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before the

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Executive Summary

Americans have entrusted more than $7 trillion to the mutual fund industry, the flagship of our financial services sector. It is imperative upon Congress to take action to address longstanding conflicts of interests and structural problems in the industry. Although the Securities and Exchange Commission has taken significant steps to protect investors and promote competition in the industry, it has left the most pressing areas of needed reform untouched, either because it lacks the necessary authority or does not support reform.

The following list of initiatives sets forth the minimum steps Congress must take to restore faith in America's most important investment vehicle.

- Mutual Fund Governance
    - Congress should create a Mutual Fund Oversight Board that would have examination and enforcement authority over fund directors. The Commission does not have the authority to create an Oversight Board.
    - Congress should establish a fiduciary duty for fund directors that requires that they find that the fund is a reasonable investment in light of its investment objectives, performance history and expenses, among other things. The Commission does not have the authority to establish such a duty.
    - Congress should require that a fund's chairman be independent. The Commission does not have the authority to impose this requirement.
    - Congress should require that a fund's board be 75% independent. The Commission does not have the authority to impose this requirement.
    - Congress should prohibit former directors, officers and employees of the fund manager from serving as independent directors. The Commission does not have the authority to impose this requirement.
    - Congress should require that independent directors stand for election at least once every five years. The Commission does not have the authority to impose this requirement.

- Fee Disclosure
    - Congress should require that funds include portfolio transaction costs in a total expense ratio. The Commission has opposed such a requirement.
    - Congress should require that the dollar amount of expenses paid by a shareholder be disclosed in his periodic statement. The Commission opposes such a requirement.
    - Congress should require that fees of similarly managed funds and appropriate index funds be disclosed in the prospectus for purposes of facilitating the comparison of fund costs. The Commission does not support such a requirement.
    - Congress should prohibit funds from showing "distribution fees" as a separate line item in the fee table if that amount shown does not include

distribution expenses paid by the fund manager. The Commission does not support such a prohibition.

- Soft Dollars
  - Congress should ban soft dollars. The Commission does not have the authority to enact such a ban.

- Distribution
  - Congress should prohibit funds from using their assets to compensate brokers for sales of fund shares. The Commission does not support such a prohibition.
  - Congress should prohibit fund managers from compensating brokers in connection with sales of fund shares. The Commission does not support such a prohibition.
  - Congress should prohibit funds from offering classes of shares that would not be the best investment option for any rational investor. The Commission does not support such a prohibition.

- Fund Advertising
  - Congress should prohibit funds from advertising one-year performance for only the fund's most recent year. The Commission does not support such a prohibition.
  - Congress should require that fund advertisements that include performance information show the performance of similarly managed funds and an appropriate index fund. The Commission does not support such a requirement.
  - Congress should require fund advertisements to include fund expense ratios with equal prominence as that afforded to performance information. The Commission does not support such a requirement

- Misleading Fund Names
  - Congress should require a fund that uses the term "U.S. Government" in its name to invest the substantial part of its assets in securities that are guaranteed by the U.S. government. The Commission opposes such a requirement.

Chairman Shelby, Ranking Member Sarbanes, members of the Committee, thank you for the opportunity to appear before you today to discuss enforcement and regulatory developments in the mutual fund industry. It is an honor and a privilege to appear before the Committee today.[1]

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified before Congressional and state committees, assisted in drafting legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site. I teach securities, banking, corporate finance and contracts at the University. I also consult with counsel in mutual fund and securities cases. I was formerly an Assistant Chief Counsel in the Division of Investment Management of the Securities and Exchange Commission, and an associate in the securities practice at Wilmer, Cutler and Pickering.

Introduction

The Committee's topic today is current investigations and regulatory actions regarding mutual funds, and this is precisely where the Committee's focus should be. With more than $7 trillion in assets, mutual funds are this country's most important investment vehicle. The ongoing scandal in the mutual fund industry has demonstrated the need for significant reform in mutual fund regulation. I applaud this Committee's deliberate, thorough and careful review of the full range of issues facing fund regulators and the fund industry today.

I commend the efforts of the Commission, Attorney General of the State of New York, Secretary of the Commonwealth of Massachusetts, National Association of Securities Dealers ("NASD"), other regulators and the Justice Department for their forceful and diligent investigation and prosecution of persons and firms who have violated the law and investors' trust.

I applaud the efforts of the Commission and NASD to identify gaps in regulation and propose practical, effective solutions. As a former member of the staff of the Division of Investment Management, I am especially impressed with the Division's extraordinary accomplishments of the last four months. During this time, the Division has made more progress in reforming mutual fund regulation than in any period in its history.

As the Commission has itself noted, however, there are many important gaps in regulation that it does not have the authority to address. There are also instances in

[1] I wish to thank the assistance of Thomas Walker and Milo Mitchel in the preparation of this testimony.

which the Commission has the authority to effectuate important reforms, but it has chosen not to do so.

Where the Commission cannot or will not implement reform, legislation provides the only hope for promoting competition and adequately protecting investors. Part I of this testimony discusses the following areas where Congressional action is necessary: mutual fund governance, disclosure of fund fees, soft dollar and distribution arrangements, and misleading fund names.

Part II briefly describes other areas where reform is needed and the Commission has taken reasonable steps in the right direction. This Committee should note, however, that the Commission is divided on a number of these matters. The Committee should continue to be vigilant that a minority of the Commission does not succeed in derailing these efforts.

I. Areas Where Legislation is Necessary

A. Mutual Fund Governance

The problems with mutual fund boards fall into two categories: (1) oversight and accountability, and (2) independence and authority. Fund directors will not actively negotiate fees to keep fund costs low or assiduously fund managers' conflicts of interest without guidance as to the minimum standards to which they will be held and accountability for living up those standards. No amount of board oversight and accountability will help shareholders if directors do not have the independence and authority to effectively carry out their mandate.

i. Mutual Fund Oversight Board

As I discussed in prior testimony,[2] the mutual fund scandal reflects pervasive, systemic compliance failures that require structural changes in the way that fund boards are regulated. These failures can be partly traced to a lack of guidance regarding the minimum standards to which boards will be held in the fulfillment of their duties. ***To address this problem, Congress should create a Mutual Fund Oversight Board that would provide such guidance.***

This Board would promulgate informal, minimum standards for fund boards regarding a range of issues, including fee negotiations, fair value pricing, market timing policies, redemption policies, and distribution practices. The Board's focused mandate would give it the flexibility to respond quickly to changing circumstances and to develop an unparalleled depth of expertise regarding the role of fund directors. The model for the

[2] Testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (Nov. 6, 2003) & Testimony before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, United States Senate (Nov. 3, 2003).

Board, the Public Company Accounting Oversight Board, is widely considered one of the most effective creations of the Sarbanes-Oxley Act of 2002.[3]

The Commission does not have the authority to create a Mutual Fund Oversight Board or the capacity to provide effective guidance itself. For example, the Commission issued guidelines for the approval of 12b-1 plans in 1980 that have never been updated,[4] despite repeated promises do so.[5] The requirements of the formal rulemaking process, among other things, make it difficult for the Commission to maintain current guidelines for fund directors. The breadth of the Commission's mandate also makes it difficult to stay continually focused on the evolving responsibilities of fund boards. The Oversight Board would effectively supplement the Commission by providing the kind of current, continuous guidance necessary for boards to function effectively.[6]

The Board also would have examination and enforcement authority over mutual fund boards. It would be charged with identifying potential problems in the fund industry and ensuring that fund boards are actively addressing these problems before they spread. For example, the Board would promulgate guidance regarding current regulatory issues and best practices regarding how to deal with them, and examine boards to ensure that they are taking necessary steps to protect shareholders.

One reason that an Oversight Board is needed is that the Commission has not held fund boards accountable for misconduct. The Commission's enforcement actions in the wake of the mutual fund scandal have suffered from a major flaw. To date, not one case has been brought against an independent fund director, despite settlements involving dozens of different complexes and individuals.[7] A settlement was recently announced

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[3] See Marcy Gordon, Accounting oversight official pledges 'tough love' Kansas City Star (Nov. 21, 2003) (William McDonough, chairman of the Public Company Accounting Oversight Board, suggesting that a similar agency may be needed for the mutual fund industry).

[4] See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11414 (Oct. 28, 1980) (adopting Rule 12b-1).

[5] See, e.g., Report on Mutual Fund Fees and Expenses, Division of Investment Management, Securities and Exchange Commission, Part IV.B.2 (Dec. 2000) (recommending that the Commission issue new guidance to fund directors regarding the review and approval of 12b-1 plans).

[6] The Board would supplement, and not in any way supplant, the SEC's authority over mutual funds. In the event of any disagreement between the SEC and the Board, the SEC would have final decisionmaking authority.

[7] See, e.g., SEC v. Columbia Management Advisors, Inc. and Columbia Funds Distributor, Inc., Civ. Action No. 04 CV 10367-GAO (D. Mass., Feb. 24, 2004); SEC v. Mutuals.Com, Inc., Connely Dowd Management, Inc., Mtt Fundcorp, Inc., Richard Sapio, Eric McDonald and Michele Leftwich, Civ. Action No. 303 CV 2912D (N.D. Tex., Dec. 4, 2003); SEC v. Invesco Funds Group, Inc., and Raymond R. Cunningham, Civ. Action No. 03-N-2421 (PAC) (D. Col., Dec. 2, 2003); SEC v. Millennium Capital Hedge Fund, L.P., Millennium Capital Group, LLC, and Andreas F. Zybell, Civil Action No. CV-03-1862-PHX-FJM (D. Ariz., Dec. 2, 2003); SEC v. Security Trust Company, N.A., Grant D. Seeger, William A. Kenyon and Nicole McDermott, Civ. Action No. CV 03-2323 PHX JWS (D. Ariz., Nov. 25, 2003); SEC v.

regarding fund directors who exempted a market timer from a fund's redemption fee, yet the only punishment for such misconduct was that the directors would have to retire by the end of 2005.[8]

In 2003, the Commission agreed to settle charges with the directors of the Heartland funds with the sole penalty being a cease and desist order.[9] These directors were responsible for overseeing the worst mispricing incident in the history of the fund industry, in which shareholders in two Heartland funds lost 70% and 44% of the savings in a single day in 2000. Nonetheless, they were permitted to retain their directors' fees -- even those earned during the three years that the case was pending. In dissent, Commissioner Campos stated:

> "the investigation in this case presents significant evidence, if proven at trial, of directors, having unambiguous information that funds' NAV is significantly overstated and that the funds were illiquid, failing to act in any meaningful way to protect shareholder interests."[10]

Gary L. Pilgrim, Harold Baxter and Pilgrim Baxter & Associates, Ltd., Civ. Action No. 03-CV-6341 (E.D. Penn., Nov. 20, 2003); SEC v. Justin M. Scott and Omid Kamshad, Civ. Action No. 03-12082-EFH (D. Mass., Oct. 28, 2003); In the Matter of Massachusetts Financial Services Co., John W. Ballen and Kevin R. Parke, Investment Company Act Rel. No. 26347 (Feb. 5, 2004); In the Matter of Paul A. Flynn, Investment Company Act Rel. No. 26345 (Feb. 3, 2004); In the Matter of Alliance Capital Management, L.P., Investment Company Act Rel. No. 26312 (Dec. 18, 2003); In the Matter of James Patrick Connelly, Jr., Investment Company Act Rel. No. 26209 (Oct. 16, 2003); In the Matter of Theodore Charles Sihpol, III, Administrative Proceeding File No. 3-11621 (Sep. 16, 2003). None of the individuals named in these complaints was an independent fund director.

[8] The Commission and Attorney General for the State of New York reported that they had reached a settlement with Bank of America in which "Bank of America has also agreed to implement certain election and retirement procedures for the Nations Funds trustees that will result in the replacement of the Nations Funds trustees within one year." SEC Press Release 2004-33 (Mar. 15, 2004); see Press Release, New York Attorney General (Mar. 15, 2004) ("Under a specific provision of the agreement, eight members of the Board of Directors of Nations Funds, BOA' s mutual fund complex, will resign or otherwise leave the board in the course of the next year"); see also Beth Healy, Pressure to Quit Riles Trustees, Boston Globe (Mar. 17, 2004) ("Under the deal, Bank of America promised the regulators it would ''use its best efforts' to persuade eight of the 10 Nations Funds directors to leave the board by May 1, 2005, . . ."). Bank of America does not have the legal authority to set procedures for the board of the Nations Funds, however, and suggesting that Bank of America has such authority effectively undermines the principle that a fund's board is independent of the fund manager. See Yuka Hayashi, Directors' Treatment In Bk Of Amer Settlement Causes Stir, Wall Street Journal (Mar. 19, 2004) (quoting Allan Mostoff, president of the Mutual Fund Directors Forum: "'I think a lot of people are confused.'") The Nations Funds trustees reportedly have denied that they plan to give up their positions, thereby suggesting that not even this *de minimis* "penalty" will stand. See Healy, supra (directors may fight agreement to by Bank of America); Christopher Oster & Tom Lauricella, Bank of America Likely Will Face Trustees' Review, Wall Street Journal (Mar. 19, 2004) (same); see generally Mark Boslet, Spitzer Reiterates Vow To Watch Mutual Fund Board Members, Wall Street Journal (Mar. 19, 2004).

[9] In the Matter of Jon D. Hammes, Albert Gary Shilling, Allan H. Stefl, and Linda F. Stephenson, Investment Company Act Rel. No. 26290 (Dec. 11, 2003).

[10] Id. (dissent of Commissioner Roel C. Campos).

In view of the extraordinary level of misconduct involved in the Heartland matter, and the impotence of the penalty imposed, it is difficult to imagine the Commission justifying any sanction on any fund director in connection with current mutual fund scandal.

For 34 years, the Commission has abdicated its statutory duty to prosecute funds and directors for excessive fees. Section 36(b) of the Investment Company Act, which was passed in 1970, provides that a fund director and fund manager shall have a fiduciary duty with respect to the fees charged by the fund, and tasks the Commission with bringing actions against directors and fund managers who violate this duty. The Commission has never brought a case for excessive fees.[11]

The Mutual Fund Oversight Board would remedy the Commission's failure to hold independent directors accountable by promulgating and enforcing minimum standards of conduct for fund boards.

The Board would be financed from assessments on mutual fund assets to provide an adequate and reliable source of funding. Board members would be persons with specific expertise in the fund industry and would be appointed for five year terms by the Commission to ensure their independence. This model, which ideally combines the strengths of independent, expert oversight with the advantages of a reliable and adequate funding source, would do more to restore confidence in the fund industry and protect fund shareholders than any changes in the makeup, qualifications or authority of fund boards.

ii. Board's Fiduciary Duty

Creating a Mutual Fund Oversight Board alone will not be sufficient to ensure that fund directors are held accountable for failing to protect the interests of shareholders. Under current federal law, the only express fiduciary duty that applies to directors is limited to fees paid to the fund manager.[12] When a fund's high fees are attributable not to fees paid to the fund manager, but to fees paid on account of the administrative expense of operating a small fund, this fiduciary duty is not triggered. Thus, a fund director's decision to offer a fund with an 8% or 10% expense may be reviewable only under a toothless state law standard.[13] Congress should enact legislation that creates a fiduciary

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[11] I am aware of two cases that the Commission has brought under Section 36(b), neither of which involved an excessive fees claim. See In the Matter of American Birthright Trust Management Company, Inc., Litigation Rel. No. 9266, 1980 SEC LEXIS 26 (Dec. 30, 1980); SEC v. Fundpack, Inc., No. 79-859, 1979 WL 1238 (D.D.C., Aug. 10, 1979).

[12] Investment Company Act Section 36.

[13] For example, my research assistant was able to identify 18 funds in Morningstar's database with expense ratios in excess of 5%, yet the average management fee for these funds was only 1.06%, and only one fund's expense ratio exceeded 1.29%.

duty for fund directors that would require, for example, that directors affirmatively find that the fund could be a reasonable investment in light of its investment objective, performance history and expenses. ***The Commission does not have the authority to establish such a fiduciary duty.***

iii. Directors' Independence and Authority

As discussed above, recent frauds demonstrate systemic weaknesses in mutual fund compliance. These systemic weaknesses necessitate the creation of a regulatory structure, such as a Mutual Fund Oversight Board, that is designed to ensure that fund boards of directors fulfill their responsibility to protect shareholders. A fund board cannot protect shareholders, however, unless its independent members have the independence and authority necessary to counter the influence of the fund manager.

In order for independent directors to provide oversight that is truly free of the fund manager's control, the board's chairman must be independent, the board must be at least 75% independent, and the definition of independent director must be amended to exclude former directors, officers, and employees of the fund manager. In addition, independent directors should have to stand for election at least every five years. Independent fund directors often are appointed by the fund manager or nominated as the result of a relationship with the fund manager and never stand for election because funds – unlike publicly traded companies – are not required to elect directors periodically. Finally, as suggested by the Commission, Congress should require that independent fund directors perform a self-evaluation at least annually and meet at least quarterly in a separate session, and expressly authorize independent directors to hire their own staff.

The necessity of these reforms has been well-documented over the last year -- in a wide range of contexts including statements by members of Congress, Commission releases, and Congressional testimony -- that does not need repeating here.[14] ***What needs to be emphasized here is that, contrary to popular perception, the Commission does not have the authority to enact these reforms.*** The Commission does not have the authority to require a fund to have an independent chairman or a 75% independent board, to hold separate meetings of independent directors, or to require annual self-evaluations. These reforms can only be accomplished through legislation.

Although the Commission has proposed certain fund governance rules,[15] these will not be remotely as effective as legislation for two reasons. ***First, the Commission***

[14] See, e.g., Letter from Senator Daniel Akaka, Representative Richard Baker, Senator Peter Fitzgerald, Senator Carl Levin, and Representative Michael Oxley to William Donaldson, Chairman, Securities and Exchange Commission (Mar. 11, 2004); Letter from Representative Richard Baker and Representative Michael Oxley to William Donaldson, Chairman, Securities and Exchange Commission (July 30, 2003); Investment Company Governance, Investment Company Act Release No. 26323 (Jan. 15, 2004); Testimony, supra note 2; Letter from Mercer Bullard to Richard Baker, Chairman, and Paul Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Financial Services Committee (July 9, 2003).

[15] See Investment Company Governance, id.

has excluded critical reforms from its proposal. The Commission's proposal includes no provisions that would prevent a former director, officer or employee of the adviser from being considered to be an independent director. Nor does the Commission's proposal include any provision regarding the election of independent directors, thereby effectively leaving their election in the hands of fund management. ***Only if Congress passes legislation will independent directors have to be truly independent and at least periodically meet with the approval of fund shareholders.***

Second, the Commission's proposal does not effectively require fund boards to be 75% independent and have an independent chairman. In fact, as the Commission concedes, the proposed rules "would apply only to funds that rely on one or more of the Exemptive Rules."[16] The Exemptive Rules to which the Commission refers are rules that many funds may, but are not required to, rely on in the operation of their funds. For example, a fund can charge a 12b-1 fee only in compliance with Rule 12b-1. The Commission proposes to amend Rule 12b-1, among other Exemptive Rules, to require that funds relying on Rule 12b-1 comply with certain fund governance provisions.[17] If a fund cancels its 12b-1 plan, however, it will be able to replace its independent chairman with an officer of the fund manager and reduce the percentage of independent directors from 75% to 40% (the statutory minimum), thereby returning control of the board and fund in the hands of the fund manager.

The Commission claims that, "[b]ecause almost all funds either rely or anticipate someday relying on at least one of the Exemptive Rules, we expect [the governance conditions] would apply to most funds."[18] This is no doubt true, but it is not "most funds" at which these provisions are targeted. These governance measures are targeted at funds where the likelihood of fund manager overreaching is greatest. The Commission's proposal has a fatal Achilles' heel. When the independence of the board is most critical, that is, when there is a conflict between the board and the fund manager, the board will know that the manager need only cease relying on the Exemptive Rules to dismiss the independent chairman and eviscerate the independent majority. The question is not whether, at any given time, "most funds" have truly independent boards, but whether fund directors have the requisite independence and authority when they most need it – when they are challenged by the fund manager.

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[16] Id.

[17] If the Commission could really impose "requirements" in this way, then it could effectively re-write the entire Investment Company Act simply by amending the Exemptive Rules and enact every reform discussed in this testimony, but the Commission has expressly conceded that its authority is not so broad. See, e.g., Ian McDonald, SEC's Roye Wades Through New Rules for Mutual Funds, Wall Street Journal Online (Mar. 19, 2004) (interview with Paul Roye, Director, SEC Division of Investment Management, in which he acknowledges that the Commission does not have the authority to ban soft dollars).

[18] Investment Company Governance, supra note 14.

This is precisely the scenario that unfolded when the independent directors of the Yacktman Funds confronted Don Yacktman, the fund manager. At the time, the Funds charged a 12b-1 fee under Rule 12b-1, which required that the board be "selected and nominated" by the independent directors. Mr. Yacktman engineered a proxy battle that led to the ouster of the independent directors and the installation of an "independent" slate of directors that he selected and nominated. No longer able to rely on Rule 12b-1, Mr. Yacktman cancelled the fund's 12b-1 plan. The "selected and nominated" provision that was intended to ensure the independence of the board was swept aside at the very moment when it was most needed. The lesson from the Yacktman experience is that the Commission's proposal will only guarantee an independent chairman and a 75% board as long as the fund manager does not object. The independent chairman and independent director majority will know that they serve at the whim of the fund manager. Only legislation can guarantee that a board must be 75% independent and that its chairman is not under the control of the fund manager.

B. Fee Disclosure

As the Commission has recognized, fund fees "can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years."[19] Notwithstanding the importance of fees, "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern."[20]

In many respects, investors' lack of understanding is directly attributable to the way in which fees are disclosed. The current expense ratio is misleading because it excludes what can be a fund's single largest expense: portfolio transaction costs. 12b-1 fees are misleading because they create the impression that funds that do not charge 12b-1 fees therefore do not incur distribution expenses. Fund fees are disclosed in dollars based on hypothetical amounts, rather than a shareholder's actual costs, and the location of this disclosure makes it unlikely that investors will pay attention to this information. Nowhere are funds required to put their fees in context by comparing them to fees charged by index funds and comparable managed funds. ***The Commission has failed to support or actively opposed reforms designed to address each of these problems.***

i. Portfolio Transaction Costs

The current expense ratio, which to be accurate should be referred to as the "partial expense ratio," excludes portfolio transaction costs. Portfolio transaction costs are the costs incurred by a fund when it trades its portfolio securities. Some portfolio transaction costs are easy to measure. For example, commissions paid by funds are

[19] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, Part I.B (Dec. 18, 2002).

[20] Id. (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns").

disclosed as a dollar amount in the Statement of Additional Information, which is provided to shareholders only upon request. Other portfolio transaction costs must be measured indirectly, such as spread costs, but their existence and their substantial impact on fund expenses is no less certain.

The Commission concedes that portfolio transaction costs constitute a significant expense for fund shareholders. "[F]or many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points**.**"[21] A recent study commissioned by the Zero Alpha Group, a nationwide network of fee-only investment advisory firms, found that commissions and spread costs for large equity funds, the expenses and turnover of which are well below average, exceeded 43% of the funds' expense ratios.[22] A recent survey by Lipper identified at least 86 equity funds for which the total amount paid in commissions alone exceeded the fund's total expense ratio, in some cases by more than 500%.[23]

Notwithstanding the significance of portfolio transaction costs, the Commission has opposed including these costs in the mutual fund expense ratio. In a June 9, 2003, memorandum, the Commission demonstrated that it had already prejudged the issue of the disclosure of portfolio transaction costs.[24] It concluded that "it would be inappropriate to account for commissions as a fund expense" and unequivocally answered the question of "whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe that the answer is 'no.'"[25] Only after reaching this decision has the Commission proceeded with the formality of issuing a concept release asking for comment on disclosure of portfolio transaction costs, apparently for the purpose of considering any alternative other than full

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[21] Concept Release at Part I (citing John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management, at 10 (Aug. 30, 2001) (available at http://finance.wharton.upenn.edu/~edelen/PDFs/MF_tradexpenses.pdf). "These estimates ***omit the effect of market impact and opportunity costs***, the magnitude of which may exceed commissions and spreads." Id. (emphasis added).

[22] See Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions at 9 (Jan. 2004) (available at http://www.zeroalphagroup.com/headlines/ZAG_mutual_fund_true_cost_study.pdf). Exhibit A to this testimony shows the expense ratios, brokerage commissions, and spread costs for total costs for eight of the funds studied.

[23] See Sara Hansard, Lipper Data Miffs Some Firms, Investment News at 3 (Feb. 23, 2004) (173 funds paid commissions in excess of 0.99% of net assets, which is the dollar-weighted average expense ratio for equity funds).

[24] Memorandum from Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, (June 3, 2003) (available at http://financialservices.house.gov/media/pdf/02-14-70%20memo.pdf) ("Donaldson Memorandum").

[25] Id. at 28 &30.

inclusion in the expense ratio.[26] Thus, without Congressional action, there is little doubt that the Commission will continue to require funds to use the current, partial expense ratio. ***Congress should require that funds include portfolio transaction costs in a total expense ratio.***

The Commission's position is flatly inconsistent with its responsibility to provide the information that the marketplace needs to promote price competition. By requiring funds to use the partial expense ratio, the Commission is effectively forcing the public to choose funds based on the Commission's view of the proper measure of fund costs. The Commission's decision to second-guess the market by deciding for investors which kinds of information they are capable of understanding contradicts basic market principles and is inconsistent with our capitalist system of free enterprise.

Investors logically look to the Commission to provide standardized reporting of expenses, and it is appropriate for the Commission to provide this service. But once the Commission has provided the important service of providing standardized information, it should remove itself from the market-driven determination of which information provides the best measure of a fund's true costs.

The Commission has argued that including portfolio transaction costs might distort fund managers' behavior.[27] As noted above, this is not for the Commission to judge. The marketplace should decide which expense ratio – the partial expense ratio or a total expense that includes portfolio transaction costs – is the best measure of a fund's costs.

Furthermore, it is the partial expense ratio that distorts fund managers' and investors' behavior alike. The partial expense ratio distorts fund managers' behavior by not holding them accountable for their decisions to spend a substantial amount of fund assets on trading securities.

As illustrated in Exhibit A, for example, the Commission believes that investors should only be told that the expense ratio for the PBHG Large Cap Fund is 1.16%, and that they should not be told that when commissions and spread costs are included, the Fund's expense ratio is 8.59%.[28] The true cost of that Fund is more than seven times the amount shown in the Commission's expense ratio! How can it be in the best interests of investors or consistent with free market economics to require, much less permit, the Fund to show its total costs of 1.16%? The partial expense ratio is misleading because it

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[26] See Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313 (Dec. 19, 2003) ("Concept Release").

[27] See, e.g., Donaldson Memorandum at 30-31, supra note 24.

[28] Exhibit A also shows that, when commissions and spread are included, the expenses of the Strong Discovery Fund rise from 1.50% to 4.50%, the CGM Focus Fund from 1.20% to 4.48%, and the RS Mid Cap Opportunities Fund from 1.47% to 7.52%.

impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership.

The data in Exhibit A does not reflect outliers, but randomly selected examples from funds with more than $100 million in assets. If smaller funds with high turnover were considered, the differentials would be so large as to render the Commission's partial expense ratio fraudulent. For example, Lipper reports that the Rydex Telecom Fund's commissions for the fiscal year ending March 31, 2003, equaled 8.04% of assets. By applying the Zero Alpha Group study's methodology of estimating spread costs, we can estimate that total spread costs during that period equaled 8.75% of assets. Thus, whereas the Commission tells us that the Rydex Telecom Fund's is only 1.37%, its true costs are 18.16%, or 13 times higher.[29] The Commission's partial expense ratio distorts investors' behavior because investors obviously would make different investment decisions if they knew the true costs of owning certain funds.

The Commission's partial expense ratio also distorts managers' behavior because it creates an incentive for them to pay for non-execution expenses with fund commissions. Under current law, fund managers can payer higher commissions – that is, more than it would cost merely to execute the fund's trades – in return for non-execution services. By paying for these non-execution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not – even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that "[t]he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services."[30]

Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized,

> "[s]oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers."[31]

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[29] The Lipper data show that at least 31 funds' expense ratios would exceed 10% if they include commissions and spread costs.

[30] Concept Release at Part III.A, supra note 26.

[31] Donaldson Memorandum at 36, supra note 24. Regarding directed brokerage, the Commission recently stated: "We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders." Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (Feb. 24, 2004).

The continued concealment of portfolio transaction costs permits the soft dollar conflict to operate virtually unchecked by market forces, whereas including portfolio transaction costs in a total expense ratio would, at least, permit the marketplace to judge the efficacy of soft dollar arrangements. If Congress does not take steps to eradicate soft dollars, at least it can require that these costs be disclosed so that the market can reach its own judgments regarding their efficacy.

ii. Dollar Disclosure of Fees

Under current disclosure rules, funds are not required to disclose to investors how much they pay in fees. Many other financial services documents show investors exactly how much they are paying the service provider, including bank statements, insurance bills, credit card statements, mortgage loans and a host of other documents. But mutual funds provide only an expense ratio (and a partial one, at that, see supra) and the dollar amount of a hypothetical account.

Congress should require that funds provide individualized dollar disclosure of fund expenses in shareholder statements, as proposed by the Government Accounting Office.[32] This requirement is necessary for two reasons. First, although the expense ratio is appropriate for providing comparability across different funds, it does not pack the same import as a dollar amount. Providing investors with the amount in dollars that they actually spent will give concrete form to an indefinite concept and make investors consider more fully the costs of different investment options.

Second, placing the dollar amount of expenses in the shareholder statement will direct shareholders' attention to the actual costs of fund ownership. No document is more likely to be read than a shareholder statement that shows the value of the shareholder's account and transaction activity during the period. Whereas the prospectus and shareholder report typically go directly from the mailbox to the trash can, even the most uninformed investors normally open their statements to check on the status of their accounts. There is no better way to draw shareholders' attention to the costs of investing than to require that the dollar amount of fees for the period be disclosed next to the value of the investor's account.

Some members of the fund industry have opposed informing investors about the actual costs of their fund investments on the grounds that doing so would be too costly and might mislead investors.[33] It appears that MFS Investment Management, the 12th largest mutual fund manager in America, disagrees. Earlier this month, MFS announced

[32] Government Accounting Office, Mutual Funds: Information On Trends In Fees And Their Related Disclosure (March 12, 2003).

[33] See, e.g., Testimony of Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Co. and Chairman, Investment Company Institute, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, at 16-17 (June 18, 2003).

that it would begin providing fund shareholders with a quarterly statement of their actual fees.[34]

The Commission opposes disclosure of shareholders' actual costs and opposes including dollar disclosure in shareholder statements. The Commission recently concluded its consideration of a proposal to require funds to disclose individualized costs in shareholder statements by expressly rejecting both concepts. Instead, the Commission decided to require disclosure of the hypothetical fees paid on a $1,000 account in the shareholder report, despite the facts that the hypothetical fees paid on a $10,000 account are already disclosed in the prospectus, and shareholders who most need to have their attention directed to the fees that they pay are least likely to read the shareholder report. ***In view of the Commission's, express opposition to effective disclosure of actual fees paid by shareholders, shareholders will receive disclosure of their actual fees in shareholder statements only if Congress requires funds to provide that information.***

iii. Fee Comparisons

Congress should take additional steps to promote price competition in the mutual fund industry by requiring that funds disclose fees charged by comparable funds and, for managed funds, the fees charged by index funds. Without any context, current fee disclosure provides no information about whether a fund's fees are higher or lower than its peers. Current disclosure rules also do not show the premium paid to invest in a managed funds as opposed to an index fund. Requiring comparative information in the fee table would enable investors to consider a fund's fees in context and evaluate how they compare to fees across the industry.

iv. Distribution Fees

The Commission currently requires that 12b-1 fees be disclosed on a separate line that describes those fees as "distribution fees." It does not require that the fee table show the amount spent on distribution by the fund manager out of its management fee. This is inherently misleading, as investors often use the presence of 12b-1 fees as a negative screen that they use to avoid paying any distribution fees. In fact, investors in non-12b-1 fee funds may actually pay as much or more in distribution expenses than some investors in 12b-1 fee funds.[35]

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[34] MFS to Make Sweeping Reforms to Tell Investors About Fees, Wall Street Journal Online (Mar. 16, 2004) ("'We want people to know that although we've had a difficult time lately, we'll do whatever's necessary to put shareholders first,' [MFS chairman Robert] Pozen said.").

[35] In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "the idea that investors ought to prefer the funds that don't tell what they're spending on distribution over the ones that do is nonsense. You know, if you're spending money on distribution, say it. If you're not spending money on distribution don't say it; but don't pretend that there are no expenses there for a fund that doesn't have a 12b-1 plan." Conference on the Role of Investment Company Directors, Washington, D.C. (Feb. 23 & 24, 1999) (Haaga was not ICI Chairman at this time).

Congress should overrule the Commission's position and require that, if distribution fees are stated separately in the fee table, they must reflect all distribution expenses paid by a fund, directly or indirectly. Alternatively, Congress should require that fund expenses be displayed in a pie chart that shows how much of a fund's fees were spent on each type of service. The Commission's current fee table is misleading and understates the amount of fund assets spent on distribution.

C. Soft Dollars

Congress should ban soft dollars. The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded $1 billion in 1998.[36] An executive with American Century Investment Management has testified that the research component of soft dollar commissions costs six times the value of the execution component.[37]

Soft dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for themselves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft dollar benefits.[38]

Soft dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.[39] Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly

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[36] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998).

[37] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (Mar. 12, 2003).

[38] Id. at 2 (the statutory safe harbor permitting soft dollars arrangements "encourages investment managers to use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager")

[39] See Investment Company Act Section 17(e); Inspection Report at 38, supra note 36.

disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio. Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

The Commission has frequently recognized but declined to address the problem of soft dollars. As discussed above, the Commission is opposed to including portfolio transaction costs in funds' expense ratios, which would have the benefit of enabling the market to determine for itself the efficacy of soft dollar arrangements. The Commission previously proposed a rule that would require that soft dollars costs be quantified, but decided against adopting it.[40] When the Commission staff last evaluated soft dollar arrangements in 1998, it concluded that additional guidance was needed in a number of areas.[41] For example, the staff found that many advisers were treating basic computer hardware -- and even the electrical power needed to run it -- as research services qualifying under the Section 28(e) safe harbor.[42] The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars, but it has failed to do so.

In fact, the only formal action that the Commission has taken in recent years is to ***expand the use of soft dollars***. In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions."[43] This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that section 28(e) "does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."[44]

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[40] Donaldson Memorandum at 13-17, supra note 24. Fidelity recently recommended that the Commission reconsider its decision not to require the quantification of soft dollar costs. Ann Davis, Fidelity Wants Trading Costs to Be Broken Down, Wall Street Journal (Mar. 15, 2004).

[41] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998) ("Section 28(e) Report").

[42] Id. at Section V.C.4.

[43] Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Rel. No. 45194 (Dec. 27, 2001).

[44] Investment Advisers Act Release No. 1469 (February 14, 1995).

Although the Commission has, once again, suggested that intends to narrow the scope of soft dollars, its recent history suggests that Congressional action is necessary. ***In any case, the Commission lacks the authority to ban soft dollars.***

There is no better evidence that the time has come to ban soft dollars than the recent recognition of the insidious nature of this practice by members of the fund industry. Earlier this month, MFS Investment Management announced that it has ceased the payment of soft dollars.[45] The chairman of the board of the Putnam Funds, America's sixth largest fund complex, recently announced that the Funds intended to severely restrict the use of soft dollars and to consider a complete ban.[46] Vanguard, the nation's second largest fund complex, has traditionally shunned soft dollars.[47] American Century, the nation's third largest fund complex, uses soft dollars only for research, and not for other non-execution services.[48]

The explanations provided by fund directors and executives reflect the insidious nature of soft dollars. In addressing the fact that soft dollars enable fund managers to use the fund's money to pay for research used by the manager, the independent chairman of the Putnam Funds stated that "[t]he best decisions get made when you buy services with your own money."[49] Similarly, MFS' chairman, Robert Pozen,

> "sees the soft-dollar funnel as a lucrative one for brokers, but one that hides the true cost of such services to shareholders. 'It's all camouflaged,' said Mr. Pozen, a former associate general counsel of the SEC. Now, he added, 'If we want something, if we think it's valuable, we will pay cash.'"[50]

A Fidelity executive acknowledged the pro-competitive advantage of a ban on soft dollars, stating: "'[w]e don't rule out a competitive environment through which all research is acquired through cash rather than commissions.'"[51]

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[45] John Hechinger, MFS Ends Soft Dollar System on Concerns over Ethics, Wall Street Journal (Mar. 16, 2004).

[46] Id.

[47] Id.

[48] Id.

[49] Id. (quoting John Hill).

[50] Id.

[51] Landon Thomas, Jr., Mutual Fund Tells Wall Street It Wants à la Carte Commissions, New York Times (Mar. 16, 2004).

The difficulty for fund firms, however, is that without a statutory ban on soft dollars they may suffer a competitive disadvantage MFS estimates that paying for its own research will reduce its advisory fees.[52] Fidelity estimates that of the $1.1 billion in commission it paid in 2003, $275 million paid for soft dollar research.[53] It is unrealistic to expect these fund managers to maintain the high road at the expense of reduced advisory fees, while other fund managers continue to pay their own research expenses through soft dollars rather than out of their own pockets.

D. Distribution

i. 12b-1 Fees and Revenue Sharing

When Congress enacted the Investment Company Act of 1940, it expressly prohibited fund managers from using fund assets to finance the distribution of the fund's shares. Section 12(b) of the Act recognized the inherent conflict of interest between the manager's desire to increase fund assets in order to increase its fees on the one hand, and the fund's desire to hold down costs on the other hand. Unfortunately, the policy underlying Section 12(b) has long been abandoned, as fund assets are used for a wide range of distribution expenses that benefit fund managers at the expense of fund shareholders.

The policy of separating the product from its distribution was first abandoned by the Commission when, after a prolonged review, it adopted Rule 12b-1 in 1980.[54] In the 1970s, mutual funds experienced periods of net redemptions that prompted fund managers to lobby the Commission to permit the use of fund assets to finance the distribution of the funds' shares.[55] Fund managers argued that net redemptions resulted in increased costs and that the financing of distribution by the fund would help reduce or eliminate net redemptions.[56]

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[52] MFS Ends 'Soft Dollar' System, supra note 35.

[53] Fidelity Wants Trading Costs to Be Broken Down, supra note 40.

[54] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11414 (Oct. 28, 1980)(adopting Rule 12b-1); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 10862 (Sep. 7, 1979) (proposing Rule 12b-1) ("12b-1 Release 10862"); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 10252 (May 23, 1978) (advance notice of rulemaking) ("12b-1 Release 10252"); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 9915 (Aug. 31, 1977)(rejecting requests to permit funds to finance their distribution expenses)("12b-1 Release 9915"). The Commission held public hearings on the bearing of distribution expenses by mutual funds on November 17, 18, 22 & 23, 1976. See Investment Company Act Rel. No. 9470 (Oct. 4, 1976) (announcing hearings on appropriateness of funds' bearing their distribution expenses); see also Vanguard Group, Inc., et al., Investment Company Act Rel. No. 9927 (Sep. 13, 1977)(order of temporary exemption and notice and hearing on application for exemption to permit funds to bear their distribution expenses).

[55] 12b-1 Release 10252, supra n.3.

[56] 12b-1 Release 10252, supra at 1.

The Commission initially rejected these arguments,[57] but ultimately relented, provided that certain conditions were observed. For example, the Commission required that the fund's independent directors approve the 12b-1 plan.[58] Among the factors that the Commission said a fund's directors should consider when evaluating whether to adopt or renew a 12b-1 plan was the plan's effectiveness in remedying the problem that it was designed to address, i.e., increased costs resulting from net redemptions.[59]

The Commission's most significant concern regarding 12b-1 fees was the conflict of interest that they created between the fund and its adviser.[60] The Commission feared that 12b-1 fees would result in higher advisory fees and the fund's adviser would not share the benefits of asset growth.[61] Some would argue that this is precisely what has happened, with any growth-based economies of scale realized from 12b-1 fees being pocketed by fund managers and not shared with fund shareholders.[62]

Of course, this analysis goes primarily to the use of 12b-1 fees for marketing the fund, which is what Rule 12b-1 was intended to permit. It does not address the ways in which 12b-1 are actually used today and that were wholly unanticipated by the Commission when Rule 12b-1 was adopted. According to the Investment Company Institute, only 5% of 12b-1 fees are spent on advertising and sales promotion, whereas 63% of 12b-1 fees are spent on broker compensation.[63]

The use of fund assets to compensate brokers is precisely what Section 12(b) was intended to prohibit. This practice puts the fund squarely in the position of underwriting its own securities. The fund's assets are used to incentivize brokers to recommend the

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[57] See 12b-1 Release 9915.

[58] See Rule 12b-1(b)(2).

[59] See 12b-1 Release 10862, supra at 11-13 (when renewing a 12b-1 plan, the directors should consider "whether or not the plan was working as anticipated").

[60] See 12b-1 Release 10252, supra at 3; 12b-1 Release 10862, supra at 9. Indeed, the Dreyfus Corporation, a major fund complex, argued against Rule 12b-1 on the ground that that no amount of protections "could ameliorate the adviser's conflict of interest." 12b-1 Release 10862, supra at 6.

[61] See 12b-1 Release 10252, supra at 3 (proposing that the advisory fee be a fixed amount to prevent the adviser from confiscating benefits derived from 12b-1 fees); Donaldson Memorandum, supra at 70-71 ("When a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.").

[62] Report on Mutual Fund Fees and Expenses, at Part F, supra note 5 (noting funds whose assets exceed their highest breakpoint).

[63] Use of Rule 12b-1 Fees by Mutual Funds in 1999, Investment Company Institute, 9 Fundamentals 2 (April 2000). Funds spend the other 32% of 12b-1 fees on administrative services. Id.

fund over competing funds. The lesser the quality of the fund, the greater the pressure on the fund and its manager to pay brokers more to sell the fund.

This irreconcilable conflict is mirrored on the distribution side of the business. When brokers are paid by the funds, rather than their customers, they have an incentive to recommend the fund that offers the biggest payout, rather than the fund that will provide the best investment for their customers.[64] There is another incentive for brokers to favor arrangements whereby they are compensated by funds, and that is the fact that the compensation from the fund is not transparent. Whereas the payment of a front-end load is relatively evident to the investor, the payment of a 12b-1 fee is not. It is even less clear that the already opaque 12b-1 fee is ending up in the broker's pocket. For this reason, brokers and investors have begun to favor classes of fund shares where the broker is compensated by the fund, regardless of whether that class is in the best interests of shareholders.[65]

Thus, the Commission has created a distribution compensation structure that is directly at odds with the interests of investors and the Investment Company Act. Rather than tying brokers' compensation to their relationships with their customers, where the Investment Company Act requires that it be placed, the Commission has tied brokers' compensation to their relationships with the funds, where the Investment Company Act expressly forbade its placement.

Congress should reaffirm the supremacy of Section 12(b) and prohibit funds from compensating brokers for selling fund shares. Although this will necessarily entail the repeal of Rule 12b-1, it will in no way limit the ways in which investors can choose to pay their brokers. It will simply require that however brokers are compensated – through a front-end load, back-end load, level-load, or any combination thereof – they are compensated by their customers, not by the funds. Thus, if a customer chooses to pay his broker on an installment basis, at 0.50% each year, for example, that amount would be paid by the customer directly or deducted from his fund account.

In addition, Congress should prohibit fund managers from compensating brokers in connection with the purchase or sale of fund shares. For decades, the Commission has permitted fund managers to circumvent the prohibition against fund assets being used for distribution by endorsing the fantasy that managers' payments to brokers are made out of the managers' "profits," and not out of the fees they receive from the funds.[66]

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[64] See Laura Johannes and John Hechinger, Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds, Wall Street Journal (Jan. 9, 2004); see also In the Matter of Morgan Stanley DW Inc., Exchange Act Rel. No. 48789 (Nov. 17, 2003).

[65] See Complaint, Benzon v. Morgan Stanley, No. 03-03-0159 (M.D. Tenn.).

[66] This has created the ludicrous situation, embodied in Commission positions, in which fund directors technically are prevented from reviewing the manager's payments to brokers. Under Section 36(b) of the Act, fund directors are supposed to consider the manager's profitability, which means that they must ignore distribution payments or risk being accused of reducing the manager's profitability to make the

One might argue that, to maintain perfect legislative coherence, Congress should also prohibit fund managers from paying for distribution that is not connected to sales and purchases, that is, distribution that does not compensate the broker for distribution services provided to its customer. I disagree. The conflict is substantially reduced in this situation because the fund manager's and the fund's interests are generally aligned. General marketing payments do not create a direct incentive for brokers to favor one fund group over another. General marketing does what advertising for decades has been shown to do: promote competition. Indeed, by locating these payments in the management fee, the manager will be spending its own money and accordingly will have an incentive to minimize costs. With an express requirement that independent fund directors evaluate the efficacy of fund manager expenditures on marketing and determine that resulting economies have been shared with fund shareholders, expressly permitting fund managers to use the management fee to pay for marketing would be appropriate.

ii. Misleading Fund Share Classes

Mutual funds often offer several classes of shares that reflect different ways of paying for distribution services. Typically, Class A shares carry a front-end load, Class B shares a back-end load, and Class C shares carry a level load. An investor is usually better off buying Class A shares if he intends to hold his shares for the long-term, and Class C shares if he may sell in the short-term. When Class B shares are best option, it is for the shareholder who holds for the mid-term. In some cases, however, there is virtually no shareholder for whom Class B shares are the best option.[67]

The Commission does not prohibit funds from offering Class B shares, even when there is no shareholder for whom Class B shares could be the best investment option. The Commission even rejected a rule amendment that would have required that funds illustrate in the prospectus the relative costs of each class of shares. Following the Commission's lead, a court held in January 2004 that, even assuming that there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.[68]

It is unconscionable that under current Commission positions a fund can offer a class of shares that would not be the best investment for any rational investor. Congress should require that multi-class funds illustrate, in a graphic format, the costs

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management fee seem more palatable. See Remarks of Robert Pozen, President and Chief Executive Officer, Fidelity Management & Research, at the Roundtable on the Role of Independent Investment Company Directors, Washington, DC (Feb. 23, 1999) ("The second deficiency is one that the SEC has chosen to take a position on that I have always believed ***doesn't make any sense***. The SEC's position is that independent directors are not allowed to see sales and promotional expenses. They're not allowed to consider them, unless there is a 12b-1 plan in place." (emphasis added)).

[67] See Complaint, Benzon v. Morgan Stanley, No. 03-03-0159 (M.D. Tenn.).

[68] See Benzon v. Morgan Stanley, Morgan Stanley, 2004 WL 62747 (M.D. Tenn.).

of investing in different classes over a 15-year period. In addition, Congress should require that the fund's independent directors find, subject to a fiduciary duty as described above, that each class of shares offered could be a reasonable investment alternative.

E. Fund Advertising

Throughout the late 1990s, the Commission frequently berated the fund industry for misleading investors by advertising short-term performance.[69] Funds with short life-spans routinely advertised one-year, sometimes even two- and three-year annualized investment returns in excess of 100%. With the crash of the stock bubble in 2000, the Commission's concerns were validated, as many of these funds experienced huge losses, in some cases in excess of 70% of their value.

The Commission's actions have not reflected its words, however. In September 2003, the Commission adopted advertising rules that utterly failed to address the very problems that it had identified in the late 1990s.[70] The rules require funds to provide a telephone number or web address where current performance information is available, as if the problem with short-term performance was that it wasn't current enough. The Commission also required that the text in fund ads include the statement that "current performance may be higher or lower than the performance data quoted."

Recent fund advertisements have demonstrated the inadequacy of the Commission's new rules. After three years of negative returns, stock funds had a banner year in 2003. Many of those funds are now advertising their stellar one-year performance without any disclosure of their poor returns in 2000, 2001, and 2002. Because they are required only to show their one-, five- and ten-year returns, the negative returns of 2000 to 2002 are hidden from view. The ads create a misleading impression by showing the outsized returns of 2003 without any mitigating disclosure of the down years that preceded them and the performance volatility that those years' returns illustrate.

For example, one ad shows SEC-mandated performance for four funds, each of which experienced superior returns in 2003, but experienced losses or substantially lower performance in each year from 2000 to 2002. As illustrated in the table below, the disclosure of each fund's annual performance in the years preceding 2003 would have presented a very different, far more accurate picture. The Commission's rulemaking has done nothing to prevent such misleading ads, which have appeared routinely in business and personal finance magazines in the first few months of this year.

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[69] See, e.g., Statement by Arthur Levitt at the Investment Company Institute (May 15, 1998) ("I want you to look beyond your prospectuses when you think about how you communicate with investors. I do, and I worry that the fund industry is building unrealistic expectations through performance hype. I read the ads. I see nothing but performance, performance, performance. Why not outline clearly the impact of expenses or the nature of risks?").

[70] Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 26195 (Sep. 29, 2003).

Funds	Disclosed*	Not Disclosed**		
	2003	2002	2001	2000
Fund #1	51.68%	(21.27%)	(7.56%)	(18.10%)
Fund #2	42.38%	(9.37%)	(12.99%)	(8.96%)
Fund #3	23.36%	(20.44%)	(3.74%)	12.25%
Fund #4	29.96%	(17.16%)	(5.02%)	8.54%

* Source: Business 2.0 (March 2004)
** Source: Fund Prospectuses.

The Commission's rulemaking also did nothing to address the problem of the disconnect between the advertised performance of funds and the actual returns experienced by shareholders. As confirmed by a recent DALBAR study, "[i]nvestment return is far more dependent on investment behavior than on fund performance."[71] DALBAR found that the average equity fund investor earned ***2.57%*** annually over the last 19 years, in comparison with the S&P 500's ***12.22%*** annual return during the same period. This translates into a cumulative return for the S&P 500 of ***793.34%*** from 1984 to 2002, compared with equity fund investors' actual cumulative return of ***62.11%*** during the same period.

These stunning and disheartening data illustrate, in part, a failure of investor education and individual choice. Investors have consistently chased the best performing funds just before they crashed, and dumped the worst performing funds just before they recovered. This sell-high, buy-low mentality is only encouraged by the Commission's current approach to fund performance advertising, which permits funds to present outsized returns with no meaningful caveats regarding their volatility and the likelihood that performance will soon revert to the mean.[72]

Not only do current rules fail to require meaningful disclosure about the volatility of fund returns, but they also fail to place outsized, one-year returns in the context of the market as a whole. To illustrate, the performance of the S&P 500 for 2003 was 28.68%, which puts the 51.68% return of the Fund cited above in a light very different (albeit still positive) from one in which the performance data stands alone. The Fund's advertised ten-year return of 10.58% would tell a different story if it were required to be juxtaposed against the S&P 500's 11.07% ten-year return.

The Commission also has recognized the need for investment returns to be considered in the context of fees, yet its rules do virtually nothing to benefit investors in this respect. In its proposing release, the Commission promised that its new rule would

[71] DALBAR, Quantitative Analysis of Investor Behavior at 2 (2003).

[72] Notably, the Commission requires that the prospectus include a bar chart that shows a fund's return for each of the preceding ten years. If such a disclosure is necessary to make the prospectus not misleading, it is unclear why the same reasoning is not applicable in the context of a fund advertisement.

"ensure that fund advertisements remind fund shareholders about the availability of information about fund charges and expenses."[73] Yet the final rule required only that fund advertisements refer investors to the prospectus for consideration of fund expenses, among other things.[74] In contrast, the NASD has proposed that fund advertisements include a box that shows both the fund's maximum sales charge and its expense ratio.[75]

Congress should require that fund advertisements include all information necessary to make the information presented not misleading. This must include, at a minimum, investment returns for each individual year where such returns differ materially from fund's one-year performance, disclosure of the fund's total expense ratio (i.e., including the fund's portfolio transaction costs) and sales charges, and the performance and expenses of a comparable index fund.

E. Misleading Fund Names

Funds are prohibited from using misleading names, yet the Commission has taken the position that a fund with "U.S. Government" in its name can invest 100 percent of its assets in Fannie Mae or Freddie Mac securities.[76] These securities are not guaranteed by the U.S. Government, which is the guarantee investors reasonably believe they are getting when they invest in government securities. ***Congress should prohibit funds from using names that imply that they invest in U.S. government securities unless at least 80 percent of the funds' assets are actually invested in securities that are backed by the full faith and credit of the U.S. government.***

II. Commission Initiatives

As discussed above, there many areas where Congressional action is needed either because the Commission lacks the necessary authority or opposes mutual fund reforms. In other areas, however, the Commission has taken strong steps to address problems in the mutual fund industry, in some cases over the objections of certain Commissioners. None of these initiatives has taken the form of final rules, and the Committee accordingly should continue to encourage the Commission to proceed with these rulemaking proposals to ensure they do, in fact, become law. Fund Democracy strongly supports the Commission's efforts in each of these areas.

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[73] Proposed Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 25575, Part II.C (May 17, 2002).

[74] Amendments to Investment Company Advertising Rules, supra note 60.

[75] See Disclosure of Mutual Fund Expense Ratios in Performance Advertising, National Association of Securities Dealers (Jan. 23, 2004).

[76] Letter from Paul F. Roye, Director, SEC Division of Investment Management, to Craig Tyle, General Counsel, Investment Company Institute (Oct. 17, 2003).

A. Directed Brokerage

Many fund managers compensate brokers for selling fund shares with fund brokerage. Under these arrangements, the fund manager pays the broker through commissions received in connection with a fund's portfolio transactions.[77] This practice increases funds' portfolio transaction costs while reducing the amount the fund manager might otherwise spend on distribution, thus creating a significant conflict of interest. The Commission has proposed to prohibit fund managers from considering sales of fund shares when selecting brokers to effect fund transactions.[78] Fund Democracy expects to file detail comments generally supporting this proposal.

B. Disclosure of Brokers' Compensation

For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and non-cash compensation.

Mutual fund shareholders should be entitled to receive the same information as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

Brokers also should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund. When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, however, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs.

The Commission has proposed to require brokers to provide, both at the point-of-sale and in the transaction confirmation, disclosure of the costs and conflicts of interest that arise from the distribution of mutual fund shares.[79] Fund Democracy expects to file comments with the Commission generally supporting its proposal.

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[77] See supra note 64.

[78] Prohibition on the Use of Brokerage Commissions, supra note 31.

[79] Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341 (Jan. 29, 2004).

C. Mandatory Redemption Fee

The most substantial losses resulting from the current mutual fund scandal were caused by funds' selling their shares at inaccurate or stale prices and allowing certain investors to trade rapidly in and out of the fund to take advantage of those pricing discrepancies. Some academics who have studied the issue have estimated that this practice costs long-term fund shareholders billions of dollars each year. Funds are already required to price their shares accurately, and this requirement should be more strictly enforced. To the extent that pricing is not a perfect science, however, some funds still may use slightly inaccurate prices that sophisticated traders can identify and exploit.

These opportunities would be eliminated by the imposition of a small redemption fee on all sales of fund shares occurring within a short time period after the purchase. The Commission has proposed to require "funds (with certain limited exceptions) to impose a two percent redemption fee on the redemption of shares purchased within the previous five days."[80] In all cases, the redemption fee would be payable to the fund, so that shareholders would receive the benefits. Fund Democracy expects to file comments with Commission generally supporting its proposal.

D. Hard 4:00 Close

In connection with the current mutual fund scandal, some mutual fund companies apparently conspired to allow late trading in their funds. Others were the victims of brokerage firms and other trade processing intermediaries who assisted their clients in evading those restrictions. Steps must be taken to better prevent evasion of the late trading restrictions, including tough sanctions against those who knowingly violate or aid their clients to violate those restrictions. In addition, the quality of compliance systems at both the funds and the trade processing intermediaries must be upgraded to ensure detection of these and other abuses and to allow an effective regulatory inspection of those procedures.

The Commission has proposed to require that orders to purchase fund shares be received by the fund, its designated transfer agent, or a registered securities clearing agency no later than the time at which the fund is priced.[81] This is known as a "hard 4:00 close" because most funds price their shares at 4:00 pm eastern time. Fund Democracy and the Consumer Federation of America have submitted joint comments to the Commission generally in support of its efforts to prevent late trading of mutual fund shares.

[80] Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Rel. No. 26375A (Mar. 5, 2004).

[81] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Rel. No. 26288 (Dec. 11, 2003).

E. Portfolio Manager Compensation

In some cases, a portfolio manager's compensation or fund investments may not align his or her interests with the interests of fund shareholders. For example, a fund portfolio manager who also manages a hedge fund or other private accounts may have an incentive to favor those accounts over the mutual funds.[82] The highest-paid executives of operating companies are required to disclose their compensation and their trades in company stock, yet there is no comparable requirement for mutual funds.

Recent revelations have included investments by portfolio managers that are harmful to shareholders' interests. The Commission has proposed that fund managers be required to disclose the structure of their compensation and their investments in the funds they manage.[83] Fund Democracy expects to file comments with the Commission generally supporting this proposal.

[82] See Ian McDonald, A Look at What Drives Money Managers' Pay, Wall Street Journal Online (Mar. 16, 2004) (describing survey that found that "most portfolio managers say their firms' sales and profits are often greater drivers of their bonuses than the investment returns they earn for clients").

[83] Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Investment Company Act Rel. No. 26383 (Mar. 11, 2004).

Exhibit A
from Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions (Jan. 2004)

Exhibit 2: Total 2001 costs of investing: 4 representative large equity funds

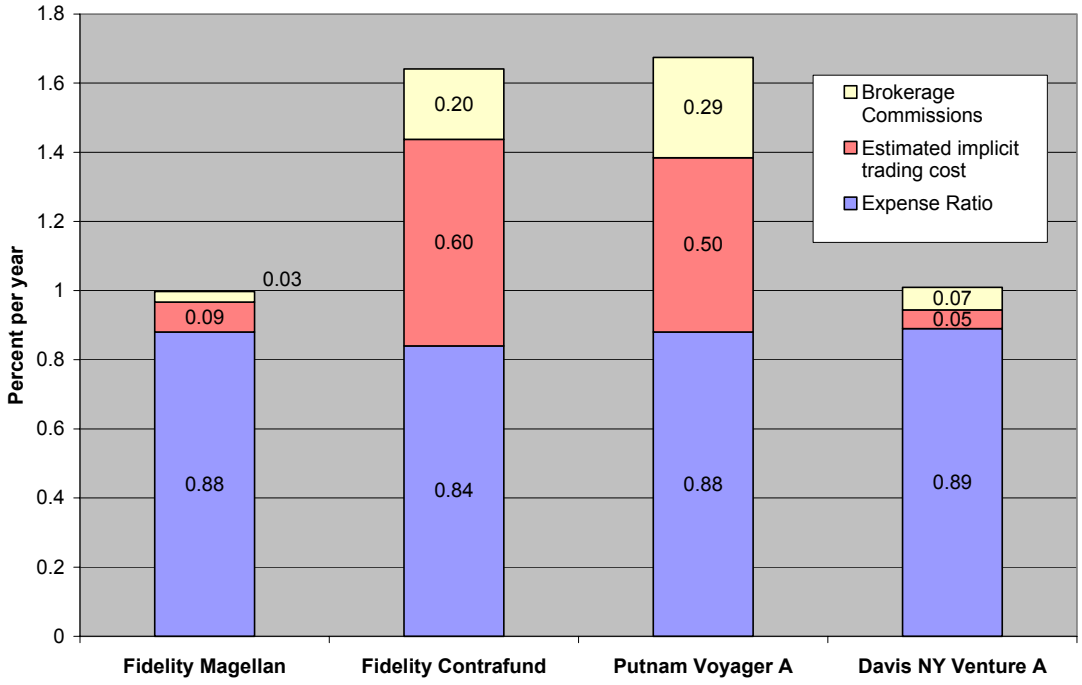

Exhibit 3: Total 2001 costs of investing in high turnover equity funds with total net assets greater than $100 Million