United States General Accounting Office

GAO

Report to Congressional Requesters

June 2003

MUTUAL FUNDS

Greater Transparency Needed in Disclosures to Investors

GAO-03-763

June 2003

MUTUAL FUNDS

Greater Transparency Needed in Disclosures to Investors

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Highlights

Highlights of GAO-03-763, a report to the Chairman, House Committee on Financial Services and Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House Committee on Financial Services

Why GAO Did This Study

The fees and other costs that investors pay as part of owning mutual fund shares can significantly affect their investment returns. As a result, questions have been raised as to whether the disclosures of mutual fund fees and other practices are sufficiently transparent. GAO reviewed (1) how mutual funds disclose their fees and related trading costs and options for improving these disclosures, (2) changes in how mutual funds pay for the sale of fund shares and how the changes in these practices are affecting investors, and (3) the benefits of and the concerns over mutual funds' use of soft dollars.

What GAO Recommends

GAO recommends that SEC consider the benefits of requiring additional disclosure relating to mutual fund fees and evaluate ways to provide more information that investors could use to evaluate the conflicts of interest arising from payments funds make to broker-dealers and fund advisers' use of soft dollars. SEC agreed with the contents of this report and indicated that it will consider the recommendations in this report carefully in determining how best to inform investors about the importance of fees. It also indicated that it will be considering ways to expand disclosure and improve other regulatory aspects of fund distribution and soft dollar practices.

www.gao.gov/cgi-bin/getrpt?GAO-03-763.

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.

What GAO Found

Although mutual funds disclose considerable information about their costs to investors, the amount of fees and expenses that each investor specifically pays on their mutual fund shares are currently disclosed as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. SEC staff has proposed requiring funds to disclose additional information that could be used to compare fees across funds. However, other disclosures could also increase the transparency of these fees, such as by providing existing investors with the specific dollar amounts of the expenses paid or by placing fee-related disclosures in the quarterly account statements that investors receive. Although some of these additional disclosures could be costly and data on their benefits to investors was not generally available, less costly alternatives exist that could increase the transparency and investor awareness of mutual funds fees that make consideration of additional fee disclosures worthwhile.

Changes in how mutual funds pay intermediaries to sell fund shares have benefited investors but have also raised concerns. Since 1980, mutual funds, under SEC Rule 12b-1 have been allowed to use fund assets to pay for certain marketing expenses. Since then, funds have developed ways to apply Rule 12b-1 fees to provide investors greater flexibility in choosing how to pay for the services of individual financial professionals that advise them on fund purchases. Another increasingly common marketing practice called revenue sharing involves fund investment advisers making additional payments to the broker-dealers that distribute their funds' shares. However, receiving these payments can limit fund choices offered to investors and conflict with the broker-dealer's obligation to recommend the most suitable funds. Regulators acknowledged that the current disclosure regulations might not always result in complete information about these payments being disclosed to investors.

Under soft dollar arrangements, mutual fund investment advisers use part of the brokerage commissions they pay to broker-dealers for executing trades to obtain research and other services. Although industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and provide other benefits, these arrangements also can create incentives for investment advisers to trade excessively to obtain more soft dollar services, thereby increasing fund shareholders' costs. SEC staff has recommended various changes that would increase transparency by expanding advisers' disclosure of their use of soft dollars. By acting on the staff's recommendations SEC would provide fund investors and directors with needed information about how their funds' advisers are using soft dollars.

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Abbreviations

ECN	electronic communications network
FSA	Financial Services Authority
ICI	Investment Company Institute
NAV	net asset value
NYSE	New York Stock Exchange
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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G A O
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

June 9, 2003

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
House of Representatives

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

Millions of U.S. households have invested in mutual funds with assets exceeding $6 trillion by year-end 2002. The fees and other costs that these investors pay as part of owning mutual fund shares can significantly affect their investment returns. As a result, questions have been raised as to whether the disclosures of mutual fund fees and others costs, including the trading costs that mutual funds incur when they buy or sell securities, are sufficiently transparent. Some have also questioned the effectiveness of mutual fund boards of directors in protecting shareholder interests and overseeing the fees funds pay to investment advisers. Many mutual funds market their shares to investors through broker-dealers or other financial professionals, such as financial planners. However, concerns have been raised over how the payments that fund advisers make to the entities that sell fund shares affect investors. When mutual fund investment advisers use broker-dealers to buy or sell securities for the fund, they generally pay these broker-dealers a commission for executing the trade. Under arrangements known as soft dollars, part of these brokerage commissions may pay for research and brokerage services that the executing broker-dealer or third parties provide to the fund's investment adviser. Because the amount of brokerage commissions a fund adviser pays directly reduces the ultimate return earned by investors in its funds, questions exist over the extent to which investors benefit from or are harmed by these soft dollar arrangements.

To address these concerns, this report responds to your January 14, 2003, request that we review issues relating to the transparency and appropriateness of certain fees and practices among mutual funds. Specifically, our objectives were to review (1) how mutual funds and their advisers disclose their fees and related trading costs and options for improving these disclosures, (2) mutual fund directors' role in overseeing fees and various proposals for improving their effectiveness, (3) changes in

how mutual funds and their advisers pay for the sale of fund shares and how the changes in these practices are affecting investors, and (4) the benefits of and the concerns over mutual funds' use of soft dollars and options for addressing these concerns.

To determine how mutual funds currently disclose their fees and other costs, we reviewed regulatory requirements and disclosures made by a selection of mutual funds. We discussed various proposals to increase disclosure with staff from regulators that oversee mutual funds, including the Securities and Exchange Commission (SEC) and NASD, and staff from mutual fund companies, industry groups and researchers. We also interviewed officials of 10 mutual fund companies that sell their funds through broker-dealers and a judgmental sample of 15 certified financial planners. To identify the activities that mutual fund directors perform, we reviewed federal laws and regulations, interviewed staff from an association representing independent directors and used a structured questionnaire to interview a judgmental sample of six independent director members of this association. To determine how mutual funds and their advisers pay for distribution, we interviewed various regulatory staff, industry associations and researchers, fund companies, and two broker-dealers that sell fund shares. We also reviewed and analyzed various documents and studies of mutual fund distribution practices. To describe the benefits and potential conflicts of interest raised by mutual funds' use of soft dollars, we spoke with SEC, NASD, and regulators in the United Kingdom and reviewed studies by regulators and industry experts on soft dollar arrangements. We conducted our work in accordance with generally accepted government auditing standards in Boston, MA; Kansas City, MO; Los Angeles and San Francisco, CA; New York, NY; and Washington, DC from February to June 2003. Our scope and methodology is described in detail in appendix I.

Results in Brief

Although mutual funds already disclose considerable information about the fees they charge, regulators and others have proposed additional disclosures that could increase the transparency and investor awareness of the costs of investing in mutual funds. Currently, mutual funds disclose information about the fees and expenses that each investor specifically pays on their mutual fund shares as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. Mutual funds also incur brokerage commissions and other trading costs when they buy or sell securities, but these costs are not prominently disclosed to investors. To provide more information about the

fees investors pay, SEC has proposed requiring mutual funds to disclose additional fee-related information, but these would not provide investors with the specific dollar amount of fees paid on their shares as others have proposed, nor would these disclosures be provided in the document generally considered to be of the most interest to investors—the quarterly statement that shows the number and value of an investor's mutual fund shares. Although continuing to consider the need for additional disclosures, SEC staff and industry participants noted that data on the extent to which additional fee information would benefit investors is generally lacking. However, continued consideration of the costs and benefits of providing additional disclosure appears worthwhile because some alternatives for providing fee information to mutual fund investors in quarterly statement could provide some benefit and may cost very little. Some industry participants have also called for more disclosure of information about the brokerage commissions and other costs that mutual funds incur when trading, but standard methodologies for determining some of these amounts do not exist and regulators and others raised concerns that such disclosures could be misleading.

Mutual funds also have boards of directors that are tasked with reviewing the fees that fund investors are charged, but some industry participants questioned whether directors have been effective in overseeing these fees. In general, SEC rules require mutual fund boards to have a majority of independent directors, who are individuals not employed by or affiliated with the fund's investment adviser. Among their many duties, these directors are specifically tasked with overseeing the fees their funds charge. However, some industry observers say that the process that fund directors are required to follow under the law fails to produce sufficient actions to minimize fees. To further reduce fees, some have suggested that fund directors should be required to seek competitive bids from other investment advisers. However, industry participants indicated that this may not result in lower costs and fees for investors and noted that directors seek to lower fund fees in other ways, such as by requiring the investment adviser to charge progressively lower fees as the assets of the fund grow. Regulators and industry bodies have also recommended various changes to the composition and structure of mutual fund boards as a means of increasing directors' effectiveness that many funds have already adopted. Many reforms being proposed as a result of the recent corporate scandals, such as Enron, also seek to enhance board of director oversight of public companies. Such reforms could serve to further improve corporate governance of mutual funds, but industry participants report that, although

not all of these proposed practices are currently required for mutual funds, most fund boards are already following many of them.

Changes in the ways that investors pay for mutual fund shares have produced benefits for investors but also raise concerns over their transparency. In 1980, an SEC rule was adopted to allow mutual funds to begin using fund assets to pay the distribution expenses, which included marketing expenses and compensation for the financial professionals who sell fund shares. Although rule 12b-1 was originally envisioned as providing funds a temporary means of increasing fund assets, the fees charged under this rule have instead evolved into an alternative way for investors to pay for the services of broker-dealers and other financial intermediaries from whom they purchase fund shares. Concerns exist over whether funds with 12b-1 fees are more costly to investors and whether current disclosures are sufficiently transparent to allow investors to determine the extent to which their particular broker-dealer representative or other financial professionals they use receive these payments. In a December 2000 report, SEC staff recommended that rule 12b-1 be modified to reflect changes in how funds are being marketed, but SEC has yet to develop a proposal to amend the requirements relating to this rule. Another distribution practice—called revenue sharing—that has become increasingly common involves investment advisers making additional payments to broker-dealers that distribute fund shares. Although little data on the extent of these payments exists, industry researchers say that such payments have been increasing and have raised concerns about how these payments may affect the overall expenses charged to fund investors. Concerns also exist over whether broker-dealers receiving payments to promote certain funds creates a conflict of interest for their sales representatives, who are responsible for recommending only investments that are suitable to their clients' objectives and financial situation, or whether this also limits the choices that investors are offered. Under current disclosure requirements, an investor might not be explicitly told that the adviser of the fund their broker-dealer is recommending made payments to that broker-dealer, and some industry participants have called for additional disclosures to address these potential conflicts.

Soft dollar arrangements allow investment advisers of mutual funds to use part of the brokerage commissions paid to broker-dealers that execute trades on the fund's behalf to obtain research and brokerage services that can potentially benefit fund investors but could increase the costs borne by their funds. Industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and

can also be used to reduce fund expenses. However, others were concerned that these arrangements can create conflicts of interest between investment advisers and investors that could increase investors' costs. For example, fund advisers might use some broker-dealers solely because of the soft dollar services they offer rather than because of their ability to execute the fund's trades in the most advantageous way. Concerns were raised that investment advisers might trade excessively to obtain additional services using soft dollars, which would increase fund investors' costs. 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 the advisers for mutual funds. In response, the SEC staff issued a report that included various 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 this could increase the transparency of these arrangements and help fund directors and investors better evaluate their fund advisers' use of soft dollars, SEC has yet to take action on these proposed recommendations.

This report contains recommendations to SEC designed to increase the transparency of mutual fund fees and of certain distribution and trading practices. Since both the extensiveness and the placement of mutual fund disclosures can affect their transparency and how effectively they increase investor awareness of the costs of investing in mutual funds, we recommend that SEC consider the benefits of additional disclosure relating to mutual fund fees, including requiring the account statements that mutual fund investors receive provide more information about the fees being paid. We also recommend that SEC consider developing disclosure requirements about revenue sharing arrangements so investors may be better able to evaluate potential conflicts arising from revenue sharing payments. Finally, we also recommend that SEC evaluate ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar examinations report.

We obtained comments from SEC and ICI, who generally agreed with the contents of this report. The letter from the SEC staff indicated that as part of their responsibilities in regulating mutual funds, they will consider the recommendations in this report very carefully in determining how best to inform investors about the importance of fees. The letter from the ICI staff noted that our report presented a generally balanced and well-informed

discussion of mutual fund regulatory requirements. However, the ICI staff were concerned over how we compare the disclosures made by mutual fund fees to those made by other financial products, and noted that mutual fund fee disclosures, which in some ways exceed the information disclosed by other products, allow individuals to make much more informed and accurate decisions about the costs of their funds than do the disclosures made by other financial service firms. We agree with ICI that mutual funds are required to make considerable disclosures that are useful to investors for comparing the level of fees across funds. However, we also believe that supplementing the existing mutual fund disclosures with additional information, particularly in the account statements that provide investors with the exact number and value of their mutual fund shares, could also prove beneficial for increasing awareness of fees and prompting additional fee-based competition among funds.

Background

Mutual funds are distinct legal entities owned by the shareholders of the fund. Each fund contracts separately with an investment adviser, who provides portfolio selection and administrative services to the fund. The costs of operating a mutual fund are accrued daily and periodically deducted from the fund's assets. These costs include the fee paid to the fund's investment adviser for managing the fund and the expenses associated with operating the fund, such as the costs for accounting and preparing fund documents. Each mutual fund has a board of directors, which is responsible for reviewing fund operations and overseeing the interests of the fund's shareholders, including monitoring for conflicts of interest between the fund and its adviser.[1]

[1]Although the Investment Company Act of 1940, which regulates mutual fund operations, does not dictate a specific form of organization for mutual funds, most funds are organized either as corporations governed by a board of directors or as business trusts governed by trustees. When establishing requirements relating to the officials overseeing a fund, the act uses the term "directors" to refer to such persons, and this report will also follow that convention.

The incredible growth of mutual fund assets and in the number of investors that hold funds has raised concerns within Congress and elsewhere over the fees funds charge investors. In a report issued in June 2000, we found that the average fees charged by 77 of the largest stock and bond mutual funds had declined between 1990 and 1998.[2] In our report, we also concluded that although many mutual funds exist that compete for investor dollars, they conduct this competition primarily on the basis of their performance rather than on the basis of the price of their service, that is, the fees they charge. In updating the results of the analysis from our June 2000 report for a hearing on mutual funds in March 2003, we found that the average fees for this group of funds had increased slightly, due in part to some funds paying higher management fees to their investment advisers because of the effect of performance fees.[3]

Mutual funds are sold through a variety of distribution channels. For instance, investors can buy them directly by telephone or mail or they can be sold by a sales staff employed by the adviser or by third parties, such as broker-dealer account representatives. To compensate financial professionals not affiliated with the adviser for distributing or selling a fund's shares, funds may levy a sales charge which is based on a percentage of the amount being invested—called a load—that the investor can either pay at the time the investment is made (a front-end load) or later when selling or redeeming the fund shares (a back-end load).[4] Many funds that use broker-dealers or other financial professionals to sell their fund shares may also charge investors ongoing fees, called 12b-1 fees that are used by funds to pay these distributors for recommending the fund or for servicing the investor's account after purchases have been made. Mutual fund shares are also available for investors to purchase through mutual fund supermarkets. These are offered by broker-dealers, including those affiliated with a fund adviser, that allow their customers to purchase and redeem the shares of mutual funds from a wide range of fund companies through their accounts at the broker-dealer operating the supermarket.

[2]U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000).

[3]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).

[4]Some funds charge what is known as a contingent deferred sales load, which is a charge that is a percent of the amount invested that declines the longer the investment is held and usually becomes zero after a certain period.

SEC is the federal regulatory agency with responsibility for overseeing the U.S. securities markets and protecting investors. Various self-regulatory organizations (SRO) also oversee the activities of securities industry participants. NASD is the SRO with primary responsibility for overseeing broker-dealers. SEC is responsible for oversight of the SROs and it also oversees and regulates the investment management industry.

Additional Disclosure of Mutual Fund Costs May Benefit Investors

Various alternatives with different advantages and disadvantages exist that could increase the amount of information that investors are provided about mutual fund fees and other costs. Currently, mutual funds disclose information about their fees as percentages of their assets whereas most other financial services disclose their costs in dollar terms. SEC and others have proposed various alternatives to disclose more information about mutual fund fees, but industry participants noted these alternatives could also involve costs to implement and data on the benefits associated with additional disclosures is not generally available. Mutual funds also incur brokerage commissions and other costs when they buy or sell securities and currently these costs are not routinely or explicitly disclosed to investors and there have been increasing calls for disclosure as well as debate on the benefits and costs of added transparency.

Unlike Other Financial Products, Mutual Funds Do Not Disclose the Actual Dollar Amount of Fees Paid by Individual Investors

Mutual funds provide various disclosures to their shareholders about fees. Presently, all funds must provide investors with disclosures about the fund in a written prospectus that must be provided to investors when they first purchase shares. SEC rules require that the prospectus include a fee table containing information about the sales charges, operating expenses, and other fees that investors pay as part of investing in the fund. Specifically, the table that mutual funds must provide presents (1) charges paid directly by shareholders out of their investment such as front or back-end sales loads and (2) recurring charges deducted from fund assets such as management fees, distribution fees, and other expenses charged to shareholder accounts. The fees deducted from the fund's assets on an ongoing basis are reported to investors as a percentage of fund assets and are called the fund's operating expense ratio. The fee table also contains a hypothetical example that shows the estimated dollar amount of expenses that an investor could expect to pay on a $10,000 investment if the investor received a 5-percent annual return and remained in the fund for 1, 3, 5, and 10 years. The examples do not reflect costs incurred as a result of the

fund's trading activity, including brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf.

Unlike many other financial products, mutual funds do not provide the exact dollar amounts of fees that individual investors pay while they hold the investment. Although mutual funds provide information about their fees in percentage terms and in dollar terms using hypothetical examples, they do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. In contrast, most other financial products and services do provide specific dollar disclosures. For example, when a borrower obtains a mortgage loan the lender is required to provide a uniform mortgage costs disclosure statement. This disclosure must show both the interest rate in percentage terms that the borrow will be charged for the loan and also the costs of the loan in dollar terms. Under the law, the lender must provide a truth in lending statement, which shows the dollar amount of any finance charges, the dollar amount being financed, and the total dollar amount of all principal and interest payments that the borrower will make under the terms of the loan.[5] As shown in table 1, investors in other financial products or users of other financial services also generally receive information that discloses the specific dollar amounts for fees or other charges they pay.

[5]The Real Estate Settlement Procedures Act, 12 U.S.C. § 2601-17.

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 are not required to disclose specific dollar amounts of fees paid by individual investors, the amount of information that they do provide does exceed that provided by some investment products. For example, fixed-rate annuities or deposit accounts that provide investors a guaranteed return on their principal at a fixed rate do not specifically disclose to the purchasers of these products the provider's operating expenses. The financial institutions offering these products generate their profits on these products by attempting to invest their customers' funds in other investment vehicles earning higher rates of return than they are obligated to pay to the purchasers of the annuities. However, the returns

they earn on customer funds and the costs they incur to generate those returns are not required to be disclosed as operating expenses to their customers.

Various Alternatives Could Improve Fee Disclosure, but the Benefits Have Not Been Quantified

In recent years, a number of alternatives have been proposed for improving the disclosure of mutual fund fees, which could provide additional information to fund investors. In response to a recommendation in our June 2000 report that SEC consider additional disclosures regarding fees, SEC has introduced a proposal to improve mutual fund fee disclosure.[6] In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[7] 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, the staff 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.

The SEC's proposed disclosures have various advantages and disadvantages. If adopted, this proposal would provide additional information to investors about the fees they pay when investing in mutual funds. In addition, these disclosures would be presented in a format that would allow investors to compare fees directly across funds. However, the disclosures would not be investor specific because they would not use an investor's individual account balance or number of shares owned. In addition, SEC is proposing to place these new disclosures in the semiannual shareholder reports, instead of in quarterly statements. Quarterly statements, which show investors the number of shares owned and value of their fund holdings, are generally considered to be of most interest and utility to investors. As a result, SEC's proposal may be less likely to increase investor awareness and improve price competition among mutual funds. According to SEC staff, they are open to consider

[6] GAO/GGD-00-126.

[7] 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).

additional disclosures if the benefits to investors appear clear, but have decided to continue pursuing approval of the proposed disclosure format from their December 2002 rule proposal. This proposal has received a wide range of comments. Most comments were in support of SEC's proposed requirement to include the dollar cost associated with a $10,000 investment. For example, one investment advisory firm commented in its letter that the new disclosures SEC is proposing would benefit investors by allowing them to estimate actual expenses and compare costs between different funds in a meaningful way.

Another alternative for disclosing mutual funds fees would involve funds specifically disclosing the actual dollar amount of fees paid by each investor. In our June 2000 report, we noted that such disclosure would make mutual funds comparable to other financial products and services such as bank checking accounts or stock transactions through broker-dealers. As our report noted, such services actively compete on the basis of price. If mutual funds made similar specific dollar disclosures, investors would be clearly reminded that they pay fees for investing in mutual funds and we stated that additional competition among funds on the basis of price could likely result among funds. An attorney specializing in mutual fund law told us that requiring funds to disclose the dollar amount of fees in investor account statements would likely encourage investment advisers to compete on the basis of fees. He believed that this could spur new entrants to the mutual fund industry and that the new entrants would promote their funds on the basis of their low costs, in much the same way that low-cost discount broker-dealers entered the securities industry.

Although some financial planners, who directly assist investors in choosing among mutual funds, thought that requiring mutual funds to provide investors with the specific dollar amounts of fees paid would be useful, most indicated that other information was more important. We spoke to a judgmental sample of 15 certified financial planners whose names were provided by the Certified Financial Planner Board of Standards, a non-profit professional regulatory organization that administers the certified financial planner examination. Of the 15 financial planners with whom we spoke, 6 believed specific dollar disclosure of mutual fund fees would provide additional benefit to investors. For example, one said that providing exact dollar amounts for expenses would be useful because investors don't take the next step to calculate the actual costs they bear by multiplying their account value by the fund's expense ratio. In contrast, the other 9 financial planners we interviewed said that the factor most investors consider more than others is the overall net performance of the

fund and thus did not think that specific dollar disclosures of fees would provide much additional benefit.

Industry officials raised concerns about requiring specific dollar fee disclosures. For example, one investment company official stated that the costs of making specific dollar disclosures would not justify any benefit that might arise from providing such information, particularly because a majority of investors make their investment decisions through intermediaries, such as financial planners, and not on their own. Some industry officials stated that additional disclosure could confuse investors and create unintended consequences. For example, one official noted that specific dollar disclosure might lead investors to think that they could deduct those expenses from their taxes. Others noted that this type of disclosure would tell current mutual fund investors what they were paying in fees, but would not provide the proper context for evaluating how much other funds would charge, and thus would be unlikely to increase competition. Another official stated that disclosing fees paid in dollars in account statements would not be beneficial to prospective investors.

Although the total cost of providing specific dollar fee disclosures might be significant, the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement, the Investment Company Institute (ICI), the industry association representing mutual funds, commissioned a study by a large accounting firm to survey mutual fund companies about the costs of producing such disclosures.[8] The study concluded 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.[9] Although these are significant costs, when spread over the accounts of many investors, the amounts are less sizeable. For example, ICI reported that at the end of 2001, a total of about 248 million shareholder accounts existed. If the fund companies represented in ICI's study, which represent 77 percent of industry assets, also maintain about the same percentage of customer accounts, then the companies would hold about 191 million accounts. As a result, apportioning the estimated $200 million in initial costs to these accounts would amount to about $1 per

[8]GAO-03-551T.

[9]However, this estimate did not include the reportedly significant costs that would be borne by third-party financial institutions, which maintain accounts on behalf of individual mutual fund shareholders.

account. Apportioning the estimated $66 million in annual costs to these accounts would amount to about $0.35 per account.

We also spoke with a full-service transfer agent that provides services for about one third of the total 240 million accounts industrywide.[10] Staff from this organization prepared estimates of the costs to their organization of producing specific dollar fee disclosures for fund investors. They estimated that to produce this information, they would incur one-time development costs between $1.5 and $3 million to revise their systems to accept and maintain individual investor account expense data, and ongoing data processing expenses of about $0.15 to $0.30 per fund/account per year. These ongoing expenses would reflect about 1 percent of the estimated $18 to $23 per year of administrative costs per account already incurred. The officials also estimated that shareholder servicing costs would increase as investors would call in to try to understand the new disclosures or offer to send payments under the mistaken impression that this was a new charge that they had to explicitly pay. Funds would also incur costs to update and modify their Web sites so that investors could find this specific expense information there as well.

Another concern raised regarding requiring mutual funds to disclose the specific dollar amount of fees was that information on the extent to which such disclosures would benefit investors is not generally available. For our work on this report, we attempted to identify studies or analyses on the impact of disclosing prices in dollars versus percentage terms, but no available information was found to exist. We also reviewed surveys done of investor preferences relative to mutual funds but none of the surveys we identified discussed disclosure of mutual fund fees in dollar terms. In our June 2000 report, we presented information from a survey of over 500 investors that was administered by a broker-dealer to its clients.[11] As we reported, this survey found that almost 90 percent of these investors indicated that specific dollar disclosures would be useful or very useful. However, only 14 percent of these investors were very or somewhat likely to be willing to pay for this information. SEC and industry participants noted that having more definitive data on the extent to which investors want and would benefit from receiving information on the specific dollar

[10]A mutual fund transfer agent maintains shareholder account records and processes share purchases and redemptions.

[11]See GAO/GGD-00-126, p. 78.

amount of fees they paid would be necessary before requiring mutual funds, broker-dealers, and other intermediaries to undertake the costly revisions to their systems necessary to capture such information.

Another option for disclosure was proposed by an industry official that may not impose significant costs on the industry. The official said that fund companies could include a notice in account statements to remind investors that they pay fees as part of investing in mutual funds. The notice, the official said could remind investors that, "Mutual funds, like all investments, do have fees and ongoing expenses and such fees and expenses can vary considerably and can affect your overall return. Check your prospectus and with your financial adviser for more information." By providing this notice in the quarterly account statements that mutual fund investors receive, mutual fund investors would be reminded about fees in a document that, because it contains information about their particular account and its holdings, is more likely to be read.

Trading and Other Costs Impact Mutual Fund Investor Returns, but Are Not Prominently Disclosed

In addition to the expenses reflected in a mutual fund's expense ratio—the fund's total annual operating expenses as a percentage of fund assets—mutual funds incur trading costs that also affect investors' returns. Among these costs are brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf. When mutual funds buy or sell securities for the fund, they may have to pay the broker-dealers that execute these trades a commission. In other cases, trades are not subject to explicit brokerage commissions but rather to "markups," which is an amount a broker-dealer may add to the price of security before selling it to another party. Trades involving bonds are often subject to markups. Commissions have also not traditionally been charged on trades involving the stocks traded on NASDAQ because the broker-dealers offering these stocks are compensated by the spread between the buying and selling prices of the securities they offer.[12]

Other trading-related costs that can also affect investor returns include potential market impact costs that can arise when funds seek to trade large amounts of particular securities. For example, a fund seeking to buy a large block of a particular company's stock may end up paying higher prices to

[12]These different prices are called the bid price, which is the price the broker-dealer is willing to pay for shares and the ask price, which is the price at which the broker-dealer is willing to sell shares.

acquire all the shares it seeks because its transaction volume causes the stock price to rise while its trades are being executed. Various methodologies exist for estimating these types of trading costs, however, no generally agreed upon approach exists for accurately calculating these costs.

Although trading costs affect investor returns, these costs are not currently required to be disclosed in documents routinely provided to investors. ICI staff and others told us that the costs of trading, including brokerage commissions, are required under current accounting practices and tax regulations to be included as part of the initial value of the security purchased. As a result, this amount is used to compute the gain or loss when the security is eventually sold and thus the amount of any commissions or other trading costs are already implicitly included in fund performance returns.[13] Investors do receive some information relating to a fund's trading activities because funds are required to disclose their portfolio turnover, (the frequency with which funds conduct portfolio trading) in their prospectuses, which are routinely sent to new and existing investors. However, the frequency with which individual mutual funds conduct portfolio trading and incur brokerage commissions can vary greatly and the amount of brokerage commissions a fund pays are not disclosed in documents routinely sent to investors. Instead, SEC requires mutual funds to disclose the amount of brokerage commissions paid in the statement of additional information (SAI), which also includes disclosures relating to a fund's policies, its officers and directors, and various tax matters. Regarding their trading activities, funds are required to disclose in their SAI how transactions in portfolio securities are conducted, how brokers are selected, and how the fund determines the overall reasonableness of brokerage commissions paid. The amount disclosed in the SAI does not include other trading costs borne by mutual funds such as spreads or the market impact cost of the fund's trading. Unlike fund prospectuses or annual reports, SAIs do not have to be sent periodically to a fund's shareholders, but instead are filed with SEC annually and are sent to investors upon request.

[13]For example, if a fund buys a security for $10 a share and pays a $.05 commission on each share, its basis in the security is $10.05, and this is the amount that will be used to calculate any subsequent gain or loss when the shares are sold.

Academics and Others Have Also Called for Increased Disclosure of Mutual Fund Trading Costs, but Others Noted that Producing Such Disclosures Would be Difficult

Academics and other industry observers have also called for increased disclosure of mutual fund brokerage commissions and other trading costs that are not currently included in fund expense ratios. In an academic study we reviewed that looked at brokerage commission costs, the authors urged that investors pay increased attention to such costs.[14] For example, the study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing trading costs as relevant information because the impact of these unobservable trading costs is comparable to the more observable expense ratio. The authors of another study noted that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' SAIs.[15]

Others who advocated additional disclosure of brokerage commissions cited other benefits. Some officials have called for mutual funds to be required to include their trading costs, including brokerage commissions, in their expense ratios or as separate disclosures in the same place their expense ratios are disclosed. For example, one investor advocate noted that if funds were required to disclose brokerage commissions in these ways, funds would likely seek to reduce such expenses and investors would be better off because the costs of such funds would be similarly reduced. He explained that this could result in funds experiencing less turnover, which could also benefit investors as some studies have found that high-turnover funds tend to have lower returns than low-turnover funds.

The majority of certified financial planners we interviewed also indicated that disclosing transaction costs would benefit investors. Of the 15 with whom we spoke, 9 stated that investors would benefit from having more cost information such as portfolio transaction costs. For example, one said that investors should know the costs of transactions paid by the fund and that this information should be disclosed in a document more prominent than the SAI. Another stated that brokerage commissions should be

[14]J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania (Nov. 2, 1999).

[15]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," Journal of Financial Research (Summer 1996).

reported as a percentage of average net assets. Overall they felt that more information would help investors compare costs across funds, which could likely result in more competition based on costs, but they also varied in opinion on the most appropriate format and place to present these disclosures. The planners who did not think transaction costs should be disclosed generally believed that investors would not benefit from this type of additional information because they would not understand it.

Some industry observers and financial planners we interviewed indicated that investors should be provided all the information that affects a fund's returns in one place. This information could include the current disclosed costs such as the total expense ratio, the impact of taxes, and undisclosed trading costs. Some financial planners and an industry consultant suggested disclosing all such expenses in percentages. They also expressed the importance of including after-tax performance returns. SEC adopted a rule in January 2001 requiring all funds to disclose their after-tax returns in their prospectus. A mutual fund industry analyst noted that when an item is disclosed, investment advisers will likely attempt to compete with one another to maximize their performance in the activity subject to disclosure. Therefore, presenting investors with information on the factors that affect their return and that are within the investment adviser's control could spur additional competition and produce benefits for investors. A financial planner we interviewed also agreed that having mutual funds disclose information about expenses, tax impacts, and trading costs, particularly brokerage commissions all in one place would increase investor awareness of the costs incurred for owning mutual fund shares and could increase competition among funds based on costs and lead to lower expenses for investors.

Although additional disclosures in this format could possibly benefit investors, developing the information needed to provide a disclosure of this type could pose difficulties. SEC officials said that, if funds were required to separately disclose brokerage commission costs as a percentage of fund assets, fund advisers would also likely want to present their fund's gross return before trading costs were included so that the information does not appear to be counted twice. However, the SEC staff noted that determining a fund's gross return before trading costs could be challenging because it could involve having to estimate markups and spread costs. ICI officials also stated that disclosing gross returns could create the idea of cost free investing, which is not a realistic expectation for investors. They also worried that mutual funds could try and market their gross return figures, which would be misleading.

Mutual fund officials also raised various concerns about expanding the disclosure of brokerage commissions and trading costs in general. Some officials said that requiring funds to present additional information about brokerage commissions by including such costs in the fund's operating expense ratios would not present information to investors that could be easily compared across funds. For example, funds that invest in securities on the New York Stock Exchange (NYSE), for which commissions are usually paid, would pay more in total commissions than would funds that invest primarily in securities listed on NASDAQ because the broker-dealers offering such securities are usually compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. As discussed earlier, ICI staff and others said that separate disclosure of these costs is not needed because the costs of trading are already included in the performance return percentages that mutual funds report. Officials at one fund company told us that it would be difficult for fund companies to produce a percentage figure for other trading costs outside of commissions because no agreed-upon methodology for quantifying market impact costs, spreads, and markup costs exists within the industry. Other industry participants told us that due to the complexity of calculating such figures, trading cost disclosure is likely to confuse investors. For example funds that attempt to mimic the performance of certain stock indexes, such as the Standard & Poors 500 stock index, and thus limit their investments to just these securities have lower brokerage commissions because they trade less. In contrast, other funds may employ a strategy that requires them to trade frequently and thus would have higher brokerage commissions. However, choosing among these funds on the basis of their relative trading costs may not be the best approach for an investor because of the differences in these two types of strategies.

Finally, some financial planners and an industry expert stated that additional disclosure of mutual fund costs would be monitored not by investors but more so by financial professionals, such as financial planners, and the financial media. These groups serve as intermediaries between fund companies and investors, and are the primary channel through which information on the performance and costs across mutual funds is distributed. The financial planners and the industry expert believed that increased disclosures of trading costs could prove beneficial to the financial professionals that help select mutual funds for their investor clients.

Independent Directors Play a Critical Role in Protecting Mutual Fund Investors

Mutual fund boards of directors have a responsibility to protect shareholder interests. Independent directors, who are not affiliated with the investment adviser, play a critical role in protecting mutual fund investors. Specifically, independent directors have certain statutory responsibilities to approve investment advisory contracts and monitor mutual fund fees. However, some industry observers believe that independent directors could do more to assert their influence to reduce fees charged by fund advisers. Alternatives are being considered to improve public company governance such as changing board composition and structure, however many practices are already in place within the mutual fund industry.

Mutual Fund Boards of Directors Are Responsible for Protecting Shareholder Interests

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 interest 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 level of the management fee representing its revenue from the fund, the adviser's desire to maximize its revenues could conflict with shareholders' goal 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's interests. These boards must also 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 addition to approval by the full board, the Investment Company Act requires that a majority of the independent directors separately approve the contracts with the investment adviser that will manage the fund's portfolio and the entity that will act as distributor of the fund's shares. A mutual fund's board, including a majority of the independent directors, are also required to review other service arrangements such as transfer agency, custodial, or bookkeeping services.

If the services to the fund are provided by an affiliate of the adviser, the independent directors also generally consider several items before approving the arrangement. Specifically they determine that the service contract is in the best interest of the fund and its shareholders, the services are required for the operation of the fund, the services are of a nature and quality at least equal to the same or similar services provided by independent third parties, and the fees for such services are fair and reasonable in comparison to the usual and customary fees charged for services of the same nature and quality.

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 the annual approval of an advisory contract by a fund's full board of directors as well as by a majority of its independent directors, acting separately and in person, at a meeting called for that purpose. 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 the 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.[16] In addition to potentially considering how a fund's fee compared to those of other funds, this court indicated that directors may find other factors more important, including

- the nature and quality of the adviser's services,
- the adviser's costs to provide those services,
- the extent to which the adviser realizes and shares with the fund economies of scale as the fund grows,

[16]*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)*.

- 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.

Fund company officials and independent directors with whom we spoke said their boards review extensive amounts of information during the annual contract renewal process to help them evaluate the fees and expenses paid by the fund. For example, they stated that they hire a third-party research organization, such as Lipper, Inc., to provide data on their funds investment performance, management fee rates, and expense ratios as they compare to funds of similar size, objective, and style. They also compare performance to established benchmarks, such as the Standard & Poors 500 Stock Index. For example, officials at one fund company told us that, for each of their funds, their board reviews information on the performance and fees charged by 20 funds with a similar investment objective, including the 10 funds closest in size with more assets than their fund and the 10 funds closest in size with fewer assets. In addition to comparing themselves to peers, they explained that their board reviews the profitability of the adviser, stability of fund personnel or staff turnover, and quality of adviser services. Fund officials stated that their boards receive a large package of information that includes all of the necessary information to be reviewed for the contract renewal process in advance of board meetings.

SEC oversight of mutual funds indicates that fund directors generally conduct their activities in accordance with the law. Staff from SEC's Office of Compliance Inspections and Examinations, which conducts examinations of mutual funds and their investment advisers, told us that as part of their examinations they review the minutes of past board meetings to ensure that the directors were told and discussed the relevant information as part of the board's decision-making process. The SEC staff also told us they review the information provided to the board by the investment adviser to ensure its completeness and accuracy. Based on their review, SEC staff said that they have not generally found problems with mutual fund board proceedings. SEC has brought cases against mutual fund directors but these involved other activities. For example, SEC settled a case involving a mutual fund's board of directors that had knowingly filed misleading information in the fund's prospectus and other fund disclosures regarding the liquidity and value of the shares of their money market fund.

Critics Suggest Independent Directors Could Do More to Assert Their Influence and Reduce Fees

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. Part of the criticism arises from the fact that during the annual contract renewal process, when boards compare fees of similar funds, the process maintains the status quo by comparing fees with the industry averages thus keeping fees at their current level. However, 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. An academic study we reviewed criticized the court cases that have shaped director's roles in overseeing mutual fund fees because these cases generally found that comparing a fund's fees to other similar investment management services, such as pension funds 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 have lacked sufficient data to show that a fund's fees are excessive.[17]

One method offered by some industry critics for improving the effectiveness of boards in lowering fees for investors was to have fund directors seek competitive bids for their fund's investment advisory contracts. Advocates of having boards take this action said that pension funds more routinely seek competitive bids from investment advisers for pension fund assets. A former Treasury Department official said that pension funds commonly seek new investment advisers every 2 to 3 years, and, as a result, pension fund investors pay two to three times less in fees than the average mutual fund investors. One academic study we reviewed that compared advisory fees for similarly-sized pension funds and mutual funds found that the average mutual fund advisory fee is twice as large as a pension fund advisory fee.[18] The study showed that the average pension fund pays 28 basis points for its advisory fee compared to 56 basis points for mutual funds. The study concluded that the main reason for differences between pension funds and mutual funds was that advisory fees for

[17]J.P. Freeman and S.L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," 26 Journal of Corporation Law 609 (2001).

[18]J.P. Freeman and S.L. Brown.

pension funds are set in a marketplace in which arm's-length bargaining occurs because of the separation of the fund and the investment advisers.

Regulators and industry participants indicated that differences in the costs and services provided by mutual funds can explain why mutual funds charge more than pension funds. According to staff of SEC and ICI with whom we spoke, investment advisers usually perform many other services for their mutual funds than does the adviser of a pension fund and that their advisory fee compensates them for these additional services. Among the services that advisers of mutual funds would provide that a pension fund adviser would not include around the clock telephone customer service, preparing periodic account statements and shareholder communications, and compiling annual tax information for fund investors. Some industry officials also noted the difference in cost structure between pension and mutual funds. One official stated that pension funds have one institutional account, whereas mutual funds have thousands of smaller accounts, which requires substantial record keeping and customer service expenses. Mutual fund advisers would also have increased costs because they have to manage their fund's daily inflows and outflows, whereas pool of assets that a pension fund adviser manages are not subject to such frequent fluctuations.

Based on information we collected, very few mutual funds change their investment advisers. According to research organizations that monitor developments in the mutual fund industry, less than 10 funds have changed their primary investment adviser within the last 15 years. The process of changing investment adviser is not solely dependent upon the board of directors. If the fund board of directors made a decision to change an investment adviser, the board would need to file a proxy statement and have the shareholders of the fund vote to approve the change.

Industry participants also said that having mutual fund boards put out their advisory service contracts for bid may not produce expected savings and could increase fund shareholders' costs. According to staff at one fund company, they would not likely bid on contracts to manage mutual fund assets at the same rate that they bid for pension fund assets because their costs to manage and administer mutual fund assets are higher. They said that pension fund assets are offered to investment advisers in a large pre-existing pool. In contrast, mutual fund assets must be accumulated over time from many investors. Each time a fund's board hired a new investment adviser, the fund's shareholders costs would also likely go up because all the accounts would have to be transferred to the new adviser

and the fund would likely incur additional document preparation, legal, and customer service costs. For example, we identified a case in which a small fund had removed its investment adviser, which resulted in a significant increase of fund expenses. In this case, the fund's investment adviser resigned and a majority of the fund's board of directors voted to take over the fund's management. The decision was submitted to the shareholders for a proxy vote and passed. As a result the fund's expense ratio went from 1.8 percent in 2001 to 3.4 percent in 2002. The fund attributed this significant increase to a number of one-time items, which consisted primarily of legal expenses associated with the removal of the investment adviser and the management of the fund's portfolio.

Finally, industry participants indicated that mutual fund shareholders likely do not expect their fund's board to change the fund's investment adviser. They said that mutual fund shareholders often choose their funds because of the reputation or services offered by a particular investment adviser and having their fund's board seek to move their fund to another company would not likely be supported by the shareholders. Furthermore, having fund boards seek new investment advisers is unnecessary because mutual fund shareholders can choose to redeem their shares of a particular adviser's fund and invest them in the funds of other advisers if they are unhappy with their existing fund or its adviser. In contrast, pension fund participants cannot move their pension fund investments if they are unhappy with their fund's investment adviser or its performance. Instead, the decisions about which advisers are hired to manage pension fund's assets are made by their fund administrators. ICI officials also questioned whether pension funds actually change investment advisers that frequently. They said that pension funds often seek long-term relationships with investment advisers.

Although they do not frequently change advisers, mutual fund directors engage in other activities to lower fees. Industry officials said that advisers typically institute management fee "breakpoints" based on the level of fund assets or performance. These breakpoints reduce the level of management fees when funds exceed certain asset levels, thus as a fund's assets grow, the investment adviser's fee is reduced for those additional assets above the levels set in the breakpoint. Directors could also approve performance fees as a part of an investment adviser's compensation that would reduce the fee the adviser was able to charge if the fund's performance fails to meet or exceed a specified performance benchmark, such as the Standard & Poors 500 Stock Index. Industry officials also stated that advisers will at times offer to waive management fees, and may also waive or cap certain

expenses such as certain transfer agency fees. Noting that the fees for mutual funds in the United States are lower compared to those of other countries, SEC and ICI officials attributed this to the role and influence of U.S. funds' board of directors because such independent oversight is not always required in other countries.

Mutual Funds Already Employ Many Practices Being Suggested to Improve Public Company Governance

Changes in the structure of mutual fund boards of directors have been proposed and adopted in recent years and recent corporate scandals have prompted consideration of additional reforms but industry participants note that most funds have already adopted such practices. In February 1999, SEC held a forum on the role of independent mutual fund directors to consider ways to improve mutual fund governance. At the forum, the SEC Chairman at that time requested proposals for improving fund governance. At the same time, ICI created the Advisory Group on Best Practices for Fund Directors. This advisory group identified 15 best practices used by fund boards to enhance the independence and effectiveness of mutual fund directors and recommended that all fund boards adopt them. The ICI recommendations included having

- independent directors constitute at least two thirds of the fund's board,
- independent directors select and nominate other independent directors, and
- independent counsel for the independent directors.

After evaluating the ideas and suggestions of the forum participants, SEC proposed various rule and form amendments designed to reaffirm the important role that independent directors play in protecting fund investors. These amendments were adopted in January 2001. They included requiring funds relying on certain exemptive rules—which includes almost all funds according to SEC staff—to have a majority of independent directors on their boards and to have their independent directors select and nominate other independent directors. SEC also required that any legal counsel for the independent directors also be independent.[19]

[19]Role of Independent Directors of Investment Companies, Securities and Exchange Commission Release Nos. 33-7932; 34-43786; IC-24816 (Jan. 2, 2001).

As a result of recent scandals such as Enron and Worldcom, various new reforms have been 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.[20] 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 also be "independent" and be responsible for selecting and overseeing outside auditors. In response to the scandals at public companies, officials at the two primary venues where public companies are traded—the NYSE and NASDAQ—have also proposed changes to the corporate governance standards that public companies seeking to be listed on their markets must meet.

However, many of the corporate governance reforms being proposed for public companies are already either required or have been recommended as best practices for mutual fund boards. Table 2 presents how the corporate governance practices that are currently required by mutual fund law or rules or recommended by ICI's best practices for mutual fund boards compare to the current and proposed NYSE and NASDAQ listing standards applicable to public company boards. As the table shows, the mutual funds boards are already recommended to have in place all of the proposed corporate listing standards.

[20]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 Corporate Governance Listing Standards Compared to those Currently Required or Recommended for Mutual Fund Boards

	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, statutes, 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 industry participants, most mutual fund boards already have the corporate governance practices recommended by these various standards in place. 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. As noted above, this practice has already been advocated by ICI's 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.

Another change related to board composition that has been proposed for mutual funds would be to have an independent director serving as the board's chair, but industry participants did not see this as a beneficial change. Some industry critics have stated that the lack of an independent chair allows the board's activities during the meeting to be controlled by fund management, as the fund's board chair is typically the chairman or other senior official of the investment adviser. A number of fund companies and independent directors we spoke with indicated that their board did have an independent chair. For the fund companies that did not have an independent chair, they had instead a lead independent director. An official from the Mutual Fund Directors Forum, an independent directors association which provides continuing education and outreach on mutual fund governance, said that the most important factor is the initiative demonstrated by the independent director, whether the individual is the lead or chair. He stated that if the lead independent director is motivated, it doesn't matter who the chair is, because the lead director will be proactive and effective on behalf of fund shareholders. Other fund company officials indicated that an independent chair could be harmful to the board. One stated that investors are better served by having a fund company executive chair the fund's board because such an official is better positioned to ensure that all of the information that the adviser needs to share with the independent directors is provided efficiently.

Changes in Mutual Fund Distribution Practices Have Increased Choices for Investors, but Have Raised Potential Concerns

Concerns have been raised over changes in how mutual funds pay for the distribution of their shares to investors. SEC Rule 12b-1 allows mutual fund companies to use fund assets to pay expenses for distributing their funds through broker-dealers, and has evolved into a means for fund companies to offer investors a variety of ways to pay for the services of financial professionals, such as broker-dealer staff or financial planners. However, 12b-1 fees remain controversial among mutual fund researchers because, in addition to increasing a fund's overall expense ratio, funds with 12b-1 fees may be more costly to own in other ways. In a recent study, SEC staff recommended rule 12b-1 modifications to reflect changes in how funds are being marketed, but as of May 2003, SEC had not proposed any amendments. Concerns also have been raised as to whether the disclosure

of 12b-1 fees is sufficient and whether, another distribution practice—referred to as revenue sharing, in which investment advisers make payments to broker-dealers for selling and marketing their funds—could limit the number of mutual fund choices offered to investors. Revenue sharing also may result in a broker-dealer's failure to recommend funds from which the brokerage firm is not being compensated by the funds' advisers, which some suggest could conflict with broker-dealers' responsibilities to recommend suitable investments.

12b-1 Plans Provide Alternative Means for Compensating Financial Professionals but Also Raise Concerns Over Costs

Previously, mutual funds distribution expenses were paid for either by charging investors a sales charge or load or by 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. Rule 12b-1 plans were envisioned as temporary measures to be used during periods of declining assets. Any activity that is primarily intended to result in the sale of mutual fund shares must be included as a 12b-1 expense and can include advertising; compensation of underwriters, dealers, and sales personnel; printing and mailing prospectuses to persons other than current shareholders; and printing and mailing sales literature.

To be allowed to use fund assets for marketing purposes, funds are required to adopt 12b-1 plans that outline how they intend to use these payments. A fund's written 12b-1 plan must describe all material aspects of the proposed financing of distribution and related agreements with distributors about how the plan is to be implemented. Before implementing a plan that will allow a fund to begin charging 12b-1 fees, rule 12b-1 requires fund shareholders and directors to approve 12b-1 plans and places other requirements on plan adoption. The plans must also be approved by a vote of a majority of outstanding shareholders and by a majority of funds' directors, including a majority of the fund's independent directors. Because such plans were envisioned to be of a limited duration, a majority of funds' directors, including a majority of the fund's independent directors, must also make various approvals on an ongoing basis, including approving the 12b-1 plans annually. They must also approve any amendment to the plan and approve on at least a quarterly basis the reports of plan expenditures and the purposes of the expenditures. 12b-1 plans must also provide for plan termination upon the vote of a majority of independent directors or a majority of shareholders.

In the adopting release for the rule, SEC presented various factors that directors should consider when approving a fund's 12b-1 plan. These factors were offered to provide guidance to directors in determining whether to use fund assets to bear expenses for fund distribution. The nine factors are shown in figure 1.

Figure 1: Factors Fund Directors Are to Consider in Voting to Approve or Continue 12b-1 Plans

1. The need for independent counsel or experts to assist the directors in reaching a determination.
2. The nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate.
3. The causes of such problems or circumstances.
4. The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved.
5. The merits of possible alternative plans.
6. The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company.
7. The possible benefits of the plan to any other person relative to those expected to inure to the company.
8. The effect of the plan on existing shareholders.
9. In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders.

Source: SEC Release Nos. 33-6254 and IC-11414.

The 12b-1 fees that are used to pay marketing and distribution expenses are deducted directly from fund assets and are reported as a separate line item in the fund's fee table and included in funds' expense ratios. 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.[21] 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. The actual dollar amount of distribution and service expenses paid under a fund's 12b-1 plan must be disclosed in an SAI, which supplements the prospectus, and in the fund's annual report.

As part of its oversight, SEC staff periodically examines mutual funds and their advisers for compliance with securities laws and rules and generally find that mutual fund boards adequately oversee their fund's 12b-1 plan. An SEC official told us that SEC examiners check to see that the directors and shareholders have approved 12b-1 plans and whether the funds have controls in place to ensure that relationships with distributors are reasonable, such as having the directors review 12b-1 fees. The official said that some examinations have found that funds lack adequate control procedures, but the SEC staff rarely have found serious material deficiencies.

12b-1 Plans Provide Additional Ways for Investors to Pay for Investment Advice and Fund Companies to Market Fund Shares

Rule 12b-1 provides investors an alternative way of paying for investment advice and purchases of fund shares. Funds can be sold directly to investors by a fund company or through financial intermediaries such as broker-dealers or financial advisers. According to ICI, approximately 80 percent of investors' mutual fund purchases are made through brokers, financial advisers, and other intermediaries, including employer-sponsored pension plans. Apart from 12b-1 fees, brokers can be paid with sales charges called "loads"; "front-end" loads are applied when shares in a fund are purchased and "back-end" loads when shares are redeemed. With a 12b-1 plan, the fund can finance the broker's compensation with installments deducted from fund assets over a period of several years. Thus, 12b-1 plans allow investors to consider the time-related objectives of their investment and possibly earn returns on the full amount of the money they have to

[21]NASD Conduct Rule 2830(d).

invest, rather than have a portion of their investment immediately deducted to pay their broker.

Rule 12b-1 has also made it possible for fund companies to market fund shares through a variety of share classes designed to help meet the different objectives of investors. For example, Class A shares might charge front-end loads to compensate brokers and may offer discounts called breakpoints for larger purchases of fund shares. Class B shares, alternatively, might not have front-end loads, but would impose asset-based 12b-1 fees to finance broker compensation over several years. Class B shares also might have deferred back-end loads if shares are redeemed within a certain number of years and might convert to Class A shares if held a certain number of years, such as 7 or 8 years. Class C shares might have a higher 12b-1 fee, but generally would not impose any front-end or back-end loads. While Class A shares might be more attractive to larger, more sophisticated investors who wanted to take advantage of the breakpoints, smaller investors, depending on how long they plan to hold the shares, might prefer Class B or C shares because no sales charges would be deducted from their initial investments.

Industry officials and analysts generally viewed the alternative marketing arrangements fostered by rule 12b-1 favorably. ICI and fund company officials generally agreed that rule 12b-1 plans gave fund distributors more options for offering investors multiple ways to pay for fund investments. For example, one company official said that 12b-1 plans have allowed investors to choose the type of fund in which they want to invest and have helped stabilize fund assets. Another official said that rule 12b-1 has provided investors choices on how to pay their broker, which investors have grown to like. He said that in his fund complex, 50 percent of shares are now held in Class B shares that charge 12b-1 fees as opposed to other share classes. A broker-dealer official that distributes funds said that 12b-1 plans are beneficial because the fees provide a revenue stream that encourages financial advisers to plan for the long-term. A mutual fund shareholders advocate said that this incentive is good because it would cause the financial advisers to recommend funds that will work out well for investors over time, rather than focus on earning front-end loads.

12b-1 Fees Raise Some Concerns Over Cost of Funds

Although providing alternative means for investors to pay for the advice of financial professionals, some concerns exist over the impact of 12b-1 fees on investors' costs. For example, an academic study of 3,861 multiple share class funds available at the end of 1997 found that funds with multiple share classes and 12b-1 fees also had higher management fees than those charged by funds with only a single share class, and, therefore, were more costly to investors before considering the additional expenses used to compensate their financial professional.[22] However, another study found that funds with 12b-1 fees might provide investors with greater performance. This study, which reviewed the risk-adjusted performance of a sample of 568 mutual funds for the period 1987-1992, found that 12b-1 plans increased fund expenses but on average generated higher risk-adjusted performance than funds with front-end loads. For this reason, the study concluded that investors should not avoid funds with 12b-1 plans.[23]

Questions involving funds with 12b-1 fees have also been raised over whether some investors are paying too much for their funds depending on which share class they purchase. Earlier in 2003, in federal court in Nashville, Tennessee, investors filed lawsuits against a brokerage firm alleging that the firms' brokers placed the investors' funds into share classes with higher 12b-1 fees when other share classes with different fee structures would have been more appropriate for the investors. A 1999 academic study also found that differing distribution arrangements cause broker-dealer sales representatives to be compensated differently depending on the class of shares they sell. These individuals, the study found, have monetary incentives to steer long-term investors to low load, high 12b-1 fee share classes and to steer short-term investors to high load, 12b-1 fee share classes.[24] However, depending on the time that they are likely to hold the investment, some investors would be better off investing in funds that charge a front-end load and have smaller 12b-1 fees than by purchasing shares in funds without loads but higher 12b-1 fees. The study noted that this conflict of interest between investors and brokers is most

[22]Lesseig, Vance P.; Long, D. Michael; and Smythe, Thomas I. "Gains to Mutual Fund Sponsors Offering Multiple Share Class Funds," *Journal of Financial Research* (March 1990).

[23]Dellva, Wilfred L. and Olson, Gerard T. "The Relationship Between Mutual Fund Fees and Expenses and Their Effects on Performance," *The Financial Review* (February 1998).

[24]O'Neal, Edward S., "Mutual Fund Share Classes and Broker Incentives," *Financial Analysts Journal* (September/October 1999).

serious when broker-dealer representatives advise relatively uninformed investors, who are more likely to seek advice on mutual fund investing.

In addition to concerns over 12b-1 fees, regulators have recently begun investigations of whether investors are receiving the appropriate discounts in mutual fund sales loads. In March 2003, NASD, NYSE, and SEC staff reported on the results of jointly administered examinations of 43 registered broker-dealers that sell mutual funds with a front-end load. The purpose of the examinations was to determine whether investors were receiving the benefit of available breakpoint discounts on front-end loads in mutual fund transactions. The examinations found that most of the brokerage firms examined, in some instances, did not provide customers with breakpoint discounts for which they appeared to have been eligible. In instances where investors were not afforded the benefit of a breakpoint discount, the average discount not provided was $364 per transaction. The most frequent causes for the broker-dealers not providing a breakpoint discount were not linking a customer's ownership of different funds within the same mutual fund family, not linking shares owned in a fund or fund family in all of a customer's accounts at the firm, and not linking shares owned in the same fund or fund family by persons related to the customer in accounts at the firm. The regulators concluded that many of the problems did not appear to have been intentional failures to charge correct loads. Among other things, the report noted that, although most of the firms had written supervisory procedures addressing breakpoints, the procedures often were not comprehensive.

SEC Report Recommended That Rule 12b-1 Be Updated to Reflect Changes in Fund Marketing

In a December 2000 report on mutual fund fees and expenses, staff in SEC's Division of Investment Management recommended that SEC consider reviewing the requirements of rule 12b-1 that govern how funds adopt and renew their 12b-1 plans.[25] The division's staff noted that modifications might be needed to reflect changes in the manner in which funds are marketed and distributed and the experience gained from observing how rule 12b-1 has operated since its adoption in 1980. The report noted that the development of multiple fund share classes permit investors to choose how distribution expenses are to be paid—for example, up front, in installments over time, or at redemption. Many funds that offer shares through broker-dealer fund supermarkets also adopt 12b-1 plans to pay for the fees that the sponsoring broker-dealer charges the funds sold through

[25]U.S. Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses* (Washington, D.C.: December 2000).

their supermarket. The division's report noted that because these 12b-1 plans are essential to the funds' participation in these supermarkets, such plans could be viewed as indefinite commitments. Also since 1980, some fund distributors have been using 12b-1 receivable revenues as collateral to obtain loans to finance their distribution efforts. The SEC staff noted that such changes illustrate that 12b-1 fees have come to be used in different ways than were originally envisioned under the rule and that changes may be needed to reflect current practices. Because of these changes, the report noted that SEC should consider whether it needed to give additional or different guidance to fund directors with respect to their review of rule 12b-1 plans, including whether the nine factors published in the 1980 release of rule 12b-1 were still valid (shown in fig. 1 of this report).

Although SEC has not yet provided additional guidance on or updated rule 12b-1 to reflect market changes, SEC staff told us that any amendment of rule 12b-1 could also involve changes to how distribution fees and expenses are disclosed. One fund independent director with whom we spoke said that rule 12b-1 should be amended to allow payment only to broker-dealers with net sales of fund shares and broker-dealers with net redemptions would not be paid. He said that this change would make sense for rule 12b-1 to fulfill its original purpose of increasing fund assets.

Concerns Raised over Adequacy of 12b-1 Fee Disclosure

Some concerns have been raised over the adequacy of 12b-1 fee disclosures. A mutual fund shareholder advocacy organization has called for reform in the disclosure of fund distribution expenses to better inform investors of possible conflicts of interest that could compromise the adviser's responsibility to control fund costs and provide investors a satisfactory return. For example, this group notes that 12b-1 fee disclosure is misleading to investors because a fund's money can be paying for distribution expenses either through a 12b-1 fee or the adviser's management fee. However, the group asserts, the fee table in the prospectus could give the investor the impression all distribution expenses are covered by 12b-1 fees, while the fund adviser benefits from all of the expenses paid from fund assets, the group noted. The group also noted that 12b-1 disclosures do not inform investors of potential conflicts of interest affecting brokers because, based on the fee disclosures in the prospectus, an investor cannot determine whether his broker received compensation from the 12b-1 fees.

Revenue Sharing Arrangements Provide Additional Distribution Options and Are Increasingly Used to Compensate Fund Distributors

Revenue sharing payments are compensation that investment advisers pay from their profits to the broker-dealers that distribute their funds. Some broker-dealers whose sales representatives market mutual funds have narrowed their offerings of funds or created preferred lists of funds, which then become the funds that receive the most marketing by these broker-dealer sales representatives. 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. According to one research organization official, there are significantly fewer distributing broker-dealers than there are mutual fund investment advisers. As a result, the mutual fund distributors have the clout to require advisers to pay more to have their funds sold by the distributing broker-dealers staff. For example, distributors sometimes require investment advisers to share their profits and pay for expenses incurred by the distributing broker-dealers, such as advertising or marketing materials that are used by the distributing broker-dealers.

The revenue sharing payments that come from the adviser's profits may supplement distribution-related payments out of fund assets. As noted, funds may annually pay up to one percent of fund assets to distributors pursuant to 12b-1 plans. However, SEC officials state that revenue sharing arrangements, paid out of the adviser's management fee, can permit broker-dealer distributors to receive payments outside of the 12b-1 limits. Further, broker-dealers have discretion as to how to use these payments, including using them to defray expenses incurred in marketing funds or to invest them in other areas of the broker-dealer's business.

Mutual funds and their investment advisers also may make distribution payments or incur revenue sharing costs when they offer funds through mutual fund supermarkets. Various broker-dealers, including those affiliated with a mutual fund adviser, allow their customers to purchase through their brokerage accounts the shares of funds operated by a wide range of investment advisers. Although these fund supermarkets provide the advisers of participating funds with an additional means of acquiring investor dollars, the firms that provide such supermarkets generally require investment advisers or funds themselves to pay a certain percentage on the dollars attracted from purchases by customers of the firm's supermarket. For example, funds or advisers for the funds participating in the Charles Schwab One Source supermarket pay that broker-dealer firm up to 0.40 percent of the amount invested by that firm's customers. While some portion of those payments may be paid out of fund assets pursuant to 12b-1 plans, those payments also may represent sharing of advisory fees. Some

or all of these payments may be for transfer agency and shareholder services.

According to SEC officials, revenue sharing is legitimate and consistent with provisions of rule 12b-1. SEC's adopting release of Rule 12b-1 states that the rule should apply to both direct and indirect distribution expenses. However, because there can be no precise definition of what expenses are indirect, SEC decided that fund directors, particularly independent directors, would bear the responsibility for determining on a case-by-case basis whether the use of fund assets for distribution is in compliance with the rule. SEC further noted that fund advisers can use the revenues they receive from their management fee to pay for distribution expenses as long as the adviser's profits are legitimate and not excessive.

Actual Amount of Revenue Sharing Occurring Is Unknown

Mutual funds are not required to disclose the revenue sharing payments made by their advisers as they are other distribution expenses paid by the funds. As noted above, any sales loads or 12b-1 fees that funds charge are disclosed in funds' prospectuses and annual reports. However, the amount of revenue sharing payments, which are paid out of the fund adviser's profits earned from the management fee or income from other sources, are not typically disclosed to investors, except for possible general disclosure in a fund's prospectus or SAI. Funds do disclose 12b-1 payments and may disclose that they may make other distribution-related payments but do not have to disclose the total amount paid or identify the recipients of those payments. As a result, complete data are not available on the extent to which mutual fund advisers are making revenue sharing payments. An industry researcher said that the cost of revenue sharing does not show up in advisers' financial reports because there is no line item for it and costs that fund advisers may incur to pay for sales meetings attended by broker-dealer staff or other promotion efforts are not specifically shown in fund adviser income statements. 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. These amounts have been growing. According to the officials of a mutual fund research organization, revenue sharing costs are hard to quantify but are rising. For example, the organization reports that about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments.

Some Industry Participants Are Concerned that Revenue Sharing Could Negatively Impact Investors

The increased use of revenue sharing payments is raising concerns among some industry participants. Although revenue sharing payments are becoming a major expense for fund advisers, industry research organization officials told us that most fund advisers are not willing to

publicly discuss the extent to which they are making such payments. A 2001 report on fund distribution practices states that "the details and levels of revenue sharing vary widely across the industry and are seldom codified in written contracts." In one industry magazine article, a mutual fund industry researcher referred to revenue sharing as "the dirty little secret of the mutual fund industry."

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. The 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing may affect other fees that funds charge, such as 12b-1 fees or management fees, is uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments had increased any fund's fees but 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 because they are paid from the adviser's profits, unless the payments are financed directly from fund assets as part of the adviser's management fee or a 12b-1 plan. Fund directors, however, in the course of their review of the advisory contract, consider the adviser's profits before marketing and distribution expenses, which also may limit the ability of advisers to shift 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, these revenue sharing arrangements may have the effect of unduly focusing the attention of investors and their broker-dealers on particular mutual fund choices, which can reduce the number of funds they consider as part of the investment decision. That not only may lead to inferior investment choices, but may also reduce fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements may 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.

Mutual fund officials' opinions about revenue sharing were mixed. Some of the fund officials with whom we spoke viewed revenue sharing as a cost of doing business, which enabled them to obtain "shelf space" for their funds with major broker-dealers and did not regard these arrangements as

potentially conflicting with investors' interests. They explained that the payments are made directly to the brokerage firm and not to individual staff financial advisers. One fund official said that there would be no incentive for broker-dealers' sales staff to push certain funds, unless managers exerted pressure on sales staff to sell those funds. Officials of one large broker-dealer with whom we spoke said that their fund sales platform has an "open architecture" through which all participating funds' agreements and payments are the same, which creates a level playing field on which no funds are given priority. One fund official commented that NASD rules require that broker-dealers sales staff recommend funds that are most suitable to the individual investor's financial situation. However, in letters commenting on certain compensation arrangements among broker-dealers, ICI has stated that cash compensation creates potential conflicts of interest between the broker-dealer receiving the compensation and the customer because the sale of a recommended security could increase the compensation paid to the broker-dealer's sales representative.

Although the extent to which revenue sharing payments are affecting the appropriateness of the fund recommendations that broker-dealers make is not known, investor's complaints regarding mutual fund shares they purchased have recently increased dramatically. According to NASD statistics, the number of NASD-administered arbitration cases involving mutual funds have increased by over 900 percent from 121 cases in 1999 to 1,249 cases in 2002. According to NASD staff, about 34 percent of the 2002 cases involved complaints of unsuitable mutual fund purchases. The extent to which revenue sharing payments are involved with these cases is unknown and NASD staff said the likely reason behind the increase in arbitrations involving mutual funds is the decline in the stock market and the associated declines in mutual fund performance.

Extent to Which Investors Are Told About the Potential Conflict That Revenue Sharing Creates Is Unclear

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 requirements of rule 10b-10 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 will not receive a confirmation, and may not view a prospectus, until after purchasing mutual fund shares. According to SEC staff, the compensation-disclosure requirements of rule 10b-10 in large part are geared toward providing investors with information that is useful over a course of dealing with a broker-dealer, rather than just one transaction. Information disclosed following the first transaction in a security can help the investor determine whether to continue to use that broker-dealer for future transactions. That is particularly applicable in the context of mutual funds, given that investors often purchase fund shares over time in a series of transactions.

Regulators and others acknowledged that additional disclosures may be necessary to better help investors assess the potential conflicts of interest associated with mutual fund transactions when distributing broker-dealers receive revenue sharing payments. According to SEC staff, additional disclosure is consistent with the principle that investors should be informed about the financial interest that their broker-dealers have with respect to mutual fund transactions. Additional disclosure about revenue sharing also may help investors be more sensitive to the question of whether they are being presented with an adequate range of investment choices within a fund class. SEC officials also told us that additional disclosure of revenue sharing payments may be justified so that investors can better assess whether the fund's advisory fees are excessive. SEC officials, in addition, noted that additional disclosure also might help promote fee competition among funds.

NASD officials said that mutual funds' revenue sharing arrangements with broker-dealers could present a conflict of interest for the broker-dealer. However, NASD looked at this issue in the past and found no hard evidence of sales representatives recommending unsuitable funds, but they acknowledged that making such a determination would be difficult. The NASD officials told us that it may be time to reexamine this issue. They said that NASD Rule 2830 prohibits member brokers from accepting compensation from fund advisers unless the funds disclose these payments in fund prospectuses. ICI has also endorsed regulatory rule changes that would require broker-dealers to disclose if they are receiving compensation from fund advisers, in addition to requiring disclosure of these payments in fund prospectuses. However, an official at one mutual fund adviser with whom we spoke said that disclosure of funds' revenue sharing agreements would not be helpful because it would include only their largest

distributors and might mislead investors about the extent of revenue sharing.

Soft Dollar Arrangements Provide Benefits, but Could Also Have an Adverse Impact on Investors

Soft dollar arrangements allow investment advisers of mutual funds and other clients to use part of the brokerage commissions paid to broker-dealers that execute trades on the fund's behalf to obtain research and brokerage services that can potentially benefit fund investors but could increase the costs borne by their funds. The research and brokerage services that fund advisers obtain through the use of soft dollars can benefit a mutual fund investor by increasing the availability of research. This practice also creates potential conflicts of interest that could harm fund investors. Some industry participants argued that when mutual fund investment advisers use fund assets to pay brokerage commissions and receive research or brokerage services as part of soft dollar arrangements, such services improve the investment advisers' management of the fund. However, others expressed concerns that such arrangements create conflicts of interest that could result in fund advisers paying higher brokerage commissions than necessary, which increases costs to fund investors. Investors' expenses also could be higher if investment advisers use brokerage commissions to pay for research and brokerage services that they do not need or would otherwise pay for out of their own profits. Expenses to investors would also be higher if investment advisers traded more to generate and receive more soft dollar services. According to SEC, soft dollar arrangements could also compromise advisers' fiduciary responsibility to seek brokers capable of providing the best execution on fund trades by choosing broker-dealers on the basis of their soft dollar offerings. With these potential conflicts of interest in mind, several interested parties in the United States and abroad have made suggestions for how potential soft dollar abuses could be mitigated, although some of these actions could have other negative consequences.

Soft Dollars Pay for Research and Brokerage Services

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.[26] In return for 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 refer to the exchange of research and brokerage services from broker-dealers to fund advisers in return for brokerage commissions. For example, many full-service broker-dealers offer trade execution services, and in exchange for paying their stated institutional commission rate, advisers conducting trades through them could be entitled to research produced by the broker-dealers' analysts or receive priority notification of market or company-specific news. In addition to providing this proprietary research, these broker-dealers may also allow the fund adviser to generate soft dollar credits with a portion of the brokerage commissions paid that the fund adviser can then use to purchase other research from third parties. These third parties can be other broker-dealers, independent research or analytical firms, or service providers such as market data or trading systems software and hardware vendors. In a 1998 inspection report that documented reviews of soft dollar practices at 75 broker-dealers and 280 investment advisers and investment companies, SEC reported for every $1.70 in commissions paid to a broker-dealer, the adviser would receive $1.00 worth of soft dollar products and services.[27]

Soft dollar arrangements are not unique to the mutual fund industry. They are widely used by investment advisers who manage portfolios for other clients besides mutual funds, including pension funds, hedge funds, and individual retail clients.

Soft Dollar Arrangements Have Evolved Over Time

Many of the features of soft dollar arrangements that exist today 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

[26]As noted previously, instead of commissions, broker-dealers executing trades also could be compensated through markups or spreads.

[27]U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Washington, D.C.: Sept. 22, 1998).

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 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 and not be in breach of their fiduciary duty. In order to be protected against a claim of breach of fiduciary duty under this safe harbor, the adviser must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

The definition of what research and brokerage services can be obtained through soft dollar arrangements has evolved over time. In a 1976 release, SEC issued guidelines for determining when a product or service is within the meaning of brokerage and research services and available for the safe harbor under section 28(e). The 1976 guidelines provided the product or service must not be "readily and customarily available and offered to the general public on a commercial basis." In 1986, noting that this standard was difficult to apply and unduly restrictive in certain instances, SEC reinterpreted the safe harbor as permitting soft dollar arrangements to purchase products and services that "provide lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities," which could then include those commercially available to the public.[28] Under the revised interpretation, the cost of products and services that provide lawful and appropriate assistance, such as computer hardware and seminars, may be paid for with soft dollars.

[28]Securities; Brokerage and Research Services, Securities and Exchange Commission Release No. 34-23170, 51 F.R. 16004 (Apr. 23, 1986).

Although the Complete Extent of Soft Dollar Use Is Unknown, Soft Dollars Could Represent a Significant Portion of Trading Commissions

Because soft dollar research is often bundled, only aggregate value estimates of soft dollar arrangements are available. According to one industry research organization, the total amount paid in brokerage commissions for U.S. stocks totaled $8.6 billion in 2001, up from $7.7 billion in 2000.[29] Of this amount, industry participants estimate that 15 percent of total annual brokerage commissions, or roughly $1 billion, is used to obtain third-party research. However, this figure does not include the value of proprietary research, which cannot be unbundled as easily as third-party research. Moreover, in light of recent declines in fund assets, concern has been raised that advisers are under increased pressure to use soft dollars to pay for research rather than incur additional fund expenses.

Soft dollar products and services appear to represent a substantial portion of the cost of brokerage commissions on individual trades. Industry participants estimate that on average broker-dealers charge commissions of between $.05 and $.06 per share traded. In contrast, one industry expert has noted that it costs less than $.01 per share to execute a trade through an electronic communications network (ECN). ECNs are registered broker-dealers that operate as electronic exchanges. Because ECNs do not offer as many of the services offered by full service broker-dealers and execute trades electronically, the cost of executing trades through these brokers is lower. However, the estimated costs of trading on an ECN may not be representative of trading in all securities because most activity on ECNs involves widely traded, liquid stocks. Other estimates of the portion of individual brokerage commissions represented by soft dollars and execution services varied. One academic study, for example, attributes 67 percent of the cost of brokerage commissions on individual trades to soft dollars that pay for proprietary or third-party research.[30] However, recognizing that a portion of brokerage commissions goes towards broker-dealer profits, a consulting firm that specializes in mutual funds estimates more conservatively that soft dollars constitute 33 percent of brokerage commission costs.

Advisers who offer mutual funds use soft dollar arrangements to varying degrees. According to one SEC official, many fund companies do their own

[29]Greenwich Associates, *Commission and Soft-Dollar Practices in U.S. Equities* (May 3, 2002).

[30]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *The Journal of Financial Research* (Summer 1996).

research and thus have less use for broker-dealer or third-party research. Fixed-income funds, because their trades largely do not involve paying commissions, may not generate many soft dollar credits that could be used to obtain third-party research. However, one adviser of fixed-income funds with whom we spoke said that his firm does receive proprietary research from the full-service broker-dealers with whom they trade. Nine of the ten fund companies with whom we spoke also used soft dollars to varying degrees. One of the fund companies indicated that they did not engage in any soft dollar arrangements. However, this company specializes in indexed funds, which do not require research, and therefore seeks execution-only trades when it engages in portfolio transactions. Officials from other firms indicated that they limited the items that they obtained with soft dollars to research reports and analysis. On the other hand, some fund companies with whom we spoke indicated that their funds engaged in greater use of soft dollar arrangements for a variety of research and brokerage services permissible under section 28(e), including computer monitors and analytical software.

Disclosure of Soft Dollar Use to Mutual Fund Investors Is Limited

Fund advisers and investment companies must make some disclosure of their soft dollar arrangements, but these disclosures are not specific and not required to be routinely provided to mutual fund investors. Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which is the form that investment advisers use to register with SEC and are required to send to their advisory clients. Specifically, Form ADV requires advisers to describe the factors considered in selecting brokers and determining the reasonableness of their commissions when the adviser has discretion in choosing brokers. 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 may pay commissions higher than those obtainable from other brokers in return for those products. The adviser is also to disclose whether research is used to service all of the adviser's accounts or just those accounts paying for it and any procedures the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received. However, SEC staff told us that the Form ADV disclosures tend to use standardized language that is difficult for advisory clients to evaluate.

The information that investment advisers disclose about their choice of broker-dealers and their use of soft dollars in their Form ADV is not required to be routinely provided to mutual fund investors. As noted above, investment advisers are required to provide their Form ADV to their advisory clients. However, in the case of mutual funds, the client is considered to be the legal entity that is registered as the investment company with SEC and not the individual shareholders of the mutual fund. SEC rules also require advisers to disclose the aggregate brokerage commissions paid by the investment adviser with fund assets, the criteria for broker selection, and the products and services obtained through soft dollar arrangements in their SAI.[31] However, SAIs are only sent to investors upon request, and industry officials noted that investors rarely request SAIs. As a result, mutual fund shareholders do not routinely receive information about the extent to which their funds' advisers receives and uses soft dollar credits when making purchases or sales of the securities in the mutual funds that they own.

In addition to oversight of fees and fund distribution expenses, mutual fund directors also have a responsibility to monitor advisers' soft dollar arrangements to ensure best execution on portfolio trades. According to SEC, fund directors typically have access to more detailed information about an adviser's soft dollar practices than described in the Form ADV, including a list of brokers used and the total commissions dollars paid to each broker, the average commission rate per share by broker, the list of brokers with which the fund adviser has soft dollar arrangements and a description of research and brokerages services received by the fund. Additionally, directors often receive the advice of independent counsel about an adviser's soft dollar practices. Both SEC examiners and fund directors evaluate soft dollar arrangements in the context of whether advisers are getting best execution on portfolio transactions. Directors and

[31]The information that investment advisers are required to file with SEC that comprises the SAI is contained in Form N-1A, which is the registration statement for open-ended management investment companies. Information about soft dollar arrangements are also contained in Form N-SAR, which is the form registered management investment companies file with SEC on a semi-annual basis. Disclosures regarding brokerage practices are found in items 20, 21, 22, and 26 of this form. In particular, item 26 requires the fund to answer yes or no as to various considerations that affected the participation of brokers or dealers in commissions or other compensation paid on portfolio transactions of the fund. These considerations include sales of the fund's shares; receipt of investment research and statistical information; receipt of quotations for portfolio valuations; ability to execute portfolio transactions to obtain best price and execution; receipt of telephone line and wire services; affiliated status of the broker or dealer; and arrangements to return or credit part or all of commissions or profits thereon to the fund and other affiliated persons of the fund.

industry participants with whom we spoke indicated that boards evaluate how advisers use soft dollars, whether these charges are reasonable, and whether these arrangements affect best execution of portfolio transactions.

Soft Dollars Benefit Investors in Various Ways, but Could Also Increase Investor Costs or Raise Conflicts of Interest

Some industry participants argue that the use of soft dollar benefits investors in various ways. They note that the prevalence of soft dollar arrangements allow 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 may also have other benefits. For example, an investment adviser official told us that the research on smaller companies for which soft dollars pay helps create a more efficient market for such companies' securities, resulting in greater market liquidity and lower spreads.

However, concerns have been raised about soft dollar arrangements because they could increase the costs that investors incur when investing in a mutual fund. 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. As a result, soft dollar trades might have both higher brokerage commissions and worse trade execution. One academic study, for example, 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.[32] 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 were not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades. Some believe soft dollars are used to purchase research and brokerage services for which advisers should pay out of their own profits and not out of fund assets. As a result, the investor assumes the direct financial burden for the advisers' costs.

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

Concerns have also been expressed that the range of products and services that advisers are obtaining with client commissions might be too broad. Critics of soft dollar arrangements have argued that the 1986 principle has legitimized the use of investor dollars to pay for products and services with only marginal research applications, such as computer terminals, telephone bills, and magazine subscriptions. Using soft dollars for such services could harm investors because advisers have an incentive to freely obtain such services that they would otherwise have to pay for out of their profits.

SEC noted that mutual fund advisers tend to abide by the spirit of section 28(e) more diligently than other investment advisers. In 1996 and 1997, SEC examiners conducted an examination sweep into the soft dollar practices of broker-dealers, investment advisers and mutual funds. In their 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. However, SEC staff indicated that their review found that mutual fund advisers engaged in far fewer soft dollar abuses than other types of advisers. They attributed mutual fund adviser compliance to the role that independent directors play in overseeing and approving advisers' soft dollar arrangements. The SEC staff also indicated that active involvement by legal counsel in the affairs of mutual funds may contribute to the relative lack of soft dollar abuses among mutual fund advisers as well.

Investment advisers also receive services in exchange for part of the brokerage commissions they pay with fund assets that directly reduce the costs borne by mutual fund investors. In these cases, instead of the adviser receiving research or brokerage services, the adviser, at the request of the fund board, could direct the broker-dealer executing a trade to use a portion of the commission paid to pay an expense of the mutual fund. For example, the executing broker-dealer could mail a payment to the fund's custodian for the services rendered to the mutual fund that could reduce the amount the fund itself would have to directly pay the custodian out of fund assets. Alternatively, the executing broker-dealer could rebate part of the brokerage commission to the fund in cash. Such directed brokerage arrangements do not fall under the section 28(e) safe harbor and do not present the same conflicts of interest as traditional soft dollar arrangements, because the investor, not the adviser, is directly benefiting from them. An industry participant has indicated that such arrangements are not very common in the mutual fund industry.

Regulators and Industry Participants Have Proposed Alternatives for Mitigating Potential Conflicts Involving Soft Dollar Use

As a result of its 1998 inspection report on its soft dollar examination sweep, SEC staff made several proposals that could help investors better evaluate advisers' use of soft dollars. In the examination sweep, SEC examiners found inconsistencies in how advisers and broker-dealers interpreted the section 28(e) safe harbor. Staff also found poor record keeping and internal controls for soft dollar arrangements and that advisers were not adequately disclosing their soft dollar usage. As a result, SEC staff recommended that Form ADV be modified to require more meaningful disclosure. To facilitate this disclosure, SEC staff also recommended that SEC publish the inspection report and issue additional guidance to clarify the scope of the safe harbor. SEC published the inspection report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers, and investment companies that participate in soft dollar arrangements. This recommendation may help industry participants apply the standards articulated in the 1986 interpretive release more consistently and ensure that investor dollars only pay for research and brokerage services within the scope of section 28(e). Additionally, SEC staff recommended that SEC consider adopting a bookkeeping requirement. A bookkeeping requirement would enable advisers to disclose more easily to investors the products and services for which soft dollars are paying. It would also ensure that directors are able to receive information that fairly reflects the adviser's soft dollar arrangements. SEC staff told us that if the expanded disclosure and other changes envisioned in their sweep report were implemented, clients of investment advisers also would have more specific information that could allow them to evaluate the appropriateness of their own adviser's use of soft dollars. The Department of Labor, which oversees pension funds, and the Association for Investment Management and Research, which administers professional certification examinations for financial analysts, have also called for improved disclosure of soft dollar usage by investment advisers.[33]

[33]See Department of Labor Advisory Council on Employee Welfare and Benefit Plans, *Report of the Working Group on Soft Dollars/Commission Recapture* (Nov. 13, 1997); and Association for Investment Management and Research, AIMR Soft Dollar Standards (August 1999).

However, SEC has yet to implement some of these recommendations due to staff turnover and other high priority business. Except for publishing the inspection report and issuing interpretative guidance that classifies certain riskless principal transactions as falling under the section 28(e) safe harbor, SEC has not issued further guidance regarding soft dollars.[34] A soft dollar bookkeeping requirement has been discussed as part of a larger SEC initiative on bookkeeping, but no formal proposal has been presented. Finally, the SEC issued a proposed rule on Form ADV modifications in April 2000, which solicited comments on several changes that could force advisers to make more meaningful disclosures of soft dollar arrangements. However, this rule has not been adopted.[35] SEC staff told us that they have not taken further actions on these proposals due to staff turnover and the press of business in other areas.

Some industry participants are not convinced that greater disclosure would benefit investors. Form ADV is sent to advisory clients, not fund investors. Thus, the proposed disclosure requirements do not address the needs of fund investors. Investors do have access to information on a fund's soft dollar arrangements through the SAI, which is available upon request. However, representatives of one fund company with whom we spoke indicated that investors very rarely request SAIs. Industry participants also noted that it might be difficult for investors to evaluate an adviser's best execution policies, which are not uniform across funds. Moreover, more disclosure might lead investors to infer that soft dollar arrangements are necessarily harmful and therefore adverse to their best interests.

[34]In SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Securities and Exchange Commission Release No. 34-45194 (12/27/2001), SEC clarified that the term "commission" for purposes of the Section 28(e) safe harbor encompasses, among other things, certain riskless principal transactions.

[35]Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Securities and Exchange Commission, Release No. IA-1862; 34-42620 (Apr. 5, 2000).

Some proposals would seek to restrict or ban the use of soft dollars in order to encourage brokerage commissions to fall. As a result of recommendations from a government-commissioned review of institutional investment in the United Kingdom, the Financial Services Authority (FSA), which regulates the financial services industry in that country, issued a consultation paper that argued that soft dollar arrangements create incentives for advisers to route trades to broker-dealers on the basis of soft dollar arrangements and, further, that these practices do not result in a good value for investors.[36] As a result of these findings, the paper proposed banning soft dollars for market pricing and information services, as well as various other products. This recommendation would provide a more direct incentive for advisers to consider what services are necessary for efficient fund management, which could lower investors costs by reducing the extent to which advisers use client funds for services that the adviser does not need. The paper also recommended that advisers quantify, or unbundle, the cost of all other soft dollar products and services and rebate those costs to investors' accounts with hard dollars, which would result in investors having lower trading costs in their funds.

Whether implementing the actions envisioned by the FSA's proposals is feasible is not certain. For example, FSA staff 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. Such restrictions could also encourage UK advisers to move their operations elsewhere. In addition, SEC staff told us that implementing the FSA proposal would be more difficult here without legislative change because the United States has the statutory safe harbor under Section 28(e), whereas the United Kingdom does not.

We learned of another proposal related to soft dollars and brokerage commissions from an industry participant who was concerned that the general practice of full-service broker-dealers charging about $0.05 to $0.06 per share in commissions and then offering discounts in the form of soft dollars was serving to keep commissions artificially high. His first suggestion would be to ban soft dollar arrangements to obtain products

[36]See P. Myners, *Institutional Investment in the United Kingdom: A Review* (Mar. 6, 2001); and Financial Services Authority, *Bundled Brokerage and Soft Commission Arrangements* (April 2003).

and services with marginal research applications, forcing advisers to pay for these products with their own profits rather than with fund assets and therefore reducing the trading costs borne by fund investors. Another suggestion he had would have broker-dealers quantify the execution-only portion of their brokerage commissions. If this information were collected by SEC and reported as industry averages, mutual fund directors would have more information to use to evaluate their fund's trading activities.

However, many industry participants are skeptical about whether soft dollar arrangements contribute to investors paying higher brokerage commissions. For example, according to SEC officials and an industry participant, many broker-dealers claim that they would not negotiate lower commission rates with investment advisers regardless of whether an adviser was willing to forfeit soft dollar products and services in return. One group with whom we spoke suggested that soft dollars might be more of a volume rebate for brokerage than a factor influencing commission rates. Moreover, surveys of investment advisers and broker-dealers conducted in the United Kingdom found that third-party soft dollar arrangements were a very minor factor on which broker-dealers competed for business and advisers selected broker-dealers. These results suggest that advisers' incentive to compromise their fiduciary responsibility to seek best execution in return for generous soft dollar arrangements might be overstated.

Concern has also been raised about how the value of some soft dollar products and services could be fairly determined. Because proprietary soft dollar products and services are bundled, their values as individually purchased items are difficult to estimate. For example, SEC officials noted that it is hard to put a meaningful value on the cost of information exchanged in a phone call between a fund adviser and a broker-dealer. Nevertheless, brokerage commissions pay for this type of informal access. Some industry experts, including SEC, have noted that attempts to require the industry to quantify the value of soft dollar services could have a disproportionate impact on third-party research. Third-party research is free from the potential conflicts of interest that have recently tainted some proprietary research from brokerage houses. Additionally, several fund companies have indicated that they find research provided by specialized research firms does provide valuable insights into investment decisions. Because broker-dealers use soft dollar credits to purchase third-party research, its value is more easily determined than proprietary research. As a result, some have expressed concern that this distinction could make third-party research more vulnerable if regulatory changes were enacted.

Some have suggested that limiting the products and services that could be obtained with soft dollars might have some unintended consequences. According to some fund officials, this option could shift a greater financial burden onto advisers, who might be tempted to raise management fees as a result. While having investment advisers pay directly for research and brokerage services rather than receive them through soft dollars could increase the transparency of these arrangements, the increased costs to the adviser could cause advisers to seek fee increases or at least prevent further reductions in the fees advisers do charge.

Conclusions

Although mutual funds disclose considerable information about their costs to investors, some industry participants urge that additional disclosures are needed to further increase the awareness of investors of the fees they pay as part of investing in mutual funds and to encourage greater competition among mutual funds on the basis of these fees. The SEC staff's proposal to require funds to disclose the actual expenses in dollars based on an investment amount of $10,000 would provide investors with more information on fund fees and in a form that would allow for direct comparison across funds. If adopted, this will provide investors selecting among different funds with useful information prior to investing. However, additional disclosures could also improve investor awareness and the transparency of these fees. Providing existing investors with the specific dollar amounts of the fees paid on their shares and placing fee related disclosures in the quarterly account statements that investors receive would put mutual fund disclosures on comparable footing to many other financial services that already disclose specifically in dollars the cost of their services. 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.

Given the cost of producing such disclosures and the lack of data on the additional benefits to investors, the SEC staff have indicated that they were not certain that specific dollar disclosures are warranted. However, we believe that actively weighing the costs and benefits of providing additional disclosure is worthwhile. 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 to present the information that SEC has proposed be added to mutual fund's semiannual reports that would disclose the dollar amounts of a fund's fees based on a set investment amount. 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. If additional fee disclosures such as these were used to supplement the existing information already provided in prospectuses and semiannual reports, both prospective and existing investors in mutual funds would have access to valuable information about the relative costs of investing in different funds.

Mutual fund directors play a critical role in overseeing fund advisers activities and have been credited with ensuring that U.S. mutual funds have lower fees than those charged in other countries. However, the popularity of mutual fund investing and the increasing importance of such investments to investors' financial well being and ability to retire securely also increases the need for regulators and industry participants to continually seek to ensure that mutual fund corporate governance practices remain strong. The recent corporate scandals have resulted in various corporate governance reforms being proposed to improve the oversight of public companies by their boards of directors. We have supported regulatory and industry efforts to strengthen the corporate governance of public companies. Although many of the reforms being sought for public companies are already either embodied in regulatory requirements or recommended as best practices by the mutual fund industry group, additional improvements to mutual fund governance, such as mandating supermajorities of independent directors, are likely to continue to be considered by regulators and industry participants, which should further benefit mutual fund investors.

Although the ways that funds use 12b-1 fees has changed over time, these fees appear to have provided investors with increased flexibility in choosing how to pay for the services of the individual financial professionals providing them with advice on fund purchases. As a result, they appear to provide benefits to the large number of investors that require assistance with their financial decisions. The revenue sharing payments that funds make to broker-dealers illustrate that mutual funds must compete to obtain access to the distribution networks that these firms provide. How and the extent to which these payments affect the

overall level of fees that fund investors pay is not clear. However, by compensating broker-dealers to market the funds of a particular company, they can introduce a conflict with the broker-dealer obligation to recommend the funds most suitable to the investor's needs. Further, even if the payments do not conflict with this obligation, the payments can result in financial professionals providing investors with fewer investment choices. Regulators acknowledged that the currently required disclosures might not provide needed transparency to investors at the time that mutual fund shares are being recommended for purchase. 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.

Fund investors can benefit when their fund's investment adviser uses soft dollars to obtain research and brokerage services that benefit the fund or to pay other fund expenses. However, investment advisers may also use soft dollars for services that may just reduce the adviser's own expenses. The SEC staff has recommended various changes that would increase the transparency of soft dollar practices by clarifying the acceptable uses of soft dollars and providing fund investors and directors with more information about how their fund's adviser is using soft dollars. However, the rule proposal to expand advisers' disclosure of their use of soft dollars was issued about 3 years ago and has not yet been acted upon. In addition, the SEC staff have not developed and issued a formal rule proposal to implement its recommendation to require increased soft dollar recordkeeping by broker dealers and advisers that would increase the transparency of these arrangements. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, by not acting on these soft dollar-related measures, 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.

Recommendations

To promote greater investor awareness and competition among mutual funds on the basis of their fees, we recommend that the Chairman, SEC increase the transparency of the fees and practices that relate to mutual funds by

- considering the benefits of additional disclosure relating to mutual fund fees, including requiring more information in mutual fund account statements about the fees investors pay;

- evaluating ways to provide more information that investors could use to evaluate possible conflicts of interest resulting from any revenue sharing payments their broker-dealers receive; and

- evaluating ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar examinations report.

Agency Comments and Our Evaluation

SEC and ICI generally agreed with the contents of this report. Regarding our recommendation that SEC consider additional ways to provide fee information to investors in account statements, the letter from the director of the Division of Investment Management notes that the SEC staff agreed that mutual fund shareholders need to understand the amount of fees that mutual funds charge and indicated that they would consider whether some form of fee disclosure could be included in account statements as they continue to evaluate the comments they have received on their proposed disclosure changes. Regarding our recommendations on increasing the amount of information disclosed about revenue sharing and soft dollar arrangements, the SEC staff also indicated that they intend to consider ways in which additional information about these practices could be disclosed.

The letter from the president of ICI notes that our report's discussion of mutual fund regulatory requirements is generally balanced and well informed. However, his letter indicates concern over how we compare the disclosures made by mutual fund fees to those made by other financial products. According to the letter, ICI staff are convinced that current mutual fund fee disclosures allow individuals to make much more informed and accurate decisions about the costs of their funds than do the disclosures made by other financial service firms. In particular, they indicated that they are not aware of any other financial product that is legally required to provide standardized information that reveals the exact level of all of its fees and expenses and projects their impact in dollar terms over various time periods.

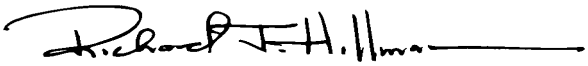
We agree with ICI that mutual funds are already required to make considerable disclosures that are useful to investors for comparing the level of fees across funds. Although our report notes that, unlike mutual funds, other financial products generally do disclose their costs in specific dollar terms, we do not make a judgment as to whether the overall disclosures provided by these products are superior to that provided for mutual funds. Instead, we believe that supplementing the existing mutual fund disclosures with additional information, particularly in the account statements that provide investors with the exact number and value of their mutual fund shares, could also prove beneficial for increasing awareness of fees and prompting additional fee-based competition among funds.

The ICI's staff's letter also indicates that our report presents a thorough and useful discussion of the role played by independent directors in overseeing mutual fund fees. However, they expressed concern that mutual fund independent directors are not usually given sufficient credit for protecting fund shareholder interests. ICI noted that independent directors have helped keep the industry free of major scandal and that mutual fund governance standards, as set by the Investment Company Act of 1940, places strict requirements on funds that exceed the voluntary standards with which public companies are expected to adhere. We agree with ICI that independent directors have played important roles in overseeing funds and, in each of the issues addressed by our report, we discuss the actions taken by mutual fund directors to oversee the issues and that SEC reviews generally find that directors have fulfilled their duties in accordance with the law. However, given recent scandals and concerns related to corporate responsibility in the financial sector and the growing importance of fund investments to the financial health and retirement security of investors, continued debate by the Congress and among regulators and industry participants about the effectiveness of existing mutual fund corporate governance standards is appropriate. SEC's and ICI's written responses are shown in appendixes II and III.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will provide copies of this report to the Chairman and the Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs, and the Ranking Minority Members, House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Copies also will be provided to the Chairman, SEC; the President, ICI; and other

interested parties. The report will also be available at no charge on GAO's home page at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact Mr. Cody Goebel or me at (202) 512-8678. GAO staff that made major contributions to this report are shown in appendix IV.



Richard J. Hillman
Director, Financial Markets
and Community Investment

Scope and Methodology

To describe mutual fund fee and trading cost disclosures and other financial product disclosures and the related costs we reviewed SEC rules and studies by academics and others, and various mutual fund company fund literature including prospectuses and SAIs, as well as prior GAO work. To evaluate the benefits of additional mutual fund cost disclosure we collected opinions from a judgmental sample of 15 certified financial planners with the use of a structured questionnaire.

To describe the role of mutual fund independent directors we reviewed federal laws and regulations, academic studies, and prior GAO work. We collected opinions from officials representing an independent directors association and from a judgmental sample of independent directors with the use of a structured questionnaire.

To obtain information on mutual fund distribution practices we interviewed officials of ten mutual fund companies, two broker-dealers, ICI, NASD, SEC, mutual fund research organizations, and investor advocacy organizations and individuals. We also reviewed and analyzed various documents and studies of mutual fund distribution practices.

To address the benefits and potential conflicts of interest raised by mutual funds' use of soft dollars, we spoke with the FSA and other industry experts on soft dollars. We also reviewed studies by regulators and industry experts on soft dollar arrangements. Some groups we spoke to had made specific recommendations for regulatory changes to soft dollar arrangements. To the extent possible, we discussed the potential advantages and disadvantages of these recommendations with officials of the ten mutual fund companies, two broker-dealers, ICI, NASD, SEC, mutual fund research organizations, and investor advocacy organizations and individuals.

For each of the topics we reviewed in this report we gathered views from staff at SEC, mutual fund company officials, broker-dealers, ICI, mutual fund research organizations, and investor advocacy organizations and individuals. We conducted our work in Washington, D.C.; Boston, MA; Kansas City, MO; Los Angeles, CA; New York, N.Y.; and San Francisco, CA, from February to June 2003, in accordance with generally accepted government auditing standards.

Comments from the Securities and Exchange Commission

DIVISION OF
INVESTMENT MANAGEMENT

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

June 2, 2003

Richard J. Hillman
Director, Financial Markets
and Community Investment
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Re: GAO Draft Report
Mutual Funds: Greater Transparency Needed in Disclosures to Investors

Dear Mr. Hillman:

Thank you for the opportunity to comment on the General Accounting Office's draft report on mutual fund expense disclosures to investors. The report reviews a variety of issues relating to mutual fund fees, including: how mutual funds disclose their fees and related trading costs; the role of mutual fund directors in overseeing fees; the effect on investors of changes in the way in which mutual fund shares are marketed and distributed; and concerns related to mutual funds managers' use of soft dollars to obtain research and other services. I commend the GAO for contributing to the public dialog about these important matters.

The report raises important issues concerning the impact of mutual fund fees on investors. The major conclusion of the report is that additional disclosure could help increase investor awareness and understanding of mutual fund fees and, thereby, promote additional competition by funds on the basis of fees. The report makes three recommendations, each of which we address below.

I. Additional Disclosure Related to Mutual Fund Fees

First, the report recommends that the Commission consider the benefits of additional disclosure relating to mutual fund fees, including requiring mutual fund account statements to remind investors of the fees they pay.

We agree that shareholders need to understand the amount of fees that mutual funds charge. The primary focus of our disclosure effort has been to make fund fees and expenses more transparent to investors and to allow investors the ability to compare fees and expenses between different funds, as well as to educate investors about the importance of fees.

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As you know, in December 2002 the Commission requested comment on a proposal to require mutual funds to include in reports to shareholders the dollar cost associated with a $10,000 investment.[1] In the proposal the Commission requested comment on whether there are better vehicles than annual and semi-annual reports to shareholders in which to include additional disclosure about fund expenses. The Commission also asked whether requiring disclosure of the actual costs paid by an individual investor in his or her account statements would be preferable, and if so, what benefits individualized cost disclosure in account statements would provide to investors that disclosure in shareholder reports of an initial $10,000 investment would not.

We currently are receiving and evaluating comments on the rule proposal. In formulating our recommendation to the Commission on how to proceed on this issue, we will consider whether some form of disclosure in account statements, including the disclosure recommended in your report, should be required.

II. Revenue Sharing Arrangements

Second, the report recommends the Commission evaluate ways to provide more information that investors could use to evaluate possible conflicts of interest resulting from any revenue sharing payments their broker-dealers receive.

A broker-dealer is generally required to disclose to its customer, in writing, at or before the completion of the transaction, that it has or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or will receive, from the fund's investment adviser.[2] A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.[3] Many funds disclose in their prospectuses information about their investment advisers' revenue-sharing payments to broker-dealers, which has the effect of facilitating the broker-dealers' compliance with that obligation.

The Commission is concerned about the disclosure of revenue sharing payments and recently has recognized that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue sharing payments. The Commission therefore directed its staff to make recommendations to the Commission as to whether additional disclosure should be

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1 Investment Company Act Release No. 25870 (Dec. 18, 2002).

2 Rule 10b-10 under the Securities Exchange Act of 1934.

3 See "Securities Confirmations," Exchange Act Release No. 13508 at n.41 (May 5, 1977); Commission brief, Cohen v. Donaldson, Lufkin & Jenrette Securities Corp., reported as Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000) (No. 97-9159).

required or current disclosure further refined.[4] The Commission's staff currently is reviewing these issues.

III. Soft Dollars

Lastly, the report recommends that the Commission evaluate ways to provide more information that fund investors and directors could use to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars, including considering and implementing the recommendations from its 1998 soft dollar report.

The soft dollar report, among other things, recommended that the Commission amend form ADV to require more specific and meaningful soft dollar disclosure (including the availability of commission recapture to clients). The soft dollar report also recommended that the Commission require advisers who obtain soft dollar benefits from broker-dealers to maintain a detailed list of all products and services received from broker-dealers for soft dollars, and that broker-dealers provide to advisers a statement of products, services and research that they provided for the soft dollars.

The Commission has proposed amendments to Form ADV as recommended by the soft dollar report. The proposal would require an adviser who receives soft dollars to disclose the adviser's soft dollar practices and discuss the conflicts of interest that result. The proposed description of soft dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and to permit clients to evaluate the conflicts.

Additionally, the staff intends to make recommendations to the Commission concerning record keeping by including soft dollar record keeping requirements as part of an overall modernization of the record keeping requirements for investment advisers.

* * * * * * * * *

We recognize that investors need to be further educated about the fees and expenses that mutual funds charge. As part of our responsibilities in regulating mutual funds, we will consider the recommendations in your report very carefully in determining how best to inform investors about the importance of fees. Again, thank you for the opportunity to comment on your report.

Sincerely,

Paul F. Roye
Director

[4] See Press v. Quick & Reilly, Inc., 218 F. 3d 121, 132 n. 13 (July 10, 2000).

Comments from the Investment Company Institute

INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK
PRESIDENT

June 2, 2003

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment
General Government Division
U.S. General Accounting Office
441 G Street N.W.
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for providing us with the opportunity to comment on GAO's draft report entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors. Overall, we believe that the draft report thoughtfully considers several approaches to enhancing the transparency of mutual funds in ways that should assist current and prospective mutual fund shareholders in achieving their long-term investment goals.

In our view, effective regulation and extensive transparency are critically important reasons why so many Americans have come to rely on mutual fund investments to help secure their retirement and support their children's education. Yet we are also aware that simply adhering to what has worked in the past does not guarantee success in the future. The mutual fund industry therefore is committed to working with you, the U.S. Securities and Exchange Commission and leaders in Congress to support meaningful regulatory reforms that will enable mutual funds to continue to earn the trust and confidence of tens of millions of individual investors.

The draft report's discussion of mutual fund regulatory requirements is generally balanced and well informed. We do have one suggestion that, if addressed, would clarify and strengthen the report's discussion of fee disclosure practices among various financial services firms.

Specifically, we are concerned about the impression conveyed by the draft report's assessment of mutual fund fee disclosures relative to other financial services products. We believe very strongly that mutual fund fees are disclosed more thoroughly, accurately and effectively than the fees of any other financial service or product. The fact is that every individual considering a mutual fund investment, whether on his or her own or with the help of an adviser, enjoys ready access to simple and easy-to-use fee information. This information is clearly presented in a strictly regulated fee table that must appear prominently at the front of every fund prospectus. The fee table provides critical information, like the fund's expense ratio, that makes exact comparisons among funds easy and reliable. The expense ratio, along with the required example showing the impact of all of the fund's fees on a standard $10,000 investment, provides

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key information to prospective investors, as well as to the media, information providers and others who offer views about mutual fund investments.[1]

We are convinced that these fee disclosures allow individuals to make much more informed and accurate decisions about the costs of their mutual funds than do the disclosures made by other financial service firms identified in the draft report. In particular, we are not aware of any other financial product or service that is legally required to provide standardized information that reveals the exact level of all of its fees and expenses and projects their impact in dollar terms, over various time periods. While the draft report does not suggest that mutual fund fee disclosures are inferior to those of other financial services, we are concerned that the discussion of products that provide "specific dollar disclosures" could convey this impression. For example, the draft report appears to cite favorably the manner in which specific costs are disclosed to mortgage borrowers. Omitted from the discussion, however, is the fact that mortgage borrowers often receive these disclosures as part of a blizzard of paperwork requirements, and that such disclosures are typically provided at a point when borrowers have little or no ability to evaluate similar costs among competing firms. As the Administration's Assistant Treasury Secretary for Financial Institutions said in late 2001, "[a]n effective disclosure scheme requires that borrowers are able to clearly understand their mortgage's terms and conditions and that the information be reliable. On both counts our current disclosure scheme appears to be lacking."[2]

We also would like to comment on the draft report's discussion of the duties of mutual fund independent directors. We believe the discussion is quite thorough, and provides a useful analysis of the manner in which they fulfill their fee-related responsibilities to fund shareholders. However, we remain concerned that mutual fund independent directors are too rarely given the credit they deserve for guarding against self-dealing, helping sustain the mutual fund industry's culture of strong compliance with the securities laws, and helping the industry remain largely free of major scandal. While there is compelling evidence that mutual fund directors have successfully overseen mutual fund fees, in part by negotiating schedules that produce substantial automatic reductions in fee levels when a fund's assets grow, we think it is important to stress that this is not the only important function independent directors perform. The report GAO authored three years ago – before the recent renewal of public attention to corporate governance matters -- acknowledged that, "the law also places various other responsibilities [beyond fee-related duties] on fund directors that exceed those of the directors of a typical corporation."[3] More recently, an analysis in *The Boston Globe* pointed out

[1] As you note in the draft report, the system of mutual fund fee disclosure may soon be enhanced. Assuming it is adopted by the SEC, reports that are sent to mutual fund shareholders twice each year will, for the first time, prominently feature fee disclosures, including exact dollars and cents costs based on a fixed dollar amount of an investment. In addition, the SEC has proposed and may soon adopt changes to mutual fund advertising rules that will require references to the fee disclosures in fund prospectuses.

[2] "Mortgage Reform and Predatory Lending: Addressing the Challenges," Remarks of the Hon. Sheila Bair, Assistant Treasury Secretary for Financial Institutions, November 8, 2001.

[3] "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," U.S. General Accounting Office (June 2000), p. 88, fn. 9.

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that governance standards at "public companies [were] behind mutual funds [because] the Investment Company Act of 1940 spells out the legal responsibilities of funds to their investors. Public companies follow voluntary codes of ethics when it comes to governance. Second, the SEC directly regulates mutual funds [but at] public companies, it has no authority to set corporate governance rules."[4]

Again, the Institute appreciates the opportunity to offer comments on the draft report. We also look forward to working constructively and expeditiously with you, the SEC and Members of Congress as the report is reviewed and the possibility of further regulatory improvements to an effective system of mutual fund fee disclosures are considered.

Very truly yours,

Matthew P. Fink

[4] Beth Healy, "A Model of Independence," The Boston Globe, July 5, 2002.

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Acknowledgments

In addition to the individuals named above, Toayoa Aldridge, Jonathan Altshul, Marc Molino, Robert Pollard, Barbara Roesmann, David Tarosky, and Sindy Udell made key contributions to this report.

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