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Donaldson Announces SEC Focus on Four Key Issues

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In the coming months, the SEC will focus on several areas that have long troubled fund directors, namely soft dollars and Rule 12b-1.

Testifying before the Senate on the state of the securities industry, SEC Chairman William Donaldson announced that the agency is looking closely at four issues: Mutual fund disclosure reform as well as portfolio transaction costs disclosure, in addition to soft dollars and Rule 12b-1.

Some independent directors and fund attorneys aren't thrilled by the prospect of more SEC tinkering. They feel the result could move directors closer to the day-to-day management of a fund and further away from their essential oversight capacity.

Other directors, fund families and shareholder groups disagree and say that some rules could use revision.

Reviewing Rule 12b-1

For example, in his testimony, Donaldson noted that when the Commission proposed a ban on directed brokerage in Feb. 2004, the agency also requested comment on whether Rule 12b-1 should be revised or even eliminated. The commission received many comments in response, Donaldson said.

Rule 12b-1 fees, originally meant to pay for marketing and advertising, are now frequently used as a substitute for a sales load. "In light of these changes in the industry and in the use of 12b-1 fees, the future of rule 12b-1 is a topic that should receive a thorough and reasoned review," Donaldson said.

Some believe the rule needs a total revamp. Marvin Mann, chairman of the Fidelity Funds' independent trustees, is one of them. Mann wrote in an SEC comment letter that 12b-1 fees should be collected by the broker or by the fund complex either by imposing a direct charge on the investor or by deducting the amount from the shareholder's account. The charges would be fully disclosed and agreed to by the shareholder.

Scrapping the rule altogether, however, would not be wise, say some experts. For example, David Spinar, vice president and CCO of Securities America, wrote in a comment letter posted on the SEC Web site that eliminating the rule completely would do more harm than good. Spinar argues that elimination would simply shift fees that shareholders pay toward higher front-end sales charges or other fees.

Within the rule proposal to ban directed brokerage, the SEC also requested comment on an alternative approach to 12b-1 fees that would require distribution-related costs to be deducted directly from shareholder accounts, instead of from fund assets. A consortium of shareholder advocacy groups, including Fund Democracy, agreed

that this approach would be an improvement over the old system.

But some directors have still not made up their minds about how to change the rule. "I'm still struggling with the 12b-1 issue," says Ronald Abdow, an independent director for **Mass Mutual's** Family of Mutual Funds.

The unlikely elimination of 12b-1 might reduce items on the agenda but would not make the issue go away, contends Helge Lee, of counsel at Kansas City-based Stinson Morrison Hecker, who advises independent directors on SEC matters. "It would come back in a different way most likely in the context of annual contract approvals as it relates to the general issue of fees," says Lee.

The "Disclosure Regime" and Portfolio Transaction Cost Disclosure

Donaldson also promised a "top-to-bottom assessment" of fund disclosures. He has asked for a comprehensive review of the current disclosure regime. The resulting report will likely be available this summer, with the intention of simplifying information and making it more useful to investors.

Disclosure reform has also received mixed reviews from the industry. Lee points out that at the recent ICI meeting, a panel consisting of SEC investment management division director Paul Roye and three of his predecessors highlighted the tension surrounding rule changes felt throughout the industry.

Paul Roye staunchly defended the disclosure initiative while his three predecessors were skeptical of Donaldson and his staff for embarking on another attempt to improve disclosure. One of the former division heads suggested that there ought to be different levels of disclosure for fund shareholders and for financial intermediaries.

Lee says directors will be as skeptical with the initiative as Roye's predecessors are, unless reforms include protection for their fund and shareholders against liability if the fund gets sued.

"Disclosure providing information that is meaningful at the point of sale is fine in and of itself as long as the document does not create liability. It may be necessary to have a statutory prospectus and the investor must be deemed to have read it," suggests Lee.

Niels Holch, founder of the Mutual Fund Investors Coalition recommends that directors look at disclosure gaps and, in particular, see what meaningful information can be added to annual and quarterly reports.

"Tweaking the prospectus and bringing SAIs out of obscurity is another means of improving disclosure and the commission is moving in that direction," says Holch.

In terms of transaction costs, Donaldson said the SEC was preparing a proposal to improve disclosure of such costs. The report will be based in part on feedback the SEC received in response to a concept release on the topic.

Holch's Coalition was one group who commented on that release. "We recommended that transaction costs be disclosed on a price basis as well as a cash basis. It would be a Morningstar-type comparison that does not have to be perfect," he says.

Soft Dollars Task Force Hard at Work

As for soft dollars, Donaldson said it's necessary to examine the nature of conflicts of interest that can arise from their use. A commission task force is reviewing how soft dollars are used. "The task force is reviewing whether we can improve disclosure to better inform investors," he said.

That's an issue directors continue to grapple with. "I have not reached a full conclusion on the kind of services and products that can be offered via soft dollars. Greater transparency and narrower use may help," says Abdow.

Finally, the four items will not be the only area of focus for the SEC this year. For one thing, the SEC has to

finish up its work on late trading, notes Holch.

In his testimony, Donaldson also listed the mutual fund reforms that have been put in place since the improper trading scandal began. Among them: fund governance reforms; a new compliance rule; a requirement that advisors adopt codes of ethics; a ban on directed brokerage; improved disclosure to fund investors in various areas; and, most recently, a "voluntary" redemption fee rule.

Donaldson said the remaining matters on the SEC's reform agenda will be completed in coming months.

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