

Letter on California Assembly Bill 2506, July 2002

July 2, 2002

Assemblymember Darrell Steinberg
State Capitol
P. O. Box 94249-0001
Sacramento, CA 94249-0001

Re: Assembly Bill 2506

Dear Assembly member Steinberg:

The Investment Company Institute,¹ on behalf of its investment company members, wishes to express the industry's concern with certain provisions of Assembly Bill 2506, which relates to the California State Teachers' Retirement System and the investment products available to California teachers for their retirement savings. The industry's interest in this issue is substantial, because Institute members offer employees of public schools the ability to invest their retirement savings in custodial accounts invested in mutual fund shares pursuant to section 403(b)(7) of the Internal Revenue Code.

As a preliminary matter, we note that the information that would be provided via the information bank proposed in the bill is readily available today to potential investors of mutual funds, which are extensively regulated under the federal securities laws. Mutual fund prospectuses contain SEC-mandated disclosures covering the fund's investment objectives, investment policies, risks, past returns, and management, as well as how to purchase and redeem shares. Importantly, the prospectus also sets forth all relevant fees and expenses in a standardized, easy-to-read fee table.

Institute members are especially concerned about two specific issues arising under the June 29 version of the bill. First, under the June 29 version, the fees that would be charged to vendors for registration with the Teachers' Retirement Board are not sufficiently detailed and appear to be completely open-ended. As described in more detail below, we recommend certain changes in the provisions regarding fees in order to provide limits upon these fees. Also, in order to ensure that the fees per vendor remain reasonable, the bill should encourage more vendors to register their products. In order to do so, however, the bill should address a second issue—that of overly broad indemnification agreements—by deleting its reference to indemnification agreements in section 25101(a)(8).

Section 25101 would require that a prospective vendor of 403(b) products must register these products with the Board. In the context of a mutual fund organization offering custodial accounts invested in mutual fund shares, often through an internal or external sales force, the "vendor" should be the mutual fund organization and not a broker or other representative through which the organization's funds are sold. The bill should be amended accordingly to define vendor in the case of a 403(b) custodial account to refer to the mutual fund investment adviser or principal underwriter.

The definition of vendor becomes particularly important in analyzing the fees that would be assessed in connection with the registration process. Section 25102 of the bill refers to initial, annual and renewal registrations, would permit registered vendors to register additional 403(b) products between registration or renewal periods, and would require that any material changes to registered products between registration or renewal periods be submitted within 60 days.² The fees set forth in section 25108 generally would include the following:

- A one-time establishment fee equal to a pro rata share of the establishment costs;
- A renewal fee every five years equal to a pro rata share of the maintenance costs; and
- An administrative fee for each investment option offered to school employees.³

As a general matter, the Institute's members are concerned about the open-ended nature of the fees that would be assessed to

registered vendors under the bill. The bill contains no limits upon the cost of creating or maintaining the required information bank; therefore, there would be no prescribed limits upon the amount of the fees assessed. Although we recognize that California faces significant revenue issues, our industry is concerned that the prospect of such unlimited fees might serve as a barrier to entry, a disincentive for vendors and ultimately disadvantage California teachers in their choice of investment options. We recommend, therefore, that the amount of fees that can be charged to any vendor be limited to \$5000.

Furthermore, the administrative fee representing the costs associated with processing the entries on the information bank likewise should be assessed at the vendor level rather than upon each investment option and should be the same for all vendors. Assessing fees for each individual investment option could serve to reduce, rather than increase, teachers' investment options.

At the same time, the bill could reduce per-vendor fees by encouraging more vendors to register under the system. In this regard, the Institute urges that the bill be amended to delete its reference to indemnification agreements. Specifically, section 25101(a)(8) of the bill would require vendors to provide in their registration information a description of their "willingness to negotiate reasonable indemnification agreements."

The Institute's members are concerned that this provision could be interpreted to legitimize the kinds of "hold harmless" agreements used by local school districts in the past, which have served to limit unduly the investment options available to California teachers. In many cases, Institute members have been discouraged from offering their investment options to California teachers because the school districts would require, as a condition of forwarding teachers' contributions to the investment option, that the mutual fund organization sign an agreement under which the organization would agree to indemnify the district against a broad range of claims and causes of action. Institute members generally object to these provisions as unacceptably broad in that the provisions could impose liability upon them for acts by others over which they have no involvement or control, including the districts themselves. In the districts requiring broad indemnification agreements, only those organizations that sign these objectionable agreements can receive teachers' contributions; therefore, these agreements have limited unnecessarily the options available to California teachers. The Institute therefore opposes any statutory provision that would "legitimize" these agreements and thus discourage potential vendors from registering.⁴

The Institute appreciates this opportunity to express our concerns about this legislation. If you have any questions, please feel free to contact me at (202) 371-5432.

Sincerely,

Kathy D. Ireland
Associate Counsel

cc: Mr. Sanjay Shah
Assembly Fellow

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,928 open-end investment companies ("mutual funds"), 499 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.898 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

² The legislation is silent as to whether any fees would be assessed for providing information as to material changes in registered products.

³ The Institute also notes that the bill does not address how often the administrative fees would be assessed, or define the term "product."

⁴ The bill's reference to "reasonable" indemnification agreements, in the Institute's view, does not sufficiently limit the scope of these provisions, because there is no mechanism under the bill for determining what would constitute a "reasonable" agreement.