Statement of Robert C. Pozen

Chairman
MFS Investment Management

and

Visiting Professor
Harvard Law School

"REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY: FUND OPERATIONS AND GOVERNANCE"

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

March 23, 2004

Thank you Chairman Shelby, Ranking Member Sarbanes and other members of the Committee for this opportunity to present my views on appropriate reforms for the mutual fund industry.

My name is Robert C. Pozen and I am from Boston, Massachusetts. I am currently Chairman of MFS Investment Management, which manages approximately $140 billion for approximately 370 accounts including over 100 mutual funds serving approximately six million investors. I am also a visiting professor at Harvard Law School and author of the textbook <u>The Mutual Fund Business</u> (2 ed. Houghton Mifflin 2001).

I commend the Committee for engaging in a deliberative and broad-ranging review of the operations and regulation of the mutual fund industry. While I welcome questions about any aspect of the fund industry, I will limit my testimony today to three areas where I believe that MFS is helping to set important new standards for the fund industry: 1) maximized shareholder value through fund brokerage; 2) individualized reporting of shareholder expenses; and 3) structural enhancements for fund governance. We are making changes in these three areas to benefit MFS shareholders and, if followed by the rest of the industry, to benefit all fund shareholders.

I. <u>Reducing Reliance on Soft Dollars</u>

The current system of paying for goods and services with "soft dollars", taken out of brokerage commissions, is detrimental to mutual fund shareholders. The use of "soft dollar" payments makes it virtually impossible for a fund manager to ascertain the true costs of executing trades because execution costs are bundled together with the costs of other goods and services such as research reports and Bloomberg terminals. If these costs were unbundled, then fund managers could pay cash out of their own pockets for independent research or market data, and could negotiate for lower execution prices for fund shareholders.

Currently, if a trader from a mutual fund executes fund trades through a full-service broker on Wall Street, the trader pays five cents a share for execution plus a broad range of goods or services from the executing broker or third parties: e.g., securities research, market data and brokerage allocations to promote fund sales. These goods and services are paid in "soft dollars": that is, they are bundled into the five cents per share charge in a non-transparent manner. If MFS does not accept these ancillary goods or services through "soft dollars", it will still be required to pay five cents per share by the full-service broker.

In other words, it is almost impossible to obtain a price discount from a full-service Wall Street firm for executing a large fund trade. However, that firm is willing to provide an in-kind discount in the form of soft dollars that can be used to purchase various goods or services. This is more than a technical pricing oddity. The key point is this: a price discount on the trade (for example, from five cents to three cents per share) would go directly to the mutual fund and its shareholders. In-kind services like market data services go directly to the fund management company and only indirectly to the mutual fund and its shareholders.

MFS has already eliminated the use of "soft dollars" to promote sales of mutual fund shares. Since January 1, 2004, MFS has been paying cash out of its own pocket to broker-dealers to promote fund sales. While the SEC has proposed a rule to this effect, MFS has switched from soft dollars to cash to promote fund sales regardless of whether and when the SEC adopts its rule.

More dramatically, earlier this month MFS decided to stop using soft dollars to pay for third-party research[1] and market data. Again MFS will pay cash out of its own pocket for these items. MFS estimates that this decision will cost the management company $10 to $15 million per year. Yet MFS has agreed not to raise its advisory fees for its funds over the next five years.

Why is MFS willing to take the lead on getting off the addiction to soft dollars and moving to the healthy environment of price discounts? The simple answer is: MFS puts the fund shareholder first. We recognize the need to employ a full-service broker to execute a large block trade (e.g., 500,000 shares in Genzyme); we need their skills and capital to actively work the trade and take up a portion of the trade themselves if necessary. But we want to pay a price in the range of three cents per share for an agency-only trade, though we are willing to pay more for a trade requiring capital to be put at risk by the broker-dealer.

[1] We are not stopping the use of "soft dollars" for proprietary research and other services. Only recently has the SEC issued a concept release on accounting for all the elements of a bundled commission. SEC Release IC-26313 (Dec. 19, 2003).

The broader answer is that MFS wants to lead the industry to lower and more transparent execution costs. To accomplish this objective, MFS will need support from other asset managers as well as the SEC. Section 28(e) of the Securities Exchange Act provides a safe harbor for asset managers using “soft dollars” for research and brokerage services. Initially, the SEC interpreted this safe harbor narrowly--allowing payment in “soft dollars” only if a good or service or product were not readily available for cash. Several years later, however, the SEC broadened the safe harbor to include any “legitimate” purpose for soft dollars (SEC Exchange Act Release 23170, April 23, 1986). The SEC should move back to its initial narrow interpretation of 28(e) to reduce the reliance on the use of “soft dollars”.

II. Individualized Expense Reporting

MFS will issue an individualized quarterly statement, rather than a general listing of fund expenses in basis points, which will show each fund shareholder a reasonable estimate of his or her actual fund expenses in dollar terms. The MFS design for this individualized quarterly statement is cost effective as a result of one key assumption: that shareholders hold their funds for the whole prior quarter. This assumption is reasonable because over 90% of MFS shareholders fall into this category.

At present, the prospectus of every mutual fund contains an expense table listing the various categories of fund expenses in basis points. The table might say, for instance:

Advisory Fee	53 bp
Transfer Agency Fee	10 bp
Other Fees	2 bp
12 b-1 Fee	25 bp
Total Expenses	90 bp

In addition, the prospectus of every fund includes a hypothetical example of a $10,000 investment in the fund to show the dollar amount of actual fund expenses paid by such a fund shareholder during the relevant period. The hypothetical example for the mutual fund with the expenses described above, for instance, would show $90 in total fund expenses over the last year.

Nevertheless, some critics have argued that mutual fund investors need customized expense statements. By that, these critics mean the actual expenses paid by a shareholder in several funds based on his or her precise holding period as well as the fund dividends during that period. For example, we would have to compute the exact expenses of a shareholder who held Fund A from January 15 until March 31 without reinvesting fund dividends; another shareholder who held Fund B for the whole year and reinvested all fund dividends; and yet another shareholder who held Fund C from February 1 until June 15 as well as from August 22 until December 11 (during both periods, assuming no record date for fund dividends occurred).

This type of customized expense statement would, in my opinion, involve enormous computer programming costs. The program would have to track the holdings of every fund shareholder on a daily basis, take into account whether a fund dividend was reinvested or paid out to the shareholder, and apply monthly basis point charges to fund balances reflecting monthly appreciation or depreciation of fund assets. Of course, these large computer costs would ultimately be passed on to fund shareholders.

At MFS, we will provide every fund shareholder with an estimate of his or her actual expenses on their quarterly statements.[2] We can do this at an affordable cost by making one reasonable assumption—that the fund holdings of the shareholder at the end of the quarter were the same throughout the quarter. Although this is a simplifying assumption, it produces a good estimate of actual fund expenses since most shareholders do not switch funds during a quarter. Indeed, this assumption will often lead to a slightly higher estimate of individualized expenses than the actual amount because some shareholders will buy the fund during the quarter and other shareholders will reinvest fund dividends during the quarter.

In addition, MFS will send its shareholders in every fund's semi-annual report the total amount of brokerage commissions paid by the fund during the relevant period as well as the fund's average commission rate per share (for example, 4.83 cents per share on average). But this information on brokerage commissions should be separated from the fund expense table because all the other items in the table are ordinary expenses expressed in basis points. By contrast, brokerage commissions are a capital expense added to the tax basis of the securities held by the fund, and brokerage commissions are expressed in cents per share.

---

[2] These individualized expenses will not include brokerage costs because they are capitalized in the cost of the portfolio security.

II. Enhanced Governance Structure

The mutual fund industry has a unique governance structure: the fund is a separate entity from its external manager. The independent directors of the fund must annually approve the terms and conditions of the fund's contract with its external manager. Of course, the independent directors usually reappoint the management company. In an industrial company, how often do the directors throw out the whole management team? But the independent directors of most mutual funds, in my experience, do represent fund shareholders by negotiating for contract terms and monitoring potential conflicts of interest.

At MFS, we believe we have the most advanced form of corporate governance in the industry. To begin with, over 75% of the board is comprised of independent directors, who elect their own independent chairman. The chairman leads the executive sessions of independent directors, which occur before or after every board meeting. The independent chairman also helps set the board's agenda for each meeting. A lead independent director could definitely take charge of the executive sessions and a lead director could also help set the board's agenda. Thus, it does not matter which title is employed; the key is to insure that a senior independent director plays these two functions.

In many boards, the independent directors have their own independent counsel, as the MFS boards do. But the independent directors of the MFS funds are going one step further by appointing their own compliance officer. This officer will monitor all compliance activities by MFS as well as supervise the fund's own activities, and will report regularly to the Compliance Committee of the Board (which itself is composed solely of independent directors).

On the management company side, MFS is the only company I know of that has a non-executive chairman reporting to the independent directors of the MFS funds. This is a new position designed to assure that the management company is fully accountable to the funds' independent directors.

Finally, MFS as a management company has established the new position of Executive Vice President for Regulatory Affairs, and filled the position with a distinguished industry veteran. In addition, MFS has hired a distinguished law firm partner as its new general counsel. Both will serve on the executive committee of MFS. The new Executive Vice President will be in charge of several regulatory functions—compliance, internal audit and fund treasury. This high profile position within MFS is more than symbolic; it represents the great significance given by MFS to these regulatory functions. While these functions are performed in most fund management companies, it is rare to see the person in charge of these functions having the title of executive vice president and serving on the executive committee of the firm.

Conclusions

In summary, MFS is trying to establish standards of best practices in three important areas to fund shareholders: 1) reduced reliance on “soft dollars”, 2) individualized expense reporting, and 3) enhanced governance structure. Other management firms are trying to take the lead in setting industry standards in other areas. At the same time, the SEC is in the process of proposing and adopting a myriad of rules on disclosure requirements and substantive prohibitions for the fund industry—which overlap to a degree with the efforts of the fund management firms.

Because the SEC and the management firms are making such serious efforts to develop higher behavioral norms for the mutual fund industry, it might be useful for Congress to monitor these efforts before finalizing a bill on mutual fund reforms. These are complex issues that may be better suited to an evolutionary process, led by an expert public agency with the flexibility to address the changing legal and factual environment.

Thank you again for this opportunity to testify on mutual fund reform. I would be pleased to answer any questions the Chairman or Committee Members might have.