

**GAO**

Testimony

Before the Committee on Banking,  
Housing and Urban Affairs, U.S. Senate

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## MUTUAL FUNDS

# Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds

Statement of David M. Walker  
Comptroller General of the United States





Highlights of [GAO-04-533T](#), a report to Chairman, Senate Committee on Banking, Housing and Urban Affairs

## Why GAO Did This Study

Since September 2003, widespread allegations of abusive practices involving mutual funds have come to light. An abuse called late trading allowed some investors, at times in collusion with pension plan intermediary, broker-dealer, or fund adviser staff, to profit at other investors' expense by submitting orders for fund shares to receive that day's price after the legal cutoff. Other investors were allowed to conduct market timing trades to take advantage of stale prices used by funds to calculate their net asset values at funds with stated policies against such trading. SEC and other regulators have responded with numerous proposals for new or revised practices. Based on a body of work that GAO has conducted involving mutual funds, GAO analyzed and provides views on proposed and final rules involving (1) fund pricing and compliance practices intended to address various mutual fund trading abuses that have come to light recently, (2) fund boards' independence and effectiveness, (3) fund adviser compensation of broker-dealers that sell fund shares, and (4) additional actions regulators could take to further improve transparency and investor understanding of the fees they pay.

## What GAO Recommends

In this statement, GAO raises a number of issues for regulators to consider that could enhance the effectiveness of proposed rule changes.

[www.gao.gov/cgi-bin/getrpt?GAO-04-533T](http://www.gao.gov/cgi-bin/getrpt?GAO-04-533T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

## MUTUAL FUNDS

# Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds

## What GAO Found

GAO commends SEC and other regulators for their swift regulatory response to recently revealed abusive mutual fund practices. However, some proposed actions need to be thoroughly assessed to ensure equitable treatment for all investors and others will need to be reinforced with enhanced compliance, enforcement, and investor education programs to be truly effective. In particular, to prevent further late trading, SEC has proposed that all mutual fund orders be received by funds or designated processors by 4:00 p.m. Eastern Time, but this action may unfairly impact some retail investors that place orders through financial intermediaries. Although GAO supports in the short run the proposed hard 4:00 p.m. close as a way of increasing the certainty that all orders have been legitimately received, GAO believes that SEC should continue to work with industry participants, including pension plan intermediaries, to address concerns that the hard close would adversely affect investors that use such intermediaries. To address market timing, SEC is proposing that funds make greater disclosure of market timing, securities pricing, and portfolio disclosure policies. GAO supports these steps and encourages regulators to educate investors about the importance of such disclosures.

To improve mutual fund corporate governance and oversight, SEC has also proposed increasing the proportion of independent directors to 75 percent and to require independent chairs. SEC is also proposing that fund advisers appoint compliance officers that report to fund boards. GAO sees these actions as giving increased prominence to independent members on fund boards of directors and providing them with additional tools to effectively oversee fund practices. However, additional actions may be needed to ensure that independent directors have no relationships with the fund adviser or its personnel that could impair their independence. SEC and other regulators have also proposed that the broker-dealers that sell fund shares make more extensive disclosures about payments they receive from fund advisers. SEC is also seeking comments on how to revise the fees they charge investors that also compensate broker-dealers for selling fund shares. GAO supports these actions as increasing the transparency of these costs to investors but recognizes that the effectiveness of these proposals could be enhanced by expanded compliance and investor education programs.

SEC is also seeking information on how fund advisers use investor dollars to obtain research under a practice called soft dollars. Given the increased spotlight that Congress and regulators are placing on the mutual fund industry, GAO believes the time is right to more effectively address the conflicts of interest created by soft-dollar arrangements. In addition, GAO identifies further actions that could be taken to improve disclosure of mutual fund fees to enhance competition among funds on the basis of the fees that are charged to shareholders.

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss GAO's work assessing the transparency of mutual fund fees and other fund practices and to discuss the various proposed or anticipated regulatory reforms designed to improve the management and sale of mutual funds. In the last 20 years, mutual funds have grown from under \$400 billion to over \$7.5 trillion in assets and have become a vital component of the financial security of the more than 95 million American investors estimated to own mutual funds. These funds have also grown to represent a significant portion of American's retirement wealth with 21 percent of the more than \$10 trillion in pension plan assets now invested in mutual funds.<sup>1</sup> As a result, ensuring that mutual funds have sound governance and trading practices has never been more important. Recent actions by the Securities and Exchange Commission (SEC) and NASD would establish new procedures to protect shareholders against recently disclosed abusive trading practices, revise the structure and duties of the boards of directors that oversee funds, and place new responsibilities on the mutual fund and brokerage industries.<sup>2</sup>

Based on the work that we have performed over the last year, I will discuss problems we have seen within the mutual fund and brokerage industries and provide our views on the various SEC and NASD-proposed regulatory reforms.<sup>3</sup> Specifically, I will discuss proposed and final rules involving (1) fund pricing and compliance practices intended to address various mutual fund trading abuses that have come to light recently, (2) fund boards' independence and effectiveness, and (3) fund advisers compensation of broker-dealers that sell fund shares. In addition I will discuss additional actions regulators could take to further improve transparency and investor understanding of the fees they pay.

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<sup>1</sup>These statistics were reported by the Investment Company Institute and the Federal Reserve Board.

<sup>2</sup>NASD oversees broker-dealers that sell mutual funds and other securities to their customers.

<sup>3</sup>See U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, [GAO-03-551T](#) (Washington, D.C.: Mar. 12, 2003); *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, [GAO-03-763](#) (Washington, D.C.: June 9, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, [GAO-03-909T](#) (Washington, D.C.: June 18, 2003); and *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, [GAO-04-317T](#) (Washington, D.C.: Jan. 27, 2004).

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In summary, we commend SEC and other regulators for their swift regulatory response to recent revelations of abusive mutual fund trading practices. We believe that many of the actions taken will provide the proper incentives to industry participants to follow sound practices and also provide regulators with additional compliance and enforcement tools to ensure that participants are held accountable for their behavior. However, some proposed actions need to be thoroughly assessed to ensure equitable treatment for all investors. In particular, while we agree that SEC's proposal to address late trading abuses with a hard 4:00 p.m. close provides increased certainty of the legitimacy of orders, we also recognize that there are wide-ranging and divergent interests in today's marketplace that must be accommodated to ensure that all retail and institutional investors are treated fairly. As such, while we agree with SEC's proposal for addressing unlawful late trading in the short run, we believe that SEC should continue to work with the retirement plan community and cognizant federal agencies to address concerns that this proposed rule may have certain adverse implications for certain participants in retirement savings plans.

We also firmly agree with SEC's proposals to enhance the independence and effectiveness of mutual fund boards. Giving increased prominence to independent members on fund boards of directors and providing them with additional tools to effectively oversee fund practices should go a long way to improve the system of checks and balances needed to avoid future trading abuses. However, additional attention could be afforded to ensuring the adequacy of the definition of an "interested person" to ensure that directors designated as independent directors are truly independent. We also recognize that other proposals for improving disclosures of mutual fund and brokerage trading practices will need to be reinforced with enhanced compliance, enforcement, and investor education programs if they are to be truly effective.

There are also other areas that warrant SEC's continued attention. SEC is seeking information on how mutual fund investors pay for advice from broker-dealers and how fund advisers use investor's dollars to obtain research. However, given the increased spotlight Congress and regulators are placing on the mutual fund industry, in our view, the time is right to address various conflicts of interest created by soft-dollar arrangements. In addition, further actions could be taken to improve disclosure of mutual fund fees to enhance competition among funds on the basis of the fees that are charged to shareholders.

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In addition to the work I am discussing today, we are currently studying other issues related to the security of workers' retirement benefits. Pensions and retirement savings plans are an important source of income for millions of retirees. As such, we are reviewing how retirement savings plans, such as 401(k) plans, have been affected by the mutual fund late trading and market timing scandals, and how SEC's proposed rules to address these practices might affect plan participants and plan administration. On the broader issue of corporate governance, we also are currently studying what actions pension plan fiduciaries take to address conflicts of interest in connection with proxy voting issues. As large institutional shareholders, pension plans have the opportunity to influence governance of funds and hold company managers accountable for the business decisions they make.

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## Regulators Are Taking Actions to Address Abusive Mutual Fund Practices

In reaction to allegations of widespread misconduct and abusive practices involving mutual funds, regulators have responded with various proposals. In early September 2003, the Attorney General of the State of New York filed charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profit at the expense of other fund shareholders.<sup>4</sup> Since then, widening federal and state investigations of illegal late trading and improper timing of fund trades have involved a growing number of prominent mutual fund companies and brokerage firms.

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## Late Trading and Market Timing Are Detrimental to Fund Long-Term Shareholders

One of the abuses that has come to light recently is late trading. Under current rules, funds accept orders to sell and redeem fund shares at a price based on the current net asset value, which most funds calculate once a day at 4:00 p.m. Eastern Time.<sup>5</sup> Many investors, however, purchase mutual fund shares through other intermediaries such as broker-dealers, banks, and retirement savings plans. Instead of submitting hundreds or even thousands of individual purchase and redemption orders each day, these

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<sup>4</sup>The term "hedge fund" generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act of 1940. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation.

<sup>5</sup>SEC rule 22c-1, promulgated under the Investment Company Act of 1940, prohibits the purchase or sale of mutual fund shares except at a price based on current net asset value of such shares that is next calculated after receipt of a buy or sell order.

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intermediaries typically aggregate orders received from investors and submit a single purchase or redemption order that nets all the individual shares their customers are seeking to buy or sell. Because this processing takes time, SEC rules permit these intermediaries to forward the order information to funds after 4:00 p.m.

However, late trading occurs when some investors are able to illegally purchase or sell mutual fund shares after the 4:00 p.m. Eastern Time close of U.S. securities markets, the time at which funds typically price their shares. An investor permitted to engage in late trading could be buying or selling shares at the current day's 4:00 p.m. price with knowledge of developments in the financial markets that occurred after 4:00 p.m. Such investors thus have unfair access to opportunities for profit that are not provided to other fund shareholders.

The extent to which some investors were allowed to submit late trading orders may have been significant. In September 2003, SEC sought information from fund advisers and broker-dealers about their pricing of mutual fund orders and late trading policies. SEC's preliminary analysis of this information showed that more than 25 percent of the 34 major broker-dealers that responded had customers that still received that day's price for orders they had placed or confirmed after 4:00 p.m. As of March 1, 2004, SEC had formally announced seven enforcement cases involving broker-dealers and other firms that were allegedly involved in late trading schemes; other cases may be forthcoming. We will be initiating a review of the adequacy of SEC's enforcement efforts and the sanctions that it can and has applied in these cases and will be reporting separately on these issues later this year. In addition, legislation is under consideration in the House of Representatives that will expand SEC's enforcement capabilities by raising the civil penalties for securities law violations, enhance the investigative procedures available to SEC, and streamline the process by which fines are disbursed among injured parties.<sup>6</sup>

Another abuse that has come to light is known as market timing. Market timing occurs when certain fund investors place orders to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. For example, U.S. mutual funds that use the last traded price for foreign securities (whose markets close hours before the U.S. markets) to value their portfolio when the U.S.

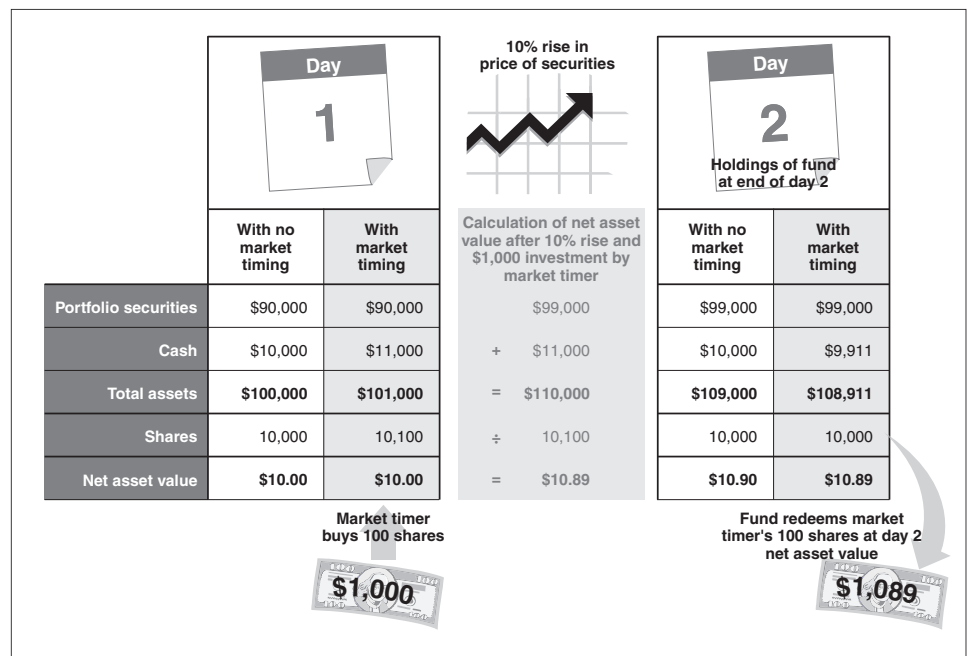
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<sup>6</sup>See H.R. 2179, *Securities Fraud Deterrence and Investor Restitution Act of 2003*.

markets close could create opportunities for market timing if events that subsequently occurred were likely to cause significant movements in the prices of those foreign securities when their home markets reopen.

Market timing, although not currently illegal, can be unfair to long-term fund investors because it provides the opportunity for selected fund investors to profit from fund assets at the expense of long-term investors. The following example illustrates how market timing transactions can reduce the return to long-term shareholders of a fund.

**Figure 1: Impact on Fund Net Asset Value (NAV) With and Without an Investment By a Market Timer**



Source: GAO.

Note: The figure shows how a hypothetical mutual fund is affected by an increase in its portfolio assets with and without a market timer transaction. In this example, a market timer invests \$1,000 in the fund on day 1 before a 10 percent rise in the value of the securities held by the fund. On day 2 the market timer redeems the shares yielding a reduction in the fund's net asset value compared to its value without a market timer transaction. The example assumes that the portfolio manager is unable to invest the market timer's cash and thus that amount does not help increase the fund's gain when the market rises.

As shown in the figure, the loss to long-term holders of the fund in this case is only \$.01 per share. Although the amount by which a single market timing transaction reduces a fund's overall return can be small, repeated and large transactions over long periods of time can have a greater

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cumulative effect. For example, one fund company whose staff were accommodating market timing transactions by 10 different investors estimated that these investors earned \$22.8 million through their trading and that these activities costs its funds \$2.7 million over a period of several years. In addition, the redemption fees that these investors should have paid but did not, amounted to another \$5 million.

Market timing may also have been widespread. According to testimony by SEC's Director of Enforcement, although most mutual funds have policies that discourage market timing, this strategy was popular among some individuals and institutional traders who attempted to conceal their identities from fund companies. He also stated that 30 percent of the broker-dealers responding to an SEC information request reported assisting customers in attempting to conduct market timing trades, by using methods, such as breaking their orders into smaller sizes to avoid detection by the fund companies. Of the twelve cases SEC formally opened that involved market timing activities, including five cases that also involved late trading, two have been settled. In the settlement for one case that involved both late trading and market timing, SEC ordered the firm to pay fines and disgorgements of \$225 million. In the other case, SEC ordered the firm to pay \$250 million in fines and disgorgements. NASD also has taken various enforcement cases against broker-dealers involving late trading and market timing, including one in which a broker-dealer was fined \$1 million and ordered to provide restitution of more than \$500,000 for failing to prevent market timing of an affiliated firm's mutual funds.

Additional abusive practices associated with mutual funds have also come to light. To facilitate late trading and market timing arrangements, some fund advisers selectively disclosed information about their funds' portfolio holdings to outsiders. They also allowed these parties to late trade or conduct market timing in their funds. For example, in one SEC case a fund manager allowed a hedge fund to engage in market timing in a fund that he managed. The fund manager also disclosed portfolio information to a broker that enabled brokerage customers to conduct market timing transactions in the funds. In another state-administered case, a hedge fund executive obtained special trading privileges from several mutual fund companies that allowed him to engage in late trading and market timing in those funds.



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Rule Changes Could Prevent Late Trading and Discourage Market Timing, but Some Investors Might Be Disadvantaged

In addition to enforcement actions, SEC has also proposed amending regulatory rules to address late trading, market timing, and selective disclosure abuses. In December 2003, SEC proposed amending the rule that governs how mutual funds price their shares and receive orders for share purchases or sales.<sup>7</sup> Since many of the cases of late trading involved orders submitted through intermediaries, including banks and pension plans not regulated by SEC, the proposed amendments to its rules would require that orders to purchase or redeem mutual fund shares be received by a fund, its transfer agent, or a registered clearing agency before the time of pricing (that is, 4:00 p.m. Eastern Time).<sup>8</sup>

Many organizations that purchase mutual fund shares, particularly those that administer retirement savings plans, have expressed concerns that such a “hard close” would unfairly prohibit some of their participants from receiving the same day’s price on share purchases. Because intermediaries generally combine individual investor orders and submit single orders to funds to buy or sell, many officials at such firms are concerned that the time required to complete this processing will not allow them to meet the 4:00 p.m. deadline. In such cases, investors purchasing shares from Western states or through intermediaries would either have to submit their trades earlier than other investors in order to receive the current day’s price or receive the next day’s price. A letter commenting on SEC’s proposal from two investor advocacy groups indicated that implementing the hard close would relegate some retail investors to the status of “second-class shareholders.” Some plan sponsor organizations and plan record keepers have also raised concerns about the potential significant administrative costs associated with adopting systems to accommodate the 4:00 p.m. hard close and other proposed rules.

Because the hard close could affect some investors’ ability to trade at the current day’s price, some groups have called on SEC to allow industry participants to develop systems of internal controls that would serve to ensure that intermediaries receive individual orders before 4:00 p.m. With such controls in place, these orders could continue to be processed after

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<sup>7</sup>Securities and Exchange Commission, Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (Dec. 11, 2003).

<sup>8</sup>A fund’s transfer agent maintains records of fund owners. Currently, the National Securities Clearing Corporation, which is the clearing organization for securities trades in the United States, also operates a system used by broker-dealers and others to transmit mutual fund orders to fund companies.

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this time. However, SEC officials told us that they were skeptical that any system that relies on internal controls could not provide certainty that late trading was not occurring because many of the late trading abuses happened at firms that purportedly had such controls in place. However, SEC remains open to the possibility of the development of systems that could reasonably detect and deter late trading. In its proposals, SEC requests comments on various approaches designed to prevent late trading. Such protections could include a system that provides an electronic or physical time-stamp on orders. Other possible controls could include certifications that the intermediary had policies and procedures in place designed to prevent late trades, or audits by independent public accountants. Because multiple regulators oversee the operations of these financial intermediaries, any assessment of the reasonableness of recommended systems or controls would likely require effective coordination.

SEC is also proposing to take actions to address market timing. On December 11, 2003, SEC released a rule proposal to provide greater transparency to funds' market timing policies. Specifically, SEC would require mutual funds to disclose in their prospectuses the risks to shareholders of the frequent purchase and redemption of investment company shares, and fund policies and procedures pertaining to frequent purchases and redemptions. The proposal also would require funds to explain both the circumstances under which they would use fair value pricing and the effects of using fair value pricing.<sup>9</sup> Another rule will require funds to adopt fair value pricing policies that require funds among other things, to monitor for circumstances that may necessitate the use of fair value pricing, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, and provide a methodology or methodologies by which the funds determine the current fair value of portfolio securities. Also, SEC is seeking comment in one of its proposals for additional ways to improve the implementation of fair value pricing. In addition, the proposal would require funds to disclose policies and procedures pertaining to their disclosing information on the funds' portfolio holdings, and any ongoing arrangements to make available information about their portfolio securities. These additional disclosures would enable investors to better assess risks, policies, and procedures,

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<sup>9</sup>Fair value pricing is a process that mutual funds use to value fund shares (such as for assets traded in foreign markets) in the absence of current market values. The Investment Company Act of 1940 requires that when market quotations for a portfolio security are not readily available, a fund must calculate its fair value.

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and determine if a fund's policies and procedures were in line with their expectations. Disclosure of a fund's procedures in these areas would also allow SEC to better examine a fund's compliance with its stated procedures and hold fund managers accountable for their actions.

To further stem market timing, on March 3, 2004, SEC issued a proposed new rule to require mutual funds to impose a 2-percent redemption fee on the proceeds of shares redeemed within 5 business days of purchase. According to the proposal, the proceeds from the redemption fees would be retained by the fund, becoming a part of fund assets. In addition, the proposal addresses the pass thru of information from omnibus accounts maintained by intermediaries. Specifically, the proposal identifies three alternatives for funds to ensure that redemption fees are imposed on the appropriate market timers through the use of Taxpayer Identification Numbers. On at least a weekly basis intermediaries would be required to provide to the fund, purchase and redemption information for each shareholder within an omnibus account to enable the fund to detect market timers and properly assess redemption fees. The rule is designed to require short-term shareholders to reimburse funds for costs incurred as a result of investors using short-term trading strategies, such as market timing. The proposal would also include an emergency exception that would allow an investor not to pay a redemption fee in the event of an unanticipated financial emergency.

Unlawful late trading and certain market timing activities, which are not currently illegal, can be unfair to long-term investors because these activities provide the opportunity for selected fund investors to profit from fund assets at the expense of fund long-term investors. SEC's proposal to address late trading with a hard 4:00 p.m. close appears, in the short-term, to be the solution that provides the most certainty that all orders being submitted to the funds legitimately deserve that day's price. However, we also recognize that this action could have a significant impact on many investors, particularly those in employer-based retirement savings plans, who own fund shares through financial intermediaries. As a result, we urge the Commission to, as a supplement to their planned action, explore alternatives to the hard 4:00 p.m. close more fully and to revisit formally the question of how best to prevent late trading. Since some of the financial intermediaries involved are either overseen by other regulators or, in the case of third-party pension plan administrators, not overseen by any regulator, any such assessment should include the development of a strategy for overseeing the intermediary processing of mutual fund trades. Having a sound strategy for oversight of the varied participants in the

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mutual fund industry would ensure that all relevant entities are held equally accountable for compliance with all appropriate laws.

We also commend SEC for proposing to require that mutual funds more fully disclose their market timing and portfolio disclosure policies. By increasing the transparency of these policies, industry participants will have the incentive to ensure that their policies are sound and will provide investors with information that they can use to distinguish between funds on the basis of these policies. The disclosures will also provide regulators and others with information to hold these firms accountable for their actions. However, such disclosures would likely also require improving related investor education programs to better ensure that investors understand the importance of these new disclosures. We also support SEC's redemption fee proposal as a means of discouraging market timing. Placing the proceeds of the fee back in the fund itself helps to ensure that the actions of short-term traders do not financially harm long-term investors, including pension plan participants who hold such funds.

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## Regulators Are Taking Actions to Improve the Effectiveness of Mutual Fund Boards of Directors

Mutual fund boards of directors have a responsibility to protect shareholder interests and SEC has issued various proposals to increase the effectiveness of these bodies. In particular, independent directors, who are not affiliated with the investment adviser, play a critical role in protecting mutual fund investors. To improve the independence of fund boards, SEC has issued various proposals to alter the structure of these boards and task them with additional duties.

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## Directors Have a Role in Overseeing Fees

Because the organizational structure of a mutual fund can create conflicts of interest between the fund's investment adviser and its shareholders, the law governing U.S. mutual funds requires funds to have a board of directors to protect the interests of the fund's shareholders. A fund is usually organized by an investment management company or adviser, which is responsible for providing portfolio management, administrative, distribution, and other operational services. In addition, the fund's officers are usually provided, employed, and compensated by the investment adviser. The adviser charges a management fee, which is paid with fund assets, to cover the costs of these services. With the management fee representing its revenue from the fund, the adviser's desire to maximize its revenues could conflict with shareholder goals of reducing fees. As one safeguard against this potential conflict, the Investment Company Act of 1940 (the Investment Company Act) requires mutual funds to have boards of directors to oversee shareholder interests. These boards must also

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include independent directors who are not employed by or affiliated with the investment adviser.

As a group, the directors of a mutual fund have various responsibilities and in some cases, the independent directors have additional duties. In particular, the independent directors also have specific duties to approve the investment advisory contract between the fund and the investment adviser and the fees that will be charged. Specifically, section 15 of the Investment Company Act requires that the terms of any advisory contracts and renewals of advisory contracts be approved by a vote of the majority of the independent directors.

Under section 36(b) of the Investment Company Act, investment advisers have a fiduciary duty to the fund with respect to the fees they receive, which under state common law typically means that the adviser must act with the same degree of care and skill that a reasonably prudent person would use in connection with his or her own affairs. Section 36(b) also authorizes actions by shareholders and SEC against an adviser for breach of this duty. Courts have developed a framework for determining whether an adviser has breached its duty under section 36(b), and directors typically use this framework in evaluating advisory fees. This framework finds its origin in a Second Circuit Court of Appeals decision, in which the court set forth the factors relevant to determining whether an adviser's fee is excessive.<sup>10</sup> The court in this case stated that to be guilty of a breach under section 36 (b), the fee must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining." The standards developed in this case, and in cases that followed, served to establish current expectations for fund directors with respect to fees. In addition to potentially considering how a fund's fee compared to those of other funds, this court indicated that directors might find other factors more important, including

- the nature and quality of the adviser's services,
- the adviser's costs to provide those services,

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<sup>10</sup>*Gartenberg v. Merrill Lynch Asset Management Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F. 2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906(1983).

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- the extent to which the adviser realizes and shares with the fund economies of scale as the fund grows,
  - the volume of orders that the manager must process,
  - indirect benefits to the adviser as the result of operating the fund, and
  - the independence and conscientiousness of the directors.

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### Concerns Over Directors' Roles Exist

Some industry experts have criticized independent directors for not exercising their authority to reduce fees. For example, in a speech to shareholders, one industry expert stated that mutual fund directors have failed in negotiating management fees. The criticism arises in part from the annual contract renewal process, in which boards compare fees of similar funds. However, the directors compare fees with the industry averages, which the experts claim provides no incentive for directors to seek to lower fees. Another industry expert complained that fund directors are not required to ensure that fund fees are reasonable, much less as low as possible, but instead are only expected to ensure that fees fall within a certain range of reasonableness.

In contrast, an academic study we reviewed criticized the court cases that have shaped directors' roles in overseeing mutual fund fees. The authors noted that these cases generally found that comparing a fund's fees to other similar investment management services, such as pension plans, was inappropriate as fund advisers do not compete with each other to manage a particular fund. Without being able to compare fund fees to these other products, the study's authors say that investors bringing these cases lacked sufficient data to show that a fund's fees were excessive.<sup>11</sup>

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### Various Actions Taken or Proposed to Increase Board Effectiveness and Mutual Fund Oversight

In light of concerns over director roles and effectiveness, including concerns arising from the recently alleged abusive practices, SEC has taken various actions to improve board governance and strengthen the compliance programs of fund advisers. To strengthen the hand of independent directors when dealing with fund management, SEC issued a proposal in January 2004 to amend rules under the Investment Company

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<sup>11</sup>J.P. Freeman and S.L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *26 Journal of Corporation Law* 609 (2001).

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Act to alter the composition and duties of many fund boards.<sup>12</sup> These reforms include

- requiring an independent chairman for fund boards of directors;
- increasing the percentage of independent directors from a majority to at least seventy-five percent of a fund's board;
- requiring fund independent directors to meet at least quarterly in a separate session; and
- providing the independent directors with authority to hire employees and others to help the independent directors fulfill their fiduciary duties.

Under the Investment Company Act, only individuals who are not “interested” can serve as independent directors. Section 2(a)(19) of the Investment Company Act defines the term “interested person” to include the fund’s investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter. Broker-dealers that distribute the fund’s shares or persons who have served as counsel to the fund would also be considered interested. However, SEC has suggested that Congress give it authority to fill gaps in the statute that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, the statute permits a former executive of the fund’s adviser to serve as an independent director two years after the person has retired from his position. This permits an adviser to use board positions as a retirement benefit for its employees. The statute also permits relatives of fund managers to serve as independent directors as long as they are not members of the “immediate family” or affiliated persons of the fund. In one case, SEC found that an uncle of the funds portfolio manager served as an independent director of the fund. Giving SEC additional rulemaking authority to define the term “interested person” clearly seems appropriate.

As part of their proposal to alter the structure of fund boards, SEC is also proposing that fund directors perform at least once annually an evaluation

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<sup>12</sup>Securities and Exchange Commission, Proposed Rule: Investment Company Governance, Release No. IC-26323 (Jan.15, 2004).

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of the effectiveness of the board and its committees. This evaluation is to consider the effectiveness of the board's committee structure and whether the directors have taken on the responsibility for overseeing too many funds. The proposal also seeks to amend the fund recordkeeping rule (rule 31a-2) to require that funds retain copies of the written materials that directors consider in approving an advisory contract under section 15 of the Investment Company Act.

According to the SEC proposal, the changes to board structure and authority are designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve. Specifically, SEC noted that commenters on a 2001 amendment believed that a supermajority of independent directors would help to strengthen the hand of independent directors when dealing with fund management, and help assure that independent directors maintain control of the board in the event of illness or absence of other independent directors. Also, SEC concluded that (1) a boardroom culture favoring the long-term interests of fund shareholders might be more likely to prevail if the board chairman does not have the conflicts of interest inherent in his role as an executive of the fund adviser, and (2) a fund board may be more effective when negotiating with the fund adviser over matters such as the advisory fee if it were not led by an executive of the adviser with whom it was negotiating. SEC also noted that separate meetings of the independent directors would afford independent directors the opportunity for frank and candid discussion among themselves regarding the management of the fund. In addition, it saw the use of staff and experts as important to help independent directors deal with matters beyond their level of expertise and give them an understanding of better practices among mutual funds.

According to SEC's proposal, having fund directors perform self-evaluations of the boards' effectiveness could improve fund performance by strengthening the directors' understanding of their role and fostering better communication and greater cohesiveness. This would focus the board's attention on the need to create, consolidate, or revise various board committees such as the audit, nominating, or pricing committees. Finally, according to SEC staff, the proposed additional recordkeeping rule would allow compliance examiners to review the quality of the materials that boards considered in approving advisory contracts.

In response to concerns regarding the adequacy of fund board review of advisory contracts and management fees, on February 11, 2004, SEC also released proposed rule amendments to require that funds disclose in



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shareholders reports how boards of directors evaluate and approve, and recommend shareholder approval of investment, advisory contracts. The proposed amendments would require a fund to disclose in its reports to shareholders the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts during the reporting period. The proposals also are designed to encourage improved disclosure in the registration statement of the basis for the board's approval of existing advisory contracts, and in proxy statements of the basis for the board's recommendation that shareholders approve an advisory contract.

In addition, to facilitate better board governance and oversight, SEC adopted requirements to ensure that mutual funds and advisers have internal programs to enhance compliance with federal securities laws and regulations. On December 17, 2003, SEC adopted a new rule that requires each investment company and investment adviser registered with the Commission to

- adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws,
- review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and
- designate a chief compliance officer to be responsible for administering the policies and procedures.

In the case of an investment company, the chief compliance officer would report directly to the fund board. These rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with federal securities laws.

To ensure that fund investment adviser officials and employees are aware of and held accountable for their fiduciary responsibilities to their fund shareholders, SEC also released a rule proposal in January 2004 that would require registered investment adviser firms to adopt codes of ethics. According to the proposal, the rule was designed to prevent fraud by reinforcing fiduciary principles that must govern the conduct of advisory firms and their personnel. The proposal states that codes of ethics remind employees that they are in a position of trust and must act with integrity at all times. The codes would also direct investment advisers to establish procedures for employees, so that the adviser would be able to determine whether the employee was complying with the firm's principles.

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In addition to these actions, SEC had previously adopted rules that became effective in April 2003 that require funds to disclose on a quarterly basis how they voted their proxies for the portfolio securities they hold. SEC also required client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, to disclose to clients how they may obtain information on how the adviser voted their proxies, and to maintain certain records relating to proxy voting. In adopting these requirements, SEC noted that this increased transparency would enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies, which may have a dramatic impact on shareholder value. We are currently reviewing whether pension plans have similar requirements to disclose their proxy voting activities to their participants and will be reporting separately on these issues later this year.

In our view, these SEC proposals should help ensure that mutual fund boards of directors are independent and take an active role in ensuring that their funds are managed in the interests of their shareholders. Many fund boards already meet some of these requirements, but SEC's proposal will better ensure that such practices are the norm across the industry. Although such practices do not guarantee that funds will be well managed and will avoid illegal or abusive behavior, greater board independence could promote board decision making that is aligned with shareholders' interests and thereby enhance board accountability. While board independence does not require eliminating all nonindependent directors, we have taken the position in previous work that it should call for a supermajority of independent directors.<sup>13</sup> Our prior work also recognized that independent leadership of the board is preferable to ensure some degree of control over the flow of information from management to the board, scheduling of meetings, setting of board agendas, and holding top management accountable. To further ensure that board members are truly independent, we would support the Congress giving SEC rulemaking authority to specify the types of persons who qualify as "interested persons." Having compliance officers report to fund boards and having advisers implement codes of ethics should also provide additional tools to hold fund advisers and boards accountable for ensuring that all fund

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<sup>13</sup>U.S. Comptroller General David M. Walker, *Integrity: Restoring Trust in American Business and the Accounting Profession* (document based on author's speech to the American Institute of Certified Public Accountants), Nov. 2002.

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activities are conducted in compliance with legal requirements and with integrity.

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## Regulators Have Responded to Broker-Dealer Compensation Issues

In addition to addressing alleged abusive practices, securities regulators are also introducing proposals that respond to concerns over how broker-dealers are compensated for selling mutual funds. Specifically, SEC is seeking comments on how to revise a rule that allows mutual funds to deduct fees to pay for the marketing and sale of fund shares. In addition, to address a practice that raises potential conflicts of interest between broker-dealers and their customers, SEC and NASD have also proposed rules that would require broker-dealers to disclose revenue sharing payments that fund advisers make to broker-dealers to compensate them for selling fund shares. SEC has also recently proposed banning a practice called directed brokerage that, if adopted, would prohibit funds from using trading commissions as an additional means of compensating broker-dealers for selling their funds.

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## 12b-1 Fees Have Increased Investor Choice but Alternatives Could Provide Additional Benefits

Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. Prior to 1980, the compensation that these financial professionals received for assisting investors with mutual fund purchases was paid either by charging investors a sales charge or load or paying for such expenses out of the investment adviser's own profits. However, in 1980, SEC adopted rule 12b-1 under the Investment Company Act to help funds counter a period of net redemptions by allowing them to use fund assets to pay the expenses associated with the distribution of fund shares. Under NASD rules, 12b-1 fees are limited to a maximum of 1 percent of a fund's average net assets per year.<sup>14</sup>

Although originally envisioned as a temporary measure to be used during periods when fund assets were declining, the use of 12b-1 fees has evolved to provide investors with flexibility in paying for investment advice and purchases of fund shares. Instead of being offered only funds that charge a front-end load, investors using broker-dealers to assist them with their

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<sup>14</sup>Specifically, NASD rules limits the amount of 12b-1 fees that may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are also allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts.

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purchases can now choose from different classes of fund shares that vary by how the broker-dealer is compensated. In addition to shares that involve front-end loads with low or no 12b-1 fee—typically called Class A shares, investors can also invest in Class B shares that have no front-end load but instead charge an annual 1 percent 12b-1 fee paid a certain number of years, such as 7 or 8 years, after which the Class B shares would convert to Class A shares. Other share classes may have lower 12b-1 fees but charge investors a redemption fee—called a back-end load—if shares are not held for a certain minimum period. Having classes of shares allows investors to choose the share class that is most advantageous depending on how long they plan to hold the investment.<sup>15</sup>

Because 12b-1 fees are used in ways different than originally envisioned, SEC is seeking public comment on whether changes to rule 12b-1 are necessary. In a proposal issued on February 24, 2004, SEC staff noted that modifications might be needed to reflect changes in the manner in which funds are marketed and distributed. For example, SEC staff told us that rule 12b-1 requires fund boards when annually re-approving a fund's 12b-1 plan, to consider a set of factors that likely are not relevant in today's environment.

In the proposal, SEC also seeks comments on whether alternatives to 12b-1 fees would be beneficial. One such alternative would have distribution-related costs deducted directly from individual customer accounts rather than having fund advisers deduct fees from the entire fund's assets for eventual payment to selling broker-dealers. The amount due the broker-dealer could be deducted over time, say once a quarter until the total amount is collected.<sup>16</sup> According to the SEC proposal, this alternative would be beneficial because the amounts charged and their effect on shareholder value would be completely transparent to the shareholder because the amounts would appear on the shareholder's account

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<sup>15</sup>Concerns over whether broker-dealers are helping investors choose the best type of fund shares for their needs have been raised recently. For example, in May 2003, SEC took an enforcement action against a major broker dealer that it accused of inappropriately selling mutual fund B shares to investors who would have been better off buying another class of shares.

<sup>16</sup>SEC's proposal provides an example where a shareholder purchasing \$10,000 of fund shares with a 5-percent sales load could pay a \$500 sales load at the time of purchase, or could pay an amount equal to some percentage of the value of his or her account each month until the \$500 amount was fully paid (plus carrying interest). If the shareholder redeemed the shares before the amount was fully paid, the proceeds of the redemption would be reduced by the unpaid amount.

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statements. According to a fund official and an industry analyst, having fund shareholders see the amount of compensation that their broker is receiving would increase investor awareness of such costs and could spur greater competition among firms over such costs.

We commend SEC for seeking comments on potentially revising rule 12b-1. Such fees are now being used in ways SEC did not intend when it adopted the rule in 1980. We believe providing alternative means for investors to compensate broker-dealers, like the one SEC's proposal describes, would preserve the beneficial flexibility that investors currently enjoy while also increasing the transparency of these fees. An approach like the one SEC describes would also likely increase competition among broker-dealers over these charges, which could lower the costs of investing in fund shares further.

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## Regulators Respond to Revenue Sharing Payment Concerns

Regulators have also acted to address concerns arising from another common mutual fund distribution practice called revenue sharing. Revenue sharing occurs when mutual fund advisers make payments out of their own revenue to broker-dealers to compensate them for selling that adviser's fund shares. Broker-dealers that have extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, increasingly demand that fund advisers make these payments in addition to the sales loads and 12b-1 fees that they earn when their customers purchase fund shares. For example, some broker-dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker-dealers. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms with revenue sharing payments. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as \$2 billion per year. According to the officials of a mutual fund research organization, about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments.

However, revenue sharing payments may create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue sharing arrangements might unduly focus the attention of broker-dealers on particular mutual

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funds, reducing the number of funds considered as part of an investment decision—potentially leading to inferior investment choices and potentially reducing fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable for the investor’s financial situation and risk profile.

Our June 2003 report recommended that SEC consider requiring that more information be provided to investors to evaluate these conflicts of interest; SEC and NASD have recently issued proposals to require such disclosure. Although broker-dealers are currently required to inform their customers about the third-party compensation the firm is receiving, they have generally been complying with this requirement by providing their customers with the mutual fund’s prospectus, which discloses such compensation in general terms. On January 14, 2004, SEC proposed rule changes that would require broker-dealers to disclose to investors prior to purchasing a mutual fund whether the broker-dealer receives revenue sharing payments or portfolio commissions from that fund adviser as well as other cost-related information. Similarly, NASD has proposed a change to its rules that would require broker-dealers to provide written disclosures to a customer when an account is first opened or when mutual fund shares are purchased that describe any compensation that they receive from fund advisers for providing their funds “shelf space” or preference over other funds. SEC is also proposing that broker-dealers be required to provide additional specific information about the revenue sharing payments they receive in the confirmation documents they provide to their customers to acknowledge a purchase. This additional information would include the total dollar amount earned from a fund’s adviser and the percentage that this amount represented of the total sales by the broker-dealer of that advisers’ fund shares over the 4 most recent quarters.

We commend SEC and NASD for taking these actions. The disclosures being proposed by SEC and NASD are intended to ensure that investors have information that they can use to evaluate the potential conflicts their broker-dealer may have when recommending particular fund shares to investors. However, such disclosures would likely also require improving related investor education programs to better ensure that investors understand the importance of these new disclosures.

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## SEC Has Also Proposed Eliminating Another Potential Mutual Fund Conflict

SEC has also taken another action to address a practice that creates conflicts of interest between fund shareholders and broker-dealers or fund advisers. On February 11, 2004, SEC proposed prohibiting fund advisers from using trading commissions as compensation to broker-dealers that sell their funds. Such arrangements are called “directed brokerage,” in which fund advisers choose broker-dealers to conduct trades in their funds’ portfolio securities as an additional way of compensating those brokers for selling fund shares. These arrangements represent a hidden expense to fund shareholders because brokerage commissions are paid out of fund assets, unlike revenue sharing, which is paid out of advisers’ revenues. We support this action as a means of better ensuring that fund advisers choose broker-dealers based on their ability to effectively execute trades and not for other reasons.

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## Other Areas Requiring Continued SEC Attention

SEC is considering actions to address conflicts of interests created by “soft-dollar arrangements” and has taken actions to enhance disclosures related to the costs of owning mutual funds, including considering making more transparent costs included in brokerage transactions. Although SEC has taken some actions, we believe that additional steps could be taken to provide further benefits to investors by increasing the transparency of certain mutual fund practices and enhancing competition among funds on the basis of the fees that are charged to shareholders.

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## Soft Dollar Arrangements Provide Benefits, but Could Adversely Impact Investors

Soft dollar arrangements allow fund investment advisers to obtain research and brokerage services that could potentially benefit fund investors but also increase investor costs. When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets. In return for these brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products.

Soft dollar arrangements are the result of regulatory changes in the 1970s. Until the mid-1970s, the commissions charged by all brokers were fixed at one equal price. To compete for commissions, broker-dealers differentiated themselves by offering research-related products and services to advisers. In 1975, to increase competition, SEC abolished fixed brokerage commission rates. However, investment advisers were concerned that they could be held in breach of their fiduciary duty to their clients to obtain best execution on trades if they paid anything but the lowest commission rate available to obtain research and brokerage

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services. In response, Congress created a “safe harbor” under Section 28(e) of the Securities Exchange Act of 1934 that allowed advisers to pay more than the lowest available commission rate for security transactions in return for research and brokerage services. Although legislation provides a safe harbor for investment advisers to use soft-dollars, SEC is responsible for defining what types of products and services are considered lawful under the safe harbor. Since 1986, the SEC has interpreted Section 28(e) as applying to a broad range of products and services, as long as they provide ‘lawful and appropriate assistance to the money manager in carrying out investment decision-making responsibilities.’

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can directly benefit fund investors if the adviser uses it to select securities for purchase or sale by the fund. The prevalence of soft dollar arrangements also allows specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars might also have other benefits. For example, an investment adviser official told us that the research on smaller companies helps create a more efficient market for securities of those companies, resulting in greater market liquidity and lower spreads, which would benefit all investors including those in mutual funds.

Although the research and brokerage services that fund advisers obtain through the use of soft dollars could benefit a mutual fund investor, this practice also could increase investors’ costs and create potential conflicts of interest that could harm fund investors. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to “over-consume” research because they would not be paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Regulators also have raised concerns over soft dollar practices. In 1996 and 1997, SEC examiners conducted an examination sweep into the soft



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dollar practices of broker-dealers, investment advisers, and mutual funds. In the resulting 1998 inspection report, SEC staff documented instances of soft dollars being used for products and services outside the safe harbor, as well as inadequate disclosure and bookkeeping of soft dollar arrangements. SEC staff told us that their review found that mutual fund advisers engaged in far fewer soft dollar abuses than other types of advisers. To address the concerns identified, the SEC staff report proposed recommending that investment advisers keep better records and make greater disclosure about their use of soft dollars. A working group formed in 1997 by the Department of Labor (DOL) to study the need for regulatory changes and additional disclosures to pension plan sponsors and fiduciaries on soft dollar arrangements recommended that SEC act to narrow the definition of products and services that are considered research and allowable under the safe harbor.<sup>17</sup> The working group also recommended that SEC prepare a specific list of acceptable purchases with soft dollars that included brokerage and research services.

#### Additional Actions to Address Conflicts Raised by Soft Dollars Could be Beneficial

Although SEC has acknowledged the concerns involved with soft-dollar arrangements, it has taken limited actions to date. SEC staff told us that the press of other business prevented them from addressing the issues raised by other regulators and their own 1998 staff report. However, in a December 2003 concept release on portfolio transaction costs staff requested comments on what types of information investment advisers should be required to provide to mutual fund boards regarding the allocation of brokerage commissions for execution purposes and soft dollar benefits.<sup>18</sup> In addition, SEC staff told us that they have formed a study group with representatives of the relevant SEC divisions, including Investment Management, Market Regulation, and the Office of Compliance Inspections and Examinations, to review soft dollar issues. This group also is collecting information from industry and foreign regulators.

Regulators in other countries and other industries have acted to address the conflicts created by soft dollars. In the United Kingdom, the Financial Services Authority (FSA), which regulates the financial services industry

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<sup>17</sup>U.S. Department of Labor, *Report of the Working Group on Soft Dollars/Commission Recapture* (Nov. 13, 1997) available at <http://www.dol.gov/ebsa/publications/softdolr.htm>. DOL oversees pension plans.

<sup>18</sup>SEC's concept release "Measures to Improve Disclosure of Mutual Fund Transaction Costs" specifically requests comments on ways to improve the qualification and disclosure of commission costs as well as other transaction related costs.

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in that country, has issued a consultation paper that argues that these arrangements create incentives for advisers to route trades to broker-dealers on the basis of soft dollar arrangements and that these practices represented an unacceptable market distortion.<sup>19</sup> As a result of recommendations from a government-commissioned review of institutional investment, FSA has proposed banning soft dollars for market pricing and information services, as well as various other products.<sup>20</sup> FSA notes that their proposal would limit the ability of fund managers to pass management costs through their customers' funds in the form of commissions and would provide more incentive to consider what services are necessary for efficient funds management, both of which could lower investor costs. However, FSA staff has acknowledged that restricting soft dollar arrangements in the United Kingdom could hurt the international competitiveness of their fund industry because fund advisers outside their country would not have to comply with these restrictions.

In addition, DOL has placed more restrictions on pension plan administrators use of soft dollars than apply to mutual fund advisers. SEC requires mutual fund boards of directors to review fund trading activities to ensure that the adviser is obtaining best execution and to monitor any conflicts of interest involving soft dollars. However, section 28(e) allows fund advisers to use soft dollars generated by trading in one fund's portfolio to obtain research that does not benefit that particular fund but instead benefits other funds managed by that adviser. In contrast, DOL requires plan fiduciaries to monitor the plan's investment managers to ensure that the soft dollar research obtained from trading commissions paid out of plan assets benefits the plan and that the benefits to the plan are reasonable in relation to the value of the brokerage and research services provided to the plan.

Some industry participants have also called on SEC to restrict soft dollar usage. For example, the board of the Investment Company Institute (ICI), which is the industry association for mutual funds, recently recommended that SEC consider narrowing the definition of allowable research under Section 28(e) and eliminate the purchase of third-party research with soft-dollars. According to statements released by ICI, SEC's definition of permitted research is overly expansive and has been susceptible to abuse.

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<sup>19</sup>Financial Services Authority, *Bundled Brokerage and Soft Commission Arrangements* (April 2003).

<sup>20</sup>P. Myners, *Institutional Investment in the United Kingdom: A Review* (Mar. 6, 2001).

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ICI recommends that SEC prohibit advisers from using soft dollars to obtain any products and services that are otherwise publicly available in the marketplace, such as periodical subscriptions or electronic news services. In a letter to the SEC Chairman, ICI wrote that its proposal would reduce incentives for investment advisers to engage in unnecessary trading and would more closely reflect the original purpose of Section 28(e), which was to allow investment advisers to take into account a broker-dealer's research capabilities in addition to its ability to provide best execution.

Beyond these proposals, some industry participants have called for a complete ban of soft dollars. If soft dollars were banned—which would require repeal of Section 28(e)—and bundled commission rates were required to be separately itemized, fund advisers would not be allowed to pay higher commissions in exchange for research. Advocates of banning soft dollars believe that this would spur broker-dealers to compete on the price of executing trades, which averages between \$.05 and \$.06 per share at large broker-dealers, whereas trades conducted through other venues can be done for \$.01 or less. Critics fear that this ban would reduce the amount of independent research that advisers obtain, which would hurt investors and threaten the viability of some existing independent research firms.

To address concerns over soft dollars, our June 2003 report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. Because SEC has not acted to more fully address soft dollar-related concerns, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of fund advisers' use of soft dollars. However, such disclosures could potentially increase the complexity of the information that investors are provided and require them to interpret and understand such information. As such, an enhanced investor education campaign would also likely be warranted.

Although disclosure can improve transparency, it may not be sufficient for creating proper incentives and accountability. In our view, the time for SEC to take bolder actions regarding soft dollars is now. Allowing the advisers of mutual funds to use customer assets to obtain services that would otherwise have to be paid for using advisers' revenues appears to create inappropriate incentives, and inadequate transparency and accountability.

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We commend SEC for initiating an internal study of soft dollar issues. As part of this evaluation, we believe that SEC should consider at a minimum the merits of narrowing the services that are considered acceptable under the safe harbor. Concerns that SEC's current definition of permitted research is overly expansive and susceptible to abuse have been recognized for years. Acting to narrow the safe harbor could reduce opportunities for abusive practices. It could also lower investor costs by reducing adviser incentives to overtrade portfolio assets to obtain soft dollar research and services. We also believe that SEC's study should consider the relative merits of eliminating soft dollar arrangements altogether. The elimination of soft dollars, which would require legislative action, could create greater incentives for broker-dealers to compete on the basis of execution cost and greater incentives for fund advisers to weigh the necessity of some of the research they now receive since they would have to pay for such items from their own revenues.

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### New and Proposed Rules Could Provide Added Transparency of the Costs of Investing in Mutual Funds

SEC recently adopted rules and rule amendments aimed at increasing investor awareness by improving the disclosures of the fees and expenses paid for investing in mutual funds. In February 2004, SEC adopted rule amendments that require mutual funds to make additional disclosures about their expenses.<sup>21</sup> This information will be presented to investors in the annual and semiannual reports prepared by mutual funds. Among other things, mutual funds will now be required to disclose the cost in dollars associated with an investment of \$1,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition to allowing existing investors to compare fees across funds, SEC staff indicated that placing these disclosures in funds' annual and semiannual reports will help prospective investors to compare funds' expenses before making a purchase decision.

In addition to this action, SEC amended fund advertising rules in September 2003 to require funds to state in advertisements that investors should consider a fund's fees before investing and direct investors to consult the fund prospectus for more information.<sup>22</sup> Additionally, in

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<sup>21</sup>Securities and Exchange Commission, Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Release Nos. 33-8393; 34-49333; IC-26372 (Feb. 27, 2004).

<sup>22</sup>Securities and Exchange Commission, Final Rule: Amendments to Investment Company Advertising Rules, Release Nos. 33-8294; 34-48558; IC-26195 (Sep. 29, 2003).

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November 2003, NASD proposed amending rules to require that mutual funds advertising their performance present specific information about the fund's expenses and performance in a more prominent format. These new requirements are aimed at improving investor awareness of the costs of buying and owning a mutual fund, facilitating comparison of fees among funds, and make presentation of standardized performance information more prominent. Specifically, NASD's proposal would require that all performance advertising contain a text box that sets forth the fund's standardized performance information, maximum sales charge, and annual expense ratio. In doing so NASD's proposal would go beyond SEC requirements by requiring funds to include specific performance and expense information within advertising materials.

Another cost-related rulemaking initiative by SEC staff seeks to improve the disclosure of breakpoint discounts for front-end sales loads. In March 2003, SEC, NASD, and the New York Stock Exchange issued a report describing the failure of some broker-dealers to issue discounts on front-end charges paid to them by mutual fund investors. Mutual funds with front-end sales loads often offer investors discounts or "breakpoints" in these sales loads as the dollar value of the shares purchased by investors or members of their family increases, such as for purchases of \$50,000 or more. To better ensure that investors receive these discounts when deserved, SEC is proposing to require funds to disclose in their prospectuses when shareholders are eligible for breakpoint discounts. According to the SEC proposal, such amendments are intended to provide greater prominence to breakpoint disclosure by requiring its inclusion in the prospectus rather than in the Statement of Additional Information, which is a document delivered to investors only upon request.

However, these actions would not require mutual funds to disclose to each investor the specific amount of fees in dollars that are paid on the shares they own. As result, investors will not receive information on the costs of mutual fund investing in the same way they see the costs of many other financial products and services that they may use. In addition, these actions do not require that mutual funds provide information relating to fees in the document that is most relevant to investors—the quarterly account statement. In a 1997 survey of how investors obtain information about their funds, ICI indicated that, to shareholders, the account statement is probably the most important communication that they receive from a mutual fund company and that nearly all shareholders use such statements to monitor their mutual funds.

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Our June 2003 report recommends that SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC has agreed to consider requiring such disclosures but was unsure that the benefits of implementing specific dollar disclosures outweighed the costs to produce such disclosures. However, we estimate that spreading these implementation costs across all investor accounts might not represent a large outlay on a per-investor basis.

Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees. For example, one less costly alternative would require quarterly statements to present the same information—the dollar amount of a fund’s fees based on a set investment amount—recently required for mutual fund semiannual reports. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative would be to require that quarterly statements also include a notice that reminds investors that they pay fees and to check their prospectus and ask their financial adviser for more information. Disclosures such as these could be the incentive that some investors need to take action to compare their fund’s expenses to those of other funds and thus make more informed investment decisions. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees.

This concludes my prepared statement and I would be happy to respond to any questions at the appropriate time.

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## Contacts and Acknowledgements

For further information regarding this testimony, please contact Richard J. Hillman or Cody J. Goebel at (202) 512-8678. Individuals making key contributions to this testimony include Toayoa Aldridge, Barbara Roesmann, George Scott, and David Tarosky.

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