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States Plan to Squeeze Funds on Reforms

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By Alison Sahoo

New York attorney general Eliot Spitzer has added a new arrow to his quiver. In addition to tough enforcement of mutual fund violations, he's now also galvanizing a battalion of state treasurers to boycott fund firms who don't follow certain business practices.

In a press conference yesterday, Spitzer and finance honchos from three states whose pension programs are among the nation's largest outlined their plan. It represents a market-driven initiative and is not intended to influence pending regulatory efforts, they said.

"We're institutional investors representing the largest pension fund systems in America," said New York state comptroller Alan Hevesi. "We have a set of principles we wish to persuade the mutual fund industry to adopt."

Those principles, said California state treasurer Phil Angelides, are the standards they expect from fund firms that do business with their states. They encompass a host of issues, many of which are currently on the table in either pending legislation or SEC rulemaking initiatives.

That includes fees and billing, board independence, board meetings, portfolio manager compensation, and ownership and sale of funds, as well as disclosure of a fund's holdings, trading costs, soft-dollar deals and professional staff arrangements.

"We'll use these as significant factors to determine if firms have the right to do business with our state or if they risk losing business because they don't live up to them," Angelides said.

The reason for the standards are severalfold, he said. First, they will help states ensure that the investment management services they obtain from fund firms are

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fairly priced, performed well and executed with integrity and honesty.

Equally important, the changes will go into effect immediately without the necessity of waiting for the SEC to implement new rules.

"It's our fervent hope that Congress finishes the job it started in reforming the mutual fund industry and that the SEC puts in place actual reforms," said Angelides. "But as of today, those reforms aren't reality, so as market participants, we don't want to stand idly by."

The list of requirements, called the Mutual Fund Protection Principles, was developed by North Carolina state treasurer Richard Moore.

One requirement the list sets forth that is significantly different from anything offered up in either Congress or the SEC concerns disclosure of fees.

Under the state's requirements, fund shareholders would receive a statement of charges at least once a year that expresses expenses such as 12b-1 and other distribution fees. The charges would be represented in a dollar figure and would have to show the amount debited from each individual's investment.

The SEC, for its part, is considering disclosure that would provide a dollar figure of fees on a hypothetical investment amount, allowing easy comparison across a variety of funds.

While the list doesn't set a limit on fees, it includes a requirement that fee schedules contain breakpoints that "provide meaningful economies of scale to shareholders."

The board should receive itemized lists of advisory service expenses such as marketing and advertising, operations and administration, overhead and pre-tax profit. Only the independent directors can vote to approve fees.

Three quarters of the board and its chairman should be independent. Those independent directors should meet at least annually with the fund's chief compliance officer and independent auditor. Management should not be present for those meetings.

The mutual fund must report the portfolio manager's compensation in its annual report along with the methodology it used to determine that compensation. For teams, the top three managers' pay would have to be disclosed along with total team earnings.

Also, the number of fund shares owned by each portfolio manager and senior management of the advisor must be listed in the annual report. Purchases and sales must also be noted.

Any portfolio managers or research, marketing or senior executive of a fund firm or its advisor must hold their fund shares for at least 12 months after they buy them.

Funds must disclose their holdings quarterly with a maximum delay of 45 days. If a fund reveals any of its holdings to a third party, it must simultaneously post that information on its website.

Annual reports must contain information on all of the fund's trading costs. That includes turnover and a schedule of commissions paid to and shares traded with broker-dealers.

In addition, the fund must state in its annual report the amount of soft dollars it paid during the year. It must include a list of the brokers it used to execute the trades and itemize the soft-dollar services purchased through the trades.

Finally, the fund must disclose in its annual report all investment professionals, in addition to the portfolio manager, who are involved with its management. It must describe turnover among those personnel in the past year, and all other products or mutual funds its portfolio manager oversees.

Firms that don't take the suggestions to heart could lose a lot of business. California, for example, manages more than $500 billion in its various pension funds.

Over the next two or three months, says California treasurer's office spokesman Mitchel Benson, the state will send an information request to fund firms that run its pension money. They'll have to provide information indicating whether or not they're in compliance with each of the points. Then the treasurer's office will verify that information.

Firms doing business with the state of North Carolina have already received the list of suggestions, says Julie White, a spokeswoman with the state treasurer's office.

The state runs $56 billion in its public pension plan and another $2.3 billion in its pubic employees 401(k) plan. Last fall, it changed plan administrators. Its new administrator, **Prudential**, brought in a new lineup of money managers. They include **Fidelity**, **Van Kampen**, **Vanguard**, **American Funds** and **OppenheimerFunds**.

White says that on the administrator's one-year anniversary, the state will conduct a review of its performance. At that time, she says, North Carolina will give serious consideration to whether or not the new money managers adhere to the state's Mutual Fund Protection Principles.

But it doesn't stop there. During the conference, Angelides said that he'll soon reach out to other state treasurers to encourage them to adopt the standards.

A year and a half ago, Angelides, Hevesi and Moore successfully undertook a similar campaign. As Eliot Spitzer's investigation of investment banking conflicts gathered steam, the three finance chiefs developed a similar set of guidelines pertaining to broker-dealers and investment banks.

"In July 2002, we announced investor protection standards to apply to broker-dealers and investment banks who do business with our states," said Angelides. "They've worked. We've reviewed initial compliance with these principles for broker-dealers and investment banks doing business with the state of California and we expect to be able to certify full compliance with those standards even though the SEC hasn't yet completed its review."

Industry insiders are taking a guardedly optimistic view of the initiative.

"This effort will not and should not preempt federal legislation and regulatory action," says **Holch & McGuiness** partner Neils Holch. "However, it is a helpful step towards aligning mutual fund and investor interests. Any effort to improve industry best practices should be welcomed by individual investors."

The SEC is also keeping an open mind to market-stimulated reforms.

"We applaud the efforts of market participants who interact with mutual funds to promote policies that benefit mutual fund investors," says an SEC spokesman. "We share the goals reflected in these principles — indeed, many of the elements embodied in the principles mirror measures the commission is pursuing on behalf of all mutual fund investors."

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