United States General Accounting Office
Washington, DC 20548

May 3, 2001

The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

Subject: SEC's Report Provides Useful Information On Mutual Fund Fees And Recommends Improved Fee Disclosure

Dear Mr. Dingell:

This letter responds to your request that we comment on the findings and recommendations in the December 2000 *Report on Mutual Fund Fees and Expenses* by the Securities and Exchange Commission's (SEC) Division of Investment Management. In this report, the SEC staff presents the results of its own analysis of the trend in mutual fund fees, including the results of its statistical analyses that identified how various fund characteristics affect fee levels. In addition, the report describes the approaches the SEC staff proposes be taken in response to the recommendation in our report *Mutual Fund Fees: Additional Disclosure Could Improve Price Competition* (GAO/GGD-00-126, June 7, 2000). In this letter, we discuss the findings of the SEC staff's report and compare them to those of our report. We also comment on the SEC staff's proposed response to our recommendation calling for additional disclosure of fee information to mutual fund investors.

Results in Brief

The results of the SEC staff's comprehensive statistical analyses and other findings generally corroborate the findings of our own report and provide considerable additional information regarding the trend in mutual fund fees. The SEC staff's report also contains several staff recommendations to the agency's Commissioners, and Commission approval has already been granted to recommendations relating to after-tax return disclosure and fund governance. In response to our recommendation that mutual fund investors' quarterly account statements disclose the specific dollar amount of fees they paid, SEC staff recommends that investors receive additional fee information in funds' annual and semiannual reports. The SEC staff's proposal would provide investors with additional information regarding fees in a form that facilitates comparison among funds. However, it will not provide information specific to each investor, nor will it be provided in the most frequent and relevant source -the quarterly statement. Therefore, it may be less likely to increase investor awareness and spur additional price competition among mutual funds to the same degree as our recommendation sought to do.

Background

We undertook our June 2000 report on mutual fund fees as the result of Congressional concerns that fees charged by mutual funds had not declined despite the growth in mutual fund assets. Our report presented information on how the growth in assets could produce cost efficiencies for funds; however, because comprehensive cost data for mutual fund companies was not available, we were unable to determine whether fund companies had experienced the type of efficiencies that would have allowed them to reduce their fees. Our report also showed that the fees charged by 77 of the largest mutual funds[1] had generally declined but that not all had reduced their fees. Our report also discussed various factors that are expected to ensure that mutual fund fees are set competitively. One such factor was direct competition among mutual funds, which we found occurs primarily on the basis of service and other fund characteristics rather than on price. In addition, our report found that, although mutual fund companies make extensive disclosures of the fees they charge, these disclosures do not include the specific dollar amount of fees each investor paid. Finally, our report noted that funds' boards of directors are tasked with overseeing the fees their funds charge but that opinions as to the effectiveness of these directors' oversight were mixed.

Because of the limitations in the various factors that are relied on to produce price competition among mutual funds, we recommended that investors receive additional information to heighten their awareness and understanding of the fees they pay, which could serve to spur additional price competition in the industry. Specifically, our report recommended that SEC require that the account statements that are provided to mutual fund investors on a quarterly basis include the dollar amount of each investor's share of the operating expense fees deducted from their funds. Because such calculations could be made in various ways, we also recommended that SEC consider alternative means of making such disclosures, taking into account the cost and burden on investors and the industry. One alternative means of disclosing such information was by having mutual funds produce an estimate of an investor's individual expenses using an average of the total value of fund shares owned multiplied by the fund's expense ratio for the period covered by the account statement. Alternatively, mutual funds could report to investors the dollar amount of expenses paid by fund shareholders for preset investment amounts, such as $1,000, which could be used by investors to estimate the amount of fees deducted from their own mutual fund shares.

[1] These 77 funds included all of the largest stock, bond, and hybrid funds in existence from 1990 to 1998. Specifically, this included the 41 stock funds with assets over $8 billion, 31 bond funds with assets of $3 billion, and 5 hybrid funds with assets over $8 billion. Collectively, these 77 funds had combined assets of $1,157 billion in 1998 and represented nearly 28 percent of the $4,177 billion in total industry assets invested in these three types of funds.

SEC Report Presents Similar Findings and Provides Additional Analyses of Fund Fees

The SEC staff report's findings on the trend in mutual fund fees were generally comparable to ours. Using data for all stock and bond mutual funds in existence at the end of 7 selected years from 1979 to 1999, the staff's report finds that the average asset-weighted expense ratio[2] of these funds has increased from 0.73 percent in 1979 to 0.94 percent in 1999. However, the SEC staff attributed this increase generally to funds' shift over time from charging loads, which are not included in the expense ratio, to charging 12b-1 fees,[3] which are included in the ratio. Although finding that fees had increased since the late 1970s, the SEC staff also found that the 1999 weighted average expense ratio of 0.94 percent represented a decline from its 1995 level of 0.99 percent. This was comparable to the finding in our report that the average asset-weighted expense ratio of the top 46 largest stock funds,[4] which peaked in 1994 at 0.81 percent, declined to 0.65 by 1998.

SEC's report also presented additional analyses on the level of fees across different fund types and how fund characteristics affect fee levels. The SEC staff found that various fund characteristics generally correlate with fund expense ratios, including finding that older funds had lower ratios than newer funds[5] and that larger funds had lower ratios than smaller funds. The staff's report also presented the results of an econometric model that showed how various fund characteristics affect fund expense ratios. Using this model, the SEC staff found that funds in families[6] with more assets tended to have lower expense ratios than did funds in families with fewer assets.

SEC also found that many large funds were already past the breakpoints in their fee structures and, as a result, may not automatically reduce fees as the assets in these funds grow. One way that mutual funds whose assets are growing can pass on cost-saving economies[7] to their investors is by establishing breakpoints in their management fee structure. Such breakpoints result in lower fees being charged as total fund assets reach various predetermined levels.[8] However, after analyzing information for the 100 largest funds from 1997, 1998, and 1999, the SEC staff found

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[2] The expense ratio for a mutual fund is the cumulative total of various fees and expenses charged to the fund during a particular period shown as a percentage of the fund's average net assets.
[3] Rule 12b-1 allows mutual funds to pay marketing and distribution expenses from fund assets. These fees are used to compensate sales professionals and others for selling fund shares as well as for fund advertising and promotion.
[4] These 46 funds included all of the largest stock funds in existence from 1990 to 1998, which comprised all such stock funds with assets over $8 billion. Also included in the 46 funds were 5 hybrid funds that also invest in bonds and other debt securities.
[5] However, SEC's econometric model that attempted to identify the factors affecting funds' expense ratios found that as funds get older, their expense ratios increase. However, their report notes that this result was largely attributed to four older funds with higher expense ratios than their peers.
[6] A fund family is a group of individual mutual funds that frequently includes one or more funds that invest in stocks, bonds, money market instruments, or combinations thereof, managed by the same firm.
[7] Such economies are operational efficiencies that arise as fund assets grow. For example, such an economy occurs when a fund's assets increase by 100 percent but the fund operator must increase its staffing costs by only 10 percent to accommodate this growth.
[8] For example, a fund's management fee could be 0.35 percent on assets up to $5 billion, 0.30 percent on assets between $5 billion and 10 billion, and 0.27 percent on assets above $10 billion.

that many of these funds' assets are already greater than the last breakpoints in their fee structures. As a result, if the assets in these funds grow, their investors will not receive further automatic fee reductions. This lack of breakpoints may result because the funds have already achieved whatever economies of scale exist so that fees may remain stable as assets grow. Alternatively, if economies of scale do exist, the lack of breakpoints could be a symptom that competitive forces are not sufficient to force funds to pass on savings to investors.

The SEC Staff Report Proposes Additional Fee Disclosure

The SEC staff's report included recommendations regarding after-tax returns, fund governance, and 12b-1 fees. It also made a recommendation for additional fee disclosure that responds to the recommendation in our report. In its report, the SEC staff recommended that investors receive information showing standardized after-tax mutual fund returns and, on January 18, 2001, the Commission approved rule amendments requiring funds to provide such disclosures. SEC officials told us that they viewed this as an important new disclosure because taxes affect investor returns to a greater degree than do fees. In their report, the SEC staff also recommended various changes to the fund governance provisions, including changes that would likely increase the percentage of independent directors that must be part of a fund's board of directors. The Commission approved these changes on January 2, 2001. The SEC staff's report also recommends that the Commission consider reviewing the requirements of the 12b-1 rule in light of changes in fund marketing and distribution since the rule's adoption in 1980. We believe that these actions should help provide important information to investors and could enhance oversight in the mutual fund industry.

After considering the costs and benefits of the recommendation in our June 2000 report, the SEC staff's report recommends a variation of one of the alternatives we discussed. In its report, the staff proposes that mutual fund investors be provided with information on the dollar amount of fees paid using preset investment amounts. In addition, the SEC staff proposed that this information be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, the SEC staff proposed requiring funds' annual reports to present a table showing the cost in dollars associated with an investment of a standardized amount (such as $10,000) that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, the SEC staff suggested that the Commission could require that this table also present the cost in dollars, based on the fund's actual expenses, of a standardized investment amount that earned a standardized return (such as 5 percent). This would result in investors receiving additional information regarding fees. However, the staff's proposed disclosures would not be specific to each investor, nor would they be provided in the most relevant and frequent source as our report recommended and, as a result, may be less likely to increase investor awareness and improve price competition as effectively as the disclosures we recommended.

SEC Staff's Proposed Additional Fee Disclosure Will Not Provide Investors With Account-Specific Information

The additional disclosures the SEC staff proposed should provide mutual fund investors with more information about the expenses associated with owning mutual fund shares in a form that will allow investors to compare fees across funds as they can with the current information disclosed about fees. However, the proposed disclosures will not provide investors with information showing, either precisely or approximately, the dollar amount of the fees they paid on their own fund shares. It is our view that receiving this account-specific fee information would be more likely to increase investors' awareness of the fees they pay and could encourage them to evaluate the relative value of the returns and service they receive from their mutual funds. As noted in our June 2000 report, financial products and services that report their charges directly in dollar terms to their users often have providers that attempt to compete more explicitly on the basis of price. Examples of these include the discount brokerage industry that developed to offer reduced charges for commissions or banks that offer no-fee checking accounts. Such competition is not totally absent from the mutual fund industry, as SEC officials noted that several low-fee mutual fund families receive a significant portion of the total of dollars invested in mutual funds.

In its report, the SEC staff noted that placing dollar amounts of fees paid in investors' account statements entails various administrative difficulties and additional costs to the industry and ultimately to investors. In discussing their report with us, one of the primary difficulties the SEC officials cited was that the quarterly statements are often prepared by third-party broker-dealers and not the mutual funds themselves. In many cases, only these broker-dealer firms maintain the account-specific information for each investor. They said it would be difficult for each mutual fund to provide these broker-dealers with fee information that could be used to determine the specific fee paid by each investor. In a letter to SEC, a representative of a committee working under the auspices of the Securities Industry Association listed the various steps believed to be needed to implement our original recommendation. For example, the letter noted that firms' systems would not only have to calculate the fee applicable to each investor, but also allow such amounts to be recalculated if errors were discovered in the expense information. The committee representative's letter also stated that firms in the industry were concerned that the added complexity of preparing statements with such fee information could result in firms' failing to mail such statements to investors within the 5-day time period currently required.

Our report also discussed the costs of providing such information to investors. Comprehensive data on the exact costs of fully implementing our recommendation were not available. However, the preliminary estimates provided by industry participants and presented in our report did not appear to be prohibitive.[9] In discussing their report's recommendations with us, SEC officials acknowledged that they were unable to assess whether the industry's estimates of the administrative effort required to implement fee disclosure specific to each investor were realistic or

[9] For example, we determined that the cost for one broker-dealer based on the total amounts its officials estimated they would incur to produce such statements were less than a dollar per account for initial development costs and less than a dollar per account each year thereafter.

reasonable. In addition, because we recognized the possibility of such administrative challenges and potential for additional costs, our report noted that mutual funds could likely provide some information that would allow the fees specific to each investor to be approximated rather than determined exactly. Such disclosures would still serve to make investors more aware of the fees they paid.

The SEC staff also noted that the disclosures they are proposing will allow investors to compare fees across funds because the information will be for comparable time periods and a standardized dollar amount invested. In contrast, the staff said that including specific dollar amounts in quarterly statements would generally not allow investors to compare across funds because of likely differences in performance, type of fund, holding periods, and the dollar amounts invested. However, for comparability purposes, investors could use the useful fee information already provided by the existing disclosures, which presents fees in terms of percentages of funds' net asset value. In addition, any additional disclosures that present investors' fees in dollar amounts could be accompanied by comparable disclosures showing such fees in percentage terms, which would facilitate comparison across funds.

SEC's Proposed Additional Fee Disclosure May Not Be Provided to Investors in the Most Relevant Source

Although the SEC staff's recommendation will improve fee disclosures, we believe that it may be less effective in increasing investor awareness and spurring additional price competition among funds because it would be provided to investors less frequently and in reports that may receive less investor attention than account statements. The SEC staff's report recommends that additional fee information be included in funds' annual and semiannual reports rather than in investors' account statements, which are provided at least quarterly. However, this less frequent distribution will likely reduce the immediacy of the information to investors. Furthermore, as part of conducting work on this letter, we contacted officials of three industry research organizations to discuss the SEC staff's report and its recommendations. These officials told us that investors generally pay more attention to the quarterly statements than they do to other information pertaining to their mutual fund investments, such as the annual and semiannual reports, because the quarterly statements report the specific value of the investors' account. One of the officials said that his firm's research has shown that, when investors receive statements that specifically show the dollar amount of the fees they are charged for other financial services, it generally triggers actions on the part of both the investor and the financial institution. According to this official, investors receiving such information frequently engage in discussions regarding the services they have received in exchange for the fees paid. Similarly, financial institution representatives tend to be more active in contacting the investors to review the activity in the account and how progress is being made toward the investors' financial plans. He said that the type of presentation that we have advocated would likely have this same beneficial effect.

SEC officials explained that they are suggesting that this information be included in the annual and semiannual reports because these documents contain more information than the quarterly statements and thus will allow investors to better understand the fee information in an appropriate context. Although the SEC staff's rationale has merit, its impact on investor awareness of fees may be reduced because such disclosures will not be in the documents that investors likely pay most attention to-the quarterly statements. The SEC staff could expand on its proposal, even without providing account-specific fee information, by requiring that the broker-dealers that prepare investors' quarterly statements periodically include in them the additional disclosures that the SEC staff's report recommends be included in funds' annual and semiannual reports. In doing so, SEC would increase investors' general awareness of the fees they paid.

In addition to their proposal for increased fee disclosure, the SEC staff's report indicated that they intend to continue to assist investors in becoming more educated about fees and to encourage the industry to be more active in this area as well. The SEC officials we spoke with noted that any additional fee disclosures would have to be accompanied by an extensive and ongoing investor education effort to ensure that investors understand and make effective use of the new disclosures. One example noted by the staff of their efforts to educate investors was the mutual fund cost calculator found on the SEC Web site. The staff also pointed out that such calculators have subsequently been added to the Web sites of several mutual fund companies.

Agency Comments

We provided a draft of this letter to the Chairman, SEC. In his letter (reproduced in the enclosure), the Director of SEC's Division of Investment Management noted that both the SEC staff's and GAO's reports had concluded that mutual fund investors could benefit from additional information about fees as a way of heightening investor awareness and understanding of the fees and their effects. However, the SEC staff disagreed with several aspects of our draft letter. First, the SEC staff took exception to our statement that its proposal to include fund fee information in annual and semiannual reports would not provide investors with either precise or approximate dollar amounts of the fees paid on their mutual fund shares. We agree that the staff's proposed disclosures, which would provide investors with the dollar amount of fees that would have been paid on a $10,000 investment in the previous period, could be used by investors to estimate the amount of fees they likely incurred on their own shares. However, we believe that providing account-specific dollar amounts of fees paid-either precisely or approximately calculated for investors-would be the most effective means of increasing investor awareness of fees and of potentially increasing price competition among funds. Short of that, we suggested that providing preset fee disclosures as part of, or along with, the quarterly statements would allow investors to calculate for themselves the fees they paid. Although the SEC staff's proposed disclosures would also allow investors to estimate their fees, their proposal would impose a larger burden on investors to collect and use two separate documents to calculate the fees they paid.

The Director's letter also discusses the SEC staff's decision to recommend that the additional fee disclosures be placed in funds' annual and semiannual shareholder reports rather than the quarterly statements. Although they acknowledge that the quarterly statements are an important source of information and are provided more frequently, they state that the proposed fee disclosures are more appropriately placed in the shareholder reports alongside the information about the fund's operating results and fund management's discussion of fund performance. This will allow, the letter notes, investors to evaluate the costs they pay against the services they receive. We agree that presenting investors with any new fee disclosures in a way that explains the information and provides a context for evaluating it is most likely to ensure that investors understand and appropriately use it, and our report noted that explanatory and contextual information could also be provided in quarterly statements. As previously stated, we believe that providing the fee information in separate documents provided at different times from the account-specific information places more burden on investors and may reduce its impact on awareness and price competition.

Finally, the Director's letter indicates that implementing the original recommendation in our June 2000 report could be costly. Noting that our report stated that the cost could be "a few dollars or less per investor," the SEC staff calculated that this could produce a cost of $480 million if providing such disclosures costs $2 for each of the estimated 240 million investor accounts. As we have stated, our original report acknowledged that SEC should attempt to balance the cost and burden on the industry, the burden placed on investors to calculate and estimate the fees they are charged, and the benefits of the additional information to investors. Although neither we nor SEC developed definitive cost estimates, we recognize that the proposals that would likely most benefit investors may be the most costly, and informed judgements will be needed in making decisions about the trade-offs. The proposal advocated by the SEC staff is probably the lowest cost option, but it may not provide as much benefit as similarly low cost alternatives due to the placement in annual and semiannual reports. Furthermore, we believe that factors in addition to implementation costs are also important in determining the most appropriate disclosures. For example, if providing account-specific fee information increases investor awareness and encourages additional price competition in the industry, fees for investors could be reduced overall.

Objectives, Scope, and Methodology

To complete our work, we analyzed the SEC staff's report and compared its findings with those of our June 2000 report. To determine the rationale for SEC's recommendations, we interviewed SEC officials. We also discussed SEC's report and recommendation with selected industry research organization officials. We conducted our work in Washington, D.C., from February to March 2001 in accordance with generally accepted government auditing standards.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this letter until 30 days from its issuance date. At that time, we will send copies to the Honorable Laura S. Unger, Acting Chairman, SEC. We will also make copies available to others upon request.

If you have any further questions, please call me at (202) 512-8678 or Cody J. Goebel, Assistant Director, at (202) 512-7329.

Sincerely yours,

Richard J. Hillman, Director
Financial Markets and
Community Investment

Enclosure

Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

April 27, 2001

Richard J. Hillman
Director, Financial Markets
and Community Investment
U.S. General Accounting Office
Washington, D.C. 20548

Re: U.S. General Accounting Office ("GAO") Review of U.S. Securities and Exchange Commission ("SEC") Staff Report on Mutual Fund Fees

Dear Mr. Hillman:

Thank you for the opportunity to comment on the GAO letter reviewing the Report on Mutual Fund Fees and Expenses by the Commission's Division of Investment Management (December 2000) ("SEC Staff Report"). Similar to the report prepared by the General Accounting Office ("GAO"), Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition (June 7, 2000) ("GAO Report"), the SEC Staff Report focused on recent trends in mutual fund fees and expenses and recommended possible regulatory initiatives.

As noted in your letter, both the SEC Staff Report and the GAO Report concluded that mutual fund investors could benefit from additional information regarding mutual fund fees so as to heighten their awareness and understanding of these fees and their effects. The GAO recommended that the SEC require mutual funds' quarterly account statements to include the dollar amount of each investor's share of operating expenses. The GAO Report acknowledged, however, that there are advantages and disadvantages to this recommendation and suggested other alternatives for enhancing investor awareness and understanding of mutual fund fees, in view of the additional costs and administrative burdens of such an approach. Recognizing that the compliance cost associated with a new personalized expense disclosure requirement would ultimately be borne by fund shareholders, and may be considerable, we embraced one of your alternative suggestions, namely, disclosure of the dollar amount of fees paid for standardized investment amounts. As discussed more fully in the SEC Staff Report, we believe that this alternative is likely to achieve the most favorable balance between costs and benefits.

Richard J. Hillman
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The approach we suggested is to require fund shareholder reports to include a table that shows the cost in dollars associated with an investment of a standardized amount (*e.g.*, $10,000) that earned the fund's actual return for the period and incurred the fund's actual expenses for the period. The Commission could require, in addition, that the table include the cost in dollars, based on the fund's actual expenses, of a standardized investment amount (*e.g.*, $10,000) that earned a standardized return (*e.g.*, 5%). This approach would provide additional information about fund fees, provide it in terms of dollar amounts, and provide it in a standardized manner that would facilitate comparison among funds. We disagree with the assertion in your letter that the "proposed [SEC staff] disclosures will not provide investors with information showing, either precisely or *approximately*, the dollar amount of the fees they paid on their own fund shares." (GAO Letter, p. 8, emphasis added). As your letter earlier acknowledges, disclosure of the dollar amount of expenses paid on a standardized investment amount "could be used by investors to estimate the amount of fees deducted from their own mutual fund shares." (GAO Letter, p. 4).

We recommended that the information regarding the dollar amount of fees and expenses be presented in a fund's shareholder reports, which are provided twice a year. While we recognize that fund quarterly account statements are an important source of information, and are provided more frequently than shareholder reports, we nonetheless believe that placement of additional fee information would be more appropriate in shareholder reports, alongside other key information about the fund's operating results, including management's discussion of fund performance. This would allow shareholders to evaluate the costs they pay against the services they receive and encourage investors to consider information about the dollar amount of fund fees in their decision-making process.

Both the SEC Staff Report and the GAO Report recognize that there are a number of formulations and potential vehicles for delivery of additional fee information to mutual fund investors and that these alternatives would impose varying degrees of administrative difficulties and additional costs on the industry and ultimately investors. The GAO Report and your letter acknowledge that the GAO has not gathered comprehensive data on the costs of fully implementing its recommendation for personalized expense disclosure. We also have not had the opportunity to gather specific cost data on the GAO Report's recommendation with regard to initial and ongoing costs. However, we do note that if the estimate in the GAO Report (p. 97) of "a few dollars or less per investor" is accurate, with some 240 million mutual fund accounts, this could entail an additional expense of $480 million (based on $2 per account) or more for mutual fund investors and the industry. Clearly, as we consider alternative ways of improving disclosures of mutual fund fees and expenses, we will have to take into account the costs and burdens of these various alternatives.

Richard J. Hillman
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We recognize that investors could benefit from additional information regarding mutual fund fees and expenses. We will carefully consider the recommendations in the GAO Report and the additional suggestions in your letter as we formulate recommendations to the Commission on how best to provide additional fee disclosure to mutual fund investors. Again, thank you for the opportunity to comment on your letter.

Sincerely,

Paul F. Roye

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