Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

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Consumers Union
Publisher of Consumer Reports

April 7, 2004

The Honorable Richard Shelby
Chairman
Committee on Banking, Housing
and Urban Development
U.S. Senate
Washington, D.C. 20510

The Honorable Paul Sarbanes
Ranking Member
Committee on Banking, Housing
and Urban Development
U.S. Senate
Washington, D.C. 20510

Dear Chairman Shelby and Ranking Member Sarbanes:

As the Committee nears the end of its scheduled hearings on mutual fund reform, we believe a compelling case has been made that legislation is needed to fill gaps in the Securities and Exchange Commission's regulatory response to the mutual fund trading and sales abuse scandals. As witness after witness has testified, the SEC lacks authority in a few key areas to adopt needed reforms. In one other essential area, promoting mutual fund cost competition, the SEC has so far been unwilling to consider meaningful investor protections. Now that your hearings have laid the groundwork, we urge you to move ahead quickly with legislation targeted at those relatively few areas where the SEC either cannot or will not act.

Our organizations believe the Commission has for the most part done a good job of responding to the mutual fund scandals. Although initially caught off guard, the agency has since launched an aggressive enforcement program, reviewed and begun to revise its industry oversight practices, and put forward a strong set of proposed rule changes to address both weaknesses in fund operations and abusive sales practices. Understanding that most of these rule proposals have not been finalized, and could be weakened before final adoption, early signs suggest that mutual fund investors will be considerably better off when the SEC has completed its reform agenda.

The one glaring exception has been the SEC's ineffective response on the crucial issue of strengthening cost competition in the mutual fund market. This was an issue before the mutual fund scandals hit, but it is of even greater concern since those scandals have revealed how willing many mutual fund managers are to place their own profits ahead of their shareholders' interests and how poorly mutual fund boards have fulfilled their responsibility to police those conflicts of interest. Substantial evidence has been presented of a similar failure on the part of fund managers and boards when it comes to ensuring that mutual fund costs are reasonable. This makes the SEC's inaction in this area difficult to comprehend.

1. Adopt legislation to strengthen mutual fund cost competition.

Because reducing the costs they pay would add thousands or even tens of thousands to the retirement and other long-term savings of average Americans, we urge you to put mutual fund costs at the top of your legislative agenda. In proposing legislation, we are not advocating that the Committee place artificial limits on mutual fund costs. Instead, we are suggesting that the Committee take appropriate steps to strengthen mutual fund cost competition and encourage investors to make cost-conscious purchase decisions. Specifically, we urge the Committee to:

- Ensure that mutual fund investors get complete information about the costs of the funds in which they invest, by requiring that at least commissions and spreads on portfolio trades be incorporated in the expense ratio. These portfolio transaction costs can be the most significant cost of an actively managed equity fund. Excluding these costs from the expense ratio is inherently misleading. Although the SEC has issued a concept release on this topic, it has long resisted incorporating portfolio transaction costs in the expense ratio, making legislation necessary to ensure that investors get complete information on fund costs.

- Ensure that mutual fund investors get cost information at a time when it is useful to them in making a purchase, which means at the time when a mutual fund purchase is recommended. This requirement could be satisfied either by providing the investor with a prospectus or a brief document, such as the existing fund profile. The benefit of this approach is that these documents also cover other key information about the fund that investors should consider prior to sale, such as risks and investment goals. Pre-sale disclosure should be followed up by post-sale dollar amount cost disclosure on account statements, along the lines that MFS has recently agreed to provide.

- Ensure that mutual fund investors get cost information in a form that encourages them to act on that information. The disclosures must be readable and must be presented in an accessible format. To make the information more compelling, cost information should be put in context so that investors are able to understand easily how the costs of the fund being recommended compare to those of similar funds. One possible approach would be to require disclosure of how costs compare to both an average for funds in that category and the costs of index funds that invest in similar securities. The dollar amount implications of any added costs (or savings) beyond the category average and index costs should be shown for one-, five-, and ten-year periods. To ensure that these goals are met, any proposed disclosures should be tested with a representative sample of investors for usability and effectiveness.

- Because disclosure on its own won't consistently overcome investors' strong inclination to rely on the recommendations of their financial professionals, require brokers and investment advisers to consider costs as one of the factors they take into account when deciding what products to recommend to their customers.

- Expand the fiduciary duty of fund directors to cover the entirety of fund fees, not just

the management fee, or authorize the SEC to do so. Fund boards must be responsible for ensuring that the funds they oversee are not so costly as to be an unsuitable investment and that, for example, economies of scale are being realized by fund shareholders as the fund grows.

Taken together, these steps should go a long way toward raising investor awareness of the importance of mutual fund costs, encouraging investors to select lower cost funds, and forcing funds to compete by keeping their costs low. Should even a relatively modest drop in fund fees result, investors would add billions of dollars each year to their savings. The benefits to their retirement preparedness would be enormous.

2. Adopt legislation to strengthen the SEC's ability to impose fund governance requirements.

In sharp contrast to its ineffective action on mutual fund costs, the SEC has proposed a strong set of reforms to enhance the independence and effectiveness of mutual fund boards of directors. The SEC is hampered in its efforts in this area by its inability to impose its reforms directly. Instead, it must rely on the indirect route of imposing the requirements as a condition of relying on any of the agency's many exemptive rules. The problem with this approach is that it is most likely to fail when it is needed most – when there is bona fide conflict between the fund manager and the independent directors. As has happened in the past, the fund manager who found itself in this position could simply cease relying on the exemptive rules in order to get out from under the governance requirements.

For this reason, we believe it is imperative that the SEC be given authority to impose its governance requirements directly. In the process, it should be specifically authorized to strengthen the definition of independent director. Until that definition is strengthened, individuals who would hardly be considered independent by a reasonable observer – close relatives, recently departed employees of the fund manager, and employees of certain significant service providers to the fund – would all still be eligible to serve as independent directors. The fiduciary duty of fund boards also should be expanded to ensure that boards do a better job of ensuring that the funds they oversee are operated in their shareholders' best interests.

3. Adopt legislation giving the SEC additional authority, if needed, to provide end-to-end tracking of mutual fund transactions.

In testimony before the Committee, SEC officials have suggested that one reason they proposed a hard 4 p.m. close as the solution to late trading abuses was that they lacked oversight authority over certain intermediaries who process mutual fund transactions. Lacking that authority, the SEC felt it could not assure compliance in a system that relied on end-to-end tracking of transactions. We believe there are probably ways around this limitation. The SEC could, for example, allow an exemption to the hard close for intermediaries who allow the SEC to inspect their operations to ensure compliance. However, if the SEC does need added authority to adopt an alternative to the hard 4 p.m. close, without its inequities for retirement plan and West Coast investors, we believe Congress should provide it.

4. Adopt legislation to ban soft dollars.

The Committee has heard convincing testimony on the distorting effect of soft dollar practices, which allow funds to pay for operating expenses out of shareholder assets through undisclosed portfolio transaction costs. Including portfolio transaction costs in the expense ratio and requiring a detailed audit trail showing how soft dollar payments are spent would offer an improvement over the existing situation. We continue to believe, however, that the cleanest solution is to ban soft dollar payments entirely. Such a ban must include a requirement that full-service brokers unbundle their commissions, so that payments for non-trading-related expenses can be accounted for separately. The SEC does not have the authority to adopt such a ban. We urge you to include a soft dollar ban in any mutual fund reform bill.

Conclusion

Because the SEC has responded effectively to the majority of issues raised by the recent mutual fund scandals, Congress finds itself in the enviable position of not needing to pass sweeping mutual fund reform legislation. Nonetheless, we believe more modest legislation is needed to address the issues described above. Almost as important, we urge the Committee to continue to monitor SEC implementation of its proposed mutual fund rules to ensure that it does not waiver in its commitment to strong, pro-investor reforms.

Thank you for your consideration of our views. Please feel free to contact us directly if you have any questions or wish to discuss these issues further.

Respectfully submitted,

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