What Directors Should Watch in 2012

By Niels Holch, Fund Directions, January 2012

***Niels Holch**, executive director of Internet-based shareholder advocacy group **Coalition of Mutual Fund Investors,** sets the scene for the New Year with a look at what mutual fund directors should have on their radar screens and makes some predictions about what will – and will not – be accomplished on the regulatory front in 2012.*

The Federal election on November 6, 2012 is likely to be remembered as a watershed event, one in which voters expressed their views about who should lead this country out of a very difficult recession and what the role of the Federal government should be in the future.

Washington politicians will remain in a state of partisan gridlock for most of the year, especially on Federal budget, spending, and tax issues. It is doubtful that any meaningful progress will be made on reducing the Federal deficit, addressing long-term entitlement spending, and reforming the Internal Revenue Code. These big issues will be the first items on the legislative agenda for Congress and the President after the November elections.

Despite the fact that Congress is expected to accomplish very little this year, the mutual fund industry should expect plenty of regulatory activity in Washington.

The **Securities and Exchange Commission** has had to place a number of mutual fund issues on the back burner as a result of the deadlines and pressures placed on the agency by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. However, the SEC intends to turn its attention back to these mutual fund issues this year.

Here are some of the regulatory areas at the SEC on which mutual fund boards can expect to see further action during 2012:

Money Market Funds

Money market funds have been subject to intense regulatory scrutiny since the Reserve Primary Fund "broke the buck" in 2008. Since that time, the SEC has promulgated a number of new rules to improve the regulatory framework for these funds. Under pressure from the **Federal Reserve** and the **U.S. Treasury Department**, the SEC is now expected to initiate another round of rulemaking. This rulemaking is a recognition that additional regulatory steps need to be taken to prevent "runs" on money market funds during a significant liquidity crisis in the capital markets.

According to SEC Chairman **Mary Schapiro**, there are two options on the table. The first option is to require money market funds to be priced in the same manner as traditional mutual funds, through a "floating" net asset value. This proposal is strongly opposed by the fund industry, as it would dramatically reduce investor interest in this investment product.

The second option under consideration is the creation of a capital buffer for each money market fund seeking to maintain a fixed price for its shares. This buffer would be a source of additional funding in an emergency and would involve monies that are segregated from other fund assets. This option is gaining support in Washington, and the SEC staff is working to develop a specific rulemaking proposal. If such a capital buffer is constructed correctly, it could provide significant protections for investors when a run occurs on a money market fund's shares.

Rule 12b-1 Reform

The SEC has been interested in reforming its Rule 12b-1 for a number of years. In 2010, the agency advanced a wide-ranging proposal to the Rule, but it was met with strong opposition from the mutual fund and brokerage industries.

In summary, the SEC's proposal would place substantive limits on ongoing sales charges and it would restructure the Rule so that fees related to distribution can be assessed at the customer account level, rather than at the fund level. If adopted as a new regulation, investors could pay directly for many of the services they seek, instead of the current "one-size-fits-all" fee structure under Rule 12b-1. This proposal also would introduce price competition for the services of financial intermediaries.

Some of the SEC's proposed changes to Rule 12b-1 are welcomed by fund boards, as these reforms address a number of problems involving director oversight of fund distribution expenses. However, the direction that the SEC plans to take on this rulemaking in 2012 is unclear.

Mutual Fund Fee Initiative

The SEC has restructured its Enforcement Division into specialized units to focus attention on targeted issues and business practices. In the mutual fund arena, the Enforcement Division is working on a Mutual Fund Fee Initiative. This Initiative is designed to develop metrics for evaluating the extent to which retail investors are being charged excessive fees.

This Initiative will look at what investment advisers and fund boards are doing to scrutinize advisory fees, distribution-related fees, and the fees charged by various service providers to funds. The first mutual fund case brought by the Enforcement Division was against a fund adviser for paying sub-adviser fees to an entity which was not fulfilling its contractual obligations. This is probably just the beginning of a number of enforcement actions which will touch on mutual fund fees of all types.

In 2011, the SEC increased the number of enforcement actions it filed against investment advisers and funds by 30% over the previous year. Expect the number of enforcement actions to increase once again in 2012.

Derivatives

As a related activity to its Dodd-Frank responsibilities, the SEC is interested in how funds are using derivatives. To develop its understanding of the issues involved, the agency issued a Concept Release in September 2011, in order to obtain public comment on this topic. It is expected that the SEC may initiate a rulemaking in this area to update its rules, or issue another Concept Release to gather more information.

Distribution of Fund Shares

In addition to reforming Rule 12b-1, the SEC also may take steps to alter the mutual fund distribution system, albeit indirectly. Its first regulatory action in this area is expected to be an effort to harmonize the standards of care provided to investors by broker-dealers and investment advisers. Broker-dealers providing personalized investment advice will likely be subject to some type of fiduciary duty, requiring them to act in the best interests of their customers when providing personalized investment advice.

This is a complicated issue for broker-dealers, as their business model permits them to act in different capacities, such as when a broker merely executes a trade at the direction of a customer. However, any resolution of this issue will impact the distribution of mutual fund shares, as broker-dealers are likely to be required to make additional disclosures to investors and to take more steps to address conflicts of interest. If the SEC takes a holistic view of these issues, it also will have to examine what type of point-of-sale disclosures should be made to investors when transactions occur.

An Important Year

This year is likely to be known as the year that partisan gridlock reached its pinnacle. But it also is expected to be a busy year for mutual fund boards, as regulatory activity at the SEC could be significant and far-reaching for both the fund industry and its investors.

Money market funds will certainly face another round of rulemaking on significant structural issues. Rule 12b-1 is ripe for its own overhaul, which is likely to be controversial. The SEC's new enforcement focus on fund fees of all types will challenge the status quo for a number of funds. The use of derivatives by funds will be examined further and clarified. And a number of fund distribution issues will be impacted by any change to the standards of care provided by broker-dealers and by the disclosures they have to make to retail investors.

All of these regulatory activities should keep fund boards actively engaged in 2012. Beyond the presidential election and the partisan gridlock, it certainly will be an important year to pay attention to what is happening in Washington.