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MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Statement of Richard J. Hillman, Director,
Financial Markets and Community Investment

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Highlights

Highlights of GAO-03-909T, a testimony to the Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Why GAO Did This Study

Concerns have been raised over whether the disclosures of mutual fund fees and other fund practices are sufficiently transparent and fair to investors. GAO's testimony discusses (1) mutual fund fee disclosures, (2) the extent to which various corporate governance reforms are in place in the mutual fund industry, (3) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (4) the benefits and concerns over fund advisers' use of soft dollars.

What GAO Recommends

GAO's report recommends that SEC consider requiring additional disclosure by mutual funds of

- the fees that investors pay in account statements,
- revenue sharing payments that broker-dealers receive; and
- fund adviser's use of soft dollars.

What GAO Found

The work that GAO has conducted at the request of this Committee addresses several of the areas that are included in the recently introduced Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420). Mutual funds disclose considerable information about their costs to investors, but unlike many other financial products and services, they do not disclose to each investor the specific dollar amount of fees that are paid on their fund shares. Consistent with H.R. 2420, our 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, which we estimate may result in minimal increases in fund expenses. Our report also discusses other alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees but be even less costly to the industry overall.

U.S. mutual funds have boards of directors who are charged with overseeing the interests of fund shareholders. Various corporate governance reforms have been proposed to improve the effectiveness of mutual fund boards. As a result of SEC requirements or industry best practice recommendations, many of these practices were already in place at many funds, but not all such practices were mandatory. H.R. 2420 would ensure that all mutual funds implement these practices.

Mutual fund advisers have been increasingly making additional payments out of their own profits to the broker-dealers that sell their fund shares. Although allowed under current rules, these revenue sharing payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that investors are offered. Under current disclosure requirements, however, investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Consistent with H.R. 2420, our report also recommended that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving.

Under a practice known as soft dollars, a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. Although this research and other services can benefit fund investors, these arrangements could result in increased expenses for fund shareholders if fund advisers trade excessively to obtain additional soft dollar research. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on all of its own recommendations. Consistent with H.R. 2420, our report recommended that more disclosure be made to mutual fund directors and investors.

www.gao.gov/cgi-bin/getrpt?GAO-03-909T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss GAO's work on the disclosure of mutual fund fees and the need for other related mutual fund disclosures to investors. The fees and other costs that mutual fund investors pay as part of owning fund shares can significantly affect their investment returns. As a result, it is appropriate to debate whether the disclosures of mutual fund fees and fund marketing practices are sufficiently transparent and fair to investors.

Today, I will summarize the results from our recently issued report entitled *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763 (Washington, D.C.: June 9, 2003) and describe how the results of this work relates to certain provisions of the proposed Mutual Funds Integrity and Fee Transparency Act of 2003 (H.R. 2420). Specifically, I will discuss (1) mutual fund fee disclosures and opportunities for improving these disclosures, (2) the extent to which various corporate governance reforms are in place in the mutual fund industry, (3) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (4) the benefits and concerns over fund advisers' use of soft dollars.

In summary:

The study that we have conducted at the request of this Committee directly supports several of the key provisions of H.R. 2420. In particular, it addresses the need to consider ways to increase the transparency of mutual fund fees and other disclosures. Mutual funds disclose considerable information about their costs to investors, including presenting the operating expense fees that they charge investors as a percentage of fund assets and providing hypothetical examples of the amount of fees that an investor can expect to pay over various time periods. However, unlike many other financial products and services, mutual funds do not disclose to individual investors the specific dollar amount of fees that are paid on their fund shares. The Securities and Exchange Commission (SEC) has proposed that mutual funds make additional disclosures to investors that would provide more information that investors could use to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that inform investors of the number and value of the mutual fund shares they own. Consistent with H.R. 2420, our 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 may result in minimal increases in fund expenses. 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.

Each mutual fund in the United States is required to have a board of directors that is charged with overseeing the interests of fund shareholders. These boards also must include directors that are not employed or affiliated with the fund's adviser, and these independent directors have specific duties to oversee the fees their fund's charge. However, some industry critics have questioned whether fund directors are adequately performing their duties and various corporate governance reforms have been proposed to improve the effectiveness of mutual fund boards. We found that many of the corporate governance reforms are already being practiced by many funds as a result of either recent SEC actions or because they are recommended as best practices by the mutual fund industry body, the Investment Company Institute. By amending the Investment Company Act of 1940 to require these and other corporate governance practices, H.R. 2420 would further strengthen certain corporate governance practices and ensure that all mutual funds implement these practices.

The work that we conducted for our report also found that mutual fund advisers have been increasingly engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses to fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that these broker-dealers offer investors. However, under current disclosure requirements investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Consistent with H.R. 2420, our report also recommended that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving.

Finally, we also reviewed a practice known as soft dollars, in which a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. These soft dollar arrangements can result in mutual fund advisers obtaining research or other services, including from third party independent research firms, that can benefit the investors in their funds. However, these arrangements also create a conflict of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain additional soft dollar research or chooses broker-dealers more on the basis of their soft dollar offerings than their ability to execute trades efficiently. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on some of its own recommendations. Consistent with H.R. 2420, our report recommended that more disclosure be made to mutual fund directors and investors to allow them to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

Additional Disclosure of Mutual Fund Costs Might Benefit Investors

Although mutual funds already disclose considerable information about the fees they charge, our report recommended that SEC consider requiring that mutual funds make additional disclosures to investors about fees in the account statements that investors receive. Mutual funds currently provide information about the fees they charge investors as an operating expense ratio that shows as a percentage of fund assets all the fees and other expenses that the fund adviser deducts from the assets of the fund. Mutual funds also are required to present a hypothetical example that shows in dollar terms what an investor could expect to pay if they invested $10,000 in a fund and held it for various periods.

Unlike many other financial products, mutual funds do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. Table 1 shows that many other financial products do present their costs in specific dollar amounts.

Table 1: Fee Disclosure Practices for Selected Financial Services or Products

Type of product or service	Disclosure requirement
Mutual funds	Mutual funds show the operating expenses as percentages of fund assets and dollar amounts for hypothetical investment amounts based on estimated future expenses in the prospectus.
Deposit accounts	Depository institutions are required to disclose itemized fees, in dollar amounts, on periodic statements.
Bank trust services	Although covered by varying state laws, regulatory and association officials for banks indicated that trust service charges are generally shown as specific dollar amounts.
Investment services provided to individual investment accounts (such as those managed by a financial planner)	When the provider has the right to deduct fees and other charges directly from the investor's account, the dollar amounts of such charges are required to be disclosed to the investor.
Wrap accounts[a]	Provider is required to disclose dollar amount of fees on investors' statements.
Stock purchases	Broker-dealers are required to report specific dollar amounts charged as commissions to investors.
Mortgage financing	Mortgage lenders are required to provide at time of settlement a statement containing information on the annual percentage rate paid on the outstanding balance, and the total dollar amount of any finance charges, the amount financed, and the total of all payments required.
Credit cards	Lenders are required to disclose the annual percentage rate paid for purchases and cash advances, and the dollar amounts of these charges appear on cardholder statements.

Source: GAO analysis of applicable disclosure regulations, rules, and industry practices.

[a]In a wrap account, a customer receives investment advisory and brokerage execution services from a broker-dealer or other financial intermediary for a "wrapped" fee that is not based on transactions in the customer's account.

Although mutual funds do not disclose their costs to each individual investor in specific dollars, the disclosures that they make do exceed those of many products. For example, purchasers of fixed annuities are not told of the expenses associated with investing in such products. Some industry participants and others including SEC also cite the example of bank savings accounts, which pay stated interest rates to their holders but do not explain how much profit or expenses the bank incurs to offer such products. While this is true, we do not believe this is an analogous comparison to mutual fund fees because the operating expenses of the bank are not paid using the funds of the savings account holder and are therefore not explicit costs to the investor like the fees on a mutual fund.

A number of alternatives have been proposed for improving the disclosure of mutual fund fees, that could provide additional information to fund investors. In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[1] This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to disclose the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, SEC also proposed that mutual funds be required to disclose the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. If these disclosures become mandatory, investors will have additional information that could be directly compared across funds. By placing it in funds' annual and semiannual reports, SEC staff also indicate that it will facilitate prospective investors comparing funds' expenses before making a purchase decision.

However, SEC's proposal 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, SEC did not propose that mutual funds provide information relating to fees in the quarterly or even more frequent account statements that provide investors with the number and value of their mutual fund shares. 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.

SEC and industry participants have indicated that the total cost of providing specific dollar fee disclosures might be significant; however, we found that the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement, ICI commissioned a large accounting firm to survey mutual fund companies about the costs of

[1]"Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission," Release Nos. 33-8164; 34-47023; IC-2587068 (Dec. 18, 2002).

producing such disclosures.[2] Receiving responses from broker-dealers, mutual fund service providers, and fund companies representing approximately 77 percent of total industry assets as of June 30, 2000, this study estimated that the aggregated estimated costs for the survey respondents to implement specific dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. Although the ICI study included information from some broker-dealers and fund service providers, it did not include the reportedly significant costs that all broker-dealers and other third-party financial institutions that maintain accounts on behalf of individual mutual fund shareholders could incur. However, using available information on mutual fund assets and accounts from ICI and spreading such costs across all investor accounts indicates that the additional expenses to any one investor are minimal. Specifically, at end of 2001, ICI reported that mutual fund assets totaled $6.975 trillion. If mutual fund companies charged, for example, the entire $266 million cost of implementing the disclosures to investors in the first year, then dividing this additional cost by the total assets outstanding at the end of 2001 would increase the average fee by .000038 percent or about one-third of a basis point. In addition, ICI reported that the $6.975 trillion in total assets was held in over 248 million mutual fund accounts, equating to an average account of just over $28,000. Therefore, implementing these disclosures would add $1.07 to the average $184 that these accounts would pay in total operating expense fees each year—an increase of six-tenths of a percent.[3]

In addition, other less costly alternatives are also available that could increase investor awareness of the fees they are paying on their mutual funds by providing them with information on the fees they pay in the quarterly statements that provide information on an investor's share balance and account value. For example, one alternative that would not likely be overly expensive would be to require these quarterly statements

[2]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).

[3]To determine these amounts, we used the operating expense ratios that ICI has estimated in its September 2002 fee study—which reported average expense ratios of 0.88 percent for equity funds, 0.57 percent for bond funds, and 0.32 percent for money market funds. By weighting each of these by the total assets invested in each fund type, we calculated that the weighted average expense ratio for all funds was 0.66 percent. Using this average expense ratio, the average account size of $28,000 would pay $184 in fees. The additional expense of implementing specific dollar disclosures of 0.000038 percent would therefore add $1.07 to this amount.

to present the information—the dollar amount of a fund's fees based on a set investment amount—that SEC has proposed be added to 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 could be to require quarterly statements to also include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information.

Because SEC's current proposal, while offering some advantages, does not make mutual funds comparable to other products and provide information in the document that is most relevant to investors—the quarterly account statement—our report recommended that SEC consider requiring additional disclosures relating to fees be made to investors in these documents. In addition to specific dollar disclosures, we also noted that investors could be provided with other disclosures about the fees they pay on mutual funds that would have a range of implementation costs, including some that would have even less overall cost to the industry. H.R. 2420 also mandates that SEC require additional information about fees be disclosed to investors. Seeing the specific dollar amount paid on their shares could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees. Because the disclosures that SEC is currently proposing be included in mutual fund annual and semiannual reports could also prove beneficial, it could choose to require disclosures in both these documents and account statements, which would provide both prospective and existing investors in mutual funds access to valuable information about the costs of investing in funds.

H.R. 2420 also mandates that SEC require mutual funds to disclose more information about portfolio transactions costs, including commissions paid with respect to the trading of portfolio securities. Although additional information about such costs could be beneficial to investors, we found that determining these costs in a way that allows them to be accurately and fairly compared across funds could prove difficult.

Mutual Fund Boards Follow Many Sound Corporate Governance Practices but Such Practices are Not Mandatory for All Funds

Mutual funds implemented many sound practices concerning their boards of directors, but these practices are not mandatory for all funds. The law governing U.S. mutual funds promotes investor protection by requiring funds to have a board of directors to protect fund shareholder interests. As a group, the directors of a mutual fund have various statutory responsibilities to oversee fund operations. In particular, the directors independent of the fund's investment adviser have additional duties including approval of the contracts with the investment adviser. As a matter of practice, independent directors also review other arrangements such as transfer agency, custodial, or bookkeeping services.

As a result of recent scandals such as Enron and Worldcom, new legislative and regulatory reforms have been adopted or proposed to increase the effectiveness and accountability of public companies' boards of directors. In July 2002, the Sarbanes-Oxley Act (Sarbanes-Oxley) was enacted to address concerns related to corporate responsibility and governance.[4] In addition to enhancing the financial reporting regulatory structure, Sarbanes-Oxley sought to increase corporate accountability by reforming the structure of corporate boards audit committees. Section 301 of Sarbanes-Oxley requires that directors who serve on a public company's audit committee be "independent" and select and oversee outside auditors. The New York Stock Exchange (NYSE) and NASDAQ have also proposed changes to the corporate governance listing standards for public companies. However, many of the proposed reforms for public companies are either already required or have been recommended as best practices for mutual fund boards. Table 2 shows how the current or recommended corporate governance practices for mutual fund boards compare to current and proposed NYSE and NASDAQ listing standards applicable to public company boards.

[4]Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

Table 2: Current and Proposed NYSE and NASDAQ Listing Standards Compared to Current or Recommended Mutual Fund Corporate Governance Requirements

	NYSE/NASDAQ listing standards		Mutual Funds	
Governance requirement	**Currently required**	**Proposed requirement**	**Required by statute or SEC rule[a]**	**ICI recommended best practice**
Board must have a majority of independent directors		X	X	X
Independent directors must be responsible for nominating new independent directors		X	X	X
Audit committee must consist of only independent directors[b]	X	X		X
Standards that define who qualifies as an independent director[c]	X	X	X	X
Independent directors required to meet separately in executive sessions		X		X

Source: GAO analysis of ICI Best Practices, SEC rules, and NYSE and NASDAQ rule proposals.

[a]SEC requires the board of directors of any fund that takes advantage of various exemptive rules to meet these requirements and SEC staff indicated that, as a result, almost all funds must comply.

[b]Although fully independent audit committees is not a requirement for funds, SEC has adopted a rule to encourage fund boards to have audit committees consisting exclusively of independent directors by exempting such committees from having to seek shareholder approval of the fund's auditor.

[c]Both the NYSE and NASDAQ definitions of director independence currently apply only to members of the audit committee, but their rule proposals would extend this definition to the full board.

According to regulators and data from industry participants that we obtained, many mutual funds have implemented many of the practices that are being recommended for public companies. As shown in table 2 above, many of these practices are already required for many funds by SEC regulation or are recommended by ICI as a best practice. Officials of the fund companies and the independent directors that we interviewed told us that the majority of their boards consisted of independent directors, and, in many cases, had only one interested director. For public companies, some commenters have called for boards of directors to have supermajorities of independent directors as a means of ensuring that the voices of the independent directors are heard. ICI already advocates this practice in its best practice recommendations and one fund governance consulting official said that a 2002 survey conducted by his firm found that, in 75 percent of the mutual fund complexes they surveyed, over 70

percent of the directors were independent. An academic study we reviewed also found that funds' independent directors already comprised funds' nominating committees and most funds have self-nominating independent directors.

However, not all of these sound corporate governance practices are currently mandatory for mutual funds. For example, if a fund does not take advantage of any of the exemptive rules that SEC cited in requiring certain corporate governance practices, such a fund may not already be following these practices. In addition, some of the reforms advocated by ICI's best practices and by those advocating change for public companies are not currently required for mutual funds. H.R. 2420 would make these and other practices mandatory for all funds, which would ensure consistent implementation of the practices across the industry.

Changes in Mutual Fund Distribution Practices Raise Potential Conflicts of Interest Between Broker-Dealers and Investors

One mutual fund distribution practice—called revenue sharing—that has become increasingly common involves mutual fund investment advisers making additional payments beyond those made under 12b-1 plans to broker-dealers that sell fund shares. Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. To be compensated for providing advice and ongoing assistance to investors, many of these financial professionals receive payments from the mutual fund either through the sales charges paid up front by the investor (called loads) or from ongoing fees that are deducted from the fund's assets. These fees are called 12b-1 fees after the rule that allows fund assets to be used to pay for fund marketing and distribution expenses. NASD, whose rules govern the distribution of fund shares by broker dealers, limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are 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. Therefore, 12b-1 fees included in a fund's total expense ratio are limited to a maximum of 1 percent per year.

However, broker-dealers, whose extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, have increasingly required mutual funds to make additional payments to their firms beyond the sales loads and 12b-1 fees. These payments, called revenue sharing payments, come from the adviser's profits and may supplement distribution-related

payments from fund assets. 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. 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.

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. A 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing might affect other fees that funds charge, such as 12b-1 fees or management fees, was uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments increased any fund's fees, but also noted that by reducing fund adviser profits, revenue sharing would likely prevent advisers from lowering their fees. In addition, fund directors normally would not question revenue sharing arrangements paid from the adviser's profits. In the course of reviewing advisory contracts, fund directors consider the adviser's profits not taking into account marketing and distribution expenses, which also could prevent advisers from shifting these costs to the fund.

Revenue sharing payments may also 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 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 given the investor's financial situation and risk profile.

Although revenue sharing payments can create conflicts of interest between broker-dealers and their clients, the extent to which broker-

dealers disclose to their clients that their firms receive such payments from fund advisers is not clear. Rule 10b-10 under the Securities Exchange Act of 1934 requires, among other things, that broker-dealers provide customers with information about third-party compensation that broker-dealers receive in connection with securities transactions. While broker-dealers generally satisfy the 10b-10 requirements by providing customers with written "confirmations," the rule does not specifically require broker-dealers to provide the required information about third-party compensation related to mutual fund purchases in any particular document. SEC staff told us that they interpret rule 10b-10 to permit broker-dealers to disclose third-party compensation related to mutual fund purchases through delivery of a fund prospectus that discusses the compensation. However, investors would not receive a confirmation and might not view a prospectus until after purchasing mutual fund shares.

As a result of these concerns, our report recommends that SEC evaluate ways to provide more information to investors about the revenue sharing payments that funds make to broker-dealers. Having additional disclosures made at the time that fund shares are recommended about the compensation that a broker-dealer receives from fund companies could provide investors with more complete information to consider when making their investment decision. This recommendation is consistent with the requirement in H.R. 2420 that mandates that SEC require mutual funds to further disclose revenue sharing payments and make annual or more frequent reports of such payments to fund boards of directors.

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 could also increase investors' 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.[5] 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.

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can

[5]Instead of commissions, broker-dealers executing trades also could be compensated through markups or spreads.

directly benefit a fund's 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 such companies' securities, 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. One academic study shows that trades executed by broker-dealers that specialize in providing soft dollar products and services tend to be more expensive than those executed through other broker-dealers, including full-service broker-dealers.[6] 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 are not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which investment advisers use to register with SEC and must send to their advisory clients. However, this form is not provided to the shareholders of a mutual fund, although the information about the soft dollar practices that the adviser uses for particular funds are required to be included in the Statement of Additional Information that funds prepare, which is available to investors upon request. Specifically, Form ADV requires advisers to describe the

[6]J.S. Conrad, K.M Johnson, and S. Wahal, "Institutional Trading and Soft Dollars" *Journal of Finance*, (February, 2001).

factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of the products, research, and services given to the adviser affects the choice of brokers or the brokerage commission paid, the adviser must also describe the products, research and services and whether clients might pay commissions higher than those obtainable from other brokers in return for those products.

In a series of regulatory examinations performed in 1998, SEC staff found examples of problems relating to investment advisers' use of soft dollars, although far fewer problems were attributable to mutual fund advisers. In response, SEC staff issued a report that included proposals to address the potential conflicts created by these arrangements, including recommending that investment advisers keep better records and disclose more information about their use of soft dollars. Although the recommendations could increase the transparency of these arrangements and help fund directors and investors better evaluate advisers' use of soft dollars, SEC has yet to take action on some of these proposed recommendations.

As a result, our report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, 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 their fund adviser's use of soft dollars. If H.R. 2420 is enacted, investors and fund directors would get more information to allow them to make these evaluations. Also, the study that H.R. 2420 would require SEC to conduct of soft dollars would likely provide SEC with valuable information to allow it to best decide the form of these disclosures and whether any other changes to soft dollar practices are warranted.

This concludes my prepared statement and I would be happy to respond to questions.

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