Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

U.S. Public Interest Research Group

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The Honorable Peter G. Fitzgerald
555 Dirksen Building
U.S. Senate
Washington, D.C. 20510

Dear Senator Fitzgerald:

We are writing to express our enthusiastic support for your draft "Mutual Fund Reform Act." More than any other legislation that has yet to be introduced since the mutual fund scandals erupted last year, this bill recognizes the need to fundamentally transform the way in which mutual funds are governed, operated, and sold to ensure that they live up to their statutory obligation to operate in their shareholders' best interests.

This legislation offers a thoughtful and far-reaching agenda for reform. It addresses significant gaps in the SEC's proposals to improve fund governance, dramatically enhances the quality of mutual fund cost disclosures, and prohibits distribution practices that create unacceptable and poorly understood conflicts of interest. It also takes the necessary step of banning hidden "soft dollar" arrangements that boost shareholder costs and create additional conflicts of interest. We look forward to working with you to win passage of these essential reforms.

Our support for this bill is based on the firm belief that mutual funds have been and will continue to be the best way for average, middle-income investors to participate in our nation's securities markets. Individuals with only modest amounts to invest have benefited greatly from the opportunity mutual funds offer to achieve broad diversification. While wealthy investors have other options that provide similar benefits, average, middle-class investors do not. The resulting influx of money into mutual funds has in turn produced generous profits for fund companies.

This long record of mutual success had caused some in the industry and among its regulators to become complacent, taking for granted that all was well. By revealing the extent to which some fund managers had abandoned their obligation to operate in fund shareholders' best interests, the trading scandals uncovered last fall provided sudden and compelling evidence that such complacency was ill-founded. The closer scrutiny of fund operations that resulted quickly uncovered evidence of other similar failings:

- management fees that had failed to drop significantly, or in some cases at all, despite a massive growth in assets.

- use of portfolio transaction commissions, which are not incorporated in the fund expense ratio, to pay for services whose costs would otherwise have to be disclosed;

- use of portfolio transaction commissions borne by shareholders to pay for services whose benefits flowed in part or in whole to the fund manager;

- use of poorly disclosed or misunderstood compensation methods, including 12b-1 fees, directed brokerage, and payments for shelf space to induce brokers to recommend particular funds; and

- broker recommendation of mutual funds based on the financial incentives received rather than on which funds offer the best quality at the most reasonable price.

By driving up costs to investors and undermining competition based on cost and quality, these practices inflict far greater financial harm on their victims than the trading scandals appear to have done.

Since it became clear that mutual fund sales and trading abuses were widespread throughout the industry, the Securities and Exchange Commission has responded with an ambitious enforcement, investigation, and rule-making agenda. In addition to developing reforms targeted specifically at excessive and late trading, the Commission has issued proposals to strengthen mutual fund governance, sought suggestions on how to improve disclosure of portfolio transaction costs, and proposed rules to improve disclosure of distribution-related costs and conflicts of interest.

Despite this important progress, there are serious gaps in the SEC's regulatory agenda. Some result from the agency's lack of authority to effect change. Others result from the SEC's lack of a vision of how mutual fund regulation must be transformed. This legislation fills those gaps. If it is adopted, it will dramatically improve fund governance, eliminate practices that create unacceptable conflicts of interest, and save mutual fund investors potentially tens of billions of dollars a year by wringing out excess costs.

Our specific comments in support of some of the bill's most important pro-investor provisions follow.

1) The legislation's fund governance reforms address significant gaps in the SEC's rule proposal.

The Securities and Exchange Commission has made a promising start on the issue of fund governance. In January, it issued a rule proposal that would require that three-quarters of mutual fund board members, including the chairman, be independent. It would further require that independent members meet at least quarterly without any interested parties present. It authorizes the board to hire staff to help it fulfill its responsibilities. And it requires boards to retain copies of the written documents considered as part of the board's annual review of the advisory contract.

Although the Commission certainly deserves credit for this important first step, there is more that must be done to achieve the goal of improved fund governance. First and foremost, the Commission lacks the authority to strengthen the definition of independent director. So, even if it adopts its independent governance requirements without weakening amendments 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. Furthermore, the SEC proposal does not require that independent directors have sole authority to nominate new directors and set director compensation, potentially leaving significant issues in the hands of fund managers.

This bill addresses all those concerns. It includes an excellent definition of independence, which both specifically addresses the issue of significant service providers and authorizes the SEC to exclude from the definition of independent director any set of individuals who for business, family, or other reasons are unlikely to demonstrate the appropriate degree of independence. It requires both that independent directors determine director compensation and that a committee of independent directors nominate new directors. And it directs the SEC to study whether any limit should be placed on the aggregate amount of director compensation an individual could receive from a single fund family and still be considered independent.

The bill further recognizes that lack of independence is not the only concern about mutual fund governance. Also problematic is the failure of many mutual fund boards to act as fiduciaries, with a broad responsibility to protect shareholder interests. The bill attacks this problem by broadening the scope of directors' fiduciary duty. As defined in the legislation, that duty would include, among other things, a responsibility to: take quality of management as well as actual costs and economies of scale into account when negotiating management contracts; evaluate the quality, comprehensiveness, and clarity of disclosures to fund shareholders regarding costs; assess any distribution and marketing plan with regard to its costs and benefits; and monitor enforcement of policies and procedures to ensure compliance with applicable securities laws. The SEC would be responsible for detailing how the board's fiduciary duty applies in each instance.

By shoring up the independence of fund boards and expanding and clarifying their fiduciary duty to shareholders, this bill would increase the likelihood that fund boards would serve their intended function as the first line of defense against a variety of abusive practices.

One element missing from the bill, however, is any consideration of creating an independent board to oversee mutual funds. In testimony late last year, SEC Chairman William Donaldson suggested that the Commission was exploring 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," he said.

Recent accounting scandals should have taught us the risks of relying on audits that are paid for by the entity being audited. If the SEC needs a supplement to its own examination program, 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. Your bill would require a GAO study of the SEC's current organizational structure with respect to mutual fund regulation. We urge you, at a minimum, to include an assessment of the benefits of establishing an independent oversight board as part of that study.

2) The legislation would dramatically enhance the quality of mutual fund cost disclosures.

A major shortcoming in the SEC's regulation of mutual funds has been its failure to take effective action to bring down excessive costs. Not only has the agency not used its own enforcement authority to bring cases against fund managers who charge and fund boards who approve unreasonable fees, it has criticized the New York Attorney General for negotiating fee reduction agreements as part of his settlement with fund companies that engaged in abusive trading. In criticizing those fee reduction agreements, Commission officials have suggested that they prefer to rely on independent fund boards and the market to discipline costs.

While the Commission can show some progress on the issue of fund governance, its proposals on cost disclosure are extremely disappointing. They fall far short of the bare minimum needed to introduce meaningful cost competition in the mutual fund marketplace. This legislation attacks excessive costs both through strengthened governance requirements that go beyond those in the SEC rule proposal and through improved disclosures that will be more effective in raising investor awareness of costs than those proposed so far by the SEC.

One important area where the bill improves on SEC proposals is in disclosure of portfolio transaction costs. These costs vary greatly from fund to fund, may be the highest cost for an actively managed stock fund, and in some cases exceed all other costs combined. A recent study found that, on average, funds spend $0.43 on portfolio transactions for every $1.00 of expenses

that are disclosed in the current expense ratio, and that in some cases fund transaction costs can exceed three or four times the current expense ratio. (Jason Karceski, Miles Livingston, Edward O'Neal, Mutual Fund Brokerage Commissions, Jan. 2004, available at http://www.zeroalphagroup.com/headlines/ZAG_mutual_fund_true_cost_study.pdf.)

Yet, the SEC has long resisted incorporating these costs in the expense ratio. In response to congressional pressure, the agency has recently issued a concept release seeking suggestions for improving transaction cost disclosure, but it is not at all clear that the agency will come out in support of an approach that goes much beyond its previously stated preference for giving greater prominence to disclosure of the portfolio turnover rate. Such an approach makes no distinction between those funds that get good execution for their trades and those that do not. Furthermore, it continues to make it possible for funds to hide costs that would otherwise have to be disclosed by paying for them through soft dollar arrangements.

The bill would bring these costs out into the open where they belong. It would do so by requiring a separate computation of portfolio transaction costs that includes, at a minimum, brokerage commissions and bid-ask spread costs. And it would require this transaction cost ratio to be disclosed both separately and as part of a total investment cost ratio in the prospectus fee table and wherever else the expense ratio is disclosed. Because the bill would retain the current expense ratio, while also creating a new total expense ratio that includes portfolio transaction costs, it would allow the markets to decide which measure of fund costs is most appropriate and useful. Once this information is brought out into the open, these costs are more likely to be subject to competitive pressures, helping to drive down expenses for shareholders.

The bill would supplement this disclosure by requiring individualized disclosure in annual reports of the projected actual dollar amount of each investor's total annual costs based upon the investor's assets at the time of the disclosure. We strongly support individualized dollar cost disclosures, but believe that, to be workable, this information must be provided in the quarterly or annual account statements that show the shareholder's account balance and transaction activity. Putting cost information in dollar amounts side-by-side with information on the fund's gains or losses for the year is key to helping investors to put those costs into perspective. We urge you to adopt this clarification.

In addition, the draft version of the legislation that we have reviewed does not require pre-sale disclosure of mutual fund costs, as opposed to distribution costs. If we are to promote effective cost competition in the mutual fund industry, investors must receive cost information in advance of the sale. Post-sale disclosure, while useful in raising investor awareness of costs, comes too late to influence the purchase decision. We believe investors would be best served by pre-sale cost disclosures that are comparative in nature, showing how the fund's costs compare to category averages and minimums, and how this is likely to affect performance over the long-term. The provision in the bill that allows for point-of-sale disclosure provides an easy mechanism for offering this information. We urge you to add a provision to this effect to your bill.

With these changes, the cost disclosure provisions in this bill will go a long way toward bringing meaningful cost competition to an industry that has too long escaped its disciplining effects.

3) The bill would prohibit a variety of distribution practices that create unacceptable conflicts of interest.

Growing investor reluctance to pay the front loads that were common in the 1980s has driven mutual fund distribution costs underground. Funds substituted a variety of distribution practices – e.g., 12b-1 fees, directed brokerage, and payments for shelf space – that were less visible to shareholders. These practices encouraged the impression that the funds were load-free when in fact they imposed significant distribution costs. The practices adopted also posed significant new conflicts of interest.

Although 12b-1 fees are disclosed as a separate line item on prospectus fee tables, evidence suggests that investors are less aware of the cost implications of annual expenses than they are of front loads and do not necessarily understand that 12b-1 fees are used to compensate brokers. Because they are included in the expense ratio, 12b-1 fees appear to be a cost the shareholder pays for the fund, not a cost they pay for the services the broker provides. Problems with 12b-1 fees abound, including the fact that investors in funds that charge substantial 12b-1 fees may be stuck paying distribution costs whose benefits flow partially, or even primarily, to the fund company. Shareholders are forced to pay the fees even when they do not use the services the fees are designed to provide. With fund manager compensation based on a percentage of assets under management, fund managers reap significant benefits from the asset growth the fees promote, without having to risk their own money in the process.

Because it also uses shareholder assets to promote distribution, directed brokerage creates many of the same conflicts as 12b-1 fees and more. Not only are shareholders forced to pay higher costs for benefits that flow in part or in full to the fund manager, in some cases costs paid by one set of shareholders may be used in part to promote sale of other funds in the same fund family. Furthermore, these arrangements may encourage fund managers to decide where to conduct their portfolio transactions based not on where they can get the best execution, but on where they get the best distribution. They may even encourage fund managers to trade more than necessary simply to fulfill their directed brokerage agreements. This, in turn, drives up costs to shareholders. While 12b-1 fees are disclosed to investors, distribution costs paid through directed brokerage are not. Instead, they are hidden in undisclosed portfolio transaction costs.

Payments for shelf space are similar to directed brokerage agreements. Instead of being paid indirectly through portfolio transaction costs, however, these financial incentives are made in the form of cash payments by the fund manager to the broker. At best, by eating into the manager's bottom line, the payments may reduce the likelihood that the management fee will be reduced in response to economies of scale. At worst, fund managers will pass along those costs to shareholders in a form that is even less transparent than directed brokerage payments.

All these practices are designed to encourage brokers to recommend funds based not on which offer the best quality at the most reasonable price, but instead on which offer the most generous compensation to the broker. As such, they stand in sharp contrast to the image brokers promote of themselves as objective advisers. To its great credit, the legislation recognizes that simply disclosing these conflicts will not solve the problem. The best disclosure in the world is unlikely to counteract multi-million dollar advertising campaigns intent on convincing investors to place their trust in the objectivity and professionalism of their "financial consultant."

Instead, the legislation deals with these conflicts in the cleanest, most sensible way possible. It eliminates them. In doing so, it takes an enormous and much needed step toward forcing brokers to act like the objective advisers they claim to be. Furthermore, reforming the distribution system in this way is one of the most important things Congress can do to promote competition in the mutual fund industry based on cost and quality. That is because these practices allow mediocre, high-cost funds to survive and even thrive simply by offering generous compensation to the brokers that sell them. And, by making it harder for brokers to hide the compensation they receive for selling particular funds, this legislation should make it easier for shareholders to assess whether the services they receive from their broker justify the costs.

4. The bill would prohibit soft dollar arrangements that boost shareholder costs and create unacceptable conflicts of interest.

Soft dollar arrangements allow fund managers to pay for services through portfolio transaction costs that they would otherwise have to bill for directly – primarily research, but a variety of other services as well. And, because these costs are hidden, they create a strong incentive for fund managers to pay for services in this fashion. The conflicts they create are substantial. As with directed brokerage agreements, they encourage fund managers to direct their portfolio transactions based on the services they receive and not on who offers the best execution for those trades. Soft dollar arrangements also may encourage excessive trading with no purpose except to fulfill soft dollar agreements. This, in turn, requires shareholders to pay those unnecessary trading costs. Soft dollar arrangements may also encourage fund managers to choose service providers based not on who offers the best service at the best price, but on what services can be paid for through soft dollars, where the costs will be hidden.

As with the distribution practices discussed above, the legislation would deal with these conflicts by eliminating them. We strongly support this approach, which would reduce shareholder costs by requiring funds to seek best execution on all their trades. Some in the independent research community have raised concerns about this approach, suggesting that it will harm independent research. Nothing could be further from the truth. As long as funds can pay for research through soft dollars, they will have an incentive to choose the research whose cost can be hidden in this fashion. If soft dollar arrangements are banned, however, funds will have no reason to choose research based on any consideration but which is of the highest quality. If independent research can compete on quality, its competitive position should be improved under a soft dollar ban.

Conclusion

Mutual funds have been largely responsible for making it possible for average, middle-income investors to participate in our nation's securities markets. As such, they have done much to promote both the financial well-being of those investors and the financial health of our capital markets. Regulatory oversight, however, has not kept pace with mutual funds' growing and changing role in our financial markets. The recent trading and sales abuse scandals have offered a painful reminder of just how far some fund companies have strayed from their obligation to operate in shareholders' best interests.

Fundamental reform is needed to get the fund industry back on track. The SEC has gotten us part of the way there with its recent enforcement actions and rule proposals. But partway there is simply not good enough. Important gaps exist in the SEC's agenda that will keep it from delivering the comprehensive reform that the current situation demands. This legislation fills those gaps. It offers a far-reaching and thoughtful approach that, if enacted, will go a long way toward getting the mutual fund industry back to operating in shareholders' best interests once again. Please let us know what we can do to help win passage of these essential, pro-investor reforms.

Respectfully submitted,

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