H.R. 2420—THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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H.R. 2420—THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

Wednesday, June 18, 2003

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Gillmor, Royce, Oxley (ex officio), Kelly, Ryun, Green, Miller of California, Toomey, Capito, Kennedy, Tiberi, Brown-Waite, Harris, Kanjorski, Inslee, Gonzalez, Capuano, Ford, Lucas of Kentucky, Clay, Baca, Matheson, Lynch, Miller of North Carolina, Emanuel and Scott.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order. Our purpose here today is to receive testimony with regard to H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003.

The committee has engaged in market review of the various sectors of market performance, beginning almost 2 years ago, preceding many of the unfortunate events in corporate governance. The committee has acted in a significant way, the Financial Services Committee particularly, with the passage of Sarbanes-0xley and other reform measures to enhance disclosure and transparency in market performance to investors.

It is exceedingly clear to me that the world has changed dramatically over the past 20 years, where historically the managed funds, institutional investors, and sophisticated investors constituted the bulk of investment of significance in our capital markets. Today, working families through pension funds, 401(k)s or direct investment are significant participants in providing capital for the continued expansion of economic activity and job creation.

In recent months, with concerns about the ability of the average investor's capability to get access to information on a timely and unbiased basis, many have chosen not to further participate in the markets and have in fact taken the money and put it on the sidelines for fear that they do not understand the risks that they may be taking. To that end, the committee is engaging today in better understanding the function of and the need for, if necessary, any potential reform in the way in which an investor may analyze the performance of individual mutual funds, and to determine if there is comparability in the data provided at year end.

I bring to this debate some personal observation. Last year, my son came to me, who is doing far better in life than I, and has several mutual fund investments. He came to me and said, "Dad, you are the smart guy; sit down and explain this to me," and I could not do it, to provide him with some measure of comparable information about which fund was actually performing to the highest level of professionalism. It made clear to me that at least a review of our disclosure regime was not only appropriate, but needed. The bill before us makes several recommendations. However, there are some areas which have yet to be resolved. In response to some who have indicated we have dodged the issue of soft-dollar arrangements, I merely point out that we have not reached some final determination, awaiting the SEC's professional review and recommendation. It is clear that disclosure would be highly warranted.

Some would go to the issue of banning those relationships, which is the issue, at least in my mind, before the committee, and we hope to get further insights into the benefits of those arrangements and how the expenditures made can actually work to the investor's best interest. On the other hand, if the funds are spent for a weekend in the south of France, that raises an entirely new consideration.

I am certain there are other issues within the legislation that will generate comment, but we appreciate all the witnesses's participation this morning in the committee's ongoing interest to provide a marketplace which is transparent and treats all stakeholders equitably. We look forward to hearing from you.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I look forward to this hearing in regard to the Mutual Funds Integrity and Fee Transparency Act. The dynamic mutual fund industry constitutes a major part of our equities market and it has without question worked to democratize investing for millions of Americans.

Despite this tremendous success, securities experts have continued to regularly examine how we can improve the performance of the mutual fund industry in order to advance the interests of investors. As you know, Mr. Chairman, I have made investors's protection one of my top priorities in my work on this committee. I consequently share your concerns that our committee must conduct vigorous oversight to examine whether our regulatory system is working as intended, and to determine how we can make it stronger.

During our last hearing on mutual funds, several individuals raised concerns that some practices within the mutual fund industry, because we identified no consensus for addressing these matters, I joined with my colleague, Congressman Bob Ney, in writing to the SEC after the hearing. In replying to our letter, the Commission staff suggested several areas for reform and for further study. In order to ensure that today's hearing record is complete, I request unanimous consent to enter into the record the response that Congressman Ney and I received from the Commission.

Chairman BAKER. Without objection.

[The following information can be found on page 165 in the appendix.]

Mr. KANJORSKI. In addition, Mr. Chairman, you also contacted the Commission after the last hearing to request their observations and recommendations regarding mutual funds. H.R. 2420 attempts to codify several reforms proposed by the Commission in its response to you. In general, H.R. 2420 seeks to enhance the disclosure of mutual fund fees and costs to investors, improve corporate governance for mutual funds, and heighten the awareness of boards about mutual fund activities.

While many of these reforms may be good ideas, we should explore whether they can instead be achieved without a legislative mandate, either through the adoption of industry best practices or the promulgation of regulations by the Securities and Exchange Commission. As you know, Mr. Chairman, I generally favor industry solving its owns problems through the use of self-regulation or the adoption of best practices whenever possible.

Nevertheless, if we decide to mark up H.R. 2420 in the weeks ahead, we should ensure that each provision of the bill is properly designed to help individual investors to make better decisions. We should also examine the effects of the changes on smaller mutual funds and whether those reforms will create barriers to entering the mutual fund marketplace. We should further determine whether the benefits of imposing a reform will outweigh its costs.

Moreover, H.R. 2420 contains provisions not included in the Commission's report. In my view, we must carefully examine these additional legislative mandates to ensure that they will not produce unintended consequences. For example, H.R. 2420 would prohibit an interested person from serving as Chairman of the Board of a mutual fund. While recognizing that there may be benefits to an independent Board Chairman, the Commission's report questions whether there is a need to mandate such a change if a majority of the mutual fund board is already independent.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on this important legislation. Mutual funds have successfully worked to help middle-income American families to save for an early retirement, higher education and a new home. We need to ensure that this success continues. I therefore hope that we will not rush into a markup on H.R. 2420 before we can work together on these matters.

I yield back the balance of my time.

[The prepared statement of Hon Paul E. Kanjorski can be found on page 58 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Mr. Scott?

Mr. SCOTT. Thank you very much, Chairman Baker and Ranking Member Kanjorski. I want to thank you for holding this hearing today regarding the mutual fund industry.

Arthur Leavitt, former Chairman of the SEC, calls the high cost of owning some mutual funds the deadliest sin of owning mutual funds. Some funds are able to get away with overly high fees because investors do not understand how fees can reduce their returns. I firmly believe that the individual investor is empowered when given the tools to compare varying investment funds. I want

to thank you, Chairman Baker, for introducing H.R. 2420 as an important step to providing transparency for investors. Given that more than half of all U.S. households now hold shares in mutual funds, any step towards transparency will have an impact on millions of investors throughout this country.

As Ms. Mellody Hobson, the CEO of Ariel Mutual Fund Group will testify later today, we must ensure that any additional regulations do not put small funds at a disadvantage. I certainly look forward to working with Ariel on financial education and literacy and investor education initiatives. I look forward to hearing from today's distinguished panels about the best way to arm investors with strong information on mutual funds.

Thank you very much, Mr. Chairman.

Mr. GREEN. [Presiding.] Mr. Miller is recognized for a brief opening statement. No opening statement? Then we will turn to our panel.

Our first witness will be Mr. Paul Roye, the Director, Division of Investment Management at the U.S. Securities and Exchange Commission. Mr. Roye, welcome.

STATEMENT OF PAUL ROYE, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. ROYE. Thank you.

Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, on behalf of the Securities and Exchange Commission, I am pleased to discuss H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003, which recently was introduced by Chairman Baker and cosponsored by several members of the subcommittee. It is a pleasure and honor to be here.

This bill would provide investors with useful information regarding their investments in mutual funds, as well as strengthen the corporate governance standards for mutual funds. In addition to providing mutual fund investors with disclosure about estimated operating expenses, soft-dollar arrangements, portfolio transaction costs, sales load breakpoints, directed brokerage and revenue sharing arrangements, the bill would also require disclosure of information on how fund portfolio managers are compensated and require fund advisers to submit annual reports to fund Directors on directed brokerage and soft-dollar arrangements, as well as revenue sharing.

It also would recognize fiduciary obligations of fund Directors to supervise these activities and assure that they are in the best interests of the funds and their shareholders. In addition, the bill would require the Commission to conduct a study of soft-dollar arrangements to assess conflicts of interest raised by these arrangements and examine whether or not the statutory safe harbor in section 28(e) of the Securities Exchange Act of 1934 should be reconsidered or modified.

As outlined in our written testimony, the Commission supports the goals of the bill and commends Chairman Baker and the cosponsors of this legislation for their initiative and support of a regulatory regime that best serves the interests of mutual fund investors. We particularly support the goals of enhancing disclosure and

the expanded authority the bill would provide the Commission to define which Directors can be considered independent. Overall, the bill has the potential to assist in maintaining investor confidence in the fairness of the operations of mutual funds, which is clearly the investment choice for millions of Americans today.

Specifically, the Commission supports the goal of section 2(a) of the bill, which would increase the transparency of mutual fund expenses, including a mutual fund's portfolio transaction costs, as well as require improved disclosure of the use of a fund's brokerage Commissions and revenue sharing payments by fund advisers. The Commission has long been committed to full disclosure of mutual fund costs, as well as other key information so that investors may make informed investment decisions.

The bill also would require improved disclosure of the structure and method of compensation of individuals employed to manage the fund portfolios. This disclosure is one way to provide fund investors with information that will be helpful in assessing the incentives of the individuals who are responsible for managing their assets. We are concerned about the growth of soft-dollar arrangements and the conflicts they may present to money managers. The bill would require improved disclosure of information concerning a mutual fund's policies and practices with respect to soft-dollar arrangements, whereby brokerage Commissions are paid to a broker who provides research and other transaction services. We agree that fund Directors and investors should be provided with better information about these arrangements. We further support the required report of section 28(e) that is included in the legislative package.

Once the reforms called for in the bill that relate to soft dollars are implemented, the Commission and the Congress will need to consider whether further revisions are needed. To accomplish this, policymakers will need current information on soft-dollar practices, their impact on fiduciary obligations of advisers, competition between broker-dealers, the impact on the securities markets and the clients and investment advisers, including mutual funds.

The bill would require improved disclosure of information concerning available discounts on front-end sales loads, including minimum purchase amounts required for such disclosures. Again, we believe that this improved disclosure could be helpful to investors in determining the sales load discount that they are entitled to when they buy front-end load mutual funds.

Section 3 of the bill would amend section 15 of the Investment Company Act to require each adviser to an investment company to submit to a fund's board of Directors on a regular basis a report on revenue sharing, directed brokerage, and soft-dollar arrangements. Again, the Commission supports these amendments. They acknowledge the important role that fund boards play in the supervision of fund brokerage arrangements by recognizing a federal duty to supervise these arrangements, and by requiring advisers to provide boards with the information so that they can fulfill their obligations and safeguard the interest of fund shareholders.

We strongly support the bill's grant of rulemaking authority, which would permit the Commission to close gaps in the Investment Company Act that have permitted persons to serve as independent Directors who do not appear to be sufficiently independent

of fund management. Section 5 would extend to mutual funds certain audit committee requirements, similar to those for listed companies required by section 301 of the Sarbanes-Oxley Act of 2002. Extending these audit committee requirements to mutual funds, again, is one way to further benefit and protect mutual fund investors.

In conclusion, the Commission supports efforts to improve transparency in mutual fund disclosures, to provide fund investors with information they need to make informed investment decisions, and to enhance the mutual fund governance framework. We look forward to working with this subcommittee to further these important goals.

Chairman Donaldson asked me on behalf of the entire Securities and Exchange Commission to thank Chairman Baker and Ranking Member Kanjorski and this entire subcommittee for the strong leadership you provided in sponsoring and supporting H.R. 658, the Accountant Compliance and Enforcement Staffing Act of 2003. Its unanimous passage yesterday by the House of Representatives was welcome news at the Commission and will go a very long way to ensure that we can rapidly hire the significant numbers of accounts, examiners and economists the SEC needs to serve America's investors.

With that, I would be glad to answer any questions.

[The prepared statement of Paul F. Roye can be found on page 140 in the appendix.]

Mr. GREEN. Mr. Roye, thank you for your testimony.

Our next witness is Mr. Richard Hillman, Director, Financial Markets and Community Investment for the U.S. GAO. Mr. Hillman, welcome, we look forward to your testimony.

STATEMENT OF RICHARD HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GAO

Mr. HILLMAN. Thank you very much. I am pleased to be here today to discuss GAO's work on the disclosure of mutual fund fees and the need for other related mutual fund disclosures to investors. The fees and other costs that mutual fund investors pay as part of owning fund shares can significantly affect their investment returns. As a result, it is appropriate to debate whether the disclosures of mutual fund fees and fund marketing practices are sufficiently transparent and fair to investors.

Today, I will summarize the results of our recently issued report entitled Mutual Funds: Great Transparency Needed in Disclosures to Investors, and describe how the results of this work relates to certain provisions of the proposed Mutual Fund Integrity and Fee Transparency Act of 2003 or H.R. 2420.

Specifically, I will discuss, one, opportunities for improving mutual fund fee disclosures; two, the extent to which various corporate governance reforms are in place in the mutual fund industry; three, the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares; and four, the benefits and concerns over fund advisers's use of soft dollars.

Regarding our first objective on mutual fund fee disclosures, we found that mutual funds disclose considerable information about their costs to investors, but unlike many other financial products

and services, they do not disclose to each investor the specific dollar amount of fees that are paid on their fund shares.

Consistent with H.R. 2420, our report recommends that the SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC and industry participants have indicated that the total cost of providing such dollar disclosures could be significant. However, on a per-investor basis, we found that the costs might not represent a large outlay.

In addition, our report also discusses other less-costly alternatives that could increase investor awareness of fees they pay on mutual funds, including requiring quarterly statements to include the same information that SEC is now proposing to include in the funds's semiannual reports, which would show the actual dollar amount of fees paid on a $10,000 investment. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative could be required to have quarterly statements include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information. These or other possible disclosures would provide investors with more information about fees in the document that they regularly use to check their account value.

Regarding our second objective on mutual fund corporate governance practices, we found that the popularity of mutual fund investing and the increasing importance of such investments to investors's financial well-being and ability to retire securely increases the need for regulators and industry participants to continually seek to ensure that mutual funds's corporate governance practices are strong. Recent corporate scandals have resulted in various reforms being proposed to improve the oversight of public companies by their boards of Directors. We have supported regulatory and industry efforts to strengthen corporate governance of public companies.

Although many of the reforms being sought for public companies are already either embodied in regulatory requirements or recommended as best practices by the Investment Company Institute, additional improvements to mutual fund governance such as mandating super-majorities of independent Directors as proposed in H.R. 2420 would further strengthen corporate governance practices and ensure that all funds implement these practices.

Regarding our third objective, we found that mutual fund advisers have been increasingly engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses of the fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that broker-dealers offer investors.

For example, some brokers require fund companies to make revenue sharing payments to become one of six or seven fund companies on the preferred list of funds of their sales representatives. However, under current disclosure requirements, investors may not

always be explicitly informed that their broker-dealer, who is also obligated to recommend only suitable investments based upon the investor's financial condition, is also receiving payments to sell particular funds. Consistent with H.R. 2420, our report also recommends that more disclosure be made to investors about any revenue sharing payments that broker-dealers are receiving.

Finally, as part of our final objective, we also reviewed a practice known as soft dollars, in which a mutual fund adviser uses fund assets to pay Commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio, but also receives research or other brokerage services as part of the transaction. These soft-dollar arrangements can result in mutual fund advisers obtaining research or other services, including from third party independent research firms, that can benefit the investor in these funds. However, these arrangements also create conflicts of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain soft-dollar research or chooses broker-dealers more on the basis of their soft-dollar offerings than their ability to execute trades efficiently.

SEC has addressed soft-dollar practices in the past and recommended actions could provide additional information to fund Directors and investors, but SEC has not yet acted on some of its own recommendations. Consistent with H.R. 2420, our report recommends that more disclosure be made to mutual fund Directors and investors to allow them to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

In conclusion, the work that GAO has conducted at the request of this committee addresses several of the areas in the recently introduced Mutual Funds Integrity and Fee Transparency Act of 2003. Passage of the Act's provisions in these areas would help to ensure management integrity of mutual fund companies and help to ensure that investors have the facts they need to make informed investment decisions.

Mr. Chairman, this concludes my prepared remarks and I would be pleased to answer any questions that you or other members of the subcommittee may have at an appropriate time.

[The prepared statement of Richard J. Hillman can be found on page 117 in the appendix.]

Mr. GREEN. Thank you, Mr. Hillman, and thank you, Mr. Roye, for your testimony.

Mr. Hillman, as you referenced in your testimony, some industry representatives have criticized the GAO recommendations that funds provide specific dollar disclosures in the shareholder account statements on the basis that it will be unduly expensive. I don't know if your report makes this estimation or others do, but they believe it will amount to approximately $266 million. Do you have any estimate as to what this additional cost increase would mean for the average mutual fund fee, on an average basis what it would cost?

Mr. HILLMAN. Yes. If mutual fund companies charge the entire $266 million, which includes estimates prepared by the Investment Company Institute, who surveyed about 77 percent of the assets in the mutual fund industry to ask them what the costs might be to include specific dollar disclosures, they found for that portion of the

industry that they surveyed, that if the $266 million in the first year were charged, that the mutual fund fee would increase. Basically, we have determined that the mutual fund increase would be about .000038 percent, or really about one-third of a basis point.

Mr. GREEN. The report in its discussion of the merits of enhanced disclosure of portfolio transaction costs cited a number of commentators who said that having mutual funds disclose information such as the report as suggested and you have testified to, would increase competition amongst funds on the basis of those costs and lead to lower expended costs for investors. Can you elaborate on that? Do you believe that would spur cost-based competition among investors and funds?

Mr. HILLMAN. We surveyed a number of individuals as part of the study requested by this committee. In particular, we talked to a number of financial planners who indicated the disclosing transaction costs would benefit investors. The overall view was suggested that with more information, investors would be able to compare costs across funds, which would likely result in more competition based upon those costs. It was also suggested that more disclosure of such transaction costs perhaps might help reduce turnover of funds, unnecessary trading that mutual fund complexes may engage in.

Mr. GREEN. If you could elaborate on that point. I am not sure I follow.

Mr. HILLMAN. With the increased disclosure based upon the costs of trading, including Commissions associated with trading, if fund investors were aware of those costs it might have interest on the part of fund advisers and others to ensure that those costs remain as low as they can possibly be, and therefore potentially reducing unnecessary trading for other Commissions.

Mr. GREEN. Is there a danger that the information provided under this legislation and pursuant to your report will be information that investors are unable to use or to process? Can it be misleading? Is there a risk that disclosure will not lead to providing more useful information to the average investor?

Mr. HILLMAN. I think there is always a risk that information in disclosures may not be interpreted correctly. Therefore, I think it is essential that as part of producing any additional disclosures, that sufficient work be done to consult with investors and others to make sure that the disclosures that are provided are clear and understandable and useful to investors. However, I do believe that such additional disclosures are necessary, and if implemented properly should have the desired results.

Mr. GREEN. Mr. Roye, do you believe that the increased disclosures will be a practical answer to the problem of regulating soft-dollar practices? Do you believe disclosure will be a sufficient approach to that?

Mr. ROYE. Historically, the Commission's approach on soft dollars is to encourage transparency of those arrangements. I think the bill would call for additional disclosure in that area and we view that as a positive. In the fund area, we look to fund Directors principally to oversee these arrangements and to make sure that they are in the best interest of the fund and the shareholders. So through our examination program and through other means, we

have encouraged Directors to focus on this issue. Again, disclosure would be beneficial.

Whether or not it is the complete answer to issues regarding soft dollars I think in our responses to Chairman Baker and Ranking Member Kanjorski, we indicated that we had some questions about disclosure and the limitations of disclosure. That has been the traditional approach, and indeed our federal securities law scheme is based on disclosure.

But in looking at some of the conflicts that soft dollars create, and as alluded to in the GAO report and in our response to the congressional inquiries, we do think it may be time to go back and reassess how the soft-dollar arrangements are working, what kind of impacts they are having, what do these conflicts lead to, and maybe a broader reexamination of soft-dollar arrangements.

Mr. GREEN. So disclosure may not be enough, is that what you are saying?

Mr. ROYE. Yes, sir.

Mr. GREEN. Okay. Thank you.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Roye, to put some perspective here for myself and maybe for the record, there are a little over 7,000 equity mutual funds and a little more than 1,000 money market funds, is that correct?

Mr. ROYE. It depends on how you count them. There are probably 7,000 entities, but each of them oftentimes have separate portfolios so there are probably more like 30,000.

Mr. KANJORSKI. Okay, let me get a handle around this. How many of these are guilty of abuses that you have clearly seen or have come to your attention, say, in the last year?

Mr. ROYE. In the mutual fund area, we find problems that merit enforcement actions from time to time, but it is not extensive.

Mr. KANJORSKI. Give me some numbers. In the last year, how many enforcement actions have been taken against mutual funds?

Mr. ROYE. In the last year, you could probably count them on one hand.

Mr. KANJORSKI. So potentially out of 30,000 mutual funds, only five enforcement actions. What did these enforcement actions emanate from? A failure to disclose soft money problems? What was the genesis of the actions?

Mr. ROYE. We have had some situations where we have had some valuation issues, mis-pricing of securities.

Mr. KANJORSKI. Mistakenly mis-pricing or intentional?

Mr. ROYE. It is really sort of negligence overseeing the process. I am trying to think of what some of the other actions have been. We have brought actions related to mutual funds, but they tend to be sales practice type of abuses.

Mr. KANJORSKI. What would you say of these five areas of abuse in the last year, how much did that cost the investors that were invested in those funds?

Mr. ROYE. It is difficult to estimate.

Mr. KANJORSKI. Billions?

Mr. ROYE. It has not been that substantial, given the $6 trillion.

Mr. KANJORSKI. Billions of dollars?

Mr. ROYE. Not billions of dollars.

Mr. KANJORSKI. Hundreds of millions of dollars?

Mr. ROYE. Probably in the millions of dollars.

Mr. KANJORSKI. Millions of dollars, something under $100 million. It seems to me that if we are going to establish a new army of regulators here, 30,000 funds, we are going to have to build you a much larger office building and hire you an awful lot of people and pay a lot of salaries. Has there been a cost analysis made here of what we are talking about, the increased cost of regulation as opposed to what we would be preventing or what we would be saving? What is the cost-benefit analysis that you have come up with?

Mr. ROYE. Yes, we have not done a cost-benefit analysis.

Mr. KANJORSKI. Don't you think we ought to do that?

Mr. ROYE. Certainly, the Commission in its process of considering regulations, we consider the costs and benefits in doing that. The bill would call for the Commission to take regulatory action in various areas and obviously that is an exercise.

Mr. KANJORSKI. I listened to Mr. Bogle's testimony last time, and I was impressed that he is very seriously worried about some abuses in the mutual fund industry. I am just wondering whether or not we shouldn't concentrate more on those abuses than trying to do the mathematical calculations of telling an individual mutual fund holder what the cost of their fund is. That could be extraordinarily expensive. It would seem to me before we do that, I would prefer the IRS to calculate my tax requirements so that I don't have to spend a week going to an accountant to do that. Where is the role of government here?

Mr. ROYE. I would make this observation. The bill essentially calls for improved disclosure in a number of areas. At the Commission, we agree that in these areas we can improve the disclosure. We think investors ought to understand.

Mr. KANJORSKI. I know you can improve the disclosure, but the question is the cost of improving that disclosure, is it worthwhile to the investor and to the marketplace? We can all write regulations. You can send me a 300-page prospectus, but it all depends on whether it is really worth it.

Mr. ROYE. Yes. I think when you look at some of the disclosures that are called for from a cost standpoint, I don't think they really incur a lot of costs.

Mr. KANJORSKI. They are negligible.

Mr. ROYE. It is information that is within the fund organization that would be surfaced to fund investors.

Mr. KANJORSKI. In this regard, though, several members of Congress requested from the SEC reports lately, and those reports came in last week. Does this bill contain anything beyond what the SEC recommended?

Mr. ROYE. The congressional inquiries asked specific questions. Your letter asked specific questions. We did our best to provide you with comprehensive and complete answers to those questions.

Mr. KANJORSKI. But my question is, I am not trying to put you on the hook here for anything, I am just asking does this bill go beyond the recommendations made by the SEC to the members of Congress in those two reports?

Mr. ROYE. I think there are areas that clearly tie in and flow from the recommendations. I think there may be some areas where

we clearly did not address in our response, but are reflected in the bill.

Mr. KANJORSKI. Right. I just have one additional observation to make.

Mrs. KELLY. [Presiding.] Go right ahead.

Mr. KANJORSKI. I will tell you what I am worried about. I am worried about the expenditure of money and additional regulation. I see now, because we have had this downturn in the stock market and Enron and all these problems, that all of us are rushing around as part of the bucket brigade to put out sometimes phantom fires. I make the other observation that every day we are eating food with an awful lot of chemicals and a lot of dyes and everything else, and the argument is made across the board, we don't have to tell the consumer; it can only kill him.

We are taking an awful lot of time and effort to try and save some dollars. And I am not against that, but quite frankly if somebody is an investor and they have extra capital, at some point there should be a stimulus there for them to make and live by the judgments they make in financial matters, rather than being spoon-fed by the government or so over-protected by the government as to make it ludicrous. Do you feel that we are going close to that edge?

Mr. ROYE. I think you make an important point. I think with some of this, the devil is in the details in terms of how you implement some of these approaches to enhancing the fee disclosure, for example. The General Accounting Office has made some recommendations. The Commission has an existing proposal outstanding on those issues. We try to balance the cost and benefits of enhancing the disclosure. So I think in a lot of these areas, you are right. We have to be sensitive to overkill. We have to make sure that the benefits outweigh the costs. We try to accomplish the goal and objective, but we do it in a cost-effective way.

Mr. KANJORSKI. You are causing me a little bit of schizophrenia here. On this side of the aisle, we are supposed to be for regulation. That side of the House is supposed to be against regulation.

[LAUGHTER]

Something has happened here in the last several months, so you have to give us some guidance down there.

Thank you very much.

Mrs. KELLY. Thank you.

Mr. Tiberi?

Mr. TIBERI. Thank you, Madam Chair.

Mr. Roye, could you comment, give us your thoughts on the issue of fund Directors's role in this entire process, and if you believe that it is important or not important to have two-thirds of the Directors be independent?

Mr. ROYE. Clearly in the mutual fund framework, where you have funds that are separate entities organized by a management company, sponsored by a management company, there are inherent conflicts of interest in those arrangements. The statutory framework contemplates a certain percentage of independent Directors who are there as watchdogs to protect the interests of fund investors and to monitor and oversee these conflicts.

We view the role of independent Directors as essential in this framework. Indeed, we think the reason for the mutual fund indus-

try being relatively free of scandal is the fact that independent Directors are present in the framework. The Commission several years ago proposed and adopted some rules that would effectively encourage most funds to have at least a majority of independent Directors. We see that as a positive benefit, and independent Directors playing a positive role in this framework.

Mr. TIBERI. Does the Commission have an opinion on whether the Chairman of the Board should be independent or not affiliated with the company?

Mr. ROYE. We recognize that there may be benefits to having an independent Chairman in terms of controlling the agenda to make sure that the appropriate issues are raised in the board meetings for consideration by the board. We pointed out in our testimony that once you get to a majority or two-thirds, effectively the independent Directors have the ability to dictate who the Chairman of the Board is.

Mr. TIBERI. So the SEC's opinion would be if there is a majority of independent Directors on the board that it would not be necessary to regulate either from a congressional standpoint or from a regulatory standpoint that the Chairman be independent.

Mr. ROYE. Quite frankly, within the building the Commissioners had some interesting discussions about that issue. I think that while the Commissioners saw benefits, they also recognized that effectively independent Directors have the power to dictate this now if they want it. Indeed, there are funds that have independent board chairmen who operate and those who don't. So I guess at best we were sort of maybe neutral on that point.

Mr. TIBERI. Mr. Hillman, can you comment on both issues?

Mr. HILLMAN. GAO has in the past as part of the Sarbanes-Oxley Act come out in favor of a super-majority of independent Directors on boards. The real idea there is giving increased voice to independent Directors, as well as investors in the decisionmaking that takes place on the board.

Regarding the notion of having an independent chair, we have come out in the past supporting separation from the CEO and the Chairman's position. We have not really discussed specifically the notion of an independent chair. I agree with SEC and Mr. Roye that it includes some positive aspects as well as potentially reducing the flexibility that a board may have in nominating its members. I also agree with a super-majority, which would be more than a simple majority, that independent Directors would have an ability to nominate potentially who they chose to be chair.

Mr. TIBERI. So your thought is that if we regulate the fact that a super-majority would be independent, that we would not need to regulate the independence of the Chairman.

Mr. HILLMAN. It may be less important to do so, yes.

Mr. TIBERI. Less important to do so. Can you comment a little bit about the relationship between the fund and the management company, and if you see there being conflicts in the way that the structure is often set up between the fund and the management company?

Mr. HILLMAN. Perhaps that might be a question best addressed to the SEC.

Mr. TIBERI. It will be.

Mr. HILLMAN. The fund and the investment company have very close relationships. That is why you really want to have strong representation of independent Directors to help ensure that the interests of investors are heard.

Mr. TIBERI. Mr. Roye, can you comment on that?

Mr. ROYE. Sure. Again, the typical structure is you have an external investment management company that is sponsoring and organizing the fund which technically is a separate entity. You typically have management company personnel who serve as officers of the fund. You have them typically represented also as Directors, but the typical framework is that you have a majority of independent Directors.

The management company is interested in making a profit and receives management fees for managing the fund. Obviously, the more money they make from managing the fund, the more profitable the enterprise. From the standpoint of the fund and the fund's investors, the lower those fees the higher their return. So there is an inherent conflict there and again, the Directors are there to scrutinize the reasonableness of those fees and the relationship between the fund and the management company.

Mr. TIBERI. So having the super-majority of independent Directors helps solve that potential conflict that you talked about?

Mr. ROYE. It certainly enhances the independence of the Board.

Mr. TIBERI. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Roye, I understand that the proposed legislation that is before us does not really provide any specific changes in what will constitute an independent Director. Most of the criticism about independent Directors has not just been that there are not enough of them, but that they are not independent enough. They tend to be recent employees, recent retirees from the fund management. They may in fact serve on the boards of several related funds. They may be making $200,000 a year serving as supposedly independent Directors for the same family of funds.

Why is it we cannot decide now on some of the restrictions that we might impose upon what constitutes an independent Director, to include in the legislation? And what kinds of requirements or restrictions would you look at by way of regulation?

Mr. ROYE. What the bill does is actually give the SEC the authority to expand the definition of independent Directors really in two areas, because of business or professional relationships or because of family relationships. Indeed, we have seen some family relationships that are outside the current definition that give us some concern, as well as some business relationships that we would have to actually commence a proceeding to have the Director to be deemed interested, and then they would only be deemed interested on a prospective basis.

So we welcome the authority to be able to respond to situations that we see as problematic. You mentioned the retired executive from the management company of being an area of concern. Quite frankly, we do not see a lot of that, but we have seen it and it concerns us. We would like the ability to deal with it. Technically, we

responded to what was in the legislation and we welcome that authority. I suppose you could give some thought to trying to specifically deal with the definition and close those gaps.

I think what the rulemaking authority does is give the Commission the opportunity to propose rules, to get comments, to react to circumstances, change circumstances, relationships that maybe we could not identify and think of today, but 10 years from now may be problematic. It would give the Commission the ability to respond and assure the independence of the Board.

Mr. MILLER OF NORTH CAROLINA. Mr. Hillman, do you think there are certain restrictions we could decide upon now, that we know enough now to include in the legislation, and then have the SEC have the authority to promulgate other regulations to deal with circumstances we have not considered or had not considered sufficiently?

Mr. HILLMAN. This is not a subject that we specifically covered in our report. However, we are aware of concerns associated with retirement issues and individuals coming back in serving as independent Directors, and also close family relationships as being potential problems. It seems that there ought to be an opportunity to quickly close those gaps in the corporate governance structure. You could do that either through legislation or through the SEC.

On an interesting parallel, the major exchanges, the New York Stock Exchange and the NASD, also as part of the Sarbanes-Oxley Act and in response to recent corporate failures, are also reconsidering their listing standards for issuers on their exchanges.

The NASD, for example, is looking at perhaps a 3-year cooling-off period before an individual would be allowed back on a board. The New York Stock Exchange is looking at a 5-year period of time. So there is a lot of debate and a lot of interest about trying to find just what the right gauge is, and it is certainly something worthy of debate.

Mr. MILLER OF NORTH CAROLINA. Okay. How about simply a restriction on the sheer number of related boards that a board member could serve on? Would that help?

Mr. ROYE. On that issue, you do have situations where you have Directors serving on multiple fund boards. There can be benefits to that. When you have a fund complex, there are common issues, common areas of concern. Having that consistency with the Directors there overseeing the group of funds can be beneficial. We see it working well in a number of circumstances.

Quite frankly, maybe at some point you get to a level where you ask questions whether or not a board can effectively oversee the number of boards that they may be asked to serve on. But I think that the industry has put out best practices in this area, recommended self-evaluation on the parts of board to go through as to whether or not they can be effective given the number of boards they serve on.

So it is an area that we have not, quite frankly, we do not have the authority to dictate the limits in terms of numbers of boards, but we do see fund groups with different arrangements. Some have cluster boards where they have a group of Directors that may be responsible for all the equity funds; another group responsible for bond funds; another group responsible for funds that are sold as

variable annuities and variable life insurance, where there are different issues. So we see funds with all different sorts of arrangements. It can work.

Chairman BAKER. The gentleman's time has expired.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

One of the things that I am concerned about is the fact that we have a need to help people feel comfortable in trading. In reading some of the information that we have here, I am interested in the fact that we talk about the fact that revenue sharing is not clearly disclosed. This is one of the areas I believe of discomfort for people who are currently looking at mutual funds. When we talk about the different ways that people do revenue sharing, I think this is part of the confusion.

Is there any way for us to see a more standardized effort out there with regard to revenue sharing, so people can get their arms around what exactly is being talked about?

Mr. Roye, do you want to answer that?

Mr. ROYE. Yes. You point up a very serious issue and a serious concern. We have strived in the disclosure area in the fund area to try to standardize the presentations with regard to fees. In the fund prospectuses, there is a standardized fee table that has the transactional expenses, the ongoing expenses that the funds pay. But revenue sharing is one of these areas where the payments are growing, the distribution channels through which funds are sold, they are demanding more in the way of compensation.

This compensation is coming from the advisers out of their so-called profits. It is an area where we think the disclosure can clearly be improved. We think it is an area where there are probably limitations in terms of what you can put in the fund prospectus to describe these arrangements.

It is really maybe the broker-dealer who is selling the shares, who is getting the payment, and the investor ought to understand the incentives and the compensation that broker has in promoting the fund or trying to sell the fund to you. So that is an area where the Commission has been focused, directed the staff to formulate some recommendations in this area, and certainly we want to frame it in a way that investors can understand it as clearly as possible.

Mrs. KELLY. Are you currently engaged in any kind of an educational effort for the general public? My concern is that anyone could get numbers on a statement. Unless they understand the numbers, the numbers do not mean anything. Is there any way to help the general public understand those statements they are getting, and what the cut of the revenue sharing is when they get the statement?

Mr. ROYE. Again, this is a real challenge for us. I think for example if you go to our Web site and look at our investor education materials, you will find a fair amount of information there that is designed to help mutual fund investors. We have something called a mutual fund cost calculator on our Web site, which allows you to take the information out of the disclosure documents and facilitates comparison of one fund to another.

We have the investor education materials that talk about the importance of fees and how they can reduce your return. We have a whole office dedicated to trying to educate investors in this area. We are open to ideas about how we can enhance investor understanding. This is the ultimate challenge for us.

Mrs. KELLY. In your testimony, you talk about portfolio transaction costs and you mention that they are substantial in the mutual funds for many of the funds. Do you think that investors really would benefit from the enhanced information about the costs? Can you talk about what that impact might be on their choices, then, of the mutual funds that they use?

Mr. ROYE. We pointed out in our responses to Chairman Baker and Ranking Member Kanjorski in their inquiries that trying to get your arms around transaction costs is really very difficult and complicated. The Commissions are easily determinable. The funds know what they pay in terms of Commissions, but spreads are not readily apparent. How do you measure market impact of trades, opportunity costs?

With all that being said, we think that we ought to work toward trying to improve the disclosure in that area and having investors come away with a better understanding that these additional costs are something that they are bearing. The return numbers that you see reflect those costs, but you ought to have a better understanding of those costs. We think there may be some ways to do that, although it is a very complicated area, as we pointed out.

Again, we are back to your question of how do you get investors information in a way that they can understand and make use of it. So we view it as a challenge, but something that we think that we have to continue to work toward.

Mrs. KELLY. I just want to ask one more question, and that is, how frequently would you see this kind of information getting to an investor? Would it be better to have it there monthly, semi-annually? What would you at the SEC feel would be a valid response time for giving information to the investor?

Mr. ROYE. That is a good question. I think it is something that we would have to analyze and think about. There are various vehicles now that potentially could be used. There is the fund prospectus that investors get when they buy fund shares. Typically as a fund investor, you get the updated prospectus every year because the funds are continuously selling shares. So that is a possible vehicle. They get shareholder reports twice a year, and we are trying to improve the presentations there. This information could be presented there. Then typically they get quarterly account statements, which is another possibility. And then we could create some additional document.

But I think we have to be sensitive, again going back to Representative Kanjorski's question, in terms of overload and trying to make sure we tailor this information in a way that is effective and useful. I think that is the benefit of rulemaking and disclosure proposals, and getting comment and having investors react in trying to figure out what is most effective.

Chairman BAKER. The gentlelady's time has expired.

Mr. Matheson?

Mr. MATHESON. Thank you, Mr. Chairman.

The first question I would like to ask is, it seems to me that our desired goal here is that we would like to move in a direction of having real price competition in the mutual fund industry. First of all, will you give me your opinion on if you think we have any, or to what extent we have price competition today in that industry? Mr. Roye?

Mr. ROYE. I think that there is evidence that there is competition. If you look at where the assets are in the mutual fund industry, about a quarter of the assets are in the three low-cost providers in the industry. So that, I think, tells you that there are investors who are paying attention to costs, sensitive to costs, and a huge chunk of the industry's assets are in those three fund groups.

If you look at the cost of comparable funds outside the U.S., in Europe for example, you will see that the cost of comparable funds are probably one-third to one-half as great as they are in the U.S. So I think there is some evidence, and there is a fair amount of information out there about costs. Certainly, we can improve it, but I think you can point to certain factors that say, look, something is working here. Our whole regime is essentially based on trying to make those costs as transparent as we can so investors can make those kinds of judgments.

Mr. MATHESON. So you are saying that there is evidence that assets have moved to the lower-cost funds, but the fact that we are here, the fact that we are talking about this tells us that probably collectively we think there is not enough price competition in this industry, or we could do better. I guess that leads to the fundamental question of as you look at this legislation, is this going to get us where we want to be? Do you think we do not go far enough? Do you think it goes too far? Is this going to really affect true price competition in a better way?

Mr. ROYE. I think that the legislation goes a long way toward making a lot of these costs more transparent. There are certain costs that we view as not transparent enough. To the extent that we can surface those and enhance investor understanding of those, then I think we can have an impact on cost competition in the industry. So we view this as a positive.

Mr. MATHESON. One specific item in terms of disclosure that we talk about is portfolio manager compensation. Do you think that this legislation is adequate in setting up a system where there will be actual compensation reported to investors for portfolio managers?

Mr. ROYE. I think technically what the legislation calls for is the method of compensation, structure of compensation. I guess what I would say is that maybe it is not so important that you know the actual dollar amount. You know what the management company is being paid. That amount of dollars is being disclosed. You know what the company is being paid to manage the fund.

But perhaps the more important information is, what are the incentives that the portfolio manager has in managing the fund? Is the portfolio manager compensated for short-term performance, long-term performance? Is the portfolio manager compensated on a pre-tax, after-tax basis? If you are a tax exempt account, you could care less about taxes, and if you have some information about how the portfolio manager is compensated, you know something about

the incentives there. Maybe that will give you some insights into how they run the fund.

Mr. MATHESON. I would endorse having that information out there about the incentives and how they are compensated. I am trying to understand, and I know you did not draft the legislation, but I am trying to understand if there is some hesitancy to put in actual compensation for a portfolio manager. What are the arguments not to do that?

Mr. ROYE. I guess it would be privacy, issues like that. Again, you know what the management company is being paid. If they are getting paid millions of dollars to manage the fund, you can make an assessment about their performance and whether or not you are getting value for what the management company is being paid. Do you need to know what they are paying every employee in the management company to kind of make that assessment, probably not, at least in my view.

Mr. MATHESON. Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Mr. Matheson.

My turn.

Mr. Roye, there are some industry critics of this approach who have stated in press reports, at least, that the cost of conforming and implementing the bill as proposed would outweigh any benefit potentially to investors. Can you comment as to whether you think from the agency perspective, the bill is constituted, even though there may be a point or two over which there would be a differing method to achieve goals, the transparency provided, the reporting provided, the competitive environment which results coming from the flow of information. Isn't that more beneficial to the investor than the potential cost, even as the bill is currently constituted?

Mr. ROYE. I guess I would answer by saying that what the bill attempts to achieve in terms of goals are certainly worth it from a benefit standpoint. I think where we have to certainly spend some time thinking about is the implementation, the details of how we carry through on some of the directions from the legislation. I think that is what the Commission would have to be sensitive to and the direction from the Congress.

Chairman BAKER. To that end, there is discussion in your testimony concerning dollar disclosure versus a formula for a model $10,000 investment. You also stipulate in your testimony that the Commission has some significant concern about the level of understanding investors have about the real fees that are assessed, and their ability, even a sophisticated investor, to get to the bottom end conclusion of comparability.

Is their concern that the dollar disclosure will cost more to fund managers and the investment world than it is worth to the investor side? I am a cost-benefit kind of guy. I don't mind spending money if the end results generates a net gain for us. Can you speak to that balance?

Mr. ROYE. Sure. We clearly share your concern, and your example in the opening statement about your son's statement and trying to figure out just what it means and what you are paying in terms of expenses is a real concern and a real problem. We want to address that. The ultimate question is, how do you get there? How do you do it? What makes sense from a cost-benefit standpoint?

The Commission has an outstanding proposal that would use fund shareholder reports to enhance this fee disclosure. It would be dollar disclosure. I think one of the problems that we sense in the fund area is that when you look at how the fees are communicated, they are largely translated in terms of a percentage of assets, expense ratios.

Actually, if you took that information and used it, you could make some good judgments about low-cost funds and high-cost funds, but investors have difficulty understanding the concept. So can we turn it into a dollars and cents analysis so investors can make sense of it?

So you want to enhance competition. You want investors to understand fees. In between, you have to have what you alluded to, which is some means to compare one fund to another. What we tried to do in the proposal with the $10,000 example was using the fund's actual expenses, using the fund's actual return on a $10,000 investment, translating that into dollars. So you could estimate what it costs you to be invested in the fund over, say, a six-month period.

We proposed a second number which would use the actual expenses of the fund and an assumed rate of return, so you could take that number and compare it to another fund. So if you got your semi-annual report and you looked at the number there, and it showed that it cost you $98 to be invested in that fund, you could take the number, get a report from another fund, and figure out whether your fund was comparable to that from a fee standpoint high or low.

So we were trying to do that in a way that minimized the burden and the cost, and do it in a way that we thought investors could understand. I think the GAO has recommended we use account statements to do that, and some of the other folks who are testifying have recommended different ways to accomplish that. This is a proposal we want to obviously step back and look at what the GAO has recommended and what others have recommended.

Chairman BAKER. Let me bring Mr. Hillman in at that point. Mr. Hillman, what is your view with regard to real-dollar versus a formula disclosure? What is the take that you have?

Mr. HILLMAN. We have endorsed what the SEC is proposing by placing additional information in specific dollar amounts on a $10,000 investment. We think it will provide additional information to investors and it will also help ensure comparability looking across funds of what these expenses are. The main issue that we seem to have, as Mr. Roye alluded to, is really the placement of some of this information, Mr. Chairman. Our view is in order for these disclosures to be of real benefit, they have to be read by the investor.

Studies conducted by the ICI and others suggest that the information of most interest to investors is disclosed in the account statement. That is where investors go regularly to determine what their account value is. If disclosures on fees were placed in that statement, we feel it would have the maximum benefit.

Putting disclosures in a prospectus or putting them in a semi-annual or annual report, or putting them in a statement of additional information which can be requested by the investor to look at, are

also important measures, but they are probably not going to give you the same benefit as coming from an account statement.

Chairman BAKER. Thank you very much. My time has expired.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

I just have a few basic questions. I have not heard anyone anywhere ever tell me that they opposed enhanced disclosure. I would just like to hear from Mr. Roye and Mr. Hillman, have you heard from anyone in a professional manner that they would oppose some form of enhanced disclosure?

Mr. ROYE. In the context of this bill?

Mr. CAPUANO. Yes.

Mr. ROYE. Not yet.

Mr. CAPUANO. Okay. Mr. Hillman?

Mr. HILLMAN. Disclosure is one of the less-costly options to ensure that investors have a good understanding of the fees and costs associated with their funds.

Mr. CAPUANO. So you have not heard anybody oppose the concept of enhanced disclosure?

Mr. HILLMAN. No.

Mr. CAPUANO. Because I haven't either, and I was kind of wondering why we are doing this so quickly if no one opposes it. We are all for it. It strikes me that I have two very professional gentlemen in front of me and I have 60-odd professional people here with me, and we are not 100 percent sure yet exactly what is the best way to go and how to get this done in a manner that is not going to overburden the industry, not going to do anything other than help the consumers. Personally from my end of it, I say, well, this is a great idea, let's do it, but let's talk this out. Let's get this right so that we don't have to go back and forth like a ping-pong ball.

Even as I sit here today, I hear two very valid different viewpoints on an important issue. My expectation is that nobody at the GAO and nobody at the SEC is trying to find ways to say they are for disclosure, but yet really not be. I assume that you are being honest about it, on a personal basis and on a professional basis, for your agency.

I would also like to know, as I understand it, under current law the SEC theoretically has the ability to do this if they wanted to do it just willy-nilly. Am I wrong in my understanding, Mr. Roye?

Mr. ROYE. We clearly have the ability to effect a lot of disclosure changes. In some of these areas, we are already working toward that. There are other aspects of the bill that we would not have authority to achieve on our own.

Mr. CAPUANO. Then I just want to close by expressing my appreciation for the fact that you are not just knee-jerking, coming up with something that though you have your opinions, you have been willing to listen to other people and to take all that into consideration before rushing to judgment. I would hope and I would assume that the Congress will do the same.

Thank you.

Chairman BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman, and welcome to our witnesses.

Mr. Roye, in your prepared remarks you state that the bill's disclosure requirements, quote, "should help to address ongoing concerns that fund investors do not understand the nature and long-term effect of recurring mutual fund fees." Would you discuss that a little bit further and indicate how the SEC has cited the lack of investor understanding of fund fees? In that context, how would this legislation and subsequent regulation help in that regard?

Mr. ROYE. Sure. There are really two categories of fund fees. There are transactional-type fees; sales loads that investors pay. They see those, they feel those. Then there are ongoing expenses and fees that are coming out of fund assets. These are typically again expressed in terms of percentages of net assets and disclosed in that way.

I think to some extent it is hard for investors to understand what that means in terms of dollars and cents. One of the goals here of the bill is to translate a lot of these ongoing expenses and expenses that are not readily apparent to the investor, to surface those and make them more transparent, again with the goal of enhancing their understanding and hopefully leading to greater competition.

Mr. OXLEY. Mr. Hillman, do you have any comments in that regard?

Mr. HILLMAN. Yes, I would agree that right now, given the fact that investors receive fund performance data net of fees, that is a problem in having investors better understand the fact that their mutual funds incur fees. The legislation requiring more specific dollar disclosure of fees would eliminate this ambiguity over how much an investor is actually paying, and we hope then potentially spur increased competition to ensure that fees are kept to a minimum.

Mr. OXLEY. In both of your works, did you actually take a look at some of these statements and fee schedules and compare and contrast some of those?

Mr. HILLMAN. A lot of that fee information that you are alluding to currently is done on a net basis of performance. Therefore, the investor really does not have an opportunity to evaluate how much the fee is and what implications that has across funds.

Mr. OXLEY. But were you able to discern that by your work that you did in background in preparation for the hearing? Obviously, you are not the average investor. I am just wondering how you came to that conclusion, and indeed how you were able to perhaps break through some of that information.

Mr. HILLMAN. As part of our study, we did for you and this committee and subcommittee, we did compare the types of disclosures required by mutual funds compared to other types of specific financial products, where they do disclose actual dollar amounts and fees, and where it becomes much more clear to the consumer what those costs are. Those same types of disclosures currently are not available to the same extent in the mutual fund environment.

Mr. OXLEY. Would you have any other comments, Mr. Roye?

Mr. ROYE. Yes, what I would add to that is, of course, we write the disclosure documents. We are in charge of the rules so we know what they require, and we know what is in the reports and we know what is in the statements. Again, I think that we look at the existing regime and believe it can be made better.

If some of the additional practices have grown, like revenue sharing, we think that the disclosures clearly should be surfaced and made clear to investors so they understand some of the incentives and conflicts associated with some of these payments. So clearly there is work to be done here, and the bill addresses those concerns.

Mr. OXLEY. Mr. Hillman, as you know and I am sure Mr. Roye obviously knows, the SEC currently has pending a rule proposal that would require mutual funds to disclose in annual and semi-annual reports new disclosure regarding mutual fund fees. Mr. Bullard, who will testify in the next panel, states that the SEC's rule proposal would require disclosure not in a document that less price-sensitive shareholders are likely to review, but in a semi-annual report. Why would the quarterly statement be more useful than the semi-annual report in a prospectus?

Mr. HILLMAN. In a survey performed by ICI about how investors obtain information about their funds, the Investment Company Institute found that account statements is probably the most important communication to investors. Nearly all shareholders use such statements to monitor their funds. The point here is, for disclosures to be beneficial, you want them to be read. The document that is most read is the quarterly account statement.

Mr. OXLEY. Thank you.

Mr. Chairman, thank you very much.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Emanuel?

Mr. EMANUEL. I apologize for missing the earlier parts. I was at another hearing at the Budget Committee on waste, fraud and abuse.

On the two approaches that SEC is studying and GAO is studying, my question is a general question on this approach. I am trying to get relevant information and not confuse the words between "relevant" versus "more." They are not the same, and for investors to get relevant information that allows them to compare fund to fund, what is your sense of how we should approach that and how we make the distinction between "relevant" versus just "more" information?

I think everybody has a sense that they are overloaded with information. Really, what we are trying to get at, and root kind of problem is, how do we get the individual investor information that is important to them so they can compare fund to fund as it relates to cost?

Mr. ROYE. That is a question that we struggle with continually at the Commission. Where we have a disclosure regime, obviously we want the disclosure to be effective. We want it to be the information that investors need to make that investment decision, and how can we present that information so they can make use out of it, and make intelligent investment decisions.

I think the debate here is how to get really fee information to investors in a way that they can understand it. We think the notion of dollars and cents disclosure is very sensible and that will demystify expense ratios and percentages of assets. If we can communicate to investors expenses in a dollars and cents common

sense way, that will go a long way toward making sure they understand mutual fund fees and expenses.

The question is, what vehicle, what document would be most effective in getting that information and the cost of doing that. We have a proposal outstanding. It is not final. Obviously, we want to step back and look at what our colleagues at GAO have recommended and suggested and others have suggested.

We are digesting the comments in this area. But the Commission's initial thought on this was again to be able to take a $10,000 investment, use the actual expenses of the fund, and use the actual return of the fund and translate that into a dollar number. So you can understand what it costs you to be invested in that fund.

Mr. EMANUEL. Can I interrupt for one second? From the GAO's perspective, if we were to adopt what the SEC has recommended, would you see that as an improvement over the present situation?

Mr. HILLMAN. Absolutely.

Mr. EMANUEL. A marked improvement? Significant?

Mr. HILLMAN. It would be a significant improvement. It would provide investors with increased information to compare fees across funds. It goes the added step of providing the specific dollar disclosure that you are looking for to reduce the ambiguity; to demystify the net assets. Our concern would be more about the placement of that information than the recommendations that SEC is making.

Mr. EMANUEL. And what would you do, then, if you were just to tweak it, just to get it over the goal line, then?

Mr. HILLMAN. One possible alternative would be to use exactly the same information that the SEC is proposing, but to put that in addition to semi-annual reports, to put that within the account statement, so that investors have a greater opportunity of actually reading it.

Mr. EMANUEL. Okay.

Mr. Chairman, no further questions. Thank you.

Chairman BAKER. Thank you, Mr. Emanuel.

We have no further members for questions at this time, am I correct? Okay, I am correct.

Mr. Roye, I would like to just make a request for the benefit of the committee. It was the hope that we could move toward subcommittee consideration of the proposal sometime in mid-July as a goal. Given the comments of the agencies this morning, we would very much request some closure on opinions perhaps on our return after the July Fourth recess for the members to have time to adequately assess any modifications that may be suggested, so that we can move as much as is practicable to a mid-month consideration of this proposal. If the agency does not find that an unreasonable request, we would certainly appreciate it.

Mr. ROYE. We will try to accommodate you.

Chairman BAKER. We thank both of you for your participation. It has been most helpful to the committee, and thank you for your help.

At this time, I will call up our next panel.

I want to welcome our panelists to the hearing this morning. As is the usual custom, we will request that if possible make your statement within a 5-minute constrain. Of course, your official testimony will be made part of the record. I am advised that we will

have a series of votes interrupt our consideration at some time within the next 15 or 20 minutes, but we will proceed to receive as much testimony as we can, and then recess the committee briefly for members to make those votes.

I would like to welcome back to the committee, certainly no stranger here, Mr. John C. Bogle, who is the founder of the Vanguard Group. Welcome, Mr. Bogle.

STATEMENT OF JOHN C. BOGLE, FOUNDER, THE VANGUARD GROUP

Mr. BOGLE. Thank you Chairman Baker and Ranking Member Kanjorski and members of the committee. I am delighted to be back with you again to talk about your proposed amendments on the Integrity and Fee Transparency Act of 2003.

And particularly on disclosure, I compliment you on the disclosure and the call for reporting of costs, the annual operating expenses borne by each shareholder, I will come back to that in a moment, and especially the requirement which has profound consequences, to have an independent Director serve as Chairman of the funds.

I want to say right at the outset, however, that I hope the final legislation you draft will go further, because I do not believe that this industry has adequately measured up to its responsibilities to mutual fund investors. The express language of the preamble to the Investment Company Act of 1940, which the Investment Company Institute in its testimony correctly called "our common legacy," calls for mutual funds to "be organized, operated and managed" in the interests of shareholders, rather than the interests of "Directors, officers, investment advisers and underwriters." I believe it is impossible to argue that that has been the case in this industry.

Consider, for example, how fund expenses have soared over the past quarter-century. I am in a little bit of trouble here with the industry for saying that expenses rose 120-fold, from $523 million in 1979 to $64 billion in 2001. Even in 2002, with our equity fund shareholders having lost 34 percent of their money from the markets deck, the total fund expenses amounted to $62 billion. That 120-fold increase is far higher than the increase in fund assets during that period, which went from $70 billion to $6.5 trillion, or about 90-times over. The net result, the expense ratio of the average mutual fund rose from about nine-tenths of 1 percent to 1.36 percent. So to be fair, the unit expenses are up only, if that is a word one can apply to such an increase, 51 percent.

In my direct personal hands-on experience in being in this business and running a company for more than 2 decades, the economies of scale in this industry are staggering, and they simply are not being shared with mutual fund investors. Specifically, Vanguard expense ratios, and I don't mean to plug Vanguard here, but we operate at-cost so we know what the costs are, are down 60 percent in that period, compared to the industry rise of 51 percent.

Expense disclosure will help. Further strengthening the board of Directors will help. But I also think we need an express standard of fiduciary duty playing off the language in the preamble to the 1940 Act, specifically a fiduciary duty that Directors place the in-

terests of fund shareholders ahead of the interests of fund managers and distributors.

I want to emphasize how crucially important costs are in shaping investment returns. The impact is enormous. For example, if we assume a future market return of 8 percent and assume, on the low side, for costs are actually higher, 2.5 percent cost of mutual funds, the compound return of the stock market at 8 percent would produce a $58,000 profit on that $10,000 investment over 25 years. The return on the same investment after costs of 2.5 percent would produce a $28,000 profit, less than half as much as the profit on the market's return. More than half is confiscated by expenses. 2.5 percent is a huge, huge cost to the long-term investor, staggering in its dimension.

Disclosing the dollar amount of costs invest incur would be very helpful to investors, and it would be virtually cost-free. I want to put that to rest. We do not need to make any estimates. All we need to do is take the fund's expense ratio during the prior 12 months, apply it to the dollar value of the assets that the investor has at the end of the period, and say these are your annualized expenses, period. It would cost so far from $265 million, the absurd estimate I have read, that you would not be able to see it. The cost would be virtually zero.

I want to emphasize something we have not talked about in these hearings. Think of the impact of that disclosure not on equity fund shareholders, but on money market shareholders. Consider a shareholder with $10,000 in a money market fund. The money market fund would yield about 1.25 percent and the investor received net income of $25, a quarter of 1 percent, after fees of perhaps $100; $100 to the manager out of $125 and $25 to the investor. If that would not open an investor's eyes, I do not know what would.

I am going to skip a couple of things over here, but I do want to get to my final point and do not want to run over my time too badly. I want to comment on the conventional industry allegation that the industry must be good because it has never had a major scandal. If a scandal is described as a "grossly discreditable condition of things," it is not clear that this statement is accurate.

Consider the returns of mutual fund shareholders versus the stock market. For the last 20 years, the U.S. stock market has averaged a return of 13 percent. The average mutual fund investor, believe this or not, has averaged a return of a little bit over 2 percent a year. An investor in the stock market, $105,000 profit on $10,000; the average mutual fund investor, $5,000. Is that a scandal or is it not?

That lag is important to the responsibility of this business. During the years leading up to the peak of the stock market bubble, we offered the public. 494 new technology, telecom, Internet and aggressive growth funds favoring those sectors. It is not conceivable that those funds were organized, operated and managed in the interests of investors, rather than the interests of fund managers. Is that a scandal or not?

These new funds, these high-risk funds, believe this or not, took in $500 billion in that period, as the investor greed of that era drew the money into funds. But we helped them. We advertised in

Money magazine in March, 2000, right at the peak, an average return of 85.6 percent in the previous year. We lured the sheep into this terrible market. Is that a scandal or not? You can decide.

I have been in this business for 52 years and I think we are suffering from a severe case of the emperor's clothes syndrome. What is all too obvious to anyone who opens their eyes, from Warren Buffett to the respected Morningstar Advisory Service, seems invisible to the industry. I want to emphasize, that every person I have ever met in this industry over my long career has not been other than a good, capable, honest human being. But I believe the powerful financial interests of investment executives and the companies that manage the funds blind them to the realities of today's investments and the terrible penalty of cost.

That is why I am here today. I believe that this industry can only survive if investors are given a fair shake, with managers focusing not on salesmanship, but on stewardship. Progress is being made, but I think we have got to go further if we are going to live up to the promise of the 1940 Act, which is to serve the national public interest and the interest of investors.

Thank you, Mr. Chairman.

[The prepared statement of John C. Bogle can be found on page 60 in the appendix.]

Chairman BAKER. Thank you, Mr. Bogle.

Our next participant is the founder and President of the Fund Democracy, Mr. Mercer Bullard. Welcome, Mr. Bullard.

STATEMENT OF MERCER BULLARD, FOUNDER AND PRESIDENT, FUND DEMOCRACY

Mr. BULLARD. Thank you, Chairman Baker, Ranking Member Kanjorski, members of the subcommittee. Thank you for the opportunity to appear before you today to discuss H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. It is an honor and a privilege to appear before the subcommittee today.

I am the founder of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders and an assistant professor of law at the University of Mississippi. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational regulatory issues that affect their fund investments. I have previously counseled mutual funds and investment advisers in private practice, served as an assistant chief counsel in the Division of Management at the SEC, published an industry newsletter for mutual fund lawyers, and published and written a column on mutual fund operational issues for Thestreet.com.

More than 95 million Americans are shareholders in mutual funds, making mutual funds America's investment vehicle of choice. These shareholders, I believe, have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative. This will continue to be true, however, only as long as mutual fund rules keep pace with changes in the fund industry. In significant respects, fund rules have not kept pace with developments in the fund industry. H.R. 2420 is necessary to update rules to ensure that mutual funds remain the best possible alternative for investors.

The fund industry owes much of its success to the requirements of the Investment Company Act of 1940 and the body of law that has grown up around it. The Act provides liquidity by requiring that mutual funds be redeemable on demand at a price based on their net assets. Fund rules provide safety by prohibiting transactions between funds and their affiliates, and by limiting the amount of leverage that funds can use. Transparency and standardization are assured by rules regarding the use of standardized investment performance and fee disclosure. These rules are buttressed by the presence of an independent board of Directors that oversees fund operations to ensure that funds are operated in the best interests of their shareholders, and not fund affiliates.

Mutual funds offer liquidity, safety, transparency and standardization at a reasonable price, again partly as a result of effective regulation. The fee information provided in the prospectus provides investors with standardized costs that can be used to compare different funds. This information can also be easily disseminated through the information channels that investors use when making investment decisions. The transparency of fund fees promotes price competition and has resulted in the availability of a wide variety of low-cost fund options.

Fund regulation has also been successful in adapting to changing business practices. Many of the fundamental characteristics of mutual funds owe their existence to regulatory reforms, including the fee table, standardized investment performance, 12b-1 plans, and multi-class funds. As Mr. Bogle can attest, The Vanguard Group itself, America's second-largest fund complex, exists and operates only by reason of the series of exemptions that Mr. Bogle obtained from the SEC in the 1970s.

In some respects, however, fund regulation has failed to adapt to changing business practices. Fund distribution and brokerage practices have changed dramatically over the last 20 years. The rules governing fund disclosure and fund Directors's responsibilities have not kept pace. The true cost of investing in mutual funds has become obscured by fee disclosures that fail to reflect accurately how and how much shareholders pay for fund-related services. Fund governance rules need to be improved to give independent Directors the authority and tools they need to oversee funds' increasingly complex distribution and brokerage practices.

H.R. 2420 takes an important first step in modernizing fund rules to reflect the way that funds operate today. H.R. 2420 will update fund disclosure rules to provide investors with needed information about fund costs. It will provide investors with a clearer understanding of the impact of fees by requiring that they be disclosed in dollar amounts. Fee disclosure will be required to incorporate all fees, including portfolio transaction costs, and to identify all distribution expenses, including those paid outside of 12b-1 plans. Improved disclosure of compensation to portfolio managers and to retail brokers will enable shareholders to evaluate the extent to which these persons' economic interests are aligned with their own.

In addition, H.R. 2420 will strengthen the role of independent Directors and further focus their energies where conflicts of interest between the fund adviser and fund shareholders are greatest.

Recent scandals have reminded us of the importance of proactive leadership in the boardroom. H.R. 2420's requirement that a fund board's Chairman be an independent Director will ensure that the leadership of America's funds is independent.

That concludes my statement.

[The prepared statement of Mercer Bullard can be found on page 66 in the appendix.]

Chairman BAKER. Thank you, Mr. Bullard.

For the introduction of our next witness, I would like to turn to Mr. Ford for a comment.

Mr. FORD. Thank you, Mr. Chairman.

In the interests of keeping the next witness in good standing with her own congressman, I would defer to her own congressman first and I would love to say a few words once he finishes. So I defer to Mr. Emanuel, Ms. Hobson's congressman.

Mr. EMANUEL. We have been having this fight for six months on who likes Mellody more.

I understand, but we have 15 minutes before votes, so I am letting Mellody go. She is an impressive person who, if you do not have an opportunity to hear her today, you can always watch her on Good Morning America giving advice. So we are very fortunate to have her here.

Chairman BAKER. Welcome, Ms. Hobson.

Mr. FORD. She also raised some important points about the size of fund that she manages, in a lot of ways ensuring some of the things that the University of Mississippi law professor just raised, ensuring that those kind of things do not impact small funds disproportionately. So it is a delight to see her and I am glad to welcome her to Washington again.

Chairman BAKER. Just for the sake of our process here, we have had votes announced. We would like to proceed to receive Ms. Hobson's testimony. In order to give you time where you will not be rushed, I would suggest at that point we then recess for votes and come back to hear Mr. Haaga's testimony at that time.

Ms. Hobson?

STATEMENT OF MELLODY HOBSON, PRESIDENT, ARIEL MUTUAL FUNDS

Ms. HOBSON. Okay. Thank you very much, Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee.

Testifying about investor confidence when the issue is more important to our economy and a more relevant event to the destinies of average Americans than ever before is a great honor and even greater responsibility. I am President of Ariel Mutual Funds. Ariel is a small investment firm and a small business. We offer four mutual funds. More than 100,000 individuals have given $3.7 billion to us to invest. Ariel is based in Chicago and we have 67 employees.

In addition to my work at our firm, I also contribute a weekly segment on personal finance and investment issues for a network television program. My colleague John Rogers founded Ariel 20 years ago. At the time, we were the first minority-owned money management firm in the nation. He was 24 years old. John discovered the stock market at the age of 12 when instead of toys, his

father bought him stocks every birthday and every Christmas. That childhood interest evolved into his life's work and ultimately created the passion that led to the creation of Ariel.

This story tells you about the heart and soul of one small mutual fund company in America. Some have suggested to the subcommittee that the mutual fund industry is dominated by firms who have forgotten their fiduciary obligations, lost their connection to individual shareholders, abandoned the basic principles of sound investment management, and repudiated the industry's proud history. Nothing could be further from the truth. As a mutual fund executive, my future, my credibility and my integrity are inextricably linked to Ariel's shareholders's success.

Moreover, Ariel takes enormous pride in being part of a great industry. We work hard to reach out to those who have not seen firsthand the wonders of long-term investing, compounded growth, and the creation of enduring wealth. One important aspect of our work is the unique mission to make the stock market a subject of dinner table conservation in the black community.

It is therefore heartening to come to Washington and see policymakers who care so much about investors. We applaud your efforts. When you find effective ways to reinforce investor protections and support the integrity of our markets, you help our business and you help our shareholders.

I am aware that four major government reports on mutual funds have been published in the last 36 months, two by the SEC and two by the GAO. Taken as a whole, the reports reaffirm the health of the fund industry and the continued effectiveness of the regulatory regime that governs it. It would be logical to think that the SEC had put other fund initiatives on hold while these studies were completed, but that has not been the case. Since 1998, the SEC appears to have adopted at least 20 new mutual fund regulatory initiatives, averaging one every 12 weeks. This appears to be the fastest rate in SEC history.

Of course, each initiative can include multiple forms, rules, requirements and mandatory filings. I will attach a more extensive list for the record, but recent SEC mutual fund regulations have included new requirements in areas ranging from consumer privacy to proxy voting to after-tax return performance. In addition, at least four new major initiatives are now pending.

The sheer number and range of these regulations demonstrates the vitality of the SEC's efforts to help 95 million fund investors. I also think it bears noting that the ICI has worked constructively with the SEC on virtually all of these matters, and has endorsed the overwhelming majority of them.

We should, however, remember that these new regulations invariably lead to significant costs. The SEC deserves credit for several efforts that reduced fund regulatory costs, but those initiatives are dwarfed by regulations that have added far larger cost burdens. Reviewing the SEC's own cost estimates for these rules is striking. The net impact of SEC mutual fund rulemakings since 1998 appears to have increased the fund industry's regulatory costs by at least several hundred million dollars annually.

I am worried that the impact of all of this on small mutual fund companies could ultimately contribute to making the fund industry

less hospitable to innovative startups and perhaps even less competitive. I am not certain that in good faith I would advise a 24-year-old today to take on the costs and burdens of starting a mutual fund family, as John Rogers did when Ariel was started.

Let me turn to some general observations about the bill. Section 2 of H.R. 2420 directs the SEC to initiate expedited rulemaking on six broad new mutual fund disclosure mandates. As the subcommittee considers whether to support this directive, as I have stated, I am hopeful that the inevitable impact on smaller fund companies will be carefully thought out. It would be deeply regrettable if attempts to heighten shareholder disclosure eroded the competitive position of the most dynamic and entrepreneurial parts of the fund business. For that reason, I urge you to provide sufficient time so that a consensus approach to these issues can be embraced.

Fed Chairman Alan Greenspan recently observed that in our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency. He said that improved transparency is more important, but harder to achieve than improved disclosure. Former SEC Chairman Leavitt once expressed a similar concern, stating that the law of unintended results has come into play. Our passion for full disclosure has created fact-full reports and prospectuses that are more redundant than revealing.

The possibility that disclosures might impede, rather than enhance, decisionmaking is a real concern. For that reason, it is worth noting that the SEC, when they made changes to their own prospectus reform five years ago, they mentioned that learning too much information discourages investors from further reading or obscures essential information about the funds.

After reading the SEC and GAO reports and reviewing the transcript of the subcommittee's March hearing, it is obvious that a substantial effort has been undertaken to explore the ways to bolster mutual fund investors' understanding of fund fees and expenses. Fortunately, recent ICI data about investors's actual behavior supports the message that fund fees has broken through.

The ICI looked at all equity fund sales over a 5-year period ending in 2001 and found that, first, 83 percent of all equity funds bought by investors had expense ratios below the 1.62 percent average charged by the average fund; and secondly, that the average investor holds equity funds with a total operating expense of .99 percent, about 39 percent lower than the fee level charged by the average fund.

These findings indicate convincingly that very large majorities of fund shareholders own funds with lower than average costs. I hope the subcommittee will bear this data in mind as it further considers these issues.

Lastly, I mentioned earlier that I conduct personal finance features on a television network news program and author a bimonthly column. I have received literally thousands of questions and requests for guidance in this role, and hear one refrain more than any other: people feel overwhelmed by information. Young, old, married, single, black, white, working, retired, investors want insight in ways to cut through the noise so they can get to the most

important information that will help them make the best investment decisions. I never hear complaints about having too little information. It is always the opposite.

Interestingly, I have received many fairly sophisticated inquiries, but never have I received one single question about soft dollars, directed brokerage, rule 12b-1, or many of the other mutual fund issues that we have discussed today. Perhaps there can be a small insight gleaned from that.

Again, many thanks for the privilege of testifying. I look forward to your questions.

[The prepared statement of Mellody Hobson can be found on page 135 in the appendix.]

Chairman BAKER. Thank you, Ms. Hobson.

We are now down to 5 minutes on votes. We will stand in recess for approximately 20 minutes. Thank you.

[RECESS]

Chairman BAKER. Just to proceed, certainly within the time frame allocated for Mr. Haaga's testimony, we should have a member return. I am advised they are on their way.

The Chairman of the Investment Company Institute, Mr. Paul Haaga, please proceed, sir.

STATEMENT OF PAUL HAAGA, CHAIRMAN, INVESTMENT COMPANY INSTITUTE

Mr. HAAGA. Great. Thank you very much, Chairman Baker and members of the subcommittee. It is actually not a problem that they will miss a lot of my testimony, because we are in very substantial agreement with the SEC and the GAO. So if they were here this morning, this may be largely a replay.

I am very pleased to be appearing before you today, as I did in March, and again I am doing so as Chairman of the Investment Company Institute's Board of Governors. H.R. 2420 was introduced shortly after the release of a detailed report by the staff of the Securities and Exchange Commission. The SEC report, we are happy to say, found no significant shortcomings in mutual fund regulation. However, the report does recommend a series of policy changes and also identifies areas warranting further study.

In large part, the industry agrees with the SEC staff's recommendations and we are committed to working with the Commission on these issues. Since then, we have also, of course, received the GAO report and we are in very substantial agreement with the GAO recommendations.

I will discuss the provisions of H.R. 2420 in three parts. The first part consists of those provisions that we believe would be beneficial to mutual fund investors and could be implemented through SEC regulation. We call upon the SEC to proceed expeditiously in these areas and we pledge our full cooperation.

The second are those which would also be beneficial to fund investors and in which voluntary industry practices could be initiated. As Chairman of the ICI, I pledge to move forward in these areas. The third are several provisions that we respectfully submit would not be advisable.

To begin with we believe the SEC should take action in four areas. First, we call upon the SEC to adopt as soon as practicable

the rules it has already proposed that would require fund shareholder reports to disclose the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and the return for the period of the report. We believe this proposal is superior to alternatives that have been suggested, as it will enhance investors' understanding of fees and most importantly, will permit them to compare the expenses of different funds.

Second, we recommend that the SEC address the other areas of disclosure identified in H.R. 2420, including portfolio transaction costs, revenue sharing arrangements, fund brokerage practices, and the structure of portfolio manager compensation. The SEC report makes several suggestions in these areas, each of which is worthy of serious consideration.

Third, we recommend that the SEC clarify the roles of fund advisers and fund Directors in connection with soft-dollar and directed brokerage arrangements as the legislation proposes. This is a good idea and the SEC does not need to wait for legislation to take this step. In fact, I would point out this has been a very important part of the SEC's regulatory agenda for a long time now. Back in 1998, they did a sweep of advisers and found a number of problems, but none of those were with respect to advisers managing mutual funds.

Fourth, the legislation requires the SEC to undertake a thorough review of soft-dollar practices. We believe this is one of the most important issues addressed by the bill. We recognize the SEC has been actively reviewing soft-dollar practices for some time, especially through its inspection program. We believe it is time now for a review of the rules governing soft dollars.

There are also areas in which the mutual fund industry can and should take voluntary steps to enhance investor confidence in our own system of corporate governance. First, we support applying the standards for audit committees established in the Sarbanes-Oxley Act to mutual funds. The audit committee standards are one of the few provisions of the Sarbanes-Oxley Act not applicable to mutual funds. H.R. 2420 would require mutual funds to adopt these standards. However, we do not need to wait for legislation, and I will recommend to the ICI board of governors that the standards proposed in H.R. 2420 be adopted as a best practice.

Second, we agree with the SEC report and H.R. 2420 that it is inappropriate for certain relatives and persons with material business or professional relationships with management to serve as independent Directors of a mutual fund. I will also recommend to the ICI board of governors that it adopt a best practice under which these individuals would not serve as mutual fund independent Directors, as the industry has already done with respect to former employees of fund management companies.

Third, I wish to point out that the ICI has adopted corporate governance best practices relevant to many of the issues addressed in the legislation. These include having independent Directors constitute at least two-thirds of fund boards, having a lead independent Director, and having independent Directors regularly meet in executive session. Because independent Directors meet and vote separately on the most important governance matters, annual renewal of the management, and distribution contracts, the latter

two accomplish the objectives behind the proposal that funds have an independent chair.

Our understanding is that the vast majority of fund groups follow all of these best practices. However, in order to ensure that their adoption is as close to universal as possible, I will also recommend to the ICI board that it take further steps to urge each individual member of the ICI to adopt them. I believe that the above SEC and industry actions will accomplish the primary objectives of H.R. 2420, and will send a message to investors that we, Congress, the SEC, the GAO and the industry, intend that their interests come first.

There are also some parts of the legislation that we just do not think would be a good idea. I would like to briefly mention three of them. First, as I stated, we believe that existing practices in the fund industry, such as lead Directors and regular meetings of independent Directors in executive session, make it unnecessary to require mutual funds to have an independent Chairman of the Board.

I might add to that the requirement that two-thirds of the Directors be independent. Not only is it unnecessary, but having an independent Chairman could actually result in a less effective board. Most matters that come before a fund board do not involve conflicts of interest, but are matters on which board oversight is facilitated by having a chair be intimately familiar with the operations of the fund. A management representative is usually in the best position to do this. As I stated, for those matters that do involve potential conflicts or would benefit from a separate discussion among independent Directors, the existing practice of an executive session chaired by a lead independent Director would suffice. We note that none of the self-regulatory organizations have proposed that operating companies be required to have an independent chair as part of their recommended corporate governance standard. We think that mutual funds are not any different in this regard and should not be singled out for this requirement.

Second, we believe it would be a mistake for the legislation to dictate the specifics of how certain items should be disclosed and in which document they should appear. The SEC is the agency charged with administering the securities laws and it has the experience and expertise to make these determinations. Moreover, the regulatory process allows input from the public and a careful weighing of costs and benefits. It also provides maximum flexibility to adjust thereafter to changing circumstances. We are particularly concerned with the legislation's presupposition that prospectus disclosure is not sufficient for any of the items covered. Under the securities laws, the prospectus is the legal document required to include all of the important information that is necessary to assist an investor in making an investment decision. Congress should not inadvertently discourage investors from viewing the prospectus as the most important disclosure document.

Third, to the extent H.R. 2420 would require disclosure of individualized operating expenses, we believe this would not be the most effective way of providing disclosure of fund expenses to investors. Unlike the SEC's proposal, this approach would not pro-

vide investors with cost information that permits comparisons because costs would not be based on a standardized amount.

In addition, as the SEC report notes, this type of disclosure would impose enormous costs and burdens on funds and intermediaries. Funds in my group are sold through independent dealers and because of this, my fund company does not send out account statements to most investors. Instead, most investors receive those from brokers or 401(k) plans, so it would be others who would have to implement that.

For these and other reasons, we recommend that once the SEC adopts its new rules on expense disclosure, which we hope will be soon, Congress study their effectiveness before mandating another costly and in our view far less effective form of disclosure.

I would also note that the GAO's report which was released this week discussed several different ways in which fee disclosure could be included in account statements. I was pleased to hear the discussion this morning that seemed to offer some flexibility there to include it in another document and to include it on a standardized basis. We would be happy to work with both agencies in that regard.

I will close by noting that beyond any of the specific matters I have touched upon, the mutual fund industry is committed to working with this subcommittee and others to continue to pursue reforms that will meaningfully benefit mutual fund investors.

Thank you very much.

[The prepared statement of Paul Haaga can be found on page 90 in the appendix.]

Chairman BAKER. Thank you, Mr. Haaga.

I think it is important just to reflect a bit on how we came to where we are this morning with the Capital Market Subcommittee review. This really is another component of our market-sector-by-market-sector analysis of arms length oversight which is frankly appropriate in light of the significant time that has passed since the committee has had a mutual fund discussion, and coupled with the enormity of growth we have seen, not only in notional dollar amount, but in numbers of investors. This is no longer an activity that is relegated to sophisticated financial individuals. Working families in everybody's community have some stake or interest in the performance and understanding of their mutual fund investments.

Secondly, we are really here to help, we hope, with restoration of investor confidence. It had a measurable economic effect when working families made a conscious decision to withdraw their money from the capital markets and park it on the sideline for whatever the reason, whether a corporate misgovernance issue, whether disappointment in the performance of a particular fund. To ensure individuals that there is a third party looking at this matters, I think ultimately is helpful.

Ms. Hobson, you indicated specifically with regard to concern of a smaller-managed fund, the impact that disclosure may have on the viability of the fund and on net return to individuals who are investors. I share those concerns. But in your further explanation, you indicated that very few investors talk to you about soft-dollar arrangements or 12b-1.

Frankly, if I went back home to Baton Rouge and talked about 12b-1, most of my constituents would think I was talking about a nutritional program. They don't know about these things. They don't have enough information to propound the question.

Are there provisions that are now applicable to the operation of your fund that you feel do not provide any significant measure of benefit to the consumer that we could repeal? This is not about just adding on pages, but in your statement, you indicated the number of regulatory steps that had been taken that now require the pronouncement of any number of forms. Help us out. We ought to be able to do both. We ought to be able to facilitate better disclosure, which in my opinion is not adequate, while at the same time helping the industry from the burden of unwarranted reporting. Do you wish to respond?

Ms. HOBSON. That is a very good question. I would have to think about the specifics of some of the regulatory issues that we confront on a daily, monthly, weekly basis at our board meetings, et cetera, that have become onerous, and bring those back to you. What I can tell you is that there is a lot of lawyering going on in our board meetings. There is a lot of discussion in every meeting that I am in now, from everything from the investment process to the marketing of the mutual funds around what the rules, laws and legal issues are, and often legal obstacles are to certain things that we would like to get done.

So I will make sure to think about that and come back to you. But it is everything from the amount of hedge that we put on the bottom of an ad or reprint is so dense that I would argue that very few people actually read that hedge copy with all the disclosure. It obviously goes through lots of forms of review before it is approved to be able to go out. That is just one of many, many examples that we have. I can come back with specifics.

Chairman BAKER. Terrific. If you could do so for, say, early in July, just take a couple of weeks or so and get us something back, it would be helpful because the goal is not to just throw more stuff inside the door and say "figure it out." It is to get something that is useful, while getting rid of that which is not helpful.

Mr. Haaga, the same point. I note in your statement you indicate that disclosure of these matters is best left to the prospectus. I turn to Ms. Hobson's comments where she acknowledges even as a critic of the bill that a lot of this stuff does not get read. I would have to say to you that most investors when you get to that little bottom line where it says "I have read and understand the conditions outlined in the prospectus" before you make your investment decision, don't put people on the stand and ask them to answer that under oath. Not many people read the entire prospectus and truly understand either the risk or the fee structure in association with it.

Is there a way for us, not without burdensome obligation, to come to some point? I mean, that is what people care about. When you go make a loan, a lot of people don't ask interest rate; they don't ask terms; what the points are. What I want to have is something that says what the note is. Can you help me there?

Mr. HAAGA. Yes. I think it is a great question. I did not mean to say that these things should only go in the prospectus. What I argued against was precluding them from going into the pro-

spectus. So let the prospectus be one of the options is really our position. I didn't mean to misstate that.

When I look at these things, I am kind of reminded of when I go to church on Sunday and I come out afterwards, there are a number of elderly people who know what business I am in or are friends of ours, and they come up to me and ask me about investing. Actually for them, it is not investing. It is taking money out. They are not putting any more money in. So all these discussions of shelf-space and distribution channels do not apply to them. It is how much can I take out. And most of them, all of them I try to get together with an investment adviser because they need to do scenario analysis and find out how much they are going to move.

I guess with them, when I talk to them about what kinds of funds they ought to be looking at, I am always aware of the fact that they are sitting down with an adviser, and that the adviser is interpreting a lot of this stuff. So the burden on us to get all of the information directly in the hands of the investor maybe in the directly sold funds may be important, but where there is an adviser or a 401(k) plan trustee, whose is reading this and selecting the funds that are going to be in the 401(k) plan, that is about 80 percent of our investors in the entire group. That is important.

I am straying a little bit from your question, but when you come back to it, I talk to them about looking at the investment objectives of the fund, the investment record of the fund, particularly volatility, not just the total return over a period. When I talk to them, it is a two-way conversation because you have to talk to them about their investment needs, and sometimes we look at these things as though investors are all the same person with the same time horizon and the same risk-reward structure, and they are not.

I do tell them that expenses are important, but it is also important to measure expenses against what you receive. The cheaper funds generally don't pay for you to have an investment adviser, so you want to think about whether you need an adviser or not. If you get an adviser, that person needs to be paid and how they are paid needs to be disclosed. That is kind of the discussion. Translating that into a document, I think frankly that the first few pages of the prospectus, which were at one time adopted as the profile prospectus, do a pretty good job of that. If we could get the profiles out there with people, it had a bar chart that showed the annual returns over the last 10 years, which gives you a good idea of the volatility, as well as the rewards. It summarized the fees and it did it in a way that was exactly comparable with other funds. Morningstar makes a lot of money doing one-page profiles about funds. It is basically the same thing. So I would put it on that.

Chairman BAKER. Thank you, Mr. Haaga.

I am reminded, since you gave us the church analogy, there was a Sunday School class during the summer and they had a little day-school thing. The kid gets in line in front of the tray where the fruit is, the preacher put up a sign that says, "Take one apple, God is watching." He gets to the end of the line where the desserts are, and another kid has scribbled out a note that says in front of the cookies, "Take all you want; God is watching the apples."

[LAUGHTER]

I think that is my problem. We have got to watch both ends of the line here.

Mr. Bogle, did you want to comment?

Mr. BOGLE. Yes. I think first of all it seems to me critically important that we have much more disclosure than the bill asks for. It is not a matter of disclosing, I don't think, just the methodology about how portfolio managers are paid. I think that is the Investment Company Institute's argument. But what is important is not only the amount of compensation the portfolio manager is paid, but how much the management company gets and where the management company spends its money. Does it spend it mostly on marketing? Does it spend it on administration? And how much is profit to the management company? All of that needs to be disclosed.

We need to pierce this sort of corporate veil that keeps the fund shareholders from knowing what the management company is doing, even though the fund is the only client that management company has. So we need to put that in shareholder reports, at least the annual report, rather than the prospectus. Visualize a situation where a fund has a million investors and no new buyers for whatever reason. Well, it is in a prospectus that nobody uses and you are depriving a million investors of the information.

So it seems to me absolute that the shareholders of the fund, the ongoing owners who maybe got a prospectus 10 years ago must be informed of that. So that is, I think, an extremely important thing to show.

Mr. HAAGA. May I add something to my answer, sir? I was worried that we read the intermediaries out of the equation. I am also worried that we may be reading the Directors out of the equation here. The Directors do know about profitability. They know about all of these things that we are saying ought to go to the shareholders.

The difference between them and the shareholders is that the Directors can sit down and discuss it with us. They have a fiduciary duty and they can ask us follow-up questions. So I worry that we are saying that everything that ought to go to a Director needs to go right through to a shareholder because that is transparency. That example is just one of them.

Mr. BOGLE. If I could add to that direct point, if I may. Vanguard reports all those costs to our investors, fund by fund, item by item, how much goes to investment management, how much to distribution, how much to operations and administration, how much to the custodian, to every fund, every investor and the aggregate if anybody wants to add them up. It is not troublesome. It is not burdensome. It is out there for everybody to see.

I am not arguing that the cost matters so much to the investor, because they clearly do not pay a lot of attention to that. I am arguing that the simple act of disclosure puts something out in the public limelight and changes the behavior of those who are disclosing.

Chairman BAKER. Ms. Hobson?

Ms. HOBSON. Yes, if I could add one point to that, respectfully disagreeing with Mr. Bogle. This would be the only industry where your profitability would be mandated to be disclosed. So for example, the way that I have thought about this when I heard this argu-

ment was that it would be as if you went to buy a jar of peanut butter; you get your Skippy off the shelf. And every item of that peanut butter is detailed for you. Peanuts cost this much; the oil cost this much; the jar cost this much. That is not material to the person picking the peanut butter off the shelf who wants to know, is it $1.29 or $1.19?

The idea of having to then disclose on top of that, we have built up this much profit into the peanuts after we shipped them and paid for all the labor et cetera. There is no other example in business of that kind of disclosure.

Chairman BAKER. Let me make the observation, though. If it is a peanut butter company that is publicly traded, I can find out all that information.

Ms. HOBSON. You can find out information about cost of labor; you can find out certain information about components of the business, but all the profitability numbers you can back out of a financial document for a public company, but they are not explicitly stated to you because of competitive considerations.

Chairman BAKER. I don't want to be argumentative, because I have gone way over my allotted time, but I just think there are some parallels between publicly traded reporting standards and what you can find out about a company's operations.

Mr. HAAGA. I think Mellody's point is that you can find that out, but you don't find it out when you decide whether to buy a jar of peanut butter.

Chairman BAKER. Right, not when you are picking up the peanut butter. Right.

Mr. BOGLE. I like to think that mutual funds are more important to the investor's financial future than peanut butter is.

Chairman BAKER. Even in that case, you have a bunch of jars and you can pick the lowest price or the crunchiest, whatever you want, but you have a choice.

Mr. Kanjorski?

Mr. KANJORSKI. We don't have peanuts in Pennsylvania, Mr. Chairman.

[LAUGHTER]

It is interesting listening to the four viewpoints given. It seems we almost have a philosophical difference. Mr. Bogle, you are equating mutual funds with almost the credit union-type movement in banking. You want to see the least expenditure on experts on investment, on management, and the most advantage to go to the investor. That is a very good concept. I tend to agree with it.

I think Ms. Hobson addresses another problem, though, allowing the field to be open to new competition, small mutual funds. And then an overall prevailing issue is, if you take your argument and you show such a small portion of expense for the operation of your fund, that is all well and good. But suppose Ms. Hobson's fund shows 10 times as much expense but 30 times as much profit? I mean, that is significant, too.

So I don't think we here in the Congress or the regulator or the marketplace is asking us to set up some measurement of certainty of success of investment. That is not our role. There used to be a principle in the law, caveat emptor, but we seem to have forgotten that altogether.

What I am most interested in is the question I asked Mr. Roye earlier. Has anybody done a cost analysis of this? I just did a back of the envelope with 30,000 funds, obviously every one of them if we pass a new statute has to have legal advice. I have nothing against lawyers. In another life, I was one. But if the minimum fee or the average fee were $10,000 per fund, we are talking about an expenditure here of $300 million to come up with some numbers.

We all probably agree, and I will confess to it, anyway, when I make a bank loan, the omnipotence of the Congress determines that they have to give us disclosure sheets that you end up signing and never reading. Quite frankly, my eyesight is not worthwhile with the small print anymore to read it. I just know I would not enjoy it, and I don't think 95 percent or 99 percent of borrowers do read those disclosure documents. I tend to agree, it is where it is placed, how it is placed and the simplicity.

I am not arguing against some simple, easy formula that sets out to give some basis of comparison. But hopefully, it is only a recognized basis. It is not the holy grail that we are putting out here. Much more thought, analysis and insight by the investor is necessary to participate in equity capital markets, whether they use a private broker or whether they use a mutual fund.

Quite frankly, I am not one of these people that believe 100 percent of the American people are eventually capable of becoming equity investors. I think we make a mistake, as sometimes my thoughts on real estate and ever pushing for higher ownership just can't be handled by some people.

But if we are going to spend $300 million here, somebody should convince us that that expenditure is going to save more than that. And yet, I heard the SEC said there are only five problems that they have had this last year, and the losses incurred to the investors in their estimation were under $100 million. So we are talking about a regulation here that is going to cost us three times as much in legal fees as the total money saved to the investors. If that is the case, let's take $100 million and put it in a fund and pay the losses to those five groups that lost. Now, quite frankly, I am going to run out and make an investment in a plane company and a paper company, because I think the stock is about to go up if we do this.

Chairman BAKER. That would be insider trading. Be careful.

[LAUGHTER]

Mr. KANJORSKI. You know, I think I have listened to everybody's argument here correctly. I think I come up with the sense that we would like to have a more open capital market. We would like to have less potential for abuse and not necessarily any proved abuse. We would like to have some standard of comparison. I think all those elements are good. I tend to favor if it can be done reasonably, that to happen.

But if we get very burdened down with passing some law empowering another regulator when they have nothing else to do, to go out and get involved in this, when I think there are many other things. I mean, if we are going to spend a lot of time in regulation, I could give a list of another 10 or 20 corporations that probably should be looked into that are probably in very serious condition, and yet haven't even been disclosed.

That all being said, why don't we look at investor education? Why wouldn't the mutual fund industry be the ideal industry to get together? We require brokers to be licensed, to have a measure of ability and capacity. Maybe we ought to license investors.

I don't agree with that. I am being facetious when I say that, but in reality, that is what we are talking about. We are saying there are a lot of people who are probably subject to being hoodwinked or scammed or taken advantage of, even in the mutual fund market, because they lack the financial capacity to make comparisons, involve themselves in the profit-loss statements of the fund, and to understand what is to their best advantage.

I am convinced that rather than the government thinking about ensuring and anticipating the inadequacies or incapacities of every investor in America, I think that is impossible. Maybe what we ought to do is invest the $300 million in some way with the SEC or NASD or somebody, to more highly educate investors as to how to compare or how to look and how to read, and then encourage a simple disclosure in the statement that people can look at and make a comparison.

But I am not sure that we should be in the make work posture of putting a federal regulator empowered with a lot more power than they would have now, to get involved in what I consider a relatively successful fund market. Now, you can make the argument, Mr. Bogle, that a lot more money is taken out than should be, and I agree with you. But at least they are allowing people to get into the equity markets. I don't think you are arguing that all advice is of the same value. If I get a brain surgeon, he is going to be high priced. I am not going to price him and bid it. I think with investment advice, you just don't bid the market and get the cheapest price. If you are smart, you pick the best expertise you can and generally it costs a little bit more.

Sometimes there is fluffing of the price. Sometimes there are add-ons that should not be there. We should find some way to have the transparency to see that simplistically, not with horrendous expense. I am just worried about what we are on a roll here is to start down that road.

May I make a suggestion? Assuming we want to get to transparency and the capacity to compare, I think Ms. Hobson came up with a very good idea, and I analogize it to the CRAs. When I first came to Congress when we have the Community Reinvestment Act, the major difficulty with the Act was that all banks were treated the same, and they had to comply with the rules and regulations of CRA.

A big bank like Citicorp, they spent maybe $100,000 to fill out their report to comply. But a little bank like Ajax National Bank in Paducah had to spend $55,000, $60,000, $65,000 to fill out the same report to show compliance. It was an unusually heavy burden on banks under $100 million, $200 million, $300 million.

We struggled here. We thought of a three-tier system and having different requirements for disclosure. We thought about taking the lawyers out and shooting them, but that didn't work. A few district attorneys and others did not like that idea.

Finally, it was resolved. A good friend of mine, Gene Ludwig, became Comptroller of the Currency. He sat down and wrote out a

computer program and offered it to every bank in America, that if you file in accordance with and use this computer program, you comply. Rather than $55,000 for lawyers, suddenly they did not have to hire a lawyer because they merely took the comptroller's program, complied with it, and filed.

Now, why can't we do that with the mutual fund industry? Have the regulator take the responsibility of coming up with whatever that disclosure figure is, where it should appear, and how it should appear; get everybody agree to do it; then put a program together; send it out so everybody can comply without going through $300,000 in legal fees. And we have accomplished something. We have given transparency. We have given a standard of comparison. And we have not shamed an industry or assaulted an industry at a very weak moment in the American economy.

If we keep questioning the integrity of every financial market and company in this country, we may improve some, and there are some losers, but some bad ones are always going to be out there. But one thing we will have a tremendous impact on, we are going to drive people out of the trust and faith of the capitalistic system. Again, I say on my side of the aisle to be arguing for that probably is a shame to some of my colleagues. But the fact of the matter is, let's not hammer it into the ground, so either the Congress or the regulators can look good and be able to say to our constituents, we did something; we put a new rule in; and we made the mutual fund industry comply, even though it cost $300 million to save $100 million.

Let's be practical and respond to all the questions raised and all the testimony given, that if the regulator takes it upon themselves, working with the associations, comes up with a simple formula or simple computer program that will be made available free of charge to the mutual fund industry, this affords the opportunity to protect everybody, to get the transparency, but most of all not to shut off the opportunity that Ms. Hobson testifies about.

We are not here as the protectors of the giants and the big ones. They are going to take care of themselves. They are going to survive. What we want to do is encourage a real egalitarian capitalist market. It is only through the successes of organizations that Ms. Hobson represents that that is going to happen. We can, in our haste to look good, in our haste to work responsive, can poison the well of the future opportunity of those types of organizations. I think that would be the worst of all.

Chairman BAKER. Can the gentleman conclude?

Mr. KANJORSKI. Mr. Chairman, I conclude. I have given you all the best thoughts I have had this morning.

Chairman BAKER. Thank you, Mr. Kanjorski.

Is there comment from the panel?

Mr. BOGLE. Could I respond to that? At least on the cost side. The way I suggest that we estimate the investor's expenses is just take the current expense ratio, it is easily ascertainable, and multiply it by the shareholder's asset value. It has a cost very close to zero. The $300 million cost is simply not relevant. It is a simple thing. Whether smaller companies should be relieved of other regulatory burdens is I think a separate issue and a reasonable one.

Now let me talk about the impact of costs on mutual funds.

Mr. KANJORSKI. Just one second. On that, you mean if you managed a fund and this new regulation came down, you would not feel compelled to call your attorney and get an opinion as to what you should do to comply with the law, and whether in fact when you decided what to do you were complying with the law?

Mr. BOGLE. I would just do it. I would comply with the law. The attorneys would probably get in there somewhere, but I think we can spend too much time with them. There is such a thing as just doing what is right.

I would rather tackle the bigger issue, if I may, of how much expenses cost investors? This is a truism, it ought to be stated before this committee, that all mutual funds investors, stock investors, bond investors, money market investors, get essentially the total return generated by those markets, less the cost of operating and trading the securities and mutual funds. That number is approximately $100 billion a year; about $65 billion of mutual fund expenses, dollar expenses, multiply the weighted expense ratios of the funds times the assets. It is not a complicated calculation. The other $35 billion more or less, probably more, can be made up of portfolio turnover costs, sales charges, and out-of-pocket costs. So every year American investors as a group lose to the returns of the stock market by $100 billion a year. That is a staggering cost, a huge cost over time.

So the way to get them aware of that is to give them their expenses and also to have somebody stand up and look at those expenses, in this case the board of Directors, and say, whoa, this has gotten out of hand; we should not be costing investors; all the fund Directors together, $100 billion a year, it is too much. We could run this industry on half that. That is why Vanguard's expense ratio is so much lower than everybody else, because so many of those items are minimized.

So it is a staggeringly large number and gives some idea of the dimension of what we have to get across to the investors relative to the tiny cost of some of these improvements.

Chairman BAKER. Any response to that?

Mr. HAAGA. I would just say, supporting Mr. Kanjorski's argument, we did not make a big deal about the cost of the individualized expense disclosure because it also happens that the cheaper solution is the better solution; the thing that costs a lot of money is the thing that destroys comparability, and we think comparability is very important. So that is why we did not argue. But I absolutely support that we need to have a very thorough cost-benefit analysis of any regulation that the SEC should pursue.

Chairman BAKER. Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

Let me pursue this in a little bit different tack. As a former realtor, when I negotiated with a client for their services, I negotiated and disclosed a percentage that I would charge them. And then when I was successful in selling their house, I would then be forced to disclose to the client, to the world, how much I charged for my services.

Ms. Hobson, you made a passionate case that was very coherent on peanut butter. Can you tell me why or what would be the reason that you would oppose, if you would oppose, maybe you would

support, some sort of simplified fee disclosure in actual dollars to me as your client, the cost of me investing with your fund?

Ms. HOBSON. I can answer that question in two ways. I in no way oppose people knowing what they are paying. It is like that saying with the commercial on TV, it is all in there, the one with the spaghetti sauce. In this situation, the fees are stated very prominently in the first pages of the prospectus.

Mr. TIBERI. In actual dollars?

Ms. HOBSON. They are actually stated. They say, if it is a fund, Ariel Fund, that this fund costs 1.25 percent a year. If you invested $1,000, you will pay $12.50, and then it states what that will be for three years, and it will state what that estimate will be for five years. That information is there. I am for anything that helps educate the investor, because long term, that means they will understand what they have bought and stick with it, and I want our customers to stick with us. So anything that helps educate them, I am absolutely for.

Mr. TIBERI. I have not seen very nice prospectuses. I have seen wonderful annual reports. Would you be opposed to putting that in an annual report or putting that in quarterly or semi-annual statements?

Ms. HOBSON. We have said we are not opposed to moving that information to another document. The question is how personalized that information gets, where it becomes onerous for mutual fund companies, particularly smaller companies like ourselves, to be able to provide that information.

Ultimately for me, the question that I am asking myself, when mom and pop are sitting at the kitchen table making their fund choice investment decisions, either for their 401(k) plan, their retirement, or Susie's college education, is this information materially helping them to make a better investment decisions? That is the critical issue for me.

Mr. TIBERI. I agree. The interesting thing is, and I would like Mr. Haaga to maybe talk about this, I got into a discussion at church, maybe that is why you should answer this, on Sunday with a group of individuals who are discussing with me the fact that mutual fund fees only came out of profit. I tried to tell them that was not the case. They argued with me that it was the case.

I think it goes to the point of disclosure, again, that these mutual fund investors happen to believe because of maybe a lack of information or a lack of detail, that on their monthly statements there wasn't anything like that. Can you expand on that?

Mr. HAAGA. Actually, that is a really good point. I would like to comment a little bit if I could first on the realtor example, because the GAO also had some examples. We are using the terms "fees and expenses" interchangeably here. Mutual funds charge both. If it is a fee, it is paid by the shareholder. So when we charge you a sales charge, you get the exact dollars, you get it on the confirm, you know exactly what you paid, and you paid it, so we can tell you that. That is the one that is analogous to a realtor and that is the one where we disclose exactly the same as you do, just as quickly and just as accurately.

What we are arguing about here is how to disclose operating expenses of the fund that fluctuates and are really borne indirectly

by the shareholder because they are taken out of, as you said, returns, if there are returns, and assets if there aren't returns, but they are basically taken out of the returns. They end up affecting the value of the account, even though they are not paid directly. That is the thing that is hard to disclose and hard to be exact about because they are indirect.

Mr. TIBERI. Mr. Bogle, do you have a view on that at all?

Mr. BOGLE. Help me out with the original question.

Mr. TIBERI. Do you have a view on the cost of personalizing expenses?

Mr. BOGLE. Yes, I think it is something that should absolutely be done, and I think the cost is trivial.

Mr. TIBERI. The cost to the fund?

Mr. BOGLE. The cost to the funds would be trivial if you do it the simple way. There is a complicated way of doing it, you know, trying to go back and show how many shares he owned each day when he goes in and out of the fund. But all you have to do is take the year-end value and multiply it by the expense ratio of the previous year, and it is a simple one extra line or two extra lines in the statement.

Mr. TIBERI. And you don't believe it will be onerous to a small mom-and-pop shop like Ms. Hobson's?

Mr. BOGLE. It is a simple shareholder statement. It is a line on the shareholder statement. It is not complicated. I don't know why it gets portrayed as being complicated. I think we ask the wrong question to give a simple answer. I think it would be very helpful, particularly to the investor, particularly in the money market example I gave where the cost in money markets are today consuming something like 80 percent of the return on money market funds.

Mr. HAAGA. Jack, you say it would be free. When we did the cost study, the cost of doing the estimate that you describe was 90 percent of the cost of doing the exact thing. What you are saying is "free," just is not free. It is 90 percent of the original cost.

Mr. BOGLE. And how do you define that original cost?

Mr. HAAGA. It is the cost of programming at brokers and all the intermediaries to provide information and then following through on it to provide information. We will show you the study.

Mr. BOGLE. I am very dubious that the simple thing and the way I am talking about doing it would cost that much, but we will take a look at it.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Tiberi.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

Just to allow you each to recap in terms of how you feel about the SEC proposal and why their proposal to disclose fees in a shareholder report is better than or worse than disclosing these costs on an individualized basis, I would like to ask you that. In terms of disclosing the operating expenses, getting back to Mellody's example of the peanut butter, I just wanted to make the observation that probably the government should impose how much of the cost of that peanut butter is a component of our policy of not allowing anybody to grow peanuts unless you had a farm in 1933.

In other words, there are government-imposed costs in all of this, too. Mr. Kanjorski's point, you know, do we mandate the government-imposed costs on some of these. There are consequences, but we also have evidence here that in this case the government-imposed cost would be very minimal. So maybe we can just kind of sum up with your views. Which approach, the SEC or the Chairman of the committee's bill, and why?

Mr. BOGLE. I opt for the individual cost disclosure, the number of dollars the investor pays, because it brings home costs relative to the value of his account.

Mr. ROYCE. But you say this is yearly. As I understand the SEC proposal and the Chairman's bill, wouldn't it presume that it was semi-annual?

Mr. BOGLE. Honestly, I don't have a strong opinion between semi-annual, quarterly and annual. I think any one of those is pretty much the same thing.

Mr. ROYCE. Yes.

Mr. BOGLE. I think it will bring home the cost to the shareholder in a way that he can compare it to the income the fund has earned. He can compare to the profits he got from the fund. He can compare it with the electric utility bill. He has got to understand it is costing him money. Anytime someone compares dealing with people's financial futures with peanut butter or toothpaste or beer or anything else, the financial service that we provide investors is basically a sacred trust to the investors. It is not a consumer product.

As in the $100 billion that I mentioned, cost means everything in terms of those returns and we have to make people aware of it. We have to make boards stand up and defend fund shareholders against the interests of the management company which conflict with that. So we need to do this whole program of greater independence.

I believe an independent Chairman is crucial. And much better cost disclosure, and I would add cost disclosure not only in the shareholder statement, but cost disclosure of all the items that the management company spends its money on, including its profits, are the right of a shareholder to know. Mr. Haaga said that his Directors already know that. Well, his Directors are there to represent the shareholders, so I don't see that it is but one small step.

Mr. ROYCE. And you are going to take a look, you said, at Mr. Haaga's study if he offers that, to see if that $300 million cost is in your estimate a wild estimation.

Mr. BOGLE. We work directly with investors. We do not have broker-dealers out there selling our funds. We are a no-load fund group and people come to us. We don't take it through the broker level, so it is probably a little bit easier for us.

Mr. ROYCE. That is one of the concerns here. You have a certain methodology that you have developed and they do have a different means, a different way of providing products that are more individualized. As a consequence, I guess you would grant that there might be additional costs in that.

Mr. BOGLE. Somebody testified that the cost was .000038 or something. I may have gotten a zero wrong.

Mr. ROYCE. Yes.

Mr. BOGLE. But fairly trivial in light of the assets of the industry, although I don't think we should be throwing money away on costs. When you realize the profitability of the management company and the management company's net profits in this business after they take the net fees, they take the advisory fees they get, and subtract their expenses and make a net profit that I estimate to be something like $25 billion, I don't think it is a serious cost relative to that profit.

Mr. ROYCE. One of the comments that I think I heard Fed Chairman Greenspan once make is that there is a tremendous benefit in terms of where someone has specific expertise and can engineer above-average returns. In terms of the results for the overall economy, this is one of the reasons the United States presumably does so well. But you essentially debunk that thesis. Your argument is that over the long haul, no matter how good the expertise, these funds don't necessarily out-perform the market.

Go ahead. I will let you state your position.

Mr. BOGLE. I would agree with something even more profound than that.

Mr. ROYCE. Yes?

Mr. BOGLE. I would argue it is not just over the long haul, it is every single day, absolutely. That is to say, investors fall behind the return of the market by the amount of the cost of our system of financial intermediation. This is not an arguable proposition. So investors lose to the market, investors as a group, not just fund investors, by roughly $1 billion a day. That is a simple fact. So it is daily. It does not always show up, and we look at returns of funds that are unweighed and all that kind of thing, but for every good adviser who is buying all the right stocks, there is a bad advisor who is selling the stocks to him.

It is a closed system. One investor's gain is another investor's loss. It has nothing to do with the expertise of a brain surgeon. I have an expert over here; he is going to be good for a while, someone else is going to be bad. But within the system, it is gross return on the market, the amount of financial intermediation costs taken out is the net return investors get. For that, there is no argument.

Mr. ROYCE. Can we have a response? Paul or Mellody?

Mr. HAAGA. Let me start. I would like to point out the irony of Jack waving off three-tenths of a basis point as irrelevant. If we had proposed to raise our fees by three-tenths of a basis point, I am sure he would have strung it out 25 years, present valued it, and made it into a big number.

Mr. BOGLE. I think the number was three one-hundredths of a basis point.

Mr. HAAGA. Well, even three one-hundredths.

Mr. BOGLE. Maybe it was three one-thousandth.

Mr. HAAGA. First of all, the question was posed as a preference for the SEC approach or the Chairman's bill. It is a matter of interpretation, but I think the Chairman's bill accommodates the SEC's approach. It depends on how you read the words "each shareholder." So they may not be incompatible, and therefore it may not be something you have to decide between the two.

Mr. ROYCE. The Chairman's bill would also ostensibly allow Jack's interpretation.

Mr. HAAGA. It could. We just have to clarify that. I just wanted to point out that they are not necessarily inconsistent.

I think what we have here is a trade-off. The more specific you get with the exact dollar amount of the shareholder's fees or expenses, the less comparability you have and the more it costs. I think what we need to do is look for a compromise here. We think the happy medium here is the SEC's approach that does use the standardized amount. People can interpolate from that what their exact cost is; saving them from the interpolation costs the industry and ultimately shareholders a lot of money, and worse than that destroys comparability. That is really our position. There are two problems. If it were only three one-hundredths of a basis point and it were better, we would be in favor of it. It happens to be three one-hundredths or some number of basis points and it is worse. That is why we are arguing against it because we think it goes too far in the direction of exactitude and gives up on the other two considerations.

Ms. HOBSON. The other thing to note is just to underscore Mr. Bogle noted that in the Vanguard situation specifically, they do not have the intermediary concern that perhaps lots of other fund companies have who distribute their funds through others. In the situation of Ariel where we have $3.7 billion under management and about 100,000 shareholders, we have over 2,000 selling agreements with different distributors around the country.

So this isn't us just flicking a switch to change how we send out a statement. There is a lot of interface that would have to occur, not only at the individual levels of those distributors, but also in our own organization, which is where these costs are meaningful.

And then the one other point that I don't want us to forget is that I strongly believe our interests, contrary to what others might think, are squarely aligned with those of our shareholders, because every single day our performance is in the newspaper. Every single day the expenses of our fund get deducted out of our performance and therefore affect our competitive standing.

Portfolio managers in this business are very competitive and they understand to the extent that they out-perform, more investors will come, so we will grow. So to the extent that we do well for our investors, we will grow. So it does put us at odds with them. When any fee discussion comes up in our board room, I can tell you the first person who is the most concerned is the portfolio manager who knows he has to give up performance for that.

Mr. ROYCE. Thank you.

Mr. BULLARD. May I add something to that? I am concerned about the disclosure of actual dollar amounts, but to some extent this discussion is making me more concerned that the bill will be viewed as being about that, when at least in my mind there are more significant aspects of the bill that will have a much greater, more positive impact. One of those that is being overlooked is the fact that the simple number, the expense ratio, that if any investor looks at anything other than performance, will be what they look at, does not include all the expenses of funds.

In fact, the SEC report shows us that portfolio transaction costs can be a substantial part of fund expenses. It varies across different funds. It depends on their strategies, and that is not being shown to investors. They are prevented effectively from consuming that information. It dampens price competition. The day you include commissions, for example, in expense ratios, I believe you would see a substantial reduction in the amount of turnover in funds portfolios.

Mr. ROYCE. Thank you.

Mr. Chairman, thank you for this hearing and for your leadership on so many issues in this Congress.

Chairman BAKER. I thank the gentleman for his kind remarks.

I want to express my appreciation to each of you. Our goal here is not to bring about unwarranted, unneeded regulatory burdens. That helps no one. It is adding simply to the expense bottom line. We do, however, want to examine the way in which information is delivered to investors. Ultimately, an enhanced disclosure regime will bring investors back to the market in greater number and both perspectives can win.

We don't yet have a perfect remedy, but in our business we have timelines and we will have to act at some point. So I encourage each of you in further written comments if you so choose to get it to the committee's attention within the next couple of weeks. We would be most appreciative.

If there are no further comments, then we stand adjourned.

Thank you very much.

[Whereupon, at 1:15 p.m., the subcommittee was adjourned.]

A P P E N D I X

July 8, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Hearing on H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act
June 18, 2003

Thank you Chairman Baker for your leadership in looking out for the interests of America's 95 million mutual fund shareholders. Today we will hear testimony from two panels of distinguished witnesses on a bill that will help every one of those shareholders. H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act, will help investors to gain a clearer understanding of the fees they are charged for investing in mutual funds, and will strengthen the role of the independent directors who are charged with guarding the interests of fund investors.

The hallmark of the federal securities laws is full and fair disclosure of information. Armed with all the relevant facts, individuals are free to select investments based on their financial goals, age, risk tolerance, and other factors. Transparency is the foundation for a robust, competitive free market.

But without accurate and complete information – presented in an understandable format – investors are unable to make informed decisions.

There is some consensus that mutual fund investors do not have all the information necessary for such decisions. For instance, the Securities and Exchange Commission, as well as the General Accounting Office – both here today – have reached this conclusion.

This legislation is an important first step towards improving the way investors consider, and choose among, mutual funds. It will help investors compare funds by giving them a full picture of all of a fund's expenses. It will help investors shop for funds with a more practical understanding of what the funds' expenses really mean to investors – by telling them, in dollars, not percentages, how much a fund costs. It will also help investors to evaluate whether a portfolio manager's compensation structure provides the kind of incentives that align the portfolio manager's interests with the investors'.

The legislation builds upon the significant corporate governance reforms that were embodied in the Sarbanes-Oxley Act of last year by focusing on the particular circumstances of mutual fund companies. It strengthens the role of independent directors. Fund boards of directors, which are supposed to supervise the operations of the investment company, should be led by those who represent the fund's owners – the independent directors.

The legislation also provides for greater oversight and transparency of distribution mechanisms that can create conflicts of interests. This will strengthen investor confidence and promote better practices through competition.

I commend Chairman Baker for his championing of the interests of American investors and thank our distinguished witnesses for their insights here today.

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STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"The Mutual Funds Integrity and Fee Transparency Act of 2003"
June 18, 2003

GOOD MORNING CHAIRMAN BAKER, RANKING MEMBER KANJORSKI, MEMBERS OF THE COMMITTEE AND WITNESSES.

I COMMEND YOU MR. CHAIRMAN AND RANKING MEMBER KANJORSKI FOR BRINGING THIS MUCH NEEDED LEGISLATION TO THE COMMITTEE. WE ALL WILL AGREE THAT THERE IS A TREMENDOUS NEED FOR IMPROVEMENT IN THE TRANSPANENCY OF MUTUAL FUNDS FEES. WE ARE IN AN ERA OF INVESTOR DISTRUST WITH OUR FINANCIAL MARKETS. THIS DISTRUST WAS EARNED WITH THE DISCOVERIES OF NUMBEROUS CASES OF INVESTORS BEING DEFRAUDED OF HUNDREDS OF MILLIONS AND OFTEN TIMES, BILLIONS OF DOLLARS.

WHAT ARE WE TO DO ABOUT THIS PROBLEM? HOW DO WE ALLAY THE FEARS OF INVESTORS WHICH IS PARAMONT TO THE STABILITY OF OUR MARKETS? WE DO NOT WANT TO RUSH AND OVER-REGULATE AN INDUSTRY THAT HAS OFFERED ITS PRODUCTS TO INVESTORS AT A REASONABLE PRICE BECAUSE OF, FOR THE MOST PART, EFFECTIVE REGULATION. INVESTORS HAVE BEEN ABLE TO GET STANDARDIZED COSTS AS ADEQUATE FEE INFORMATION IS USUALLY PROVIDED IN THE VARIOUS FUND PROSPECTUS. THIS ALLOWS FOR A BETTER COMPARSION OF PRICES OF DIFFERENT FUNDS.

IT IS THIS TRANSPARENCY OF FEES THAT PROMOTE PRICE COMPETITION AND HAS RESULTED IN THE AVAILABILITY OF A WIDE VARIETY OF FUNDS OPTIONS AT REASONABLE OR LOW COSTS.

WE DO WANT TO MAKE SURE THAT THE TRANSPARENCY THAT IS ADVERTISED IS REALLY ACCURATE. WE HAVE TO MAKE SURE THAT WE ARE SEEING THE TRUE COSTS OF THE EXPENSES OF INVESTMENT. WE HAVE TO MAKE SURE THAT THE PROPER TOOLS ARE GIVEN TO THOSE WITH OVERSIGHT TO PROPERLY ANALYZE COMPLEX DISTRIBUTION AND BROKERAGE PRACTICES. WE MUST ACCERTAIN THAT THE DISCLOSURE PRACTICES AND PROCEDURES ARE NOT OBSELETE.

I WILL BE INTERESTED IN HEARING HOW WE WILL ACCOMPLISH THESE IMPROVEMENTS.

MR. CHAIRMAN, I ASK UNANIMOUS CONSENT TO ENTER MY STATEMENT INTO THE RECORD.

June 18, 2003
Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Re: Hearing on the Mutual Funds Integrity and Fee Transparency Act of 2003

- Mr. Chairman, thank you for holding this important hearing on mutual fund industry practices and their effect on individual investors. I also want to commend you on your leadership in this area.

- I've read the recently released GAO Report and SEC study on mutual funds, and each does a good job of laying out the issues we need to discuss today, most notably transparency, disclosure, fees and conflicts of interest.

- It's clear that mutual funds have some work to do in each of those areas, and I think the industry recognizes that changes need to be made. The fundamental goal of our efforts should be to provide investors with the relevant information they need to make informed decisions. More information isn't necessarily better information. The key is to make sure investors receive clear, transparent, and relevant information. Additional transparency in the mutual fund industry will go a long way to helping investors regain confidence in the markets.

- However, I think we should defer to the SEC for the specific rule-making on how information should be disclosed, how often it should be released, and the form it should assume. In the area of fee statements, for example, I agree with Paul Roye, Director of the SEC's Division of Investment Management, that providing "personalized" fee statements to investors will do little to address the need for more competition among mutual funds. In my view, the better approach would be to require fee disclosure based on a standardized $10,000 investment. In that way, investors can more easily compare ongoing costs among funds.

- I'm interested in hearing the panel's views on disclosure and also on board independence and corporate governance. Boards should be focused on hiring the best available investment managers and on negotiating for lower fees on the shareholders' behalf. I agree with many of my colleagues that requiring at least 2/3 of the board to be independent will help achieve those objectives. Applying the audit committee standards established under Sarbanes-Oxley to mutual funds is also a practice all funds should adopt as soon as possible. Finally, I believe that the definition of who should qualify as a truly "independent" director needs to be tightened.

- I look forward to working with my colleagues and the SEC to ensure that mutual fund investors have the information they need to make informed decisions, and I look forward to hearing from the witnesses. Thank you.

June 18, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing on HR 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003

Thank you, Mr. Chairman, for holding this important hearing and for your leadership on this issue. I am happy to be an original cosponsor of the Mutual Funds Integrity and Fee Transparency Act. HR 2420 will strengthen corporate governance and management integrity at mutual fund companies by directing reforms to create the type of climate in the mutual fund industry where honest management is commonplace and the interests of the shareholders are placed before personal economic gain. It will provide investors with more complete and useful information regarding the fees they are assessed while also strengthening director oversight of soft-dollar and certain distribution arrangements, enhancing management integrity.

Over the past two decades, the percentage of households in the United States invested in the stock market has grown from 32.5 to 49.5 percent, according to a recent survey published by the Investment Company Institute (ICI) and the Securities Industry Association (SIA). In Ohio alone, there are 3, 916, 000 shareholders with $295.4 billion invested. Many of these Americans and families in the Fifth District of Ohio are invested through mutual funds and often they depend on the safety of their funds to enjoy a secure retirement. This committee must remember that the money at stake here, is money that belongs to the shareholders not fund management.

Issues surrounding the disclosure practices within the Mutual Fund Industry have been of great interest to me throughout my career in Congress and specifically as sponsor of the "Mutual Fund Tax Awareness Act of 1999," HR 1089, during the 106th Congress. I was happy to work with the SEC on this issue and eventually see the Final Rule on Disclosure of Mutual Fund After-Tax Returns come into effect of April 16, 2001. Requiring the communication of this information to individual shareholders goes a long way in assisting with fund performance comparisons and enabling better informed investing decisions. However, as the Securities and Exchange Commission (SEC) made clear, in

its response to Chairman Baker's letter expressing concerns from this subcommittee's last hearing on the mutual fund industry, further reforms are necessary.

Today, I am particularly interested to hear the opinions of our witnesses on the "soft dollar" provisions in HR 2420. This legislation calls for greater disclosure of this practice, encouraging brokers to sell mutual fund shares, but I would like to hear more from the industry on the SEC's suggestion of changing the law that permits this activity.

Again, Mr. Chairman, I would like to thank you for your leadership on this issue and I look forward to a thorough debate of this legislation here today. Greater disclosure in the mutual fund industry is one of the most important issues this subcommittee will consider during the 108th Congress.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 2420, THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

WEDNESDAY, JUNE 18, 2003

Mr. Chairman, thank you for the opportunity to offer my initial thoughts on H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act, before we hear from our witnesses.

The dynamic mutual fund industry constitutes a major part of our equities markets, and it has, without question, worked to democratize investing for millions of Americans. Despite this tremendous success, securities experts have continued to regularly examine how we can improve the performance of the mutual fund industry in order to advance the interests of investors.

As you know, Mr. Chairman, I have made investor protection one of my top priorities for my work on this committee. I consequently share your concerns that our committee must conduct vigorous oversight to examine whether our regulatory system is working as intended and to determine how we could make it stronger.

During our last hearing on mutual funds, several individuals raised concerns about some practices within the mutual fund industry. Because we identified no consensus for addressing these matters, I joined with my colleague, Congressman Bob Ney, in writing to the Securities and Exchange Commission after the hearing. In replying to our letter, the Commission's staff suggest several areas for reform and for further study. In order to ensure that today's hearing record is complete, I request unanimous consent to enter into the record the response that Congressman Ney and I recently received from the Commission.

In addition, Mr. Chairman, you also contacted the Commission after our last hearing to request their observations and recommendations regarding mutual funds. H.R. 2420 attempts to codify several reforms proposed by the Commission in its response to you. In general, H.R. 2420 seeks to enhance the disclosure of mutual fund fees and costs to investors, improve corporate governance for mutual funds, and heighten the awareness of boards about mutual fund activities.

While many of these reforms may be good ideas, we should explore whether they can instead be achieved without a legislative mandate either through the adoption of industry best practices or the promulgation of regulations by the Securities and Exchange Commission. As you know, Mr. Chairman, I generally favor industry solving its own problems through the use of self-regulation or the adoption of best practices whenever possible.

Nevertheless, if we decide to mark up H.R. 2420 in the weeks ahead, we should ensure that each provision in the bill is properly designed to help individual investors to make better decisions. We should also examine the effects of the changes on smaller mutual funds and whether these reforms will create barriers to entering the mutual fund marketplace. We should further determine whether the benefits of imposing a reform will outweigh its costs.

(over)

Moreover, H.R. 2420 contains provisions not included in the Commission's report. In my view, we must carefully examine these additional legislative mandates to ensure that they will not produce unintended consequences. For example, H.R. 2420 would prohibit an interested person from serving as the chairman of the board of a mutual fund. While recognizing that there may be benefits to an independent board chairman, the Commission's report questions whether there is a need to mandate such a change if a majority of a mutual fund board is already independent.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on this important legislation. Mutual funds have successfully worked to help middle-income American families to save for an early retirement, higher education, and a new home. We need to ensure that this success continues. I therefore hope that we will not rush into a markup on H.R. 2420 before we can work together on these matters.

I yield back the balance of my time.

Statement of John C. Bogle

Founder and Former Chief Executive of the Vanguard Group and
President of the Bogle Financial Markets Research Center
Before the U.S. House of Representatives
Sub-Committee on Capital Markets, Insurance and
Government Sponsored Enterprises of the
Committee on Financial Services
Washington, DC
June 18, 2003

Thank you for the opportunity to appear again before this distinguished Committee. I compliment you on the additional protections accorded to investors in the "Mutual Funds Integrity and Fee Transparency Act of 2003," especially the sections calling for disclosure of the dollar amount of annual operating expenses borne by each shareholder, the increase in the number of fund independent directors to two-thirds of the board, and the requirement that the fund chairman be an independent director.

In candor, however, I would hope that the final legislation will go further. For I believe that this industry has not adequately measured up to its responsibilities to mutual fund investors. While the express language of the preamble to the Investment Company Act of 1940 calls for mutual funds to be "organized, operated (and) managed" in the interests of shareholders rather than in the interest of "directors, officers, investment advisers . . . underwriters or brokers," it is simply impossible to believe that such is the case.

Fund Expenses Rise 120-Fold

Consider, for example, how fund expenses have soared over the past quarter century. Applying the data on weighted expense ratios (recently submitted to the Committee by the Securities and Exchange Commission) to fund net assets, the *dollar amount* of fund expenses rose from $523 *million* in 1979 to $31 *billion* in 1996, to $64 *billion* in 2001. And in 2002, fund expenses totaled $62 billion, even more than 1999's $58 billion, despite the 34% erosion in their capital suffered by equity fund shareholders during the three-year bear market period ended

March 31, 2003. In my personal experience, the economies of scale in this industry are staggering, and it would be simply incredible to argue that they have been adequately shared with fund owners.

The expense disclosure and increased director independence called for in the legislation should help limit future increases in fund expense ratios, but I believe the addition of a section in the 1940 Act is also necessary. It would call for an express standard of fiduciary duty on the part of directors to act in precisely the manner called for by the preamble: *A fiduciary duty to place the interests of fund shareholders ahead of the interests of fund managers and underwriters.*

I also urge the Committee to require mutual funds to report their estimated portfolio transaction costs to investors. These numbers are not nearly as mysterious as they are portrayed, and are in fact frequently calculated for fund managers by independent services, and, at least in some cases, shared with fund directors. I see no reason that transaction costs should not be shared with fund shareowners as well.

The Impact of Costs

Bit by bit, investors are learning the important role that costs play in reducing the share of financial market returns that fund investors receive. Adding together the average equity fund expense ratio plus turnover costs, plus sales charges, plus opportunity costs and out-of-pocket fees, all-in costs come to between 2½% and 3% of the investment of an equity fund owner.

But that seemingly small number is in fact powerful. If we enjoy, for example, a future stock market return of 8%, annual costs of 3% would consume nearly 40% of it, leaving 60% for the investor—who, after all, put up 100% of the capital and who took 100% of the risk. And over the long term, say, 25 years, even a 2½% cost would reduce a compound market profit of *$58,000* on a cost-free *stock market* investment of $10,000 earning 8% a year to a *$28,000* profit on a *mutual fund* that earned 5½% after costs—more than half the long-term profit confiscated by expenses.

Making the *dollar amount* of the costs they incur would help investors to become aware of the truly punishing penalty of high expenses. *Properly handled, such disclosure would be virtually cost-free to the funds.* Rather that all of the machinations surrounding showing the

actual costs paid by an investor during the prior year, a simple report showing the *current rate* of costs would do the job. That is, simply print the fund's current expense ratio in the shareholder statement, and multiply it by the asset value of the investor's account at quarter's end (i.e., 1.40% x $17,241 = $241). The cost to the funds of this simple addition in the statement would be close to zero, a far cry from the $265 million estimate of first-year fund costs offered by the Investment Company Institute.

It is frequently alleged that the availability of low-cost funds indicates that there is ample price competition in the fund industry. *That is simply not so.* While it is true that three "low cost" fund groups hold a 26% market share of industry assets, that is a reflection of consumer choice, and does *not* reflect any significant reduction in fees charged by other firms. *Price competition is defined, not by the action of consumers, but by the action of producers.* Yet the record is clear that most of the changes in fund fee structure in recent years have been to *increase* rates, hardly evidence of competition. (Indeed, an Investment Company Institute study several years ago noted that the *lowest* cost decile of funds had actually experienced a 27% *increase* in expense ratios.)

What is more, describing a fund as "low cost" because its expense ratio is below industry norms is a circular argument, rather like describing a CEO's compensation as "low" because it is fractionally below the grotesquely excessive level of compensation of CEOs as a group. Yet it is the generally high level of mutual fund costs that has demonstrably eroded the net returns earned by fund investors.

Further Disclosure of Costs

While I applaud the section of the proposed legislation that calls for disclosure of the compensation structure of the individual portfolio managers employed by the investment adviser, I do not believe it goes nearly far enough. Not only do I believe that the *actual amount* of such compensation be disclosed, but the idea that it's too complicated to deal with compensation for management teams or managers of multiple funds strikes me as an inadequate basis for depriving fund owners of the information to which they are entitled.

But even that disclosure is not enough. I estimate, for example that, of the approximately $62 billion of fund expenses in 2002, only about $4 billion represented compensation for

investment advisory services—portfolio managers, security analysts, traders, support staff, and overhead. I believe that shareholders of the funds are entitled to know not only the aggregate expenses of the funds they own, but *where that money goes*. Specifically, fund managers should report the salaries of senior officers, expenditures on investment advisory services, on marketing and advertising, and on operations and administration, as well as the remaining net income of the adviser, both before and after taxes. In addition, fund shareholders have a right to know how those profits are divided among the major individuals and corporations that own the adviser's shares, often the major source of compensation of executives.

Such disclosures, of course, are quite typical among ordinary business corporations. But in this peculiar mutual fund industry, such disclosure has been stymied by the fact that the fund's payments are largely made a separate corporation, and, as it has been argued, "the corporate veil cannot be pierced." In the extraordinary structure of the mutual fund industry—in which the advisor controls the fund and is typically the sole provider of all investment, distribution, and marketing services, and in which the adviser negotiates (or fails to negotiate) its fees with, as it were, *itself* (it can even sell itself to an outside financial conglomerate, which is tacitly assured that the huge capital commitment required in its purchase will be rewarded by a continuing contractual relationship with the funds)—it is high time that, in this age of full disclosure, the disclosure of all relevant financial information to shareowners becomes an accepted part of mutual fund investing.

I'm not arguing that most fund investors are demanding—or even care about—this information. Rather, I'm arguing that, once exposed to the sunlight of disclosure, the behavior of fund managers will change. It will lead to substantial reductions in costs, and will therefore materially enhance the returns that shareholders receive.

Free From Scandal?

I would like to close by commenting on the conventional industry allegation, accepted by the SEC, that the fund industry must be good because it has never had a major "scandal." Yet if a scandal is defined as "a grossly discreditable condition of things," it is not clear that the statement is accurate.

- Shareholder Returns vs. Stock Market Returns: During the past 20 years, the U.S. stock market has earned a return of 13% per year, while the average mutual fund investor has earned a return of approximately 2% per year. An initial investment of $10,000 in the stock market, then, would have earned a profit of $105,000, while the average fund owner would have earned a profit of just $5,000. *Is that a scandal, or is it not?*
- Part of that lag in returns is the responsibility of the fund industry. During the period leading up to very top of the market bubble, we created, and offered to investors, 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors. (Referring back to the 1940 Act's preamble, is it even *remotely* possible that these funds were "organized, operated, and managed" in the interest of investors rather than in the interests of fund distributors?) *Is that a scandal, or is it not?*
- These new funds, and similar aggressive funds that were organized earlier, took in $490 billion—almost one-half a trillion dollars!—at the worst possible time. It was not only the stock market mania and investor greed of the era that drew these assets into those funds. Fund managers not only formed these funds knowing they were likely to fail—or *not* knowing it; I'm not sure which is worse—but vigorously engaged in marketing and advertising the returns that these funds had achieved during the bubble. For example, in the March 2000 issue of *Money* magazine, just as the market crash was about to begin, 44 mutual funds advertised their average returns during the prior year. The average return of these funds: +85.6%. *Is that a scandal, or is it not?*

The industry that I have been a part of for my entire 52-year business career, it seems to me, has a severe case of the "Emperor's Clothes Syndrome," failing to see what is obvious to all who only open their eyes. While not a single one of the men and women that I've met over my career has been other than a good, capable, honest, human being, I believe that the powerful financial interests our industry's executives hold in the companies that manage the funds has blinded them to the realities I've described today. Yet in the long run, we in this industry will grow only as fund shareholders are given a fair shake, not only in costs and disclosure, but also in having truly independent directors who put their interests first, and in retaining managers whose highest priority is not salesmanship, but stewardship. Saying that "my costs are fine" as long as they don't materially exceed industry norms is simply not good enough.

While considerable progress is being made, we need more than the valuable advances called for by the legislation before this Committee that would provide better cost disclosure and strengthen the independence of fund directors. This industry needs, well, a change of heart, one in which our very focus changes—from placing the interests of *managers* first to placing the interests of *shareholders* first. The Congress can't mandate, as far as I know, such a change of heart. But even taking the steps contemplated in the legislation before this Committee, to which I hope will be added the recommendations I've made in this statement, will at least begin the process of serving, just as the 1940 Act sought, "the national public interest and the interest of investors."

Testimony of Mercer E. Bullard
Founder and President
Fund Democracy, Inc.

before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

on

The Mutual Funds Integrity and Fee Transparency Act of 2003

June 18, 2003

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for

hearings, submitted comment letters on rulemaking proposals, testified on legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site.

I. Introduction

More than 95 million Americans are shareholders of mutual funds, making mutual funds America's investment vehicle of choice. These shareholders have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative. This will continue to be true, however, only as long as mutual fund rules keep pace with changes in fund practices. In significant respects, fund rules have not kept pace with developments in the fund industry. H.R. 2420 is necessary to update fund rules to ensure that mutual funds remain the best possible alternative for investors.

The mutual fund industry owes much of its success to the requirements of the Investment Company Act of 1940 and the body of regulatory law that has developed around it. The Act provides liquidity by requiring that mutual funds be redeemable on demand at a price based on the value of their net assets. Fund rules provide safety by prohibiting transactions between funds and their affiliates and by limiting the amount of leverage that funds can use. Transparency and standardization are assured by rules regarding the use of standardized investment performance and fee disclosure. These rules are buttressed by the presence of an independent board of directors that oversees fund operations to ensure that funds are operated in the best interests of their shareholders and not fund affiliates.

Mutual funds offer liquidity, safety, transparency and standardization at a reasonable price – again, partly as a result of effective regulation. The fee information provided in the fund prospectus provides investors with standardized costs that can be used to compare different funds. This information also can be easily disseminated through the information channels that investors use when making investment decisions. The

transparency of fund fees promotes price competition and has resulted in the availability of a wide variety of low cost fund options.

Fund regulation also has been successful in adapting to changing business practices. Many of the fundamental characteristics of funds owe their existence to regulatory reforms, including the fee table, standardized investment performance, 12b-1 fees, and multiclass funds. The Vanguard Group, America's second largest fund complex, exists and operates only by reason of a series of exemptions granted by the SEC.[1] Exchange-traded funds, which are similarly a creation of innovative regulation,[2] did not exist ten years ago. They now hold approximately $100 billion in assets.

In some respects, however, fund regulation has failed to adapt to changing business practices. Fund distribution and brokerage practices have changed dramatically over the last twenty years, but rules governing fund disclosure and fund directors' responsibilities have not kept pace. The true cost of investing in mutual funds has become obscured by fee disclosure that fails to reflect accurately how and how much shareholders pay for fund-related services. Fund governance rules need to be improved to give independent directors the authority and tools they need to oversee funds' increasingly complex distribution and brokerage practices. H.R. 2420 takes an important first step in modernizing mutual fund rules to reflect the way that funds operate today.

H.R. 2420 will update fund disclosure rules to provide investors with needed information about fund costs. It will provide investors with a clearer understanding of the impact of fees by requiring that they be disclosed in dollar amounts. Fee disclosure will be required to incorporate all fees, including portfolio transaction costs, and to identify all distribution expenses, including those paid outside of 12b-1 plans. Improved disclosure of compensation paid to portfolio managers and retail brokers will enable shareholders to

[1] See, e.g., In the Matter of Wellington Fund, Inc., Investment Company Act Release Nos. 8644 (Jan. 17, 1975) (notice) & 8676 (Feb. 18, 1975) (order) (permitting operation of Vanguard as internally managed mutual fund).

[2] See, e.g., The Select SPDR Trust, Investment Company Act Rel. Nos. 23492 (Oct. 20, 1998) (notice of exemptive application) & 23534 (Nov. 13, 1998)(order).

evaluate the extent to which these persons' economic interests are aligned with their own. In addition, H.R. 2420 will strengthen the role of independent directors and further focus their energies where conflicts of interest between the fund adviser and fund shareholders are greatest.

The remainder of this testimony discusses separately each section of H.R. 2420.

II. Section 2: Improved Transparency of Mutual Fund Costs

a. Individualized Dollar Fee Disclosure

Section 2(a)(1) of H.R. 2420 will require, through SEC rulemaking, funds to disclose in dollars the amount of operating expenses paid by individual shareholders.[3]

The disclosure of expenses in dollars will benefit shareholders in two principal respects. First, it will illustrate expenses in a more direct, concrete form than currently provided in the prospectus. The prospectus includes a fee table and a hypothetical fee sample. The fee table shows expenses as a percentage of assets (the expense ratio). The fee sample shows the hypothetical expenses in dollars that would be incurred by a $10,000 account. Section 2(a)(1) will be more concrete than the expense ratio by requiring disclosure of a dollar amount, and more direct than the hypothetical fee sample by requiring disclosure of the actual amount paid by each investor.

Second, individualized dollar fee disclosure will provide special benefits to investors for whom current disclosure rules are not effective communication tools. For price conscious investors who already are aware of the importance of fund fees, current disclosure may be adequate. In contrast, individualized dollar fee disclosure has the potential to raise the fee awareness of less price sensitive investors.

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[3] On December 18, 2002, the Commission proposed to require funds to provide dollar fee disclosure in the semiannual report. See Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Rel. No. 25870.

Unfortunately, Section 2(a)(1)'s potential to raise investors' fee awareness may not be fully realized, as the Commission's current intention is to require disclosure not of each shareholder's actual expenses, but rather of a hypothetical shareholder's expenses, and to require disclosure not in a document that less price sensitive shareholders are likely to review, but in the semiannual report.[4] This approach provides essentially the same information already provided in the fee sample in the prospectus and is likely to provide minimal added benefit to shareholders.[5]

Ideally, all shareholders would carefully consider the expense information in the prospectus and assiduously review semiannual reports, but they do not. And the shareholders who are least likely to exercise such diligence are the ones who most need to have their attention affirmatively directed to the costs of investing. The SEC's proposal would benefit only price sensitive investors, but common sense necessitates that effective disclosure rules reflect the characteristics of the intended audience of less price conscious investors.

Section 2(a)(1)'s purpose can best be realized by requiring disclosure that less price sensitive shareholders will actually use. For this reason, the Government Accounting Office, Fund Democracy and the Consumer Federation of America have argued for providing individualized dollar fee disclosure on quarterly statements.[6] Quarterly statements are the documents that less price sensitive shareholders are most likely to review, as these documents show changes in the value of their accounts and any account activity. Dollar fee disclosure would be particularly appropriate in quarterly statements

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[4] Memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, at 13-17 (June 9, 2003) ("SEC Report").

[5] See generally, Letter from Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan Katz, Secretary, Securities and Exchange Commission, at Section IV (Feb. 14, 2003), at http://www.sec.gov/rules/proposed/s75102/mbullard1.htm.

[6] Id.; Government Accounting Office, Mutual Funds: Information On Trends In Fees And Their Related Disclosure (March 12, 2003).

because it would juxtapose the dollar amount of fees deducted from the account with the dollar value of the account.

b. Fund Portfolio Manager Compensation

Section 2(a)(2) of H.R. 2420 will require, through SEC rulemaking, disclosure of the structure of the compensation of persons employed to manage a mutual fund's portfolio.

The structure and source of compensation paid to a fund's portfolio manager or portfolio management team ("portfolio manager" hereinafter includes the portfolio management team) are highly relevant to an investor's evaluation of a fund. As noted by the SEC staff, whether a portfolio manager's compensation is based on short-term or long-term performance, or pre-tax or after-tax performance, may indicate whether the manager's and the shareholders' interests are aligned.[7] Whether a portfolio manager is compensated for services provided to other mutual funds or other fund or non-fund clients, or for providing other outside services generally, is also highly relevant to shareholders who wish to evaluate the manager's commitment to a fund and the presence of conflicts of interest that the manager may have as a result of outside duties.[8]

In contrast, the total value of the portfolio manager's compensation is not especially relevant.[9] The total fees paid by fund shareholders is a direct function not of the portfolio manager's compensation, but of the adviser's total compensation. While the total compensation paid to the portfolio manager indirectly bears on the total fees paid by shareholders, and therefore disclosure of this information could help some shareholders

[7] SEC Report at 43.

[8] See Remarks by Paul Roye, Director, Division of Investment Management, before the ALI/ABA Investment Company Regulation and Compliance Conference (June 14, 2001)("As many mutual fund managers look to generate revenues by expanding into other areas of the investment management business such as offering private accounts or sponsoring and advising hedge funds and other alternative investment vehicles, they should be mindful that certain of these new opportunities raise conflict of interest issues and the potential for abuse.").

[9] Accord, SEC Report at 42-43.

to evaluate fund fees, there is a risk that identifying the portfolio manager's total compensation would distract shareholders from the more fruitful exercise of evaluating the fund's and the adviser's total fees as disclosed in the fee table in the prospectus.

c. Fund Portfolio Transaction Costs

Section 2(a)(3) of H.R. 2420 will require, through SEC rulemaking, funds to set forth information about their portfolio transaction costs, including commissions, in a manner that facilitates comparisons across funds.

As stated by the Commission, "fund trading costs incurred in a typical year can be substantial."[10] The Commission cites studies that estimate that brokerage commissions alone cost about 0.30% of equity funds' net assets.[11] Other studies estimate that market spread, or the amount by which the price of a security is marked up or marked down, costs about 0.50% of equity funds' net assets, and that "opportunity costs may amount to 0.20% of value."[12]

Another study found that the mean brokerage and market spread costs for a sample of equity funds was 0.75% of assets – almost three-quarters of the mean expense ratio of 1.09%.[13] The brokerage and spread costs constituted an even larger percentage of the total costs of funds with the highest trading costs, with mean brokerage and spread costs equaling 1.54% of assets and the mean expense ratio equaling only 1.24%.[14]

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[10] Id. at 19.

[11] Id. at 22.

[12] Id.

[13] Chalmers, Edelen & Kadlee, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management (Dec. 29, 2001)

[14] Id.

Thus, portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided in the prospectus. Section 2(a)(3) takes the first step in ensuring that investors are made aware of transaction costs and that they can consider these costs when making investment decisions. Transaction costs vary greatly among funds, and full disclosure of these expenses will help hold fund advisers accountable for their trading practices.

Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices. In short, transaction cost disclosure will subject fund expenditures on soft dollar services to market forces, and thereby provide a practical solution to the problem of regulating soft dollar practices. This benefit is addressed further in the next part of this testimony.

For some transaction costs, fashioning disclosure rules will be a relatively easy task. Fund brokerage commissions already are disclosed in the Statement of Additional Information as a dollar amount. Converting this dollar amount to a percentage of assets and including it with other expenses in the expense ratio in the fee table would be simple and inexpensive.[15]

Providing disclosure regarding other types of transaction costs will be more difficult, but no less necessary. There are no standardized methods for calculating spread costs, market impact or opportunity costs. Nor are these concepts, unlike fund brokerage, generally understood by the investing public. Nonetheless, the Commission has been able to develop effective, standardized, quantitative disclosure tools in other contexts, such as funds' investment performance and expense ratios. There are a number of private companies that already provide fund advisers with quantitative assessments of their funds' transaction costs for self-evaluative and board review purposes.[16] The SEC's inspection staff routinely considers these quantitative assessments when evaluating a fund

[15] Accord, SEC Report at 28.

[16] Id. at 21-22

adviser's obligation to obtain best execution of fund transactions. It should not be difficult, over time, to develop quantitative tools to measure fund transaction costs and disclosure formats that will provide this information in a way that helps investors understand these costs.

The Commission has objected to the disclosure of fund portfolio transaction costs on the grounds that the disclosure of brokerage commissions, while easily comparable and verifiable, would be incomplete, and the disclosure of other components of transaction costs, while completing the transaction cost picture, would not lack comparability.[17] This objection misunderstands the purpose of fee disclosure rules and is not consistent with Section 2(a)(3).

The purpose of fee disclosure rules is to ensure that investors have the information they need to make informed investment decisions. Thus, the issue is not whether the disclosure is theoretically perfect or complete, but rather whether it provides information that facilitates better investment decisions.

For example, Commission-mandated standardized investment performance is imperfect and incomplete in a number of ways. It is calculated net of fees, notwithstanding that this does not accurately portray a fund adviser's pure stock picking ability before expenses. It arbitrarily measures performance at 1-, 5-, and 10-year intervals, and not periods in-between. It is based on only one of a number of different methods of calculating an internal rate of return. In advertisements, it is permitted to show the returns of a single class, even though the performance of other classes may have been different.

Similar observations could be made about imperfections in the fee table. Indeed, one drawback of the expense ratio is that it is incomplete, and including commissions would make it a more complete measure of the cost of fund investing. Both standardized

[17] Id. at 20-22 & 28-35.

performance and the fee table have provided an undisputed net benefit to shareholders, notwithstanding their theoretical inadequacies.[18]

The fact that there is more than one way to calculate the different components of fund transaction costs is not a reason to deprive shareholders of useful information about these costs. The Commission has suggested enhanced disclosure of funds' turnover ratios as an alternative to disclosure of actual transaction costs. Using the turnover ratio as a proxy for transaction costs, itself an imperfect measure, would be an inferior and inadequate substitute for disclosure of actual transaction costs.[19]

d. Soft Dollar Disclosure

Section 2(a)(4)(A) & (B) of H.R. 2420 will require, through SEC rulemaking, improved disclosure of funds' soft dollar arrangements. (Section 2(a)(4)(C) is addressed in the next part of this testimony.)

The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded $1 billion in 1998.[20] An executive with American Century Investment Management recently testified before this Subcommittee that the research

[18] Indeed, the same observations could be made about the SEC's preference for turnover rates as a proxy for portfolio transactions costs. Chalmers, supra note 13 (demonstrating that fund turnover is not a reliable proxy for fund trading expenses). If an imperfect, indirect measure of transaction costs such as portfolio turnover is to be used, it is unclear why a direct measure, such as commissions, spread costs, market impact or opportunity costs would not be preferable.

[19] Id.

[20] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998) ("Section 28(e) Report").

component of soft dollar commissions costs six times the value of the execution component.[21]

Soft dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for themselves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft dollar benefits.[22]

Soft dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.[23] Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio.

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[21] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (Mar. 12, 2003).

[22] See id. at 2 (the statutory safe harbor permitting soft dollars arrangements "encourages investment managers to **use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager**." (emphasis in original)).

[23] See Investment Company Act Section 17(e); SEC Report at 38.

Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

Section 2(a)(4)(A) & (B) will help reduce adviser conflicts and fund costs by subjecting soft dollars to the disciplining effect of public disclosure and market competition. To the extent that shareholders are able to compare soft dollar expenditures of different funds, they will have a more complete picture of the relative costs of investing in different funds.

One way to achieve this objective would be to require the quantification of soft dollar expenses. The Commission has previously proposed requiring such disclosure, but has relented under the weight of arguments that the benefits of soft dollars to a particular fund could not be quantified.[24] The Commission also has argued that the oversight of soft dollar arrangements is best left to fund directors. It is unclear, however, how fund directors are able to provide such oversight if it is not possible to measure the cost of soft dollars (or why director oversight should preclude providing more information to shareholders). The Commission should revisit the possibility of requiring the quantification of soft dollar costs in a format that allows meaningful comparison across different funds.

The Commission also should consider requiring that commissions be included in fund expense ratios, as discussed in the immediately preceding part of this testimony. This solution would indirectly subject soft dollars to price competition without the necessity of separately quantifying their cost. The SEC staff has argued that "greater transparency of brokerage costs is unlikely to help an investor evaluate a fund adviser's conflicts in using

[24] SEC Report at 40.

soft dollars."[25] But directly educating investors about the conflicts inherent in using soft dollars is only one way to address such conflicts. Greater transparency of brokerage costs would address such conflicts by ensuring, at a minimum, that the cost of the conflicts can be considered by the marketplace.

e. Disclosure of Distribution Expenses

Sections 2(a)(4)(C), (5) & (6) of H.R. 2420 will require, through SEC rulemaking, improved disclosure of: the use of fund brokerage to compensate brokers for selling fund shares, payments for fund distribution made by someone other than the fund, and breakpoints on front-end sales loads.

These provisions of H.R. 2420 will help improve investors' understanding of fund distribution costs and brokers' compensation, each of which is addressed separately below.

1. Fund Distribution Costs

Under current disclosure rules, the treatment of fund distribution expenses is inadequate in a number of respects. Although the disclosure of the amount of sales loads and breakpoints in the prospectus is relatively straightforward and clear, there is no required disclosure of the advantages and disadvantages of different selling arrangements or investment amounts. Thus, while an investor may be able to easily determine the amount of his sales load, he will not be able to easily determine whether he has invested in the optimal fund class or invested the optimal amount.[26]

[25] Id. at 37.

[26] See Lauricella, Mutual-Fund Investors Take Quiz: A, B or C?, Wall Street Journal (Mar. 7, 2003).

The suitability of a particular fund class may depend on the length of the investor's expected holding period or the amount invested.[27] In addition, the choice of fund class or the optimal allocation of assets among different investments may depend on the amount at which commission breakpoints are triggered.

The Commission should consider requiring disclosure, in the form of web-based calculators for example, that illustrates the relative advantages and disadvantages of different share classes and the effect of breakpoints based on different investment amounts. The Commission also should direct the National Association of Securities Dealers ("NASD") to take steps to ensure that brokers direct their clients' attention to such disclosure.

The 12b-1 fee is set forth in a separate line in the fee table in the prospectus. The purpose of this information is not to help investors understand the total cost of investing in the fund, because the 12b-1 fee is already included in the fund's expense ratio. Rather, the 12b-1 fee line item purports to provide investors with a functional understanding of how much of the fund's assets are spent on distribution. Indeed, many shareholders use the 12b-1 fee as a screening tool to eliminate funds that pay for distribution.

In fact, 12b-1 fees are not the only distribution fees that the fund shareholders pay. Fund advisers routinely use some of their fee revenues to make payments to brokers for selling fund shares. Retail brokers also are routinely compensated for selling fund shares in the form of fund brokerage. This use of fund assets to pay for distribution, unlike 12b-1 fees, is not disclosed in the fee table or anywhere else in the prospectus. These payments are disclosed only in the Statement of Additional Information, a document that is provided to shareholders only upon request.

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[27] See Lauricella, Morgan Stanley Faces Inquiry into Fund Sales, Wall Street Journal (Apr. 2, 2003); Lauricella, Morgan Stanley is Sued on 'Break Points,' Wall Street Journal (Mar. 5, 2003).

Current disclosure rules lead investors to believe that the absence of a 12b-1 fee in the fee table means that the fund is not spending their money on distribution.[28] In fact, a shareholder in a 12b-1 fee fund may actually pay less for distribution than a shareholder in a fund that does not charge a 12b-1 fee but whose adviser makes payments to brokers for selling fund shares out of the adviser's own pocket or compensates brokers in the form of fund brokerage. To remedy this confusion, the Commission should consider eliminating the 12b-1 fee line item from the fee table and replacing it with one or more lines that show the total fund assets spent on distribution or types of distribution.

The Commission should consider extending this approach to other types of expenses. For example, the Commission could revise the entire fee table to set forth two categories of information: (1) the costs of the investing in the fund (a single expense ratio, plus shareholder expenses such as loads and account fees), and (2) how fund fees are allocated among different types of services. The first category could continue to be provided in the form of a fee table, and the second category could be provided in the form of a pie chart. This approach would make it easier for investors to evaluate how much it will cost them to invest in the fund and, for those who are interested in this information, how their money will be spent.

[28] In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "the idea that investors ought to prefer the funds that don't tell what they're spending on distribution over the ones that do is nonsense. You know, if you're spending money on distribution, say it. If you're not spending money on distribution don't say it; but don't pretend that there are no expenses there for a fund that doesn't have a 12b-1 plan." Conference on the Role of Investment Company Directors, Washington, D.C. (Feb. 23 & 24, 1999)(Haaga was not ICI Chairman at this time).

2. Brokers' Compensation

The purpose of prospectus disclosure is to inform investors about the cost of investing in a fund. In contrast, the purpose of point-of-sale disclosure is to inform investors about the economic motives of the person (referred to herein as the "broker") recommending the fund. Rule 10b-10 under the Securities Exchange Act accordingly requires that brokers disclose, to purchasers of securities, "the source and amount of . . . remuneration received or to be received by the broker in connection with the transaction." This disclosure is known as the "trade confirmation" or "confirm." The Commission has taken the position that Rule 10b-10 does not apply to sales of mutual fund shares.[29]

As noted above, the prospectus does not disclose all of the compensation that may be paid to brokers for selling fund shares. Even the compensation that is disclosed has no necessary relationship to the amount paid to a broker in a particular transaction. For example, the prospectus for two different mutual funds may show that an investor will pay the same front-end load of $500 on a $10,000 investment, but the broker selling the funds may be paid more for selling one fund than another.[30] The broker payout for both of these funds may be lower than for a fund with a 1.00% 12b-1 fee, for which brokers often receive a flat, upfront payment substantially in excess of the amount of 12b-1 fees that the shareholder will pay in the course of a single year. The broker also may receive payments directly from the fund adviser or compensation in the form of fund portfolio brokerage commissions.

If an investor buys shares of IBM or Dell, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. If an investor buys shares in a mutual fund, the confirm is not required to provide this information. The Commission should rescind its position that Rule 10b-10 does not apply to sales of fund shares and consider whether disclosure in addition to that required by the rule is

[29] SEC Report at 80.

[30] See Lauricella, Investment Firm's Portfolios Get Priority Despite Rules: 'The Home Field Advantage,' Wall Street Journal (May 22, 2003).

necessary to direct investors' attention to any incentives that a broker may have to prefer the sale of one fund over another. Further, in light of the Commission's recent discovery that brokers routinely fail to credit investors with commission breakpoints,[31] it should consider whether fund confirms should include a separate box that shows the breakpoint schedule and how it was applied to the purchase.

III. Section 3: Obligations Regarding Certain Distribution and Soft Dollar Arrangements

Section 3 of H.R. 2420 will require that fund advisers provide reports to their funds' directors on revenue sharing, soft dollar, and directed brokerage arrangements, and will provide that the directors shall have a fiduciary duty to supervise such arrangements to ensure that they are in the best interests of the funds' shareholders.

As discussed above, revenue sharing, soft dollar, and directed brokerage arrangements create significant conflicts of interest between a fund's adviser and its shareholders. One way to control these conflicts is through disclosure that enables investors to evaluate these conflicts and that subjects these arrangements to the forces of market competition.

Another way to control these conflicts is to provide fund directors with the tools they need to evaluate whether revenue sharing, soft dollar, and directed brokerage arrangements benefit shareholders. Some might argue, erroneously, that because fund directors already have a duty to conduct such evaluations, and fund advisers already have a duty to provide the information necessary thereto, Section 3's reporting requirements will be superfluous.

Granted, the reporting requirement may be unnecessary for fund complexes in which the advisers are fully forthcoming about these arrangements and the directors are aggressively questioning the information they receive. In some cases, however, these

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[31] SEC Report at 52-53.

arrangements may not benefit shareholders, and the adviser accordingly will be less willing to provide information about these arrangements to the directors. These are the situations in which a full evaluation of revenue sharing, soft dollar, and directed brokerage arrangements is most needed. Section 3's formal reporting requirement provides a structure that advisers will be less able to circumvent and that directors will be able to use to elicit more and higher quality information than they might otherwise receive.

Similarly, assigning fund directors a formal supervisory role with respect to such arrangements, as provided in Section 3, will further enhance the protection of shareholders who need it most.

IV. Section 4: Mutual Fund Governance

Section 4 of H.R. 2420 will require that fund boards be two-thirds independent and be chaired by an independent director, and authorize the Commission to deem to be non-independent certain persons who, by reason of business or family relationships, are unlikely to exercise an appropriate degree of independence.

a. Structure of Fund Boards

As often noted by the Commission, a mutual fund is effectively dominated by its adviser,[32] and this fact necessarily compromises the control normally exercised under state law by a board of directors. To compensate for this imbalance, it follows that additional requirements, beyond those provided under state law, may be necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders.

These additional requirements have become especially important in light of recent state law developments. Ironically, while Congress has acted to strengthen the accountability

[32] See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082, at Part I (Oct. 15, 1999) ("investment advisers typically dominate the funds they advise").

of corporate executives and directors, states have weakened the independence of fund boards. The three states in which the vast majority of mutual funds are domiciled – Massachusetts, Maryland and Delaware – have enacted legislation that requires courts to treat a federally independent director as independent for all purposes under state law, even if that director has a direct conflict of interest with respect to the matter on which he is exercising his responsibilities.[33] As stated by the Commission, there are gaps in the definition of a federally independent director "that have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management."[34] The effect of these state law amendments has been to dilute the state law duties of care and loyalty that frame the federal regulation of mutual funds.[35]

Fortunately, recent Commission rulemaking materially strengthened the role of independent directors,[36] and Section 4(a) of H.R. 2420 will further this process. In its rulemaking, the Commission effectively required that only a majority of directors be independent. By increasing the minimum to two-thirds, Section 4(a) will ensure that the independent directors will be able to exercise the independence necessary to protect shareholders, especially when dealing with matters where the interests of shareholders and the adviser conflict.

Section 4(a)'s requirement that fund boards be chaired by an independent director will further ensure that the fund boards will be able to exercise independent judgment and control the operational aspects of fund governance. The Commission staff has suggested that this step is unnecessary because the independent directors already can "influence the

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[33] See generally, Testimony of Mercer Bullard, Founder and President, Fund Democracy, before the Committee on Economic Matters, Maryland House of Delegates (Mar. 28, 2001); Tamar Frankel, The Different Design of Corporate Governance under State Law and Federal Law and the Aftermath of the Strougo Case, 7 The Investment Lawyer 3 (Feb. 2000).

[34] SEC Report at 47.

[35] See id. at 56 (discussing directors' state law duties of care and loyalty); Frankel, supra note 33.

[36] See SEC Report at 8; Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001).

agenda and the flow of information to the board."[37] It is not enough, however, that the independent directors "influence" the information they receive; nor is the staff's position consistent with the principle underlying the directors' affirmative statutory duty to "request and evaluate" the information necessary to evaluate the advisory contracts.[38] Indeed, the staff's suggestion that fund boards designate a "lead independent director" acknowledges the need for independent directors to exercise authority beyond that afforded by their numerical superiority. Formally appointing an independent director as chairman would better fill that need.

There is an inherent conflict between the board's duty to evaluate the adviser's conflicts of interest on the one hand, and the appointment of an employee of the adviser as the board's chairman on the other. Requiring that the chairman be independent will remove this conflict and ensure that the fund's independent directors have complete control over the board.

b. Definition of Interested Person

It is generally accepted that the definition of "interested person" in the Investment Company Act fails to cover many persons who have conflicts that may impair their independence.[39] The Commission has only limited authority to deem persons to be "interested persons," and that authority may be exercised only on a case-by-case basis by individual order.[40]

Section 4(b) of H.R. 2420 will authorize the Commission to fill important gaps in the definition of "interested person" in the Investment Company Act. These gaps permit

[37] SEC Report at 50.

[38] See Investment Company Act Section 15(c).

[39] See, e.g., Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute, at Part III.2 (recommending that former officers and directors of a fund's adviser not serve on the fund's board as an independent director).

[40] Investment Company Act Sections 2(a)(19)(A)(vii) & (B)(vii).

persons to serve as independent directors notwithstanding, for example, their prior employment by the adviser or familial relationship with executives of the adviser. Section 4(b) will authorize the Commission to fill these gaps by rulemaking, rather than the more cumbersome process of issuing an order in each case.

V. Section 5: Audit Committee Requirements for Investment Companies

Section 5 of H.R. 2420 will extend certain provisions of the Sarbanes-Oxley Act, as applicable to company audit committees, to mutual funds.

Many of the provisions of the Sarbanes-Oxley Act already apply to mutual funds, including some that are related to audit committees and auditors. For example, mutual funds are subject to Sarbanes-Oxley's audit committee pre-approval, auditor rotation and reporting requirements.[41] Sarbanes-Oxley provisions regarding audit-related employment restrictions, the improper influencing of audits, and attorney conduct also apply in the mutual fund context.[42]

It also is important to note that, as a general matter, mutual fund rules regarding accounting, independent auditors, employees' personal trading practices, affiliated transactions and other areas have generally exceeded and continue to exceed the standards applicable to other industries and other financial services products. For example, had Enron been subject to mutual fund rules, the special purpose entities that contributed to its demise could not have been created, much less used to steal from shareholders. The mutual fund industry has generally been free of the kinds of abuses that prompted the Sarbanes-Oxley Act.

Nonetheless, there have been instances in which mutual fund affiliates have engaged in wrongful conduct that a stronger, more independent audit committee would have been in

[41] Sarbanes-Oxley Act Sections 202, 203 & 204.

[42] Id. at Sections 206, 303 & 307.

a better position to detect and prevent. For example, the Commission, NASD and New York Stock Exchange recently conducted examinations "that found significant failures by broker-dealers to deliver breakpoint discounts to eligible customers."[43] Earlier this year, the SEC staff tentatively decided to recommend that the Commission initiate enforcement proceedings against an investment adviser for mispricing private equity holdings.[44] In late 2000, two municipal bond funds lost 70% and 44% of their value in a single day due to the mispricing of their portfolios.[45]

Section 5 will help reduce the likelihood of this type of wrongdoing going undetected. This provision strengthens the independence of the audit committee by requiring that all of its members be independent and establishing that the committee will have direct responsibility for overseeing the fund's accountant. It also ensures that the independent directors can retain and pay for independent advisers that it needs to determine whether the fund's securities are being priced accurately, and whether the fund's shareholders are paying the correct amount of fees, sales charges and other expenses.

VI. Section 6: Commission Study and Report Regulating Soft Dollar Arrangements

Section 6 of H.R. 2420 requires that the Commission report to Congress regarding soft dollar trends, services, conflicts of interest, and transparency, and how soft dollar arrangements affect investors' ability to compare mutual fund fees. Section 6 also asks the Commission to consider whether Section 28(e) of the Securities Exchange Act should be repealed or modified.

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[43] SEC Report at 53.

[44] Van Wagoner Funds, Inc., Attachment 77E to Form NSAR-B, at http://www.sec.gov/Archives/edgar/data/1002556/000094040003000110/van77.txt.

[45] The funds were placed into receivership on March 21, 2001. See generally, SEC v. Heartland Group, Inc., Litigation Rel. No. 16938 (Mar. 22, 2001). The Commission has yet to take any enforcement action against the fund's independent directors or adviser.

The soft dollar report will provide an opportunity for the Commission to update its understanding of how soft dollars are being used and provide the basis for further improvement in the regulation of soft dollar arrangements. When the Commission staff last evaluated soft dollar arrangements, it concluded that additional guidance was needed in a number of areas.[46] For example, the staff found that many advisers were treating basic computer hardware – and even the electrical power needed to run it – as research services qualifying under the Section 28(e) safe harbor.[47] The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars.

The soft dollar report also will improve the SEC's understanding of how mutual fund rules regarding soft dollars affect price competition in the fund industry. As discussed above, current disclosure rules provide an incentive to use soft dollars to purchase services, the cost of which would otherwise be included in the expense ratio in the fee table. These rules also enable the investment adviser to receive undisclosed compensation in addition to its management fee. The cost of soft dollar arrangements is invisible to the marketplace and therefore is immune to the disciplining forces of price competition.

Finally, the soft dollar report should benefit mutual fund shareholders by focusing their attention on how Section 28(e) affects their interests. Section 28(e) affects mutual funds differently from other advisory clients because without this provision the soft dollar benefits received by the adviser would be a prohibited affiliated transaction. Thus, Section 28(e) conflicts with the foundation of mutual fund regulation, which is built on a set of rules that prevent the kinds of conflicted transactions that historically have led to the greatest abuses in our financial markets.

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[46] See Section 28(e) Report, supra note 20.

[47] Id. at Section V.C.4.

There is reason for concern, however, regarding the direction of the soft dollar report. The Commission's most recent interpretive position on soft dollar arrangements suggests that it favors ***expanding*** the scope of the Section 28(e) safe harbor. In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions." This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that section 28(e) "does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."[48] The Commission staff has stated that it may be appropriate "to ***narrow*** the scope of this safe harbor."[49] The first step toward such narrowing would be for the Commission to withdraw its ultra vires expansion of Section 28(e)'s scope.

[48] Investment Advisers Act Release No. 1469 (February 14, 1995).

[49] SEC Report at 41 (emphasis added).

STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON H.R. 2420
MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003

EXECUTIVE SUMMARY

- Consistent with the industry's longstanding support of efforts to provide real, meaningful help to mutual fund investors, we stand ready to work constructively and respectfully with members of the Subcommittee and officials at the SEC and GAO to identify the best ways to accomplish our common goals of restoring investor confidence and helping individuals make well-informed investment decisions.

- H.R. 2420 was introduced shortly after the release of a detailed report by the staff of the SEC, which found no significant shortcomings in mutual fund regulation. The report recommends, however, a series of policy changes and also identifies areas warranting further study. In large part, the industry agrees with the SEC staff's recommendations. We clearly recognize the need, especially in the current environment, to re-examine our regulatory system in order to determine if it is working as intended, and – even if it is – to determine whether there are ways to make it even stronger.

- We believe that many of the provisions in H.R. 2420 would be beneficial to mutual fund investors. These include steps to:

    - further enhance the independence of fund boards;
    - further enhance the independence of fund audit committees;
    - clarify the role of fund directors and advisers with respect to soft dollar and directed brokerage arrangements; and
    - require the SEC to adopt rules mandating additional disclosure in certain areas including the structure of portfolio manager compensation, revenue sharing arrangements and fund brokerage practices.

- Many of the important policy changes in H.R. 2420 could be swiftly and effectively implemented even in the absence of legislation, through either regulatory action by the SEC or the adoption of best practices by the mutual fund industry. Similarly, the review of soft dollar practices required by the bill – which we strongly support – could be undertaken by the SEC long before legislation is enacted directing the SEC to do so.

- Certain parts of the bill, however, are unnecessary and in fact could be harmful to mutual fund shareholders.

    - *Independent Chair* – It is neither necessary nor appropriate to require mutual funds to have an independent chairman of the board. In many cases, a person needs to be intimately familiar with the operations of a company in order to be an effective chairman, and a management representative is often in the best position to do this. In addition, the combination of regulatory mandates and industry corporate governance best practices make an independent chair unnecessary.

    - *Location of Disclosure* – The specifics of how certain items should be disclosed, and in which document they should appear should not be dictated by legislation. We are particularly concerned with the legislation's presupposition that prospectus disclosure is not sufficient for any of the items covered. Under the securities laws,

the prospectus is the legal document required to include all of the important information that is necessary to assist an investor in making an investment decision including. Congress should not inadvertently discourage investors from viewing the prospectus as the most important disclosure document.

- *Estimated Operating Expenses* – The provision in the bill relating to fund operating expenses seems to contemplate disclosure of expenses on an individualized basis. The SEC's report noted that there were serious problems with this approach, including significant costs and logistical complexity, lack of comparability and lack of an effective context for investors to evaluate the expenses shown. While a requirement to disclose *estimated* fund expenses might reduce the costs and complexities associated with individualized cost disclosure, albeit to a relatively small extent, it would run the risk of confusing and misleading investors by including an imprecise number in a document that otherwise contains very exact and precise numerical data. And, it still would result in disclosure of information that would make it difficult for investors to make meaningful comparisons.

- *Board Oversight of Revenue Sharing* – While the Institute believes that it is entirely appropriate for directors to review soft dollar and directed brokerage arrangements, we do not believe that it is necessary or appropriate for boards to review revenue sharing arrangements. These payments are, by definition, not made by the fund. They are made by a fund's underwriter or adviser out of its own resources to compensate financial intermediaries who sell fund shares. In addition, fund directors are not permitted to take distribution expenses into account when determining whether a fund's advisory fee is reasonable.

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I. Introduction

My name is Paul G. Haaga, Jr. I appreciate the opportunity to appear before the Subcommittee today to discuss H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act."

I am appearing before you today, as I did in March, as chairman of the Investment Company Institute's Board of Governors.[1] My testimony is offered on behalf of the Institute and its members. My own firm is the investment adviser to the American Funds, which manages $350 billion on behalf of about 12 million mutual fund investors. We are the third largest mutual fund family in the United States, and – of particular significance today given several provisions in H.R. 2420 – we are the largest mutual fund company that sells exclusively or primarily through financial intermediaries. Before I joined the American Funds in 1985, I was a securities attorney in private practice in Washington, DC and, prior to that, was on the staff of the Securities and Exchange Commission.

When I testified three months ago I said that mutual fund companies view strict regulation under the federal securities laws as a valuable asset, not a liability. I believe that point is sufficiently important that it bears repeating today.

Mutual funds are not recent converts to the cause of reinforcing investor confidence. Our support for comprehensive regulation and increased resources for the SEC is not a

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,688 open-end investment companies ("mutual funds"), 556 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.475 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

temporary post-Enron public relations strategy. In fact, our views on these matters have been at the heart of how we serve 95 million shareholders. We have embraced the critical principles of integrity, transparency, accountability and competition – in both word and deed – for decades.

In 1940, Congress enacted the Investment Company Act. The Act is a comprehensive, strict and detailed statute that governs nearly all aspects of a mutual fund's organization, structure and operations. Unlike the other major securities laws, the Investment Company Act was supported – not opposed – by the industry it was intended to regulate. Indeed, the Act was drafted with input from the SEC and full cooperation from the fund industry, a fact President Roosevelt highlighted when he signed the bill. The manner in which the Investment Company Act became law is more than just our common history. It is, in my judgment, our common legacy.

Today's hearing brings SEC representatives, mutual fund leaders, industry observers and members of Congress together again. Our charge is to determine whether a common set of initiatives can be devised that would provide real, meaningful help to mutual fund investors. All of us are acutely aware that this effort occurs at a time when investor confidence in our equity markets has declined during the second worst bear market in the last century. Consistent with the tradition established with the enactment of the Investment Company Act, we hope to work constructively and respectfully with members of this Subcommittee and officials at the SEC and GAO to identify the best ways to accomplish our common goals of restoring investor confidence and helping individuals make well-informed investment decisions.

II. General Views on H.R. 2420

H.R. 2420 was introduced shortly after the release of a detailed report by the staff of the Securities and Exchange Commission that was requested by Chairman Baker.[2] The SEC Report addresses a broad array of complex issues.

We believe that the SEC Report is thorough, thoughtful and balanced. Among other things, the report discusses recent steps taken by the SEC, as well as pending proposals, designed to enhance disclosure to, and further the protection of, fund investors. The ICI has expressed the mutual fund industry's support of most of these initiatives, including rule amendments to enhance the independence of fund directors and proposals to improve disclosure of fees and other matters in mutual fund shareholder reports and to reform the rules governing mutual fund advertising.

The SEC Report also recommends a series of additional policy changes and identifies areas warranting further study. In large part, the industry agrees with the SEC staff's recommendations and is committed to working constructively and expeditiously with the Commission if it and the Congress determine to go forward with them.

Provisions in H.R. 2420 address several matters that are covered in the SEC Report; in particular, enhancements to disclosure and corporate governance requirements. We believe it is especially important for public understanding and for informed debate to point out that the

[2] *See* Memorandum to SEC Chairman William H. Donaldson from Paul F. Roye, Division of Investment Management, re Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (June 9, 2003) (the "SEC Report").

SEC Report did not find significant shortcomings in either area. For example, with respect to mutual fund fees, the SEC Report notes that prospective mutual fund investors currently "receive significant disclosure about fund fees and expenses."[3] The SEC Report also notes that its pending proposal to enhance disclosure of fees "would go beyond the disclosure provided by other financial service providers," including banks and mortgage companies.[4] More generally, the SEC Report notes that there is evidence of "significant competition based on costs in the fund industry."[5] With respect to mutual fund corporate governance, the SEC Report states that "one of the principal reasons the mutual fund industry has avoided the scandals that have plagued other segments of the securities industry is the presence of independent directors."[6]

These and similar conclusions in the SEC Report affirm our belief that the mutual fund industry continues to adhere to extremely high ethical and business standards, is strictly and effectively regulated by an active and vigorous independent agency, and is highly competitive in a manner that promotes service and responsiveness to individuals saving for the future. While we are proud of all of this, we also clearly recognize the need, especially in the current environment, to re-examine our regulatory system in order to determine if it is working as intended, and – even if it is – to determine whether there are ways to make it even stronger and more responsive to investor needs.

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[3] SEC Report at 9.

[4] *Id.* at 17.

[5] *Id.* at 5.

[6] *Id.* at 48.

H.R. 2420 would impose several significant new disclosure requirements upon mutual funds. It also contains provisions relating to the structure and duties of mutual fund directors. In some instances, the bill's provisions echo recommendations in the SEC Report; in other cases, the bill proposes a different approach, or would constrain the SEC's flexibility in responding to its directives.

We believe that the new requirements and policy changes envisioned by many of the provisions in H.R. 2420 would be beneficial to mutual fund investors. These include steps to:

- further enhance the independence of fund boards;
- further enhance the independence of fund audit committees;
- clarify the role of fund directors and advisers with respect to soft dollar and directed brokerage arrangements; and
- require the SEC to adopt rules mandating additional disclosure in certain areas.

We believe it is important for the Subcommittee to recognize that most, if not all, of these policy changes could be swiftly and effectively implemented even in the absence of legislation, through either regulatory action by the SEC or the adoption of best practices by the mutual fund industry. Similarly, the review of soft dollar practices required by the bill – which we strongly support – could be undertaken by the SEC for the Subcommittee long before legislation is enacted directing the SEC to do so.

At the same time, however, as I will explain in further detail below, we believe that some parts of the legislation are unnecessary and potentially harmful. These include certain aspects of the additional disclosure requirements and the requirement that fund boards have

independent chairpersons. We do not believe that these proposed changes would be beneficial to fund shareholders.

I now turn to a more detailed discussion of the provisions of H.R. 2420.

III. Soft Dollars

The Institute believes that one of the most important issues addressed by H.R. 2420 is soft dollars. The SEC has been very active in this area for some time, including issuing an extensive report on inspections[7] and proposing new disclosure requirements for investment advisers.[8] Nevertheless, we believe the time has come for a top to bottom re-examination by the SEC of soft dollar arrangements. We agree with the discussion in the SEC Report, which states that soft dollar arrangements may involve the potential for conflicts on the part of investment advisers, including – but certainly not limited to – advisers to mutual funds. The SEC Report notes that, in the case of mutual funds, these types of potential conflicts are generally managed by fund boards of directors and that mutual funds (and pension plans) are subject to stricter standards and more oversight regarding their adviser's soft dollar practices than other accounts.[9] The issues surrounding soft dollars are extremely complicated, have significant policy dimensions, raise a host of practical concerns and have been the subject of intense debate for decades. Therefore, we concur that it is prudent for the SEC to first undertake another careful analysis of the relevant issues. One particular area that we believe is

[7] The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (September 22, 1998).

[8] Investment Advisers Release No. 1862 (April 5, 2000).

[9] SEC Report at 36-39.

ripe for re-examination by the SEC is whether the definition of "research" for purposes of the soft-dollar safe harbor is overly broad.

IV. Audit Committee Requirements

The Institute agrees that it would be appropriate for audit committees of mutual funds to follow standards that are similar to those required by Section 301 of the Sarbanes-Oxley Act of 2002.[10] While most provisions of the Sarbanes-Oxley Act apply equally to mutual funds and operating companies,[11] Section 301 applies only to companies that are listed on an exchange. This includes closed-end funds and most exchange-traded funds, but does not include mutual (open-end) funds.

With respect to the audit committee standard, members of the Subcommittee might want to note that many funds already have chosen voluntarily to implement, or are currently considering voluntarily implementing, most of the requirements of Section 301. In a recent speech, Paul Roye, Director of the SEC's Division of Investment Management, stated that these requirements "represent 'best practices' worthy of consideration by all mutual fund boards of directors."[12] We believe that it makes sense for mutual funds to follow the strict standards for

[10] The SEC recently adopted Rule 10A-3 under the Securities Exchange Act of 1934 to implement Section 301 of the Sarbanes-Oxley Act. SEC Release No. IC-26001 (April 9, 2003).

[11] For example, pursuant to Sections 302 and 906 of the Act, periodic reports of funds must be certified by the fund's principal executive officer and principal financial officer; pursuant to Section 307 of the Act, rules regarding attorney conduct apply to attorneys representing funds; pursuant to Section 406 of the Act, funds must disclose whether they have a code of ethics that applies to senior financial officers; and pursuant to Section 407 of the Act, funds must disclose whether they have a "financial expert" on their audit committees. In addition, fund auditors are subject to the various provisions of the Act relating to auditor independence (*e.g.*, Section 206).

[12] *See* "A New Era of Accountability in Fund Regulation," Remarks by Paul F. Roye, Director, SEC Division of Investment Management, at the Investment Company Institute's 2003 Mutual Funds and Investment Management Conference, March 31, 2003.

audit committees established under Section 301 of the Sarbanes-Oxley Act. In the absence of legislation, we would commit to urging the mutual fund industry to adopt them as a best practice.

V. Super-Majority of Independent Directors

The Investment Company Act currently requires that at least 40 percent of a fund's board consist of individuals who are not "interested persons" of the fund or certain affiliates. In addition, when mutual fund shares are offered through an affiliate of the fund's investment adviser, which is quite common, the Investment Company Act requires a majority of the mutual fund's board to be independent.

These statutory provisions establish baseline requirements with respect to the composition of mutual fund boards. But there are additional requirements that reinforce and strengthen the role and responsibilities of independent directors on mutual fund boards. For example, in 2001, the SEC adopted rule amendments that require funds that rely on any of ten key exemptive rules to have a majority of independent directors.[13] As almost all funds rely on one or more of these rules, the effect of these amendments is to require virtually all mutual funds to have a majority of independent directors.

H.R. 2420 would amend the Investment Company Act to require at least *two-thirds* of the directors of all investment companies to be independent directors. We note that a two-thirds

[13] SEC Release No. IC-24816 (January 2, 2001). The rule amendments also require, for funds relying on these exemptive rules, that the independent directors select and nominate other independent directors and that any legal counsel for the independent directors be "independent legal counsel" as defined by the SEC.

standard would be consistent with existing mutual fund industry practices. In June 1999, an Advisory Group on Best Practices for Fund Directors established by the Institute and on which I served recommended that at least two-thirds of the directors of all investment companies be independent directors.[14] The Advisory Group concluded that having a super-majority of independent directors on fund boards would enhance the authority of independent directors. It is the Institute's understanding that most fund boards have adopted this best practice and currently have a super-majority of independent directors.[15]

We also think it bears mentioning that the super-majority standard in the bill exceeds the standard currently being considered for public operating companies. For example, currently pending proposals of the New York Stock Exchange, Nasdaq and the American Stock Exchange would require listed companies to have a *majority* of independent directors.

VI. Qualification as an Independent Director

Section 4(b) of the bill would give the Commission additional authority to define, by rule, categories of persons who should not be treated as independent directors for purposes of the Investment Company Act. The Institute agrees that there may be types of family, business and professional relationships – in addition to those currently enumerated in Section 2(a)(19) of the Act – that, both for appearances sake and as a matter of fact, should disqualify persons from serving as independent directors of a mutual fund.

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[14] *Report of the Advisory Group on Best Practices for Fund Directors, Enhancing a Culture of Independence and Effectiveness*, June 24 (1999) ("Best Practices Report") at 10. The Best Practices Report recommended fifteen best practices for enhancing the effectiveness and independence of fund boards. It was issued by an advisory group of independent and management fund directors.

[15] If it is deemed appropriate to mandate that *all* funds adopt this standard, this could be implemented through SEC rulemaking.

The Act broadly defines those persons who are considered "interested persons" of a fund or its affiliates and thus disqualified from independent status. Nevertheless, the current definition technically would allow persons such as former executives of the fund's adviser and persons with certain family relationships to senior officers of the adviser, underwriter or their affiliates (*e.g.*, aunts and uncles) to be considered independent directors.[16] While the Institute believes that such situations are rare, when they come to light, they risk undermining public confidence in the system of fund governance.

For this reason, the Institute supports the concept of making the strict standards for independence under the Investment Company Act even stricter. We note that the Advisory Group on Best Practices for Fund Directors recommended that "former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund."[17] While recognizing that such persons may be valuable board members because of their extensive knowledge of the industry, the fund complex and the operations of the adviser or underwriter, the Advisory Group concluded that their prior service may affect the directors' independence, both in fact and appearance. Accordingly, the Advisory Group recommended that such persons should not be considered *independent* directors if they serve on fund boards. Family relationships not specifically covered by Section 2(a)(19) may raise similar concerns over independence. In the absence of legislation, it would therefore seem appropriate to adopt a best practice similar to that adopted for former executives that would

[16] The Act considers "immediate family" members of such persons to be "interested persons." Immediate family members are defined as any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and they include step and adoptive relationships.

[17] Best Practices Report at 12.

have the effect of extending the exclusion from the definition of "disinterested director" to additional family members, as well as business or professional associates.

VII. Board Oversight of Soft Dollars, Directed Brokerage and Revenue Sharing

H.R. 2420 would impose requirements on fund directors to: (1) supervise the investment adviser's direction of the fund's brokerage arrangements and soft dollar arrangements, and to determine that the direction of such brokerage is in the best interests of the fund's shareholders; and (2) supervise any "revenue sharing arrangements" to ensure compliance with the Investment Company Act and rules thereunder and to determine that such arrangements are in the best interests of investors.

The Institute believes it is entirely appropriate for investment advisers to report to fund boards on soft dollar and directed brokerage arrangements, and for directors to review those arrangements. Soft dollars and brokerage are fund assets, and these arrangements involve the potential for conflicts between the interests of the fund and those of the adviser or its affiliates. As such, these matters fall squarely within the purview of fund director oversight responsibilities. As noted in the SEC Report, these matters already are overseen by fund boards of directors in connection with their obligation to request and review such information as may reasonably be necessary to evaluate the terms of the contract between the fund and its investment adviser.[18] Nevertheless, we would have no objection to making the duties of fund

[18] SEC Report at 26-27. The SEC Report explains, for example, that research and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because such services otherwise would have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser.

advisers and fund directors in this area more explicit.[19] The SEC currently has the authority to do so, even in the absence of legislation, through rulemaking and/or an interpretive release.

By contrast, so-called "revenue sharing" arrangements involve payments by a fund's principal underwriter or investment adviser out of its own resources to compensate financial intermediaries who sell fund shares. These payments are, by definition, not made by the fund.[20] In addition, the SEC has taken the position that fund directors should not take distribution expenses into account when determining whether a fund's advisory fee is reasonable, and courts have applied the same standard.[21] For these reasons, it would be unnecessary and perhaps even inappropriate for fund boards to review such payments. As is discussed further below, the principal investor protection concern that is raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. For this reason, we have long advocated additional disclosure of these payments directly to investors in order to put them on notice of these potential conflicts.

VIII. Disclosures by Mutual Funds

Section 2 of the bill would require the SEC to adopt rules to require mutual funds to provide investors with additional disclosures on various matters. These new disclosures would

[19] Directors should not, however, serve in the role of "supervising" the investment adviser's soft dollar and directed brokerage activities. This term suggests a degree of board involvement that could improperly transform the board's oversight role into one of direct management.

[20] As the SEC Report notes, if such payments are made directly or indirectly by a fund, they must be in accordance with Rule 12b-1 under the Investment Company Act. SEC Report at 77.

[21] *See, e.g.*, SEC Release No. IC-11414 (October 28, 1980); *Schuyt v. T.Rowe Price Prime Reserve Fund*, 663 F.Supp. 962 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988).

be required to be set forth in a document other than the fund's prospectus, although presumably the SEC could require that the disclosure also be in the prospectus.

As a preliminary matter, the Institute strongly shares the Subcommittee's commitment to full disclosure. Because mutual funds are the investment vehicles of choice for millions of Americans, it is imperative that they communicate with investors as clearly and effectively as possible. Therefore, it is important that information be provided to investors in a format that is easy to understand and does not inadvertently mislead investors. In addition, it is important that regulators carefully consider the costs associated with different disclosure requirements, because ultimately all costs borne by a fund reduce investor returns.

All of the disclosures that would be required under H.R. 2420 concern matters that are discussed in the SEC Report. The Report contains a detailed analysis of disclosure of fund operating expenses, portfolio transaction costs, portfolio manager compensation, soft dollars, and revenue sharing. We believe the SEC staff's discussion provides a sound basis on which to proceed in enhancing disclosure in these areas. Moreover, as the agency charged with administering the securities laws, we believe that the SEC should be accorded deference and granted discretion in determining in what form and in what document any new disclosures should be made. The SEC and its staff have the requisite expertise and experience to make these determinations, and to do so, after seeking public comment, based on a complete analysis of benefits and costs to funds and their shareholders.

Other more specific thoughts on this section of the bill are set forth below.

A. Location of Disclosure

As a general matter, we believe that funds should be permitted to include several of the proposed disclosures exclusively in the prospectus if the SEC so determines. The fund's prospectus is the document under the securities laws that is required to provide investors in mutual funds (and all issuers of securities) with all material information that is likely to be relevant to an investment decision. In 1998, the SEC substantially revised the mutual fund prospectus to simplify it and make it easier to read and understand. Key information that is necessary to assist an investor in making an investment decision should be contained in the prospectus. In addition, some of the specific disclosures need to be in the prospectus in order to put them in proper context. For example, fund prospectuses are required to disclose various information about the fund's portfolio manager. It would seem appropriate, therefore, to have any disclosure about how that person is compensated in the same document. Similarly, fund prospectuses must describe the fund's investment strategies; brokerage practices can be an important element of these strategies. Finally, including material information in a document other than the prospectus could have the perverse effect of causing investors to view that information as being more important than the prospectus disclosure. This could result in an investor, for example, focusing on disclosure relating to a fund's directed brokerage arrangements but not on the disclosure in the prospectus discussing the risks of investing in the fund.

B. Specific Disclosure Items

Estimated Dollar Amount of Operating Expenses – Section 2 would require funds to disclose the estimated dollar amount of operating expenses that are borne by each shareholder. This seems to contemplate disclosure of expenses on an individualized basis. We question both the practicability and the necessity of this requirement. As the SEC Report discusses, mutual fund investors currently receive significant disclosure about fund fees and expenses.[22] The Report describes, in particular, the fee table that is included in the front of every fund prospectus and discloses to investors all of the costs of owning the fund – both initial and ongoing – in a standardized format that is intended to facilitate cost comparisons among funds. It discloses the fund's overall expense ratio and includes a numerical example that illustrates the effect of all fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare two or more funds because it presents an "all-in" figure that takes into account both sales charges and annual fees and is expressed as a dollar amount.

In December 2002, the SEC proposed additional disclosure to enhance investors' understanding of the ongoing expenses they incur when they invest in a fund. Under the SEC's proposal, funds would have to disclose in their semi-annual and annual reports to shareholders the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the period.

The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment return.

[22] SEC Report at 9.

Because the disclosure would be based on a standardized investment amount ($10,000), it would also assist them in comparing the expenses of different funds. In addition, including this information in fund shareholder reports alongside key information about the fund's operating results, including management's discussion of the fund's performance, would allow investors to place the information in context.

The SEC Report stated that as an alternative to the proposed approach above, the SEC also considered the GAO's recommendation in its June 2000 report.[23] The GAO recommended that the SEC require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement. The SEC Report noted that there were serious problems with the GAO's alternative, including costs and logistical complexity, lack of comparability and lack of an effective context for investors to evaluate the expenses shown.

The Institute believes that the SEC should proceed with its proposal, and that Congress should study the effectiveness of the new fee disclosure initiatives in development before mandating yet another related and costly disclosure requirement. In addition, we wish to point out that requiring funds to provide only an estimate of an investor's share of the costs would only reduce the costs associated with individualized cost disclosure to a relatively small extent.[24]

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[23] United States General Accounting Office, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition" (June 2000).

[24] A survey of industry participants conducted by the Institute in late 2000 with the assistance of an industry task force and PricewaterhouseCoopers LLP found that the aggregate costs to survey respondents associated with calculating and disclosing the actual dollar amount of fund operating expenses attributable to each investor on quarterly account statements would be $200.4 million in initial implementation costs and $65 million in annual, ongoing costs. ICI Survey on GAO Report on Mutual Fund Fees (January 31, 2001). The survey found that the costs of providing an estimate of fund operating expenses attributable to each investor would be $189.4 million in annual costs and $58.3 million in annual, ongoing costs. Because the survey respondents included only a sample of affected organizations, the total costs incurred by mutual funds, service providers, financial intermediaries and ultimately fund investors under either approach likely would be significantly higher.

Also, if it were required to be disclosed in account statements, it would run the risk of confusing and misleading investors, by including an *imprecise* number in a document that otherwise contains very exact and precise numerical data, *e.g.*, number of shares owned, value of an investor's holdings. And, it still would result in disclosure of information that would make it difficult for investors to make meaningful comparisons.

Transaction Costs – Under Section 2, funds would be required to disclose transaction costs "in a manner that facilitates comparisons." The SEC Report includes a lengthy discussion of this issue, noting that that while shareholders could benefit from a better understanding of a fund's trading costs, quantitative disclosure of such costs is highly problematic. For example, the SEC Report notes that while commissions are the only type of trading cost that can be measured directly, disclosure of commissions alone would be misleading as they do not capture all trading costs, including spreads, market impact, and lost opportunity, and thus would make it difficult for investors to compare costs.[25] However, including these other costs would result in funds being forced to speculate about costs that are not quantifiable and could mislead investors, particularly when they attempt to compare costs among funds using different methods of estimation.[26] The potential benefits of complicated new disclosure requirements must be weighed against the costs – including potential unintended consequences – of providing them.

[25] SEC Report at 28-29.

[26] The Report states that implementation shortfall may be the most all-inclusive way to measure transaction costs. *Id.* at 30. Implementation shortfall measures transaction cost as the difference between the price of each trade that was actually made and the price that prevailed in the market when the decision to trade was made. The Report acknowledges that the practical difficulties of constructing the implementation shortfall would be daunting because funds would need to collect and analyze enormous quantities of information throughout the trading process, and develop objective and verifiable criteria for determining when a trading decision has actually been made, determining when the decision has been modified or revised and selecting the figure that represents a security's market price at each of these times. In addition, determining the extent to which the fund's actual trading activity has varied from its intention would be difficult, even if new recordkeeping requirements relating to the motivations of the trade were mandated.

Notwithstanding these difficulties, the SEC Report identifies and evaluates several possible approaches for improving disclosure of portfolio transaction costs, including (1) giving greater prominence to the portfolio turnover ratio, (2) requiring disclosure in the prospectus of the impact the fund's management style would have on portfolio transaction costs, (3) moving information on brokerage costs from the statement of additional information to the prospectus and (4) reinstating some form of average commission rate per share disclosure. The Institute believes that these ideas are worthy of serious consideration by the SEC. The Report also states that the staff will consider whether to recommend that the SEC issue a concept release on this matter. The Institute supports the issuance of a concept release in this area in order to explore whether it is feasible to construct a transaction cost measure that is accurate, verifiable and comparable, and not overly burdensome for funds.

"Revenue-Sharing" – As explained in the SEC Report, there is competition among funds for the services of selling broker-dealers, who frequently demand compensation, or expense-sharing, for distributing fund shares and servicing shareholders beyond the amounts they receive through sales charges and fees paid from fund assets under a Rule 12b-1 plan. Thus, it is common practice in the fund industry for fund principal underwriters and/or investment advisers to pay additional compensation to selling broker-dealers out of their own resources.[27] The bill would require disclosure concerning these payments.[28]

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[27] *See id.* at 77.

[28] Specifically, Section 2(a)(5) would require disclosure of "[i]nformation concerning payments by any person other than a fund itself that are intended to facilitate the sale and distribution of the fund's shares."

Disclosure concerning these additional payments to broker-dealers already is required in fund prospectuses, and the Institute agrees that general prospectus disclosure is appropriate to alert investors to the existence of the payments so that they can request additional information from their sales professionals if they so wish.

According to the SEC Report, the SEC staff is considering whether also requiring point-of-sale disclosure by broker-dealers would be appropriate. Consistent with our longstanding position on this issue,[29] the Institute believes that it would.

The NASD has previously raised the concern that these payment arrangements "may provide point-of-sales incentives that could compromise proper suitability determinations or otherwise create a perception that a [broker-dealer's] interests might not, in some circumstances, be fully aligned with the interests of customers."[30] General point-of-sale disclosure by broker-dealers of the existence of payments by fund advisers would help investors assess and evaluate recommendations to purchase fund shares.

Breakpoint Discounts – Section 2(a)(6) of the bill would require disclosure of information concerning discounts on front-end sales loads for which investors may be eligible, including the minimum purchase amounts required for such disclosure. This requirement is

[29] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[30] NASD Request for Comment 97-50 (August 1997) at 409.

intended to address concerns raised by recent regulatory examinations that found significant failures by broker-dealers to deliver such discounts to eligible investors.[31]

The Institute and its members have been working with the broker-dealer community on several levels to examine the causes for these problems and develop and implement appropriate solutions. A task force convened by the NASD that consists of regulators and representatives from the broker-dealer and fund industries, and on which I serve, is in the process of studying this issue and formulating recommendations for both regulatory and voluntary industry measures that would minimize the potential for future problems in this area. The task force is expected to issue its recommendations very shortly, and it is likely that those recommendations will include additional disclosure concerning front-end sales charge discount privileges. This is intended to help ensure that fund investors will be aware of discounts for which they may be eligible and of the need to communicate relevant information to their sales professional. We would urge Congress to review the recommendations of the task force before moving legislation to specify additional disclosure requirements.

C. Timing of Rulemaking

The bill would require the SEC to adopt final rules within 270 days after enactment of the legislation. This means that the entire process of studying the issues involved, developing proposed rules, soliciting public comment, analyzing the comments, making any appropriate modifications and issuing final rules would have to be completed within that period. The Institute is concerned that such a compressed time period imposes an unreasonable burden on

[31] *See* Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003). The report noted that these failures did not appear to involve intentional misconduct.

the SEC and will likely curtail opportunities for meaningful public comment. Given the importance and complexity of the issues involved, Congress should provide a longer time period that would allow for a thorough and deliberate process rather than a rushed one. We note that, by contrast, the bill would provide an 18-month period for the SEC to conduct a study of soft dollars. It is unclear why it would be necessary to accelerate the completion of all of the stages of formal rulemaking proceedings that will involve considering and addressing several diverse topics, in half the time allotted for an agency study of one issue.[32]

IX. Independent Chair of Fund Boards

As noted above, the Institute supports appropriate measures, such as requiring two-thirds of a fund's board to be independent and making the standards for independence stricter, to further enhance the strong system of corporate governance already in place in the mutual fund industry. We do not believe, however, that requiring all fund boards to have an independent chair is necessary or appropriate.

To begin with, having an independent chair might be counterproductive and impractical. For example, a management representative, due to his or her knowledge of the details of a fund's operations, will often be a more effective chair. It is likely that, for reasons such as this, an independent chair has not been among the many corporate governance reforms that are currently under consideration by the major securities self-regulatory organizations. We can think of no reasons why different considerations should apply in the case of mutual funds.

[32] Indeed, given the importance of the issues raised by soft dollar practices, the Committee may wish to consider setting an earlier deadline for the completion of that report.

Indeed, if anything, the concerns that proponents of requiring an independent chair seek to address are *already* addressed in an effective manner by existing legal requirements and industry practices that bolster the independence and authority of fund independent directors. For example, the Investment Company Act requires a separate vote of the independent directors to approve certain important decisions, such as the approval of the fund's investment advisory and underwriting agreements and the use of fund assets to support the distribution of fund shares under a Rule 12b-1 plan.

Moreover, best practices followed by many boards further reinforce the independence and authority of the independent directors. As noted above, while virtually all funds are required to have a majority of independent directors, many boards actually have a super-majority of independent directors. In addition, many have meetings of the independent directors separately from management on a regular basis, and many have a lead independent director.[33] As noted in the SEC Report, "a lead director can coordinate the activities of the independent directors, act as a spokesperson for the independent directors in between meetings of the board, raise and discuss issues with counsel on behalf of the independent directors and chair separate meetings of the independent directors."[34] We believe that this combination of regulatory mandates and industry best practices, which go beyond those of operating companies, make an independent chair unnecessary.

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[33] Each of these practices was recommended by the Advisory Group on Best Practices for Fund Directors. *See* Best Practices Report at 10 (super-majority), 24 (separate meetings of independent directors), and 25 (lead independent director or directors).

[34] SEC Report at 51.

X. Conclusion

The Institute appreciates the opportunity to testify before the Subcommittee. We fully support all appropriate initiatives to promote investor confidence in mutual funds. We stand ready to work with the Subcommittee and the SEC to achieve this shared goal.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EST
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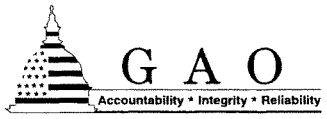
MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Statement of Richard J. Hillman, Director,
Financial Markets and Community Investment



GAO-03-909T

June 18, 2003

GAO
Accountability • Integrity • Reliability
Highlights

Highlights of GAO-03-909T, a testimony to the Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Why GAO Did This Study

Concerns have been raised over whether the disclosures of mutual fund fees and other fund practices are sufficiently transparent and fair to investors. GAO's testimony discusses (1) mutual fund fee disclosures, (2) the extent to which various corporate governance reforms are in place in the mutual fund industry, (3) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (4) the benefits and concerns over fund advisers' use of soft dollars.

What GAO Recommends

GAO's report recommends that SEC consider requiring additional disclosure by mutual funds of

- the fees that investors pay in account statements,
- revenue sharing payments that broker-dealers receive; and
- fund adviser's use of soft dollars.

www.gao.gov/cgi-bin/getrpt?GAO-03-909T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

The work that GAO has conducted at the request of this Committee addresses several of the areas that are included in the recently introduced Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420). Mutual funds disclose considerable information about their costs to investors, but unlike many other financial products and services, they do not disclose to each investor the specific dollar amount of fees that are paid on their fund shares. Consistent with H.R. 2420, our report recommends that SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements, which we estimate may result in minimal increases in fund expenses. Our report also discusses other alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees but be even less costly to the industry overall.

U.S. mutual funds have boards of directors who are charged with overseeing the interests of fund shareholders. Various corporate governance reforms have been proposed to improve the effectiveness of mutual fund boards. As a result of SEC requirements or industry best practice recommendations, many of these practices were already in place at many funds, but not all such practices were mandatory. H.R. 2420 would ensure that all mutual funds implement these practices.

Mutual fund advisers have been increasingly making additional payments out of their own profits to the broker-dealers that sell their fund shares. Although allowed under current rules, these revenue sharing payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that investors are offered. Under current disclosure requirements, however, investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Consistent with H.R. 2420, our report also recommended that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving.

Under a practice known as soft dollars, a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. Although this research and other services can benefit fund investors, these arrangements could result in increased expenses for fund shareholders if fund advisers trade excessively to obtain additional soft dollar research. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on all of its own recommendations. Consistent with H.R. 2420, our report recommended that more disclosure be made to mutual fund directors and investors.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss GAO's work on the disclosure of mutual fund fees and the need for other related mutual fund disclosures to investors. The fees and other costs that mutual fund investors pay as part of owning fund shares can significantly affect their investment returns. As a result, it is appropriate to debate whether the disclosures of mutual fund fees and fund marketing practices are sufficiently transparent and fair to investors.

Today, I will summarize the results from our recently issued report entitled *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763 (Washington, D.C.: June 9, 2003) and describe how the results of this work relates to certain provisions of the proposed Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420). Specifically, I will discuss (1) mutual fund fee disclosures and opportunities for improving these disclosures, (2) the extent to which various corporate governance reforms are in place in the mutual fund industry, (3) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (4) the benefits and concerns over fund advisers' use of soft dollars.

In summary:

The study that we have conducted at the request of this Committee directly supports several of the key provisions of H.R. 2420. In particular, it addresses the need to consider ways to increase the transparency of mutual fund fees and other disclosures. Mutual funds disclose considerable information about their costs to investors, including presenting the operating expense fees that they charge investors as a percentage of fund assets and providing hypothetical examples of the amount of fees that an investor can expect to pay over various time periods. However, unlike many other financial products and services, mutual funds do not disclose to individual investors the specific dollar amount of fees that are paid on their fund shares. The Securities and Exchange Commission (SEC) has proposed that mutual funds make additional disclosures to investors that would provide more information that investors could use to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that inform investors of the number and value of the mutual fund shares they own. Consistent with H.R. 2420, our report recommends that SEC consider requiring mutual funds to make

additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC has agreed to consider requiring such disclosures but was unsure that the benefits of implementing specific dollar disclosures outweighed the costs to produce such disclosures. However, we estimate that spreading these implementation costs across all investor accounts may result in minimal increases in fund expenses. Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees.

Each mutual fund in the United States is required to have a board of directors that is charged with overseeing the interests of fund shareholders. These boards also must include directors that are not employed or affiliated with the fund's adviser, and these independent directors have specific duties to oversee the fees their fund's charge. However, some industry critics have questioned whether fund directors are adequately performing their duties and various corporate governance reforms have been proposed to improve the effectiveness of mutual fund boards. We found that many of the corporate governance reforms are already being practiced by many funds as a result of either recent SEC actions or because they are recommended as best practices by the mutual fund industry body, the Investment Company Institute. By amending the Investment Company Act of 1940 to require these and other corporate governance practices, H.R. 2420 would further strengthen certain corporate governance practices and ensure that all mutual funds implement these practices.

The work that we conducted for our report also found that mutual fund advisers have been increasingly engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses to fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that these broker-dealers offer investors. However, under current disclosure requirements investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Consistent with H.R. 2420, our report also recommended that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving.

Finally, we also reviewed a practice known as soft dollars, in which a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. These soft dollar arrangements can result in mutual fund advisers obtaining research or other services, including from third party independent research firms, that can benefit the investors in their funds. However, these arrangements also create a conflict of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain additional soft dollar research or chooses broker-dealers more on the basis of their soft dollar offerings than their ability to execute trades efficiently. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on some of its own recommendations. Consistent with H.R. 2420, our report recommended that more disclosure be made to mutual fund directors and investors to allow them to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

Additional Disclosure of Mutual Fund Costs Might Benefit Investors

Although mutual funds already disclose considerable information about the fees they charge, our report recommended that SEC consider requiring that mutual funds make additional disclosures to investors about fees in the account statements that investors receive. Mutual funds currently provide information about the fees they charge investors as an operating expense ratio that shows as a percentage of fund assets all the fees and other expenses that the fund adviser deducts from the assets of the fund. Mutual funds also are required to present a hypothetical example that shows in dollar terms what an investor could expect to pay if they invested $10,000 in a fund and held it for various periods.

Unlike many other financial products, mutual funds do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. Table 1 shows that many other financial products do present their costs in specific dollar amounts.

Table 1: Fee Disclosure Practices for Selected Financial Services or Products

Type of product or service	Disclosure requirement
Mutual funds	Mutual funds show the operating expenses as percentages of fund assets and dollar amounts for hypothetical investment amounts based on estimated future expenses in the prospectus.
Deposit accounts	Depository institutions are required to disclose itemized fees, in dollar amounts, on periodic statements.
Bank trust services	Although covered by varying state laws, regulatory and association officials for banks indicated that trust service charges are generally shown as specific dollar amounts.
Investment services provided to individual investment accounts (such as those managed by a financial planner)	When the provider has the right to deduct fees and other charges directly from the investor's account, the dollar amounts of such charges are required to be disclosed to the investor.
Wrap accounts*	Provider is required to disclose dollar amount of fees on investors' statements.
Stock purchases	Broker-dealers are required to report specific dollar amounts charged as commissions to investors.
Mortgage financing	Mortgage lenders are required to provide at time of settlement a statement containing information on the annual percentage rate paid on the outstanding balance, and the total dollar amount of any finance charges, the amount financed, and the total of all payments required.
Credit cards	Lenders are required to disclose the annual percentage rate paid for purchases and cash advances, and the dollar amounts of these charges appear on cardholder statements.

Source: GAO analysis of applicable disclosure regulations, rules, and industry practices.

*In a wrap account, a customer receives investment advisory and brokerage execution services from a broker-dealer or other financial intermediary for a "wrapped" fee that is not based on transactions in the customer's account.

Although mutual funds do not disclose their costs to each individual investor in specific dollars, the disclosures that they make do exceed those of many products. For example, purchasers of fixed annuities are not told of the expenses associated with investing in such products. Some industry participants and others including SEC also cite the example of bank savings accounts, which pay stated interest rates to their holders but do not explain how much profit or expenses the bank incurs to offer such products. While this is true, we do not believe this is an analogous comparison to mutual fund fees because the operating expenses of the bank are not paid using the funds of the savings account holder and are therefore not explicit costs to the investor like the fees on a mutual fund.

A number of alternatives have been proposed for improving the disclosure of mutual fund fees, that could provide additional information to fund investors. In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[1] This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to disclose the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, SEC also proposed that mutual funds be required to disclose the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. If these disclosures become mandatory, investors will have additional information that could be directly compared across funds. By placing it in funds' annual and semiannual reports, SEC staff also indicate that it will facilitate prospective investors comparing funds' expenses before making a purchase decision.

However, SEC's proposal would not require mutual funds to disclose to each investor the specific amount of fees in dollars that are paid on the shares they own. As result, investors will not receive information on the costs of mutual fund investing in the same way they see the costs of many other financial products and services that they may use. In addition, SEC did not propose that mutual funds provide information relating to fees in the quarterly or even more frequent account statements that provide investors with the number and value of their mutual fund shares. In a 1997 survey of how investors obtain information about their funds, ICI indicated that to shareholders, the account statement is probably the most important communication that they receive from a mutual fund company and that nearly all shareholders use such statements to monitor their mutual funds.

SEC and industry participants have indicated that the total cost of providing specific dollar fee disclosures might be significant; however, we found that the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement, ICI commissioned a large accounting firm to survey mutual fund companies about the costs of

[1]"Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission," Release Nos. 33-8164; 34-47023; IC-2587068 (Dec. 18, 2002).

producing such disclosures.[2] Receiving responses from broker-dealers, mutual fund service providers, and fund companies representing approximately 77 percent of total industry assets as of June 30, 2000, this study estimated that the aggregated estimated costs for the survey respondents to implement specific dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. Although the ICI study included information from some broker-dealers and fund service providers, it did not include the reportedly significant costs that all broker-dealers and other third-party financial institutions that maintain accounts on behalf of individual mutual fund shareholders could incur. However, using available information on mutual fund assets and accounts from ICI and spreading such costs across all investor accounts indicates that the additional expenses to any one investor are minimal. Specifically, at end of 2001, ICI reported that mutual fund assets totaled $6.975 trillion. If mutual fund companies charged, for example, the entire $266 million cost of implementing the disclosures to investors in the first year, then dividing this additional cost by the total assets outstanding at the end of 2001 would increase the average fee by .000038 percent or about one-third of a basis point. In addition, ICI reported that the $6.975 trillion in total assets was held in over 248 million mutual fund accounts, equating to an average account of just over $28,000. Therefore, implementing these disclosures would add $1.07 to the average $184 that these accounts would pay in total operating expense fees each year—an increase of six-tenths of a percent.[3]

In addition, other less costly alternatives are also available that could increase investor awareness of the fees they are paying on their mutual funds by providing them with information on the fees they pay in the quarterly statements that provide information on an investor's share balance and account value. For example, one alternative that would not likely be overly expensive would be to require these quarterly statements

[2]U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003).

[3]To determine these amounts, we used the operating expense ratios that ICI has estimated in its September 2002 fee study—which reported average expense ratios of 0.88 percent for equity funds, 0.57 percent for bond funds, and 0.32 percent for money market funds. By weighting each of these by the total assets invested in each fund type, we calculated that the weighted average expense ratio for all funds was 0.66 percent. Using this average expense ratio, the average account size of $28,000 would pay $184 in fees. The additional expense of implementing specific dollar disclosures of 0.000038 percent would therefore add $1.07 to this amount.

to present the information—the dollar amount of a fund's fees based on a set investment amount—that SEC has proposed be added to mutual fund semiannual reports. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative could be to require quarterly statements to also include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information.

Because SEC's current proposal, while offering some advantages, does not make mutual funds comparable to other products and provide information in the document that is most relevant to investors—the quarterly account statement—our report recommended that SEC consider requiring additional disclosures relating to fees be made to investors in these documents. In addition to specific dollar disclosures, we also noted that investors could be provided with other disclosures about the fees they pay on mutual funds that would have a range of implementation costs, including some that would have even less overall cost to the industry. H.R. 2420 also mandates that SEC require additional information about fees be disclosed to investors. Seeing the specific dollar amount paid on their shares could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees. Because the disclosures that SEC is currently proposing be included in mutual fund annual and semiannual reports could also prove beneficial, it could choose to require disclosures in both these documents and account statements, which would provide both prospective and existing investors in mutual funds access to valuable information about the costs of investing in funds.

H.R. 2420 also mandates that SEC require mutual funds to disclose more information about portfolio transactions costs, including commissions paid with respect to the trading of portfolio securities. Although additional information about such costs could be beneficial to investors, we found that determining these costs in a way that allows them to be accurately and fairly compared across funds could prove difficult.

Mutual Fund Boards Follow Many Sound Corporate Governance Practices but Such Practices are Not Mandatory for All Funds

Mutual funds implemented many sound practices concerning their boards of directors, but these practices are not mandatory for all funds. The law governing U.S. mutual funds promotes investor protection by requiring funds to have a board of directors to protect fund shareholder interests. As a group, the directors of a mutual fund have various statutory responsibilities to oversee fund operations. In particular, the directors independent of the fund's investment adviser have additional duties including approval of the contracts with the investment adviser. As a matter of practice, independent directors also review other arrangements such as transfer agency, custodial, or bookkeeping services.

As a result of recent scandals such as Enron and Worldcom, new legislative and regulatory reforms have been adopted or proposed to increase the effectiveness and accountability of public companies' boards of directors. In July 2002, the Sarbanes-Oxley Act (Sarbanes-Oxley) was enacted to address concerns related to corporate responsibility and governance.[4] In addition to enhancing the financial reporting regulatory structure, Sarbanes-Oxley sought to increase corporate accountability by reforming the structure of corporate boards audit committees. Section 301 of Sarbanes-Oxley requires that directors who serve on a public company's audit committee be "independent" and select and oversee outside auditors. The New York Stock Exchange (NYSE) and NASDAQ have also proposed changes to the corporate governance listing standards for public companies. However, many of the proposed reforms for public companies are either already required or have been recommended as best practices for mutual fund boards. Table 2 shows how the current or recommended corporate governance practices for mutual fund boards compare to current and proposed NYSE and NASDAQ listing standards applicable to public company boards.

[4]Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

Table 2: Current and Proposed NYSE and NASDAQ Listing Standards Compared to Current or Recommended Mutual Fund Corporate Governance Requirements

	NYSE/NASDAQ listing standards		Mutual Funds	
Governance requirement	Currently required	Proposed requirement	Required by statute or SEC rule[a]	ICI recommended best practice
Board must have a majority of independent directors		X	X	X
Independent directors must be responsible for nominating new independent directors		X	X	X
Audit committee must consist of only independent directors[b]	X	X		X
Standards that define who qualifies as an independent director[c]	X	X	X	X
Independent directors required to meet separately in executive sessions		X		X

Source: GAO analysis of ICI Best Practices, SEC rules, and NYSE and NASDAQ rule proposals.

[a]SEC requires the board of directors of any fund that takes advantage of various exemptive rules to meet these requirements and SEC staff indicated that, as a result, almost all funds must comply.

[b]Although fully independent audit committees is not a requirement for funds, SEC has adopted a rule to encourage fund boards to have audit committees consisting exclusively of independent directors by exempting such committees from having to seek shareholder approval of the fund's auditor.

[c]Both the NYSE and NASDAQ definitions of director independence currently apply only to members of the audit committee, but their rule proposals would extend this definition to the full board.

According to regulators and data from industry participants that we obtained, many mutual funds have implemented many of the practices that are being recommended for public companies. As shown in table 2 above, many of these practices are already required for many funds by SEC regulation or are recommended by ICI as a best practice. Officials of the fund companies and the independent directors that we interviewed told us that the majority of their boards consisted of independent directors, and, in many cases, had only one interested director. For public companies, some commenters have called for boards of directors to have supermajorities of independent directors as a means of ensuring that the voices of the independent directors are heard. ICI already advocates this practice in its best practice recommendations and one fund governance consulting official said that a 2002 survey conducted by his firm found that, in 75 percent of the mutual fund complexes they surveyed, over 70

percent of the directors were independent. An academic study we reviewed also found that funds' independent directors already comprised funds' nominating committees and most funds have self-nominating independent directors.

However, not all of these sound corporate governance practices are currently mandatory for mutual funds. For example, if a fund does not take advantage of any of the exemptive rules that SEC cited in requiring certain corporate governance practices, such a fund may not already be following these practices. In addition, some of the reforms advocated by ICI's best practices and by those advocating change for public companies are not currently required for mutual funds. H.R. 2420 would make these and other practices mandatory for all funds, which would ensure consistent implementation of the practices across the industry.

Changes in Mutual Fund Distribution Practices Raise Potential Conflicts of Interest Between Broker-Dealers and Investors

One mutual fund distribution practice—called revenue sharing—that has become increasingly common involves mutual fund investment advisers making additional payments beyond those made under 12b-1 plans to broker-dealers that sell fund shares. Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. To be compensated for providing advice and ongoing assistance to investors, many of these financial professionals receive payments from the mutual fund either through the sales charges paid up front by the investor (called loads) or from ongoing fees that are deducted from the fund's assets. These fees are called 12b-1 fees after the rule that allows fund assets to be used to pay for fund marketing and distribution expenses. NASD, whose rules govern the distribution of fund shares by broker dealers, limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts. Therefore, 12b-1 fees included in a fund's total expense ratio are limited to a maximum of 1 percent per year.

However, broker-dealers, whose extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, have increasingly required mutual funds to make additional payments to their firms beyond the sales loads and 12b-1 fees. These payments, called revenue sharing payments, come from the adviser's profits and may supplement distribution-related

payments from fund assets. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. According to the officials of a mutual fund research organization, about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments. For example, some broker-dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker-dealers. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms with revenue sharing payments.

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. A 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing might affect other fees that funds charge, such as 12b-1 fees or management fees, was uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments increased any fund's fees, but also noted that by reducing fund adviser profits, revenue sharing would likely prevent advisers from lowering their fees. In addition, fund directors normally would not question revenue sharing arrangements paid from the adviser's profits. In the course of reviewing advisory contracts, fund directors consider the adviser's profits not taking into account marketing and distribution expenses, which also could prevent advisers from shifting these costs to the fund.

Revenue sharing payments may also create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue sharing arrangements might unduly focus the attention of broker-dealers on particular mutual funds, reducing the number of funds considered as part of an investment decision–potentially leading to inferior investment choices and potentially reducing fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable given the investor's financial situation and risk profile.

Although revenue sharing payments can create conflicts of interest between broker-dealers and their clients, the extent to which broker-

dealers disclose to their clients that their firms receive such payments from fund advisers is not clear. Rule 10b-10 under the Securities Exchange Act of 1934 requires, among other things, that broker-dealers provide customers with information about third-party compensation that broker-dealers receive in connection with securities transactions. While broker-dealers generally satisfy the 10b-10 requirements by providing customers with written "confirmations," the rule does not specifically require broker-dealers to provide the required information about third-party compensation related to mutual fund purchases in any particular document. SEC staff told us that they interpret rule 10b-10 to permit broker-dealers to disclose third-party compensation related to mutual fund purchases through delivery of a fund prospectus that discusses the compensation. However, investors would not receive a confirmation and might not view a prospectus until after purchasing mutual fund shares.

As a result of these concerns, our report recommends that SEC evaluate ways to provide more information to investors about the revenue sharing payments that funds make to broker-dealers. Having additional disclosures made at the time that fund shares are recommended about the compensation that a broker-dealer receives from fund companies could provide investors with more complete information to consider when making their investment decision. This recommendation is consistent with the requirement in H.R. 2420 that mandates that SEC require mutual funds to further disclose revenue sharing payments and make annual or more frequent reports of such payments to fund boards of directors.

Soft Dollar Arrangements Provide Benefits, but Could Adversely Impact Investors

Soft dollar arrangements allow fund investment advisers to obtain research and brokerage services that could potentially benefit fund investors but could also increase investors' costs. When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets.[5] In return for these brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products.

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can

[5]Instead of commissions, broker-dealers executing trades also could be compensated through markups or spreads.

directly benefit a fund's investors if the adviser uses it to select securities for purchase or sale by the fund. The prevalence of soft dollar arrangements also allows specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars might also have other benefits. For example, an investment adviser official told us that the research on smaller companies helps create a more efficient market for such companies' securities, resulting in greater market liquidity and lower spreads, which would benefit all investors including those in mutual funds.

Although the research and brokerage services that fund advisers obtain through the use of soft dollars could benefit a mutual fund investor, this practice also could increase investors' costs and create potential conflicts of interest that could harm fund investors. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. One academic study shows that trades executed by broker-dealers that specialize in providing soft dollar products and services tend to be more expensive than those executed through other broker-dealers, including full-service broker-dealers.[6] Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to "over-consume" research because they are not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which investment advisers use to register with SEC and must send to their advisory clients. However, this form is not provided to the shareholders of a mutual fund, although the information about the soft dollar practices that the adviser uses for particular funds are required to be included in the Statement of Additional Information that funds prepare, which is available to investors upon request. Specifically, Form ADV requires advisers to describe the

[6]J.S. Conrad, K.M Johnson, and S. Wahal, "Institutional Trading and Soft Dollars" *Journal of Finance*, (February, 2001).

factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of the products, research, and services given to the adviser affects the choice of brokers or the brokerage commission paid, the adviser must also describe the products, research and services and whether clients might pay commissions higher than those obtainable from other brokers in return for those products.

In a series of regulatory examinations performed in 1998, SEC staff found examples of problems relating to investment advisers' use of soft dollars, although far fewer problems were attributable to mutual fund advisers. In response, SEC staff issued a report that included proposals to address the potential conflicts created by these arrangements, including recommending that investment advisers keep better records and disclose more information about their use of soft dollars. Although the recommendations could increase the transparency of these arrangements and help fund directors and investors better evaluate advisers' use of soft dollars, SEC has yet to take action on some of these proposed recommendations.

As a result, our report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, because SEC has not acted to more fully address soft dollar-related concerns, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars. If H.R. 2420 is enacted, investors and fund directors would get more information to allow them to make these evaluations. Also, the study that H.R. 2420 would require SEC to conduct of soft dollars would likely provide SEC with valuable information to allow it to best decide the form of these disclosures and whether any other changes to soft dollar practices are warranted.

This concludes my prepared statement and I would be happy to respond to questions.

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Testimony of Mellody Hobson

President
Ariel Mutual Funds

"H.R. 2420, The Mutual Funds Integrity and Fee Transparency Act"

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE &
GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

June 18, 2003

ARIEL MUTUAL FUNDS 20 YEARS OF PATIENT INVESTING 20

Thank you Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, and members of the Subcommittee. Testifying about investor confidence when that issue is more important to our economy and more relevant to the destinies of average Americans than ever before is a great honor – and an even greater responsibility.

I am the President of Ariel Mutual Funds. Ariel is a small investment firm and a small business. We offer four mutual funds. More than 100,000 individuals have $3.7 billion currently invested in our funds. Ariel is based in Chicago and has 67 employees. In addition to my work at Ariel, I have for the last three years contributed a weekly segment on personal finance issues for a network television news program.

My colleague John Rogers founded Ariel twenty years ago. It was the first minority-owned money management firm in the United States. He was 24 years old. John discovered the stock market at a very early age, when his father began buying him stocks on his birthday and at Christmas instead of toys. John's childhood interest evolved into his life's work. That passion led to the creation of Ariel Mutual Funds.

This story tells you about the heart and soul of one small mutual fund company. Some have suggested to the Subcommittee that the mutual fund industry is dominated by firms who've forgotten their fiduciary obligations, lost their connection to individual shareholders, abandoned the basic principles of sound investment management, and repudiated the industry's proud history. Nothing could be farther from truth. As a mutual fund executive, my future, my credibility and my integrity are inextricably linked to Ariel shareholders' success.

Ariel takes enormous pride in being part of a great industry. We work hard to reach out to those who've not seen firsthand the wonders of long-term investing, compound growth, and the creation of enduring wealth. One important aspect of our work is a unique mission: to make the stock market a subject of dinner table conversation in the Black community.

It is heartening to come to Washington and see policymakers who care so much about our shareholders. We applaud your efforts. When you find effective ways to reinforce investor protections and support the integrity of our markets, you help our business and our shareholders.

REGULATIONS

I'm aware that four major government reports on mutual funds have been published in the last 36 months, two by the SEC and two by the GAO. Taken as a whole, the reports reaffirm the health of the fund industry and the continued effectiveness of the regulatory regime that governs it.

It would be logical to think that the SEC put most other fund initiatives on hold while these studies were completed, but that has not been the case. Since 1998, the SEC appears to have adopted at least 20 new mutual fund regulatory initiatives –

averaging at least one every twelve weeks. This appears to be the fastest rate in the SEC's history. Of course, each initiative can include multiple forms, rules, requirements and mandatory filings. I'll attach a more extensive list for the record, but recent SEC mutual fund regulations have included new requirements in areas ranging from consumer privacy, to proxy voting, to after-tax performance.

In addition, at least four new major rules are pending.

The sheer number and range of these regulations demonstrates the vitality of the SEC's efforts to help 95 million fund investors. I also think it bears noting that the ICI has worked constructively with the SEC on virtually all of these matters and has endorsed the overwhelming majority of them.

COSTS

We should remember, however, that new regulations invariably lead to significant costs. The SEC deserves credit for several efforts that reduced fund regulatory costs. But those initiatives are dwarfed by regulations that have added far larger costs and burdens. Reviewing the SEC's own cost estimates for these rules is striking. The net impact of SEC mutual fund rulemakings since 1998 appears to have increased the fund industry's regulatory costs by at least several hundred million dollars annually.

I'm worried that the impact of all this on small mutual fund companies could ultimately contribute to making the fund industry less hospitable to innovative start-ups and perhaps less competitive. I'm not certain I could, in good faith, advise a 24 year old today to take on the costs and burdens of starting a mutual fund as John Rogers did.

Let me turn to some general observations about the bill.

Section 2 of H.R. 2420 directs the SEC to initiate expedited rulemakings on six broad new mutual fund disclosure mandates. As the Subcommittee considers whether to support this directive, we are hopeful that the inevitable impact on smaller fund companies will be carefully considered. It would be deeply regrettable if attempts to heighten shareholder disclosure eroded the competitive position of one of the most dynamic and entrepreneurial parts of the fund business. I strongly agree with Paul Haaga's comments a few minutes ago, and urge you to provide sufficient time so that a consensus approach to these issues can be embraced.

INFO OVERLOAD

Fed Chairman Alan Greenspan recently observed that "in our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."[1]

[1] "Corporate Governance," Remarks by The Honorable Alan Greenspan, Chairman, U.S. Federal Reserve Board, May 8, 2003.

He said that improved transparency is more important -- but harder to achieve -- than improved disclosure. "Transparency challenges market participants not only to provide information but also to place that information in a context that makes it meaningful."[2] Former SEC Chairman Levitt once expressed a similar concern, "[t]he law of unintended results has come into play: Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing."[3]

The possibility that disclosures might impede rather than enhance decision-making is a real concern. For example, when the SEC overhauled mutual fund prospectuses five years ago, prospectus reform was hailed as the most beneficial SEC change to disclosure requirements for individual investors in its 60 year history. At the time, the SEC urged great caution about succumbing to the future temptations to add new disclosure requirements, noting that they had learned that too much information "discourages investors" from further reading or "obscures essential information" about the fund.[4]

FEES

After reading the SEC and GAO reports and reviewing the transcript of the Subcommittee's March hearing, it is obvious that a substantial effort has been undertaken to explore ways to bolster mutual fund investors' understanding of their funds' fees and expenses. Fortunately, recent ICI data about investors' actual behavior strongly suggests that the message about fund fees has broken through. The ICI looked at all equity fund sales over a five-year period ending in 2001 and found that.

- 83 percent of all equity funds bought by investors had expense ratios below the 1.62 percent charged by the average fund.

- The average investor holds equity funds with a total operating expense ratio of 0.99 percent – about 39 percent lower than the fee level charged by the average fund.

Similar findings have been reported by others. I am pleased but not surprised by these findings. They indicate convincingly that very large majorities of fund shareholders own funds with lower than average costs. I hope the Subcommittee will bear this data in mind as it further considers these issues.

As consideration of H.R. 2420's various provisions advances, I am particularly hopeful that the Subcommittee will review the new account statement alternative described by the GAO. Most of the fee disclosure proposals for account statements that we've heard have given us shivers. From our perspective, these proposals, including

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[2] Id.

[3] "Taking the Mystery Out of the Marketplace: The SEC's Consumer Education Campaign," Remarks by The Honorable Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, October 13, 1994.

[4] Id.

regrettably the provision in H.R. 2420, produce two undesirable but certain outcomes: breathtakingly high costs, and substantial shareholder confusion. However, a new "legend" alternative -- described by the GAO in its report yesterday -- avoids both problems. Instead, for what we suspect will be a much more reasonable cost, the proposal fully accomplishes the goal of providing investors with a prominent reminder of the fact that fund fees reduce investment returns. As we understand it, the legend could also encourage investors to review the fee table in the prospectus or to consult with their financial adviser.

By bringing the SEC, the GAO, fund industry representatives and industry critics together today, the Subcommittee is simultaneously providing leadership on these issues and helping to facilitate a consensus approach to their resolution. Because H.R. 2420 was introduced just as the SEC report was submitted, and several days before the GAO report was released, I would respectfully suggest that another review would seem to make sense. In the meantime Paul Haaga set forth a thoughtful and proactive way for the fund industry to embrace and push forward on many of the H.R. 2420's important reforms. Ariel would be pleased to work constructively with the Subcommittee in full support of such an approach.

I mentioned earlier that I conduct personal finance features on a television network news program and author a bi-monthly column. I've literally received thousands of questions and requests for guidance, and hear one refrain more than any other: people feel overwhelmed. Young, old, married, single, black, white, working, or retired. Investors want insight, timesavers, and ways to cut through the noise to get to the most important information that will help them make the best investment decisions. I never hear complaints about receiving too little information; it's always the opposite – from shareholder mailings to the broadcast media to magazines to websites. Interestingly, I've received many fairly sophisticated inquiries, but have never once received a single question about soft dollars, directed brokerage, rule 12b-1, or many of the other mutual fund issues we've discussed today. Perhaps there's a small insight to be gleamed from that.

Thanks again for the privilege of testifying. I look forward to your questions, and would welcome the chance to work with you on these issues in the days and weeks to come.

TESTIMONY

OF

PAUL F. ROYE, DIRECTOR
DIVISION OF INVESTMENT MANAGEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003, H.R. 2420

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

JUNE 18, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY

OF

PAUL F. ROYE
DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE MUTUAL FUNDS INTEGRITY AND FEE TRANSPARENCY ACT OF 2003, H.R. 2420

BEFORE THE HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES, COMMITTEE ON FINANCIAL SERVICES

JUNE 18, 2003

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission (the "Commission"), I am pleased to discuss H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," (the "Bill"), which recently was introduced by Chairman Baker and co-sponsored by several members of the Subcommittee. It is both a pleasure and an honor to testify before you today.

This Bill can provide investors with important information regarding their investments in mutual funds, as well as strengthen the corporate governance standards of mutual funds. In addition to providing mutual fund investors with disclosures about estimated operating expenses incurred by shareholders, soft dollar arrangements, portfolio transaction costs, sales load breakpoints, directed brokerage and revenue sharing

arrangements, the Bill also would require disclosure of information on how fund portfolio managers are compensated and require fund advisers to submit annual reports to fund directors on directed brokerage and soft-dollar arrangements, as well as revenue sharing. It also would recognize fiduciary obligations of fund directors to supervise these activities and assure that they are in the best interest of the fund and its shareholders. In addition, the Bill would require the Commission to conduct a study of soft dollar arrangements to assess conflicts of interest raised by these arrangements and examine whether the statutory safe harbor in section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") should be reconsidered or modified.

As discussed in more detail below, we support the goals of the Bill and commend Chairman Baker and the co-sponsors of this legislation for their initiative and support of a regulatory regime that best serves the interests of mutual fund investors. We particularly support the goals of enhancing disclosure and the expanded authority the Bill would provide the Commission to define which directors can be considered independent. With respect to some other provisions, while supporting the goals, the Commission believes the Bill should preserve the Commission's flexibility to determine appropriate standards through the notice and comment rulemaking process. Overall, this Bill has the potential to assist in maintaining investor confidence in the fairness of the operations of mutual funds – the investment of choice for millions of Americans.

I. Improved Transparency of Mutual Fund Costs

Section 2(a) of the Bill would require the Commission to revise regulations under the Securities Act of 1933 ("Securities Act"), the Exchange Act, or the Investment Company Act of 1940 ("Investment Company Act"), or any combination thereof, to

require improved mutual fund disclosure. The Commission supports the goals of this provision of the Bill, which would increase the transparency of costs and other information to mutual fund investors. The Commission has long been committed to full disclosure of mutual fund costs and other key information so that investors may make informed decisions. We believe that the Bill represents a step in improving the disclosure that mutual fund investors receive about their funds.

Improved disclosure in these areas will support the current lynchpin of a mutual fund's cost disclosure – the standardized fee table – which the Commission has required in every mutual fund prospectus since 1988.[1] The Bill would require improved disclosure of mutual fund costs and provide key information to investors as outlined below.

A. Dollar Disclosure of Operating Expenses Borne by Shareholders

The Bill would require improved disclosure of the estimated amount, in dollars, of a mutual fund's operating expenses that are borne by each shareholder. This should help to address ongoing concerns that fund investors may not understand the nature and long-term effect of recurring mutual fund fees. By requiring that the disclosure be provided in dollar terms, rather than just as a percentage of net assets, the Bill should help investors to understand, in very practical terms, the impact of fund expenses on the value of their investments.

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[1] Item 3 of Form N-1A. The table reflects both (i) transactional fees, *i.e.*, charges paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and (ii) recurring charges deducted from fund assets, such as management fees and 12b-1 fees. The table is located at the beginning of the prospectus. It is accompanied by a numerical example that illustrates the total dollar amounts, including both transactional costs paid directly by a shareholder and ongoing asset-based expenses, that an investor could expect to pay on a $10,000 investment if the fund achieved a 5% annual return and the investor remained invested in the fund for 1-, 3-, 5-, and 10-year periods.

Despite existing disclosure requirements, as well as educational efforts,[2] the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. While transactional fees, such as front- and back-end sales loads, are relatively transparent, portfolio transaction costs, such as management fees and distribution fees, are less evident because they are deducted directly from fund assets. These charges are reflected in reduced account balances and expressed as a percentage of net assets in a fund's prospectus, making their impact less evident to an investor. Surveys have indicated that investors may not understand the nature and effect of these recurring mutual fund fees.[3]

In December 2002, the Commission proposed new disclosure requirements that would achieve the same objectives as proposed in the Bill and are intended to increase investors' understanding of the recurring expenses that they pay to invest in a fund. Specifically, the Commission proposed to require mutual funds to disclose in their annual and semi-annual reports to shareholders fund expenses borne by shareholders during the reporting period. Under the Commission's proposal, fund shareholder reports would be required to include: (i) the cost in dollars associated with an investment of $10,000, based on the fund's actual expenses and return for the period; and (ii) the cost in dollars,

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2 In 1999, for example, the Commission introduced the Mutual Fund Cost Calculator, an Internet-based tool available on the Commission's website that enables investors to compare the costs of owning different mutual funds over a selected period. SEC Mutual Fund Cost Calculator <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm> (last modified July 24, 2000).

3 Securities and Exchange Commission and Office of the Comptroller of the Currency, *Report on the OCC/SEC Survey of Mutual Fund Investors,* at 14-15 (June 26, 1996). The report found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns. A recent survey found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns. *See Investors Need to Bone Up on Bonds and Costs, According to Vanguard/MONEY Investor Literacy Test,* Press Release, BUSINESS WIRE, Sept. 25, 2002.

associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.[4] The first figure is intended to permit investors to estimate the actual cost, in dollars, that they bore over the reporting period. The second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds. The Commission staff is currently reviewing the comments on the proposal and expects to present the Commission with a recommendation in this area expeditiously.

B. Portfolio Manager Compensation

The Bill would require improved disclosure of the structure of, or method used to determine, the compensation of individuals employed by a mutual fund's investment adviser to manage the fund's portfolio. Mutual funds typically are externally managed by an investment adviser, to which they pay an advisory fee directly from fund assets. The investment adviser in turn employs the individuals who act as portfolio managers. Commission rules currently require a fund to provide disclosure only of the amount of the advisory fee paid to the investment adviser in the fee table in the fund's prospectus.[5]

Disclosure regarding the structure of an individual portfolio manager's compensation would be useful in supplementing existing disclosure of the advisory fee.

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[4] Investment Company Act Release No. 25870 (Dec. 18, 2002).

[5] Item 3 and Instruction 3(a) to Item 3 of Form N-1A. In addition, the prospectus must include a description of the investment adviser's compensation, including the aggregate fee paid to the adviser for the most recent fiscal year as a percentage of average net assets. *See* Item 6(a)(1)(ii)(A) of Form N-1A. If the fee is not based on a percentage of average net assets, *e.g.*, if the adviser receives a performance-based fee, the prospectus also is required to describe the basis of the adviser's compensation. *See* Item 6(a)(1)(ii)(B) of Form N-1A. Further, a fund is required to provide disclosure in its statement of additional information ("SAI") regarding the method of calculating the advisory fee payable by the fund, including the total dollar amounts that the fund paid to the investment adviser under the investment advisory contract for the last three fiscal years. *See* Item 15(a)(3) of Form N-1A. The SAI is a portion of a fund's registration statement that is not part of the fund's prospectus but is required to be delivered to investors free of charge upon request.

Such disclosure is one way to provide fund shareholders with information that would be helpful in assessing the incentives of the individuals who are managing the fund. For example, disclosure that a manager is compensated based on the fund's performance for a particular period (*e.g.*, 3 months, 1 year, or 5 years) may shed light on the manager's incentives to maximize short-term or long-term performance. Similarly, disclosure of whether a portfolio manager's compensation is based on a fund's pre-tax or after-tax returns would be useful in assessing whether a fund is an appropriate investment for a taxable or tax-deferred account.

C. Portfolio Transaction Costs

The Bill would require improved disclosure of a mutual fund's portfolio transaction costs, including commissions paid with respect to the trading of portfolio securities, set forth in a manner that facilitates comparison among funds. Although transaction costs are currently taken into account in computing a fund's total return, they generally are not included as part of a fund's expense ratio.[6] The improved disclosure of transaction costs that the Bill would require should provide investors with a better understanding of these costs, which are substantial for many funds.

Broadly defined, a mutual fund's transaction costs are the overall costs of implementing the fund's trading strategy.[7] Transaction costs include commissions, spreads, market impact costs, and opportunity costs. Commissions are per share charges

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[6] Commission rules, however, require a mutual fund to record as an expense the value of services received under a brokerage service arrangement, pursuant to which a broker agrees to pay certain fund operating expenses and the fund agrees to direct a minimum amount of brokerage to the broker. *See* Regulation S-X, Article 6-07(2)(g).

[7] John M.R. Chalmers, Roger M. Edelen and Gregory B. Kadlec, "Mutual Fund Trading Costs," University of Pennsylvania, Rodney L. White Center for Financial Research, Working Paper 027-99, Nov. 2, 1999, at 1.

paid to a broker to act as agent for a customer (the fund) in the process of executing and clearing a trade. Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (above current value) or sells a security to a dealer at the "bid" price (below current value). The variance from current value is known as the "spread." Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security. Market impacts are the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.[8] Opportunity cost is the cost of delayed or missed trades. The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the stock and, by doing so, drive up (or down) the price.

Commissions are the only type of transaction cost that can be measured directly. Measurement is straightforward because the commission is separately stated as a per share charge on the transaction confirmation and is paid directly from fund assets. Spread, market impact, and opportunity costs, however, can only be estimated.[9] As a result, there is no generally agreed-upon method to calculate overall transaction costs.

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[8] *See* Stephen A. Berkowitz and Dennis E. Logue, "Transaction Costs: Much Ado about Everything," 27 JOURNAL OF PORTFOLIO MANAGEMENT 65, 68 (2001).

[9] *See* SEC Staff Memorandum in Response to March 26, 2003 Letter from Richard H. Baker, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated June 9, 2003 ("Baker Staff Response") at 22; SEC Staff Memorandum in Response to March 26, 2003 Letter from Representatives Robert W. Ney and Paul E. Kanjorski, Members, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated June 11, 2003 ("Ney/Kanjorski Staff Response" and, together with the Baker Staff Response, the "Staff Responses"), at 24.

Some have suggested that mutual funds should be required to disclose a quantitative measure of their overall transaction costs.[10] Although proposals to quantify overall transaction costs are attractive in theory, they may not be feasible in practice. Estimates of overall transaction costs appear to lack the attributes of uniformity, reliability, and verifiability.[11] Nonetheless, consistent with the Bill, the Commission believes that investors would benefit from better, more understandable disclosure of transaction costs, set forth in a manner that facilitates comparison among funds.

The Commission believes that a variety of approaches could achieve the objectives of the provision and deserve further consideration. First, because commission costs are identifiable, in terms of cents per share, and because commission rates currently are more transparent, disclosure of the fund's average and range of commission costs would aid in the assessment of soft-dollar arrangements by directors and investors, as discussed in section I.D of this testimony. Further, we could require funds to give greater prominence to the portfolio turnover ratio. This ratio is a relatively good proxy for transaction costs, simple to calculate, relatively straightforward to understand, and subject to comparison across funds. Another approach that deserves consideration is to require all funds to include in the prospectus a discussion of the impact of their investment objectives, strategies, and management style on portfolio turnover and overall transaction costs. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, only if it is a principal investment strategy. Thus, funds also could be required to give greater

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[10] Testimony of John Montgomery, March 12, 2003, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives.

[11] *See* discussions of transaction costs in Staff Responses, *supra* note 9.

prominence to the information on brokerage costs that is currently included in the SAI and this information could be disclosed together with portfolio turnover information in order to give shareholders a more complete understanding of the fund's transaction costs.

D. "Soft Dollar" Arrangements

"Soft dollars" involve a portion of the commission charged to funds (and other investors) for the execution of their portfolio trades, which are directed by the investment manager to brokers who provide services such as investment research and to reward brokers for their sale of fund shares. Soft dollars also may be "recaptured" for the benefit of funds by directing brokers to pay for expenses normally paid by the funds directly (*e.g.*, accounting fees, transfer agency and custodian services).

1. *Soft Dollars for Research*

The use of soft dollars for research should be reviewed and authorized as in the best interests of the fund by the fund's board of directors. The Bill would require improved disclosure of information concerning a mutual fund's policies and practices with respect to certain soft dollar arrangements whereby brokerage commissions are paid to a broker who provides research and other transaction related services. We are concerned about the growth of soft dollar arrangements and the conflicts they may present to money managers, including fund advisers. We agree that fund directors and investors should be provided with better information about soft dollar arrangements.

Soft dollar arrangements involve the potential for conflicts of interest between a mutual fund and its investment adviser, since they involve incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage

costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers.

These types of conflicts generally are monitored and managed by fund boards of directors. Fund independent directors are in a better position to monitor the adviser's direction of the fund's brokerage than are fund investors. As a result, the Commission historically has not required fund prospectuses to disclose specific information about the use of soft dollars. Funds are required, however, to disclose information about soft dollar arrangements in the SAI.[12] We agree that the time has come to consider improving disclosure along the lines suggested by the Bill. While we remain convinced that independent directors are in the best position to monitor the use of a fund's brokerage, investors can benefit from improved information about a fund's policies and practices with respect to soft dollar arrangements. Fund brokerage is an asset of the fund and its shareholders, and those shareholders should be provided with better information about the use of this asset. As described in Section V of this testimony, we also support the Bill's provisions regarding a study of soft dollar arrangements, including the safe harbor created in section 28(e) of the Exchange Act.

2. *Use of Brokerage to Facilitate Distribution of Mutual Fund Shares*

The Bill would require improved information concerning a mutual fund's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the fund's shares. The Commission supports greater transparency in this area, to provide fund investors with better information

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[12] Item 16 of Form N-1A.

concerning the use of this valuable fund asset to compensate brokers who distribute the fund's shares.

Over the past decade, broker-dealers selling fund shares have increasingly demanded compensation for distributing fund shares that is over and above the amounts that they receive in the form of sales loads and rule 12b-1 distribution fees. Thus, brokers have required payments for "shelf space," that is, for giving "preferred" status to a particular fund group.[13] To meet this demand, fund advisers increasingly have been required to make payments out of their own resources to broker-dealers selling their fund shares ("selling broker-dealers") and have used fund brokerage commissions as additional compensation to these selling broker-dealers.

Funds and their investment advisers use a number of different brokerage commission practices to compensate selling broker-dealers. For example, in some cases, a fund's investment adviser, when selecting among executing broker-dealers will consider, among other things, sales of the fund's shares by the executing broker-dealer.[14] In other arrangements, a fund's investment adviser places an order to buy or sell portfolio securities with a selling broker-dealer and the selling broker-dealer then forwards, or introduces, the trade to another broker-dealer, who then executes the trade. In such cases, the selling broker-dealer may or may not provide any execution services in connection

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[13] "Preferred" status may involve priority on the broker's list of recommended funds, access by the fund distributors to the broker's sales force, and appearances at broker-sponsored retreats and seminars.

[14] NASD Conduct Rule 2830(k)(7)(B) permits a broker-dealer to sell to its customers the shares of a fund that follows a policy of considering past sales of fund shares in selecting broker-dealers to execute portfolio transactions, subject to the requirements of best execution.

with the trade and part of the commission paid is used to compensate the selling broker-dealer for selling fund shares.[15]

The Commission supports the Bill's goal of improved information concerning a mutual fund's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the fund's shares. A fund's brokerage commissions are a valuable asset of the fund and its shareholders, and we believe fund investors are entitled to greater transparency with respect to the use of those commissions to facilitate the sale of fund shares.

E. Revenue Sharing

The Bill would require improved disclosure of information concerning "revenue-sharing" payments by persons other than a mutual fund, *e.g*, the fund's investment adviser and its affiliates, that are intended to facilitate the sale and distribution of the fund's shares. The Commission has previously recognized that this area deserves further consideration and has directed the staff to make recommendations regarding improved disclosure of revenue-sharing payments.[16] Accordingly, the Commission supports the legislation in this area.

As a general matter, many funds compete intensely to secure a prominent position in the distribution systems that selling broker-dealers maintain for distributing fund shares. As noted earlier, selling broker-dealers have increasingly demanded

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15 As discussed in the Staff Responses, certain of these arrangements raise issues under rule 12b-1 under the Investment Company Act, when fund brokerage commissions are used to reward brokers for distribution without appropriate compliance with the rule.

16 *See Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 132 n.13 (July 10, 2000) ("Press v. Quick & Reilly"). *See also* Brief of the Securities and Exchange Commission, Amicus Curiae, in *Cohen, et al. v. Donaldson, Lufkin & Jenrette Securities Corp., et al.* No. 97-9159 (2d Cir.) (Feb. 2000) ("Amicus Brief").

compensation for distributing fund shares that is in addition to the amounts that they receive from sales loads and 12b-1 fees. To meet this demand, fund investment advisers have increasingly made revenue-sharing payments to the selling broker-dealers.

"Revenue-sharing" payments are not a fund expense because they are made from the adviser's own resources, rather than fund assets. As a result, mutual funds are not required to disclose these payments,[17] however, at some point, as demands escalate, the manager may be tempted to ask for an increase in its fees from the fund.

Broker-dealers, however, are required to disclose their receipt of revenue-sharing payments to their customers that purchase fund shares. A broker-dealer generally is required, by Rule 10b-10 under the Exchange Act, to disclose to its customer, in writing, at or before the completion of a transaction, that it has received or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or will receive, from the fund's investment adviser.[18] A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.[19] Many funds disclose in their prospectuses general information about their investment advisers' revenue-sharing payments to broker-

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17 As discussed above, a mutual fund is required to disclose in its prospectus the fees that it pays to its investment adviser.

18 Rule 10b-10 under the Exchange Act.

19 *See* Securities Confirmations, Securities Exchange Act Release No. 13508 at n.41 (May 5, 1977). *See also* Amicus Brief, *supra* note 16.

dealers, which in some cases has the effect of facilitating the broker-dealers' compliance with that obligation. Many funds also disclose certain additional details about revenue-sharing payments made by their investment advisers in their SAIs.

The Commission has recognized, however, that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue-sharing payments to meet the requirements of rule 10b-10 under the Exchange Act. Indeed, consistent with the Bill, the Commission has directed its staff to make recommendations as to whether additional disclosure should be required or current disclosure further refined.[20]

F. Breakpoint Disclosure

The Bill would require improved disclosure of information concerning available discounts on front-end sales loads, including the minimum purchase amounts required for such discounts. We believe that this improved disclosure could be helpful to investors in determining discounts to which they are entitled.

Many mutual funds offer shares subject to front-end sales loads. These sales loads are expressed as a percentage of the purchase price of the funds' shares and are paid to broker-dealers that sell those shares. Funds frequently offer discounts on front-end sales loads based on breakpoints that are linked to the dollar amounts of the purchases.[21] Funds that offer breakpoint discounts must disclose the breakpoints and related

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[20] *See* Press v. Quick & Reilly, *supra* note 16 at 132 n.13. *See also* Amicus Brief, *supra* note 16.

[21] For example, a fund may offer shares subject to a front-end sale load equal to 5% for purchase amounts up to $50,000, 4% for purchase amounts between $50,000 and $100,000, 3% for purchase amounts between $100,000 and $250,000, and so on until the front-end sales load is reduced to 0% for purchase amounts over $1 million. *See Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (March 2003) ("Staff Breakpoint Report") <http://www.sec.gov/news/studies/breakpointrep.htm>.

procedures in their offering documents.[22] Some funds disclose breakpoints in their prospectuses, while many others do so in the SAI.

The staffs of the Commission, the National Association of Securities Dealers ("NASD"), and the New York Stock Exchange ("NYSE") recently conducted examinations of 43 broker-dealers that sell funds that offer shares subject to front-end sales loads.[23] The purpose of the examinations was to determine whether investors were receiving the benefit of available breakpoint discounts on funds that offer shares subject to front-end sales loads. The Commission, NASD, and NYSE examiners reviewed thousands of fund transactions and found significant failures by the broker-dealers to deliver breakpoint discounts to eligible customers.

We believe that improved disclosure to investors of available breakpoint discounts, as the Bill would require, would help investors to monitor whether they are receiving the discounts to which they are entitled.[24]

G. Location of Disclosure

Section 2(a) of the Bill provides that the Commission require improved disclosure of the above matters in a mutual fund's quarterly statement, periodic report to shareholders, or other appropriate disclosure document. Section 2(b) provides that a

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22 Items 8(a)(1) & (2) of Form N-1A.

23 *See* Staff Breakpoint Report, *supra* note 21, at 10.

24 *See* Letter from Harvey L. Pitt, Chairman, SEC, to Robert R. Glauber, Chairman and Chief Executive Officer, NASD, Matthew P. Fink, President, Investment Company Institute, and Marc E. Lackritz, President, Securities Industry Association (Jan. 15, 2003). *See also* NASD News Release dated February 18, 2003. As part of the Commission's review of the breakpoint issue, the NASD convened a task force comprised of regulators and representatives from broker-dealers, funds, fund administrators, and operational personnel to review solutions to help ensure that mutual fund investors receive the breakpoints to which they are entitled. The task force has met several times, and it is expected that it will formulate recommendations, both for regulatory action and voluntary industry measures, that can minimize problems in this area.

disclosure is not considered to be made in an appropriate disclosure document if the disclosure is made exclusively in a prospectus or statement of additional information, or both such documents.

While we support improved disclosure of mutual fund costs and related matters, the Commission believes that the Bill should preserve the Commission's flexibility to determine the appropriate disclosure document or documents for each of the mandated disclosures and not preclude any particular document. Broad public input would be extremely useful in assessing the benefits (*e.g*, accessibility and understandability to investors) and costs (*e.g.*, needed systems changes, printing, and mailing) of each potential disclosure location.

II. Distribution and Soft Dollar Arrangements

Section 3 of the Bill would amend section 15 of the Investment Company Act to require each adviser to an investment company to submit to the fund's board of directors a report on three types of common arrangements that raise significant issues in the management of an investment company. The report would cover:

- Revenue sharing arrangements, in which the adviser (or one of its affiliated persons) makes payments out of its own resources to promote the sale of fund shares;
- Directed brokerage arrangements, in which the fund obtains payments or services as a result of the adviser's direction of its brokerage transactions; and
- Soft dollar arrangements, in which the fund's adviser obtains research services from brokers in return for the direction of fund brokerage transactions.

Section 3 of the Bill also recognizes fund boards' fiduciary obligation to supervise the adviser's direction of fund brokerage transactions, including soft dollar and directed brokerage arrangements, and to determine that they are in the best interests of fund

shareholders. In the case of revenue sharing arrangements, section 3 would require the board to determine that they are in compliance with the Investment Company Act and Commission rules, and also that they are in the best interests of fund shareholders. Finally, the section directs the Commission to adopt rules to implement the section by, for example, specifying the contents of the reports.

The Commission supports these proposed amendments. They acknowledge the important role that fund boards play in the supervision of fund brokerage arrangements by recognizing a federal duty to supervise the adviser's use of the fund's brokerage, and by requiring advisers to provide fund boards with information sufficient to fulfill that obligation and safeguard the interests of fund shareholders. The amendments also add what we believe may be a new duty with respect to scrutinizing revenue sharing arrangements, which as noted above, have become increasingly important in the distribution of fund shares and can raise difficult issues.[25] We agree with the Bill's grant of additional rulemaking authority, which will help the Commission maximize the effectiveness of the provision and resolve questions that may arise.

III. Mutual Fund Governance

Section 4 of the Bill would amend section 10 of the Investment Company Act to increase the number of independent directors who must serve on fund boards by reducing the maximum percentage of board members who may be "interested persons" from 60 percent to one third. As a result, at least two-thirds of a fund's directors would be

[25] We commend the sponsors of the Bill for drawing a distinction between soft dollar arrangements and directed brokerage arrangements, which may involve conflicts of interest, and revenue sharing arrangements, which typically raise questions of whether payments by the adviser are an indirect use of the fund's assets to finance the distribution of its shares and thus must be made in compliance with the requirements of the Commission's rule 12b-1.

required to be independent of fund management. The Commission supports the goal of this amendment, which is to give shareholders a greater voice in how their fund is managed, and is consistent with the best practices adopted by many fund groups.[26] While this could impose additional costs on some funds because they may be required to add additional independent directors, the Advisory Group indicated that the benefits of a two-thirds standard justified their recommendation.[27] Independent directors in many fund groups already constitute more than a majority of the board and a number have boards with only one or two inside directors.

Section 4 of the Bill also would amend section 10 of the Investment Company Act to require that an independent director serve as the chairman of the board of directors. We agree that there may be benefits to having an independent director serve as the board chairman, such as the ability to control boardroom agendas and manage the flow of information to members of the board. We would note, however, that by increasing the representation of independent directors on fund boards, the Bill clearly would empower independent directors to select one of their own as chairman and to use their judgment as to who should serve as chairman.

Finally, section 4 of the Bill would amend section 2(a)(19) of the Investment Company Act to give the Commission rulemaking authority to deem certain persons to be

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[26] *See* Enhancing a Culture of Independence and Effectiveness, Report of the Advisory Group on Best Practices for Fund Directors (the "Advisory Group"), the Investment Company Institute (June 24, 1999)("Advisory Group Report") (recommending that independent directors constitute at least two-thirds of fund boards because a "two-thirds standard will be more effective than a simple majority in enhancing the authority of the independent directors").

[27] *Id.* at 11. In 2001, the Commission adopted rule amendments requiring that a majority of a fund's directors be independent if the fund relies on certain rules that exempt funds from various requirements of the 1940 Act. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). Independent directors comprise a majority of most fund boards.

interested persons as a result of certain material business or close familial relationships.[28] We strongly support this amendment, which would permit us to close "gaps" in the Investment Company Act that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, currently a fund manager's uncle is permitted to serve on the fund's board as an independent director.[29] In other cases, former executives of fund management companies have served as independent directors.[30] Best practice guidelines of the Advisory Group provided that former fund management executives should not serve as independent directors because their prior service may affect their independence, both in fact and in appearance.[31]

IV. Audit Committee Requirements

Section 5 of the Bill would extend to mutual funds certain audit committee requirements similar to those for listed companies required by section 301 of the

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28 Section 2(a)(19) of the Investment Company Act defines the term "interested person" to include the fund's investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter. It also encompasses a broader category of persons having business relationships with the fund or its investment adviser, including certain broker-dealers and persons who have served as counsel to the fund, its investment adviser or principal underwriter within the last two fiscal years of the fund. Finally, section 2(a)(19) provides the Commission authority to issue an order deeming a natural person to be an "interested person" as a result of certain material business relationships occurring within the last two fiscal years of the fund.

29 *See* Aaron Lucchetti, *SEC Backs Role of Uncle as Director*, Wall St. J., Nov. 11, 1999 at C1.

30 Section 2(a)(19) of the Investment Company Act permits a fund executive to serve as an independent director two years after his or her retirement.

31 *See* Advisory Group Report, *supra* note 26, at 12-13. The Advisory Group Report recommended that former officers or directors of a fund's investment adviser, principal underwriters or certain of their affiliated persons not serve as independent directors. It believed that such a standard "provides more meaningful assurance of directors' independence and enhances the overall credibility of the system of independent directors."

Sarbanes-Oxley Act of 2002 and codified in Section 10A(m) of the Exchange Act.[32] Section 10A(m) required the Commission, by rule, to direct the national securities exchanges and national securities associations ("SROs") to prohibit the listing of any security of an issuer that is not in compliance with certain enumerated standards regarding issuer audit committees. The Commission adopted new rule 10A-3 under the Exchange Act to implement section 301 of the Sarbanes-Oxley Act.[33] Under section 301 and rule 10A-3, SROs are prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

Because section 301 of the Sarbanes-Oxley Act requires the Commission to direct the SROs to prohibit the listing of any security of an issuer that is not in compliance with these audit committee standards, new rule 10A-3 applies only to listed issuers, including

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32 Pub. L. 107-204, 116 Stat. 745 (2002).

33 Investment Company Act Release No. 26001 (Apr. 9, 2003).

listed investment companies. Thus, the new rule generally covers closed-end investment companies, but does not cover most mutual funds.

While many mutual funds already employ some or all of the principles embodied in rule 10A-3, extending similar audit committee requirements to mutual funds is one way to further benefit mutual fund investors. While mutual fund financial statements may, in many cases, be simpler than those of some operating companies, the underlying financial systems, reporting mechanisms, and internal controls are sufficiently complex that a mutual fund would benefit from each of the corporate governance reforms embodied in section 301 of the Sarbanes-Oxley Act and the Commission's implementing rules.

First, fund governance would be enhanced if each member of the audit committee of a mutual fund were required to be independent. As the Commission noted in the release adopting rule 10A-3, an audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.[34]

Second, a requirement that the audit committee appoint, compensate, retain, and oversee the outside auditor would help to further the objectivity of financial reporting. The auditing process may be compromised when a fund's outside auditors view their main responsibility as serving the fund's management rather than its board or audit committee. We note that the issue of appointment of the fund's independent auditor has

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[34] In 2001, the Commission adopted rule 32a-4 under the Investment Company Act to encourage mutual funds to have independent audit committees. Rule 32a-4 exempts a fund from the requirement that selection of the fund's accountant be submitted to shareholders for ratification at the next annual meeting, if the fund has an audit committee composed solely of independent directors.

already been addressed for both listed and non-listed funds by section 202 of the Sarbanes-Oxley Act and the Commission's auditor independence rules. Section 202 and the Commission's rules require that the audit committee of a fund pre-approve all audit, review, or attest engagements required under the securities laws.[35]

Third, requiring the establishment of formal procedures by a fund's audit committee for receiving and handling complaints would serve to facilitate disclosure of questionable practices, encourage proper individual conduct, and alert the audit committee to potential problems before they have serious consequences.

Fourth, a requirement that a fund's audit committee have the authority to engage outside advisors, including counsel, as it determines necessary would assist the audit committee in performing its role effectively. The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye.

Fifth, a requirement for the fund to provide appropriate funding to compensate the independent auditor and the advisors employed by the audit committee should further enhance the required standard relating to the audit committee's responsibility to appoint, compensate, retain, and oversee the outside auditor, and add meaning to the standard relating to the audit committee's authority to engage independent advisors.

V. Report on Soft Dollar Arrangements

Section 6 of the Bill would require the Commission to submit to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs a report on use of soft dollars by investment advisers. The section would

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[35] *See* Investment Company Act Release No. 25915 (Jan. 28, 2003); rule 2-01(c)(7) of Regulation S-X. The audit committee is also required to pre-approve all permissible non-audit services.

require that the report cover a number of areas of concern, including conflicts of interest created by soft dollar arrangements, as well as their effect on the transparency of mutual fund expenses. Perhaps most significantly, the section asks the Commission to examine whether Congress should repeal or modify section 28(e) of the Exchange Act.[36]

Section 28(e) provides a "safe harbor" permitting money managers, including investment advisers, to cause a client to pay more than the lowest available commission rate if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research provided by the broker.[37] Simply put, section 28(e) permits a money manager to use client brokerage to pay for research that the adviser would otherwise be required to produce himself or pay for in cash out of his own pocket.

According to one recent estimate, the soft dollar market for investment research and related services exceeds $1 billion and is growing.[38] While the research an adviser obtains may benefit the client, it will clearly benefit the adviser, and thus presents an adviser that participates in these arrangements with a conflict of interest. Our current regulatory regime primarily relies on disclosure by advisers of their soft dollar policies and practices. The Staff Responses submitted last week suggested that disclosure alone might not be adequate and suggested the need for Congressional reconsideration of section 28(e).

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[36] We note that the staff has conducted a study that encompassed a number of these issues related to soft dollars. Inspection Report on the Soft Dollar Practices of Broker Dealers, Investment Advisers and Mutual Funds (1998).

[37] Section 28(e) only protects advisers if they pay more than the lowest available commission, and it does not shield a person who exercises investment discretion from charges, for example, that he churned the account, failed to seek the best price, or failed to make required disclosures.

[38] Bear Stearns, Brokers and Asset Managers (June 2003).

The Commission supports including a required report on section 28(e) in this legislative package. Once the reforms called for in the Bill that relate to soft dollars are implemented, the Commission and Congress will need to consider whether further revisions are needed. To accomplish this, policymakers will need current information on soft dollar practices and their impact on the fiduciary obligations of advisers, competition between broker-dealers, the securities markets, and the clients of investment advisers, including mutual funds.

VI. Conclusion

The Commission supports Congressional efforts to improve transparency in mutual fund disclosures, to provide mutual fund investors with the information they need to make informed investment decisions and enhance the mutual fund governance framework. We look forward to working with this Subcommittee to further these important goals.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 11, 2003

The Honorable Paul E. Kanjorski
U.S. House of Representatives
2353 Rayburn House Office Building
Washington, DC 20515

The Honorable Robert W. Ney
U.S. House of Representatives
2438 Rayburn House Office Building
Washington, DC 20515

Dear Congressmen Kanjorski and Ney:

Thank you for your March 26, 2003 letter concerning the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises' ongoing review of mutual funds. The Commission shares your goal of helping to restore investor confidence in our securities markets. We applaud the efforts of the Subcommittee for focusing on these important issues and exploring ways to help mutual fund investors make better and more informed investment decisions.

In your letter, you have raised a number of questions regarding transparency of mutual fund expenses and transaction costs, as well as mutual fund governance, payments for distribution, mutual fund performance information and other matters. I share your interest in these matters and how they impact mutual fund investors. At my request, Paul Roye, the Director of the Division of Investment Management, and his staff have prepared the enclosed memorandum that provides the analysis you requested in your letter regarding these and other issues.

I hope that the Division's memorandum is helpful to you and your colleagues. As with other issues involving the protection of investors, I welcome the opportunity to share our views on these matters. If you have additional questions or comments, please do not hesitate to contact me at (202) 942-0100 or contact Paul directly at (202) 942-0720.

Sincerely,

William H. Donaldson

Enclosure

MEMORANDUM

TO: Chairman William H. Donaldson

FROM: Paul F. Roye
Division of Investment Management

DATE: June 11, 2003

RE: Correspondence from Congressmen Paul E. Kanjorski and Robert W. Ney, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

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In correspondence addressed to you dated March 26, 2003, Congressmen Paul E. Kanjorski and Robert W. Ney of the House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises asked the Securities and Exchange Commission (the "Commission") to respond to a number of questions related to mutual funds.

At your request, the staff diligently has endeavored to answer these questions as completely as possible. There may be a few instances, as noted, where the staff has incomplete information. The questions presented in the letter are set forth below in bold italics, followed by the staff's responses. We recognize that the views expressed in this memorandum may not necessarily reflect your views or those of the other Commissioners.

Fund expenses

It appears that several recent studies of mutual fund fees have reached conflicting conclusions. For example, a study by the General Accounting Office in 2000 concluded that fees had declined on average from 1990 to 1998. An update of this report recently prepared for the House Financial Services Committee, however, indicated that fees for equity funds had risen from 1999 through 2001, while bond fund fees had declined over the same time period.

A December 2000 study by the Commission also identified conflicting trends related to mutual fund fees. That report states: "overall, mutual fund expense ratios (i.e., a fund's total expenses, including Rule 12b-1 fees, divided by its average net assets) have increased since the late 1970s, although they have declined in three of the last four years." The SEC study also notes that "[a]lthough fund expense ratios rose on average during the 20 years covered by our study, the overall cost of owning fund shares may not have risen if changes in sales loads are taken into consideration."

The Commission's 2000 study additionally identifies a number of factors affecting the change in mutual fund expenses over time, including that mutual fund

expense ratios generally decline as the amount of fund assets increase. Accordingly, we would like to learn whether the recent increase in expenses for equity funds and decline for bond funds is a result of this phenomenon, or are other factors involved?

Furthermore, some critics of the mutual funds industry have raised concerns that increases in fund expenses may reflect a lack of competition among funds on the basis of expenses. Does the Commission believe that additional disclosure of fund expenses would increase price competition?

Moreover, the Commission, as we understand, has recently proposed a regulatory change that would require additional expense disclosures, expressed in dollars, to be added to shareholder reports. While such disclosures should help to improve transparency, some industry experts have stated that this proposed disclosure regime is insufficient, and recommended that the disclosure of fund fees in dollar terms on fund statements would be beneficial to investors. What were the Commission's reasons for rejecting this approach in the past? Please also address, to the extent possible, the costs of complying with such a proposal and the likely effect on fund expenses and competition if fund expenses were disclosed on statements in this manner. In addition, what would be the likely effects of such disclosures on investors' decision making? Please also advise us as to whether similar cost disclosures are provided for other financial and securities products. Finally, please advise us as to whether providing too much information to investors may deter their ability to quickly understand the performance of a mutual fund.

Finally, the Commission's 2000 study observes that there were differing trends in fund expenses by distribution category, with no-load classes recording expense declines over time while expenses of load classes increased. To what extent does the investor's choice of distribution method influence the fund expenses the investor pays, and what additional services, if any, do the investors receive when they invest in load funds and classes compared to no-load funds and classes? Are there differing concerns regarding expense disclosure or competitiveness depending on distribution method? Additionally, to what extent do fund sponsors, as opposed to fund distributors, effectively control, set, or receive loads and 12b-1 expenses?

Since 1988, the Commission has required uniform cost disclosure in mutual fund prospectuses to help investors make informed investment decisions. Today, the Commission continues to address concerns about investors' understanding of mutual fund expenses. The response below provides background information, as well as addresses the questions set forth above regarding fund expenses. Specifically, the response discusses the extent to which cost-based competition currently exists in the fund industry and

describes the current framework for disclosure of mutual fund expenses and Commission efforts to improve investor awareness of fund expenses. The response also discusses the Commission's recent proposal to require disclosure in shareholder reports of expenses borne by fund shareholders and a suggested alternative approach that would require disclosure of mutual fund expenses in investors' quarterly account statements. Finally, the response addresses the manner in which the Commission's proposed requirement for expense disclosure in reports to shareholders complements the current requirement for disclosure of expenses in the fund prospectus.

A. Cost-Based Competition Among Mutual Funds

As discussed below, while there is some evidence that mutual fund expense ratios have risen over time, it is not clear that the overall costs of owning mutual fund shares has risen. Moreover, although it is difficult to measure the extent to which cost-based competition exists in the mutual fund industry, there is a basis for arguing that significant competition based on costs exists in the mutual fund industry.

Despite increases in fund expense ratios, the overall cost of owning fund shares may not have risen if changes in sales loads, which have generally decreased during the period of our study, are taken into consideration.[1] The Division of Investment Management's December 2000 Report on Mutual Fund Fees and Expenses (the "Staff Fee Study") concluded that the increase in mutual fund expense ratios since the 1970s can be attributed primarily to changes in the manner that distribution and marketing charges are paid by mutual funds and their shareholders. Many funds have decreased or

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[1] Division of Investment Management, SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES, at 9 (Dec. 2000) (the "Staff Fee Study"). Sales loads, which are paid by an investor upon purchase or sale of a fund's shares, are not taken into consideration when calculating expense ratios.

replaced front-end loads, which are not included in a fund's expense ratio, with ongoing 12b-1 fees, which are included in a fund's expense ratio. This change complicates the comparison of current expense ratios with expense ratios from earlier periods. The Staff Fee Study analyzed the expenses of all stock and bond funds for the years 1979, 1992, and 1995 through 1999, in order to describe how fee levels have changed over time.[2] The Staff Fee Study found that the expense ratio of the average mutual fund class rose from 0.73% in 1979 to 0.99% in 1995, fell in 1996, 1997, and 1998 to 0.91%, and then rose to 0.94% in 1999.[3]

The table below updates the study results to include 2000, 2001 and preliminary results for 2002.

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2 The Staff Fee Study selected 1979 as a benchmark because it is the year before rule 12b-1 distribution fees were first permitted. A 12b-1 fee is a fee charged by some mutual funds against fund assets to pay for marketing and distribution activities. *See* section 12(b) of the 1940 Act; rule 12b-1 thereunder. The Staff Fee Study also analyzed data for 1992 because it is the first year for which the SEC has expense data in electronic format, and the years 1995 through 1999 to get a more recent picture of trends in fund expenses. Staff Fee Study, *supra* note 1, at 30.

3 Staff Fee Study, *supra* note 1, at 41. The Staff Fee Study focused on expense ratios weighted by class size, rather than an equally weighted average. The Staff Fee Study noted that evaluations of fund fees should generally give more weight to classes with more assets (and more shareholders) and that the typical fund investor is likely to own one of the larger classes. *Id.*

Expense Ratio Trends: All Classes

	Unweighted Average Expense Ratio	Weighted Average Expense Ratio
1979	1.14%	0.73%
1992	1.19%	0.92%
1995	1.30%	0.99%
1996	1.32%	0.98%
1997	1.33%	0.95%
1998	1.35%	0.91%
1999	1.36%	0.94%
2000	1.37%	0.92%
2001	1.38%	0.92%
Preliminary 2002 [4]	1.40%	0.93%

The table indicates that mutual fund expense ratios remained relatively stable between 1999 and 2002. The weighted average expense ratio was 0.93% in 2002 compared to 0.94% in 1999. We believe this may reflect that the assets of many bond funds increased during the period while the assets of many stock funds declined. These trends would tend to lower the weighted average expense ratio because bond funds as a group have lower expense ratios than stock funds.

In addition, recent analysis by the United States General Accounting Office ("GAO") noted that the asset-weighted average expense ratio for 46 large stock funds analyzed by GAO had declined from 0.74 percent in 1990 to 0.70 percent in 2001, but that the asset-weighted average expense ratio of these funds has increased recently by

[4] The data for 2002 is preliminary because it is derived from the February 2003 edition of the Morningstar *Principia* database and may not contain expense ratios for funds with December 31 fiscal year-ends.

about 11 percent, from 0.63 percent in 1999 to 0.70 percent in 2001.[5] In looking at the expenses of 30 bond funds over this period, the average bond fund expense ratio decreased by 5.3%.

The decrease in bond fund expense ratios may reflect economies of scale arising from an increase in the assets of bond funds in the sample and the increase in stock fund expense ratios may reflect the decrease in assets of some stock funds in the sample.

An additional factor – the behavior of performance-based fees paid by certain large funds – may account for a portion of the increase in the average stock fund expense ratio. [6] For example, certain stock funds in the sample performed better than their benchmark indices in 2001 and 2002, with the result that their performance-based fees increased during these years. Because these funds had performed worse than their benchmark indices in 1998, 1999 and 2000, their performance-based fees had decreased during those years.

There is also empirical evidence suggesting that there is significant competition based on costs in the fund industry. Three fund groups that have been characterized as featuring relatively low costs have increased their share of total fund assets from 17% at

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5 Statement for the Record by Richard J. Hillman, Director, Financial Markets and Community Investment, GAO, MUTUAL FUNDS: INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE, at 2 & 6-7 (March 12, 2003) ("March 2003 GAO Report"). A June 2000 GAO report had concluded that "the expense ratios charged by the largest funds were generally lower in 1998 than their 1990 levels, but this decline did not occur consistently over this period." GAO, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION, at 8 (June 7, 2000) ("June 2000 GAO Report"). It should be noted that when we analyzed the stock funds in the GAO sample using the methodology employed in our 2000 fee study we found that average expense ratios increased 5.6%. The difference in results can be attributed to differences in methodology with respect to how expense ratios based on varying fund fiscal years were assigned to calendar years for the purposes of analysis.

6 Mutual fund performance fees typically reflect the results of a fund's performance compared to the performance of a securities index over a rolling thirty-six month period.

the beginning of 1990 to more than 26% at the end of 2002.[7] In addition, index funds, which are often characterized by lower costs, have grown from less than 2% of stock fund assets in 1990 to 12.6% today.[8] These data suggest that fund groups may effectively compete on the basis of cost for the segment of investors for whom cost is a significant factor in selecting investments.

Moreover, competitive pressures within the industry appear to be prompting an increasing number of fund mergers as fund sponsors attempt to streamline their offerings and eliminate uneconomical funds. Competition also has increased because of the offering of low-cost exchange traded funds (ETFs), which are pooled vehicles generally sponsored by large broker-dealers and stock exchanges that allow investors to buy and sell the funds' shares at any time during the day at market prices. Further, mutual funds face increased competition from sources outside of the fund industry, such as on-line trading accounts and individual account management services provided by investment advisers and broker-dealers.

It is important to note that the choice of distribution channel can significantly influence the amount and type of fund expenses that the investor pays. Typically, fund expenses, such as investment advisory fees, custody fees and 12b-1 fees, are charged to a fund by a fund service provider and are paid by all of the shareholders of a fund in

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[7] The fund groups are American Funds, Fidelity, and Vanguard. See Scott Cooley, *Revisiting Fund Costs: Up or Down?*, MORNINGSTAR.COM <http://news.morningstar.com/news/MS/Commentary/990219com.html> (visited April 28, 2003) (characterizing American Funds, Fidelity, and Vanguard as relatively low cost fund families); LIPPER INC., LIPPER DIRECTORS' ANALYTICAL DATA (1st ed. 2003); LIPPER INC., LIPPER DIRECTORS' ANALYTICAL DATA (1st ed. 1989) (data on fund family assets). The asset figures include stock, bond, and money market mutual funds and exclude underlying mutual funds of insurance company separate accounts.

[8] This estimate is based on the Commission staff's analysis of data from MORNINGSTAR PRINCIPIA PRO PLUS, LIPPER DIRECTORS' ANALYTICAL DATA, and Commission filings.

proportion to their investment in the fund. Fund investors therefore may be viewed as indirectly paying fund expenses. In contrast, front-end sales loads are not *fund* expenses, rather they are *shareholder* expenses that shareholders pay directly, and the amounts paid are not included in fund assets. As a result, an investor's choice of distribution method will influence the amount of fund expenses that the investor pays only to the extent that the fund pays a 12b-1 fee to finance the distribution of its shares.

The choice of distribution method, however, generally does not influence the extent to which the investor will pay for the fund's non-distribution expenses, such as investment advisory, custodial fees and other expenses related to the management of the assets of the fund or class. Those expenses generally must be charged to all shareholders in the fund or class on a proportionate basis.[9]

Investors in load funds pay sales loads and 12b-1 fees for the services provided by the broker-dealers that sell the funds' shares to them.[10] The sales loads and 12b-1 fees compensate the broker-dealers and their registered representatives for their selling efforts. The broker-dealers' services may include determinations for customers as to the suitability of particular funds and their classes of shares, and the provision of ongoing investment advice about the funds. A broker-dealer's determination of the suitability of a fund investment for a customer would include consideration of the customer's investment

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[9] The Commission's rules permit funds to issue multiple classes of shares, but each class must have a different arrangement for shareholder services and/or distribution and each class must pay all of the expenses of that arrangement. Each class also may pay a different share of other expenses, except advisory or custodial fees or other expenses related to the management of the fund's assets, but only if these expenses are actually incurred by that class, or if the class receives services of a different kind or to a different degree than other classes. *See* rule 18f-3(a) under the 1940 Act.

[10] Load funds are funds, or classes of funds, that charge a front-end or a deferred sales load, or funds that charge no sales load but pay a rule 12b-1 fee that is greater than .25% of their net assets.

objectives, and risk tolerances, and the cost structure of the various classes of shares of the fund.

Except as described above, investors in no-load funds generally receive similar but fewer services compared with investors in load funds. Investors that invest directly in no-load funds and classes typically purchase their shares from the fund or the fund's principal underwriter, which provides the investors with prospectuses and other information concerning the funds and classes that it offers. The funds and their principal underwriters may answer questions from investors concerning the characteristics of the funds and classes. The funds and their principal underwriters also process any orders from investors who purchase, redeem or exchange shares of the funds, and they provide the investors with confirmations of transactions and account statements that set forth the dollar amount and number of shares of the funds held by the investors. No-load funds and their principal underwriters typically do not provide investors with investment advice or determinations of the suitability of fund investments.

Typically, the sponsor of a fund establishes the characteristics of the fund, including its investment objectives and policies, and the methods by which the fund's shares will be distributed (and whether the fund will issue multiple classes of shares). The fund's board of directors, however, must approve those characteristics. A fund's sponsor (principal underwriter), and not the broker-dealers that sell the fund's shares, will establish the levels of any applicable sales loads and 12b-1 fees.[11] As a practical matter, however, when a fund sponsor establishes the sales load and the level of rule 12b-1 fees

[11] With the approval of the fund's board of directors, fund sponsors generally have the freedom to set the fund's sales loads and rule 12b-1 fees at whatever levels they deem appropriate, subject to the limits established by the NASD and the requirements of rule 12b-1 under the 1940 Act.

for a fund, it takes into account the expectations that broker-dealers may have concerning the compensation that they will receive for selling the fund's shares. A number of broker-dealers with large retail networks appear to have a significant amount of leverage in dictating compensation levels because of the limited number of fund share distribution systems and the competition among fund groups in securing prominent positions in these distribution systems. As a result, fund sponsors typically work together with broker-dealers to establish sales loads and rule 12b-1 fees at levels that they believe will provide sufficient incentives to broker-dealers to sell their fund shares.

B. Current Disclosure Requirements and Investor Awareness Efforts

Currently, prospective mutual fund investors receive significant disclosure about fund fees and expenses. Since 1988, Form N-1A, the form used by mutual funds to register their shares under the Securities Act of 1933 (the "1933 Act"), has required every mutual fund prospectus to include a fee table.[12] This table presents fund investors with cost disclosure in a standardized format that is intended to facilitate cost comparisons among funds. The fee table requires a uniform, tabular presentation of all fees and expenses associated with a mutual fund investment. The fee table reflects both (i) transactional costs paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and (ii) ongoing expenses deducted from fund assets, such as advisory fees and 12b-1 fees. The table is accompanied by a numerical example that illustrates the total dollar amounts, including both transactional costs paid directly by a shareholder and ongoing asset-based expenses, that an investor could expect to pay on a $10,000 investment if the fund achieved a 5% annual return and the investor remained

[12] Item 3 of Form N-1A.

invested in the fund for 1-, 3-, 5-, and 10-year periods. This example is intended to enable a prospective investor to estimate the total costs associated with a fund investment, in order to permit the investor to make an informed cost comparison among funds.

In addition, the Commission requires average annual total returns for the past 1-, 5-, and 10-years (or the life of the fund, if shorter), which are required as part of the risk-return summary in the mutual fund prospectus, to be calculated reflecting the payment of costs, including sales loads and ongoing shareholder account fees.[13] Under rule 482 under the 1933 Act and rule 34b-1 under the 1940 Act, the Commission also requires mutual fund sales material that includes performance information to include similar average annual total return quotations, calculated reflecting the payment of costs.[14] In 2001, the Commission enhanced these disclosure requirements by requiring mutual funds to report their average annual returns in their prospectuses on an after-tax basis as well.[15] This requirement reflects the fact that taxes often represent the largest single expense borne by many fund investors.[16]

In addition to requiring cost disclosure, the Commission has undertaken efforts to educate investors about the significance of the costs that they pay in connection with mutual fund investments. Most notably, in 1999, the Commission introduced the Mutual

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13 Item 2(c)(2) and Instruction 2(a) to Item 2(c)(2) of Form N-1A.

14 Rule 482(e)(3) and (5)(ii) under the 1933 Act; rule 34b-1 under the 1940 Act; Item 21(b) of Form N-1A.

15 Item 2(c)(2)(i) and (iii) of Form N-1A; Investment Company Act Release No. 24832 (Jan. 18, 2001).

16 *See* Investment Company Act Release No. 24832, *supra* note 15 (citing estimate that two and one-half percentage points of the average stock fund's total return is lost each year to taxes).

Fund Cost Calculator (the "Cost Calculator"), an Internet-based tool available on the Commission's website that enables investors to compare the costs of owning different mutual funds over a selected period.[17] Like the prospectus example, the costs shown by the Cost Calculator include transactional costs paid directly by a shareholder and ongoing asset-based expenses. In addition, the costs shown by the Cost Calculator include earnings foregone on fees and expenses paid. For example, if an investor paid a $500 sales charge, and a fund earned a 5% return, the investor would "forego" $25 ($500 x .05) in earnings as a result of the sales charge. To use the Cost Calculator, an investor enters the time period that he or she expects to hold the investment, the dollar amount of the investment, and an assumed annual rate of return, as well as the fund's fees and expenses, which are set forth in the prospectus fee table. In addition, the Commission has produced an on-line brochure explaining the basics of mutual fund investing that includes an extensive discussion of fees and expenses.[18]

C. Recommendations for Improving Mutual Fund Expense Disclosure

1. Continuing Concerns over Investor Awareness

Despite existing disclosure requirements and educational efforts, the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. As noted above, mutual fund fees are of two types, transactional (*e.g.*, sales loads, redemption fees) and ongoing (*e.g.*, asset-based charges such as management fees and 12b-1 fees). While transactional fees are relatively transparent, ongoing fees are less

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[17] SEC Mutual Fund Cost Calculator <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm> (last modified July 24, 2000).

[18] *Invest Wisely: An Introduction to Mutual Funds* <www.sec.gov/investor/pubs/inwsmf.htm> (last modified June 2, 2003).

evident because they are deducted from fund assets and are reflected in reduced account balances and expressed as a percentage of net assets in a fund's prospectus.

Surveys have indicated that investors may not understand the nature and effect of these ongoing mutual fund fees. A joint report of the Commission and the Office of the Comptroller of the Currency, for example, found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns.[19] A recent survey found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns.[20]

2. Commission Proposals

In December 2002, the Commission proposed additional disclosure to increase investors' understanding of the expenses that they incur when they invest in a fund, in particular, ongoing expenses. Specifically, the Commission proposed to require mutual funds to disclose in their annual and semi-annual reports to shareholders fund expenses borne by shareholders during the reporting period. Under the Commission's proposal, fund shareholder reports would be required to include: (i) the cost in dollars, associated with an investment of $10,000, based on the fund's actual expenses and return for the period; and (ii) the cost in dollars, associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.[21] The first figure is intended to permit investors to estimate the actual cost, in dollars, that they

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[19] Securities and Exchange Commission and Office of the Comptroller of the Currency, *Report on the OCC/SEC Survey of Mutual Fund Investors,* at 14-15 (June 26, 1996).

[20] *Investors Need to Bone Up on Bonds and Costs, According to Vanguard/MONEY Investor Literacy Test*, Press Release, BUSINESS WIRE, Sept. 25, 2002.

[21] Investment Company Act Release No. 25870 (Dec. 18, 2002).

bore over the reporting period. The second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds.

The proposed numerical expense disclosure would be accompanied by a prescribed narrative explanation. The narrative would explain that mutual funds charge both transactional costs and ongoing costs and that the example is intended to help a shareholder understand his or her ongoing costs and to compare those costs with the ongoing costs of investing in other mutual funds. The narrative also would explain the assumptions used in the example, note that the example does not reflect any transactional costs, and caution that the example is useful in comparing ongoing costs but not total costs of different funds.

3. Comparison of Commission's Proposal and Alternative Approach

The expense disclosure that the Commission has proposed to require in shareholder reports is designed to increase investors' understanding of the fees that they pay on an ongoing basis for investing in a fund and enhance cost competition among funds. As an alternative to this proposed approach, the Commission also considered the recommendation of the June 2000 GAO Report.[22] This report recommended that the Commission require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement.

The GAO's alternative would have the benefit of providing fund shareholders with personalized information, expressed as a dollar amount, about the fees and expenses that they paid and of presenting that information together with the investor's account value. The Commission's proposed approach, however, effectively permits an investor to

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[22] *See* June 2000 GAO Report, *supra* note 5.

estimate his or her personalized expenses by multiplying the cost shown for a $10,000 investment by the investor's account value and, in addition, has significant advantages compared to the GAO's alternative. Disclosure of the dollar amount of fees and expenses paid by investors in a fund's shareholder reports would enable investors to evaluate this information alongside other key information about the fund's operating results, including management's discussion of the fund's performance. In effect, shareholders would be able to evaluate the costs that they pay against the services that they receive. By contrast, expense disclosure in quarterly account statements would not provide an effective context for investors to assess the expenses shown.

In addition, the Commission's proposed disclosure of the cost in dollars associated with an investment of $10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year, would provide investors with expense information in a standardized manner that would facilitate comparison of ongoing costs among funds. By contrast, expense disclosure in quarterly account statements would not provide an effective context for investors to assess the expenses shown.

In addition to the advantages of the Commission's proposed approach in contributing to greater investor understanding of the costs that they pay, this approach also avoids certain costs and logistical complexity that the GAO's alternative likely would entail. Mutual fund expenses are charged against fund assets and are not currently accounted for on an individual account basis. Therefore, implementation of the GAO's recommendation would require system changes to provide for expense accounting on an individual account basis. Moreover, in many cases fund shares are held by broker-dealers, financial advisers, and other third-party intermediaries, who must prepare

accurate and timely customer account statements by integrating data supplied by many unrelated fund groups. In addition to any systems changes necessary for the fund itself, these financial intermediaries also would need to implement system changes in order to calculate and report personalized expense information for each fund held in an account each quarter.

The GAO report recommending personalized expense disclosure had estimated that the cost of this disclosure "might be a few dollars or less per investor" in one-time and annual costs.[23] As of year-end 2001, there were approximately 248 million shareholder accounts invested in funds.[24] At a cost of $1 per shareholder account, this would translate to a cost of approximately $248 million. Further, a survey of various industry participants conducted by the Investment Company Institute concluded that the aggregate costs to survey respondents associated with calculating and disclosing the actual dollar amount of fund operating expenses attributable to each investor on quarterly account statements would be $200.4 million in initial implementation costs and $65 million in annual, ongoing costs.[25] These costs do not reflect the costs to financial intermediaries, such as broker-dealers, who would be required to prepare account statements for their clients containing this information.

Both the Commission's proposed approach, requiring disclosure in shareholder reports of period expenses for a standardized $10,000 investment amount, and the GAO's suggested approach, requiring personalized expense disclosure on account statements, are

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23 *Id.* at 97.

24 Investment Company Institute, MUTUAL FUND FACT BOOK 63 (42d ed. 2002).

25 Investment Company Institute, ICI SURVEY ON GAO REPORT ON MUTUAL FUND FEES (Jan. 31, 2001).

designed to improve transparency. While the Commission has not yet made a final decision, the Commission's proposed approach, however, may strike a more appropriate balance between investors' need for more information about fund expenses and the costs and burdens that would be associated with providing this disclosure. The increased transparency of costs resulting from either the Commission's proposal or the GAO's recommended alternative would tend to enhance cost competition among funds. This effect may not, however, be direct or immediate because, under both approaches, the new disclosures would be provided to existing investors. Even if an existing investor is dissatisfied with the level of ongoing costs in a fund, the investor faces disincentives to selling his or her fund shares, *e.g.*, because of tax consequences or sales loads imposed upon a sale of fund shares. Over time, however, the enhanced transparency should have a positive effect on competition among funds and on competition between funds and other financial service providers. In addition, the Commission's proposed approach may have a somewhat greater effect on competition than the GAO's alternative because funds are required to make their shareholder reports available upon request to a prospective investor. Therefore, requiring the inclusion of information on ongoing costs in shareholder reports would add to the information available to prospective investors in making investment decisions.[26]

It is difficult to assess the effects of the Commission's proposed disclosure or the GAO's alternative on competition in the fund industry, in part, because this disclosure appears to be unique in the financial services industry. Both the Commission's and the

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[26] *See* Item 1(b)(1) and Instruction 3 to Item 1(b)(1) of Form N-1A (requiring a fund to make reports to shareholders available without charge, upon request, within three business days of receipt of the request).

GAO's alternative would go beyond the disclosure provided by other financial service providers by requiring dollar amount disclosure of fees and expenses that are charged indirectly to the customer. The GAO has noted that providers of other financial products and services usually disclose the specific dollar amount of the charges that their customers incur. For example, banks that provide deposit accounts and trust services, advisers that provide investment services and wrap accounts, financing entities that provide mortgages and credit cards, and brokers that charge commissions all disclose the dollar amounts of their fees. Like these service providers, mutual funds provide information about the dollar amount of fees that are charged directly to an account, such as sales loads, redemption fees, and account fees. However, expenses that other service providers indirectly charge as part of the product or service are not disclosed.[27] For example, the holder of a deposit account is not provided any information about the spread between the gross amount earned by the bank on customer funds and the net amount paid out to the customer. This spread is a significant, and largely hidden, cost to the customer.[28] Similarly, mortgage providers add a mark-up to their cost of funds in order to cover the expenses of processing loans. Because other service providers do not provide disclosure of this type, it is difficult to assess its impact on competition.

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[27] June 2000 GAO Report, *supra* note 5, at 70-71.

[28] There is some evidence that competition based on fees has decreased in the banking industry in recent years. A recent study by the Federal Reserve found that from 1997 to 2001, for the various types of checking and savings accounts tracked, monthly fees tended to rise by statistically significant amounts, as did the minimum balances that depositors needed to maintain to avoid the fees. In addition, comparisons of the fees charged by institutions of different sizes in 2001 indicated that, in general, the incidence and levels of fees were higher at larger institutions. Timothy H. Hannan, *Retail Fees of Depository Institutions, 1997-2001*, FEDERAL RESERVE BULLETIN 405 (Sept. 2002).

See the answer to the question regarding transaction costs below that discusses enhancing disclosure of fund transaction costs, which would promote greater transparency of fund expenses.

D. Relationship between Expense Disclosure in Prospectus and Proposed Expense Disclosure in Shareholder Reports

The recent proposal by the Commission is intended to complement the expense disclosure currently required in the fund prospectus. Under current disclosure requirements, prospective investors in a fund receive information in the prospectus about all of the expenses associated with an investment in the fund, including both transactional costs and ongoing expenses. This information is useful to prospective investors in comparing the costs of different funds and making an informed investment decision. If the proposed expense disclosure requirement for shareholder reports is adopted, current investors in a fund would receive information that should help them to understand the costs that they are paying on an ongoing basis and to compare these costs with those of other funds. In addition, as noted above, because funds must make their shareholder reports available to prospective investors upon request, requiring this information on ongoing costs in shareholder reports would also add to the information available to prospective investors. Thus, the information provided would be appropriately tailored for its audience and should not overwhelm investors or detract from their ability to understand other aspects of a mutual fund, such as its performance.

Transaction costs

During the recent hearing about mutual funds before the Capital Markets Subcommittee, several witnesses testified that transaction costs were a factor in fund returns but that the exact effect of these transactions was difficult to quantify or to separate from fund performance as a whole. What transaction costs are currently required to be disclosed to investors? One witness stated that his funds made transaction costs estimates available to the fund's board of directors. Are all funds

presently required to review transaction costs with their directors, and is there an agreed-upon method of calculating transaction costs for equity and other types of funds? Would investors benefit from the standardized disclosure of transaction costs?

Some industry commentators have further recommended that brokerage commissions and other transaction costs be stated as part of fund expense ratios. How are commissions disclosed by funds presently? What is the rationale for treating brokerage commissions and other transaction costs as capital items rather than as expenses? Finally, would investors benefit from accounting for commissions differently?

At the hearing, soft-dollar arrangements, where mutual funds use fund trades or brokerage commissions to pay for investment research, were criticized by some as a contributor to higher fund costs. The SEC, as we understand, has studied soft-dollar arrangements on several occasions, and we would like to know what disclosures of soft dollar arrangements are currently required of mutual funds, as well as the Commission's current views on whether those disclosures should be expanded. In addition, what obligations are placed on mutual fund directors to review soft-dollar practices? In the Commission's view are the present safeguards against the misuse of soft-dollars sufficient or should they be strengthened?

We further understand that the Commission is presently considering additional regulations regarding the practice of using fund trades or commissions to compensate brokers that have sold mutual fund shares. We would therefore appreciate learning of your plans in this area. Should such uses of commissions be regulated under Rule 12b-1?

Finally, some witnesses at the Capital Markets Subcommittee hearing pointed out that soft-dollar practices are not limited to the mutual fund industry. They also asserted that soft-dollar regulation should not favor one type of managed account over other types. Therefore, please inform us as to how soft-dollar regulation differ between mutual funds and other entities regulated by the SEC such as investment advisers to non-funds. Additionally, are the requirements substantially different for entities that are less subject to SEC regulation, such as hedge funds or pension funds?

The response set forth below provides background information regarding mutual fund transaction costs, as well as answers the specific questions set forth in the letter regarding soft dollar arrangements and the use of brokerage commissions to compensate broker-dealers that have sold fund shares.

In addition to the costs described in the section regarding fund expenses above, funds incur portfolio transaction costs (trading costs) when they buy or sell portfolio

securities. For many funds, the amount of trading costs incurred during a typical year can be substantial. Although trading costs are taken into account in computing a fund's total return, they are not included as part of a fund's expense ratio. Consequently, some industry observers suggest that funds be required to provide quantitative disclosure of their trading cost as a percentage of total assets.

We believe that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. Quantitative disclosure of trading costs is, however, problematic. Although some trading costs components can be quantified easily and precisely, others can be quantified only with great difficulty, using one of a variety of estimation methods. As a result, we believe that additional numerical disclosure of trading costs would result either in a number that would be comparable and verifiable, but incomplete, or a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund. Below we examine the major issues with respect to disclosure of portfolio transaction costs. First, we describe the different types of trading costs and estimate their magnitude. Next, we explain the current requirements with respect to accounting, disclosure, and information to be provided to fund directors. Finally, we identify and evaluate various proposals for additional quantitative disclosures.

A. Types of Transaction Costs Incurred by Mutual Funds

Broadly defined, a mutual fund's trading costs are the overall costs of implementing the fund's trading strategy.[29] Trading costs include commissions, spreads, market impact costs and opportunity costs.

Commissions are per share charges that a broker collects to act as agent for a customer in the process of executing and clearing a trade. Commissions are the only type of trading cost that can be measured directly. Measurement is easy because the commission is separately stated as a per share charge on the transaction confirmation and is paid directly from fund assets.[30]

Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The variance from current value is known as the "spread."[31] Spread costs include both an imputed commission on the trade and any market impact cost associated with the trade.

Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security.[32] Stated formally, market impacts are the

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29 John M.R. Chalmers, Roger M. Edelin, Gregory B. Kadlec, "Mutual Fund Trading Costs," University of Pennsylvania, Rodney L. White Center for Financial Research, Working Paper 027-99, Nov. 2, 1999 at 1.

30 Stephan A. Berkowitz and Dennis E. Logue, "Transaction Costs: Much ado about everything," JOURNAL OF PORTFOLIO MANAGEMENT (Winter 2001) at 67-68.

31 Funds incur spread costs on trades that are made on a principal basis (trades executed from dealer inventory). The "commission" is the unstated increase to the buy price or reduction in the sell price at which the trade is executed. Although these markups and markdowns cannot be directly calculated, they can be estimated, but only with data collected with much difficulty some days after the trade is executed. *See* Berkowitz and Logue, *supra* note 30 at 68.

32 The average trade on the New York Stock Exchange and on NASDAQ is approximately 1,700 shares. The average order placed by institutions (including mutual funds) is 44,600 shares, according to an estimate from Plexus, Inc. (Testimony of Wayne H. Wagner at 6). Basic

price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.[33]

Market impact cost cannot be calculated directly. It can be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade.[34] Impact cost can be reduced by stretching out a trade over a long time period. The benefit of reduced impact cost may be reduced or eliminated by an increase in opportunity cost.

Opportunity cost is the cost of delayed or missed trades. The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the stock and, by doing so, drive up (or down) the price.[35]

Opportunity cost cannot be measured directly. The joint effect of market impact and opportunity cost can be estimated by comparing market prices at the time that the transaction is conceived to the price at which the transaction was actually executed.

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economics dictate that, if the supply of a good or service is held steady, increased demand drives up the price. Large trades have an impact on price. They "move the market" (drive the price up if the fund is buying; down if the fund is selling.)

33 *See* Berkowitz and Logue, *supra* note 30 at 68.

34 *See* Berkowitz and Logue *supra* note 30 at 68. Theory suggests comparing the actual price paid or received to what would have prevailed had the order never been placed. In practice, we can observe only actual market prices and the contemporaneous bids and offers to trade.

35 An opportunity cost is incurred when three conditions hold: (1) the price of a stock rises (falls) after an investor decides to buy (sell) it, but before he or she is actually able to do so; (2) the price change is independent of the investor's decision; and (3) the price change is "permanent" – *i.e.*, it is caused by the dissemination of information relevant to the valuation of the asset. Other factors may influence the price of an asset, such as temporary liquidity imbalances, but they do not generate opportunity costs. Robert A. Schwartz and Benn Steil, "Controlling Institutional Transactions Costs," THE JOURNAL OF PORTFOLIO MANAGEMENT (Spring 2002) at 67.

Consulting firms, including Plexus, Inc., have developed quantitative tools that attempt to estimate these costs for their clients.[36]

Although estimates of the magnitude of transaction cost and its components vary, the following estimates are representative. For the average stock fund, brokerage costs have been estimated at approximately .30% of net assets [37] and spread costs have been estimated at approximately .50% of net assets.[38] Market impact cost and opportunity cost are more difficult to measure. One study estimates that total transactions costs (including market impact and opportunity costs) for large capitalization equity transactions range from 0.18% to as much as 1% of the principal amount of the transaction.[39] Another study estimates that for institutional investors, under relatively calm market conditions, opportunity costs may amount to 0.20% of value.[40]

In summary, commission costs can be easily determined, but spread, impact, and opportunity costs can only be roughly estimated. As a result, because of the varying factors involved, there is no generally agreed-upon method to calculate transaction costs.

B. Accounting Treatment of Transaction Costs

Under generally accepted accounting principles, portfolio transaction costs are generally capitalized (added to the cost basis of securities purchased or subtracted from

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36 *See* Berkowitz and Logue, *supra* note 30 at 70.

37 Miles Livingston and Edward O'Neal, Mutual Fund Brokerage Commissions, Journal of Financial Research, Vol. XIX, No. 2 (Summer 1996) at 280. *See, also,* Chalmers, Edelin, and Kadlec, *supra* note 29 at 2.

38 Chalmers, Edelin and Kadlec, *supra* note 29 at 2.

39 *See* Schwartz and Steil, *supra* note 35 at 43 (citing estimates of commission and market impact costs according to Abel-Noser Benchmarks and the *Plexus Change Commentary*, January 1998; and cost estimates contained in Stephan A. Berkowitz, Dennis E. Logue, and Eugene Noser, "The Total Costs of Transacting on the NYSE," Journal of Finance, March 1988, at pp. 97-112).

40 *See* Schwartz and Steil, *supra* note 35 at 43-44.

the net proceeds of securities sold) rather than treated as a fund expense.[41] Consequently, each additional dollar of transaction cost produces a one-dollar decrease in total return. One exception (described later in this section) is that certain brokerage service costs are expensed.

Transaction costs are capitalized for two reasons. First, accounting theory considers transaction costs that represent payments for execution and clearing services to be part of the cost of buying or selling a security. Accounting theory dictates that security acquisition and disposition costs be capitalized into the price at which a security is purchased or sold.[42] Second, to the extent that the purchase or sale price includes transaction costs that have been incurred for other reasons, but are difficult to separately identify and strip out of the overall purchase or sales price, accounting theory recognizes that it would be neither feasible nor practical to account for these costs as a fund expense.[43]

Commissions (and spreads) incurred by funds may include payments made under directed brokerage arrangements – arrangements under which a broker agrees to pay certain fund operating expenses and the fund agrees to direct a minimum amount of brokerage to the broker.[44] Conceptually, directed brokerage arrangements are considered

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41 Federal tax law requires transaction costs to be handled in the same manner. *See* AICPA Audit and Accounting Guide for Investment Companies, paragraph 2.40.

42 *See* FASB Concept Statement No. 2 and AICPA Audit and Accounting Guide for Investment Companies.

43 *See* FASB Concept Statement No. 2 and 5. This reasoning may be applied, for example, to spread, market impact, and opportunity costs, as well as to certain "soft dollar" commission costs. *See* response below regarding soft dollars discussion.

44 In a typical directed brokerage arrangement, a fund will earn a credit for a certain level of trading volume placed with one broker. The broker agrees to use that credit to pay a fund's custody, transfer agent, or other expenses. The fund usually negotiates the terms of the agreement with the custodian or transfer agent, which is paid directly by the broker. Directed brokerage arrangements

to be payments for current services received by the fund and are properly accounted for as a fund expense.[45] The aggregate value of all fund operating expenses paid for by brokers is easily identifiable and measurable, even if the payments cannot be allocated to individual trades. Recognizing this fact, the Commission in 1995 adopted a rule under Regulation S-X that requires a mutual fund to record as an expense the value of services received under a brokerage service arrangement.[46] This requirement also assures that the value of these services is properly reflected in the expense ratios reported by mutual funds in their annual reports to shareholders and their prospectuses.[47] The result is that the portion of commission cost that represents an operating expense of the fund – and is measurable – is reflected in the fund's expense ratio, fee table, and statement of operations.

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are also referred to as brokerage offset or expense offset arrangements. *See* Investment Company Act Release No. 21221 at 1 (July 21, 1995).

45 *See* FASB Concept Statement No. 5.

46 *See* Regulation S-X, Article 6-07(2)(g). In effect, expenses shown in the fund's statement of operations for transfer agency, custody, and other services paid by brokerage firms on behalf of the fund must be increased by the amount paid by the broker. The fund is allowed to show after total expenses the amount paid by the brokerage firms as an expense offset (income item). This presentation results in a gross-up of expenses in the statement of operations. For purposes of the expense ratio, however, the component of commission/spread costs that should be classified as an expense is so classified in this presentation.

The following example illustrates the required adjustments to the statement of operations:

Expenses	
Management Fee	$50
[Other direct fund expenses]	48
Custodian Fee [would include 8 paid by brokers]	10
Total Expenses	108
Fees Paid Indirectly	(8)
Net Expenses	100

47 Brokerage offset amounts may not be netted against fund expenses for purposes of calculating expense ratios.

C. Disclosure of Transaction Costs in Prospectuses and SAIs

All mutual funds (except money market funds) provide investors with information about two items that are related to transaction costs – portfolio turnover rate and dollar amount of brokerage commissions.[48] Funds disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years.[49] Portfolio turnover rate measures the average length of time that a security remains in a fund's portfolio.[50] Portfolio turnover rate is a useful statistic because a fund's transaction costs tend to be highly correlated with its turnover rate, other factors held equal. Thus, by comparing turnover rates, investors can obtain an indication of how transaction costs are likely to vary among different funds. The advantage that turnover rate (an indirect indicator of fund transaction costs) has over the dollar amount of brokerage costs (a more direct measure) is that turnover rate is less affected by the asset size of a fund. For example, a fund with assets of $1 billion is likely to pay many more dollars of brokerage commissions than a fund with assets of $100 million, even if their turnover rates are identical.

In addition to providing their portfolio turnover rates, funds are required to disclose in their prospectus whether they may engage in active and frequent trading of portfolio securities to achieve their investment strategies. If so, funds must explain the

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[48] Money market funds purchase and sell securities on a principal basis. Transaction costs for these securities are embedded in the purchase price or sale proceeds and are not separately stated.

[49] *See* Item 9 of Form N-1A, the form on which a mutual fund registers the offering of its shares under the Securities Act of 1933. Form N-1A includes a description of the information that a fund must provide in its prospectus and statement of additional information.

[50] For example, a fund that has a portfolio turnover rate of 100% holds its securities for one year, on average. A fund with a portfolio turnover rate of 200% holds its securities for six months on average.

tax consequences to shareholders of the increased portfolio turnover, and how the trading costs and tax consequences may affect investment performance.[51]

Funds (with the exception of money market funds) also must disclose the actual dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.[52] Brokerage commission amounts, although they must be interpreted carefully, can nevertheless provide useful information to fund investors. The dollar amounts appear in a fund's statement of additional information (SAI), which, as its name suggests, is a disclosure document that provides information that adds to and supplements the information provided in the prospectus about a fund's policies, procedures and operations.[53] This disclosure informs investors of the magnitude of the fund's overall assets that are expended on commissions.

D. Review of Transaction Costs by Fund Directors

Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.[54] The transaction costs incurred by a mutual fund are generally reviewed by the fund's board of directors because section 15(c) of the 1940 Act requires a fund's board to request and review such information as may reasonably be

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51 *See* Item 4(b), instruction 7 or Form N-1A.

52 *See* Item 16(a) of Form N-1A.

53 All funds are required to provide their SAI to investors upon request. In addition, the SAI of any fund may be accessed via the Commission's website (www.sec.gov) and frequently on a fund's or a fund sponsor's web site.

54 *See* Securities Exchange Act Release No. 23170 (April 23, 1986).

necessary to evaluate the terms of the advisory contract between the adviser and the fund. Research and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because the research and other services would otherwise have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser. Therefore, mutual fund advisers that have soft dollar arrangements must provide their funds' boards with information regarding their soft dollar practices.[55]

E. Proposals for Additional Transaction Cost Disclosure

During the March 12th hearings, several witnesses testified about the opacity of portfolio trading costs and made suggestions for additional disclosure. Mr. Montgomery, for example, stated that his funds obtain an independent review of their trading costs, and make that report available to the funds' board of directors, but not to investors, for competitive reasons. He stated that if all funds disclosed such data, however, they would be "willing and happy to do so."[56]

In subsequent discussions with the staff, Mr. Montgomery clarified his proposal, indicating that because narrative disclosures would inevitably be complex and technical, his preferred approach would be to require funds to disclose their total transaction costs as a percentage of average net assets.[57] Total transaction costs would be measured by applying the concept of "implementation shortfall" – for each trade, the difference between the price actually paid for the security and the price that existed when the trading

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55 *See* Section 15(c) of the 1940 Act. *See also* SEC OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKERS/DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS at 30 (Sept. 22, 1998).

56 Testimony of John Montgomery at 5.

57 Telephone conversation dated April 8, 2003 with John Montgomery.

decision was made.[58] Mr. Montgomery believes that the fund industry could reach consensus on how to estimate this number.[59]

Other suggestions made during the hearings include:

- Add to the fee table example an estimate of transaction costs (including commissions, spreads, market impact costs).[60]
- Disclose overall transactions costs, either as a numerical estimate or in categories such as Very High, High, Average, Low and Very Low Cost.[61]

F. Analysis of Proposals for Additional Transaction Cost Disclosure

Some witnesses have proposed that mutual fund transaction costs be accounted for as an expense item in fund financial statements and included as an expense in fund expense ratios and fee tables.

For commissions, this would be relatively easy. As previously indicated, the per share commission appears on the confirmation of each transaction and funds already report in their SAIs the aggregate dollar amounts of commissions paid.

The staff has considered the matter informally on several occasions and continues to believe that it would be inappropriate to account for commissions as a fund expense unless spreads, and possibly impact and opportunity costs, were treated in a similar

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58 The term "implementation shortfall" was introduced by Perold in 1988. Implementation shortfall is defined as a measure of the degree to which execution, market impact and opportunity costs prevent the investor from taking advantage of his or her stock selection skills. Perold, Andre F. *The Implementation Shortfall: Paper vs. Reality*, JOURNAL OF PORTFOLIO MANAGEMENT, Spring 1988 at 5-6. Leinweber illustrates the concept by noting that from 1979 to 1991 stocks classified as "Group 1" by Value Line had an annualized return of 26.3% while the Value Line mutual fund that contained the same stocks returned only 16.1%. The difference between the paper return and the actual portfolio return is the cost of trading. Leinweber, D. 1995, *Using Information from Trading in Trading and Portfolio Management*, 4 JOURNAL OF INVESTING No. 1: 40-50.

59 Telephone conversation dated April 8, 2003 with John Montgomery and testimony of John Montgomery at 4.

60 Testimony of John Bogle (April 1, 2003) at 11.

61 Testimony of Wayne H. Wagner at 3.

manner. Commissions and spreads, for example, pay for similar services. Expensing commissions and not spreads would cause funds that execute their trades on an agency basis (and pay commissions) to report higher expenses than funds that execute their trades on a principal basis (and incur the cost of the bid-asked spread).[62] This disparity could encourage funds to shift their trading activity in listed securities from exchanges to Nasdaq in order to appear less costly, even if better execution prices could be obtained on an exchange.

Furthermore, an expense number that included commissions and spreads, but not market impact and opportunity costs would still be problematic because funds that are more costly from an overall transaction cost standpoint might appear to be less costly if only commission and spread costs were disclosed.[63] An investor who evaluates whether a fund is getting best execution needs to consider not only commissions and spreads, but also the prices at which security purchases and sales are executed. Transactions with low commissions or spreads and a less favorable execution price may be less beneficial than transactions with higher commissions or spreads and more favorable execution prices.

This brings us to the issue of whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe that the answer is "no."

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62 The Commission has recognized that money managers opting for certain riskless principal transactions on Nasdaq would now be informed of the entire amount of a market maker's charge for effecting the trade. *See* Securities Exchange Act Release No. 45194 (Dec. 27, 2001). In this release, the Commission also recognized that fees on other riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction), and that fees on traditional principal transactions also can include an undisclosed fee based on some portion of the spread.

63 Testimony of Wayne H. Wagner at 5 and John Bogle at 4.

Consultants and academics derive transaction cost estimates that include spreads and market impact costs by using a variety of algorithms to compare the actual price that was paid in each transaction with the market price that prevailed at some time before[64] or after[65] the transaction was completed. Perhaps the most all-inclusive way to measure transaction cost is "implementation shortfall" – the approach recommended by Mr. Montgomery. Implementation shortfall measures transaction cost as the difference between the price of each trade that was actually made and the price that prevailed in the market when each decision to trade was made.

Although the transaction cost estimates described above may provide valuable information to funds, their boards of directors, and researchers, we believe that these estimates would not provide an appropriate basis for reporting transaction costs as an expense in fund financial statements, or reporting these costs separately in fund disclosure documents.

With respect to the before trade and after trade methods, a common standard would need to be chosen from among the wide variety of estimation techniques that are used, opportunity costs would remain unaccounted for, and some measures in this category would be vulnerable to being "gamed."[66]

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64 A "before trade" measure compares the actual price of each trade with the price that prevailed in the market at the time that the decision to trade was made. *See* Perold, *supra* note 58 at 7-8.

65 In an "after trade" measure, the market price might be today's closing price, tomorrow's closing price, some other price in effect after the fund completed the trade, the average of the high and the low for the day, or a weighted average of all prices at which market participants transacted on that day. *See* Berkowitz and Logue, *supra* note 30 at 65.

66 For example, because a before trade measure compares the actual price of each trade with the market price in effect when the decision to trade was made, the market price is known in advance. A trader working on behalf of a fund could "manufacture" low transaction costs if, after each decision to trade is made, the trader would wait to take action on the order list, implement only the buy orders for which prices have fallen since the receipt of the order, implement only the sell

The advantages of the implementation shortfall method are that it includes all trading costs and may be less vulnerable to being gamed. However, because implementation shortfall compares prices of actual trades to prices in effect when trading decisions were made, the practical difficulties of mandating its use by all funds are daunting. Funds would need to collect and analyze enormous quantities of information throughout the trading process – from the portfolio manager, the trader, and the broker, whenever each makes a decision that affects the outcome of the trade – including the time, price, and quantity outcomes for each decision in the process of filling an order.[67] Objective and verifiable criteria would need to be developed for determining when a trading decision has actually been made, determining when the decision has been modified or revised, and selecting the figure that represents a security's market price at each of these times. These criteria would need to be mandated for use by all funds. Determining the extent to which the fund's actual trading activity has varied from its intention would be difficult, even if additional record keeping requirements were mandated concerning the motivations for the trade, such as investment objective, target price, and time horizon.[68]

To summarize, our view is that although proposals to quantify transaction costs are attractive in theory, it is difficult to see how they could be feasible. Even if a detailed regulatory regime were imposed on the operational procedures that funds use to effect portfolio transactions, the resulting estimates of transaction costs would appear to lack

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orders for which the prices have risen, and dismiss the rest of the orders as "too expensive" to execute. *See* Perold, *supra* note 58 at 7-8.

67 *See* Berkowitz and Logue, *supra* not 30 at 70-73.

68 Donald B. Keim and Ananth Madhavan, *The Cost of Institutional Equity Trades*, FINANCIAL ANALYSTS JOURNAL (July/Aug. 1998) at 54-55.

the attributes of uniformity, reliability and verifiability that are the hallmarks for recording operations results in financial statements.

One commenter suggested transaction costs could be disclosed in terms of rated categories, instead of as part of the expense ratio or as a stand-alone ratio. The commenter suggested funds would categorize their trading costs as either very high, high, average, low or very low. The commenter acknowledged this disclosure might be a rough estimate, but a "rough estimate was better than no estimate at all."[69] Although we agree that a rough estimate might be better than nothing, each fund would still have to be compared to an industry standard. In order for such a comparison to be made, a transaction cost measure would still have to be developed. It would have to be determined whether, for example, any comparison should be against other funds generally or only against similar funds. After all, the transaction costs of an equity fund are likely not comparable to a fixed-income or money market fund. Therefore, comparing a high rating on an equity fund to a low rating on a fixed-income fund might prove confusing and misleading to investors. If the Commission were to set the standard for comparison, the Commission would be put in the unusual position of passing judgment on a fund's cost structure. The suggestion is theoretically acceptable but practically difficult to implement.

Although each of the suggestions outlined above has merit, we believe as a practical matter that it would be enormously difficult to implement any of the suggestions. Nonetheless, we agree that investors would benefit from better, more understandable disclosure of transaction costs. We therefore will consider whether to recommend that the Commission issue a concept release to elicit views on the

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[69] Testimony of John Bogle at 11.

suggestions outlined above, and to solicit additional suggestions. The goal of such a release would be to obtain comment on whether it is possible to construct a transaction cost measure that would be comparable, verifiable and complete, yet not unduly burdensome to funds and their service providers.

Investors currently get disclosure on transaction costs from several sources in the prospectus, SAI, and annual report; however, the issue remains whether investors understand the information that is being disclosed. Accordingly, the staff intends to examine several approaches for improving the current disclosure of transaction costs to make the information more understandable to the average investor.

One approach the staff will consider is to require funds to give greater prominence to the portfolio turnover ratio. Portfolio turnover can be calculated easily by all funds. The ratio is simple and easy to understand and readily comparable among funds. The ratio is a good proxy for costs because the turnover rate is highly correlated with transaction costs. We recognize, however, the imprecision of using portfolio turnover as a means of evaluating transaction costs. It is possible that two funds could have very similar turnover ratios, but have vastly different transaction costs. For example, a foreign fund may incur high transaction costs per trade and a domestic fund with the same turnover may pay significantly lower transaction costs per trade. Even funds that may have similar investment styles could pay significantly different transaction costs per trade, depending, for example, on the size of the fund. Notwithstanding these drawbacks, we believe that the advantages of being able to easily calculate, understand, and compare portfolio turnover rates outweigh any imprecision in its correlation to transaction costs. Arguably, providing additional prominence to

portfolio turnover might be as good as requiring funds to categorize themselves in a transaction cost category (*e.g.*, "very high," "high," "average," etc.). Both types of disclosure are somewhat inexact, especially if the "cost" category is based upon a rough estimate of transaction costs.

Another approach the staff will consider is whether to require a discussion of transaction costs and portfolio turnover in the prospectus. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, if it is a principal investment strategy. The Commission could require that all funds discuss the impact that their management style would have on portfolio turnover. Funds also could be required to discuss the impact on portfolio transaction costs by: trading in various types of securities in which the fund will invest; markets in which they will invest (*e.g.*, on an exchange or through over-the-counter transactions, or in foreign or domestic markets); and the portfolio management strategies that a fund's adviser will employ. In addition, the Commission could require a fund to disclose the portfolio turnover rate that the fund would not expect to exceed.

We also will consider whether the information on brokerage costs included in the statement of additional information should be moved to the fund prospectus and prominently displayed with the portfolio turnover information to give shareholders a more complete understanding of the underlying transaction costs of the fund. In addition, we could consider whether some form of average commission rate per share disclosure[70]

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[70] The Commission in 1995 amended Form N-1A to require funds to disclose in the financial highlights table their average commission rate per share. *See* Investment Company Act Release No. 21221 (July 21, 1995). This amount was calculated by dividing the total dollar amount of commissions paid during the fiscal year by the total number of shares purchased and sold during the fiscal year for which commissions were charged. In 1998 the Commission eliminated this requirement in the belief that the fund prospectus is not the most appropriate document through which to make this information public. *See* Investment Company Act Release No. 23064, (March

should be reinstated, with appropriate revisions to make it more meaningful than the previously eliminated disclosures of such information in the fund's financial highlights table.

In conclusion, we believe that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. Quantitative disclosure of fund commission costs would result in a number that would be comparable and verifiable, but incomplete. Disclosure of a more all-inclusive estimate of transaction costs would result in a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund. As outlined above, we intend to examine whether steps can be recommended to the Commission to improve the current disclosure of transaction costs in order to make the information more understandable to the average investor.

G. Soft Dollar Arrangements

The term "soft dollars"[71] typically refers to arrangements under which an investment adviser directs client brokerage transactions to a broker and, in exchange, obtains research products or services in addition to brokerage services from or through the broker. We agree that soft dollar arrangements may involve the potential for conflicts of interest between a fund and its investment adviser. Soft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego

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13, 1998). The Commission noted that industry analysts had informed the staff that average commission rate information is only of marginal benefit to them and to typical fund investors, and that the analysts support the view that these rates are technical information that typical investors are unable to understand.

[71] Section 28(e) of the Securities Exchange Act of 1934 permits money managers to obtain research with soft dollars without breaching their fiduciary duty to their client as discussed below.

opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers.[72]

These types of conflicts, however, are generally managed by fund boards of directors. Fund independent directors are in a better position to monitor the adviser's direction of the fund's brokerage than are fund investors.[73] Accordingly, the Commission has not required fund prospectuses to disclose specific information about the use of soft dollars and the Commission has made clear the responsibilities of fund independent directors in connection with their oversight of the allocation of fund brokerage.[74]

Arguments in favor of improved transparency of fund brokerage are usually framed in terms of improving the information that investors have about fund "expenses" rather than providing investors with specific information about conflicts of the fund adviser.[75] For example, as discussed above, shareholders are provided with the fund's

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[72] Recent studies by securities regulators in the United Kingdom have drawn similar conclusions. "[S]oft commission arrangements . . . create powerful incentives that complicate the principal-agent relationship between a fund manager and its clients. The conflicts of interest involved raise doubts about the ability of fund managers both to obtain value for money when spending their clients' funds on acquiring additional broker services, and to trade for their clients on the most advantageous terms—that is to deliver best execution." FINANCIAL SERVICES AUTHORITY, BUNDLED BROKERAGE AND SOFT COMMISSIONS §2.11 (Apr. 2003) ("FSA Report"). *See also* Paul Myners, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (March 6, 2001).

[73] Moreover, directors must assess the fund adviser's use of soft dollars when evaluating the amount of the adviser's compensation. *See* Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 20614 (Oct. 13, 1994) at n.38. *See also* Securities Exchange Act Release No. 23170 (Apr. 23, 1986) at nn.40-43 and accompanying text ("Disinterested directors are required to 'exercise informed discretion,' and the responsibility for keeping the independent directors informed lies with management, *i.e.*, the investment adviser and interested directors.").

[74] Even though most investors may not find this information important, the Commission believes that those investors who desire to know more about brokerage allocation practices should have access to the information. Funds are therefore required to make brokerage information available, upon request, in their Statement of Additional Information. *See* Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 13436 (Aug. 12, 1983)

[75] *See, e.g.*, March 2003 GAO Report, *supra* note 5 at 18.

portfolio turnover rate, from which they can deduce the extent to which the fund incurs securities trading costs. A relatively high level of turnover, however, may result from a management strategy that requires frequent trading, rather from the need to acquire soft dollar benefits with the brokerage. Thus, greater transparency of brokerage costs is unlikely to help an investor evaluate a fund adviser's conflicts in using soft dollars.

We are nonetheless concerned about the growth of soft dollar arrangements and the conflicts they may present to money managers, including fund advisers. Many soft dollar arrangements are protected by section 28(e) of the Securities Exchange Act of 1934 (the "1934 Act"). Section 28(e) creates a safe harbor permitting money managers (including fund advisers) to pay more than the lowest available commission if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. This section only excludes paying more than the lowest available commission and does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws or from allegations, for example, that he churned an account, failed to seek the best price, or failed to make required disclosures. The effect of section 28(e) is to suspend the application of otherwise applicable law, including fiduciary principles, and to shift responsibility to advisory clients (including fund boards) to supervise their money manager's use of soft dollars and the resulting conflicts of interest, based on disclosure that the clients receive from the money manager.[76]

All discretionary money managers can use the safe harbor provided by section 28(e) to obtain research with soft dollars from clients' brokerage, whether the clients are

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[76] Section 28(e)(2) of the 1934 Act authorizes the Commission to require disclosure of an adviser's soft dollar policies and practices.

mutual funds, individuals, pension funds or hedge funds. One key difference is that an adviser to a mutual fund (*e.g.*, a registered investment company)[77] or a pension fund[78] cannot receive compensation (including research) pursuant to a soft dollar arrangement involving the fund outside of the safe harbor provided by section 28(e). Advisers are not subject to this constraint with respect to other types of clients, including individuals and hedge funds.[79] Our recent examination sweep of hedge funds found that a number of hedge funds advisers often use soft dollars to pay for service that are clearly outside of the safe harbor, including payment for office operations.

Advisory clients receive information about their adviser's soft dollar practices in the adviser's disclosure statement or "brochure," which the client receives at the beginning of the advisory relationship.[80] The adviser must disclose factors that it uses to select brokers for client transactions, the types of research or services that the adviser receives in return for brokerage, whether the adviser "pays up" for research, and whether the adviser may use one client's brokerage to obtain research that benefits other clients.

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77 Section 17(e)(1) of the 1940 Act provides that it is unlawful for the fund adviser "acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered investment company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; . . ."

78 The Department of Labor has interpreted the Employee Retirement Income Security Act of 1974 (ERISA) to prohibit and adviser to an employee pension or benefit plans subject to ERISA from obtaining soft dollar benefits from allocating plan brokerage, except within the section 28(e) safe harbor. Department of Labor, Technical Release 86-1, (May 22, 1986) app. III.

79 An adviser may, however, be subject to some other specific restriction under state or federal law that is unique to a particular client. Our response addresses only the most common restrictions imposed on money managers.

80 Rule 204-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). It should be noted that Form ADV is not required to be provided to fund shareholders.

The Commission has proposed to improve the quality of information provided to clients in Form ADV, the adoption of which we expect the Commission to consider soon.[81] Disclosure, however, has its limitations. Because advisers necessarily have an interest in maintaining their flexibility to serve their clients, disclosure brochures thus often describe a wide range of research and other services that the advisers might obtain with client brokerage. Although the disclosure may satisfy or even exceed the adviser's legal requirements, most clients may find it very difficult to evaluate soft dollar practices based on (sometimes lengthy) narrative discussions of practices that may or may not occur in the future. Moreover, many clients may not even understand the best-written disclosure, having hired an adviser because they do not have the expertise, time or inclination to worry about matters such as soft dollars.

Without ongoing quantitative information about soft dollar practices and their effect on brokerage decisions and their costs (both implicit and explicit), even the most knowledgeable advisory clients (including fund boards of directors and pension plan officials) will find it difficult to effectively supervise their advisers' use of brokerage. The Commission twice has proposed to require advisers to give clients periodic quantitative information about the use of client brokerage and the research and services advisers obtain from brokers.[82] Both times the rules were not adopted because of intractable problems in valuing the research and services that advisers receive for soft

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81 Investment Advisers Act Release No. 1862 (Apr. 5, 2000).

82 As discussed earlier, section 28(e)(2) of the 1934 Act authorizes the Commission to require this disclosure.

dollars, tracing the allocation of those benefits to clients' accounts, and quantifying the effect of the benefits on the accounts' performance.[83]

We are not sanguine that enhanced disclosure will alone provide sufficient transparency to permit advisory clients to supervise their money managers' use of soft dollars. Even if the measurement problems were solved so that advisers could provide quantitative information to clients, we think it is unlikely that most clients would (or could) become sufficiently involved in brokerage decisions to fully protect their interests. Moreover, to the extent that some clients do become involved and effectively restrict their advisers' use of soft dollars, the advisers may compensate by increasing their use of other clients' brokerage to obtain research and other soft dollar benefits.

We note that section 28(e) was enacted in 1975 to protect brokers' practice of providing discounts on brokerage commissions that had been fixed pursuant to exchange and Commission rules.[84] After negotiated commissions were permitted, money managers and broker-dealers expressed concern that causing a client to pay a commission in excess of the lowest rate available for services that benefited the client only indirectly would be considered a breach of the advisers' fiduciary duty.[85] While we intend to continue our efforts to improve disclosure and expect to ask the Commission to propose changes to the record-keeping rule under the Advisers Act to require advisers to keep better records of

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83 Securities Exchange Act Release No. 13024 (Nov. 30, 1976); Investment Advisers Act Release No. 1469 (Feb. 14, 1995).

84 P.L. No 94-29, 89 Stat. 97, 10707.

85 The concern over "paying up" arose in part out of litigation relating to whether advisers to investment companies had an obligation to recapture commission rebates for the benefit of their investment company clients. *See Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977); *Arthur Lipper Corp. v. Securities and Exchange Commission*, 547 F.2d 171 (2d Cir. 1976); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); and *Moses v. Burgin*, 445 F. 2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971).

the products and services they receive for soft dollars, we believe that after 28 years it may be appropriate to reconsider section 28(e) or, alternatively, to amend the provision to narrow the scope of this safe harbor.[86]

H. Rule 12b-1 and Brokerage Commissions

Rule 12b-1 prohibits any mutual fund from acting as a distributor of its shares, either directly or indirectly, unless the fund complies with the requirements of the rule.[87] Rule 12b-1 generally provides that a fund is acting as a distributor of its shares if it engages "directly or indirectly" in "financing any activity which is primarily intended to result in the sale of shares," such as the "compensation of underwriters, dealers and sales personnel."

A development that we have observed is the increasing use by some funds of a portion of the brokerage commissions that they pay on their portfolio transactions to compensate broker-dealers for distribution of fund shares. Certain of these arrangements, we believe, result in the use of fund assets to facilitate distribution and should be reflected in rule 12b-1 distribution plans. For instance, some fund investment advisers direct broker-dealers that execute transactions in the fund's portfolio securities to pay a portion of the fund's brokerage commissions to selling broker-dealers. In some

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86 The FSA Report recommended that British money managers not be able to purchase with client commissions "goods and services for which demand is reasonably predictable." FSA Report at 4.4. Another approach might be to preclude money managers from paying for subscriptions, data feeds, pricing services and other services that more closely resemble overhead items.

87 Section 12(b) of the 1940 Act prohibits an open-end investment company from acting:

> as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

In 1980, the Commission adopted rule 12b-1 under the provisions of this section. Investment Company Act Release No. IC-11414 (Oct. 28, 1980).

instances, the selling broker-dealers perform no execution-related services in connection with the portfolio transactions. These payments are intended to compensate selling broker-dealers for selling fund shares and are a use of fund assets for distribution of fund shares. We intend to recommend that the Commission take action to clarify the circumstances pursuant to which the use of brokerage commissions to facilitate the distribution of fund shares should be reflected in a rule 12b-1 plan.

Mutual Fund Governance

The Sarbanes-Oxley Act, as you already know, applied a number of new corporate governance rules to non-mutual funds that are quite similar to those used by mutual funds for many years. In the Commission's view are there additional aspects of the Sarbanes-Oxley Act corporate governance standards that should now be applied to mutual funds? Conversely, are there aspects of the Sarbanes-Oxley Act's corporate governance standards from which we should exempt mutual funds?

Some critics of the mutual fund industry have also noted that mutual fund directors rarely terminate the management contracts of the funds on which they serve and select a different investment adviser. In the Commission's view, does this fact pattern suggest that independent directors are not being sufficiently forceful in representing shareholders' interests? In addition, to the extent possible, please discuss the frequency of termination of management contracts in the past ten years compared to the frequency of other changes to management contracts, such as increases or decreases in fund fees.

A. Sarbanes-Oxley Act

Section 301 of the Sarbanes-Oxley Act requires the Commission, by rule, to direct the national securities exchanges and national securities associations ("SROs") to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees.[88] The Commission adopted new rule 10A-3 under the 1934 Act to implement section 301 of the Sarbanes-Oxley Act on April 9,

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[88] Pub. L. 107-204, 116 Stat. 745 (2002).

2003.[89] Under section 301 and rule 10A-3, SROs are prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

Because section 301 requires the Commission to direct the SROs to prohibit the listing of any security of an issuer that is not in compliance with these audit committee standards, new rule 10A-3 applies only to listed issuers, including listed investment companies. Thus, the new rule would generally cover closed-end investment companies, but would not cover most mutual funds.

While many mutual funds already employ some or all of the principles embodied in rule 10A-3, extending the audit committee requirements of rule 10A-3 to mutual funds, as well as closed-end funds, could further benefit mutual fund investors. While mutual fund financial statements may, in many cases, be simpler than those of some operating

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89 Investment Company Act Release No. 26001 (Apr. 9, 2003).

companies, the underlying financial systems, reporting mechanisms, and internal controls are sufficiently complex that a mutual fund could benefit from each of the corporate governance reforms embodied in section 301 of the Sarbanes-Oxley Act and the Commission's implementing rules. However, assessing the benefits should be balanced with the costs to funds and their shareholders.

First, fund governance would be enhanced if each member of the audit committee of a mutual fund were required to be independent. As the Commission noted in the release adopting rule 10A-3, an audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.[90]

Second, a requirement that the audit committee appoint, compensate, retain, and oversee the outside auditor could help to further the objectivity of financial reporting. The auditing process may be compromised when a fund's outside auditors view their main responsibility as serving the fund's management rather than its board or audit committee. We note that the issue of appointment of the fund's independent auditor has already been addressed for both listed and non-listed funds by section 202 of the Sarbanes-Oxley Act and the Commission's auditor independence rules. Section 202 and the Commission's rules require that the audit committee of a fund pre-approve all audit, review, or attest engagements required under the securities laws.[91]

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90 In 2001, the Commission adopted rule 32a-4 to encourage mutual funds to have independent audit committees. Rule 32a-4 exempts a fund from the requirement that selection of the fund's accountant be submitted to shareholders for ratification at the next annual meeting, if the fund has an audit committee composed solely of independent directors.

91 *See* Investment Company Act Release No. 25915 (Jan. 28, 2003); rule 2-01(c)(7) of Regulation S-X. The audit committee is also required to pre-approve all permissible non-audit services.

Third, requiring the establishment of formal procedures by a fund's audit committee for receiving and handling complaints could serve to facilitate disclosure of questionable practices, encourage proper individual conduct, and alert the audit committee to potential problems before they have serious consequences.

Fourth, a requirement that a fund's audit committee have the authority to engage outside advisors, including counsel, as it determines necessary could assist the audit committee in performing its role effectively. The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye.

Fifth, a requirement for the fund to provide for appropriate funding to compensate the independent auditor and the advisors employed by the audit committee should further the required standard relating to the audit committee's responsibility to appoint, compensate, retain, and oversee the outside auditor, and add meaning to the standard relating to the audit committee's authority to engage independent advisors.

The staff has not identified any aspects of the Sarbanes-Oxley Act's corporate governance standards from which mutual funds should be exempted. The provisions of the Sarbanes-Oxley Act generally do not distinguish between investment companies and operating companies.[92] As a result, outside of section 301, which, by its terms, applies only to listed issuers, the Commission's rules generally apply the corporate governance requirements of the Sarbanes-Oxley Act to mutual funds. These requirements include section 202, which requires that audit committees pre-approve audit and permitted non-

[92] Section 405 of the Sarbanes-Oxley Act exempts registered investment companies from sections 401 (disclosure of material off-balance sheet transactions and pro forma financial information), 402 (prohibition on personal loans to executives), and 404 (management assessment of internal controls).

audit services,[93] and section 407, which requires an issuer to disclose whether at least one member of its audit committee is a "financial expert."[94] These requirements, which should help to improve the quality of the financial disclosure that an issuer provides to its investors, are as important for investors in mutual funds as they are for investors in operating companies.

B. Advisory Contracts

1. Contract Approval Process

a. Legal Standards

Fund directors and investment advisers have a number of obligations with respect to the approval of management contracts. Those obligations stem from principles of fiduciary duty under state and federal law and the specific requirements of the 1940 Act.

In particular, fund directors are subject to fiduciary duties of care and loyalty. The duty of care generally requires that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position.[95] The duty of loyalty generally requires fund directors to exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization (*e.g.*, the investment adviser).[96] Under state law, the business judgment rule can protect fund directors from liability for

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93 *See* section 10A(i) of the 1934 Act; Investment Company Act Release No. 25915 (Jan. 28, 2003).

94 *See* Investment Company Act Release No. 25914 (Jan. 27, 2003) (implementing section 407 of the Sarbanes-Oxley Act with respect to funds).

95 *See, e.g., Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) and *Norlin Corp v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984).

96 *See* the policy directives contained in sections 1(b)(2), (4) and (6) of the 1940 Act. *See also, Norlin Corp v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984), citing *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

their decisions, including their approval of a fund's investment advisory contract, so long as the directors acted in good faith, were reasonably informed, and rationally believed that the action taken was in the best interests of the fund.[97]

The 1940 Act also imposes specific statutory obligations on fund directors' approval and renewal of fund investment advisory contracts. Those obligations enhance the integrity of the approval and renewal process by, among other things, enhancing the authority of funds' independent directors.[98] For instance, the 1940 Act requires that a majority of a fund's independent directors must approve the fund's investment advisory contract at an in-person meeting called for that purpose,[99] before the investment adviser may serve or act as the fund's investment adviser.[100] The 1940 Act also generally requires that a fund's independent directors must annually approve the fund's investment advisory contract at an in-person meeting called for that purpose.[101] Furthermore, in connection with the initial approval and any renewal of a fund's investment advisory contract, the 1940 Act specifically requires fund directors to request and evaluate, and the

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97 *See, e.g., Salomon v. Armstrong*, 1999 Del. Ch. LEXIS 62, 23 (Del. Ch. Mar. 25, 1999). *See generally* Dennis J. Block *et al.*, THE BUSINESS JUDGMENT RULE - FIDUCIARY DUTIES OF CORPORATE DIRECTORS (5th ed. 1998).

98 The 1940 Act requires that at least 40% of a fund's directors must be independent. *See* section 10(a) of the 1940 Act. In 2001, the Commission strengthened the role of independent directors by requiring that a majority of a fund's directors be independent if the fund relies on certain rules that exempt funds from various requirements of the 1940 Act. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). Independent directors comprise a majority of most fund boards.

99 The "in-person meeting requirement" was intended "to assure informed voting on matters which require action of the board of directors of registered investment companies." Sen. Rep. No. 91-184, 91st[th] Cong., 1st Sess. 4082 (1969).

100 *See* Section 15(c) of the 1940 Act, which requires approval of fund investment advisory contracts by the vote of a majority of the directors who are not parties to such contract or agreement, or interested persons of any such a party, cast in person at a meeting called for the purpose of voting on such approval.

101 *Id.*

investment adviser to furnish, "such information as may reasonably be necessary to evaluate" the terms of the contract.[102]

The 1940 Act further requires fund directors to evaluate the amount of compensation that the fund pays to its investment adviser under the fund's investment advisory contract. Section 36(b) imposes on fund investment advisers a fiduciary duty with respect to their receipt of compensation from funds.[103] Congress adopted section 36(b) in response to concerns that fund advisory fees were not subject to the usual competitive pressures because funds typically are organized and operated by their investment advisers.[104] Director's responsibilities under section 36(b) involve the evaluation of whether the compensation that is paid to a fund's investment adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[105] When approving and renewing investment advisory agreements, particularly the compensation to be paid to the investment advisers, fund directors typically consider the following relevant factors:

- The nature and quality of all of the services provided by the adviser (either directly or through affiliates), including the performance of the fund;
- The adviser's cost in providing the services and the profitability of the fund to adviser;

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[102] *Id.*

[103] Section 36(b) specifically authorizes the Commission, and any fund shareholder, to bring an action in federal district court against the fund's investment adviser for a breach of fiduciary duty "with respect to the receipt of compensation for services, or of payments of a material nature" made by the fund to the investment adviser (or to an affiliated person of the investment adviser).

[104] *See* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 10-12, 126-27, 130-32 (1966). *See also* DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 317-319 (May 1992) ("Protecting Investors").

[105] *Gartenberg v. Merrill Lynch Asset Management, Inc.* 694 F.2d 923, 928 (2d Cir. 1982) ("Gartenberg I"). *See also Gartenberg v. Merrill Lynch Asset Management, Inc.*, 740 F.2d 190 (2d Cir. 1984).

- The extent to which the adviser realizes economies of scale as the fund grows larger;
- The "fall-out" benefits that accrue to the adviser and its affiliates as a result of the adviser's relationship with the fund (*e.g.*, soft dollar benefits);
- The performance and expenses of comparable funds; and
- The volume of transaction orders that must be processed by the adviser.

Fund directors should not approve or renew an investment advisory contract if the investment adviser's receipt of compensation under the contract would constitute a breach of the adviser's fiduciary duty under section 36(b).

Like fund directors, fund investment advisers are subject to fiduciary duties under state and federal law in connection with the approval and renewal of investment advisory contracts.[106] Fund investment advisers are subject to duties of care and loyalty[107] and must affirmatively disclose to a fund's board of directors all facts that are material to the board's approval and renewal of the investment advisory contract.[108] In particular, a fund's investment adviser is required by the 1940 Act to furnish "such information as may reasonably be necessary" for the fund's directors to evaluate the fund's investment advisory contract.[109] Furthermore, the 1940 Act authorizes the Commission to sue any fund investment adviser for "any act or practice constituting a breach of fiduciary duty

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106 *See, e.g., Transamerica Mortgage Advisors, Inc. v. Lewis,* 444 U.S. 11, 17 (1979).

107 *See, e.g., SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191-92 (1963); In the Matter of Kemper Financial Services, Inc. *et al.*, Investment Advisers Act Release No. 1476 (Mar. 2, 1995); In the Matter of Joan Conan, Investment Advisers Act Release No. 1446 (Sept. 30, 1994).

108 *Id.*

109 *See* Section 15(c) of the 1940 Act.

involving personal misconduct" in connection with, among other things, the approval or renewal of the fund's investment advisory contract.[110]

b. Utility of the Standards in Light of Infrequent Terminations of Fund Advisory Contracts

The infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that the legal standards that are applicable to the approval of investment advisory contracts are inadequate, or that independent directors have not been forceful enough in representing shareholders' interests. Fund directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds. For example, fund directors may reasonably conclude that it would be in the best interests of the fund and its shareholders to renegotiate, rather than to terminate, the fund's investment advisory contract. Fund directors also may reasonably conclude that it would be in the best interests of the fund and its shareholders to require the fund's investment adviser to take appropriate steps to improve its performance, such as by hiring a new portfolio manager for the fund, increase the adviser's investment research capacity, move to a team approach of portfolio management, insist on retention of a sub-adviser, merge or liquidate the fund, close the fund to new investors, or adjust the fee structure, such as adding a performance fee component to the advisory fee, without seeking to terminate the investment advisory contract. In sum, fund directors are empowered with the ability to terminate a fund's investment advisory contract when the directors determine that it would be in the best interests of the fund and its shareholders to do so, and they are empowered to renegotiate the contract and/or take other remedial steps when that would be the better course.

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[110] *See* Section 36(a) of the 1940 Act.

When fund directors consider whether or not to approve an investment advisory contract with an investment adviser, the directors generally must act in the best interests of the fund and its shareholders in light of all of the relevant facts and circumstances. The directors must carefully consider all information that is material to their evaluation of the terms of the contract, including the amount of the compensation to be paid by the fund to the investment adviser. If the fund's directors are not satisfied with the performance of the investment adviser under the contract, however, termination of the contract is not the only course of action that is available to the directors, and termination may not necessarily be in the best interests of the fund.

Under certain circumstances, however, the termination of a fund's investment advisory contract may be in the best interests of the fund and its shareholders. For instance, fund directors may decide to terminate the fund's investment advisory contract because the fund's investment adviser lacks the financial resources to adequately perform its obligations under the contract. In deciding whether termination of the contract would be in the best interests of the fund, the directors would need to consider, among other things, whether the benefits of termination would outweigh the potential costs and disruption associated with the termination. Failure to terminate could constitute a breach of fiduciary duty by the fund's directors. Traditionally, the Commission and the courts have avoided substituting their business judgment regarding the approval of fund investment advisory contracts for the judgment of the fund boards.[111]

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[111] *See, e.g., Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F.Supp. 962, 971 (S.D. N.Y. 1987) *aff'd.*, 835 F.2d 45 (2d Cir. 1987). "The legislative history of the [Investment Company] Act clearly indicates that it is not the role of the Court to 'substitute its business judgment for that of the mutual fund's board of directors in the area of management fees.'" *Id.* (quoting S. Rep. No. 194, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Ad. News 4902).

c. Termination of Contracts

To the best of our knowledge, fund directors have infrequently terminated or rejected management or investment advisory contracts during the past ten years. The Commission does not maintain data on the frequency of the rejection or termination of, or other changes to, investment advisory contracts by fund directors.[112] Funds and their directors are not required to seek Commission approval or provide the Commission with notice of the directors' rejection or termination of investment advisory contracts between the funds and their investment advisers.

Fund directors may terminate investment advisory contracts in several ways.[113] Fund investment advisory contracts are required by law to provide that fund directors, with 60 days' notice, may terminate the contracts at any time, without the payment of any penalty.[114] In addition, a fund's investment advisory contract generally must be re-approved each year by the majority of independent directors of the fund.[115] A fund's

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112 Before funds enter into investment advisory contracts with new investment advisers, or amend existing investment advisory contracts, the funds' boards of directors and shareholders must approve the new or amended contracts. To obtain shareholder approval, a fund typically distributes a proxy statement to its shareholders that discloses the circumstances surrounding the fund's decision to enter into a new contract or to amend the existing contract. The Commission's staff generally reviews the proxy statements for compliance with the rules regulating the solicitation of proxies, but does not maintain data regarding the frequency of terminations of investment advisory contracts by fund directors or data regarding the frequency of other changes to advisory contracts, such as increases or decreases in advisory fees.

113 No more than 60% of a fund's directors may be "interested" directors. *See* Section 10(a) of the 1940 Act. An independent director is a director who is not an "interested person" of the fund.

114 Section 15(a) of the 1940 Act requires all fund investment advisory contracts to contain that provision.

115 Section 15(a) of the 1940 Act generally makes it unlawful for any person to serve as an investment adviser to a fund except pursuant to a written contract that has been approved by a majority of the fund's outstanding voting securities and a majority of the fund's independent directors. Typically, the fund's investment adviser, as the initial, sole shareholder of the fund, initially approves the investment advisory contract. After the initial two-year contractual period, section 15 requires that the contract be renewed annually by a majority of the fund's independent directors or its shareholders.

independent directors may effectively terminate or reject the fund's investment advisory contract by not voting to approve its continuance.[116] We understand that fund directors have terminated investment advisory contracts between their funds and the funds' investment advisers for various reasons, including disputes between directors and investment advisers over the quality of information provided to the directors by the investment adviser regarding the adviser's management of the fund, the fund's investment techniques, converting the fund from a closed-end fund to an open-end fund, and merging the fund with another fund.

Payments For Distribution

A study in 2000 by the SEC states that increases "in mutual fund expense ratios since the 1970s can be attributed primarily to changes in the manner that distribution and marketing charges are paid by mutual funds and their shareholders. Many funds have decreased or replaced front-end loads, which are not included in a fund's expense ratio, with ongoing Rule 12b-1 fees, which are included in a fund's expense ratio." In light of experience since the 1970s, are further changes to Rule 12b-1 warranted at this time? What are the advantages and disadvantages to investors of paying for distribution and marketing via a 12b-1 fee rather than via a front-end load? Furthermore, has Rule 12b-1 increased or decreased price competition in the Commission's opinion?

We additionally understand that fund advisors sometimes make payments to third parties for distribution and/or shareholder services known as "revenue sharing," and that the use of these payments may be increasing. We also understand that revenue sharing usually refers to payments made out of fees that are nominally intended for various purposes, including management fees, transfer agent fees, and 12b-1 fees. What are the typical sources of revenue sharing payments, and are they subjected to the controls of Rule 12b-1? Additionally, what are the current disclosure requirements for such payments? In the opinion of the Commission, is there presently adequate disclosure of revenue sharing payments by the fund, the payor, and by the recipient? What services do funds, fund shareholders and fund sponsors typically obtain for such payments? Lastly, do these payments stimulate or inhibit price competition in the Commission's view?

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[116] Fund directors also may decline to approve proposed amendments to existing investment advisory contracts, and may decline to approve proposed investment advisory contracts for newly created funds.

The area of payments for distribution has been a focus for the staff for the last several years. Our response gives both background information on the subject, as well as specific answers to the questions posed.

A. The Obligations of Fund Directors Regarding Approval of Distribution Arrangements under Rule 12b-1 and Otherwise

Rule 12b-1 prohibits any mutual fund from acting as a distributor of its shares, either directly or indirectly, unless the fund complies with the requirements of the rule.[117] Rule 12b-1 generally provides that a fund is acting as a distributor of its shares if it engages "directly or indirectly" in "financing any activity which is primarily intended to result in the sale of shares," such as the "compensation of underwriters, dealers and sales personnel."

Under the rule, a fund's directors generally are obligated to approve initially, and oversee on ongoing basis, the use of fund assets to pay for the distribution of fund shares. The payment of any distribution expense by a fund must be made pursuant to a written plan that describes all material aspects of the proposed financing of distribution (a "12b-1 plan"). The directors of a fund who vote to approve the implementation or continuance of a 12b-1 plan must conclude, in the exercise of their reasonable business judgment and

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[117] Section 12(b) of the 1940 Act prohibits an open-end investment company from acting:

> as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

In 1980, the Commission adopted rule 12b-1 under the provisions of this section. Investment Company Act Release No. 11414 (Oct. 28, 1980).

in light of their fiduciary duties under state law[118] and under sections 36(a) and (b) of the 1940 Act,[119] that there is a reasonable likelihood that the plan will benefit the fund and its shareholders.[120] Under the rule, directors have the duty to request and evaluate such information as may reasonably be necessary to make an informed determination of whether a 12b-1 plan should be implemented or continued, and directors should consider and give weight to all pertinent factors.[121]

More specifically, the requirements of rule 12b-1 that relate to fund directors are as follows:

- The 12b-1 plan must be approved by a vote of the board of directors of a fund, and by the directors of the fund who are independent, cast in person at a meeting called for the purpose of voting on the plan;[122]

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118 As noted above, fund directors are subject to state law fiduciary duties of care and loyalty. The duty of care generally requires that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position. *See Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984). *See generally* James Solheim and Kenneth Elkins, 3A Fletcher Cyclopedia of the Law of Private Corporations § 1029 (perm. ed.). The duty of loyalty generally requires that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization. *See Norlin Corp.*, 744 F.2d at 264 (*citing Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)). *See generally* Beth A. Buday and Gail A. O'Gradney, 3 Fletcher Cyclopedia of the Law of Private Corporations § 913 (perm. ed.).

119 Section 36(a) of the 1940 Act authorizes the Commission to institute civil actions in federal district court against fund directors who engage in conduct constituting a breach of fiduciary duty involving personal misconduct. The legislative history of the section indicates that: "In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970); S. Rep. No. 184, 91st Cong, 2d Sess. 36 (1969). Section 36(b) of the 1940 Act authorizes the Commission and fund shareholders to institute civil actions in federal district court against fund directors for breach of fiduciary duty with respect to payments made by the fund to the fund's investment adviser and affiliated persons of the adviser.

120 Rule 12b-1(e).

121 Rule 12b-1(d).

122 Rule 12b-1(b)(2). An independent, or disinterested, director is a director that is not an "interested person" of the fund as defined in section 2(a)(19) of the 1940 Act. In addition, for the purposes of rule 12b-1, an independent director must also have no direct or indirect financial interest in the 12b-1 plan or any agreements under that plan. *Id.*

- The 12b-1 plan must provide that any person authorized to direct the disposition of monies paid or payable by the fund pursuant to the 12b-1 plan or any related agreement shall provide to the fund's board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which the expenditures were made;[123]

- The 12b-1 plan must provide that all material amendments to the plan must be approved by a vote of the fund's directors, and by the fund's independent directors, cast in person at a meeting called for the purpose of voting on the amendments;[124]

- The 12b-1 plan's continuance must be approved at least annually by the fund's board as well as its independent directors;[125] and

- A majority of the fund's directors must be independent, the independent directors must select and nominate any other independent directors, and any person who acts as legal counsel for the independent directors of the fund must be an "independent counsel" as defined in rule 0-1 under the 1940 Act.[126]

These requirements are intended, in part, to address the potential conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses. When a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.[127]

When the Commission adopted rule 12b-1 in 1980, it enumerated the following factors that it believed, at the time, would normally be relevant to a determination by a fund's board of directors of whether to use fund assets to pay for distribution:

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123 Rule 12b-1(b)(3)(ii).

124 *Id.*

125 Rule 12b-1(b)(3)(i).

126 Rule 12b-1(c)(1) and (2).

127 *See generally* Investment Company Act Release No. 10252 (May 23, 1978).

(1) The need for independent counsel or experts to assist the directors in reaching a determination;

(2) The nature of the problems or circumstances which purportedly make implementation or continuation of a 12b-1 plan necessary or appropriate;

(3) The causes of such problems or circumstances;

(4) The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures, the relationship of such expenditures to the overall cost structure of the fund, the nature of the anticipated benefits, and the time it would take for those benefits to be achieved;

(5) The merits of possible alternative plans;

(6) The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the fund's shares, including whether any payments by the fund to such other person are made in such a manner as to constitute the indirect financing of distribution by the fund;

(7) The possible benefits of the plan to any other person relative to those expected to inure to the fund;

(8) The effect of the plan on existing shareholders; and

(9) In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the fund and its shareholders.[128]

Fund directors also have statutory obligations regarding distribution arrangements that are not within the scope of rule 12b-1. Funds typically employ principal underwriters. Under section 15(c) of the 1940 Act, a majority of a fund's independent directors must vote to approve any contract, or any renewal thereof, under which a person agrees to act as the fund's principal underwriter. In addition, under section 15(b) of the 1940 Act, a principal underwriting contract may continue in effect for more than two years from the date of its execution only if the fund's board of directors or shareholders

[128] *See* Investment Company Act Release No. 11414 (Oct. 28, 1980).

approve its continuance annually. In approving principal underwriting contracts, fund directors are subject to their fiduciary duties under section 36 of the 1940 Act and state law, as discussed above.

B. Should Rule 12b-1 Be Updated in Light of the Evolution of Fund Distribution Since the Rule's Adoption?

In December 2000, the Commission's staff recommended to the Commission that the Commission should consider reviewing and amending the requirements of rule 12b-1.[129]

The staff's recommendation that the Commission should consider reviewing and amending the requirements of rule 12b-1 was based in part on the changes in the manner in which funds have been marketed and distributed, and the experience gained from observing how the rule has operated, since it was adopted in 1980.[130]

Rule 12b-1 essentially requires fund directors to view a fund's 12b-1 plan as a temporary measure even in situations where the fund's existing distribution arrangements would collapse if the 12b-1 plan were terminated. As described previously, under the rule, fund directors must adopt a 12b-1 plan for not more than one year, may terminate the plan even before the end of that year, and must consider at least annually whether the plan should be continued. In addition, many directors believe that when they consider whether to approve or continue a 12b-1 plan, they are required to evaluate the plan as if it were a temporary arrangement. As discussed above, the adopting release for rule 12b-1 included a list of factors that fund boards might take into account when they consider whether to approve or continue a 12b-1 plan. Many of the factors presupposed that funds

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[129] *See* Staff Fee Study, *supra* note 1.

[130] *See* Staff Fee Study, *supra* note 1.

would typically adopt 12b-1 plans for relatively short periods in order to solve a particular distribution problem or to respond to specific circumstances, such as net redemptions. Although the factors are suggested and not required, some industry participants indicate that the factors are given great weight by fund boards. Some argue that the recitation of the factors impedes board oversight of 12b-1 plans because the temptation to rely on the factors, whether they are relevant to a particular situation or not, is too great to ignore. Although the factors may have appropriately reflected industry conditions as they existed in the late 1970s, others argue that many have subsequently become obsolete because, today, many funds adopt a 12b-1 plan as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements.

The mutual fund industry utilizes a number of marketing and distribution practices that did not exist when rule 12b-1 was adopted. For example, many funds offer their shares in multiple classes – an organizational structure that permits investors to choose whether to pay for fund distribution and marketing costs up-front (via front-end sales charge), over time from their fund investment (via 12b-1 fee), when they redeem (via deferred sales charge), or in some combination of the above. Rule 12b-1 plans are integral to these arrangements – they are the means by which the brokers that sell fund shares under these arrangements are paid. Some industry observers argue that fund principal underwriters and boards of directors may have good reason to view this type of 12b-1 plan as an indefinite commitment because a multi-class distribution arrangement could not continue to exist if the associated 12b-1 plan were terminated or not renewed.

Other funds offer their shares primarily through fund supermarkets -- programs sponsored by financial institutions through which their customers may purchase and redeem a variety of funds, with or without paying transaction fees. Fund supermarkets are popular because they have been heavily advertised, indicate or imply that the sponsor has screened the participating funds for quality of management, enable investors to consolidate their holdings of funds from different fund groups in a single brokerage account and to receive a consolidated statement listing all fund holdings. Many funds that offer shares through fund supermarkets adopt 12b-1 plans to finance the payment of fees that are charged by the sponsors of fund supermarkets. Some may argue that because these 12b-1 plans are essential to the funds' participation in fund supermarket programs, these 12b-1 plans may be legitimately viewed as indefinite commitments. In addition, because most funds pay fees to fund supermarkets for a mixture of distribution and non-distribution services, it can be difficult to determine when and how rule 12b-1 applies to these fees. Although the Division of Investment Management has provided additional guidance about what constitutes a distribution expense,[131] questions still remain about how to determine whether a particular activity is primarily intended to result in the sale of fund shares, and therefore must be covered by a 12b-1 plan.[132]

A third significant change in distribution practices is that some fund distributors are now able to finance their efforts by borrowing from banks, finance companies, or the

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131 Letter from Douglas Scheidt, Associate Director of the Commission's Division of Investment Management, to Craig S. Tyle, General Counsel of the Investment Company Institute (pub. avail. Oct. 30, 1998).

132 Nonetheless, bundled fees that purport to include services such as transfer agency and shareholder servicing fees can be scrutinized by directors to allocate the proportion of the fee that is for distribution and thus is includable in a 12b-1 plan.

capital markets because they can use anticipated 12b-1 revenues as collateral, or as the promised source of payment. If a fund adopts a 12b-1 plan, the right of its distributor to receive future 12b-1 fees from the fund is an asset of the distributor. Some distributors borrow from banks, finance companies, or other financial intermediaries, using this asset as collateral. Other distributors issue debt securities (asset-backed securities) for which the payment of principal and interest is backed by the distributors' contractual right to receive a stream of future 12b-1 fees. Although the independent directors of a fund have the legal right to terminate a fund's 12b-1 plan, the independent directors may be less likely to do so if the fund's future 12b-1 fees have been pledged to secure a bank loan or to pay principal and interest due on asset-backed securities.

Another development that we have observed is the increasing use by some funds of a portion of the brokerage commissions that they pay on their portfolio transactions to compensate broker-dealers for distribution of fund shares. Certain of these arrangements, we believe, result in the use of fund assets to facilitate distribution and should be reflected in rule 12b-1 distribution plans. For instance, some fund investment advisers direct broker-dealers that execute transactions in the fund's portfolio securities to pay a portion of the fund's brokerage commissions to selling broker-dealers. In some instances, the selling broker-dealers perform no execution-related services in connection with the portfolio transactions. These payments are intended to compensate selling broker-dealers for selling fund shares and are a use of fund assets for distribution of fund shares. We intend to recommend that the Commission take action to clarify the circumstances pursuant to which the use of brokerage commissions to facilitate the distribution of fund shares should be reflected in a rule 12b-1 plan.

In view of the foregoing, we will continue to assess the issues raised by rule 12b-1 and discuss with the Commission the current status of the rule in light of our recommendation in December 2000 and the changes in fund distribution practices that have developed since the rule was adopted over twenty years ago.

C. Revenue-Sharing Payments and Rule 12b-1

A "revenue-sharing" payment generally refers to any payment that is made by a fund's investment adviser, from its own resources, to finance the distribution of the fund's shares. As explained below, revenue-sharing payments generally are not a fund expense. Fund investment advisers use revenue-sharing payments primarily to compensate broker-dealers that sell the funds' shares ("selling broker-dealers").[133]

As a general matter, funds intensely compete to secure a prominent position in the distribution systems that selling broker-dealers maintain for distributing fund shares. Over the past decade, selling broker-dealers have increasingly demanded compensation for distributing fund shares that is in addition to the amounts that they receive from sales loads and rule 12b-1 fees. To meet this demand, fund investment advisers have increasingly made revenue-sharing payments to the selling broker-dealers, which may be a "major expense" for some investment advisers. Further, the allocation of fund brokerage to "supplement" the adviser's payments to broker-dealers for distribution generally is bundled into the commission rate and not separately identified or reported as

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[133] Based on information derived from recent examinations conducted by Commission staff of funds, their investment advisers and broker-dealers, we understand that fund investment advisers typically make revenue-sharing payments to selling broker-dealers at the rate of between .20% and .25% of the annual gross sales of fund shares made by a broker-dealer, and between .01% and .05% of the net asset value of fund shares held by customers of a broker-dealer.

12b-1 fees. Under certain circumstances, the portion of the commission devoted to payment for distribution is more discernable. See discussion above regarding use of brokerage commissions to facilitate distribution.

The primary legal issue raised by a fund investment adviser's revenue-sharing payments is whether the payments are an indirect use of the fund's assets to finance the distribution of its shares and therefore must be made in accordance with the requirements of rule 12b-1 under the 1940 Act. A mutual fund that directly or indirectly finances any activity that is primarily intended to result in the sale of fund shares must comply with rule 12b-1.[134] Whether a fund indirectly finances the distribution of its shares through revenue-sharing payments that are made by its investment adviser depends on all of the facts and circumstances

In the Commission's view, a fund indirectly finances the distribution of its shares within the meaning of rule 12b-1 if any allowance is made in the fund's investment advisory fee to provide money to finance the distribution of the fund's shares. In that case, the investment advisory fee essentially serves as a conduit for the indirect use of the fund's assets for distribution, and the portion of the advisory fee that is used to finance the distribution of the fund's shares must be paid in compliance with the requirements of rule 12b-1.[135]

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[134] As discussed above, section 12(b) and rule 12b-1 thereunder address the conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses. In particular, when a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser. The requirements of rule 12b-1 address those concerns.

[135] *See Bearing of Distribution Expenses by Mutual Funds,* Investment Company Act Release No. 11414 (Oct. 28, 1980).

On the other hand, revenue-sharing payments do not involve an indirect use of a fund's assets for distribution if the fund's investment adviser makes the payments from the profits of its investment advisory fee that are "legitimate" or "not excessive," *i.e.*, if they are derived from an investment advisory contract that does not result in a breach of the investment adviser's fiduciary duty under section 36(b) of the 1940 Act.[136] Whether the profits are legitimate depends on whether the compensation received by the investment adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[137] Factors relevant to this determination are, among other things, the nature and quality of all of the services provided by the adviser (either directly or through affiliates), including the performance of the fund, the adviser's cost in providing the services and the profitability of the fund to the adviser.

D. Price Competition

Price competition generally refers to the competition among funds to attract and retain shareholders based upon the total costs of investing in the funds. The Commission has not specifically studied the relationship between price competition and the various distribution methods employed by funds.[138]

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136 As previously noted, Section 36(b) of the 1940 Act imposes on fund investment advisers a fiduciary duty with respect to their receipt of compensation from the fund.

137 Gartenberg I, *supra* note 105 at 928. *See also Gartenberg v. Merrill Lynch Asset Management, Inc.*, 740 F. 2d 190, 192 (2d Cir. 1984).

138 In the 1960s, the Commission studied the effect of section 22(d) of the Company Act on price competition in the mutual fund industry. That section requires that all sales of fund shares be made at a fixed offering price specified in the fund's prospectus. The Commission found that section 22(d) made lawful a system of retail price maintenance, eliminated all secondary market trading, and impeded price competition. In response, Congress considered repealing section 22(d) but deferred action pending a formal Commission study. As an interim measure, Congress gave rulemaking authority to the National Association of Securities Dealers, Inc. to prevent "excessive sales loads;" under this authority, the NASD imposed an 8.5% cap on front-end sales loads. The

Funds compete for shareholders on many bases, including, among others, price, performance, investment objective, and shareholder services. Funds that compete for shareholders on the basis of price may emphasize that they have no sales loads, or low sales loads, and they may emphasize that they incur low overall operating expenses. Some funds that compete on the basis of price also may emphasize that they charge no rule 12b-1 fees, or that they charge low rule 12b-1 fees. Funds, however, generally cannot compete solely on the basis of whether or not they charge rule 12b-1 fees because other operating expenses, such as management, custodial and transfer agent fees, significantly affect the total costs of investing in funds.

It is difficult to assess whether rule 12b-1 has increased or decreased price competition among funds. Many funds that charge rule 12b-1 fees use those fees, in conjunction with contingent deferred sales loads, as a substitute for front-end sales loads. (The rule 12b-1 fees are used primarily to reimburse the fund's principal underwriter for distribution payments made to broker-dealers that sell the fund's shares.) As a result, rule 12b-1 has permitted funds to offer investors an alternative to paying for distribution through front-end sales loads. However, we note that funds that charge rule 12b-1 fees generally are at a competitive disadvantage, in terms of price competition, relative to other similar funds, because funds that charge rule 12b-1 fees typically have higher operating expenses than similar funds that do not charge rule 12b-1 fees.

It is also difficult to assess whether revenue-sharing payments generally have stimulated or inhibited price competition among funds. Investment advisers make

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Commission, after further study, did not recommend an immediate repeal of section 22(d) but instead recommended an administrative program to allow the retail price maintenance system to be replaced over time by competition, *e.g.*, by relaxing rigid advertising rules and permitting more sales load variations. Since that time, the Commission has implemented several measures pursuant to this program, including the adoption of rule 12b-1.

revenue-sharing payments to support the distribution of both load and no-load funds. These payments do not directly increase the total costs of investing in funds because they are made from the investment advisers' own resources, and not from the funds' assets. As a result, revenue-sharing payments do not necessarily put a fund whose investment adviser makes such payments at a competitive disadvantage.[139]

The Commission's disclosure requirements for funds facilitate price competition among funds and enable fund investors to make informed decisions about whether and how they will pay for the distribution of fund shares. These disclosure requirements are the same regardless of the distribution methods employed by the fund. All funds are required to prominently disclose, in a standardized manner, the fees and expenses that shareholders may pay if they buy and hold shares of the funds, including the maximum amount of any sales loads and the total amount of fund expenses, as a percentage of the funds' net assets, including investment advisory fees and rule 12b-1 fees. In addition, each fund is required to provide a fee table that summarizes the sales charges and fund operating expenses associated with an investment in the fund. The fee table is designed to help investors understand the costs of investing in a fund and to compare those costs with the costs of investing in other funds.

E. Transparency of Revenue-Sharing Payments and Their Associated Costs

As discussed below, broker-dealers are required to disclose their receipt of revenue-sharing payments to their customers that purchase fund shares. Some funds

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[139] Revenue-sharing payments by a fund's investment adviser, however, may indirectly cause the fund to be at a competitive disadvantage, in terms of price competition relative to funds whose investment advisers do not make revenue-sharing payments, if the payments deter the investment adviser from voluntarily reducing its investment advisory fees.

disclose details of the revenue-sharing payments made by their investment advisers to facilitate the broker-dealers' compliance with their disclosure obligation.

A broker-dealer generally is required to disclose to its customer, in writing, at or before the completion of a transaction, that it has or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or will receive, from the fund's investment adviser.[140] A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.[141] Many funds disclose in their prospectuses information relating to their investment advisers' revenue-sharing payments to broker-dealers, which has the effect of facilitating the broker-dealers' compliance with that obligation. Many funds disclose additional details about revenue-sharing payments made by their investment advisers in their SAIs.

The Commission recently has recognized, however, that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue-sharing payments to meet the requirements of rule 10b-10 under the 1934 Act. The Commission therefore has directed its staff to make recommendations to the Commission as to whether additional disclosure should be

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[140] Rule 10b-10 under the Securities Exchange Act of 1934.

[141] *See* Securities Confirmations, Securities Exchange Act Release No. 13508 at n.41 (May 5, 1977).

required or current disclosure further refined.[142] The staff is considering whether disclosure made by the broker-dealer at the point of sale and in subsequent periodic filings would be appropriate mechanisms for this disclosure..

As discussed above, distribution related payments are made either from the fund's assets or from the resources of the fund's investment adviser. When fund assets are used to make distribution related payments, the fund generally must disclose the total amount of expenses that it incurs for distribution, including payments from the funds' assets, and the fund must disclose that its assets are used to compensate broker-dealers for distributing the funds' shares. When fund assets are not used to make distribution related payments, *e.g.*, when the fund's investment adviser makes the payments out of its own resources, funds incur no costs and thus are not required to disclose the payments as expenses of the funds. Funds, however, are required to disclose the investment advisory fees that they pay to their investment advisers.

F. Impact on Investors

As explained above, if a fund makes payments from the fund's assets pursuant to rule 12b-1, the fund's expenses increase and the returns to the fund's shareholders are lower. If, however, a fund's investment adviser makes revenue-sharing payments out of its own resources, there generally is no direct impact on the fund and its shareholders because the payments are not made from fund assets.

Revenue-sharing payments may nonetheless affect funds and their shareholders. Investment advisory fees may be higher than they otherwise would be if no revenue-sharing payments were made. For example, an investment adviser that expects to make

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142 *See Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 132 n.13 (July 10, 2000). *See also,* Brief of the Securities and Exchange Commission, Amicus Curiae, in *Cohen, et al., v. Donaldson, Lufkin & Jenrette Securities Corp., et al.* No. 97-9159 (2d Cir.)(Feb. 2000).

revenue-sharing payments for a new fund may be less willing to enter into an investment advisory agreement with the fund unless the investment advisory fee is high enough to allow the adviser to earn an acceptable profit after taking into account the anticipated revenue-sharing payments. In addition, an investment adviser that makes revenue-sharing payments for an existing fund may be less willing to agree to a reduction of its investment advisory fee because its profit already is reduced from making the payments. Thus, in some instances, funds and their shareholders may be effectively bearing the costs of the revenue-sharing payments made by the funds' investment advisers.[143]

Fund Performance Information

The Commission requires extensive disclosure of fund performance on a standardized basis to facilitate comparisons of funds by investors. Standardized returns are required for one, five and ten years, and both pre-tax and after-tax returns are required in some cases. Standardized returns are required to be net of all fund expenses and sales charges, although funds are allowed to provide additional optional performance data calculated differently or for different time periods.

Some critics believe investors focus too much on fund performance. In the Commission's view, do mutual fund investors have too much or too little performance data available to them? Please compare the performance disclosure required for mutual funds to the disclosure required for other financial products, including (1) closed-end funds, (2) unit investment trusts, (3) investment advisors, and (4) hedge funds. Please also discuss what additional information presented in a standardized format could help to improve investors' decisions.

Finally, some witnesses at the hearing in the Capital Markets Subcommittee criticized industry performance data on the basis that it was distorted by so-called "incubator funds" and "survivor bias." Please describe the Commission's position on these practices. Does the SEC regulate incubator funds or require specific disclosures regarding them? Does the Commission require or permit funds to disclose performance on a complex-wide basis, and does survivor bias influence the results? To what extent is survivor bias a product of mutual fund practices and to what extent is it a product of how mutual fund returns are reported by third-party fund tracking

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[143] This does not necessarily mean, however, that the funds' investment advisers have violated their fiduciary duties within the scope of section 36(b) of the 1940 Act, because the advisory fees paid by the funds to their advisers may not be excessive.

entities? Finally, what is the effect on incubator funds and survivor bias on investors' perceptions of fund performance?

Many investors consider past performance to be one of the most significant factors when selecting a mutual fund.[144] For many years, the Commission has taken steps to address performance advertisements that may create unrealistic investor expectations. The current rules regarding performance disclosure by mutual funds in prospectuses and advertisements are described below. In addition, performance disclosures provided by closed-end funds, unit investment trusts, investment advisers, and hedge funds are briefly summarized. Next, the Commission's concerns regarding performance advertising are discussed, as well as recent Commission initiatives intended to reinforce the antifraud protections that apply to fund advertisements and to encourage funds to use advertisements that convey balanced information to prospective investors, particularly with respect to past performance.

A. Current Performance Disclosures

1. Current Requirements for Mutual Fund Performance Disclosure

The Commission has adopted rules governing performance disclosure in mutual fund prospectuses and performance advertising by mutual funds. Although market forces generally determine the amount of performance information that is made available to investors, the Commission's rules are designed to prevent misleading performance claims

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144 *See* Investment Company Institute, *Understanding Shareholders' Use of Information and Advisers* (Spring 1997), at 21 and 24 (Total return information was frequently considered by investors before a purchase, second only to the level of risk of the fund. Eighty-eight percent of fund investors surveyed said that they considered total return before their most recent purchase of a mutual fund. Eighty percent of fund owners surveyed reported that they followed a fund's rate of return at least four times per year).

and to permit investors to make meaningful comparisons among fund performance claims in advertisements.[145]

The registration statement form for mutual funds, Form N-1A, requires funds to disclose certain performance information as part of a risk/return summary. Item 2 of Form N-1A requires the risk/return summary to include a bar chart showing the fund's annual total returns for each of the last 10 calendar years (or for the life of the fund, if shorter) and to disclose the fund's highest and lowest return for a quarter during the period of the bar chart.[146] Item 2 also requires the risk/return summary to include a table comparing the fund's average annual before- and after-tax total returns for the last 1-, 5-, and 10-calendar years (or for the life of the fund, if shorter) to those of a broad-based securities market index.[147] The bar chart is intended to illustrate graphically the variability of a fund's returns and thus provide investors with some idea of the risk of an investment in the fund. The average annual return information in the table is intended to enable investors to evaluate a fund's performance and risks relative to "the market."[148]

Further, Item 5 of Form N-1A requires a mutual fund to include Management's Discussion of Fund Performance ("MDFP") in its prospectus or annual report.[149] Mutual funds generally choose to include MDFP in their annual reports. MDFP must include a discussion of the factors that materially affected the fund's performance during the most

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145 Investment Company Act Release No. 16245 (Feb. 2, 1988).

146 Item 2(c)(2)(i) and (ii) of Form N-1A.

147 Item 2(c)(2)(i) and (iii) of Form N-1A.

148 Investment Company Act Release No. 23064 (Mar. 13, 1998).

149 The Commission has proposed that MDFP be in a fund's annual report. *See* Investment Company Act Release No. 25870 (Dec. 18, 2002).

recently completed fiscal year, a line graph comparing the fund's performance over the most recently completed 10 fiscal years (or the life of the fund, if shorter) to that of a broad-based market index, and a table of the fund's average annual total returns for 1-, 5-, and 10-fiscal year periods (or the life of the fund, if shorter). The MDFP requirement is intended to provide investors with a "management's discussion and analysis" of investment performance that would give fund management an opportunity to explain the fund's investment results.[150]

Mutual funds are required to calculate the returns required in the risk/return summary and MDFP according to standardized formulas.[151] In addition, both the risk/return summary and the MDFP must include a statement to the effect that the fund's past performance is not necessarily an indication of how it will perform in the future.[152]

Disclosure of performance by mutual funds in advertisements is governed by rule 482 under the 1933 Act.[153] Rule 482 permits investment companies to advertise investment performance data, as well as other information.[154] Since 1988, the Commission has required fund performance data used in advertisements to be calculated according to standardized formulas. The Commission adopted the use of standardized

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150 Investment Company Act Release No. 19382 (Apr. 6, 1993).

151 Items 2(c)(2), 5(b)(2), and 21(b)(1), Instructions 1(a) and 2(a) to Item 2(c)(2), and Instructions to Item 9(a) of Form N-1A.

152 Items 2(c)(2)(i) and 5(b)(2) of Form N-1A.

153 A rule 482 advertisement is a prospectus under section 10(b) of the 1933 Act, which permits the Commission to adopt rules that provide for a prospectus that "omits in part" or "summarizes" information contained in the statutory prospectus.

154 Investment Company Act Release No. 25575 (May 17, 2002).

formulas in order to prevent misleading performance claims and to permit investors to make meaningful comparisons among fund performance claims in advertisements.[155]

Under rule 482, a mutual fund advertisement that includes performance information is required to include quotations of average annual total return for 1-, 5-, and 10-year periods (or the life of the fund, if shorter) computed according to standardized formulas.[156] Rule 482 also requires all performance data contained in any mutual fund advertisement to be as of the most recent practicable date, provided that any advertisement containing total return quotations is considered to have complied with this requirement if the total return quotations are current to the most recent calendar quarter ended prior to submission of the advertisement for publication.[157] In addition, rule 482 requires mutual fund performance advertisements to disclose that the performance data quoted represents past performance.[158]

In addition, rule 34b-1 under the 1940 Act applies to mutual fund supplemental sales literature, *i.e.*, sales literature that is preceded or accompanied by the statutory prospectus required by Section 10(a) of the 1933 Act.[159] Under rule 34b-1, any performance data included in supplemental sales literature must be accompanied by performance data computed using the standardized formulas for advertising performance under rule 482.

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155 Investment Company Act Release No. 16245 (Feb. 2, 1988).

156 Rule 482(e)(3) and (5)(ii) under the 1933 Act; Item 21(b) of Form N-1A.

157 Rule 482(g) under the 1933 Act.

158 Rule 482(a)(6) under the 1933 Act.

159 17 CFR 270.34b-1. Under section 2(a)(10)(a) of the 1933 Act, a communication sent or given after the effective date of the registration statement is not deemed a "prospectus" if it is proved that prior to or at the same time with such communication a written statutory prospectus was sent or given to the person to whom the communication was made.

Mutual fund distributors and broker-dealers who are NASD members must file all mutual fund sales material with NASD. For example, virtually all mutual fund advertisements on the television and in newspapers and magazines must be filed with NASD. NASD reviews this sales material to ensure that it is accurate, not misleading and provides a sound basis for an investment decision under Commission and NASD advertising rules. Between January 1, 2000 and December 31, 2002 NASD reviewed 189,041 items of sales material about mutual funds. These reviews represented 75% of the advertising reviews completed by NASD.

2. Current Performance Disclosure by Other Entities

Generally speaking, mutual funds disclose as much, if not more, information about their performance than other types of financial products or services, such as closed-end funds, unit investment trusts, investment advisers, and hedge funds. The performance disclosures provided by these entities are summarized below. Although these entities generally are not required to disclose performance data, they are subject to the general antifraud provisions of the federal securities laws, and therefore any performance disclosure must comply with these provisions.[160]

a. Closed-End Funds

Closed-end funds typically do not engage in continuous offerings of their shares, but instead have an initial offering period like operating companies. Thereafter, shares of many closed-end funds are listed and traded on stock exchanges, and investors purchase shares at market price rather than at net asset value from the fund itself, as they do for

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160 *See, e.g.*, section 17(a) of the 1933 Act; section 10(b) of the 1934 Act; section 34(b) of the 1940 Act; section 206 of the Advisers Act.

mutual funds. As a result, closed-end funds, unlike mutual funds, typically do not promote their shares through performance advertisements on an ongoing basis. Closed-end fund performance disclosure has not been standardized in the way that mutual fund performance disclosure has.

Item 4 of Form N-2, the registration form for closed-end funds, requires a closed-end fund to disclose in its prospectus its beginning and ending net asset value, as well as total investment return based on market prices of the common stock, for each of the last ten fiscal years (or the life of the fund, if shorter).[161] Item 23 of Form N-2 requires a closed-end fund to provide this information in annual reports to shareholders for the five most recent fiscal years,[162] and in semi-annual reports to shareholders for the most recent fiscal year and the period of the report.[163] Items 4 and 23 permit, but do not require, a closed-end fund to disclose its total return based on net asset value.[164] Thus, the performance required to be disclosed pursuant to these items is based on changes in the market price of the securities issued by the closed-end fund, rather than on changes in the fund's net asset value.

b. Unit Investment Trusts

Unit investment trusts ("UITs") issue securities, or "units," which represent an undivided interest in a relatively fixed portfolio of securities. UITs are typically sponsored by broker-dealers, which assemble the UIT's portfolio securities, deposit the securities in a trust, and sell the units of the UIT in a public offering. There are two

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[161] Item 4.1.a. and 4.1.g. and Instructions 3 and 13 to Item 4.1 of Form N-2.

[162] Instruction 4.b. to Item 23 of Form N-2.

[163] Instruction 5.b. to Item 23 of Form N-2.

[164] Instruction 14 to Item 4.1. of Form N-2.

general types of UITs: UITs that hold fixed-income securities and UITs that hold equity securities. As contrasted with the mutual fund industry, the UIT industry is relatively small and has been declining in size during the past several years. From year-end 1991 to 2001, UIT assets under management decreased from over $102 billion to less than $50 billion,[165] as contrasted with mutual fund assets of approximately $7.0 trillion at year-end 2001.[166]

UITs are not required to disclose performance information. In marketing UITs that hold fixed-income securities to investors, sponsors typically quote a rate of return that estimates the income that an investor who holds a unit for the expected life of the UIT can anticipate receiving.[167] This method of marketing fixed-income UITs is similar to the manner in which individual bonds are marketed to investors based on a bond's "yield to maturity,"[168] and may be contrasted to mutual fund performance marketing, which is based exclusively on the past performance of the mutual fund. The UIT industry has developed standardized rates of return, and the Commission staff has issued informal guidance regarding how these rates of return should be calculated.[169]

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165 Investment Company Institute, MUTUAL FUND FACT BOOK 102 (41st ed. 2001); Investment Company Institute, Statistics and Research, UIT Statistics, Unit Investment Trust Data (Feb. 2003) <http://www.ici.org/ici_frameset.html> (last visited Apr. 23, 2003). These figures do not include the assets of exchange-traded funds organized as UITs, however. As of year-end 2002, exchange-traded funds organized as UITs had $ 66.3 billion in assets under management.

166 Investment Company Institute, MUTUAL FUND FACT BOOK 37 (42d ed. 2002).

167 Investment Company Act Release No. 21538 (Nov. 22, 1995).

168 Yield to maturity is the discount rate that equates the present value of future promised cash flows from the security to the current market price of the security. William F. Sharpe *et al.*, INVESTMENTS 1028 (5th ed. 1995).

169 *See, e.g., Investment Company Institute*, Division of Investment Management No-Action Letter (pub. avail. Aug. 2, 1995).

The sponsors or broker-dealers of UITs holding equity securities have taken multiple approaches to disclosing performance. Two approaches have been disclosure of the performance of prior portfolios of the UIT and disclosure of data that displays how the investment strategy of the trust would have performed historically.[170]

c. Investment Advisers

The federal securities laws do not require investment advisers to disclose performance data, and the Commission has not adopted standardized disclosure for advisers that elect to advertise their performance. If investment advisers choose to advertise performance information, however, the advertisements must not be false or misleading,[171] and advisers must maintain records necessary to substantiate their performance claims.[172] The staff has identified a number of inappropriate advertising practices, including the following: failing to disclose the effect of material market or economic conditions on the results portrayed; including results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid; [173] failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; suggesting or making claims about the potential for profit without also disclosing the possibility of loss; comparing results to an

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170 *See, e.g.*, Merrill Lynch Defined Asset Funds, Equity Investor Fund Select S&P Industrial Portfolio 1998 Series H, Prospectus at 5, 6 (Dec. 14, 1998) (Securities Act Release No. 64577).

171 Rule 206(4)-1(a)(5) under the Advisers Act. *See, e.g., Allied Investments Co.*, Division of Investment Management No-Action Letter (pub. avail. May 24, 1979) (incomplete or inaccurate presentations by advisers of their past performance may be in violation of section 206 of the Advisers Act or rule 206(4)-1 thereunder).

172 Rule 204-2(a)(16) under the Advisers Act.

173 The staff has provided guidance on certain circumstances where advisers may provide their performance before fee deductions, such as to sophisticated clients and to consultants. *See Investment Company Institute*, Division of Investment Management No-Action Letter (pub. avail. Sept. 23, 1988).

index without disclosing all material facts relevant to the comparison; failing to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed; and failing to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.[174]

The private sector is playing a growing role in establishing performance presentation standards for advisers. In response to requirements of pension funds and other institutional clients, many investment advisers choose to follow performance presentation standards set out by the Association for Investment Management and Research ("AIMR").[175] Although compliance with the AIMR standards is not legally required, the Commission has brought enforcement actions against investment advisers for misrepresenting their compliance with AIMR standards.[176]

d. Hedge Funds

The term "hedge fund" typically refers to private investment pools that are not registered with the Commission. Hedge funds are typically sold by means of referrals and one-on-one meetings rather than through broad advertising as a result of the manner in which they are structured. To avoid regulation under the 1940 Act, hedge funds

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174 *Clover Capital Management, Inc.*, Division of Investment Management No-Action Letter (pub. avail. Oct. 28, 1986).

175 AIMR is a nonprofit organization that seeks to educate and examine investment managers and analysts and to sustain standards of professional conduct. Association for Investment Management and Research, *AIMR Description* <http://www.aimr.com/support/about/> (last modified Mar. 28, 2003).

176 *See In the Matter of Stan D. Kiefer & Assoc. and Stanley D. Kiefer*, Investment Advisers Act Release No. 2023 (Mar. 22, 2002); *In the Matter of Schield Management Company*, Investment Advisers Act Release Nos. 1871 (May 31, 2000) and 1824 (Sept. 9, 1999) ; *In the Matter of Engebretson Capital Management, Inc. and Lester W. Engebretson*, Investment Advisers Act Release No. 1825 (Sept. 13, 1999).

typically rely on two statutory exceptions from the definition of "investment company" in the 1940 Act. Section 3(c)(1) of the 1940 Act excepts any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which is not and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the 1940 Act excepts any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers,"[177] and which is not making and does not at that time propose to make a public offering of such securities. To qualify for the exceptions under these sections, and to qualify for an exemption from the registration requirements of the 1933 Act, hedge funds conduct private offerings of their shares pursuant to section 4(2) of the 1933 Act or Regulation D. To qualify as a private offering, there can be no general solicitation of the offering and hedge funds therefore do not utilize broad advertising.

Hedge funds and their advisers are not required by statute or Commission rule to disclose performance information. As in the case of other entities discussed above, however, hedge funds are subject to the general antifraud provisions of the federal securities laws. In addition, all hedge fund advisers are subject to the antifraud provisions of section 206 of the Advisers Act. The Commission has brought enforcement actions in the hedge fund area involving the reporting of false or misleading performance information.[178]

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[177] Section 2(a)(51) of the 1940 Act defines the term "qualified purchaser," which generally includes natural persons who own at least $5 million in investments, and any person, acting for its own account or the accounts of other qualified persons, who owns and invests on a discretionary basis no less than $25 million in investments.

[178] *See, e.g., SEC v. Beacon Hill Asset Management, LLC, et al.*, Litigation Release No. 17841 (Nov. 15, 2002); *SEC v. House Asset Management, LLC, et al.*, Litigation Release No. 17583 (June 24, 2002); *In the Matter of Edward Thomas Jung and E. Thomas Jung Partners, Ltd.*, Investment

B. Concerns Regarding Mutual Fund Performance Advertising

Although there are many factors other than performance that an investor should consider in deciding whether to invest in a particular fund, many investors consider performance to be one of the most significant factors when selecting or evaluating mutual funds. Eager to attract new investors, many funds have, from time to time, engaged in advertising campaigns focusing on past performance. As a result of advertising that focused on extraordinary fund performance during 1999-2000, there have been increasing concerns that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors. The Commission has expressed particular concerns about the following practices.[179]

1. Unusual Circumstances That Contribute to Fund Performance

Mutual fund performance advertisements may be materially misleading when they fail to adequately disclose that unusual circumstances contributed to the fund's advertised performance. In each of two enforcement actions, an investment adviser marketed a relatively small fund's unusually high return without disclosing that a significant percentage of the return was attributable to investments in securities issued in initial public offerings.[180] Given the substantial growth in the funds' assets as a result of sales of the funds' shares to the public, to the point where the funds were no longer experiencing, by investing in additional initial public offerings, substantially similar

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Advisers Act Release No. 2025 (March 28, 2002); *SEC v. Michael W. Berger, et al.*, Litigation Release No. 17230 (Nov. 13, 2001).

179 Investment Company Act Release No. 25575 (May 17, 2002).

180 *In the Matter of The Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 (May 10, 2000); *In the Matter of Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Investment Advisers Act Release No. 1819 (Sept. 8, 1999).

performance as they previously experienced, the Commission found that the failure to disclose the contribution to the funds' performance of the initial public offering investments was materially misleading. Along similar lines, the Commission also recently brought an enforcement action based on a fund's failure to disclose in its MDFP the material impact that investments in initial public offerings had on its performance during its previous fiscal year.[181]

2. Currentness of Performance Information

As noted above, rule 482 requires all performance data contained in any mutual fund advertisement to be as of the most recent practicable date, provided that any advertisement containing total return quotations is considered to have complied with this requirement if the total return quotations are current to the most recent calendar quarter ended prior to submission of the advertisement for publication. As a result, total return quotations may be up to three months old at the time that an advertisement is submitted for publication. In some cases, an advertisement that complies with these requirements of rule 482 may nonetheless confuse, or even mislead, investors regarding the fund's current performance, particularly when the fund's performance has declined significantly after the period reflected in an advertisement.

The Commission questioned this practice in an enforcement action where it found that the failure to disclose the large impact of initial public offerings on a fund's performance during the fund's first fiscal year made the fund's performance

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[181] *In the Matter of Davis Selected Advisers-NY, Inc.*, Investment Advisers Act Release No. 2055 (Sept. 4, 2002).

advertisements materially false and misleading.[182] One of the significant facts in that case was that the fund's advertisements publicized extraordinary first-year returns at a time when the fund's more current returns had become negative.[183] While the fund advertisements complied with rule 482, the Commission noted that rule 482 advertisements remain "subject to the general antifraud provisions of the federal securities laws and must not be false or misleading."[184] In another recent enforcement action, the Commission determined that a fund's advertisements were materially misleading where they did not comply with the requirement of rule 482 that historical performance information be current to the most recent calendar quarter ended prior to the submission of the advertisement for publication. As of December 2000, the fund's website advertised a total return of 422% from inception to March 10, 2000, but the fund's total returns since inception had declined to 191% by September 30, 2000, the end of the most recent quarter.[185]

3. Selective Use of Performance Figures

A mutual fund advertisement may be materially misleading when it showcases a fund's performance for a certain time period without providing sufficient information to permit an investor to evaluate the significance of the performance data. As noted above, rule 482, by its terms, permits a mutual fund to advertise its performance for any period

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182 *In the Matter of The Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 (May 10, 2000).

183 *Id.* (81.92% total return for the one-year period ended September 30, 1996, publicized in October through December 1996 when total returns for the three-month periods ended August 30, September 30, October 31, November 29, and December 31, 1996, were negative 17.03%, 7.71%, 7.79%, 16.25%, and 13.37%, respectively).

184 *Id.* at n.16.

185 *In the Matter of The Thurlow Funds, Inc., Thurlow Capital Management, Inc., and Thomas F. Thurlow*, Investment Advisers Act Release No. 2065 (Oct. 2, 2002).

so long as it is accompanied by performance for 1-, 5-, and 10-year periods (or, if shorter, for the life of the fund) current to the most recent quarter. Nonetheless, if a fund selectively advertises performance that is unusually high and not representative of the fund's historical performance, investors may potentially be misled. Selectively advertising performance as of a particular date may be particularly problematic where performance has declined after the chosen date but before the advertisement is submitted for publication.

C. Commission Initiatives to Address Mutual Fund Performance Advertising Concerns

The Commission has taken steps to address these concerns, including proposing rules regarding fund advertisements and promoting investor education.

1. Proposed Rules

In May 2002, the Commission proposed amendments to its mutual fund advertising rules that would require enhanced disclosure in fund advertisements and are designed to encourage advertisements that convey balanced information to prospective investors, particularly with respect to past performance.[186] These proposed amendments would re-emphasize that fund advertisements are subject to the antifraud provisions of the federal securities laws, require that funds that advertise performance information make available to investors total returns that are current to the most recent month-end, and require that fund advertisements include improved explanatory information and present this information more prominently.

First, the Commission's proposals would re-emphasize that fund advertisements are subject to the antifraud provisions of the federal securities laws. In order to

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[186] Investment Company Act Release No. 25575 (May 17, 2002).

emphasize this principle, the proposals would add a note to rule 482 that would state that an advertisement that complies with rule 482 does not relieve the fund, underwriter, or dealer of the obligation to ensure that the advertisement is not false or misleading and would add a similar note to rule 34b-1 under the 1940 Act with respect to supplemental sales literature. In addition, the Commission's proposals would modify the language of rule 156 under the 1933 Act, which provides guidance on the types of information that could be misleading in fund sales literature, to state more explicitly that portrayals of past income, gain, or growth of assets may be misleading where the portrayals omit explanations, qualifications, limitations, or other statements necessary or appropriate to make these portrayals of past performance not misleading.[187] This language is intended to address the Commission's concerns with fund performance advertisements that do not provide adequate disclosure (i) of unusual circumstances that have contributed to fund performance; (ii) that more current performance may be lower than advertised performance; or (iii) that would permit an investor to evaluate the significance of performance that is based on selective dates.

Second, in order to address concerns about the currentness of performance information, the Commission's proposals would add an additional condition for a fund advertisement to be considered to have complied with the requirement of rule 482 that performance be as of the most recent practicable date.[188] Specifically, total return quotations current to the most recent month-end would have to be provided at a toll-free (or collect) telephone number. As a result, investors who are provided advertisements

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[187] Rule 156 applies to all fund advertisements and supplemental sales literature.

[188] Investment Company Act Release No. 25575 (May 17, 2002).

touting a fund's performance would have ready access to performance that is current to the most recent month-end and would not be forced to rely on performance data that may be more than three months old at the time of use by the investor.

Third, the Commission's proposals include changes to the explanatory information that is required to accompany performance advertisements in order to help investors understand the limitations of past performance data and enhance the ability of investors to obtain updated performance information.[189] The Commission's proposals would require funds to include the following information in rule 482 advertisements that include past performance figures: (i) a statement that past performance does not guarantee future results, (ii) a statement that current performance may be lower or higher than the performance data quoted, and (iii) a toll-free (or collect) telephone number and, if available, website where an investor may obtain performance data current to the most recent month-end. In addition, the proposals would require a fund to note in its rule 482 advertisements that information about charges and expenses is contained in the fund's prospectus. This requirement should help to address concerns that advertisements highlighting fund performance may cause investors to overlook the importance of fund costs.

Fourth, the Commission's proposals would require funds to present certain information in their rule 482 advertisements more prominently.[190] For example, the proposals would require that the narrative disclosures that specifically relate to fund performance be presented in close proximity to the performance data in both print and

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189 *Id.*

190 *Id.*

radio and television advertisements. This proximity requirement is intended to help investors more readily find information necessary to understand and evaluate the performance data shown.

Overall, the proposed amendments to the fund advertising rules are an integral part of the Commission's continuing efforts to raise the bar for fund performance advertising so that investors are informed, and not misled, by that advertising. We expect shortly to recommend to the Commission adoption of amendments to the advertising rules.

2. Investor Education

In addition to rulemaking initiatives, the Commission has engaged in education efforts to caution investors against the dangers of overemphasizing fund performance in investment decisions. For example, the Commission published an investor alert on its website that explains to investors the importance of looking beyond past performance in making investment decisions.[191] The investor alert emphasizes that the long-term success (or failure) of a mutual fund investment also depends on factors such as the fund's sales charges, fees, and expenses; the taxes investors may have to pay when they receive distributions; the age and size of the fund; the fund's risks and volatility; and recent changes in the fund's operations.

NASD also has published notices and other reminders to members concerning the application of the advertising rules to mutual fund performance. In recent years, there have been two notices that addressed the overstatement of mutual fund performance. An article in the Summer 1999 edition of the NASD Regulatory and Compliance Alert

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[191] *See* Securities and Exchange Commission, *Mutual Fund Investing: Look at More Than a Fund's Past Performance* <*at* http://www.sec.gov/investor/pubs/mfperform.htm> (last modified Jan. 24, 2000).

directed member firms to amend their historical performance communications if the advertised fund has experienced abrupt negative performance since the advertisement was developed. This requirement forces members to include information beyond the minimum standards of performance disclosure. The second notice was included in NASD Notice To Members 00-21 (April 2000). This notice reminded broker-dealers that if they prominently advertise their extraordinarily high mutual fund performance, they also must explain what conditions led to that performance and the risks that the advertised mutual fund will not achieve similar performance in the future.

D. Complex-Wide Performance Disclosure

Some have suggested that fund families be required to disclose the average performance of all their funds, including the performance of funds no longer in existence.[192] The Commission's regulations neither require funds to disclose their performance on a complex-wide basis, nor do they specifically prohibit funds from doing so.[193] Supporters of this requirement have argued that this disclosure would provide investors with a more accurate picture of the performance achieved by fund families because it would include the aggregate performance data of all funds managed by the family and not only those that are currently in existence. These supporters argue that, in marketing a new fund, fund families may initially create a number of funds with the same strategy, and after a year will advertise the performance of the most successful fund and

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[192] *Mutual Fund Industry Practices and their Effect on Individual Investors*: Hearings Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Comm., 108th Congress (2003) (testimony of Gary Gensler).

[193] Most fund marketing materials are required to be filed with and reviewed by NASDR, the independent subsidiary of the NASD, a self-regulatory organization authorized by the Commission under the 1934 Act. NASDR takes the position that aggregated performance must not be used with the general public. *See* "Blended Fund Family Performance Concerns NASD Regulation, Inc.," NASD Regulatory and Compliance Alert Articles, Oct. 1996.

will liquidate or merge the others. Arguably, requiring disclosure of the performance of an entire fund family would illuminate this survivorship bias[194] and would benefit investors who are trying to decide among different mutual fund families.[195]

This suggestion presents several practical issues. For example, as in the case of individual mutual funds, the past performance of a fund family would not necessarily be indicative of the performance that it would achieve in the future. In addition, the investment objectives, strategies, and risks of funds managed by fund families vary widely and therefore the value of comparisons among families could be limited. Thus, to facilitate useful comparisons among fund families, it might be necessary to disclose performance by fund category (*e.g.*, high-yield bond funds, growth stock funds) within each fund family. Placing mutual funds into defined categories, however, could present complex issues because of the numerous potential combinations and definitions of mutual fund objectives and strategies, as well as the potentially subjective nature of any determination made by a fund family in categorizing its funds.

We also note that some fund groups prepare promotional materials that list the individual returns of all of the funds within a complex. The exclusion of the performance of funds that have been liquidated or merged out of existence could suggest that the overall performance of all of the funds in the same complex during the relevant period was better than it actually was if the performance of the excluded funds was sub-standard. We have not specifically studied the effect, if any, that incubator funds and

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[194] The term "survivor bias" as it relates to complex-wide performance would be the effect of excluding, from a presentation of the complex-wide fund performance, the performance of funds that have liquidated or merged out of existence during the relevant period.

[195] *Mutual Fund Industry Practices and their Effect on Individual Investors*: Hearings Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Comm., 108th Congress (2003) (testimony of Gary Gensler).

survivorship bias may have on investor perceptions. Anecdotal evidence suggests that many investors choose to invest in a fund based on that fund's past performance and not on the performance of all the funds in the same complex.

Because the NASD does not permit the use of aggregated fund family performance in advertising and sales material, any survivorship bias would be a product of how this information is reported by third party fund tracking entities.

E. Incubator Funds

1. General Characteristics of Incubator Funds

An incubator fund is an investment vehicle that an investment adviser establishes to, among other things, test investment techniques and create a performance record. Initially, an incubator fund is lightly capitalized and typically is not marketed to the public. The investors in the incubator fund may be, for instance, insiders of the investment adviser and/or certain of the adviser's clients. If the incubator fund achieves strong performance, the investment adviser typically will market the fund to the public. If the marketing is successful, the fund's assets will increase and, as a result, the investment advisory fee revenues to the investment adviser also will increase.

An investment adviser may establish several incubator funds to test several different investment techniques. After waiting a period of time (an incubation period), the investment adviser may select the incubator funds with the best performance and market them to the public, using the funds' performance as a marketing tool. The investment adviser typically liquidates the other incubator funds.

2. Regulation of Incubator Funds

During its incubation period, an incubator fund may be structured and operated in reliance on exceptions from regulation as an investment company under the 1940 Act and registration of securities offerings under the 1933 Act.[196] The Commission does not regulate those incubator funds, although the antifraud provisions of the federal securities laws apply to their operation and to the offer and sale of their shares. Some incubator funds may register with the Commission as investment companies, but refrain from marketing themselves to the public during their incubation period. The Commission regulates those funds as investment companies, and they must comply with all of the provisions of the 1940 Act. Regardless of whether or not an incubator fund is registered with the Commission, the use of the incubator fund's prior performance to market the fund is subject to the antifraud provisions of the federal securities laws.

3. Steering Hot IPOs

The term "hot IPOs" generally refers to initial public offerings of securities that are in great demand, of limited availability, and for which trading is expected to occur in the immediate aftermarket at a significant premium to the initial offering price ("hot IPO securities"). Hot IPO securities are valuable investment opportunities, of limited quantity and temporary duration. An investment adviser must allocate hot IPO securities among its clients in a manner that is consistent with the investment adviser's fiduciary duties to its clients and with its disclosures to its clients. An investment adviser could defraud its clients by preferring incubator funds in the allocation of hot IPO securities. The

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196 *See* sections 3(c)(1) and 3(c)(7) of the 1940 Act; section 4(2) of the 1933 Act and regulation D thereunder.

Commission has instituted several enforcement actions against investment advisers for fraudulently allocating hot IPO securities.[197]

During the time that an incubator fund is lightly capitalized, its performance may be significantly affected by the positive returns of a few of its portfolio securities, such as hot IPO securities. After the incubation period, however, when an incubator fund is marketed to the public and has an increased asset base (the "post-incubation period"), the fund likely may not continue to experience, by investing in hot IPO securities, substantially similar performance. For instance, during the post-incubation period, hot IPO securities may not be available to the investment adviser in sufficient quantities to maintain the positive results that the fund experienced when its asset base was smaller.

4. Using Incubator Fund Performance as a Marketing Tool, and Specific Disclosures Regarding Incubator Funds

Incubator funds may typically use their performance information as a marketing tool to raise capital from the public. The marketing of incubator funds, however, is subject to the antifraud provisions of the federal securities laws.[198] Whether incubator fund performance information is presented in a false or misleading manner depends on all of the facts and circumstances relating to its presentation.

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[197] *See, e.g., In the Matter of F.W. Thompson Co., Ltd. and Frederick W. Thompson*, Investment Advisers Act Release No. 1895 (Sept. 7, 2000); *In the Matter of McKenzie Walker Investment Management, Inc. and Richard C. McKenzie, Jr.*, Investment Advisers Act Release No. 1571 (July 16, 1996); *In the Matter of Account Management Corporation, Peter De Roetth and Richard C. Albright*, Investment Advisers Act Release No. 1529 (Sept. 29, 1995).

[198] *See* section 34(b) of the 1940 Act and rule 34b-1 thereunder, section 10(b) of the 1934 Act and rule 10b-5 thereunder, section 17(a) of the 1933 Act and section 206 of the Advisers Act. *See also* rule 156 under the 1933 Act.

The Commission has instituted enforcement actions against investment advisers of incubator funds for their use of misleading incubator fund performance information.[199] In those actions, the incubator funds and their investment advisers marketed the funds and their performance to the public without disclosing that (a) a substantial portion of the funds' performance was attributable to investing in hot IPO securities and, (b) given the growth in the funds' assets, it was questionable whether the funds could continue to experience, by investing in hot IPO securities, substantially similar performance as previously experienced.

In addition, if an investment adviser establishes several incubator funds to generate performance track records, but selects only the best performing incubator fund to market to the public, it may be misleading for the fund to present its performance information without also clearly disclosing the performance information of the other, less successful incubator funds.[200]

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199 *See, e.g., In the Matter of Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Investment Advisers Act Release No. 1819 and Investment Company Act Release No. 23996 (Sept. 8, 1999) (http://www.sec.gov/litigation/admin/ia-1819.htm); *In the Matter of Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 and Investment Company Act Release No. 24450 (May 10, 2000) (http://www.sec.gov/litigation/admin/33-7857.htm). *See also In the Matter of Davis Selected Advisers-NY, Inc.*, Investment Advisers Act Release No. 2055 and Investment Company Act Release No. 25727 (Sept. 4, 2002) (http://www.sec.gov/litigation/admin/ia-2055.htm).

200 *See generally* Stern School of Business (pub. avail. Feb. 3, 1997).

United States General Accounting Office

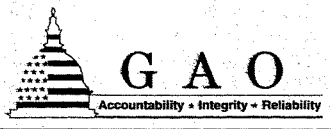
GAO

Report to Congressional Requesters

June 2003

MUTUAL FUNDS

Greater Transparency Needed in Disclosures to Investors



GAO-03-763

GAO
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Highlights

Highlights of GAO-03-763, a report to the Chairman, House Committee on Financial Services and Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House Committee on Financial Services

Why GAO Did This Study

The fees and other costs that investors pay as part of owning mutual fund shares can significantly affect their investment returns. As a result, questions have been raised as to whether the disclosures of mutual fund fees and other practices are sufficiently transparent. GAO reviewed (1) how mutual funds disclose their fees and related trading costs and options for improving these disclosures, (2) changes in how mutual funds pay for the sale of fund shares and how the changes in these practices are affecting investors, and (3) the benefits of and the concerns over mutual funds' use of soft dollars.

What GAO Recommends

GAO recommends that SEC consider the benefits of requiring additional disclosure relating to mutual fund fees and evaluate ways to provide more information that investors could use to evaluate the conflicts of interest arising from payments funds make to broker-dealers and fund advisers' use of soft dollars. SEC agreed with the contents of this report and indicated that it will consider the recommendations in this report carefully in determining how best to inform investors about the importance of fees. It also indicated that it will be considering ways to expand disclosure and improve other regulatory aspects of fund distribution and soft dollar practices.

www.gao.gov/cgi-bin/getrpt?GAO-03-763.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

June 2003

MUTUAL FUNDS

Greater Transparency Needed in Disclosures to Investors

What GAO Found

Although mutual funds disclose considerable information about their costs to investors, the amount of fees and expenses that each investor specifically pays on their mutual fund shares are currently disclosed as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. SEC staff has proposed requiring funds to disclose additional information that could be used to compare fees across funds. However, other disclosures could also increase the transparency of these fees, such as by providing existing investors with the specific dollar amounts of the expenses paid or by placing fee-related disclosures in the quarterly account statements that investors receive. Although some of these additional disclosures could be costly and data on their benefits to investors was not generally available, less costly alternatives exist that could increase the transparency and investor awareness of mutual funds fees that make consideration of additional fee disclosures worthwhile.

Changes in how mutual funds pay intermediaries to sell fund shares have benefited investors but have also raised concerns. Since 1980, mutual funds, under SEC Rule 12b-1 have been allowed to use fund assets to pay for certain marketing expenses. Since then, funds have developed ways to apply Rule 12b-1 fees to provide investors greater flexibility in choosing how to pay for the services of individual financial professionals that advise them on fund purchases. Another increasingly common marketing practice called revenue sharing involves fund investment advisers making additional payments to the broker-dealers that distribute their funds' shares. However, receiving these payments can limit fund choices offered to investors and conflict with the broker-dealer's obligation to recommend the most suitable funds. Regulators acknowledged that the current disclosure regulations might not always result in complete information about these payments being disclosed to investors.

Under soft dollar arrangements, mutual fund investment advisers use part of the brokerage commissions they pay to broker-dealers for executing trades to obtain research and other services. Although industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and provide other benefits, these arrangements also can create incentives for investment advisers to trade excessively to obtain more soft dollar services, thereby increasing fund shareholders' costs. SEC staff has recommended various changes that would increase transparency by expanding advisers' disclosure of their use of soft dollars. By acting on the staff's recommendations SEC would provide fund investors and directors with needed information about how their funds' advisers are using soft dollars.

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Abbreviations

ECN	electronic communications network
FSA	Financial Services Authority
ICI	Investment Company Institute
NAV	net asset value
NYSE	New York Stock Exchange
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

United States General Accounting Office
Washington, D.C. 20548

June 9, 2003

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
House of Representatives

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

Millions of U.S. households have invested in mutual funds with assets exceeding $6 trillion by year-end 2002. The fees and other costs that these investors pay as part of owning mutual fund shares can significantly affect their investment returns. As a result, questions have been raised as to whether the disclosures of mutual fund fees and others costs, including the trading costs that mutual funds incur when they buy or sell securities, are sufficiently transparent. Some have also questioned the effectiveness of mutual fund boards of directors in protecting shareholder interests and overseeing the fees funds pay to investment advisers. Many mutual funds market their shares to investors through broker-dealers or other financial professionals, such as financial planners. However, concerns have been raised over how the payments that fund advisers make to the entities that sell fund shares affect investors. When mutual fund investment advisers use broker-dealers to buy or sell securities for the fund, they generally pay these broker-dealers a commission for executing the trade. Under arrangements known as soft dollars, part of these brokerage commissions may pay for research and brokerage services that the executing broker-dealer or third parties provide to the fund's investment adviser. Because the amount of brokerage commissions a fund adviser pays directly reduces the ultimate return earned by investors in its funds, questions exist over the extent to which investors benefit from or are harmed by these soft dollar arrangements.

To address these concerns, this report responds to your January 14, 2003, request that we review issues relating to the transparency and appropriateness of certain fees and practices among mutual funds. Specifically, our objectives were to review (1) how mutual funds and their advisers disclose their fees and related trading costs and options for improving these disclosures, (2) mutual fund directors' role in overseeing fees and various proposals for improving their effectiveness, (3) changes in

how mutual funds and their advisers pay for the sale of fund shares and how the changes in these practices are affecting investors, and (4) the benefits of and the concerns over mutual funds' use of soft dollars and options for addressing these concerns.

To determine how mutual funds currently disclose their fees and other costs, we reviewed regulatory requirements and disclosures made by a selection of mutual funds. We discussed various proposals to increase disclosure with staff from regulators that oversee mutual funds, including the Securities and Exchange Commission (SEC) and NASD, and staff from mutual fund companies, industry groups and researchers. We also interviewed officials of 10 mutual fund companies that sell their funds through broker-dealers and a judgmental sample of 15 certified financial planners. To identify the activities that mutual fund directors perform, we reviewed federal laws and regulations, interviewed staff from an association representing independent directors and used a structured questionnaire to interview a judgmental sample of six independent director members of this association. To determine how mutual funds and their advisers pay for distribution, we interviewed various regulatory staff, industry associations and researchers, fund companies, and two broker-dealers that sell fund shares. We also reviewed and analyzed various documents and studies of mutual fund distribution practices. To describe the benefits and potential conflicts of interest raised by mutual funds' use of soft dollars, we spoke with SEC, NASD, and regulators in the United Kingdom and reviewed studies by regulators and industry experts on soft dollar arrangements. We conducted our work in accordance with generally accepted government auditing standards in Boston, MA; Kansas City, MO; Los Angeles and San Francisco, CA; New York, NY; and Washington, DC from February to June 2003. Our scope and methodology is described in detail in appendix I.

Results in Brief

Although mutual funds already disclose considerable information about the fees they charge, regulators and others have proposed additional disclosures that could increase the transparency and investor awareness of the costs of investing in mutual funds. Currently, mutual funds disclose information about the fees and expenses that each investor specifically pays on their mutual fund shares as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. Mutual funds also incur brokerage commissions and other trading costs when they buy or sell securities, but these costs are not prominently disclosed to investors. To provide more information about the

fees investors pay, SEC has proposed requiring mutual funds to disclose additional fee-related information, but these would not provide investors with the specific dollar amount of fees paid on their shares as others have proposed, nor would these disclosures be provided in the document generally considered to be of the most interest to investors—the quarterly statement that shows the number and value of an investor's mutual fund shares. Although continuing to consider the need for additional disclosures, SEC staff and industry participants noted that data on the extent to which additional fee information would benefit investors is generally lacking. However, continued consideration of the costs and benefits of providing additional disclosure appears worthwhile because some alternatives for providing fee information to mutual fund investors in quarterly statement could provide some benefit and may cost very little. Some industry participants have also called for more disclosure of information about the brokerage commissions and other costs that mutual funds incur when trading, but standard methodologies for determining some of these amounts do not exist and regulators and others raised concerns that such disclosures could be misleading.

Mutual funds also have boards of directors that are tasked with reviewing the fees that fund investors are charged, but some industry participants questioned whether directors have been effective in overseeing these fees. In general, SEC rules require mutual fund boards to have a majority of independent directors, who are individuals not employed by or affiliated with the fund's investment adviser. Among their many duties, these directors are specifically tasked with overseeing the fees their funds charge. However, some industry observers say that the process that fund directors are required to follow under the law fails to produce sufficient actions to minimize fees. To further reduce fees, some have suggested that fund directors should be required to seek competitive bids from other investment advisers. However, industry participants indicated that this may not result in lower costs and fees for investors and noted that directors seek to lower fund fees in other ways, such as by requiring the investment adviser to charge progressively lower fees as the assets of the fund grow. Regulators and industry bodies have also recommended various changes to the composition and structure of mutual fund boards as a means of increasing directors' effectiveness that many funds have already adopted. Many reforms being proposed as a result of the recent corporate scandals, such as Enron, also seek to enhance board of director oversight of public companies. Such reforms could serve to further improve corporate governance of mutual funds, but industry participants report that, although

not all of these proposed practices are currently required for mutual funds, most fund boards are already following many of them.

Changes in the ways that investors pay for mutual fund shares have produced benefits for investors but also raise concerns over their transparency. In 1980, an SEC rule was adopted to allow mutual funds to begin using fund assets to pay the distribution expenses, which included marketing expenses and compensation for the financial professionals who sell fund shares. Although rule 12b-1 was originally envisioned as providing funds a temporary means of increasing fund assets, the fees charged under this rule have instead evolved into an alternative way for investors to pay for the services of broker-dealers and other financial intermediaries from whom they purchase fund shares. Concerns exist over whether funds with 12b-1 fees are more costly to investors and whether current disclosures are sufficiently transparent to allow investors to determine the extent to which their particular broker-dealer representative or other financial professionals they use receive these payments. In a December 2000 report, SEC staff recommended that rule 12b-1 be modified to reflect changes in how funds are being marketed, but SEC has yet to develop a proposal to amend the requirements relating to this rule. Another distribution practice—called revenue sharing—that has become increasingly common involves investment advisers making additional payments to broker-dealers that distribute fund shares. Although little data on the extent of these payments exists, industry researchers say that such payments have been increasing and have raised concerns about how these payments may affect the overall expenses charged to fund investors. Concerns also exist over whether broker-dealers receiving payments to promote certain funds creates a conflict of interest for their sales representatives, who are responsible for recommending only investments that are suitable to their clients' objectives and financial situation, or whether this also limits the choices that investors are offered. Under current disclosure requirements, an investor might not be explicitly told that the adviser of the fund their broker-dealer is recommending made payments to that broker-dealer, and some industry participants have called for additional disclosures to address these potential conflicts.

Soft dollar arrangements allow investment advisers of mutual funds to use part of the brokerage commissions paid to broker-dealers that execute trades on the fund's behalf to obtain research and brokerage services that can potentially benefit fund investors but could increase the costs borne by their funds. Industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and

can also be used to reduce fund expenses. However, others were concerned that these arrangements can create conflicts of interest between investment advisers and investors that could increase investors' costs. For example, fund advisers might use some broker-dealers solely because of the soft dollar services they offer rather than because of their ability to execute the fund's trades in the most advantageous way. Concerns were raised that investment advisers might trade excessively to obtain additional services using soft dollars, which would increase fund investors' costs. In a series of regulatory examinations performed in 1998, SEC staff found examples of problems relating to investment advisers' use of soft dollars, although far fewer problems were attributable to the advisers for mutual funds. In response, the SEC staff issued a report that included various proposals to address the potential conflicts created by these arrangements, including recommending that investment advisers keep better records and disclose more information about their use of soft dollars. Although this could increase the transparency of these arrangements and help fund directors and investors better evaluate their fund advisers' use of soft dollars, SEC has yet to take action on these proposed recommendations.

This report contains recommendations to SEC designed to increase the transparency of mutual fund fees and of certain distribution and trading practices. Since both the extensiveness and the placement of mutual fund disclosures can affect their transparency and how effectively they increase investor awareness of the costs of investing in mutual funds, we recommend that SEC consider the benefits of additional disclosure relating to mutual fund fees, including requiring the account statements that mutual fund investors receive provide more information about the fees being paid. We also recommend that SEC consider developing disclosure requirements about revenue sharing arrangements so investors may be better able to evaluate potential conflicts arising from revenue sharing payments. Finally, we also recommend that SEC evaluate ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar examinations report.

We obtained comments from SEC and ICI, who generally agreed with the contents of this report. The letter from the SEC staff indicated that as part of their responsibilities in regulating mutual funds, they will consider the recommendations in this report very carefully in determining how best to inform investors about the importance of fees. The letter from the ICI staff noted that our report presented a generally balanced and well-informed

discussion of mutual fund regulatory requirements. However, the ICI staff were concerned over how we compare the disclosures made by mutual fund fees to those made by other financial products, and noted that mutual fund fee disclosures, which in some ways exceed the information disclosed by other products, allow individuals to make much more informed and accurate decisions about the costs of their funds than do the disclosures made by other financial service firms. We agree with ICI that mutual funds are required to make considerable disclosures that are useful to investors for comparing the level of fees across funds. However, we also believe that supplementing the existing mutual fund disclosures with additional information, particularly in the account statements that provide investors with the exact number and value of their mutual fund shares, could also prove beneficial for increasing awareness of fees and prompting additional fee-based competition among funds.

Background

Mutual funds are distinct legal entities owned by the shareholders of the fund. Each fund contracts separately with an investment adviser, who provides portfolio selection and administrative services to the fund. The costs of operating a mutual fund are accrued daily and periodically deducted from the fund's assets. These costs include the fee paid to the fund's investment adviser for managing the fund and the expenses associated with operating the fund, such as the costs for accounting and preparing fund documents. Each mutual fund has a board of directors, which is responsible for reviewing fund operations and overseeing the interests of the fund's shareholders, including monitoring for conflicts of interest between the fund and its adviser.[1]

[1]Although the Investment Company Act of 1940, which regulates mutual fund operations, does not dictate a specific form of organization for mutual funds, most funds are organized either as corporations governed by a board of directors or as business trusts governed by trustees. When establishing requirements relating to the officials overseeing a fund, the act uses the term "directors" to refer to such persons, and this report will also follow that convention.

The incredible growth of mutual fund assets and in the number of investors that hold funds has raised concerns within Congress and elsewhere over the fees funds charge investors. In a report issued in June 2000, we found that the average fees charged by 77 of the largest stock and bond mutual funds had declined between 1990 and 1998.[2] In our report, we also concluded that although many mutual funds exist that compete for investor dollars, they conduct this competition primarily on the basis of their performance rather than on the basis of the price of their service, that is, the fees they charge. In updating the results of the analysis from our June 2000 report for a hearing on mutual funds in March 2003, we found that the average fees for this group of funds had increased slightly, due in part to some funds paying higher management fees to their investment advisers because of the effect of performance fees.[3]

Mutual funds are sold through a variety of distribution channels. For instance, investors can buy them directly by telephone or mail or they can be sold by a sales staff employed by the adviser or by third parties, such as broker-dealer account representatives. To compensate financial professionals not affiliated with the adviser for distributing or selling a fund's shares, funds may levy a sales charge which is based on a percentage of the amount being invested—called a load—that the investor can either pay at the time the investment is made (a front-end load) or later when selling or redeeming the fund shares (a back-end load).[4] Many funds that use broker-dealers or other financial professionals to sell their fund shares may also charge investors ongoing fees, called 12b-1 fees that are used by funds to pay these distributors for recommending the fund or for servicing the investor's account after purchases have been made. Mutual fund shares are also available for investors to purchase through mutual fund supermarkets. These are offered by broker-dealers, including those affiliated with a fund adviser, that allow their customers to purchase and redeem the shares of mutual funds from a wide range of fund companies through their accounts at the broker-dealer operating the supermarket.

[2]U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000).

[3]U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003).

[4]Some funds charge what is known as a contingent deferred sales load, which is a charge that is a percent of the amount invested that declines the longer the investment is held and usually becomes zero after a certain period.

SEC is the federal regulatory agency with responsibility for overseeing the U.S. securities markets and protecting investors. Various self-regulatory organizations (SRO) also oversee the activities of securities industry participants. NASD is the SRO with primary responsibility for overseeing broker-dealers. SEC is responsible for oversight of the SROs and it also oversees and regulates the investment management industry.

Additional Disclosure of Mutual Fund Costs May Benefit Investors

Various alternatives with different advantages and disadvantages exist that could increase the amount of information that investors are provided about mutual fund fees and other costs. Currently, mutual funds disclose information about their fees as percentages of their assets whereas most other financial services disclose their costs in dollar terms. SEC and others have proposed various alternatives to disclose more information about mutual fund fees, but industry participants noted these alternatives could also involve costs to implement and data on the benefits associated with additional disclosures is not generally available. Mutual funds also incur brokerage commissions and other costs when they buy or sell securities and currently these costs are not routinely or explicitly disclosed to investors and there have been increasing calls for disclosure as well as debate on the benefits and costs of added transparency.

Unlike Other Financial Products, Mutual Funds Do Not Disclose the Actual Dollar Amount of Fees Paid by Individual Investors

Mutual funds provide various disclosures to their shareholders about fees. Presently, all funds must provide investors with disclosures about the fund in a written prospectus that must be provided to investors when they first purchase shares. SEC rules require that the prospectus include a fee table containing information about the sales charges, operating expenses, and other fees that investors pay as part of investing in the fund. Specifically, the table that mutual funds must provide presents (1) charges paid directly by shareholders out of their investment such as front or back-end sales loads and (2) recurring charges deducted from fund assets such as management fees, distribution fees, and other expenses charged to shareholder accounts. The fees deducted from the fund's assets on an ongoing basis are reported to investors as a percentage of fund assets and are called the fund's operating expense ratio. The fee table also contains a hypothetical example that shows the estimated dollar amount of expenses that an investor could expect to pay on a $10,000 investment if the investor received a 5-percent annual return and remained in the fund for 1, 3, 5, and 10 years. The examples do not reflect costs incurred as a result of the

fund's trading activity, including brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf.

Unlike many other financial products, mutual funds do not provide the exact dollar amounts of fees that individual investors pay while they hold the investment. Although mutual funds provide information about their fees in percentage terms and in dollar terms using hypothetical examples, they do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. In contrast, most other financial products and services do provide specific dollar disclosures. For example, when a borrower obtains a mortgage loan the lender is required to provide a uniform mortgage costs disclosure statement. This disclosure must show both the interest rate in percentage terms that the borrow will be charged for the loan and also the costs of the loan in dollar terms. Under the law, the lender must provide a truth in lending statement, which shows the dollar amount of any finance charges, the dollar amount being financed, and the total dollar amount of all principal and interest payments that the borrower will make under the terms of the loan.[5] As shown in table 1, investors in other financial products or users of other financial services also generally receive information that discloses the specific dollar amounts for fees or other charges they pay.

[5]The Real Estate Settlement Procedures Act, 12 U.S.C. § 2601-17.

Table 1: Fee Disclosure Practices for Selected Financial Services or Products

Type of product or service	Disclosure requirement
Mutual funds	Mutual funds show the operating expenses as percentages of fund assets and dollar amounts for hypothetical investment amounts based on estimated future expenses in the prospectus.
Deposit accounts	Depository institutions are required to disclose itemized fees, in dollar amounts, on periodic statements.
Bank trust services	Although covered by varying state laws, regulatory and association officials for banks indicated that trust service charges are generally shown as specific dollar amounts.
Investment services provided to individual investment accounts (such as those managed by a financial planner)	When the provider has the right to deduct fees and other charges directly from the investor's account, the dollar amounts of such charges are required to be disclosed to the investor.
Wrap accounts[a]	Provider is required to disclose dollar amount of fees on investors' statements.
Stock purchases	Broker-dealers are required to report specific dollar amounts charged as commissions to investors.
Mortgage financing	Mortgage lenders are required to provide at time of settlement a statement containing information on the annual percentage rate paid on the outstanding balance, and the total dollar amount of any finance charges, the amount financed, and the total of all payments required.
Credit cards	Lenders are required to disclose the annual percentage rate paid for purchases and cash advances, and the dollar amounts of these charges appear on cardholder statements.

Source: GAO analysis of applicable disclosure regulations, rules, and industry practices.

[a]In a wrap account, a customer receives investment advisory and brokerage execution services from a broker-dealer or other financial intermediary for a "wrapped" fee that is not based on transactions in the customer's account.

Although mutual funds are not required to disclose specific dollar amounts of fees paid by individual investors, the amount of information that they do provide does exceed that provided by some investment products. For example, fixed-rate annuities or deposit accounts that provide investors a guaranteed return on their principal at a fixed rate do not specifically disclose to the purchasers of these products the provider's operating expenses. The financial institutions offering these products generate their profits on these products by attempting to invest their customers' funds in other investment vehicles earning higher rates of return than they are obligated to pay to the purchasers of the annuities. However, the returns

they earn on customer funds and the costs they incur to generate those returns are not required to be disclosed as operating expenses to their customers.

Various Alternatives Could Improve Fee Disclosure, but the Benefits Have Not Been Quantified

In recent years, a number of alternatives have been proposed for improving the disclosure of mutual fund fees, which could provide additional information to fund investors. In response to a recommendation in our June 2000 report that SEC consider additional disclosures regarding fees, SEC has introduced a proposal to improve mutual fund fee disclosure.[6] In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[7] This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to disclose the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, the staff also proposed that mutual funds be required to disclose the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent.

The SEC's proposed disclosures have various advantages and disadvantages. If adopted, this proposal would provide additional information to investors about the fees they pay when investing in mutual funds. In addition, these disclosures would be presented in a format that would allow investors to compare fees directly across funds. However, the disclosures would not be investor specific because they would not use an investor's individual account balance or number of shares owned. In addition, SEC is proposing to place these new disclosures in the semiannual shareholder reports, instead of in quarterly statements. Quarterly statements, which show investors the number of shares owned and value of their fund holdings, are generally considered to be of most interest and utility to investors. As a result, SEC's proposal may be less likely to increase investor awareness and improve price competition among mutual funds. According to SEC staff, they are open to consider

[6]GAO/GGD-00-126.

[7]Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission Release Nos. 33-8164; 34-47023; IC-2587068 (Dec. 18, 2002).

additional disclosures if the benefits to investors appear clear, but have decided to continue pursuing approval of the proposed disclosure format from their December 2002 rule proposal. This proposal has received a wide range of comments. Most comments were in support of SEC's proposed requirement to include the dollar cost associated with a $10,000 investment. For example, one investment advisory firm commented in its letter that the new disclosures SEC is proposing would benefit investors by allowing them to estimate actual expenses and compare costs between different funds in a meaningful way.

Another alternative for disclosing mutual funds fees would involve funds specifically disclosing the actual dollar amount of fees paid by each investor. In our June 2000 report, we noted that such disclosure would make mutual funds comparable to other financial products and services such as bank checking accounts or stock transactions through broker-dealers. As our report noted, such services actively compete on the basis of price. If mutual funds made similar specific dollar disclosures, investors would be clearly reminded that they pay fees for investing in mutual funds and we stated that additional competition among funds on the basis of price could likely result among funds. An attorney specializing in mutual fund law told us that requiring funds to disclose the dollar amount of fees in investor account statements would likely encourage investment advisers to compete on the basis of fees. He believed that this could spur new entrants to the mutual fund industry and that the new entrants would promote their funds on the basis of their low costs, in much the same way that low-cost discount broker-dealers entered the securities industry.

Although some financial planners, who directly assist investors in choosing among mutual funds, thought that requiring mutual funds to provide investors with the specific dollar amounts of fees paid would be useful, most indicated that other information was more important. We spoke to a judgmental sample of 15 certified financial planners whose names were provided by the Certified Financial Planner Board of Standards, a non-profit professional regulatory organization that administers the certified financial planner examination. Of the 15 financial planners with whom we spoke, 6 believed specific dollar disclosure of mutual fund fees would provide additional benefit to investors. For example, one said that providing exact dollar amounts for expenses would be useful because investors don't take the next step to calculate the actual costs they bear by multiplying their account value by the fund's expense ratio. In contrast, the other 9 financial planners we interviewed said that the factor most investors consider more than others is the overall net performance of the

fund and thus did not think that specific dollar disclosures of fees would provide much additional benefit.

Industry officials raised concerns about requiring specific dollar fee disclosures. For example, one investment company official stated that the costs of making specific dollar disclosures would not justify any benefit that might arise from providing such information, particularly because a majority of investors make their investment decisions through intermediaries, such as financial planners, and not on their own. Some industry officials stated that additional disclosure could confuse investors and create unintended consequences. For example, one official noted that specific dollar disclosure might lead investors to think that they could deduct those expenses from their taxes. Others noted that this type of disclosure would tell current mutual fund investors what they were paying in fees, but would not provide the proper context for evaluating how much other funds would charge, and thus would be unlikely to increase competition. Another official stated that disclosing fees paid in dollars in account statements would not be beneficial to prospective investors.

Although the total cost of providing specific dollar fee disclosures might be significant, the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement, the Investment Company Institute (ICI), the industry association representing mutual funds, commissioned a study by a large accounting firm to survey mutual fund companies about the costs of producing such disclosures.[8] The study concluded that the aggregated estimated costs for the survey respondents to implement specific dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million.[9] Although these are significant costs, when spread over the accounts of many investors, the amounts are less sizeable. For example, ICI reported that at the end of 2001, a total of about 248 million shareholder accounts existed. If the fund companies represented in ICI's study, which represent 77 percent of industry assets, also maintain about the same percentage of customer accounts, then the companies would hold about 191 million accounts. As a result, apportioning the estimated $200 million in initial costs to these accounts would amount to about $1 per

[8]GAO-03-551T.

[9]However, this estimate did not include the reportedly significant costs that would be borne by third-party financial institutions, which maintain accounts on behalf of individual mutual fund shareholders.

account. Apportioning the estimated $66 million in annual costs to these accounts would amount to about $0.35 per account.

We also spoke with a full-service transfer agent that provides services for about one third of the total 240 million accounts industrywide.[10] Staff from this organization prepared estimates of the costs to their organization of producing specific dollar fee disclosures for fund investors. They estimated that to produce this information, they would incur one-time development costs between $1.5 and $3 million to revise their systems to accept and maintain individual investor account expense data, and ongoing data processing expenses of about $0.15 to $0.30 per fund/account per year. These ongoing expenses would reflect about 1 percent of the estimated $18 to $23 per year of administrative costs per account already incurred. The officials also estimated that shareholder servicing costs would increase as investors would call in to try to understand the new disclosures or offer to send payments under the mistaken impression that this was a new charge that they had to explicitly pay. Funds would also incur costs to update and modify their Web sites so that investors could find this specific expense information there as well.

Another concern raised regarding requiring mutual funds to disclose the specific dollar amount of fees was that information on the extent to which such disclosures would benefit investors is not generally available. For our work on this report, we attempted to identify studies or analyses on the impact of disclosing prices in dollars versus percentage terms, but no available information was found to exist. We also reviewed surveys done of investor preferences relative to mutual funds but none of the surveys we identified discussed disclosure of mutual fund fees in dollar terms. In our June 2000 report, we presented information from a survey of over 500 investors that was administered by a broker-dealer to its clients.[11] As we reported, this survey found that almost 90 percent of these investors indicated that specific dollar disclosures would be useful or very useful. However, only 14 percent of these investors were very or somewhat likely to be willing to pay for this information. SEC and industry participants noted that having more definitive data on the extent to which investors want and would benefit from receiving information on the specific dollar

[10]A mutual fund transfer agent maintains shareholder account records and processes share purchases and redemptions.

[11]See GAO/GGD-00-126, p. 78.

amount of fees they paid would be necessary before requiring mutual funds, broker-dealers, and other intermediaries to undertake the costly revisions to their systems necessary to capture such information.

Another option for disclosure was proposed by an industry official that may not impose significant costs on the industry. The official said that fund companies could include a notice in account statements to remind investors that they pay fees as part of investing in mutual funds. The notice, the official said could remind investors that, "Mutual funds, like all investments, do have fees and ongoing expenses and such fees and expenses can vary considerably and can affect your overall return. Check your prospectus and with your financial adviser for more information." By providing this notice in the quarterly account statements that mutual fund investors receive, mutual fund investors would be reminded about fees in a document that, because it contains information about their particular account and its holdings, is more likely to be read.

Trading and Other Costs Impact Mutual Fund Investor Returns, but Are Not Prominently Disclosed

In addition to the expenses reflected in a mutual fund's expense ratio—the fund's total annual operating expenses as a percentage of fund assets—mutual funds incur trading costs that also affect investors' returns. Among these costs are brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf. When mutual funds buy or sell securities for the fund, they may have to pay the broker-dealers that execute these trades a commission. In other cases, trades are not subject to explicit brokerage commissions but rather to "markups," which is an amount a broker-dealer may add to the price of security before selling it to another party. Trades involving bonds are often subject to markups. Commissions have also not traditionally been charged on trades involving the stocks traded on NASDAQ because the broker-dealers offering these stocks are compensated by the spread between the buying and selling prices of the securities they offer.[12]

Other trading-related costs that can also affect investor returns include potential market impact costs that can arise when funds seek to trade large amounts of particular securities. For example, a fund seeking to buy a large block of a particular company's stock may end up paying higher prices to

[12]These different prices are called the bid price, which is the price the broker-dealer is willing to pay for shares and the ask price, which is the price at which the broker-dealer is willing to sell shares.

acquire all the shares it seeks because its transaction volume causes the stock price to rise while its trades are being executed. Various methodologies exist for estimating these types of trading costs, however, no generally agreed upon approach exists for accurately calculating these costs.

Although trading costs affect investor returns, these costs are not currently required to be disclosed in documents routinely provided to investors. ICI staff and others told us that the costs of trading, including brokerage commissions, are required under current accounting practices and tax regulations to be included as part of the initial value of the security purchased. As a result, this amount is used to compute the gain or loss when the security is eventually sold and thus the amount of any commissions or other trading costs are already implicitly included in fund performance returns.[13] Investors do receive some information relating to a fund's trading activities because funds are required to disclose their portfolio turnover, (the frequency with which funds conduct portfolio trading) in their prospectuses, which are routinely sent to new and existing investors. However, the frequency with which individual mutual funds conduct portfolio trading and incur brokerage commissions can vary greatly and the amount of brokerage commissions a fund pays are not disclosed in documents routinely sent to investors. Instead, SEC requires mutual funds to disclose the amount of brokerage commissions paid in the statement of additional information (SAI), which also includes disclosures relating to a fund's policies, its officers and directors, and various tax matters. Regarding their trading activities, funds are required to disclose in their SAI how transactions in portfolio securities are conducted, how brokers are selected, and how the fund determines the overall reasonableness of brokerage commissions paid. The amount disclosed in the SAI does not include other trading costs borne by mutual funds such as spreads or the market impact cost of the fund's trading. Unlike fund prospectuses or annual reports, SAIs do not have to be sent periodically to a fund's shareholders, but instead are filed with SEC annually and are sent to investors upon request.

[13]For example, if a fund buys a security for $10 a share and pays a $.05 commission on each share, its basis in the security is $10.05, and this is the amount that will be used to calculate any subsequent gain or loss when the shares are sold.

Academics and Others Have Also Called for Increased Disclosure of Mutual Fund Trading Costs, but Others Noted that Producing Such Disclosures Would be Difficult

Academics and other industry observers have also called for increased disclosure of mutual fund brokerage commissions and other trading costs that are not currently included in fund expense ratios. In an academic study we reviewed that looked at brokerage commission costs, the authors urged that investors pay increased attention to such costs.[14] For example, the study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing trading costs as relevant information because the impact of these unobservable trading costs is comparable to the more observable expense ratio. The authors of another study noted that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' SAIs.[15]

Others who advocated additional disclosure of brokerage commissions cited other benefits. Some officials have called for mutual funds to be required to include their trading costs, including brokerage commissions, in their expense ratios or as separate disclosures in the same place their expense ratios are disclosed. For example, one investor advocate noted that if funds were required to disclose brokerage commissions in these ways, funds would likely seek to reduce such expenses and investors would be better off because the costs of such funds would be similarly reduced. He explained that this could result in funds experiencing less turnover, which could also benefit investors as some studies have found that high-turnover funds tend to have lower returns than low-turnover funds.

The majority of certified financial planners we interviewed also indicated that disclosing transaction costs would benefit investors. Of the 15 with whom we spoke, 9 stated that investors would benefit from having more cost information such as portfolio transaction costs. For example, one said that investors should know the costs of transactions paid by the fund and that this information should be disclosed in a document more prominent than the SAI. Another stated that brokerage commissions should be

[14]J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania (Nov. 2, 1999).

[15]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," Journal of Financial Research (Summer 1996).

reported as a percentage of average net assets. Overall they felt that more information would help investors compare costs across funds, which could likely result in more competition based on costs, but they also varied in opinion on the most appropriate format and place to present these disclosures. The planners who did not think transaction costs should be disclosed generally believed that investors would not benefit from this type of additional information because they would not understand it.

Some industry observers and financial planners we interviewed indicated that investors should be provided all the information that affects a fund's returns in one place. This information could include the current disclosed costs such as the total expense ratio, the impact of taxes, and undisclosed trading costs. Some financial planners and an industry consultant suggested disclosing all such expenses in percentages. They also expressed the importance of including after-tax performance returns. SEC adopted a rule in January 2001 requiring all funds to disclose their after-tax returns in their prospectus. A mutual fund industry analyst noted that when an item is disclosed, investment advisers will likely attempt to compete with one another to maximize their performance in the activity subject to disclosure. Therefore, presenting investors with information on the factors that affect their return and that are within the investment adviser's control could spur additional competition and produce benefits for investors. A financial planner we interviewed also agreed that having mutual funds disclose information about expenses, tax impacts, and trading costs, particularly brokerage commissions all in one place would increase investor awareness of the costs incurred for owning mutual fund shares and could increase competition among funds based on costs and lead to lower expenses for investors.

Although additional disclosures in this format could possibly benefit investors, developing the information needed to provide a disclosure of this type could pose difficulties. SEC officials said that, if funds were required to separately disclose brokerage commission costs as a percentage of fund assets, fund advisers would also likely want to present their fund's gross return before trading costs were included so that the information does not appear to be counted twice. However, the SEC staff noted that determining a fund's gross return before trading costs could be challenging because it could involve having to estimate markups and spread costs. ICI officials also stated that disclosing gross returns could create the idea of cost free investing, which is not a realistic expectation for investors. They also worried that mutual funds could try and market their gross return figures, which would be misleading.

Mutual fund officials also raised various concerns about expanding the disclosure of brokerage commissions and trading costs in general. Some officials said that requiring funds to present additional information about brokerage commissions by including such costs in the fund's operating expense ratios would not present information to investors that could be easily compared across funds. For example, funds that invest in securities on the New York Stock Exchange (NYSE), for which commissions are usually paid, would pay more in total commissions than would funds that invest primarily in securities listed on NASDAQ because the broker-dealers offering such securities are usually compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. As discussed earlier, ICI staff and others said that separate disclosure of these costs is not needed because the costs of trading are already included in the performance return percentages that mutual funds report. Officials at one fund company told us that it would be difficult for fund companies to produce a percentage figure for other trading costs outside of commissions because no agreed-upon methodology for quantifying market impact costs, spreads, and markup costs exists within the industry. Other industry participants told us that due to the complexity of calculating such figures, trading cost disclosure is likely to confuse investors. For example funds that attempt to mimic the performance of certain stock indexes, such as the Standard & Poors 500 stock index, and thus limit their investments to just these securities have lower brokerage commissions because they trade less. In contrast, other funds may employ a strategy that requires them to trade frequently and thus would have higher brokerage commissions. However, choosing among these funds on the basis of their relative trading costs may not be the best approach for an investor because of the differences in these two types of strategies.

Finally, some financial planners and an industry expert stated that additional disclosure of mutual fund costs would be monitored not by investors but more so by financial professionals, such as financial planners, and the financial media. These groups serve as intermediaries between fund companies and investors, and are the primary channel through which information on the performance and costs across mutual funds is distributed. The financial planners and the industry expert believed that increased disclosures of trading costs could prove beneficial to the financial professionals that help select mutual funds for their investor clients.

Independent Directors Play a Critical Role in Protecting Mutual Fund Investors

Mutual fund boards of directors have a responsibility to protect shareholder interests. Independent directors, who are not affiliated with the investment adviser, play a critical role in protecting mutual fund investors. Specifically, independent directors have certain statutory responsibilities to approve investment advisory contracts and monitor mutual fund fees. However, some industry observers believe that independent directors could do more to assert their influence to reduce fees charged by fund advisers. Alternatives are being considered to improve public company governance such as changing board composition and structure, however many practices are already in place within the mutual fund industry.

Mutual Fund Boards of Directors Are Responsible for Protecting Shareholder Interests

Because the organizational structure of a mutual fund can create conflicts of interest between the fund's investment adviser and its shareholders, the law governing U.S. mutual funds requires funds to have a board of directors to protect the interest of the fund's shareholders. A fund is usually organized by an investment management company or adviser, which is responsible for providing portfolio management, administrative, distribution, and other operational services. In addition, the fund's officers are usually provided, employed, and compensated by the investment adviser. The adviser charges a management fee, which is paid with fund assets, to cover the costs of these services. With the level of the management fee representing its revenue from the fund, the adviser's desire to maximize its revenues could conflict with shareholders' goal of reducing fees. As one safeguard against this potential conflict, the Investment Company Act of 1940 (the Investment Company Act) requires mutual funds to have boards of directors to oversee shareholder's interests. These boards must also include independent directors who are not employed by or affiliated with the investment adviser.

As a group, the directors of a mutual fund have various responsibilities and in some cases, the independent directors have additional duties. In addition to approval by the full board, the Investment Company Act requires that a majority of the independent directors separately approve the contracts with the investment adviser that will manage the fund's portfolio and the entity that will act as distributor of the fund's shares. A mutual fund's board, including a majority of the independent directors, are also required to review other service arrangements such as transfer agency, custodial, or bookkeeping services.

If the services to the fund are provided by an affiliate of the adviser, the independent directors also generally consider several items before approving the arrangement. Specifically they determine that the service contract is in the best interest of the fund and its shareholders, the services are required for the operation of the fund, the services are of a nature and quality at least equal to the same or similar services provided by independent third parties, and the fees for such services are fair and reasonable in comparison to the usual and customary fees charged for services of the same nature and quality.

The independent directors also have specific duties to approve the investment advisory contract between the fund and the investment adviser and the fees that will be charged. Specifically, section 15 of the Investment Company Act requires the annual approval of an advisory contract by a fund's full board of directors as well as by a majority of its independent directors, acting separately and in person, at a meeting called for that purpose. Under section 36(b) of the Investment Company Act, investment advisers have a fiduciary duty to the fund with respect to the fees they receive, which under state common law typically means that the adviser must act with the same degree of care and skill that a reasonably prudent person would use in connection with his or her own affairs. Section 36(b) also authorizes actions by shareholders and the SEC against an adviser for breach of this duty. Courts have developed a framework for determining whether an adviser has breached its duty under section 36(b), and directors typically use this framework in evaluating advisory fees. This framework finds its origin in a Second Circuit Court of Appeals decision, in which the court set forth the factors relevant to determining whether an adviser's fee is excessive.[16] In addition to potentially considering how a fund's fee compared to those of other funds, this court indicated that directors may find other factors more important, including

- the nature and quality of the adviser's services,
- the adviser's costs to provide those services,
- the extent to which the adviser realizes and shares with the fund economies of scale as the fund grows,

[16]*Gartenberg v. Merrill Lynch Asset Management Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F. 2d 923 (2d Cir. 1982), *cert. denied*, *461 U.S. 906(1983)*.

- the volume of orders that the manager must process,
- indirect benefits to the adviser as the result of operating the fund, and
- the independence and conscientiousness of the directors.

Fund company officials and independent directors with whom we spoke said their boards review extensive amounts of information during the annual contract renewal process to help them evaluate the fees and expenses paid by the fund. For example, they stated that they hire a third-party research organization, such as Lipper, Inc., to provide data on their funds investment performance, management fee rates, and expense ratios as they compare to funds of similar size, objective, and style. They also compare performance to established benchmarks, such as the Standard & Poors 500 Stock Index. For example, officials at one fund company told us that, for each of their funds, their board reviews information on the performance and fees charged by 20 funds with a similar investment objective, including the 10 funds closest in size with more assets than their fund and the 10 funds closest in size with fewer assets. In addition to comparing themselves to peers, they explained that their board reviews the profitability of the adviser, stability of fund personnel or staff turnover, and quality of adviser services. Fund officials stated that their boards receive a large package of information that includes all of the necessary information to be reviewed for the contract renewal process in advance of board meetings.

SEC oversight of mutual funds indicates that fund directors generally conduct their activities in accordance with the law. Staff from SEC's Office of Compliance Inspections and Examinations, which conducts examinations of mutual funds and their investment advisers, told us that as part of their examinations they review the minutes of past board meetings to ensure that the directors were told and discussed the relevant information as part of the board's decision-making process. The SEC staff also told us they review the information provided to the board by the investment adviser to ensure its completeness and accuracy. Based on their review, SEC staff said that they have not generally found problems with mutual fund board proceedings. SEC has brought cases against mutual fund directors but these involved other activities. For example, SEC settled a case involving a mutual fund's board of directors that had knowingly filed misleading information in the fund's prospectus and other fund disclosures regarding the liquidity and value of the shares of their money market fund.

Critics Suggest Independent Directors Could Do More to Assert Their Influence and Reduce Fees

Some industry experts have criticized independent directors for not exercising their authority to reduce fees. For example, in a speech to shareholders, one industry expert stated that mutual fund directors have failed in negotiating management fees. Part of the criticism arises from the fact that during the annual contract renewal process, when boards compare fees of similar funds, the process maintains the status quo by comparing fees with the industry averages thus keeping fees at their current level. However, another industry expert complained that fund directors are not required to ensure that fund fees are reasonable, much less as low as possible, but instead are only expected to ensure that fees fall within a certain range of reasonableness. An academic study we reviewed criticized the court cases that have shaped director's roles in overseeing mutual fund fees because these cases generally found that comparing a fund's fees to other similar investment management services, such as pension funds was inappropriate as fund advisers do not compete with each other to manage a particular fund. Without being able to compare fund fees to these other products, the study's authors say that investors bringing these cases have lacked sufficient data to show that a fund's fees are excessive.[17]

One method offered by some industry critics for improving the effectiveness of boards in lowering fees for investors was to have fund directors seek competitive bids for their fund's investment advisory contracts. Advocates of having boards take this action said that pension funds more routinely seek competitive bids from investment advisers for pension fund assets. A former Treasury Department official said that pension funds commonly seek new investment advisers every 2 to 3 years, and, as a result, pension fund investors pay two to three times less in fees than the average mutual fund investors. One academic study we reviewed that compared advisory fees for similarly-sized pension funds and mutual funds found that the average mutual fund advisory fee is twice as large as a pension fund advisory fee.[18] The study showed that the average pension fund pays 28 basis points for its advisory fee compared to 56 basis points for mutual funds. The study concluded that the main reason for differences between pension funds and mutual funds was that advisory fees for

[17]J.P. Freeman and S.L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," 26 Journal of Corporation Law 609 (2001).

[18]J.P. Freeman and S.L. Brown.

pension funds are set in a marketplace in which arm's-length bargaining occurs because of the separation of the fund and the investment advisers.

Regulators and industry participants indicated that differences in the costs and services provided by mutual funds can explain why mutual funds charge more than pension funds. According to staff of SEC and ICI with whom we spoke, investment advisers usually perform many other services for their mutual funds than does the adviser of a pension fund and that their advisory fee compensates them for these additional services. Among the services that advisers of mutual funds would provide that a pension fund adviser would not include around the clock telephone customer service, preparing periodic account statements and shareholder communications, and compiling annual tax information for fund investors. Some industry officials also noted the difference in cost structure between pension and mutual funds. One official stated that pension funds have one institutional account, whereas mutual funds have thousands of smaller accounts, which requires substantial record keeping and customer service expenses. Mutual fund advisers would also have increased costs because they have to manage their fund's daily inflows and outflows, whereas pool of assets that a pension fund adviser manages are not subject to such frequent fluctuations.

Based on information we collected, very few mutual funds change their investment advisers. According to research organizations that monitor developments in the mutual fund industry, less than 10 funds have changed their primary investment adviser within the last 15 years. The process of changing investment adviser is not solely dependent upon the board of directors. If the fund board of directors made a decision to change an investment adviser, the board would need to file a proxy statement and have the shareholders of the fund vote to approve the change.

Industry participants also said that having mutual fund boards put out their advisory service contracts for bid may not produce expected savings and could increase fund shareholders' costs. According to staff at one fund company, they would not likely bid on contracts to manage mutual fund assets at the same rate that they bid for pension fund assets because their costs to manage and administer mutual fund assets are higher. They said that pension fund assets are offered to investment advisers in a large pre-existing pool. In contrast, mutual fund assets must be accumulated over time from many investors. Each time a fund's board hired a new investment adviser, the fund's shareholders costs would also likely go up because all the accounts would have to be transferred to the new adviser

and the fund would likely incur additional document preparation, legal, and customer service costs. For example, we identified a case in which a small fund had removed its investment adviser, which resulted in a significant increase of fund expenses. In this case, the fund's investment adviser resigned and a majority of the fund's board of directors voted to take over the fund's management. The decision was submitted to the shareholders for a proxy vote and passed. As a result the fund's expense ratio went from 1.8 percent in 2001 to 3.4 percent in 2002. The fund attributed this significant increase to a number of one-time items, which consisted primarily of legal expenses associated with the removal of the investment adviser and the management of the fund's portfolio.

Finally, industry participants indicated that mutual fund shareholders likely do not expect their fund's board to change the fund's investment adviser. They said that mutual fund shareholders often choose their funds because of the reputation or services offered by a particular investment adviser and having their fund's board seek to move their fund to another company would not likely be supported by the shareholders. Furthermore, having fund boards seek new investment advisers is unnecessary because mutual fund shareholders can choose to redeem their shares of a particular adviser's fund and invest them in the funds of other advisers if they are unhappy with their existing fund or its adviser. In contrast, pension fund participants cannot move their pension fund investments if they are unhappy with their fund's investment adviser or its performance. Instead, the decisions about which advisers are hired to manage pension fund's assets are made by their fund administrators. ICI officials also questioned whether pension funds actually change investment advisers that frequently. They said that pension funds often seek long-term relationships with investment advisers.

Although they do not frequently change advisers, mutual fund directors engage in other activities to lower fees. Industry officials said that advisers typically institute management fee "breakpoints" based on the level of fund assets or performance. These breakpoints reduce the level of management fees when funds exceed certain asset levels, thus as a fund's assets grow, the investment adviser's fee is reduced for those additional assets above the levels set in the breakpoint. Directors could also approve performance fees as a part of an investment adviser's compensation that would reduce the fee the adviser was able to charge if the fund's performance fails to meet or exceed a specified performance benchmark, such as the Standard & Poors 500 Stock Index. Industry officials also stated that advisers will at times offer to waive management fees, and may also waive or cap certain

expenses such as certain transfer agency fees. Noting that the fees for mutual funds in the United States are lower compared to those of other countries, SEC and ICI officials attributed this to the role and influence of U.S. funds' board of directors because such independent oversight is not always required in other countries.

Mutual Funds Already Employ Many Practices Being Suggested to Improve Public Company Governance

Changes in the structure of mutual fund boards of directors have been proposed and adopted in recent years and recent corporate scandals have prompted consideration of additional reforms but industry participants note that most funds have already adopted such practices. In February 1999, SEC held a forum on the role of independent mutual fund directors to consider ways to improve mutual fund governance. At the forum, the SEC Chairman at that time requested proposals for improving fund governance. At the same time, ICI created the Advisory Group on Best Practices for Fund Directors. This advisory group identified 15 best practices used by fund boards to enhance the independence and effectiveness of mutual fund directors and recommended that all fund boards adopt them. The ICI recommendations included having

- independent directors constitute at least two thirds of the fund's board,
- independent directors select and nominate other independent directors, and
- independent counsel for the independent directors.

After evaluating the ideas and suggestions of the forum participants, SEC proposed various rule and form amendments designed to reaffirm the important role that independent directors play in protecting fund investors. These amendments were adopted in January 2001. They included requiring funds relying on certain exemptive rules—which includes almost all funds according to SEC staff—to have a majority of independent directors on their boards and to have their independent directors select and nominate other independent directors. SEC also required that any legal counsel for the independent directors also be independent.[19]

[19]Role of Independent Directors of Investment Companies, Securities and Exchange Commission Release Nos. 33-7932; 34-43786; IC-24816 (Jan. 2, 2001).

As a result of recent scandals such as Enron and Worldcom, various new reforms have been proposed to increase the effectiveness and accountability of public companies' boards of directors. In July 2002, the Sarbanes-Oxley Act (Sarbanes-Oxley) was enacted to address concerns related to corporate responsibility.[20] In addition to enhancing the financial reporting regulatory structure, Sarbanes-Oxley sought to increase corporate accountability by reforming the structure of corporate boards audit committees. Section 301 of Sarbanes-Oxley requires that directors who serve on a public company's audit committee also be "independent" and be responsible for selecting and overseeing outside auditors. In response to the scandals at public companies, officials at the two primary venues where public companies are traded—the NYSE and NASDAQ—have also proposed changes to the corporate governance standards that public companies seeking to be listed on their markets must meet.

However, many of the corporate governance reforms being proposed for public companies are already either required or have been recommended as best practices for mutual fund boards. Table 2 presents how the corporate governance practices that are currently required by mutual fund law or rules or recommended by ICI's best practices for mutual fund boards compare to the current and proposed NYSE and NASDAQ listing standards applicable to public company boards. As the table shows, the mutual funds boards are already recommended to have in place all of the proposed corporate listing standards.

[20]Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

Table 2: Current and Proposed NYSE and NASDAQ Corporate Governance Listing Standards Compared to those Currently Required or Recommended for Mutual Fund Boards

	NYSE/NASDAQ listing standards		Mutual funds	
Governance requirement	Currently required	Proposed requirement	Required by statute or SEC rule[a]	ICI recommended best practice
Board must have a majority of independent directors		X	X	X
Independent directors must be responsible for nominating new independent directors		X	X	X
Audit committee must consist of only independent directors[b]	X	X		X
Standards that define who qualifies as an independent director[c]	X	X	X	X
Independent directors required to meet separately in executive sessions		X		X

Source: GAO analysis of ICI Best Practices, statutes, SEC rules, and NYSE and NASDAQ rule proposals.

[a]SEC requires the board of directors of any fund that takes advantage of various exemptive rules to meet these requirements and SEC staff indicated that, as a result, almost all funds must comply.

[b]Although fully independent audit committees is not a requirement for funds, SEC has adopted a rule to encourage fund boards to have audit committees consisting exclusively of independent directors by exempting such committees from having to seek shareholder approval of the fund's auditor.

[c]Both the NYSE and NASDAQ definitions of director independence currently apply only to members of the audit committee, but their rule proposals would extend this definition to the full board.

According to industry participants, most mutual fund boards already have the corporate governance practices recommended by these various standards in place. Officials of the fund companies and the independent directors that we interviewed told us that the majority of their boards consisted of independent directors, and, in many cases, had only one interested director. For public companies, some commenters have called for boards of directors to have supermajorities of independent directors as a means of ensuring that the voices of the independent directors are heard. As noted above, this practice has already been advocated by ICI's best practice recommendations and one fund governance consulting official

said that a 2002 survey conducted by his firm found that, in 75 percent of the mutual fund complexes they surveyed, over 70 percent of the directors were independent. An academic study we reviewed also found that funds' independent directors already comprised funds' nominating committees and most funds have self-nominating independent directors.

Another change related to board composition that has been proposed for mutual funds would be to have an independent director serving as the board's chair, but industry participants did not see this as a beneficial change. Some industry critics have stated that the lack of an independent chair allows the board's activities during the meeting to be controlled by fund management, as the fund's board chair is typically the chairman or other senior official of the investment adviser. A number of fund companies and independent directors we spoke with indicated that their board did have an independent chair. For the fund companies that did not have an independent chair, they had instead a lead independent director. An official from the Mutual Fund Directors Forum, an independent directors association which provides continuing education and outreach on mutual fund governance, said that the most important factor is the initiative demonstrated by the independent director, whether the individual is the lead or chair. He stated that if the lead independent director is motivated, it doesn't matter who the chair is, because the lead director will be proactive and effective on behalf of fund shareholders. Other fund company officials indicated that an independent chair could be harmful to the board. One stated that investors are better served by having a fund company executive chair the fund's board because such an official is better positioned to ensure that all of the information that the adviser needs to share with the independent directors is provided efficiently.

Changes in Mutual Fund Distribution Practices Have Increased Choices for Investors, but Have Raised Potential Concerns

Concerns have been raised over changes in how mutual funds pay for the distribution of their shares to investors. SEC Rule 12b-1 allows mutual fund companies to use fund assets to pay expenses for distributing their funds through broker-dealers, and has evolved into a means for fund companies to offer investors a variety of ways to pay for the services of financial professionals, such as broker-dealer staff or financial planners. However, 12b-1 fees remain controversial among mutual fund researchers because, in addition to increasing a fund's overall expense ratio, funds with 12b-1 fees may be more costly to own in other ways. In a recent study, SEC staff recommended rule 12b-1 modifications to reflect changes in how funds are being marketed, but as of May 2003, SEC had not proposed any amendments. Concerns also have been raised as to whether the disclosure

of 12b-1 fees is sufficient and whether, another distribution practice—referred to as revenue sharing, in which investment advisers make payments to broker-dealers for selling and marketing their funds—could limit the number of mutual fund choices offered to investors. Revenue sharing also may result in a broker-dealer's failure to recommend funds from which the brokerage firm is not being compensated by the funds' advisers, which some suggest could conflict with broker-dealers' responsibilities to recommend suitable investments.

12b-1 Plans Provide Alternative Means for Compensating Financial Professionals but Also Raise Concerns Over Costs

Previously, mutual funds distribution expenses were paid for either by charging investors a sales charge or load or by paying for such expenses out of the investment adviser's own profits. However, in 1980, SEC adopted rule 12b-1 under the Investment Company Act to help funds counter a period of net redemptions by allowing them to use fund assets to pay the expenses associated with the distribution of fund shares. Rule 12b-1 plans were envisioned as temporary measures to be used during periods of declining assets. Any activity that is primarily intended to result in the sale of mutual fund shares must be included as a 12b-1 expense and can include advertising; compensation of underwriters, dealers, and sales personnel; printing and mailing prospectuses to persons other than current shareholders; and printing and mailing sales literature.

To be allowed to use fund assets for marketing purposes, funds are required to adopt 12b-1 plans that outline how they intend to use these payments. A fund's written 12b-1 plan must describe all material aspects of the proposed financing of distribution and related agreements with distributors about how the plan is to be implemented. Before implementing a plan that will allow a fund to begin charging 12b-1 fees, rule 12b-1 requires fund shareholders and directors to approve 12b-1 plans and places other requirements on plan adoption. The plans must also be approved by a vote of a majority of outstanding shareholders and by a majority of funds' directors, including a majority of the fund's independent directors. Because such plans were envisioned to be of a limited duration, a majority of funds' directors, including a majority of the fund's independent directors, must also make various approvals on an ongoing basis, including approving the 12b-1 plans annually. They must also approve any amendment to the plan and approve on at least a quarterly basis the reports of plan expenditures and the purposes of the expenditures. 12b-1 plans must also provide for plan termination upon the vote of a majority of independent directors or a majority of shareholders.

In the adopting release for the rule, SEC presented various factors that directors should consider when approving a fund's 12b-1 plan. These factors were offered to provide guidance to directors in determining whether to use fund assets to bear expenses for fund distribution. The nine factors are shown in figure 1.

Figure 1: Factors Fund Directors Are to Consider in Voting to Approve or Continue 12b-1 Plans

1. The need for independent counsel or experts to assist the directors in reaching a determination.
2. The nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate.
3. The causes of such problems or circumstances.
4. The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved.
5. The merits of possible alternative plans.
6. The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company.
7. The possible benefits of the plan to any other person relative to those expected to inure to the company.
8. The effect of the plan on existing shareholders.
9. In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders.

Source: SEC Release Nos. 33-6254 and IC-11414.

The 12b-1 fees that are used to pay marketing and distribution expenses are deducted directly from fund assets and are reported as a separate line item in the fund's fee table and included in funds' expense ratios. NASD, whose rules govern the distribution of fund shares by broker-dealers, limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year.[21] Funds are allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts. Therefore, 12b-1 fees included in a fund's total expense ratio are limited to a maximum of 1 percent per year. The actual dollar amount of distribution and service expenses paid under a fund's 12b-1 plan must be disclosed in an SAI, which supplements the prospectus, and in the fund's annual report.

As part of its oversight, SEC staff periodically examines mutual funds and their advisers for compliance with securities laws and rules and generally find that mutual fund boards adequately oversee their fund's 12b-1 plan. An SEC official told us that SEC examiners check to see that the directors and shareholders have approved 12b-1 plans and whether the funds have controls in place to ensure that relationships with distributors are reasonable, such as having the directors review 12b-1 fees. The official said that some examinations have found that funds lack adequate control procedures, but the SEC staff rarely have found serious material deficiencies.

12b-1 Plans Provide Additional Ways for Investors to Pay for Investment Advice and Fund Companies to Market Fund Shares

Rule 12b-1 provides investors an alternative way of paying for investment advice and purchases of fund shares. Funds can be sold directly to investors by a fund company or through financial intermediaries such as broker-dealers or financial advisers. According to ICI, approximately 80 percent of investors' mutual fund purchases are made through brokers, financial advisers, and other intermediaries, including employer-sponsored pension plans. Apart from 12b-1 fees, brokers can be paid with sales charges called "loads"; "front-end" loads are applied when shares in a fund are purchased and "back-end" loads when shares are redeemed. With a 12b-1 plan, the fund can finance the broker's compensation with installments deducted from fund assets over a period of several years. Thus, 12b-1 plans allow investors to consider the time-related objectives of their investment and possibly earn returns on the full amount of the money they have to

[21]NASD Conduct Rule 2830(d).

invest, rather than have a portion of their investment immediately deducted to pay their broker.

Rule 12b-1 has also made it possible for fund companies to market fund shares through a variety of share classes designed to help meet the different objectives of investors. For example, Class A shares might charge front-end loads to compensate brokers and may offer discounts called breakpoints for larger purchases of fund shares. Class B shares, alternatively, might not have front-end loads, but would impose asset-based 12b-1 fees to finance broker compensation over several years. Class B shares also might have deferred back-end loads if shares are redeemed within a certain number of years and might convert to Class A shares if held a certain number of years, such as 7 or 8 years. Class C shares might have a higher 12b-1 fee, but generally would not impose any front-end or back-end loads. While Class A shares might be more attractive to larger, more sophisticated investors who wanted to take advantage of the breakpoints, smaller investors, depending on how long they plan to hold the shares, might prefer Class B or C shares because no sales charges would be deducted from their initial investments.

Industry officials and analysts generally viewed the alternative marketing arrangements fostered by rule 12b-1 favorably. ICI and fund company officials generally agreed that rule 12b-1 plans gave fund distributors more options for offering investors multiple ways to pay for fund investments. For example, one company official said that 12b-1 plans have allowed investors to choose the type of fund in which they want to invest and have helped stabilize fund assets. Another official said that rule 12b-1 has provided investors choices on how to pay their broker, which investors have grown to like. He said that in his fund complex, 50 percent of shares are now held in Class B shares that charge 12b-1 fees as opposed to other share classes. A broker-dealer official that distributes funds said that 12b-1 plans are beneficial because the fees provide a revenue stream that encourages financial advisers to plan for the long-term. A mutual fund shareholders advocate said that this incentive is good because it would cause the financial advisers to recommend funds that will work out well for investors over time, rather than focus on earning front-end loads.

12b-1 Fees Raise Some Concerns Over Cost of Funds

Although providing alternative means for investors to pay for the advice of financial professionals, some concerns exist over the impact of 12b-1 fees on investors' costs. For example, an academic study of 3,861 multiple share class funds available at the end of 1997 found that funds with multiple share classes and 12b-1 fees also had higher management fees than those charged by funds with only a single share class, and, therefore, were more costly to investors before considering the additional expenses used to compensate their financial professional.[22] However, another study found that funds with 12b-1 fees might provide investors with greater performance. This study, which reviewed the risk-adjusted performance of a sample of 568 mutual funds for the period 1987-1992, found that 12b-1 plans increased fund expenses but on average generated higher risk-adjusted performance than funds with front-end loads. For this reason, the study concluded that investors should not avoid funds with 12b-1 plans.[23]

Questions involving funds with 12b-1 fees have also been raised over whether some investors are paying too much for their funds depending on which share class they purchase. Earlier in 2003, in federal court in Nashville, Tennessee, investors filed lawsuits against a brokerage firm alleging that the firms' brokers placed the investors' funds into share classes with higher 12b-1 fees when other share classes with different fee structures would have been more appropriate for the investors. A 1999 academic study also found that differing distribution arrangements cause broker-dealer sales representatives to be compensated differently depending on the class of shares they sell. These individuals, the study found, have monetary incentives to steer long-term investors to low load, high 12b-1 fee share classes and to steer short-term investors to high load, 12b-1 fee share classes.[24] However, depending on the time that they are likely to hold the investment, some investors would be better off investing in funds that charge a front-end load and have smaller 12b-1 fees than by purchasing shares in funds without loads but higher 12b-1 fees. The study noted that this conflict of interest between investors and brokers is most

[22]Lesseig, Vance P.; Long, D. Michael; and Smythe, Thomas I. "Gains to Mutual Fund Sponsors Offering Multiple Share Class Funds," *Journal of Financial Research* (March 1990).

[23]Deliva, Wilfred L. and Olson, Gerard T. "The Relationship Between Mutual Fund Fees and Expenses and Their Effects on Performance," *The Financial Review* (February 1998).

[24]O'Neal, Edward S., "Mutual Fund Share Classes and Broker Incentives," *Financial Analysts Journal* (September/October 1999).

serious when broker-dealer representatives advise relatively uninformed investors, who are more likely to seek advice on mutual fund investing.

In addition to concerns over 12b-1 fees, regulators have recently begun investigations of whether investors are receiving the appropriate discounts in mutual fund sales loads. In March 2003, NASD, NYSE, and SEC staff reported on the results of jointly administered examinations of 43 registered broker-dealers that sell mutual funds with a front-end load. The purpose of the examinations was to determine whether investors were receiving the benefit of available breakpoint discounts on front-end loads in mutual fund transactions. The examinations found that most of the brokerage firms examined, in some instances, did not provide customers with breakpoint discounts for which they appeared to have been eligible. In instances where investors were not afforded the benefit of a breakpoint discount, the average discount not provided was $364 per transaction. The most frequent causes for the broker-dealers not providing a breakpoint discount were not linking a customer's ownership of different funds within the same mutual fund family, not linking shares owned in a fund or fund family in all of a customer's accounts at the firm, and not linking shares owned in the same fund or fund family by persons related to the customer in accounts at the firm. The regulators concluded that many of the problems did not appear to have been intentional failures to charge correct loads. Among other things, the report noted that, although most of the firms had written supervisory procedures addressing breakpoints, the procedures often were not comprehensive.

SEC Report Recommended That Rule 12b-1 Be Updated to Reflect Changes in Fund Marketing

In a December 2000 report on mutual fund fees and expenses, staff in SEC's Division of Investment Management recommended that SEC consider reviewing the requirements of rule 12b-1 that govern how funds adopt and renew their 12b-1 plans.[25] The division's staff noted that modifications might be needed to reflect changes in the manner in which funds are marketed and distributed and the experience gained from observing how rule 12b-1 has operated since its adoption in 1980. The report noted that the development of multiple fund share classes permit investors to choose how distribution expenses are to be paid—for example, up front, in installments over time, or at redemption. Many funds that offer shares through broker-dealer fund supermarkets also adopt 12b-1 plans to pay for the fees that the sponsoring broker-dealer charges the funds sold through

[25]U.S. Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses* (Washington, D.C.: December 2000).

their supermarket. The division's report noted that because these 12b-1 plans are essential to the funds' participation in these supermarkets, such plans could be viewed as indefinite commitments. Also since 1980, some fund distributors have been using 12b-1 receivable revenues as collateral to obtain loans to finance their distribution efforts. The SEC staff noted that such changes illustrate that 12b-1 fees have come to be used in different ways than were originally envisioned under the rule and that changes may be needed to reflect current practices. Because of these changes, the report noted that SEC should consider whether it needed to give additional or different guidance to fund directors with respect to their review of rule 12b-1 plans, including whether the nine factors published in the 1980 release of rule 12b-1 were still valid (shown in fig. 1 of this report).

Although SEC has not yet provided additional guidance on or updated rule 12b-1 to reflect market changes, SEC staff told us that any amendment of rule 12b-1 could also involve changes to how distribution fees and expenses are disclosed. One fund independent director with whom we spoke said that rule 12b-1 should be amended to allow payment only to broker-dealers with net sales of fund shares and broker-dealers with net redemptions would not be paid. He said that this change would make sense for rule 12b-1 to fulfill its original purpose of increasing fund assets.

Concerns Raised over Adequacy of 12b-1 Fee Disclosure

Some concerns have been raised over the adequacy of 12b-1 fee disclosures. A mutual fund shareholder advocacy organization has called for reform in the disclosure of fund distribution expenses to better inform investors of possible conflicts of interest that could compromise the adviser's responsibility to control fund costs and provide investors a satisfactory return. For example, this group notes that 12b-1 fee disclosure is misleading to investors because a fund's money can be paying for distribution expenses either through a 12b-1 fee or the adviser's management fee. However, the group asserts, the fee table in the prospectus could give the investor the impression all distribution expenses are covered by 12b-1 fees, while the fund adviser benefits from all of the expenses paid from fund assets, the group noted. The group also noted that 12b-1 disclosures do not inform investors of potential conflicts of interest affecting brokers because, based on the fee disclosures in the prospectus, an investor cannot determine whether his broker received compensation from the 12b-1 fees.

Revenue Sharing Arrangements Provide Additional Distribution Options and Are Increasingly Used to Compensate Fund Distributors

Revenue sharing payments are compensation that investment advisers pay from their profits to the broker-dealers that distribute their funds. Some broker-dealers whose sales representatives market mutual funds have narrowed their offerings of funds or created preferred lists of funds, which then become the funds that receive the most marketing by these broker-dealer sales representatives. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms. According to one research organization official, there are significantly fewer distributing broker-dealers than there are mutual fund investment advisers. As a result, the mutual fund distributors have the clout to require advisers to pay more to have their funds sold by the distributing broker-dealers staff. For example, distributors sometimes require investment advisers to share their profits and pay for expenses incurred by the distributing broker-dealers, such as advertising or marketing materials that are used by the distributing broker-dealers.

The revenue sharing payments that come from the adviser's profits may supplement distribution-related payments out of fund assets. As noted, funds may annually pay up to one percent of fund assets to distributors pursuant to 12b-1 plans. However, SEC officials state that revenue sharing arrangements, paid out of the adviser's management fee, can permit broker-dealer distributors to receive payments outside of the 12b-1 limits. Further, broker-dealers have discretion as to how to use these payments, including using them to defray expenses incurred in marketing funds or to invest them in other areas of the broker-dealer's business.

Mutual funds and their investment advisers also may make distribution payments or incur revenue sharing costs when they offer funds through mutual fund supermarkets. Various broker-dealers, including those affiliated with a mutual fund adviser, allow their customers to purchase through their brokerage accounts the shares of funds operated by a wide range of investment advisers. Although these fund supermarkets provide the advisers of participating funds with an additional means of acquiring investor dollars, the firms that provide such supermarkets generally require investment advisers or funds themselves to pay a certain percentage on the dollars attracted from purchases by customers of the firm's supermarket. For example, funds or advisers for the funds participating in the Charles Schwab One Source supermarket pay that broker-dealer firm up to 0.40 percent of the amount invested by that firm's customers. While some portion of those payments may be paid out of fund assets pursuant to 12b-1 plans, those payments also may represent sharing of advisory fees. Some

or all of these payments may be for transfer agency and shareholder services.

According to SEC officials, revenue sharing is legitimate and consistent with provisions of rule 12b-1. SEC's adopting release of Rule 12b-1 states that the rule should apply to both direct and indirect distribution expenses. However, because there can be no precise definition of what expenses are indirect, SEC decided that fund directors, particularly independent directors, would bear the responsibility for determining on a case-by-case basis whether the use of fund assets for distribution is in compliance with the rule. SEC further noted that fund advisers can use the revenues they receive from their management fee to pay for distribution expenses as long as the adviser's profits are legitimate and not excessive.

Actual Amount of Revenue Sharing Occurring Is Unknown

Mutual funds are not required to disclose the revenue sharing payments made by their advisers as they are other distribution expenses paid by the funds. As noted above, any sales loads or 12b-1 fees that funds charge are disclosed in funds' prospectuses and annual reports. However, the amount of revenue sharing payments, which are paid out of the fund adviser's profits earned from the management fee or income from other sources, are not typically disclosed to investors, except for possible general disclosure in a fund's prospectus or SAI. Funds do disclose 12b-1 payments and may disclose that they may make other distribution-related payments but do not have to disclose the total amount paid or identify the recipients of those payments. As a result, complete data are not available on the extent to which mutual fund advisers are making revenue sharing payments. An industry researcher said that the cost of revenue sharing does not show up in advisers' financial reports because there is no line item for it and costs that fund advisers may incur to pay for sales meetings attended by broker-dealer staff or other promotion efforts are not specifically shown in fund adviser income statements. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. These amounts have been growing. According to the officials of a mutual fund research organization, revenue sharing costs are hard to quantify but are rising. For example, the organization reports that about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments.

Some Industry Participants Are Concerned that Revenue Sharing Could Negatively Impact Investors

The increased use of revenue sharing payments is raising concerns among some industry participants. Although revenue sharing payments are becoming a major expense for fund advisers, industry research organization officials told us that most fund advisers are not willing to

publicly discuss the extent to which they are making such payments. A 2001 report on fund distribution practices states that "the details and levels of revenue sharing vary widely across the industry and are seldom codified in written contracts." In one industry magazine article, a mutual fund industry researcher referred to revenue sharing as "the dirty little secret of the mutual fund industry."

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. The 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing may affect other fees that funds charge, such as 12b-1 fees or management fees, is uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments had increased any fund's fees but noted that by reducing fund adviser profits, revenue sharing would likely prevent advisers from lowering their fees. In addition, fund directors normally would not question revenue sharing arrangements because they are paid from the adviser's profits, unless the payments are financed directly from fund assets as part of the adviser's management fee or a 12b-1 plan. Fund directors, however, in the course of their review of the advisory contract, consider the adviser's profits before marketing and distribution expenses, which also may limit the ability of advisers to shift these costs to the fund.

Revenue sharing payments may also create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, these revenue sharing arrangements may have the effect of unduly focusing the attention of investors and their broker-dealers on particular mutual fund choices, which can reduce the number of funds they consider as part of the investment decision. That not only may lead to inferior investment choices, but may also reduce fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements may conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable given the investor's financial situation and risk profile.

Mutual fund officials' opinions about revenue sharing were mixed. Some of the fund officials with whom we spoke viewed revenue sharing as a cost of doing business, which enabled them to obtain "shelf space" for their funds with major broker-dealers and did not regard these arrangements as

potentially conflicting with investors' interests. They explained that the payments are made directly to the brokerage firm and not to individual staff financial advisers. One fund official said that there would be no incentive for broker-dealers' sales staff to push certain funds, unless managers exerted pressure on sales staff to sell those funds. Officials of one large broker-dealer with whom we spoke said that their fund sales platform has an "open architecture" through which all participating funds' agreements and payments are the same, which creates a level playing field on which no funds are given priority. One fund official commented that NASD rules require that broker-dealers sales staff recommend funds that are most suitable to the individual investor's financial situation. However, in letters commenting on certain compensation arrangements among broker-dealers, ICI has stated that cash compensation creates potential conflicts of interest between the broker-dealer receiving the compensation and the customer because the sale of a recommended security could increase the compensation paid to the broker-dealer's sales representative.

Although the extent to which revenue sharing payments are affecting the appropriateness of the fund recommendations that broker-dealers make is not known, investor's complaints regarding mutual fund shares they purchased have recently increased dramatically. According to NASD statistics, the number of NASD-administered arbitration cases involving mutual funds have increased by over 900 percent from 121 cases in 1999 to 1,249 cases in 2002. According to NASD staff, about 34 percent of the 2002 cases involved complaints of unsuitable mutual fund purchases. The extent to which revenue sharing payments are involved with these cases is unknown and NASD staff said the likely reason behind the increase in arbitrations involving mutual funds is the decline in the stock market and the associated declines in mutual fund performance.

Extent to Which Investors Are Told About the Potential Conflict That Revenue Sharing Creates Is Unclear

Although revenue sharing payments can create conflicts of interest between broker-dealers and their clients, the extent to which broker-dealers disclose to their clients that their firms receive such payments from fund advisers is not clear. Rule 10b-10 under the Securities Exchange Act of 1934 requires, among other things, that broker-dealers provide customers with information about third-party compensation that broker-dealers receive in connection with securities transactions. While broker-dealers generally satisfy the requirements of rule 10b-10 by providing customers with written "confirmations," the rule does not specifically require broker-dealers to provide the required information about third-party compensation related to mutual fund purchases in any particular document. SEC staff told us that they interpret rule 10b-10 to permit

broker-dealers to disclose third-party compensation related to mutual fund purchases through delivery of a fund prospectus that discusses the compensation. However, investors will not receive a confirmation, and may not view a prospectus, until after purchasing mutual fund shares. According to SEC staff, the compensation-disclosure requirements of rule 10b-10 in large part are geared toward providing investors with information that is useful over a course of dealing with a broker-dealer, rather than just one transaction. Information disclosed following the first transaction in a security can help the investor determine whether to continue to use that broker-dealer for future transactions. That is particularly applicable in the context of mutual funds, given that investors often purchase fund shares over time in a series of transactions.

Regulators and others acknowledged that additional disclosures may be necessary to better help investors assess the potential conflicts of interest associated with mutual fund transactions when distributing broker-dealers receive revenue sharing payments. According to SEC staff, additional disclosure is consistent with the principle that investors should be informed about the financial interest that their broker-dealers have with respect to mutual fund transactions. Additional disclosure about revenue sharing also may help investors be more sensitive to the question of whether they are being presented with an adequate range of investment choices within a fund class. SEC officials also told us that additional disclosure of revenue sharing payments may be justified so that investors can better assess whether the fund's advisory fees are excessive. SEC officials, in addition, noted that additional disclosure also might help promote fee competition among funds.

NASD officials said that mutual funds' revenue sharing arrangements with broker-dealers could present a conflict of interest for the broker-dealer. However, NASD looked at this issue in the past and found no hard evidence of sales representatives recommending unsuitable funds, but they acknowledged that making such a determination would be difficult. The NASD officials told us that it may be time to reexamine this issue. They said that NASD Rule 2830 prohibits member brokers from accepting compensation from fund advisers unless the funds disclose these payments in fund prospectuses. ICI has also endorsed regulatory rule changes that would require broker-dealers to disclose if they are receiving compensation from fund advisers, in addition to requiring disclosure of these payments in fund prospectuses. However, an official at one mutual fund adviser with whom we spoke said that disclosure of funds' revenue sharing agreements would not be helpful because it would include only their largest

distributors and might mislead investors about the extent of revenue sharing.

Soft Dollar Arrangements Provide Benefits, but Could Also Have an Adverse Impact on Investors

Soft dollar arrangements allow investment advisers of mutual funds and other clients to use part of the brokerage commissions paid to broker-dealers that execute trades on the fund's behalf to obtain research and brokerage services that can potentially benefit fund investors but could increase the costs borne by their funds. The research and brokerage services that fund advisers obtain through the use of soft dollars can benefit a mutual fund investor by increasing the availability of research. This practice also creates potential conflicts of interest that could harm fund investors. Some industry participants argued that when mutual fund investment advisers use fund assets to pay brokerage commissions and receive research or brokerage services as part of soft dollar arrangements, such services improve the investment advisers' management of the fund. However, others expressed concerns that such arrangements create conflicts of interest that could result in fund advisers paying higher brokerage commissions than necessary, which increases costs to fund investors. Investors' expenses also could be higher if investment advisers use brokerage commissions to pay for research and brokerage services that they do not need or would otherwise pay for out of their own profits. Expenses to investors would also be higher if investment advisers traded more to generate and receive more soft dollar services. According to SEC, soft dollar arrangements could also compromise advisers' fiduciary responsibility to seek brokers capable of providing the best execution on fund trades by choosing broker-dealers on the basis of their soft dollar offerings. With these potential conflicts of interest in mind, several interested parties in the United States and abroad have made suggestions for how potential soft dollar abuses could be mitigated, although some of these actions could have other negative consequences.

Soft Dollars Pay for Research and Brokerage Services

When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets.[26] In return for brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products. Soft dollar arrangements refer to the exchange of research and brokerage services from broker-dealers to fund advisers in return for brokerage commissions. For example, many full-service broker-dealers offer trade execution services, and in exchange for paying their stated institutional commission rate, advisers conducting trades through them could be entitled to research produced by the broker-dealers' analysts or receive priority notification of market or company-specific news. In addition to providing this proprietary research, these broker-dealers may also allow the fund adviser to generate soft dollar credits with a portion of the brokerage commissions paid that the fund adviser can then use to purchase other research from third parties. These third parties can be other broker-dealers, independent research or analytical firms, or service providers such as market data or trading systems software and hardware vendors. In a 1998 inspection report that documented reviews of soft dollar practices at 75 broker-dealers and 280 investment advisers and investment companies, SEC reported for every $1.70 in commissions paid to a broker-dealer, the adviser would receive $1.00 worth of soft dollar products and services.[27]

Soft dollar arrangements are not unique to the mutual fund industry. They are widely used by investment advisers who manage portfolios for other clients besides mutual funds, including pension funds, hedge funds, and individual retail clients.

Soft Dollar Arrangements Have Evolved Over Time

Many of the features of soft dollar arrangements that exist today are the result of regulatory changes in the 1970s. Until the mid-1970s, the commissions charged by all brokers were fixed at one equal price. To compete for commissions, broker-dealers differentiated themselves by offering research-related products and services to advisers. In 1975, to

[26]As noted previously, instead of commissions, broker-dealers executing trades also could be compensated through markups or spreads.

[27]U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Washington, D.C.: Sept. 22, 1998).

increase competition, SEC abolished fixed brokerage commission rates. However, investment advisers were concerned that they could be held in breach of their fiduciary duty to their clients to obtain best execution on trades if they paid anything but the lowest commission rate available to obtain research and brokerage services. In response, Congress created a "safe harbor" under section 28(e) of the Securities Exchange Act of 1934 that allowed advisers to pay more than the lowest available commission rate for security transactions in return for research and brokerage services and not be in breach of their fiduciary duty. In order to be protected against a claim of breach of fiduciary duty under this safe harbor, the adviser must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

The definition of what research and brokerage services can be obtained through soft dollar arrangements has evolved over time. In a 1976 release, SEC issued guidelines for determining when a product or service is within the meaning of brokerage and research services and available for the safe harbor under section 28(e). The 1976 guidelines provided the product or service must not be "readily and customarily available and offered to the general public on a commercial basis." In 1986, noting that this standard was difficult to apply and unduly restrictive in certain instances, SEC reinterpreted the safe harbor as permitting soft dollar arrangements to purchase products and services that "provide lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities," which could then include those commercially available to the public.[28] Under the revised interpretation, the cost of products and services that provide lawful and appropriate assistance, such as computer hardware and seminars, may be paid for with soft dollars.

[28]Securities; Brokerage and Research Services, Securities and Exchange Commission Release No. 34-23170, 51 F.R. 16004 (Apr. 23, 1986).

Although the Complete Extent of Soft Dollar Use Is Unknown, Soft Dollars Could Represent a Significant Portion of Trading Commissions

Because soft dollar research is often bundled, only aggregate value estimates of soft dollar arrangements are available. According to one industry research organization, the total amount paid in brokerage commissions for U.S. stocks totaled $8.6 billion in 2001, up from $7.7 billion in 2000.[29] Of this amount, industry participants estimate that 15 percent of total annual brokerage commissions, or roughly $1 billion, is used to obtain third-party research. However, this figure does not include the value of proprietary research, which cannot be unbundled as easily as third-party research. Moreover, in light of recent declines in fund assets, concern has been raised that advisers are under increased pressure to use soft dollars to pay for research rather than incur additional fund expenses.

Soft dollar products and services appear to represent a substantial portion of the cost of brokerage commissions on individual trades. Industry participants estimate that on average broker-dealers charge commissions of between $.05 and $.06 per share traded. In contrast, one industry expert has noted that it costs less than $.01 per share to execute a trade through an electronic communications network (ECN). ECNs are registered broker-dealers that operate as electronic exchanges. Because ECNs do not offer as many of the services offered by full service broker-dealers and execute trades electronically, the cost of executing trades through these brokers is lower. However, the estimated costs of trading on an ECN may not be representative of trading in all securities because most activity on ECNs involves widely traded, liquid stocks. Other estimates of the portion of individual brokerage commissions represented by soft dollars and execution services varied. One academic study, for example, attributes 67 percent of the cost of brokerage commissions on individual trades to soft dollars that pay for proprietary or third-party research.[30] However, recognizing that a portion of brokerage commissions goes towards broker-dealer profits, a consulting firm that specializes in mutual funds estimates more conservatively that soft dollars constitute 33 percent of brokerage commission costs.

Advisers who offer mutual funds use soft dollar arrangements to varying degrees. According to one SEC official, many fund companies do their own

[29]Greenwich Associates, *Commission and Soft-Dollar Practices in U.S. Equities* (May 3, 2002).

[30]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *The Journal of Financial Research* (Summer 1996).

research and thus have less use for broker-dealer or third-party research. Fixed-income funds, because their trades largely do not involve paying commissions, may not generate many soft dollar credits that could be used to obtain third-party research. However, one adviser of fixed-income funds with whom we spoke said that his firm does receive proprietary research from the full-service broker-dealers with whom they trade. Nine of the ten fund companies with whom we spoke also used soft dollars to varying degrees. One of the fund companies indicated that they did not engage in any soft dollar arrangements. However, this company specializes in indexed funds, which do not require research, and therefore seeks execution-only trades when it engages in portfolio transactions. Officials from other firms indicated that they limited the items that they obtained with soft dollars to research reports and analysis. On the other hand, some fund companies with whom we spoke indicated that their funds engaged in greater use of soft dollar arrangements for a variety of research and brokerage services permissible under section 28(e), including computer monitors and analytical software.

Disclosure of Soft Dollar Use to Mutual Fund Investors Is Limited

Fund advisers and investment companies must make some disclosure of their soft dollar arrangements, but these disclosures are not specific and not required to be routinely provided to mutual fund investors. Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which is the form that investment advisers use to register with SEC and are required to send to their advisory clients. Specifically, Form ADV requires advisers to describe the factors considered in selecting brokers and determining the reasonableness of their commissions when the adviser has discretion in choosing brokers. If the value of the products, research and services given to the adviser affects the choice of brokers or the brokerage commission paid, the adviser must also describe the products, research and services and whether clients may pay commissions higher than those obtainable from other brokers in return for those products. The adviser is also to disclose whether research is used to service all of the adviser's accounts or just those accounts paying for it and any procedures the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received. However, SEC staff told us that the Form ADV disclosures tend to use standardized language that is difficult for advisory clients to evaluate.

The information that investment advisers disclose about their choice of broker-dealers and their use of soft dollars in their Form ADV is not required to be routinely provided to mutual fund investors. As noted above, investment advisers are required to provide their Form ADV to their advisory clients. However, in the case of mutual funds, the client is considered to be the legal entity that is registered as the investment company with SEC and not the individual shareholders of the mutual fund. SEC rules also require advisers to disclose the aggregate brokerage commissions paid by the investment adviser with fund assets, the criteria for broker selection, and the products and services obtained through soft dollar arrangements in their SAI.[31] However, SAIs are only sent to investors upon request, and industry officials noted that investors rarely request SAIs. As a result, mutual fund shareholders do not routinely receive information about the extent to which their funds' advisers receives and uses soft dollar credits when making purchases or sales of the securities in the mutual funds that they own.

In addition to oversight of fees and fund distribution expenses, mutual fund directors also have a responsibility to monitor advisers' soft dollar arrangements to ensure best execution on portfolio trades. According to SEC, fund directors typically have access to more detailed information about an adviser's soft dollar practices than described in the Form ADV, including a list of brokers used and the total commissions dollars paid to each broker, the average commission rate per share by broker, the list of brokers with which the fund adviser has soft dollar arrangements and a description of research and brokerages services received by the fund. Additionally, directors often receive the advice of independent counsel about an adviser's soft dollar practices. Both SEC examiners and fund directors evaluate soft dollar arrangements in the context of whether advisers are getting best execution on portfolio transactions. Directors and

[31]The information that investment advisers are required to file with SEC that comprises the SAI is contained in Form N-1A, which is the registration statement for open-ended management investment companies. Information about soft dollar arrangements are also contained in Form N-SAR, which is the form registered management investment companies file with SEC on a semi-annual basis. Disclosures regarding brokerage practices are found in items 20, 21, 22, and 26 of this form. In particular, item 26 requires the fund to answer yes or no as to various considerations that affected the participation of brokers or dealers in commissions or other compensation paid on portfolio transactions of the fund. These considerations include sales of the fund's shares; receipt of investment research and statistical information; receipt of quotations for portfolio valuations; ability to execute portfolio transactions to obtain best price and execution; receipt of telephone line and wire services; affiliated status of the broker or dealer; and arrangements to return or credit part or all of commissions or profits thereon to the fund and other affiliated persons of the fund.

industry participants with whom we spoke indicated that boards evaluate how advisers use soft dollars, whether these charges are reasonable, and whether these arrangements affect best execution of portfolio transactions.

Soft Dollars Benefit Investors in Various Ways, but Could Also Increase Investor Costs or Raise Conflicts of Interest

Some industry participants argue that the use of soft dollar benefits investors in various ways. They note that the prevalence of soft dollar arrangements allow specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars may also have other benefits. For example, an investment adviser official told us that the research on smaller companies for which soft dollars pay helps create a more efficient market for such companies' securities, resulting in greater market liquidity and lower spreads.

However, concerns have been raised about soft dollar arrangements because they could increase the costs that investors incur when investing in a mutual fund. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. As a result, soft dollar trades might have both higher brokerage commissions and worse trade execution. One academic study, for example, shows that trades executed by broker-dealers that specialize in providing soft dollar products and services tend to be more expensive than those executed through other broker-dealers, including full-service broker-dealers.[32] Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to "over-consume" research because they were not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades. Some believe soft dollars are used to purchase research and brokerage services for which advisers should pay out of their own profits and not out of fund assets. As a result, the investor assumes the direct financial burden for the advisers' costs.

[32]J.S. Conrad, K.M Johnson, and S. Wahal, "Institutional Trading and Soft Dollars," *Journal of Finance* (February 2001).

Concerns have also been expressed that the range of products and services that advisers are obtaining with client commissions might be too broad. Critics of soft dollar arrangements have argued that the 1986 principle has legitimized the use of investor dollars to pay for products and services with only marginal research applications, such as computer terminals, telephone bills, and magazine subscriptions. Using soft dollars for such services could harm investors because advisers have an incentive to freely obtain such services that they would otherwise have to pay for out of their profits.

SEC noted that mutual fund advisers tend to abide by the spirit of section 28(e) more diligently than other investment advisers. In 1996 and 1997, SEC examiners conducted an examination sweep into the soft dollar practices of broker-dealers, investment advisers and mutual funds. In their 1998 inspection report, SEC staff documented instances of soft dollars being used for products and services outside the safe harbor, as well as inadequate disclosure and bookkeeping of soft dollar arrangements. However, SEC staff indicated that their review found that mutual fund advisers engaged in far fewer soft dollar abuses than other types of advisers. They attributed mutual fund adviser compliance to the role that independent directors play in overseeing and approving advisers' soft dollar arrangements. The SEC staff also indicated that active involvement by legal counsel in the affairs of mutual funds may contribute to the relative lack of soft dollar abuses among mutual fund advisers as well.

Investment advisers also receive services in exchange for part of the brokerage commissions they pay with fund assets that directly reduce the costs borne by mutual fund investors. In these cases, instead of the adviser receiving research or brokerage services, the adviser, at the request of the fund board, could direct the broker-dealer executing a trade to use a portion of the commission paid to pay an expense of the mutual fund. For example, the executing broker-dealer could mail a payment to the fund's custodian for the services rendered to the mutual fund that could reduce the amount the fund itself would have to directly pay the custodian out of fund assets. Alternatively, the executing broker-dealer could rebate part of the brokerage commission to the fund in cash. Such directed brokerage arrangements do not fall under the section 28(e) safe harbor and do not present the same conflicts of interest as traditional soft dollar arrangements, because the investor, not the adviser, is directly benefiting from them. An industry participant has indicated that such arrangements are not very common in the mutual fund industry.

Regulators and Industry Participants Have Proposed Alternatives for Mitigating Potential Conflicts Involving Soft Dollar Use

As a result of its 1998 inspection report on its soft dollar examination sweep, SEC staff made several proposals that could help investors better evaluate advisers' use of soft dollars. In the examination sweep, SEC examiners found inconsistencies in how advisers and broker-dealers interpreted the section 28(e) safe harbor. Staff also found poor record keeping and internal controls for soft dollar arrangements and that advisers were not adequately disclosing their soft dollar usage. As a result, SEC staff recommended that Form ADV be modified to require more meaningful disclosure. To facilitate this disclosure, SEC staff also recommended that SEC publish the inspection report and issue additional guidance to clarify the scope of the safe harbor. SEC published the inspection report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers, and investment companies that participate in soft dollar arrangements. This recommendation may help industry participants apply the standards articulated in the 1986 interpretive release more consistently and ensure that investor dollars only pay for research and brokerage services within the scope of section 28(e). Additionally, SEC staff recommended that SEC consider adopting a bookkeeping requirement. A bookkeeping requirement would enable advisers to disclose more easily to investors the products and services for which soft dollars are paying. It would also ensure that directors are able to receive information that fairly reflects the adviser's soft dollar arrangements. SEC staff told us that if the expanded disclosure and other changes envisioned in their sweep report were implemented, clients of investment advisers also would have more specific information that could allow them to evaluate the appropriateness of their own adviser's use of soft dollars. The Department of Labor, which oversees pension funds, and the Association for Investment Management and Research, which administers professional certification examinations for financial analysts, have also called for improved disclosure of soft dollar usage by investment advisers.[33]

[33]See Department of Labor Advisory Council on Employee Welfare and Benefit Plans, *Report of the Working Group on Soft Dollars/Commission Recapture* (Nov. 13, 1997); and Association for Investment Management and Research, AIMR Soft Dollar Standards (August 1999).

However, SEC has yet to implement some of these recommendations due to staff turnover and other high priority business. Except for publishing the inspection report and issuing interpretative guidance that classifies certain riskless principal transactions as falling under the section 28(e) safe harbor, SEC has not issued further guidance regarding soft dollars.[34] A soft dollar bookkeeping requirement has been discussed as part of a larger SEC initiative on bookkeeping, but no formal proposal has been presented. Finally, the SEC issued a proposed rule on Form ADV modifications in April 2000, which solicited comments on several changes that could force advisers to make more meaningful disclosures of soft dollar arrangements. However, this rule has not been adopted.[35] SEC staff told us that they have not taken further actions on these proposals due to staff turnover and the press of business in other areas.

Some industry participants are not convinced that greater disclosure would benefit investors. Form ADV is sent to advisory clients, not fund investors. Thus, the proposed disclosure requirements do not address the needs of fund investors. Investors do have access to information on a fund's soft dollar arrangements through the SAI, which is available upon request. However, representatives of one fund company with whom we spoke indicated that investors very rarely request SAIs. Industry participants also noted that it might be difficult for investors to evaluate an adviser's best execution policies, which are not uniform across funds. Moreover, more disclosure might lead investors to infer that soft dollar arrangements are necessarily harmful and therefore adverse to their best interests.

[34]In SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Securities and Exchange Commission Release No. 34-45194 (12/27/2001), SEC clarified that the term "commission" for purposes of the Section 28(e) safe harbor encompasses, among other things, certain riskless principal transactions.

[35]Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Securities and Exchange Commission, Release No. IA-1862; 34-42620 (Apr. 5, 2000).

Some proposals would seek to restrict or ban the use of soft dollars in order to encourage brokerage commissions to fall. As a result of recommendations from a government-commissioned review of institutional investment in the United Kingdom, the Financial Services Authority (FSA), which regulates the financial services industry in that country, issued a consultation paper that argued that soft dollar arrangements create incentives for advisers to route trades to broker-dealers on the basis of soft dollar arrangements and, further, that these practices do not result in a good value for investors.[36] As a result of these findings, the paper proposed banning soft dollars for market pricing and information services, as well as various other products. This recommendation would provide a more direct incentive for advisers to consider what services are necessary for efficient fund management, which could lower investors costs by reducing the extent to which advisers use client funds for services that the adviser does not need. The paper also recommended that advisers quantify, or unbundle, the cost of all other soft dollar products and services and rebate those costs to investors' accounts with hard dollars, which would result in investors having lower trading costs in their funds.

Whether implementing the actions envisioned by the FSA's proposals is feasible is not certain. For example, FSA staff acknowledged that restricting soft dollar arrangements in the United Kingdom could hurt the international competitiveness of their fund industry because fund advisers outside their country would not have to comply with these restrictions. Such restrictions could also encourage UK advisers to move their operations elsewhere. In addition, SEC staff told us that implementing the FSA proposal would be more difficult here without legislative change because the United States has the statutory safe harbor under Section 28(e), whereas the United Kingdom does not.

We learned of another proposal related to soft dollars and brokerage commissions from an industry participant who was concerned that the general practice of full-service broker-dealers charging about $0.05 to $0.06 per share in commissions and then offering discounts in the form of soft dollars was serving to keep commissions artificially high. His first suggestion would be to ban soft dollar arrangements to obtain products

[36]See P. Myners, *Institutional Investment in the United Kingdom: A Review* (Mar. 6, 2001); and Financial Services Authority, *Bundled Brokerage and Soft Commission Arrangements* (April 2003).

and services with marginal research applications, forcing advisers to pay for these products with their own profits rather than with fund assets and therefore reducing the trading costs borne by fund investors. Another suggestion he had would have broker-dealers quantify the execution-only portion of their brokerage commissions. If this information were collected by SEC and reported as industry averages, mutual fund directors would have more information to use to evaluate their fund's trading activities.

However, many industry participants are skeptical about whether soft dollar arrangements contribute to investors paying higher brokerage commissions. For example, according to SEC officials and an industry participant, many broker-dealers claim that they would not negotiate lower commission rates with investment advisers regardless of whether an adviser was willing to forfeit soft dollar products and services in return. One group with whom we spoke suggested that soft dollars might be more of a volume rebate for brokerage than a factor influencing commission rates. Moreover, surveys of investment advisers and broker-dealers conducted in the United Kingdom found that third-party soft dollar arrangements were a very minor factor on which broker-dealers competed for business and advisers selected broker-dealers. These results suggest that advisers' incentive to compromise their fiduciary responsibility to seek best execution in return for generous soft dollar arrangements might be overstated.

Concern has also been raised about how the value of some soft dollar products and services could be fairly determined. Because proprietary soft dollar products and services are bundled, their values as individually purchased items are difficult to estimate. For example, SEC officials noted that it is hard to put a meaningful value on the cost of information exchanged in a phone call between a fund adviser and a broker-dealer. Nevertheless, brokerage commissions pay for this type of informal access. Some industry experts, including SEC, have noted that attempts to require the industry to quantify the value of soft dollar services could have a disproportionate impact on third-party research. Third-party research is free from the potential conflicts of interest that have recently tainted some proprietary research from brokerage houses. Additionally, several fund companies have indicated that they find research provided by specialized research firms does provide valuable insights into investment decisions. Because broker-dealers use soft dollar credits to purchase third-party research, its value is more easily determined than proprietary research. As a result, some have expressed concern that this distinction could make third-party research more vulnerable if regulatory changes were enacted.

Some have suggested that limiting the products and services that could be obtained with soft dollars might have some unintended consequences. According to some fund officials, this option could shift a greater financial burden onto advisers, who might be tempted to raise management fees as a result. While having investment advisers pay directly for research and brokerage services rather than receive them through soft dollars could increase the transparency of these arrangements, the increased costs to the adviser could cause advisers to seek fee increases or at least prevent further reductions in the fees advisers do charge.

Conclusions

Although mutual funds disclose considerable information about their costs to investors, some industry participants urge that additional disclosures are needed to further increase the awareness of investors of the fees they pay as part of investing in mutual funds and to encourage greater competition among mutual funds on the basis of these fees. The SEC staff's proposal to require funds to disclose the actual expenses in dollars based on an investment amount of $10,000 would provide investors with more information on fund fees and in a form that would allow for direct comparison across funds. If adopted, this will provide investors selecting among different funds with useful information prior to investing. However, additional disclosures could also improve investor awareness and the transparency of these fees. Providing existing investors with the specific dollar amounts of the fees paid on their shares and placing fee related disclosures in the quarterly account statements that investors receive would put mutual fund disclosures on comparable footing to many other financial services that already disclose specifically in dollars the cost of their services. Seeing the specific dollar amount paid on their shares could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees.

Given the cost of producing such disclosures and the lack of data on the additional benefits to investors, the SEC staff have indicated that they were not certain that specific dollar disclosures are warranted. However, we believe that actively weighing the costs and benefits of providing additional disclosure is worthwhile. In addition, other less costly alternatives are also available that could increase investor awareness of the fees they are paying on their mutual funds by providing them with information on the fees they pay in the quarterly statements that provide information on an investor's share balance and account value. For example, one alternative that would

not likely be overly expensive would be to require these quarterly statements to present the information that SEC has proposed be added to mutual fund's semiannual reports that would disclose the dollar amounts of a fund's fees based on a set investment amount. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative could be to require quarterly statements to also include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information. If additional fee disclosures such as these were used to supplement the existing information already provided in prospectuses and semiannual reports, both prospective and existing investors in mutual funds would have access to valuable information about the relative costs of investing in different funds.

Mutual fund directors play a critical role in overseeing fund advisers activities and have been credited with ensuring that U.S. mutual funds have lower fees than those charged in other countries. However, the popularity of mutual fund investing and the increasing importance of such investments to investors' financial well being and ability to retire securely also increases the need for regulators and industry participants to continually seek to ensure that mutual fund corporate governance practices remain strong. The recent corporate scandals have resulted in various corporate governance reforms being proposed to improve the oversight of public companies by their boards of directors. We have supported regulatory and industry efforts to strengthen the corporate governance of public companies. Although many of the reforms being sought for public companies are already either embodied in regulatory requirements or recommended as best practices by the mutual fund industry group, additional improvements to mutual fund governance, such as mandating supermajorities of independent directors, are likely to continue to be considered by regulators and industry participants, which should further benefit mutual fund investors.

Although the ways that funds use 12b-1 fees has changed over time, these fees appear to have provided investors with increased flexibility in choosing how to pay for the services of the individual financial professionals providing them with advice on fund purchases. As a result, they appear to provide benefits to the large number of investors that require assistance with their financial decisions. The revenue sharing payments that funds make to broker-dealers illustrate that mutual funds must compete to obtain access to the distribution networks that these firms provide. How and the extent to which these payments affect the

overall level of fees that fund investors pay is not clear. However, by compensating broker-dealers to market the funds of a particular company, they can introduce a conflict with the broker-dealer obligation to recommend the funds most suitable to the investor's needs. Further, even if the payments do not conflict with this obligation, the payments can result in financial professionals providing investors with fewer investment choices. Regulators acknowledged that the currently required disclosures might not provide needed transparency to investors at the time that mutual fund shares are being recommended for purchase. Having additional disclosures made at the time that fund shares are recommended about the compensation that a broker-dealer receives from fund companies could provide investors with more complete information to consider when making their investment decision.

Fund investors can benefit when their fund's investment adviser uses soft dollars to obtain research and brokerage services that benefit the fund or to pay other fund expenses. However, investment advisers may also use soft dollars for services that may just reduce the adviser's own expenses. The SEC staff has recommended various changes that would increase the transparency of soft dollar practices by clarifying the acceptable uses of soft dollars and providing fund investors and directors with more information about how their fund's adviser is using soft dollars. However, the rule proposal to expand advisers' disclosure of their use of soft dollars was issued about 3 years ago and has not yet been acted upon. In addition, the SEC staff have not developed and issued a formal rule proposal to implement its recommendation to require increased soft dollar recordkeeping by broker dealers and advisers that would increase the transparency of these arrangements. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, by not acting on these soft dollar-related measures, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

Recommendations

To promote greater investor awareness and competition among mutual funds on the basis of their fees, we recommend that the Chairman, SEC increase the transparency of the fees and practices that relate to mutual funds by

- considering the benefits of additional disclosure relating to mutual fund fees, including requiring more information in mutual fund account statements about the fees investors pay;
- evaluating ways to provide more information that investors could use to evaluate possible conflicts of interest resulting from any revenue sharing payments their broker-dealers receive; and
- evaluating ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar examinations report.

Agency Comments and Our Evaluation

SEC and ICI generally agreed with the contents of this report. Regarding our recommendation that SEC consider additional ways to provide fee information to investors in account statements, the letter from the director of the Division of Investment Management notes that the SEC staff agreed that mutual fund shareholders need to understand the amount of fees that mutual funds charge and indicated that they would consider whether some form of fee disclosure could be included in account statements as they continue to evaluate the comments they have received on their proposed disclosure changes. Regarding our recommendations on increasing the amount of information disclosed about revenue sharing and soft dollar arrangements, the SEC staff also indicated that they intend to consider ways in which additional information about these practices could be disclosed.

The letter from the president of ICI notes that our report's discussion of mutual fund regulatory requirements is generally balanced and well informed. However, his letter indicates concern over how we compare the disclosures made by mutual fund fees to those made by other financial products. According to the letter, ICI staff are convinced that current mutual fund fee disclosures allow individuals to make much more informed and accurate decisions about the costs of their funds than do the disclosures made by other financial service firms. In particular, they indicated that they are not aware of any other financial product that is legally required to provide standardized information that reveals the exact level of all of its fees and expenses and projects their impact in dollar terms over various time periods.

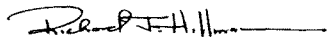
We agree with ICI that mutual funds are already required to make considerable disclosures that are useful to investors for comparing the level of fees across funds. Although our report notes that, unlike mutual funds, other financial products generally do disclose their costs in specific dollar terms, we do not make a judgment as to whether the overall disclosures provided by these products are superior to that provided for mutual funds. Instead, we believe that supplementing the existing mutual fund disclosures with additional information, particularly in the account statements that provide investors with the exact number and value of their mutual fund shares, could also prove beneficial for increasing awareness of fees and prompting additional fee-based competition among funds.

The ICI's staff's letter also indicates that our report presents a thorough and useful discussion of the role played by independent directors in overseeing mutual fund fees. However, they expressed concern that mutual fund independent directors are not usually given sufficient credit for protecting fund shareholder interests. ICI noted that independent directors have helped keep the industry free of major scandal and that mutual fund governance standards, as set by the Investment Company Act of 1940, places strict requirements on funds that exceed the voluntary standards with which public companies are expected to adhere. We agree with ICI that independent directors have played important roles in overseeing funds and, in each of the issues addressed by our report, we discuss the actions taken by mutual fund directors to oversee the issues and that SEC reviews generally find that directors have fulfilled their duties in accordance with the law. However, given recent scandals and concerns related to corporate responsibility in the financial sector and the growing importance of fund investments to the financial health and retirement security of investors, continued debate by the Congress and among regulators and industry participants about the effectiveness of existing mutual fund corporate governance standards is appropriate. SEC's and ICI's written responses are shown in appendixes II and III.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will provide copies of this report to the Chairman and the Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs, and the Ranking Minority Members, House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Copies also will be provided to the Chairman, SEC; the President, ICI; and other

interested parties. The report will also be available at no charge on GAO's home page at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact Mr. Cody Goebel or me at (202) 512-8678. GAO staff that made major contributions to this report are shown in appendix IV.



Richard J. Hillman
Director, Financial Markets
and Community Investment

Appendix I

Scope and Methodology

To describe mutual fund fee and trading cost disclosures and other financial product disclosures and the related costs we reviewed SEC rules and studies by academics and others, and various mutual fund company fund literature including prospectuses and SAIs, as well as prior GAO work. To evaluate the benefits of additional mutual fund cost disclosure we collected opinions from a judgmental sample of 15 certified financial planners with the use of a structured questionnaire.

To describe the role of mutual fund independent directors we reviewed federal laws and regulations, academic studies, and prior GAO work. We collected opinions from officials representing an independent directors association and from a judgmental sample of independent directors with the use of a structured questionnaire.

To obtain information on mutual fund distribution practices we interviewed officials of ten mutual fund companies, two broker-dealers, ICI, NASD, SEC, mutual fund research organizations, and investor advocacy organizations and individuals. We also reviewed and analyzed various documents and studies of mutual fund distribution practices.

To address the benefits and potential conflicts of interest raised by mutual funds' use of soft dollars, we spoke with the FSA and other industry experts on soft dollars. We also reviewed studies by regulators and industry experts on soft dollar arrangements. Some groups we spoke to had made specific recommendations for regulatory changes to soft dollar arrangements. To the extent possible, we discussed the potential advantages and disadvantages of these recommendations with officials of the ten mutual fund companies, two broker-dealers, ICI, NASD, SEC, mutual fund research organizations, and investor advocacy organizations and individuals.

For each of the topics we reviewed in this report we gathered views from staff at SEC, mutual fund company officials, broker-dealers, ICI, mutual fund research organizations, and investor advocacy organizations and individuals. We conducted our work in Washington, D.C.; Boston, MA; Kansas City, MO; Los Angeles, CA; New York, N.Y.; and San Francisco, CA, from February to June 2003, in accordance with generally accepted government auditing standards.

Appendix II

Comments from the Securities and Exchange Commission

DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 2, 2003

Richard J. Hillman
Director, Financial Markets
and Community Investment
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Re: GAO Draft Report
Mutual Funds: Greater Transparency Needed in Disclosures to Investors

Dear Mr. Hillman:

Thank you for the opportunity to comment on the General Accounting Office's draft report on mutual fund expense disclosures to investors. The report reviews a variety of issues relating to mutual fund fees, including: how mutual funds disclose their fees and related trading costs; the role of mutual fund directors in overseeing fees; the effect on investors of changes in the way in which mutual fund shares are marketed and distributed; and concerns related to mutual funds managers' use of soft dollars to obtain research and other services. I commend the GAO for contributing to the public dialog about these important matters.

The report raises important issues concerning the impact of mutual fund fees on investors. The major conclusion of the report is that additional disclosure could help increase investor awareness and understanding of mutual fund fees and, thereby, promote additional competition by funds on the basis of fees. The report makes three recommendations, each of which we address below.

I. Additional Disclosure Related to Mutual Fund Fees

First, the report recommends that the Commission consider the benefits of additional disclosure relating to mutual fund fees, including requiring mutual fund account statements to remind investors of the fees they pay.

We agree that shareholders need to understand the amount of fees that mutual funds charge. The primary focus of our disclosure effort has been to make fund fees and expenses more transparent to investors and to allow investors the ability to compare fees and expenses between different funds, as well as to educate investors about the importance of fees.

As you know, in December 2002 the Commission requested comment on a proposal to require mutual funds to include in reports to shareholders the dollar cost associated with a $10,000 investment.[1] In the proposal the Commission requested comment on whether there are better vehicles than annual and semi-annual reports to shareholders in which to include additional disclosure about fund expenses. The Commission also asked whether requiring disclosure of the actual costs paid by an individual investor in his or her account statements would be preferable, and if so, what benefits individualized cost disclosure in account statements would provide to investors that disclosure in shareholder reports of an initial $10,000 investment would not.

We currently are receiving and evaluating comments on the rule proposal. In formulating our recommendation to the Commission on how to proceed on this issue, we will consider whether some form of disclosure in account statements, including the disclosure recommended in your report, should be required.

II. Revenue Sharing Arrangements

Second, the report recommends the Commission evaluate ways to provide more information that investors could use to evaluate possible conflicts of interest resulting from any revenue sharing payments their broker-dealers receive.

A broker-dealer is generally required to disclose to its customer, in writing, at or before the completion of the transaction, that it has or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or will receive, from the fund's investment adviser.[2] A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.[3] Many funds disclose in their prospectuses information about their investment advisers' revenue-sharing payments to broker-dealers, which has the effect of facilitating the broker-dealers' compliance with that obligation.

The Commission is concerned about the disclosure of revenue sharing payments and recently has recognized that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue sharing payments. The Commission therefore directed its staff to make recommendations to the Commission as to whether additional disclosure should be

1 Investment Company Act Release No. 25870 (Dec. 18, 2002).

2 Rule 10b-10 under the Securities Exchange Act of 1934.

3 See "Securities Confirmations," Exchange Act Release No. 13508 at n.41 (May 5, 1977); Commission brief, Cohen v. Donaldson, Lufkin & Jenrette Securities Corp., reported as Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000) (No. 97-9159).

required or current disclosure further refined.[4] The Commission's staff currently is reviewing these issues.

III. Soft Dollars

Lastly, the report recommends that the Commission evaluate ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar report.

The soft dollar report, among other things, recommended that the Commission amend form ADV to require more specific and meaningful soft dollar disclosure (including the availability of commission recapture to clients). The soft dollar report also recommended that the Commission require advisers who obtain soft dollar benefits from broker-dealers to maintain a detailed list of all products and services received from broker-dealers for soft dollars, and that broker-dealers provide to advisers a statement of products, services and research that they provided for the soft dollars.

The Commission has proposed amendments to Form ADV as recommended by the soft dollar report. The proposal would require an adviser who receives soft dollars to disclose the adviser's soft dollar practices and discuss the conflicts of interest that result. The proposed description of soft dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and to permit clients to evaluate the conflicts.

Additionally, the staff intends to make recommendations to the Commission concerning record keeping by including soft dollar record keeping requirements as part of an overall modernization of the record keeping requirements for investment advisers.

* * * * * * * * *

We recognize that investors need to be further educated about the fees and expenses that mutual funds charge. As part of our responsibilities in regulating mutual funds, we will consider the recommendations in your report very carefully in determining how best to inform investors about the importance of fees. Again, thank you for the opportunity to comment on your report.

Sincerely,

Paul F. Roye
Director

[4] See Press v. Quick & Reilly, Inc., 218 F. 3d 121, 132 n. 13 (July 10, 2000).

Appendix III

Comments from the Investment Company Institute

INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK
PRESIDENT

June 2, 2003

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment
General Government Division
U.S. General Accounting Office
441 G Street N.W.
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for providing us with the opportunity to comment on GAO's draft report entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors. Overall, we believe that the draft report thoughtfully considers several approaches to enhancing the transparency of mutual funds in ways that should assist current and prospective mutual fund shareholders in achieving their long-term investment goals.

In our view, effective regulation and extensive transparency are critically important reasons why so many Americans have come to rely on mutual fund investments to help secure their retirement and support their children's education. Yet we are also aware that simply adhering to what has worked in the past does not guarantee success in the future. The mutual fund industry therefore is committed to working with you, the U.S. Securities and Exchange Commission and leaders in Congress to support meaningful regulatory reforms that will enable mutual funds to continue to earn the trust and confidence of tens of millions of individual investors.

The draft report's discussion of mutual fund regulatory requirements is generally balanced and well informed. We do have one suggestion that, if addressed, would clarify and strengthen the report's discussion of fee disclosure practices among various financial services firms.

Specifically, we are concerned about the impression conveyed by the draft report's assessment of mutual fund fee disclosures relative to other financial services products. We believe very strongly that mutual fund fees are disclosed more thoroughly, accurately and effectively than the fees of any other financial service or product. The fact is that every individual considering a mutual fund investment, whether on his or her own or with the help of an adviser, enjoys ready access to simple and easy-to-use fee information. This information is clearly presented in a strictly regulated fee table that must appear prominently at the front of every fund prospectus. The fee table provides critical information, like the fund's expense ratio, that makes exact comparisons among funds easy and reliable. The expense ratio, along with the required example showing the impact of all of the fund's fees on a standard $10,000 investment, provides

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key information to prospective investors, as well as to the media, information providers and others who offer views about mutual fund investments.[1]

We are convinced that these fee disclosures allow individuals to make much more informed and accurate decisions about the costs of their mutual funds than do the disclosures made by other financial service firms identified in the draft report. In particular, we are not aware of any other financial product or service that is legally required to provide standardized information that reveals the exact level of all of its fees and expenses and projects their impact in dollar terms, over various time periods. While the draft report does not suggest that mutual fund fee disclosures are inferior to those of other financial services, we are concerned that the discussion of products that provide "specific dollar disclosures" could convey this impression. For example, the draft report appears to cite favorably the manner in which specific costs are disclosed to mortgage borrowers. Omitted from the discussion, however, is the fact that mortgage borrowers often receive these disclosures as part of a blizzard of paperwork requirements, and that such disclosures are typically provided at a point when borrowers have little or no ability to evaluate similar costs among competing firms. As the Administration's Assistant Treasury Secretary for Financial Institutions said in late 2001, "[a]n effective disclosure scheme requires that borrowers are able to clearly understand their mortgage's terms and conditions and that the information be reliable. On both counts our current disclosure scheme appears to be lacking."[2]

We also would like to comment on the draft report's discussion of the duties of mutual fund independent directors. We believe the discussion is quite thorough, and provides a useful analysis of the manner in which they fulfill their fee-related responsibilities to fund shareholders. However, we remain concerned that mutual fund independent directors are too rarely given the credit they deserve for guarding against self-dealing, helping sustain the mutual fund industry's culture of strong compliance with the securities laws, and helping the industry remain largely free of major scandal. While there is compelling evidence that mutual fund directors have successfully overseen mutual fund fees, in part by negotiating schedules that produce substantial automatic reductions in fee levels when a fund's assets grow, we think it is important to stress that this is not the only important function independent directors perform. The report GAO authored three years ago – before the recent renewal of public attention to corporate governance matters – acknowledged that, "the law also places various other responsibilities [beyond fee-related duties] on fund directors that exceed those of the directors of a typical corporation."[3] More recently, an analysis in *The Boston Globe* pointed out

[1] As you note in the draft report, the system of mutual fund fee disclosure may soon be enhanced. Assuming it is adopted by the SEC, reports that are sent to mutual fund shareholders twice each year will, for the first time, prominently feature fee disclosures, including exact dollars and cents costs based on a fixed dollar amount of an investment. In addition, the SEC has proposed and may soon adopt changes to mutual fund advertising rules that will require references to the fee disclosures in fund prospectuses.

[2] "Mortgage Reform and Predatory Lending: Addressing the Challenges," Remarks of the Hon. Sheila Bair, Assistant Treasury Secretary for Financial Institutions, November 8, 2001.

[3] "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," U.S. General Accounting Office (June 2000), p. 88, fn. 9.

that governance standards at "public companies [were] behind mutual funds [because] the Investment Company Act of 1940 spells out the legal responsibilities of funds to their investors. Public companies follow voluntary codes of ethics when it comes to governance. Second, the SEC directly regulates mutual funds [but at] public companies, it has no authority to set corporate governance rules."[4]

Again, the Institute appreciates the opportunity to offer comments on the draft report. We also look forward to working constructively and expeditiously with you, the SEC and Members of Congress as the report is reviewed and the possibility of further regulatory improvements to an effective system of mutual fund fee disclosures are considered.

Very truly yours,

Matthew P. Fink

[4] Beth Healy, "A Model of Independence," The Boston Globe, July 5, 2002.

Appendix IV

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