or research or who facilitate the sale of the fund's shares; (5) payments to any other person who facilitates the sale of the fund's shares; and (6) information on discounts in front-end fees for which investors may be eligible, including the minimum required purchase amounts (breakpoints). (Sec. 101)</p>	<p>Brokers selling mutual funds would be required to disclose to their customers the amount of compensation to be received by the broker. Such disclosure must be made before the sale is final. (Sec. 2(a))</p> <p>Funds would be required to include the cost of brokerage commissions in any disclosure of fees and expenses that may be payable by shareholders. (Sec. 2(b))</p> <p>SEC shall by rule require funds to disclose how they compensate portfolio managers, and the ownership of fund shares by such investment advisers and their employees. (Sec. 4)</p>	<p>Directs the SEC to revise its regulations to require disclosure of: (1) the estimated dollar amount of the fund's operating expenses borne by each shareholder (and the amount per \$1000 invested); (2) how the fund pays investment advisers, and those advisers' holdings in the fund; (3) the rate at which the fund turns over its portfolio; (4) commission payments to brokers who provide investment advice or research or who facilitate the sale of the fund's shares; (5) payments to any other persons who facilitate the sale of the fund's shares; and (6) information on discounts in front-end fees for which investors may be eligible, including the minimum required purchase amounts ("breakpoints"). (Sec. 101)</p>	<p>Directs SEC to require disclosure of: (1) the actual dollar amount borne by each shareholder of the fund's expenses; (2) the structure and total amount of compensation paid to investment advisers, and advisers' investments in the fund; (3) the dollar amounts of all payments made by the fund, set out so as to permit comparison among funds; (4) how the fund pays commissions to brokers who provide investment advice or research or who facilitate the sale of the fund's shares; (5) payments to any other person who facilitates the sale of the fund's shares; and (6) information on discounts in front-end fees for which investors may be eligible, including the minimum required purchase amounts (breakpoints). (Sec. 101)</p>

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Mandatory inclusions in fee disclosures	SEC shall require that quarterly statements disclose that investors have been charged fees, and where additional information on fees may be found. (Sec. 101)	No provision.	Fee disclosure must be included in each statement of account, and fee information must be displayed in close proximity to the value of the investor's shares. (Sec 101)	No provision.
Disclosure of fees and compensation in mutual fund sales	SEC shall by rule require disclosure by brokers of the amount and source of sales fees and charges, incentives, commissions, any other expenses incurred in the sale of mutual funds or municipal securities, as well as related conflicts of interest between the broker and the customer. (Sec. 110)	Brokers selling mutual funds would be required to disclose to their customers the amount of compensation to be received by the broker. (Sec. 2(a))	No provision.	Brokers would be required to disclose in writing to their customers the amount and nature of compensation they receive for selling mutual funds, and any conflicts of interest that arise from such compensation. (Sec. 104)
Reduction of disclosure burden on small funds	SEC shall consider ways of reducing costs associated with disclosure to small funds, consistent with public interest. (Sec. 101)	No provision.	SEC shall consider ways of reducing costs associated with disclosure to small funds, consistent with public interest. (Sec. 101)	No provision.
Definition of no-load fund	SEC directed to make rules defining "no-load" mutual funds and requiring disclosure to prevent investors from being misled by the use of such terminology. (Sec. 106)	No provision.	No provision.	SEC directed to make rules defining "no-load" mutual funds and requiring disclosure to prevent investors from being misled by the use of such terminology. (Sec. 103)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Soft Dollar, Revenue Sharing, and Directed Brokerage Arrangements.				
<p>Disclosure of soft dollar, revenue sharing, and directed brokerage arrangements</p>	<p>Investment advisers to mutual funds must report annually to the fund’s board on (1) payments made to promote sale of the fund’s shares (“revenue sharing”), (2) services or payments to the fund by a broker in exchange for brokerage business (“directed brokerage”), and (3) research services obtained by the adviser from a broker in exchange for securities transactions (“soft dollar arrangements”). A summary of this annual report must be included in the annual report to shareholders. (Sec. 102)</p>	<p>Soft dollar payments would be included in the aggregate brokerage commission disclosure required by Sec. 2(b).</p>	<p>Certain soft dollar payments would be included in the aggregate operating expenses disclosures mandated by Sec. 101.</p>	<p>Investment advisers to registered mutual funds would be required to report annually to the fund’s board regarding all payments received and services provided (including research). A summary of these reports would be included in the fund’s annual report to shareholders. (Sec. 102)</p>
<p>Fiduciary duty of mutual fund directors regarding soft dollar, revenue sharing, and directed brokerage arrangements</p>	<p>Directors shall have a fiduciary duty to review such arrangements to ensure that they comply with law and regulation and are in the best interests of fund shareholders. (Sec. 102)</p>	<p>No provision.</p>	<p>SEC shall issue regulations establishing a fiduciary duty for directors to demonstrate that all management, marketing, and investment advisory fees paid by the fund are reasonable and in the best interests of fund shareholders. (Sec. 101(g))</p>	<p>No provision.</p>

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Record keeping requirements regarding soft dollar, revenue sharing, and directed brokerage arrangements	SEC shall by rule require that all such arrangements involving research service be documented by written contracts that describe the nature and value of services provided. (Sec. 102)	No provision.	No provision.	No provision.
Mutual Fund Governance.				
Independent directors	At least 2/3 of a mutual fund's directors must be independent (versus 40% under current law). (Sec. 103(a))	At least 75% of a mutual fund's directors must be independent. Interested persons who serve as board members or chairmen must be approved by shareholder vote at least every five years. (Sec. 3(a))	At least 75% of a mutual fund's directors must be independent. The chairman of the board must be independent. (Sec. 101(e))	At least 75% of a mutual fund's directors must be independent. The chairman of the board must be independent. (Sec. 201)
Prohibition on actions requiring the vote of non-independent directors	No provision.	No action taken by the board may require the vote of a non-independent director. (Sec. 3(b))	No provision.	No provision.
Nomination of directors	No provision.	A committee made up entirely of independent directors shall select persons to be nominated to the board and adopt qualification standards for directors. (Sec. 3)	No provision.	A committee made up entirely of independent directors shall select persons to be nominated to the board and adopt qualification standards for directors. (Sec. 201)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Definition of “interested person” (i.e., not independent)	A member of a class of persons whom the SEC by rule deems to be unlikely to exercise an appropriate degree of independence because of a business, professional, or family relationship with fund management or investment advisers. (Sec. 103(b))	Includes any person with a material business or family relationship with, or who was employed by a fund’s investment adviser, underwriter, or who served as an officer or director of a “significant service provider” (to be defined by the SEC) within the last 10 years. (If one was merely employed by the significant service provider, the term of restriction is five years.) (Sec. 3)	A member of a class of persons whom the SEC by rule deems to be unlikely to exercise an appropriate degree of independence because of a business, professional, or family relationship with fund management or investment advisers. (Sec. 101(f))	Includes any person with a material business or family relationship with, or who was employed by a fund’s investment adviser, underwriter, or who served as an officer or director of a “significant service provider” (to be defined by the SEC) within the last 10 years. (If one was merely employed by the significant service provider, the term of restriction is five years.) (Sec. 201)
Audit committee composition and responsibilities	A mutual fund’s board shall include an audit committee, made up entirely of independent directors, which shall be responsible for selection, compensation, and oversight of the fund’s independent auditor, and for procedures for monitoring complaints from investors and fund employees regarding questionable accounting and auditing practices. (Sec. 104)	No provision.	No provision.	Audit committees would consist entirely of independent directors, and would be responsible for hiring, compensating, and overseeing outside auditors. The audit committee will also establish procedures for receiving and encouraging complaints about auditing and accounting matters. (Sec. 202)
Financial expert	No provision.	No provision.	No provision.	Each mutual fund board shall include a financial expert, to be defined by the SEC. (Sec. 201)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Exemption from in-person meeting requirements	SEC may exempt mutual fund directors from the requirement that they be physically present to cast a vote, if their presence is impractical, and if this exemption is consistent with the public interest. (Sec. 108)	No provision.	No provision.	No provision.
Notice of regulatory deficiencies	If an SEC inspection discovers deficiencies in a fund's operations, fund management must inform the board of directors. (Sec. 107)	No provision.	No provision.	Significant deficiencies in a fund or its advisers and underwriters found by SEC inspectors must be disclosed to the fund's board. The 10 most common deficiencies in mutual funds would be made public annually by the SEC. (Sec. 203)
Insider transactions in fund shares	Short-term transactions in fund shares by insiders, advisers, or underwriters prohibited. (Sec. 203)	No provision.	No provision.	Share purchases by senior executive officers of mutual funds must be disclosed and shares must be held at least six months. (Sec. 307)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Certification of financial statements	<p>Independent directors shall certify in disclosure documents that procedures are in place to oversee the setting of net asset values, the flow of funds in and out of the mutual fund, the provision of discounts to eligible investors, that different classes of mutual fund shares are appropriate for investors, disclosure of the fund's portfolio, compensation of portfolio managers, and the fund's code of ethics and antifraud policies.</p> <p>(Sec. 201)</p>	No provision.	No provision.	<p>Board chairman would be required to certify the accuracy of disclosure documents, and that procedures were in place to oversee the setting of net asset values, the flow of funds in and out of the mutual fund, the provision of discounts to eligible investors, that different classes of mutual fund shares are appropriate for investors, disclosure of the fund's portfolio, compensation of portfolio managers, and that the fund has established and enforces a code of ethics.</p> <p>(Sec. 204)</p>
Ethics compliance	<p>Requires funds and investment advisers to adopt a code of ethics and policies and procedures to prevent violations of law and SEC regulations, to review those policies annually, and to appoint a compliance officer. Independent directors shall certify that such procedures and policies are in force.</p> <p>(Sec. 201)</p>	No provision.	<p>Directs the SEC to require funds to appoint a compliance officer, who will report only to independent directors.</p> <p>(Sec. 101(j))</p>	<p>Requires funds and investment advisers to adopt a code of ethics and policies and procedures to prevent violations of law and SEC regulations, to review those policies annually, and to appoint a compliance officer, who would certify that appropriate internal controls existed..</p> <p>(Sec. 301)</p>

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Restrictions on Late Trading, Market Timing, and Other Forms of Trading.				
Late trading rules	SEC directed to write rules to prevent after-hours trading. (Sec. 205)	No provision.	Amends the Investment Company Act to prohibit late trading. (Sec. 101(a))	SEC directed to write rules to prevent and detect after-hours trading. (Sec. 306)
Increased penalties	No provision.	No provision.	Increases civil and criminal penalties. (Sec. 101)	No provision.
Market timing rules	Short-term transactions in fund shares by affiliated persons (fund managers, directors, advisers, or underwriters) are prohibited. SEC directed to make rules permitting funds to charge redemption fees in excess of 2% to prevent short-term trading that the SEC deems unfair to fund shareholders. (Sec. 203)	No provision.	Requires disclosure of market timing policies and steps taken to prevent abuse of such policies. (Sec. 101(d)) Prohibits short-term transactions in fund shares by interested persons (fund managers, directors, advisers, or underwriters). (Sec. 101(i))	Short-term transactions in fund shares by affiliated persons (fund managers, directors, advisers, or underwriters) are prohibited. Directs the SEC to require funds that do not allow market timing trading to charge a redemption fee for short-term trades. (Sec. 303)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Elimination of stale prices	SEC directed to make rules governing the use of fair value pricing to set net asset values when market quotations are unavailable or out of date. (Sec. 204)	No provision.	No provision.	SEC directed to make rules governing the use of fair value pricing to set net asset values when market quotations are unavailable or out of date. Funds and advisers would be required to adopt formal policies regarding price-setting procedures and certify that they were being adhered to. (Sec. 304)
Suspension of redemptions	Mutual funds may not suspend investors' right of redemption unless the primary stock market is closed or other emergency exists. SEC is directed to make rules specifying the conditions under which trading may be restricted. (Sec. 105)	No provision.	No provision.	No provision.
Other Provisions.				
Disclosure of proxy votes	Codifies SEC rules that require funds to disclose how they voted in proxy contests of companies whose shares they hold. (Sec. 109)	No provision.	No provision.	No provision.

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Hedge funds	Prohibits persons from serving as advisers or managers of both mutual funds and hedge funds. (Sec. 202)	No provision.	No provision.	Prohibits persons from serving as advisers or managers of both mutual funds and hedge funds. (Sec. 302)
Arbitration of investor disputes	SEC directed to study trends in mutual fund arbitration claims, and the reasons for the increase in such claims since 1995. (Sec. 112)	No provision	Directs the SEC to adopt rules giving complainants in mutual fund disputes the right to have their complaints heard in an independent arbitration forum. (Sec. 209)	SEC directed to study trends in mutual fund arbitration claims, and the reasons for the increase (if any) in such claims since 1995. (Sec. 406)
Whistleblowers	A mutual fund's audit committee shall be responsible for monitoring complaints from fund employees and others regarding questionable accounting and auditing practices. (Sec. 104)	No provision.	No provision.	Requires funds to establish policies and procedures to protect whistleblowers from retaliation. (Sec. 301)
Studies and Reports Called For.				
Soft dollar arrangements and transaction costs	SEC directed to study soft dollar arrangements involving fund investment advisers – trends, amounts, benefits and costs to investors, possible conflicts of interest, and transparency – and to make legislative recommendations. (Sec. 111)	No provision.	SEC to issue a concept release and report to Congress on portfolio transaction costs, including commission, spread, opportunity, and market impact costs. (Sec. 101(h))	SEC directed to study soft dollar arrangements – trends, amounts, benefits and costs to investors, possible conflicts of interest, and transparency. (Sec. 404)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Arbitration claims	SEC directed to study trends in mutual fund arbitration claims, and the reasons for the increase in such claims since 1995. (Sec. 112)	No provision.	No provision.	SEC directed to study trends in mutual fund arbitration claims, and the reasons for the increase (if any) in such claims since 1995. (Sec. 406)
Adequacy of remedial actions	SEC to report to Congress on market timing and late trading, including (1) economic harm to long-term shareholders, (2) the SEC's findings regarding such trading practices, (3) when and how the SEC discovered that such trading was harming shareholders, (4) steps taken by the SEC to protect long-term shareholders, and (5) additional legislation or regulation needed to protect shareholders. (Sec. 206)	No provision.	No provision.	GAO directed to study the coordination of the enforcement activities of the SEC and the states. (Sec. 402) SEC to study the allocation and adequacy of its regulatory and enforcement resources devoted to mutual funds. (Sec. 403) SEC to report on economic harm caused by late trading and market timing and the SEC's actions since becoming aware of those practices. (Sec. 405)
Creation of a Mutual Fund Oversight Board	No provision.	SEC shall study and report to Congress on the creation of an entity with inspection and enforcement authority over mutual fund boards of directors, funded by assessments on mutual funds, and appointed by the SEC. (Sec. 3(e))	No provision. (Section 101 establishes such a board.)	GAO to study the feasibility and benefits (if any) to shareholders of establishing a Mutual Fund Oversight Board with inspection, examination, and enforcement authority over mutual fund boards of directors. (Sec. 401)

Provision	H.R. 2420	S. 1822	S. 1958	S. 1971
Financial literacy	No provision.	SEC shall study and report to Congress on the existing level of financial literacy among mutual fund investors, what information they most need, the transparency of fee disclosure, and efforts and strategies to educate investors. (Sec. 5)	No provision.	SEC to study the existing level of financial literacy among mutual fund investors, the information most needed by investors, methods to increase transparency, and existing and improved methods of educating investors. (Sec. 501)
Mutual fund advertising	No provision.	The GAO shall study and report to Congress on the impact and regulation of mutual fund advertising, current sales practices in the industry, and consider recommendations to improve investor protection. (Sec. 6)	No provision.	No provision.