Consumer Federation of America

Testimony of
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On Financial Management, the Budget, and International Security

Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors

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Good morning. I am Travis Plunkett, Legislative Director of the Consumer Federation of America. CFA is a non-profit association of 300 organizations founded in 1968 to advance the consumer interest through advocacy, research and education. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is one of our top priorities.

Introduction

I want to congratulate Chairman Fitzgerald, Ranking Member Akaka and the members of the Committee for holding hearings today on mutual fund practices that harm investors, including excessive costs and the convoluted and sometimes hidden incentives used to promote their sale. In doing so, you have opened a window into a mutual fund scandal that does far more harm to its victims than the recently revealed trading abuses – and that is the scandal of how mutual funds are sold to unsuspecting investors and the high costs that result.

This is not to excuse the trading abuses that were permitted to occur at all too many fund companies. They represent a gross violation of trust. However, investors who fall victim to abusive sales practices are likely to suffer far greater financial harm over the life of their investment than those who are victims of trading abuses.

I am referring here to the nearly 50 percent of mutual fund transactions that are conducted between broker-dealers and retail investors. What sets these transactions apart is the veneer of "impartial" advice that attaches to them. Recognizing that investors want and expect objective advice from their financial professionals, brokers have marketed themselves very aggressively in recent years as professional purveyors of just such advice. And they justify the commissions they receive in large part as compensation for the "advice" they offer. In fact, broker-dealers are not advisers, but salespeople. And the overwhelming evidence now suggests that they select the mutual funds (and other products) they recommend, not based on which offer the highest quality at the lowest price, as one would expect from an objective, professional adviser, but rather based on which offer lucrative financial incentives to the brokerage firm and the individual sales representative.

The incentives that are used to induce those sales are complex and often poorly disclosed, if they are disclosed at all. They include 12b-1 fees, directed brokerage, and payments for shelf space, in addition to the front and back loads that some funds charge. Furthermore, the competition among funds to be sold, in which compensation to the broker is often the most important determinant of fund sales, frees funds from having to compete by offering a high quality product at a reasonable price. As such, it allows funds to survive and even thrive that could not do so based on an objective assessment of their cost and quality.

This abusive approach to mutual fund sales harms some investors directly – by channeling them into funds with higher costs and poorer performance than they might otherwise have purchased. The long-term costs of a poor selection can be measured in the added thousands or tens of thousands of dollars that might have been earned from a lower cost, higher quality fund. Even investors who are not saddled with high sales loads, 12b-1 fees, and other distribution costs for poorly performing funds may be harmed indirectly by the sales model's weakening effect on mutual fund price competition. This lack of effective price competition permits and may even encourage escalation not just of distribution costs, but also of other shareholder expenses, such as portfolio transaction costs and management and administrative fees.

Abusive sales practices are not new. As a result of the negative light cast on the mutual fund industry by the recently revealed trading scandals, however, these old practices are getting new scrutiny – from Congress, the Securities and Exchange Commission, the National Association of Securities Dealers, and state securities regulators. This is a healthy, and long-overdue development.

So far, however, those who have examined these issues have tended to look at each practice – 12b-1 fees, payment for shelf space, soft dollar arrangements, unreasonably high management/administrative costs – in isolation. It is our strongly held view, however, that these practices – these problems – are closely related and need a unified, rather than piecemeal solution. Furthermore, while the mutual fund companies have certainly been accomplices in these practices, and thus bear a portion of the blame, many of these are problems that derive in large part from the broker-dealer sales model. Only a solution that addresses the gaping disparity between brokers' self-promoted images as objective advisers and their status as biased salespeople will be effective in driving down costs.

In my testimony today, I will discuss several abusive practices that help to drive up the cost of mutual funds to unreasonable levels. These include:

- 12b-1 fees that are used for entirely different purposes than those for which they were intended;

- revenue sharing arrangements that inflate current shareholders' portfolio transaction costs or management fees in return for agreements that promote the sale of the fund to new shareholders;

- soft-dollar agreements that similarly inflate shareholders' portfolio transaction costs in return for benefits that may or may not flow to those shareholders; and

- unreasonably high management/administrative costs at some fund companies that cannot be justified based on any additional level of performance or service offered by those funds.

I will then discuss how the mutual fund distribution system permits and even promotes these practices and review the regulatory response to date. Finally, I will propose additional reforms that can and should form the basis for comprehensive legislation to eliminate abuses and bring real price competition to the mutual fund marketplace.

12b-1 Fees

Rule 12b-1 was adopted by the SEC in 1980 after a lengthy period in the seventies in which funds had been losing assets. The rule permitted funds to use shareholder assets, rather than fund company assets, for certain marketing expenses. Under the rule, fees of up to 100 basis points, or one percent, can be charged as part of the fund's annual operating expenses.[1] Before the fees can be imposed, however, a 12b-1 plan must be approved by the fund's board of directors.

As the factors that directors are required to consider in approving such plans make clear, 12b-1 fees were intended to be used as "a short-term fix to a temporary problem" – the need to counter redemptions and build fund assets – not as a permanent means of paying for fund distribution.[2] Today, however, real world practice no longer reflects that intent. A study to be released today by mutual fund data research firm Lipper, Inc. has reportedly found that two-thirds of funds charge the fees, and 90 to 95 percent of them use the money to compensate brokers.[3] This allows funds to compensate brokers without having to charge an up-front sales load.[4] Similarly, fund companies that participate in fund supermarkets may use 12b-1 fees to cover the cost. Neither of these practices is consistent with the temporary nature of the fees envisioned by the SEC when it adopted the rule.

As a result of the transformation of 12b-1 fee from temporary to primarily permanent uses, these fees are no longer imposed exclusively by small, struggling funds as a way to build

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[1] NASD rules limit the amount of the fee that can be paid to broker-dealers to no more than 0.75 percent of the fund's average net assets for the year. An additional 0.25 percent service fee can go to the broker for providing on-going services to investors or for maintaining their accounts.

[2] "12b-1 Fees: Politics and Policy," *Fund Democracy Insights*, Vol. 1, Issue 4, September 2001. The article lists the relevant factors directors are required by the rule to consider in approving a 12b-1 plan, including "the nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate," "how it would be expected to resolve or alleviate them," and "the time it would take for those benefits to be achieved." The factors also require directors to "consider 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."

[3] Brooke A. Masters, "Fund Fees Vital but Need Review, Lipper Says," *The Washington Post*, January 20, 2004.

[4] When brokers sell B shares of a fund, for example, the fund company typically pays the broker a commission up-front out of fund company revenues and then uses revenues generated by 12b-1 fees to reimburse itself for that cost.

assets and create economies of scale. As the Lipper research apparently shows, they have become all but ubiquitous, charged even by funds with billions of dollars in assets. The reason is hardly mysterious. As investors in the late 1980s and early 1990s became increasingly resistant to paying up-front sales loads when no-load options abound, the industry began looking for other ways of paying those distribution costs that would be less likely to attract investors' notice. 12b-1 fees filled the bill perfectly, because, although 12b-1 fees are disclosed as a line item in the fee table contained in fund prospectuses, many if not most investors appear to have a poor understanding of the fees and their long-term impact on shareholder returns.[5]

Brokers benefited from the increasing use of 12b-1 fees, because it gave the funds they were selling the appearance of lower costs, at least to unsophisticated investors, even when the opposite was true. Fund companies have benefited as well, because their management fees are paid as a percentage of assets under management and grow when fund assets grow. Use of 12b-1 fees allows them to boost their bottom line without risking fund company assets in the process. While fund companies often reduce management fees as fund assets hit certain benchmarks, they have clearly not fully passed along the economies of scale that have come with a rapidly growing asset base.[6] Thus, investors in funds that charge substantial 12b-1 fees may be stuck paying distribution costs whose benefits flow partially, or primarily, to the fund company, even when they themselves do use the services the fees are designed to provide.

Directed Brokerage

Another practice that grew out of the industry's desire to find less visible ways to pay distribution costs is the use of directed brokerage for this purpose. Under this form of "revenue sharing" payment, a fund agrees to conduct portfolio transactions through a particular broker in return for an agreement by that broker to sell the funds in that fund family. In practice, such agreements often mean the fund foregoes an opportunity to obtain lower transaction costs. Since transaction costs are paid directly from fund assets, any practice that drives up fund transaction costs will depress shareholder returns.

The conflict is virtually identical to that described above with regard to 12b-1 fees. The fund company uses the assets of current shareholders to promote the sale of the fund, or other funds in the same family, to potential investors. In the process, it boosts its own bottom line, which is based on a percentage of assets under management, without having to risk its own assets. As a result, shareholders are forced to pay higher costs for benefits that flow in part or in full to the fund company or, in some cases, to investors in other funds. Furthermore, some have

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[5] For example, Paul Roye, Director of the Division of Investment Management of the Securities and Exchange Commission commented on the poor state of investor understanding of mutual fund costs and fees in his July testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives.

[6] "Tricks of the Trade," by Craig D. Rose, *Union-Tribune* quotes New York Attorney General Eliot Spitzer as saying that mutual fund investment grew 60-fold between 1980 and 2000, while the industry's fees increased 90-fold, indicating that economies of scale are not being passed along to shareholders.

suggested that fund companies may be tempted by directed brokerage agreements to engage in unnecessary and excessive trading, which drives up shareholders' costs, in order to generate more commissions and boost the incentive for a broker to sell the family's funds.[7]

The practice appears to be quite widespread. A recent SEC enforcement sweep of 15 broker-dealers that sell mutual funds found that 10 of the 15 accepted revenue sharing payments in the form of brokerage commissions on fund transactions.[8] According to one estimate, $1.5 billion a year of the fund industry's $6 billion in trading commissions goes to pay for distribution through such arrangements, but others have suggested the percentage is much higher.[9]

Directed brokerage has one enormous advantage over 12b-1 fees as a means of paying distribution costs, at least if your goal is to keep those costs hidden. While 12b-1 fees enable funds to lower or eliminate the up-front load many investors object to, they still inflate the annual expense ratio and are clearly disclosed as a separate line item in mutual fund prospectuses.[10] Portfolio transaction costs, on the other hand, are only incompletely disclosed in the Statement of Additional Information, which is not automatically distributed to investors and is rarely requested.[11] Thus, distribution costs paid for through directed brokerage do not show up either in the form of a sales load or in the form of an inflated expense ratio.

Payments for Shelf Space

Payments for shelf space are another form of revenue sharing payment used to promote distribution. In this case, the fund's investment adviser makes cash payments to the broker-dealer in return for "increased access to their sales staff, or for 'shelf space.'"[12] The SEC, in its examination sweep, found that payments vary considerably, from 5 to 40 basis points on sales and from 0 to 25 basis points on assets that remain invested through the broker-dealer. Fourteen

[7] "Misdirected Brokerage," by Rich Blake, *Institutional Investor Magazine*, June 17, 2003.

[8] "SEC Revenue Sharing Examination Findings" email provided to reporters by SEC Tuesday, January 13, 2004.

[9] "Misdirected Brokerage." The $1.5 billion figure – or 25 percent of funding industry generated trading commissions, is attributed to a "former fund marketing executive." The article quotes former SEC attorney Edward Siedle as suggesting the amount is closer to 75 percent.

[10] Since investors who purchase funds through brokers often do not receive the prospectus until after the sale, this "clear" disclosure does not necessarily equate with effective disclosure.

[11] Funds report the commissions they pay, but not other portfolio transaction costs, such as spreads, in the SAI. In addition, they may disclose the existence of revenue sharing payments generally in their prospectuses or the SAI, according to the SEC's email outlining its examination findings. The SEC also found that only about half of the broker-dealers disclosed their revenue sharing arrangements in any way, and that some of those disclosed only the existence of the payments without providing any other details.

[12] SEC email of examination findings.

of 15 broker-dealers examined as part of the SEC sweep received such cash payments. Thirteen "appear to have favored the sale of the revenue sharing funds by providing increased access and visibility in the broker-dealer's sales networks (e.g. listings on firms' websites, access to sales staff, promotional material sent to customers, inclusion on firms' recommended lists)."[13] About half of the brokers also paid their registered representatives more to sell the revenue sharing funds than they paid for the sale of other funds (except, in three cases, for proprietary funds).[14]

Unlike 12b-1 fees and directed brokerage, payments for shelf space do not come directly out of shareholders' pockets. Instead, the fund managers make the payments out of fund company revenues and must either absorb the cost or pass it along to shareholders indirectly as part of the management fee. At the very least, by eating into the manager's bottom line, the payments may reduce the likelihood that the management fee will be reduced in response to growth in fund assets. At worst, fund managers will pass those costs along to investors in a form that is even less transparent than directed brokerage payments.

Soft Dollar Arrangements

Soft dollar arrangements, like directed brokerage, involve an agreement by the fund company to pay higher trading commissions than might otherwise be available on its portfolio trades. In return, in this case, the fund receives not distribution, but research and other services. The practice is permitted as a result of a 1975 amendment to the Securities Exchange Act, which created a "safe harbor" for money managers who do not seek the lowest commission costs but instead use commissions to pay for certain types of non-overhead services.

The safe harbor was conceived primarily to allow funds to purchase research. A 1998 SEC study estimated that funds used soft dollar arrangements to purchase more than $1 billion in third-party research in a year.[15] A mutual fund executive testified before a House subcommittee in March that the research component of soft dollar commissions is worth six times the execution component.[16] Thus, the potential for these arrangements to significantly drive up shareholder costs is substantial. In recent years, soft dollars have also been used for a variety of services beyond research, including subscriptions, data feeds, pricing services, and other such services that closely resemble the type of overhead items for which use of soft dollars is prohibited.

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[13] Ibid.

[14] Ibid.

[15] *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, Securities and Exchange Commission, September 22, 1998.

[16] 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, March 12, 2003.

Like directed brokerage, soft dollar arrangements allow mutual fund managers to shift costs onto to shareholders that they would otherwise be forced to pay themselves. As Paul Roye, Director of the SEC's Division of Investment Management, testified in June before a House subcommittee:

> "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."[17]

These conflicts of interest are exacerbated by the fact that no guarantees exist to ensure that shareholders who pay the soft-dollar costs reap the benefits of any research or other services paid for in this manner. In some cases, soft dollars may pay for services that primarily benefit the fund manager rather than fund shareholders. In other cases, the benefits paid for by shareholders in one fund may flow at least in part to shareholders in another fund. For example, investors in a fund family's bond funds might get benefits from soft dollar payments whose costs are borne by shareholders in a stock fund.

Soft dollar arrangements have another characteristic in common with directed brokerage. The potentially substantial costs they impose on shareholders are largely hidden from view. This is because the costs come in the form of portfolio transaction costs that are not included in the fund's expense ratio and are only partially disclosed in the fund's SAI. (See footnote 8 and text at footnote 8.)

Management/Administrative Fees

As the example of soft dollar arrangements make clear, not all high mutual fund costs are driven by distribution. Another type of non-distribution-related mutual fund cost that has come in for criticism is the exorbitant management/administrative fee[18] charged by some funds with no apparent justification in terms of improved performance or enhanced service quality.

In recent years, the debate over mutual fund management fees has focused primarily on questions of why – given the enormous growth in fund assets in the past two decades – mutual fund shareholders have not seen more benefit from resulting economies of scale. No one has made the argument that mutual fund expenses are excessive more eloquently, or more relentlessly, than my fellow panelist, John Bogle, Founder and former CEO of the Vanguard

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[17] Testimony of Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, June 18, 2003.

[18] Although these fees cover both portfolio management fees and fees for administrative services, for the purposes of simplicity I will from now on refer to these fees as management fees.

Group. The industry has attempted to answer this argument by showing that investors' total costs, including distribution costs, had declined in recent years.[19] However, about half the decline found by industry trade association Investment Company Institute (ICI) was the result of shareholder behavior – putting more money into no-load funds. Even the ICI research found that average expense ratios for stock funds had risen, from 0.77 percent in 1980 to 0.83 percent in 1998 and to 0.88 percent in 2001. That finding is compatible with the findings of recent studies by both the SEC and the Government Accounting Office, which also uncovered evidence of rising expenses.[20] It is incompatible only with the notion that growing assets would result in economies of scale that would be passed along to investors.

Since the emergence of the mutual fund trading scandals, the debate over management fees has tended to focus more on alleged differences in the fees that pension funds and mutual fund shareholders pay for advisory services. That case has been defined by another of my fellow panelists, University of South Carolina Professor John P. Freeman, whose definitive research paper on the topic found that pension funds paid roughly half as much in advisory fees as did mutual fund shareholders.[21]

That research has been hotly contested by the mutual fund industry, which argued that the management fees paid by pension funds and mutual funds are not comparable because of operational differences between the two types of accounts. To bolster its argument, ICI issued new research in November and expanded on that research in January claiming the advisory costs for mutual fund shareholders and pension funds are virtually identical once these operational differences are taken into account.[22] To get a "clean" number for advisory services, without attendant administrative costs included, ICI compared pension fund advisory costs to those of sub-advised funds. While we do not have the definitive answer with regard to the comparability of costs between pension and mutual funds, it seems clear that fees paid to sub-advisers should not be viewed as typical of the industry as a whole, since these, like pension fund advisory fees, are negotiated at arm's length, whereas most mutual fund advisory fees are not.

Regardless of the outcome of this debate, we believe there is compelling evidence that management costs at some funds are excessive. To approach this issue from the simplest, most straightforward angle, CFA recently examined costs at S&P 500 index funds, using a list of such

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[19] Investment Company Institute, *Total Shareholder Cost of Mutual Funds: An Update*, September 2002.

[20] Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses*, December 2000 found evidence that average expense rations of all stock and bond funds had risen from 0.73 percent in 1979 to 0.94 percent in 1999, primarily as a result of increasing use of 12b-1 fees to pay for fund distribution costs. General Accounting Office, *Mutual Funds: Information on Trends in Fees and their Related Disclosure*, March 2003 found that average expense ratios for large stock funds have risen since 1998, while fees for bond funds have declined.

[21] John P. Freeman and Stewart Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 Journal of Corporation Law 610 (2001).

[22] Investment Company Institute, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, January 2004.

funds compiled for us and Fund Democracy in July of 2003 by Morningstar. We chose this type of fund because no one can credibly argue that higher costs bring added benefits to shareholders in these passive investments, which seek only to match the returns of the underlying index. In reexamining the data last fall, we verified the information against fund profiles obtained through Yahoo! Finance, eliminated a handful of funds that had mistakenly been included in the data set, and identified the level of any 12b-1 fees imposed by the funds on the list.

Our search turned up 16 fund families that offer S&P 500 index funds with annual expenses of more than one percent. The highest cost fund charged annual expenses of 2.18 percent, according to the Morningstar data.[23] This compares with expenses of 0.18 percent and 0.19 percent respectively for the Vanguard and Fidelity funds. Most of the funds on the list consisted of B and C shares, with a significant portion of annual expenses coming from 12b-1 fees set at or near the maximum permissible level. However, two of the funds identified – AAL Large Company Index II A and Mainstay Equity Index A – charged front loads of 5.75 percent and 3 percent respectively for their high-cost funds.[24]

While distribution costs were a significant contributing factor to the high costs of many of the funds, virtually all of the funds on the list had underlying management costs (with 12b-1 fees subtracted) that were two, three, and even four times as high as those of the Vanguard and Fidelity funds. While we recognize that not every fund company can match the rock-bottom prices charged by Vanguard, for such large cost discrepancies to exist in a passive investment like an S&P 500 index fund, it seems reasonable to conclude that costs at the higher end of that scale are unreasonable. Furthermore, we have every reason to believe that a similar examination of other index funds would produce similar results, and no reason to believe that index funds are alone in charging these excessive fees.

Why High Costs Persist

Congress enacted legislation in 1970 authorizing the SEC to sue fund managers and fund directors when they impose fees that are excessive. Although the SEC requested this authority, it has never to our knowledge chosen to use it. Excessive is of course a subjective term and open to interpretation. It is possible the SEC has not yet encountered a fee it considers excessive. However, given the results of our quick review of S&P 500 index funds, and in light of the fact that a recent spot search turned up seven actively managed funds with annual expenses near or above 10 percent, there would seem to be ample candidates for SEC attention.[25]

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[23] This was the AAL Large Company Index II B fund.

[24] The AAL fund A shares had an expense ratio of 1.29 percent, including a 0.25 percent 12b-1 fee. The Mainstay fund had annual expenses of 1.02 percent, including a 0.25 percent 12b-1 fee.

[25] The search was conducted by Fund Democracy President Mercer Bullard in response to a request from Chairman Fitzgerald. The highest cost fund turned up in that search was the Frontier Equity Fund, which, according to its registration statement has annual expenses of 43.24 percent and a front load of 8 percent. Because the adviser waives certain fund expenses, however, the annual fee charged to investors is reduced to 42.26 percent.

Instead, current leaders at the SEC have said that they prefer to rely on improved governance and market competition to discipline costs. They have been highly critical of New York Attorney General Eliot Spitzer for taking a more interventionist approach. At first glance, the SEC's preference for market discipline of costs appears to be a perfectly reasonable approach. After all, where could one find a more robustly competitive market than the mutual fund market? Investors are free to choose from among hundreds of fund companies offering thousands of funds using several distribution and pricing models. In a market so rich in choice, how could excessive prices possibly persist?

A closer look, however, quickly reveals that the mutual fund market lacks three key characteristics needed to effectively discipline costs: transparent disclosure, meaningful price competition, and, absent those two characteristics, regulatory policing of the worst abuses.

Lack of Transparent Disclosure: Mutual funds provide more and sometimes better cost information than many other financial products. These disclosures nonetheless fail all three critical tests of for effective disclosure: does it provide 1) the information investors need, 2) in a form they can understand and use, 3) at a time when it is likely to affect their purchase decision?

1) Mutual fund cost disclosures fail to provide all the information investors need to assess costs and their likely effect on investment returns.

In the disclosure of mutual fund operating expenses, the most glaring short-coming is the omission of portfolio transaction costs from the annual expense ratio. These costs vary greatly from fund to fund and, in some cases, may exceed all other fund expenses combined.[26] Failure to include these costs in the expense calculation is an invitation to abuse. First and foremost, it creates a strong incentive for funds to pay for distribution and other services through directed brokerage and soft dollar arrangements, since these arrangements allow them to hide costs that they would otherwise have to disclose and, in the process, make the fund look like a better deal than it really is. It also reduces, though it does not eliminate, the incentive for funds to compete by keeping their brokerage costs as low as possible.[27]

We recognize that incorporating all transaction costs in the expense ratio is not necessarily an easy thing to do. While commissions are fairly easily quantifiable, spreads,

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[26] A memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, June 9, 2003 cited studies of mutual fund portfolio transaction costs that estimated brokerage commission costs at 0.30 percent of equity funds' net assets, market spread costs at about 0.50 percent of equity funds' net assets, and opportunity costs at 0.20 percent. Others have estimated the costs to be even higher. See, for example, Chalmers, Edelen & Kadlee, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management*, December 29, 2001.

[27] Since transaction costs are a drag on performance, funds still have an incentive to minimize costs, although for many funds the perceived benefits of directed brokerage and soft dollar arrangements clearly outweigh those incentives.

market impact, and opportunity costs are more difficult. On the other hand, the fact that a number of private companies already provide fund advisers with quantitative assessments of their transaction costs suggests that this is not an insurmountable task. Given the serious problems that result from not disclosing these costs, it is clearly a task that must be tackled.

Another shortcoming of operating cost disclosure is its lack of transparency regarding how management and administrative fees are spent. Although investors receive a general number for the operating costs, they have little if any ability to determine how much of that fee goes toward salaries, how much toward distribution payments, how much toward various administrative services, and, if transaction costs were to be included, how much toward portfolio transaction costs. Presenting this information in an easily understood pie chart would give investors a clearer understanding of how their money is being spent and whether it is being spent wisely.

Other disclosures are also lacking. Investors clearly do not receive adequate information about the financial incentives brokers receive to sell particular funds. Currently, because of an SEC rule interpretation, brokers do not have to disclose the source and amount of compensation they receive from fund sales on confirmations, as they must do for the other products they sell. This rule interpretation should be rescinded by the SEC. Brokers that receive payments for shelf space or participate in other revenue sharing arrangements should have to disclose that fact prominently before the sale. Information on sales incentives should include not just the existence of the incentives, but also the dollar amounts involved, how those compare to industry norms, and the nature of the conflicts of interest created. Investors would also benefit from better information about the availability of breakpoints as well as information that would allow them to compare the appropriateness of different share classes for different investment scenarios.

2) Mutual fund costs disclosures do not provide that information in a format that is likely to be read, understood, and used by investors.

One key short-coming of the current cost-disclosure system is that most disclosure requirements are satisfied if the information is included in the fund prospectus, where it may get lost in the huge mass of information provided. Other disclosures are relegated to the Statement of Additional Information (SAI), which is not automatically provided to investors and is rarely requested. As a result these disclosures may never be seen. Furthermore, neither document is designed to entice investors to read it, and many funds obscure the information they do provide by couching it in highly technical language.

Another shortcoming of the current system is that the key cost information, the annual expense ratio, is presented as a percentage of assets under management. Presented in this way, differences of a few basis points hardly seem significant, at least to unsophisticated investors, but they can have dramatic long-term effects on shareholder returns. In its on-line profiles of mutual funds, Yahoo! Finance computes three-, five-, and ten-year expense projections and presents them in a table next to projections based on the average cost for that fund category. While the system of categorization is imperfect, this approach offers a promising model for presenting cost information in a format that would really help investors to understand the long-

term implications of those costs and to compare costs across funds.

The SEC should conduct a comprehensive evaluation of existing disclosures and proposed new disclosures to determine what does and doesn't work to effectively convey information to shareholders, particularly those who are not well served by existing disclosures. That evaluation should include issues related to format, placement, and readability, as well as content of disclosures.

3) Mutual fund cost disclosures do not provide key information at a time when it is most likely to influence purchase decisions.

Simple logic dictates that for cost disclosures to have an impact on the purchase decision, they must occur before the sale. Yet most cost disclosure requirements are satisfied by delivery of the prospectus, which may occur with the confirmation after the sale. We will never have effective cost competition in the mutual fund industry until this system is changed to require pre-sale disclosure.

Lack of Effective Cost Competition: Despite appearances, only a relatively small portion of the mutual fund marketplace could be said to be truly competitive. That is the 13 percent of mutual fund transactions that occur directly between the fund company and the retail investor and outside of any employer-sponsored retirement plan.[28] While performance-based advertising may distort this market somewhat, the prevalence of relatively low-cost funds in the direct-marketed segment of the industry strongly suggests that minimizing costs is viewed as critical to success for funds that rely on their ability to sell themselves to investors directly.

A growing percentage of mutual fund transactions occur through employer-sponsored retirement plans.[29] In these plans, investors generally have very limited options and therefore cannot effectively make cost-conscious purchase decisions. These investors must instead rely on their employers to consider cost when selecting the plan. But plans often compete for employers' business by shifting the administrative costs onto the employees in the form of higher 12b-1 fees. While the recent trading scandal may have made employers more sensitive to their fiduciary duties in selecting a plan, it is not certain that this is the case or, if it is, that this new sensitivity will extend to issues of cost.

That leaves the approximately 50 percent of mutual fund transactions that occur through broker-dealers and other salespeople and outside a company-sponsored retirement plan.[30] Funds that rely on this market compete to be sold, not bought. While funds that compete to be bought can be expected to do so by offering a high quality product and good service at a reasonable price, funds that compete to be sold do so by offering generous remuneration to the selling firm

[28] Investment Company Institute, *2003 Mutual Fund Fact Book*, 43rd Edition.

[29] Ibid.

[30] "Misdirected Brokerage."

and to the individual salesperson. They do this through a variety of means discussed above – sales loads, 12b-1 fees, payments for shelf space, and directed brokerage – that drive costs to investors up, not down. As I previously noted, this sales-driven model frees funds from having to compete based on the quality or low costs of their product and allows high-cost, inferior funds to survive, and even thrive, that simply could not do so in a truly competitive market.

The Regulatory Response

The SEC was slow to acknowledge the need for fundamental reforms to bring down the costs of mutual funds. Last year, for example, when the House was considering mutual fund reform legislation, the agency opposed individualized cost disclosures on account statements as too costly, without ever conducting a cost-benefit analysis that considered cost savings to investors from making more cost-conscious decisions.[31] As an alternative, it proposed dollar amount cost disclosures for a hypothetical $10,000 account in the annual and semi-annual reports, a location where it is almost certain to have no effect on investor purchase decisions. The agency was lukewarm at best in its response to proposals to require funds to have an independent board chairman, a lack of support that helped keep this provision out of the House bill. And, more recently, when Attorney General Spitzer included cost reductions in his settlement with Alliance Capital Management, the Commission took the virtually unprecedented step of issuing a news release critical of the fee reduction agreement.

On the other hand, the Commission has conducted important investigations of both breakpoint practices and revenue-sharing arrangements. It reached a landmark settlement with Morgan Stanley over its mutual fund sales practices that should have put the brokerage industry on notice that it can no longer assume such practices will be ignored. And it has recently proposed several promising rules, though details on some of its proposals are not yet available. Specifically:

- The Commission recently proposed rules to strengthen the independence of mutual fund boards by requiring three-quarters of board members, including the chairman, to be independent, requiring independent members to meet at least quarterly without any interested parties present, and authorizing the board to hire staff to help it fulfill its responsibilities.

- This rule proposal would require boards to retain copies of the written materials they consider in conducting their annual review and approval of the advisory contract.

- The Commission issued a concept release seeking suggestions on how to improve disclosure of portfolio transaction costs.

[31] New York Attorney General Eliot Spitzer noted in November 4, 2003 testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives that a 25 basis point reduction in the annual expenses that shareholders pay would result in a savings of $10 billion annually.

- The Commission is developing proposed rules to improve disclosure of conflicts of interest related to mutual fund sales that, according to media reports, will include a point-of-sale document. That document would show investors in dollars what they would pay for any initial sales charges or loads, with estimates of next-year payments for funds with deferred loads or 12b-1 fees. The point-of-sale disclosure would also reportedly show whether the broker receives compensation from the mutual fund company in exchange for promoting the fund company's products and whether the brokerage firm or broker is paid more to sell that firm's funds rather than those from other fund families.[32]

- The same rule proposal will reportedly require increased disclosure on confirmation reports, including the price and any front-end sales charge in dollars and as a percentage of the purchase, dollar estimates of 12b-1 fees and of back-end loads, the levels at which discounts are available on sales charges, a dollar break-down of any payments brokers receive for selling particular funds or classes of fund shares over others, and, for the sale of proprietary or affiliated funds, whether the broker gets a higher percentage payout than he or she would for selling other funds.[33]

- In November testimony before the Senate Banking Committee, SEC Chairman Donaldson indicated that the Commission is considering additional reforms, including development of a solution to the problem of trading through omnibus accounts, and is examining the use of soft dollar arrangements.

Despite this important progress, there are serious gaps in the SEC's regulatory agenda. For example, the SEC does not have the authority to strengthen the definition of independent director. So, even if it adopts its independent governance requirements over the already announced objections of two Commissioners, non-immediate family members, individuals associated with significant service providers of the fund, and recently retired fund company employees would all be eligible to serve as "independent" directors. In addition, the SEC proposal does not require that a nominating committee of independent directors select new independent directors, nor does it require directors to periodically stand for election – proposals that have been included in mutual fund reform legislation. Congress must act to strengthen the definition of independent director and fill in these gaps in the SEC proposal.[34] The legislation introduced by Sen. Akaka and Chairman Fitzgerald contains an excellent definition of independence that would be an excellent supplement to the SEC's rule proposals.

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[32] This description is taken from a January 21, 2004 Dow Jones Newswires article by Judith Burns, "SEC Seeks Input on Fund Reports," which ran in the *Wall Street Journal*.

[33] Ibid.

[34] The SEC rules apply to funds that rely on one of its exemptive rules. The SEC has stated in its rule proposal that "almost all" funds either rely on or expect at some time to rely on one of these rules, so they believe the governance reforms would reach all funds. Legislation would eliminate this ambiguity.

It is impossible to judge at this point whether the SEC's concept release on portfolio transaction costs represents a genuine effort on the part of the Commission to come up with a workable solution or whether the Commission is merely going through the motions in order to affirm its long-held view that only very limited portfolio transaction information can be disclosed to investors.[35] Until these costs are incorporated in the expense ratio, funds will have a powerful incentive to shift operating and distribution costs into the one channel where they are invisible. Only time will tell whether the SEC is willing to embrace this approach. It would be far better for Congress to mandate this essential reform.

Even the Commission's promising disclosure proposals on conflicts of interest appear to have serious gaps. Although it is impossible to be sure until the rule proposal is published, it does not appear that the Commission intends to include information about the non-distribution related expenses of the fund – the annual expense ratio – in either the point-of-sale document or on the confirmation statement. Furthermore, if the Commission is going to take the unprecedented step of requiring point-of-sale disclosure, it should do more to ensure that it covers all the information investors should have prior to sale, including information on investment risks, for example, and comparative information on fund costs, not just sales incentives. Congress should build on what the Commission has begun and ensure that all the key information investors need pre-sale is included in these reports.

Chairman Donaldson has indicated the agency will study use of soft dollars, but the SEC does not have the authority to repeal the safe harbor. Soft dollars create unacceptable conflicts of interest. While some may have been content to trust mutual fund executives to handle these conflicts ethically before the trading scandals, that would be an irresponsible position to take in light of recent events. Congress should step in and do what the SEC cannot, repeal the soft dollar safe harbor, restoring funds' obligation to obtain best execution on their trades, and require funds to have explicit contracts outlining any services they receive from brokers and what they pay for them.

Suggestions for Additional Congressional Reforms

One shortcoming of the SEC approach is that it relies exclusively on better disclosure of broker-dealer conflicts of interest rather than on bans of conflict-inducing practices. We believe it would be a serious mistake to put too much faith in the ability of disclosure to influence purchase decisions made by investors who purchase their funds through brokers. Such an approach ignores the fundamental reality of how investors relate to brokers and the degree to which they rely on them for advice.

Brokers are legally salespeople, without the adviser's obligation to place client interests

[35] In the past, Commission staff members have suggested that inclusion of commission costs in the prospectus and more prominent disclosure of the fund turnover rate might satisfy this requirement. Turnover rate is a far from perfect proxy for transaction costs, however, and does nothing to distinguish between funds that obtain inexpensive execution for their trades and funds that do not. This is not a satisfactory approach.

ahead of their own. In fact, their exemption from the Investment Advisers Act is conditioned on their limiting themselves to giving advice that is "solely incidental" or "merely secondary" to product sales. However, this is *not* how they present themselves to clients. Instead, they adopt titles, such as financial adviser or investment consultant, that are designed to convey to their clients that advice is the primary service they have to offer. Their advertising campaigns relentlessly send the same message.

Even sophisticated personal finance writers often fail to make this distinction between brokers, whose role is to effect transactions in securities, and investment advisers, who role is to offer advice. If those who make their living covering personal finance issues make this mistake, it should not be surprising that unsophisticated investors tend to approach their relationship with their broker with an attitude of trust. Lacking confidence in their own financial acumen, they seek out the advice of a financial professional, and they expect to rely without question on that professional's recommendations.

Improved disclosure should help encourage investors to see their financial professionals in a more realistic light. We doubt, however, that even the best disclosures will be able to overcome multi-million-dollar advertising campaigns that send exactly the opposite message. Instead, we believe it is long past time to require brokers either to live up to the advisory image they project – and accept the attendant responsibility to make recommendations that are in their clients' best interests – or to cease misrepresenting themselves to clients as advisers. To the degree that the Commission has taken a position on this issue, however, it has been to propose to expand the loophole that allows brokers to portray themselves as advisers, earn fees they identify as fees for advice, and still rely on the "solely incidental" exclusion from the advisers act.[36]

Even where advisers have an obligation to put their clients' interests ahead of their own, the SEC has not to our knowledge ever enforced this obligation with respect to price or ever challenged advisers based on their recommendation of high-cost, inferior products. We believe it is time for the agency to start. However, we doubt the Commission will take this position without prodding from Congress. As a first step, Congress should conduct a thorough investigation of the role and operations of brokers and advisers as the basis for legislation to ensure that their conduct matches their representations about the services they offer.

Even before such a comprehensive review is undertaken, however, the current focus on mutual fund sales practices offers several opportunities to end some of the most abusive such practices. For example, an early news account of Lipper's research on 12b-1 fees included an interesting proposal in this regard. According to an article in *The Washington Post*, Lipper Vice President Jeffrey C. Keil suggested that investors might be better served if companies sold the

[36] SEC Proposed Rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," File No. S7-25-99. The rule was proposed in 1999, at which time the Commission adopted a "no action" position that assured brokers that they would not be subject to enforcement actions based on violation of the rule pending adoption of a final rule. No final rule has been adopted.

funds at a set price and left it to each broker to charge a specific commission and service fee.[37] This is an intriguing idea. There is, after all, no compelling reason why distribution costs should be paid through the mutual fund rather than directly by investors. The costs would be more transparent under such a system, and the change could transform the dynamics of competition. Specifically, if funds got out of the business of competing to be sold, and brokers' compensation came directly from the investor and did not depend on which fund they sold, then brokers might begin to compete on the basis of the quality of their recommendations, and funds might have to compete accordingly, by offering a quality product and good service at a reasonable price.

Finally, in his November testimony, SEC Chairman Donaldson also said the Commission was considering whether there were ways in which funds could "assume greater responsibilities for compliance with the federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers." Recent accounting scandals should have taught us all the risks of relying on audits that are paid for by the entity being audited. Even today, after passage of significant reform legislation, each new accounting scandal seems to be accompanied by a statement from the auditor expressing bewilderment at the idea that anyone would think they should have uncovered and prevented the fraud. We fear a new program of private audits in this area would produce the same, predictable response.

If the SEC needs a supplement to its own examination program, therefore, we believe a far better approach would be to create an independent board, subject to SEC oversight, to conduct such audits. The board could be modeled on the Public Company Accounting Oversight Board, with similar authority to set standards, conduct inspections, and bring enforcement actions and similar (or, better yet, stronger) requirements for board member independence. Several bills have been introduced that address this issue. S. 1822, Sen. Akaka and Chairman Fitzgerald's bill, would require the SEC to study the advisability of such a board. Legislation introduced by Senators Dodd and Corzine would instead entrust the study to the GAO. And legislation introduced by Senators Daschle, Kerry and Kennedy would create such a board. At the very least, we believe Congress needs to assess the adequacy of SEC resources for oversight of mutual funds and determine whether an independent board would provide the best supplement if those resources are determined to be inadequate.

Conclusion

Mutual funds have long offered the best way for investors who have only modest amounts of money to invest to obtain broad diversification and professional management. The trading scandals have sullied the fund industry's reputation, but they have also opened up an opportunity to reexamine some industry practices that had too long gone unchallenged. The SEC appears to be making genuine progress in addressing some of these issues related to fund

[37] Brooke A. Masters, "Fund Fees Vital but Need Review, Lipper Says," *The Washington Post*, January 20, 2004.

governance and cost and conflict disclosure, but there are serious gaps in its efforts. Some result from the SEC's lack of authority to effect change, and others result from the SEC's lack of a vision for how the market could be transformed. In holding these and previous hearings, this Committee has helped to expand our understanding of what can and should be done to protect investors from abusive practices and to bring down unreasonable costs. We appreciate your efforts and look forward to working with you to make this vision of a more equitable marketplace a reality.