Consumer Federation of America

Analysis of Criticisms of the New York Attorney General's Fee Reduction Settlement with Alliance Capital Management

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Last week, the Securities and Exchange Commission and New York Attorney General's Office announced separate settlements of enforcement actions against Alliance Capital Management. The actions settled charges that the fund company had defrauded mutual fund investors by allowing market timing in certain of its funds in exchange for financial benefits to the fund managers.

Both settlements contain provisions that benefit investors. The SEC settlement imposes a substantial fine – $250 million – which will be used to provide restitution to shareholders who were harmed by the market timing arrangements. The SEC settlement also imposes new governance requirements on Alliance that should help to strengthen the independence of its board and of its compliance program, reducing the likelihood that it will engage in similar abuses in the future. The New York Attorney General's settlement adds an agreement by Alliance to reduce its management fees by 20 percent over at least the next five years.

Unfortunately, instead of focusing on the benefits to investors offered by the combined settlement package, officials at the SEC and some members of Congress have chosen to criticize the fee reduction agreement negotiated by New York Attorney General Eliot Spitzer. In fact, the SEC took the highly unusual step of issuing a statement critical of the New York action when it announced its own settlement agreement with Alliance. And SEC officials have made numerous critical comments in the media.

As the following analysis shows, the SEC's criticisms are baseless. As such, they only serve to detract from the agency's own accomplishments.

SEC Argument: Fees are not relevant to trading abuses that are the subject of the settlement and therefore should not be included in settlement negotiations.

Excessive fees spring from the same cause as trading abuses, a willingness by fund managers to place their interests ahead of those of their shareholders. It is logical, therefore, for enforcement officials who are investigating trading abuses to look also for evidence of excess costs. At Alliance, the New York Attorney General found management fees that are among the highest in an industry rife with high costs. Negotiating a reduction in those fees was thus an appropriate step to take. Furthermore, since greed is the motivating factor behind trading abuses, negotiating a settlement that imposes a significant and on-going hit to the fund manager's bottom line is likely to have a real deterrent effect.

SEC Argument: Alliance fees are not illegally high.

Arguing that Alliance fees are not illegally high implies that the SEC has some standard of what constitutes an illegally high fee and that Alliance is not in violation of it. Unfortunately, there is no evidence that the SEC considers any fees illegally high. It has never, to our knowledge, taken any action challenging excessive fund fees.

Candidates for such action certainly exist. In response to a Congressional request, Fund Democracy recently identified seven funds with expense ratios near or above 10 percent. At the top of the list 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. The adviser waives certain fund expenses, however, bringing the annual cost down to 42.26 percent. The Ameritor Investment Fund and the Ameritor Security Trust had expenses of 30.6 percent and 15.03 percent respectively, according to their registration statements. (A more recent check on Yahoo! Finance indicates those fees have come down to 21.57 percent and 11.79 percent respectively.) And four other funds had expenses clustered around 10 percent. Since the SEC apparently does not consider these fees illegally high, it is hard to imagine what would prompt the agency to act to bring down excessive fees.

SEC Argument: Government should not set prices.

Negotiating a fee reduction for one firm as part of a settlement is not the same thing as fixing prices. This argument is a red herring.

SEC Argument: The fee reductions will benefit future investors, not those hurt by trading abuses.

Not all investors hurt by the trading abuses at Alliance have pulled out their money. Many investors may feel they can't move their money because of the tax implications of such a move. Given the widespread nature of abuses, others may not know where it would be safe to move their funds. Whatever the cause, many of the "future" investors who will benefit from the fee reductions are the very same investors as those who were hurt by the trading abuses.

Furthermore, if this argument made sense, it would apply equally to the governance reforms included in the SEC's settlement. After all, the beneficiaries of those reforms are future, not past, investors. The SEC did not apparently feel that was reason to exclude governance reforms from its settlement negotiations. Why are fees different?

SEC Argument: Reducing fees may result in a decline in service quality.

Many fund firms, including some of the most successful, offer good service while charging rates that are significantly lower than Alliance's will be, even after the fee reduction. There is therefore no reason to believe Alliance won't also be able to offer good service under the new fee structure. If they aren't, or if they choose to reduce costs by cutting service rather than cutting their own profits, investors will be free to vote with their feet and move their money to one of the alternative firms that combine low costs and high quality service.

SEC Argument: Market competition, not regulators, should set fees.

Obviously, market competition should discipline costs, and equally obviously, it hasn't done so effectively. Despite the fact that there are literally thousands of funds offered by hundreds of fund companies, there is no meaningful price competition in the mutual fund industry, at least not for the majority of transactions that occur through brokers and other salespeople.

This is because competition among mutual funds is dominated by competition to be sold, not competition to be bought. When funds compete to be bought, they compete by offering good value at a reasonable price. When they compete to be sold, they compete by offering generous remuneration to the sales force. This can clearly be seen in the mutual fund market, where fund firms compete in ways (commissions, 12b-1 fees, directed brokerage, soft dollar arrangements, payment for shelf space) that drive costs to investors up, not down.

A recent study of mutual fund costs by CFA and Fund Democracy found 16 mutual fund companies that offer S&P 500 index funds with expense ratios of *more than one percent*. In contrast, industry leaders Vanguard and Fidelity charge 0.18 percent and 0.19 percent respectively for their comparable funds. It is no coincidence that all of the high-cost funds identified by CFA and Fund Democracy were broker-sold funds. Interestingly, while distribution fees contributed significantly to the high costs, they did not account for all of the price differential. Even after distribution costs (including 12b-1 fees) were subtracted, the management fees on these funds were two to five times as high as those charged by Vanguard and Fidelity. This is for a passive investment where no one can credibly argue that additional costs bring additional benefits. If market competition worked to discipline prices, these funds would not have any shareholders. The fact that they do have investors, and in some cases substantial assets, shows the insufficiency of relying on market competition to drive down excess costs.

SEC Argument: A Better Approach is to Improve Disclosure of Fund Fees and Install More Independent Directors.

Contrary to the way it is presented by the SEC, this is not an either-or proposition. One can favor reforms to enhance board independence and improve disclosure as long-term industry-wide solutions while still supporting a settlement that includes a roll-back of excessive fees at one fund company.

Furthermore, the SEC's record on this front is not reassuring. Although it appears to have come around and is now voicing support for strong board independence reforms, as recently as last summer the SEC questioned the benefits of requiring fund boards to have an independent chairman. Their lack of support helped to keep such a requirement out of the mutual fund bill that recently passed the House. It is good news that the agency has apparently since decided to put its weight behind this important reform.

Unfortunately, we have not seen similar progress in the SEC's position on the issue of cost disclosure. The SEC has consistently opposed the more stringent proposals put forward to improve cost disclosure and has offered no better alternatives. Its proposal to require new disclosures in annual and semi-annual reports fails every test of effective disclosure. Put succinctly, it doesn't provide the information investors need, in a form they can understand, at a time when it is useful to them. Specifically:

- The cost disclosures provided under the SEC proposal would cover costs on a hypothetical account, not actual costs to the investor. Furthermore, the SEC has opposed requiring transaction costs to be incorporated in the expense ratio, thus leaving what for many actively managed stock funds is the most significant cost hidden from investors. Under pressure from Congress, the SEC is now issuing a concept release on that issue, but questions remain as to whether the agency will abandon its "can't do" attitude on the issue of portfolio transaction cost disclosure.

- Current disclosures work fairly well for those relatively sophisticated investors who understand their significance and know where to look for them. New disclosures must be designed with the many investors in mind who do not benefit from existing disclosures. Using dollar amounts rather than percentages to convey costs is a step in the right direction, but does not go nearly far enough. The SEC needs to look at innovative new approaches, such as requiring funds to disclose how their costs compare to costs of comparable funds, and what the dollar amount impact of that cost differential would be over 1-, 5-, and 10-year periods. Whatever approach the agency takes, it needs to be tested for effectiveness with the target audience – those mutual fund investors who are not well served by existing cost disclosures.

- The annual and semi-annual reports are not documents routinely read by investors before making a fund purchase. The SEC's proposed disclosures are therefore highly unlikely to affect fund purchase decisions and thus will not introduce real price competition into this market. To be effective, new disclosures need to be pre-sale, prominent, and in plain English.

Given the distribution system for funds, where most funds are sold through intermediaries who have a conflict of interest when it comes to keeping down fund costs, disclosure alone will not be enough to drive out excess costs. Brokers routinely market

themselves as objective advisers, yet they are not legally obligated to make recommendations that are in their clients' best interests. The requirement that financial planners and other advisers do so has never been effectively enforced with regard to issues of cost. Those short-comings should be rectified. And, at the very least, brokers and other salespeople ought to have to provide pre-sale disclosures that highlight, among other things, the costs of the fund and the conflict of the broker. Burying those disclosures in the fund prospectus is not the answer. If reforms are to be effective in bringing down excess fund costs, meaningful regulatory changes need to be part of the package.

Congressman Baker's Argument: The fee reduction agreement demonstrates the need to preempt state enforcement authority.

The SEC is not the only one criticizing the New York settlement. Some in Congress, led by Rep. Richard Baker (R-LA), have responded to the Alliance settlement by calling for passage of state preemption legislation. Given the lead role the states played in exposing trading abuses that have now been found to pervade the mutual fund industry, it is hard believe anyone would take this argument seriously. States have clearly shown that they play a vital role in policing our nation's securities markets. They must not be deprived of the enforcement tools necessary to perform that function effectively.

The simple fact is that preemption is unwarranted. While preemption supporters have argued that it is needed to reassert the SEC's authority to set national rules for national markets, this is not the case. Imposing conduct remedies on specific firms, as both the analyst settlement and the Alliance settlement do, is not the same thing as setting rules for the whole industry. All the SEC needs to do to assert its preeminence as the regulator of the national marketplace is to regulate. Interestingly, however, the SEC has not followed up the analyst settlement by proposing industry-wide rules, even though they are clearly needed in several areas to bring the benefits of the settlement to all investors. Furthermore, the preemption proposed by Rep. Baker as an amendment to H.R. 2179, his otherwise pro-investor bill to enhance SEC civil enforcement authority, is far broader than his statements imply. States would be preempted not just by the SEC but also by the industry self-regulatory organizations. Their enforcement authority would be constrained, not just when they deal with issues that are national in scope, but also when they use the type of conduct remedies they rely on routinely to protect the citizens of their states from abusive practices.

Preemption would harm investors and undermine investor confidence. The mutual fund trading scandals are just the latest in a devastating series of frauds that have penetrated every corner of our nation's financial markets. A number of those frauds have been uncovered by state regulators. And, as the head of the SEC's enforcement division has noted, there is more than enough fraud in the marketplace to keep federal and state regulators busy. But, if we want to have an aggressive state regulatory program, those regulators need to have the ability to impose appropriate remedies, an ability the preemption legislation would undermine. Furthermore, fear of embarrassment by the states has clearly been a factor in the SEC's aggressive response to the analyst and mutual fund scandals. Remove that threat and there is a very real risk that we will

see a return to the complacency that has all too often characterized the SEC's response to widespread and ingrained, but abusive, industry practices.

Like it or not – and some at the SEC and in Congress clearly don't like it – the New York Attorney General has done more in the last two years to inspire investor confidence that government is working on their behalf than the rest of the regulators combined. Some have argued that this is part luck, based on the fact that the whistleblower in the Canary case just happened to report the trading abuses to the New York Attorney General rather than the SEC. But according to Noreen Harrington's account, as reported in the *Wall Street Journal* ("Behind the Mutual-Fund Probe: Three Informants Opened Up," December 9, 2003), chance had nothing to do with it. She went to the New York Attorney General because she wasn't confident the SEC would follow up on her allegations, she reportedly said. Had Rep. Baker already succeeded in pushing through his preemption legislation, it not unreasonable to assume that Ms. Harrington would never have come forward to trigger the trading abuse investigations, and mutual fund shareholders would still be having their profits skimmed off by unscrupulous fund managers.

Conclusion

The SEC is right when it argues that investors need comprehensive reforms to bring down mutual fund costs on an industry-wide basis. However, it is going to have to come forward with far stronger and more innovative proposals than it has offered to date if it wants to be taken seriously when it makes that argument. In the meantime, where enforcement officials find evidence of high costs at funds that have also been shown to be abusing shareholder trust in other areas, they are right to include fee reductions as a part of the total penalty imposed on the firm. The need for industry-wide reform, which may or may not be forthcoming, should not preclude firm-specific actions that bring relief to aggrieved shareholders.