Consumer Federation of America

Testimony of
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Consumer Federation of America

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Committee on Banking, Housing and Urban Affairs
U.S. Senate

Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance

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Good morning. I am Barbara Roper, Director of Investor Protection for the Consumer Federation of America. CFA is a nonprofit association of 300 consumer groups, which in turn represent more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is among our top legislative and regulatory priorities.

Introduction

I want to congratulate Chairman Shelby, Ranking Member Sarbanes, and the members of this Committee for the thorough and careful attention you have given to a wide range of issues arising out of the recent mutual fund trading and sales abuse scandals. In the best tradition of the congressional oversight process, your hearings have helped to inform the debate, guide the SEC regulatory response, and lay the groundwork for additional reforms.

Let me make clear at the outset, CFA believes the SEC has done a very good job since the trading scandals first broke of developing a strong and credible mutual fund reform agenda. While the SEC may have initially been caught unawares, it has since responded aggressively on all three fronts of agency responsibility – enforcement, oversight, and regulation. The settlements of enforcement actions announced by the SEC in recent months have included an appropriate combination of shareholder restitution, stiff penalties, and governance reforms. The agency is reportedly at work on a number of positive steps designed to promote quicker identification of potential problems within the industry and to improve the quality of its oversight program. On the regulatory front, the Commission has proposed a host of new rules to end trading abuses, strengthen fund governance, and address a range of abuses in the sale of mutual funds.

It is in this area of the regulatory response that CFA has primarily focused its attention. Last November, CFA and Fund Democracy developed a "blueprint" for mutual fund reform, which we released together with Consumer Action, Consumers Union, and the U.S. Public Interest Research Group.[1] The document provided a brief review of the broad range of reforms we believed were needed to restore badly shaken investor confidence in the mutual fund industry. Our proposals fell into five basic categories: reforms specifically designed to address trading abuses; reforms to improve regulatory oversight of mutual funds; reforms to enhance the independence and effectiveness of mutual fund boards of directors; reforms to improve mutual fund sales practices; and reforms to improve mutual fund fee disclosures. (A copy of the blueprint is included as an appendix to my testimony.)

The purpose of the blueprint was to provide a benchmark against which our organizations would measure legislative and regulatory proposals put forward in the wake of the trading and sales abuse scandals. In preparing for my testimony today, I have used that document as a starting point for assessing the adequacy of the SEC's regulatory response to date. My conclusions are necessarily preliminary, as the SEC is still in either the rule proposal or concept release stage on a number of key issues. We won't know for some time what the Commission's final actions will be. In some instances, we support the general thrust of an SEC proposal but have suggestions for significant amendments that may or may not be adopted. Despite those

[1] *A Pro-Investor Blueprint for Mutual Fund Reform,* prepared by Mercer Bullard, Founder and President of Fund Democracy, and Barbara Roper, Director of Investor Protection for the Consumer Federation of America, November 25, 2003.

caveats, what is really quite remarkable is how many of the suggestions laid out in our blueprint have since been taken up by the SEC.

Despite that fact, we believe legislation is absolutely essential this year to fill certain significant gaps in the SEC's regulatory response. Several of these gaps result from the SEC's lack of authority to act. For example, legislation is needed to enhance the SEC's independent governance reforms by giving the agency authority to impose its requirements directly, to strengthen the definition of independent directors, and to expand the fiduciary duty of fund directors. We also believe investors would benefit from a repeal of the soft dollar safe harbor, which cannot be accomplished without legislation. In addition, we believe legislation is needed to give the SEC limited oversight authority over intermediaries that handle mutual fund transactions. This would allow the agency to develop an effective alternative to the hard 4 p.m. close that provides a strong degree of certainty that late trading will be prevented without the inequities associated with the hard 4 p.m. close.

When we look beyond the areas where the agency is prevented from acting, the one area where we see major short-comings is in the SEC's completely inadequate efforts to promote vigorous cost competition among mutual funds. This is a serious deficiency, since evidence strongly suggests market discipline is not currently serving as a reliable and effective check on excessive fees. Because bringing down costs even a modest amount would add billions each year to the retirement and other savings of mutual fund shareholders, we believe it is essential that Congress step in and adopt major improvements to mutual fund cost disclosure. The goal should be to enable and encourage investors to make better mutual fund purchase decisions and to enhance the ability of market forces to discipline costs.

These are the proposals we believe should be included in legislation this year. In addition, although the SEC has put forward a number of very useful proposals to reform mutual fund sales, we believe the issue of abusive broker-dealer sales practices deserves much further scrutiny and a more comprehensive legislative and regulatory response. We recognize, however, that this as a task that cannot be accomplished in the time remaining in this legislative session. We therefore urge the Committee to make this a top priority for comprehensive review in the next Congress.

My testimony will briefly review the reforms we have advocated in each of the categories mentioned above, what actions the SEC has taken, where the SEC lacks authority to complete its reform agenda, and what additional actions Congress should take for the benefit of mutual fund investors. I will then lay out in greater detail what steps we believe are needed to promote effective cost competition in the mutual fund industry and to further reform broker-dealer sales practices.

Reforms to Address Trading Abuses

Our blueprint outlined several steps to ensure that abusive trading practices are ended, that perpetrators are punished, and that investors receive full and fair restitution for their losses.

- Fair Value Pricing

Our recommendation: As a starting point, our organizations advocated stricter enforcement of the existing requirement that funds price their shares accurately. Such an approach is key to reducing the opportunity for investors to trade rapidly in and out of a fund to take advantage of pricing discrepancies.

Commission action: In December, the Commission issued a release clarifying its position that funds are required to calculate their net asset value based on the "fair value" of a portfolio security if the market quotes are either unavailable or unreliable. In addition, the Commission staff is reportedly currently gathering additional information about funds' fair value pricing practices to determine whether additional steps are needed. CFA strongly supports this approach. However, because fair value pricing introduces an element of subjectivity into the pricing of fund shares, it also creates an opportunity for abuse. We therefore believe it is essential that the SEC continue to carefully monitor funds' use of fair value pricing to ensure that a reform adopted to address one set of abuses doesn't itself become an avenue of abuse.

Congressional oversight needed: We urge this Committee to provide on-going oversight to ensure that mutual funds are not abusing fair value pricing or that this approach to pricing does not create unanticipated flaws in the pricing of mutual fund shares. Should it find problems with the use of fair value pricing, we urge the Committee to work with the SEC to identify steps that could be taken to eliminate those problems.

- Mandatory Redemption Fees

Our recommendation: Because pricing is not a perfect science, we also recommended requiring at least those funds that claim to restrict short-term trading to impose a small redemption fee on sales occurring within a short time period after the purchase. We specified that the fee should be payable to the fund, so that shareholders and not management would receive the benefit. And we indicated that redemptions should be permitted without triggering a redemption fee in financial emergencies.

Commission action: The Commission issued a proposed rule in March that would require all funds except those that disclose that they allow rapid trading to impose a mandatory, uniform two percent redemption fee on trades within five days of purchase.[2] Although we have not yet had an opportunity to review this proposal in detail, it appears to meet the basic criteria that we laid out for helping to take the profits out of rapid trading. It contains provisions to allow partial, small, and emergency redemptions without triggering the fee, which should limit any potentially harmful effects on average retail investors. It also requires that fees be paid to the fund, not the fund managers. The rule also includes a requirement that intermediaries send funds, on at least a weekly basis, taxpayer identification numbers and specific trading information for those shareholders who trade through omnibus accounts. This is an essential and welcome step to allow funds to identify those shareholders who engage in rapid trades and ensure that they pay appropriate redemption fees.

- Prevent Late Trading

Our recommendation: In addition to advocating tough sanctions for those who knowingly help their clients to evade late trading restrictions, we recommended that the Commission adopt an approach to ending late trading that relies on compliance systems to provide reliable tracking of fund trades. With that in mind, we suggested that the quality of compliance systems at funds and trade processing intermediaries needs to be upgraded to ensure detection of these and other abuses. We also noted that the system must allow an effective regulatory inspection of those procedures. Under our suggested approach, intermediaries who could not provide adequate assurances of the integrity of their order processing systems,

[2] File No. S7-11-04.

including fool-proof time-stamping of trades, would be prohibited from submitting orders to the fund after 4 p.m.

Commission action: The Commission has finalized a rule requiring that funds have policies and procedures in place that are designed to prevent late trading and requiring that these policies and procedures be administered by a chief compliance officer who reports to the fund board.[3] In addition, the Commission has proposed a rule requiring that all orders for the purchase or sale of mutual fund shares be received by the fund, its designated transfer agent, or a registered clearing agency before the time the fund is priced in order to receive that day's price.[4] Because of concerns expressed over inequities in this approach, the Commission is reportedly currently considering whether alternative approaches exist that would prove equally effective without posing the same drawbacks of a hard 4 p.m. close.

Congressional oversight needed: While we do not oppose the hard 4 p.m. close as a short-term solution to late trading abuses, we believe an alternative long-term solution must be found. With that in mind, we urge this Committee to monitor developments to ensure that the final, long-term approach adopted by the Commission meets basic standards of fairness to all investors.

Legislation needed: In addition, the Commission has suggested that one reason it adopted the hard 4 p.m. close approach is that it lacks oversight authority over certain intermediaries who handle mutual fund transactions and therefore cannot assure their compliance with appropriate standards under an alternative system that relies on creating an end-to-end audit

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[3] File No. S7-03-03.

[4] File No. S7-27-03.

trail for mutual fund transactions. To the degree that the Commission needs additional oversight authority to provide end-to-end tracking of mutual fund transactions, Congress should provide the Commission with that authority. The goal would be to provide the Commission with narrowly targeted oversight authority, for example to inspect systems to determine whether they are adequate to prevent late trading and other trading abuses. This would enable the SEC to identify those intermediaries that lack adequate systems to prevent trading abuses and deny them the privilege of forwarding transactions after the 4 p.m. close.

Reforms to Improve Regulatory Oversight of Mutual Funds

Because we believe the mutual fund scandals provided evidence of a structural breakdown of mutual fund oversight, our blueprint identified several steps necessary to strengthen regulatory oversight of the fund industry.

- SEC Efforts to Enhance its Regulatory Operations

Our recommendation: Acknowledging that the SEC had begun to take steps to improve its regulatory oversight, we urged Congress to support and expand on those efforts to ensure that the agency gets at the root cause of its oversight failure in this and other areas.

Commission action: Responding to criticism that it should have detected trading abuses earlier, the Commission announced late last year that it was creating a new risk assessment office whose purpose is to identify emerging problems and better coordinate the agency's response. In addition, in recent testimony before this Committee, Lori Richards, Director of the Office of Compliance Inspections and Examinations, outlined a number of steps being taken to improve the SEC's oversight of the mutual fund industry. These include creating a new surveillance program for mutual funds, improving examination procedures, by including more interviews and reviewing more email for example, conducting more targeted mini-sweep examinations, and reviewing the largest and highest risk funds more frequently.

Congressional actions needed: We believe these efforts both deserve congressional support, in the form of adequate agency funding, and merit congressional scrutiny, to ensure that they deliver the desired results – a more aggressive and effective oversight program for the mutual fund industry and for the securities industry as a whole.

- Independent Regulatory Board to Oversee Mutual Funds

Our recommendation: We recommended that Congress consider creating an independent board, modeled after the Public Company Accounting Oversight Board, with examination and enforcement authority to supplement SEC oversight and enforcement efforts.

Commission actions: SEC Chairman William Donaldson said in November testimony before the House Financial Services Committee that the Commission was considering whether there were ways in which funds could "assume greater responsibilities for compliance with the federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers." Ms. Richards indicated in her March testimony before this Committee that the size of mutual funds precluded a comprehensive audit of every area of fund operations. Given the poor record of private audits in uncovering wrong-doing, if the SEC needs a supplement to its own examination program, we believe a far better approach would be to create an independent board, subject to SEC oversight, to conduct such audits.

Legislation and oversight needed: As a first step, we believe Congress needs to assess the adequacy of SEC resources for oversight of mutual funds. If it is not possible to provide the agency with adequate funding directly, Congress should determine whether an independent board would provide the best supplement to agency efforts. With this in mind, we support the requirement in legislation introduced by Senators Dodd and Corzine (S. 1971) to require a General Accounting Office study of the issue. We also urge this Committee, which has taken the lead in the past in improving SEC funding, to provide on-going oversight on this issue.

- Settlements Without an Admission of Wrong-doing

Our recommendation: Although the SEC settlements of trading abuse cases have included a number of pro-investor provisions, the agency continues to rely almost exclusively in this and other areas on settlements without any admission of wrong-doing by the perpetrators. While we believe this is in most cases an appropriate approach for the agency to take, we also believe there are some instances when the Commission should not allow those guilty of egregious violations to get off without an admission of culpability. We therefore recommended that Congress look into this practice, not just with regard to the mutual fund scandals, but also with regard to the SEC's enforcement program more generally.

Congressional action needed: Either through its own oversight process or by commissioning a GAO report, we urge this Committee to examine the SEC policy of settling even cases involving egregious ethical and legal violations without an admission of wrong-doing.

Reforms to Enhance the Independence and Effectiveness of Mutual Fund Boards

The mutual fund scandals helped to shine new light on the failure of all too many mutual fund boards to provide effective oversight of fund managers on behalf of fund shareholders. To address this systemic breakdown in fund governance, we advocated a number of steps to improve the independence and effectiveness of fund boards.

- Independence of fund boards

Our recommendation: To clarify that fund boards are responsible for representing shareholders, not management, our organizations recommended that three-quarters of fund boards be required to be independent and that funds be required to have an independent chairman. Such an approach should help to ensure that fund boards are firmly under the control of those individuals whose sole obligation is to shareholders. Given the primary role of the board in policing conflicts of interest and negotiating the management contract, we believe it is essential that funds be chaired and dominated by individuals whose loyalty is exclusively to shareholders.

Commission action: The Commission proposed a rule that would require all funds that rely on one of the Commission's exemptive rules to have an independent chairman and three-quarters of board members who are independent.[5] The rule, portions of which face strong industry opposition, has not been finalized, so it is not clear whether this strong proposal will actually be adopted. The Commission also requested comment on a much weaker alternative approach that would require funds to have a lead independent director. This approach would

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[5] File No. S7-03-04.

continue to allow executives of the fund management firm to chair the board, putting them in the position, among other things, of negotiating with themselves when it comes time to negotiate the advisory contract.

Legislation needed: Because the SEC lacks authority to strengthen the definition of independent director, individuals with close family and business ties to the fund manager could still serve in this capacity, undermining the intent of this reform. Congress should adopt legislation that, at a minimum, gives the SEC authority to strengthen the definition of independent director. The definition included in the bill introduced by Senators Fitzgerald, Collins, and Levin (S. 2059) provides both a good statutory definition and authorization for the SEC to further refine the definition as needed. The Dodd-Corzine bill (S. 1971) gives the SEC authority to add new categories of individuals who would be precluded from serving as independent directors because family or business ties to the fund manager. Either approach would provided much needed enhancements to the SEC's proposed independent governance reforms.

In addition, because the SEC lacks authority to impose its governance reforms directly, it is forced to rely on the indirect means of imposing them as a condition of relying on the Commission's exemptive rules. Past experience suggests that this approach may be most likely to fail just when it is needed most – when there is a bona fide confrontation between the independent directors and the fund manager. The risk is that, in the event of such a confrontation, the fund manager will simply cease relying in the exemptive rules, in which case the independence requirements will no longer apply. We therefore strongly urge Congress to amend the Investment Company Act to give the SEC authority to impose its fund governance requirements directly. *Congressional oversight needed:* We also urge this Committee to monitor agency action on this issue to ensure that the final rule does not back away from the Commission's initial very strong reform proposal.

- Election of independent directors

Our recommendation: Fund directors rarely stand for election by shareholders, leaving shareholders with little ability to hold directors accountable for protecting their interests. We therefore recommended that independent directors be required to stand for election every five years.

Legislation needed: The Committee should seriously consider adopting provisions from the Dodd-Corzine bill (S. 1971) which would require that all directors be approved by shareholders every five years and would establish a nominating committee composed entirely of independent members to nominate new board members.

- Fiduciary duty of board members

Our recommendations: Current law imposes a fiduciary duty on a fund's manager and directors only with respect to fees received by the manager. We recommended that the fiduciary duty of fund directors be expanded to cover the totality of a fund's fees in relation to the services offered.

Commission actions: As part of its rule on independent governance, the SEC would require fund boards to maintain records of documents used in the review of the fund manager's contract. It has proposed a separate rule that would require funds to disclose more detailed information regarding its approval of the advisory contract, including such factors as the actual cost of services provided and the degree to which economies of scale are being realized by shareholders.[6] We believe the Commission requirements are a good step toward making fund directors more aware of their responsibilities to keep fund costs reasonable and more accountable for how they arrive at those decisions. However, we believe more can and should be done to increase board accountability on this central area of board responsibility.

Legislation needed: The Fitzgerald-Collins-Levin bill (S. 2059) contains excellent provisions spelling out an expanded fiduciary duty for fund directors. We strongly support its adoption.

Reforms to Improve Mutual Fund Sales Practices

The mutual fund scandals helped to shine a light on a number of unsavory sales practices that stand in sharp contrast to the image brokers promote of themselves as objective, professional financial advisers. We recommended a number of steps to improve the quality of mutual fund sales practices and to give investors information they need to better protect themselves.

- Pre-sale Delivery of Mutual Fund Profile

Our recommendation: When investors purchase mutual funds from brokers, they are not required to receive the fund prospectus until three days after the sale. The idea is that the broker's obligation to make suitable recommendations substitutes for full pre-sale disclosure. Because this clearly provides inadequate protections to investors, we recommended that investors who purchase funds through a broker or other sales person be provided with at least a copy of the fund profile at the point when the broker makes his or her recommendation.

[6] File No. S7-08-04.

Commission actions: The Commission has proposed a rule that would require point-of-sale disclosure of broker-dealer costs and conflicts, but it would not require comparable disclosure about the operating costs of the mutual fund or about other important fund characteristics, such as investment strategy and risk.[7]

Legislation needed: We urge the Committee to adopt legislation that would require mutual fund investors to be provided with a copy of either the fund profile or the full prospectus at the time when a mutual fund purchase is recommended.

- Disclosure of broker compensation

Our recommendation: We recommended that mutual fund investors get the same disclosure on the transaction confirmation that is provided for virtually all other securities transactions showing how much the broker was paid in connection with the transaction. We also recommended that mutual fund investors get an up-front estimate of both broker compensation and the total cost of investing in the fund.

Commission actions: The Commission has proposed a rule that would require point-of-sale disclosure of the dollar amount of any front-end or deferred sales load, if applicable, including the amount of the sales fee that is to be paid to the broker.[8] It would also require disclosure of the estimated first-year asset-based distribution fees or service fees to be received by the broker from the fund (12b-1 fees). In addition, the point-of-sale document would disclose whether the broker engages in certain practices that create potential conflicts of interest, including directed brokerage arrangements, revenue sharing payments, increased compensation

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[7] File No. S7-06-04.

[8] File No. S7-06-04.

for sale of proprietary products, and increased compensation for sale of back-end sales load products. The same rule would require disclosure on the confirmation statement of the actual amount paid in the sales load and how it compares with industry norms and the amounts paid to the broker by the fund and its affiliates.

The rule proposal offers significant progress in getting investors important information about costs and conflicts in advance of the sale. While we have not yet completed our review of the rule proposal, our initial review has led us to conclude that it needs significant amendments, to improve the timing, format, and content of the proposed disclosures. Among other things, we believe it is essential that the proposed disclosures also include mutual fund operating costs, in addition to sales costs. Creating a document that purports to offer apparently comprehensive information on mutual fund costs but leaves out this key cost may make investors even less likely to consider operating costs when selecting a mutual fund than they already are. To the degree possible, information provided should be specific to the fund being recommended. For example, instead of using boilerplate language referring investors to the prospectus for more information on breakpoints, it could identify the next available breakpoint opportunity. We also believe the disclosures should be reworded and reformatted to improve their readability for average, unsophisticated investors and should be tested for effectiveness on investors. Finally, we believe the information must be provided at the point of recommendation, rather than at the point of sale, so that the investor has an opportunity to consider the information in making their purchase decision. Leaving these disclosures to the last minute – when the investor is preparing to write a check or transfer funds for the purchase – greatly diminishes the likelihood that they will be carefully read and incorporated into the purchase decision.

Congressional oversight needed: We urge this Committee to monitor development of this proposal to ensure that it fulfills its potential. We also believe investors would greatly benefit from a long-term comprehensive review of securities industry disclosure practices generally. The goal of such a review should be to determine, comprehensively, whether these disclosures are effective in giving investors the information they need about the professionals they hire and the products they purchase, at a time when it is useful to them, and in a form they can understand. Ultimately, we believe investors would benefit from major reforms in the disclosure system. Obviously, that is not a goal that can be accomplished in the time remaining in this Congress. We therefore urge the Committee to make this a top legislative priority in the next Congress.

- Directed Brokerage

Our recommendation: Many fund managers compensate brokers for selling fund shares by directing their portfolio transactions to that broker, often paying commissions on those transactions that are higher than those available elsewhere. Because this drives up portfolio transaction costs and creates significant conflicts of interest for both fund managers and brokers, we recommended that this practice be banned.

Commission actions: The Commission has proposed a rule that would prohibit funds from compensating brokers for distribution by allocating portfolio transactions to that broker.[9] It would require that funds have procedures in place to prevent allocation of portfolio transactions based on distribution considerations. We strongly support this rule.

[9] File No. S7-09-04.

- 12b-1 Fees

Our recommendation: At the time we developed our blueprint, our organizations recommended only that disclosure of 12b-1 fees be reformed to eliminate the currently misleading impression that these are the only distribution payments being made by fund managers out of shareholder assets. Our thinking on this issue has since evolved, and we have subsequently recommended that all payments for distribution using shareholder assets be banned. We do not object to a system that allows periodic (annual, quarterly, or monthly) payments for distribution as an alternative to paying a front-end or deferred load, but we believe the current system creates unacceptable conflicts of interest. Furthermore, we believe the growing use of 12b-1 fees to compensate brokers is a direct result of funds' and brokers' desire to hide the distribution costs from investors who might otherwise prefer a genuine no-load fund.

Commission actions: As part of its rule proposal to ban directed brokerage the Commission has solicited suggestions on how to reform 12b-1 fees.[10] Although it is too soon to say what approach the Commission will ultimately recommend, it appears to be leaning toward an approach that would require funds to deduct 12b-1 fees directly from shareholder accounts, rather than from fund assets. Under such an approach, the account-based fee would be subject to NASD caps on sales charges. This approach would make the charges more transparent, particularly if they are accompanied by good disclosures making clear that these are charges for the services provided by the broker rather than charges associated with operations of the fund. As an important added benefit, long-term shareholders wouldn't be forced to go on paying the fees after their own distribution costs had been paid, and existing shareholders wouldn't be

[10] File No. S7-09-04.

forced to bear the cost of distribution to other shareholders. While we have not yet had an opportunity to study the proposal in detail, we strongly approve of the Commission decision to study the issue and believe the approach they have outlined offers a number of significant benefits over the current system.

Congressional oversight needed: We encourage this Committee to conduct a comprehensive review of distribution practices in the securities industry to determine whether they create unacceptable conflicts of interest. Although the Commission has made a good start in examining mutual fund sales practices, we believe a more thorough, long-term review of this issue is warranted, as we will discuss in more detail below.

Reforms to Improve Mutual Fund Fee Disclosures

Regulators, financial advisers, and investor advocates all agree that minimizing costs is one of the most effective steps investors can take to improve the long-term performance of their investments. Unfortunately, most also agree that investors do not currently give adequate consideration to costs in selecting mutual funds and other investment products. This is a particularly troubling situation with regard to mutual funds, given the central role they play in the long-term savings of average, middle class Americans. Our blueprint contained several recommendations to improve mutual fund fee disclosures to make them more complete and to make it more likely that investors will incorporate that information into their investment decisions.

- Portfolio Transaction Costs

Our recommendation: Investors in mutual funds receive information on fund expenses that purports to provide an accurate assessment of the costs of operating that fund. In reality, however, the fund expense ratio omits what for many actively managed stock funds is the largest expense – the trading costs for portfolio transactions. Because this failure to include portfolio transactions costs results in fee disclosures that may dramatically understate actual costs, eliminates market discipline to keep these costs as low as possible, and creates a strong incentive for funds to pay for other operating costs through portfolio commissions, our organizations recommended that portfolio transaction costs be incorporated in the fund operating expense ratio.

Commission actions: The Commission issued a concept release at the end of last year seeking suggestions on whether and how disclosure of portfolio transaction costs could be improved.[11] The industry opposes incorporating transaction costs in the expense ratio, and the Commission has long resisted this approach. It is therefore not at all clear that this concept release will result in meaningful improvements to portfolio transaction cost disclosure.

Legislation needed: Congress should require that all portfolio transaction costs be included in the expense ratio that can feasibly be included. The Fitzgerald-Collins-Levin bill (S. 2059) takes a reasonable approach to this issue, requiring that at least the commission and spread costs be incorporated in the expense ratio and requiring that the information be provided both as part of a total expense ratio and separately. Such an approach allows the market to decide which

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[11] File No. S7-12-03.

number is most useful to investors. We urge this Committee to include this provision in any legislation it adopts on mutual fund issues.

- Soft Dollars

Our recommendation: Failure to incorporate portfolio transaction costs in the expense ratio creates a strong incentive for funds to find a way to pay for other items, beyond trading services, through their portfolio transaction payments. This allows fund managers both to create the impression that the funds are cheaper than they actually are and to shift costs the manager would otherwise have to absorb onto the fund shareholders. For these reasons, we have advocated a ban on use of soft dollars for all purposes. Such a ban should include a requirement that Wall Street firms unbundle their commissions and charge funds separately for research and other services currently being paid for through trading commissions.

Commission actions: The Commission is reportedly studying soft dollar practices, but it lacks authority to ban soft dollars. It could, however, take steps to improve the current situation, by limiting use of soft dollars to genuine research and requiring full disclosure of soft dollar payments, including total unbundling of commissions by full-service brokerage firms who conduct portfolio transactions for mutual funds. Absent congressional action, this is the approach we believe the Commission should take.

Legislation needed: Because we believe a soft dollar ban is the cleanest solution that offers the greatest benefits to investors, however, we urge this Committee to repeal Section 28(e) of the Investment Company Act.

- Comparative Fee Disclosures

Our recommendation: If the goal is to get investors to make more cost-conscious mutual fund purchase decisions, they need to receive cost information pre-sale and in a format that is likely to help them understand the differences in mutual fund costs. To accomplish that goal, we recommended requiring that fee tables show both the average fees charged by a peer group of funds and the average fees for index funds that invest in the same types of securities. Ideally, the table should show the dollar amount impact of those costs over 1-, 5-, and 10-year periods, assuming a uniform rate of return. Such an approach would help investors to better understand the significant differences in fund costs and the major impact that paying higher costs can have on long-term returns.

Commission actions: The Commission adopted a rule requiring mutual funds to disclose their costs in dollar amounts in annual and semi-annual shareholder reports.[12] While requiring the information to reported in dollar amounts, and in a form that allows comparison among funds, is a step forward, putting the information in the shareholder reports greatly minimizes its benefits. Because few investors read these reports in advance of a fund purchase, the new disclosures will do little if anything to change investor behavior or introduce meaningful cost competition to the mutual fund industry.

Legislation needed: In order to promote cost-conscious purchase decisions by mutual fund investors, the Committee should adopt legislation that requires pre-sale disclosure of fund costs and presents those costs in comparative terms, as described above. These changes could be incorporated into the fund profile document as well as the prospectus, in keeping with our earlier

[12] File No. S7-51-02.

recommendation that investors be provided with one or the other of these documents at the time a fund purchase is recommended.

- Actual Dollar Cost Disclosure

Our recommendation: As another way to get investors to focus more on costs, we recommended requiring funds to present individualized information on actual dollar amount costs on the shareholder account statement. Putting this information on the account statement would greatly increase the likelihood that it would get read. In addition, putting the information in close proximity to information on fund returns would help investors to understand how high costs can eat into fund returns. While not as desirable as pre-sale disclosure, since it would come too late to influence the purchase decision, this approach could at least make investors more cost-conscious when it comes to future mutual fund purchases.

Commission action: The Commission has opposed requiring individualized cost disclosure on account statements and adopted its far weaker shareholder report disclosure requirement instead.

Legislation needed: The Committee should adopt legislation requiring mutual funds to provide dollar amount cost information on account statements in close proximity to information on fund returns.

Why High Mutual Fund Costs Persist

Three forces are supposed to work together to discipline mutual fund costs. Mutual fund boards of directors are supposed to ensure that fees are reasonable, and the SEC has authority to take action against fund boards and managers that charge excessive fees. But the main check on excess costs is supposed to be supplied by market discipline. Many within the industry argue that these forces, and market discipline in particular, are working effectively to keep costs reasonable. There is compelling evidence, however, that this is not the case.

To approach this issue from the simplest, most straightforward angle, CFA examined costs at S&P 500 index funds, using a list of such funds complied for us and Fund Democracy in July of last year by Morningstar. We chose this type of fund because no one can credibly argue that higher costs bring added benefits to shareholders in these passive investments, which seek only to match the returns of the underlying index. Yet, when we examined the data last fall, we turned up 16 fund families that offer S&P 500 index funds with annual expenses of more than one percent. This compares with expenses of 0.18 percent and 0.19 percent respectively for the Vanguard and Fidelity funds.

Most of the funds on the list were B and C shares, for which a significant portion of the annual expenses came in the form of 12b-1 fees set at or near the maximum permissible level. The most expensive of these was the AAL Large Company Index II B fund, with an annual expense ratio at that time of 2.18 percent. However, two of the funds on the list – the AAL Large Company Index A and Mainstay Equity Index A – charged front loads of 5.75 percent and 3 percent respectively for their very high-cost funds.

While distribution costs were a significant factor contributing to the high costs of most of the funds, virtually all of the funds on the list had underlying management and administrative costs (with 12b-1 fees subtracted) that were two, three, and even four times as high as those of the Vanguard and Fidelity funds. While we recognize that not every fund company can match the rock-bottom prices charged by Vanguard, when such large discrepancies exist for a passive investment like an S&P 500 index fund, we believe it is reasonable to conclude that the costs at the higher end of that scale are excessive. If funds that charge clearly excessive costs exist among S&P 500 index funds, there is every reason to believe they exist among all other types of funds as well. A separate search for very high cost funds confirmed this view, when it turned up a handful of funds with annual expenses at or around 10 percent.[13]

The question is why, given the several protections that exist, high fund costs persist. One reason is that the SEC has never used its authority to attack excessive fees. Some progress is apparently being made on that front, with the enforcement division reportedly looking into high costs for index funds. Another reason is that mutual fund boards have too often taken the approach of approving fees as reasonable, without regard to the underlying cost of services provided, as long as they are not too far out of line with industry norms. The recently proposed rules on independent governance and disclosure regarding approval of the advisory contract offer the prospect of progress on this front as well. Supplemented by legislation as outlined above, this approach could provide real progress toward getting boards to take seriously their obligation to keep costs reasonable.

Despite this progress, market discipline will continue to be the primary factor keeping costs reasonable. In a market in which investors are free to choose from among hundreds of fund companies offering thousands of funds using several different distribution and pricing models, one would expect to find vigorous price competition. In reality, however, only a

[13] The search was conducted by Fund Democracy President Mercer Bullard in response to a request from Sen. Fitzgerald. The highest cost fund turned up in that search was the Frontier Equity Fund, which according to its registration statement, has annual expenses of 43.24 percent and a front load of 8 percent. Because the adviser waives certain fund expenses, however, the annual fee charged to investors is reduced to 42.26 percent.

relatively small portion of the mutual fund marketplace could currently be said to be truly cost competitive. That is the roughly 13 percent of mutual fund transactions that occur directly between the fund company and the retail investor and outside of any employer-sponsored retirement plan.[14] While performance-based advertising may distort this market somewhat, the prevalence of relatively low-cost funds in the direct-marketed segment of the industry strongly suggests that minimizing costs is viewed as critical to success for funds that rely on their ability to sell themselves to investors directly.

As we all know, a growing percentage of mutual fund transactions today occur through employer-sponsored retirement plans.[15] In these plans, investors generally have very limited options and therefore very little ability to consider costs in choosing among funds. These investors must instead rely on their employers to consider cost when selecting the plan. But plans often compete for employers' business by keeping administrative costs low, which they are able to do by shifting those costs onto employees in the form of higher 12b-1 fees. While the recent trading scandals may have made employers somewhat more sensitive to their fiduciary duties in selecting a plan, it is by no means certain that this is that case or, if it is, that this new sensitivity will extend to issues of cost.

That leaves the approximately 50 percent of mutual fund transactions that occur through broker-dealers and other salespeople outside a company-sponsored retirement plan.[16] Funds that rely on this market compete to be sold, not bought. While funds that compete to be bought can

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[14] Investment Company Institute, *2003 Mutual Fund Fact Book*, 43rd Edition.

[15] Ibid.

[16] "Misdirected Brokerage," by Rich Blake, *Institutional Investor Magazine,* June 17, 2003.

be expected to do so by offering a high-quality product and good service at a reasonable price, funds that compete to be sold do so by offering generous financial incentives to the selling firm and to the individual salesperson. They do this through a variety of means – sales loads, 12b-1 fees, payments for shelf space, and directed brokerage – that drive costs to investors up, not down. This sales-driven model offers mediocre, high-cost funds a means to compete for sales despite the fact that better alternatives for investors are widely available. As such, it allows funds to survive, and even thrive, that simply could not do so in a truly competitive market.

How to Encourage Vigorous Cost Competition in the Mutual Fund Marketplace

To turn this situation around, it will require both truly innovative and effective cost disclosure and a new approach to sales practices.

- Improved Cost Disclosure

We have described above some of the changes needed to improve cost disclosure. The goal is to ensure that these disclosures provide the information that investors need to accurately assess costs, at a time when it is useful to them in making their purchase decision, and in a format that catches their attention and conveys the information clearly and compellingly.

Content: At its most basic, the cost information provided must be accurate. That means it must incorporate as many of the operating costs of the fund as possible. Ideally, this means including all portfolio transaction costs in the annual expense ratio. As we explained in more detail in our joint CFA-Fund Democracy comment letter on the SEC's concept release, we believe this is an achievable goal. Many funds already get an analysis of their total transaction costs for their internal use. Setting standards for computing these costs and then requiring that they be included in a total expense ratio, while complex, should therefore not pose insurmountable challenges.

Should Congress and SEC decide for some reason against incorporating portfolio transaction costs in the expense ratio, it becomes even more important to ban soft dollars – something the SEC cannot do on its own. Soft dollar payments are used to shift operating costs out of the sunlight of disclosed costs and into the undisclosed arena of portfolio transaction costs. If portfolio transaction costs remain undisclosed, then it is imperative that they be used only to cover trading costs and not to cover other products and services. Failure to adopt these reforms makes a mockery of the expense ratio as an accurate reflection of mutual fund operating costs.

In addition, if cost disclosure is to promote cost-conscious purchase decisions, the information must be presented in a context that helps investors to understand the long-term implication of paying higher costs. We believe the best way to accomplish this is by requiring comparative information to be included when costs are disclosed. One such approach would be to require the fee table to include an average cost figure for funds in the category and an average cost for index funds that invest in similar securities. To make the information even more compelling, the one-, five-, and ten-year dollar amount added costs or savings, relative to the category average and index fund cost should be presented. Showing an investor that, performance being equal, they will pay an additional $900 over five years in fees because of a fund's above-average costs might cause them to carefully consider what they are getting in return for those high costs. Showing that they could save thousands over ten years by investing in a low-cost index fund could provide an even greater incentive to take costs into account when purchasing a fund.

Timing: It is simple common sense to suggest that cost competition will only thrive if investors receive cost information in advance of the sale. Yet the current disclosure system does not require that this information be disclosed until several days after the sale has been completed. The SEC has taken an enormous step forward by suggesting that distribution-related costs should be provided pre-sale, but it has not suggested providing similar pre-sale disclosure of operating costs. This makes no sense from an agencies that has emphasized the importance of allowing market competition to discipline costs. Once you have taken the step of requiring pre-sale disclosure, there is every reason to use that opportunity to ensure that investors receive all the appropriate information that should inform their purchase decision. We believe the best approach would be to amend the fee table along the lines that we have suggested above and require that investors receive a copy of either the fund prospectus or fund profile including that fee table in advance of the sale.

It is not enough to provide the information at the actual point of sale, when the check is being written or the funds are being transferred. At that point, the purchase decision has already been made. Far better is to provide the information at the point of recommendation, so that the investor has a reasonable opportunity to include cost considerations (and other factors, such as investment strategies and risks) as they decide whether to accept the recommendation or seek out a better alternative.

Format: Almost as important as getting investors the right information at the right time is getting it to them in a format that catches their attention. The best disclosure in the world can be fatally undermined if it is presented in a way that encourages investors to ignore it. If the Commission can be convinced, or compelled by Congress, to develop more effective cost disclosures, they should consult experts such as my fellow panelist Professor Lutz on the best way to convey the appropriate information. They should also be required to test prototype disclosures with investors to determine whether they are effective.

- A New Approach to Product Sales

While improved disclosure can help to alert investors to conflicts of interest and to make them more aware of the importance of costs, disclosure alone is unlikely to promote vigorous cost competition in the broker-sold market. A broader solution to this problem must take into account the fundamental reality of how investors relate to brokers and other financial professionals and, specifically, the degree to which they rely on them for advice.

Brokers are legally salespeople, without an adviser's obligation to place client interests ahead of their own. In fact, their exemption from the Investment Advisers Act is conditioned on their limiting themselves to giving advice that is "solely incidental" or "merely secondary" to product sales. However, this is *not* how they present themselves to clients. Instead, they adopt titles, such as financial adviser or investment consultant, that are designed to convey to their customers that advice is the primary service they have to offer. They spend millions on advertising campaigns that relentless send the same message.

Even sophisticated personal finance writers often fail to make this distinction between brokers, whose role is to effect transactions in securities, and investment advisers, whose role is to offer advice. If those who make their living covering personal finance issues make this mistake, it should not come as a big surprise that unsophisticated investors tend to approach their relationship with their broker with an attitude of trust. Lacking confidence in their own financial acumen, they seek out the advice of a financial professional, and they expect to rely without question on that professional's recommendations.

Improved disclosure of conflicts of interest, as the SEC has proposed, should help encourage investors to see their financial professionals in a more realistic light. We doubt, however, that even the best disclosures will be able to overcome multi-million-dollar advertising campaigns that send exactly the opposite message. Instead, we believe it is long past time to require brokers either to live up to the advisory image they project – and accept the attendant responsibility to make recommendations that are in their customers' best interests – or to cease misrepresenting themselves to customers and prospective customers as advisers. To the degree that the Commission has taken a position on this issue, however, it has been to propose to expand the loophole that allows brokers to portray themselves as advisers, earn fees they identify as fees for advice, and still rely on the "solely incidental" exclusion from the advisers act.[17]

Even where advisers have an obligation to put their clients' interests ahead of their own, the SEC has not to our knowledge ever enforced this obligation with respect to price or challenged advisers based on their recommendation of high-cost, inferior products. We believe it is high time for the agency to start. However, given its history on this issue, we doubt the Commission will take this position without prodding from Congress. As a first step, Congress should conduct a thorough investigation of the role and operations of brokers and advisers as the

[17] SEC Proposed Rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," File No. S7-25-99. The rule was proposed in 1999, at which time the Commission adopted a "no action" position that assured brokers that they would not be subject to enforcement actions based on a violation of the rule pending adoption of a final rule. No final rule has been adopted, and the no action position is apparently still in place.

basis for legislation to ensure that their conduct matches their representations about the services they offer.

The focus on mutual fund sales practices has raised some issues that should be included in such a review. One question it has raised for us is why distribution costs should be set by and paid through the mutual fund. When an investor buys shares in Microsoft, Microsoft does not determine what the broker is paid for that transaction. As a result, we have vigorous cost competition among brokers when it comes to trading costs for stocks. Yet, when an investor purchases shares in a mutual fund, the mutual fund's underwriter sets the level of the broker's compensation, either through loads or asset-based distribution fees. This results in the kind of competition to be sold that we described above – a competition that drives costs up and allows mediocre, high-cost funds to survive that could not do so absent their ability to buy distribution. If funds got out of the business of competing to be sold, and brokers' compensation came directly from the investor and did not depend on which fund they sold, then brokers might begin to compete on the basis of the quality of their recommendations, and broker-sold funds might have to compete by offering a quality product and good service at a reasonable price, just as direct-marketed funds must do.

Obviously, this is not an approach that can be adopted without more thorough study of all its implications. We believe, however, that similarly dramatic changes in the sales practices of brokers and other financial professionals will be necessary to truly change the dynamics of this marketplace in ways that benefit investors. We urge this Committee to include these issues on its agenda, if not this Congress, which is quickly drawing to a close, then in the next Congress.

Conclusion

Mutual funds have long offered the best way for investors who have only modest amounts of money to invest to obtain broad diversification and professional management. The trading scandals have sullied the fund industry's reputation, but they have also opened up an opportunity to reexamine some industry practices that have too long gone unchallenged. The SEC has so far done an excellent job of addressing many of these issues, particularly fund governance, sales abuses, and improved regulatory oversight.

There are, nonetheless, significant gaps in its efforts. Some result from the SEC's lack of authority to act. Others result from the SEC's apparent lack of a vision for how the market could be transformed. The most serious gap in this regard is the agency's total failure to adopt reforms that would introduce vigorous cost competition in the mutual fund marketplace. It is a failure that is responsible for allowing billions of dollars to be transferred each year from the retirement savings of working Americans into the pockets of highly profitable mutual fund companies and financial services firms.

Because of the SEC's aggressive response to the mutual fund scandals, there is not a pressing need for sweeping legislation to address the abuses that have been uncovered. Legislation is clearly needed, however, to fill specific gaps in the SEC's regulatory agenda. Such a bill should do the following things:

- strengthen the definition of independent director, authorize the SEC to impose its governance requirements directly (rather than as a condition of relying on exemptive rules), and clarify and expand the fiduciary duty of fund directors;

- give the SEC the oversight authority it needs over intermediaries who handle mutual fund transactions in order to enable the agency to adopt an alternative late trading solution that does not rely on a hard 4 p.m. close;
- ban soft dollars; and
- direct the SEC to adopt rules to require that portfolio transaction costs be included in the operating expense ratio, to amend the fee disclosure table to provide comparative operating cost information; to require that mutual fund investors receive a copy of either the prospectus or the fund profile at the time when a fund purchase is recommended; to require dollar amount cost disclosure on shareholder account statements; and to pre-test those disclosures for effectiveness in conveying the key information to investors.

It is also imperative that Congress continue to ensure that the agency has adequate funding to fulfill its responsibilities, as this Committee has taken the lead in doing in the past. As part of that effort, we would encourage you to include in legislation a provision requiring a GAO study of whether investors would also benefit from creation of an independent oversight board for mutual funds. Another area that deserves further study, in our view, is the SEC's reliance on settlements without an admission of wrong-doing.

Beyond the issues that can and should be addressed in legislation this year, we believe there is a compelling longer term need to reexamine broker sales practices. The goal should be to eliminate the gaping divide that separates the professional, advisory image brokers promote to the public and the reality of their conflict-laden, sales-driven conduct. Forcing brokers to live up to the advisory standards they promote, and raising the bar for advisors as well, would go a long way toward improving the long-term financial well-being of American investors.

We congratulate you, Chairman Shelby and members of the Committee for the thorough and careful consideration you have given to a wide range of mutual fund issues. That attention has already helped to support and promote pro-investor reforms at the SEC. It has also helped to identify additional areas where legislation is needed. We look forward to working with you to create a more equitable and honest mutual fund marketplace.

Appendix A

Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

U.S. Public Interest Research Group

Consumers Union
Publisher of Consumer Reports

Consumer @ction

A Pro-Investor Blueprint for Mutual Fund Reform

Prepared by
Mercer Bullard, Founder and President of Fund Democracy and
Barbara Roper, Director of Investor Protection for the Consumer Federation of America

Sweeping reforms are needed to restore badly shaken investor confidence in the mutual fund industry. These reforms must do more than address the specific abuses uncovered by the recent state and federal investigations, they must also recognize and address the systemic nature of recent compliance failures and other problems, the role of broker-dealers in assisting the abuses, and other problems, such as excessive and poorly disclosed fund fees, that also result from poor board and regulatory oversight. Only a comprehensive approach to reform will justify renewed investor confidence in the integrity of the mutual fund marketplace. With that in mind, Fund Democracy, Consumer Federation of America, Consumer Action, and U.S. Public Interest Research Group offer the following specific proposals that we believe must be included in the legislative and regulatory response to the current mutual fund crisis.

1. Adopt reforms designed to address specific abuses uncovered by the recent investigations.

While our organizations strongly encourage Congress and the Securities and Exchange Commission (SEC) to look beyond the recent scandal in adopting mutual fund reforms, it is certainly not our intention that the current scandal be ignored. Any legislative and/or regulatory reform package should take specific steps to ensure that abusive trading practices uncovered in recent investigations are ended, that the perpetrators are punished, and that investors receive full and fair restitution for their losses.

A. Require Funds To Impose Short-Term Redemption Fees

The most substantial losses resulting from the current 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. Our organizations therefore support requiring funds (or at least those that claim to restrict short-term trading) to impose redemption fees of two percent for fund sales within 30 days of purchase, and permitting funds to impose redemption fees of up to five percent for sales within five days of the purchase. Funds that adopt such fees could also adopt procedures to permit redemptions without payment of the redemption fee in the case of a genuine emergency. In all cases, the redemption fee would be payable to the fund, so that shareholders would receive the benefits.

B. Take Steps to Prevent Late Trading

While 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. Intermediaries who cannot provide adequate assurances of the integrity of their order processing systems, including foolproof time-stamping of trades, should be prohibited from submitting orders to the fund after 4 p.m. While we are reluctant to rely on a system that depends at least to some extent on after-the-fact regulatory scrutiny for its effectiveness, we believe such an approach could be effective, particularly when combined with a redemption fee imposed on short-term trades, which would reduce, if not eliminate, the financial reward for late trading.

C. Require Full and Fair Restitution of Shareholder Losses

Regulators, federal and state prosecutors, and the fund firms themselves have provided assurances regarding restitution for losses to shareholders. That is reassuring. However, these promises have been short on specifics indicating how those losses will be measured and how the compensation will be provided.

Any restitution remedy must, at a minimum, satisfy the following criteria. It must be accompanied by a public statement detailing the basis for the restitution amount and an explanation of the methodologies used to calculate the amount. Furthermore, payments must be based on a methodology that takes into account not just the dollar amount of the relevant trades, but also the dilution caused by those trades (whether resulting from the execution of the trades at a stale price or from the processing of an order entered after the fund was priced); any administrative, trading, performance and other costs resulting from such trades; and the amount that money would have earned in the interim based on the fund's subsequent performance. Those who profited from abusive practices should be forced to disgorge those profits, including management fees received on accounts of traders who engaged in these practices, sales charges received on account of these traders' transactions, and interest or other compensation received on loans to these traders. High level executives who were aware of abusive practices but failed to take action should also pay their share of investor losses and should be required to forfeit any compensation they received in connection with those practices.

2. Improve Regulatory Oversight of Mutual Funds

The mutual fund scandal represents a structural breakdown in the regulatory oversight of mutual funds. Some have faulted the SEC's inspection program, which certainly appears to be in need of a major overhaul. However, allegations of abusive trading practices at mutual funds have been around for years. The SEC shouldn't have waited to uncover evidence of a problem in routine inspections, it should have gone looking for signs of trouble. This did not occur. Even when the problem had been exposed and the SEC received a tip of problems at a particular fund company, it was slow to act. These are signs of a regulatory oversight operation that is fundamentally broken.

The SEC has recently announced that it is creating a new risk assessment office whose purpose is to identify emerging problems and coordinate the agency's response. This is a good idea, but it is just a start. Congress needs to look further to determine whether additional reforms are needed to buttress the SEC's inspection and oversight program. We believe the following are among those that ought to be adopted.

A. Create an Independent Regulatory Organization to Oversee Mutual Funds

One obvious conclusion from the recent scandals is that mutual fund directors at implicated fund companies have failed to provide fundamental compliance oversight of their funds. While fund directors have failed their shareholders, the existing regulatory structures have also failed fund directors, by not providing them with consistent, effective guidance regarding their duties. We believe the best way to redress this short-coming is for Congress to create an Independent Regulatory Organization (IRO), patterned on the Public Company Accounting Oversight Board, with examination and enforcement authority over mutual fund boards and financed out of fund assets or management fees. The purpose of the board would be to supplement, rather than supplant, the SEC as the primary regulator of the mutual fund industry. While the SEC would continue to oversee investment advisers directly, the new board would, among other things, establish uniform, minimum fiduciary standards for fund directors' oversight of their funds, including their evaluation of advisory contracts, fund compliance procedures, and the implementation of those procedures.

B. Support and Expand SEC Efforts to Enhance its Regulatory Operations

As the SEC conducts its own internal investigation and reorganization, Congress should provide effective oversight of that effort in order to assure that it gets to the root cause of the SEC's lax regulatory response on this and other issues. The goal should be to revitalize the agency's inspection and oversight program, as well as to provide better direction for the agency's regulatory and enforcement efforts. In return for assurances of a newly aggressive approach to its regulatory responsibilities, Congress should provide the SEC with the resources it needs to fulfill those responsibilities effectively.

C. Review SEC's Reliance on Settlements without an Admission of Wrong-doing

The SEC's recent settlement with Putnam included many beneficial provisions for shareholders, particularly in the area of enhancing the independence of the board of directors. However, by settling such an egregious case without an admission of wrong-doing, the SEC has sent the unfortunate signal that this is yet another scandal for which no one is personally to blame. In its response to the recent corporate scandals, this administration promised a tough enforcement program, with individuals forced to accept the consequences of their actions. Congress adopted tough new criminal penalties. So far, however, we have seen little evidence that much has changed in a culture that favors quick settlements. While not every case should be subject to a protracted legal action, the worst cases should be held up as examples. The Putnam case would seem to qualify for this treatment, with fund managers apparently having timed their own funds – picking the pockets of their own shareholders – and management having done nothing to make them give back the money once the practices were uncovered. Congress should look into this practice, not just with regard to the Putnam settlement, but with regard to the SEC's enforcement program generally.

3. Enhance the Independence and Effectiveness of Mutual Fund Boards of Directors

As we noted above, mutual fund boards of directors at fund companies implicated in the scandal have clearly failed to provide fundamental compliance oversight of their funds. The recent scandals are not the only such evidence. Further evidence can be found in the exorbitant and unjustifiable fees that some funds impose, with the approval of the board, or in the soft-dollar and directed brokerage practices engaged in by many fund companies. One problem is that, even where they are independent in theory, mutual fund boards tend to be dominated by the fund managers. Legislative and regulatory responses to recent scandals must include comprehensive reforms designed to make boards more independent and effective.

A. Strengthen the Independence of Independent Directors

The current definition of an independent director includes a host of persons who are not independent from the fund manager. For example, a former director or officer of the fund's manager can be an independent director, as can a current officer or director of a service provider to the fund. The definition of independent director should be substantially strengthened, and the SEC should be given the authority to adopt rules excluding specified categories of persons from serving as independent directors.

B. Require an Independent Chairman

Most fund boards have a chairman who works for the fund's manager. All things being equal, when it comes to weighing issues where there is a direct conflict between the interests of the fund manager and the interests of shareholders, an independent chairman should provide stronger leadership and exercise greater independence in thought and action than a chairman who is employed by the fund manager.

C. Require a Substantial Majority of Independent Directors

To further clarify that boards really are designed as shareholders' representatives, three-quarters of their members should be required to be independent. This would allow the board to retain enough board members from the fund management to benefit from their expertise without risking domination by those members.

D. Require Independent Directors to Stand for Election.

Most fund directors are appointed for life and rarely stand for re-election by shareholders. Even when independent directors retire or resign, new independent directors often are not elected, because fund mergers have provided enough replacements to continue without any shareholder action. Fund shareholders should have a say in who serves as an independent director, and should have the ability to remove those who fail to act in their interests. Requiring independent directors to stand for election every five years would give them that ability.

E. Establish a Fiduciary Duty with Respect to All Fees.

Current federal law imposes a fiduciary duty on a fund's manager and directors only with respect to fees received by the manager. This has enabled the public offering of funds, in the most extreme examples, with annual expense ratios in excess of 10 percent – a level of fees that exceeds the one-time maximum sales load permitted under NASD rules and is inconsistent with the protections that should apply to a publicly offered investment vehicle. Fund directors and managers should have a duty to ensure not only that the manager's fee is reasonable, but also that the totality of a fund's fees is reasonable in relation to the services offered.

4. Improve Mutual Fund Sales Practices

Not all of the abusive practices in the recent fund scandals can be laid at the feet of fund companies. Some – like the failure to provide appropriate commission discounts and the sale of the inappropriate class of fund shares – are attributable to abusive sales practices by broker-dealers. We congratulate the SEC for its recent settlement with Morgan Stanley regarding its inappropriate sales practices, but a more comprehensive response is needed. Clearly, it is no longer reasonable to assert that brokers' obligation to make suitable recommendations substitutes for full pre-sale disclosure to investors. The following are important steps that Congress should take to reform broker-dealer sales practices.

A. Require Delivery of Fund Profile Prior to the Sale

Because the broker's suitability obligation is supposed to substitute for full disclosure, the securities laws do not require that brokers provide any disclosure document to shareholders at or before the time that the investment decision is made outlining key characteristics of that investment, including costs, risks, or investment goals. Current law requires only that a prospectus be delivered with the transaction confirmation, which is typically mailed days after the investor has made his or her investment decision.

In the mutual fund arena, a document exists – the fund profile – which covers basic characteristics of the investment. Such a document could easily be provided in advance of the sale – in person, through email, or by fax – without unduly delaying the sale. Since brokers have repeatedly shown that they do not consistently operate in their clients' best interests, and since the SEC has failed to enforce the suitability obligation to provide meaningful protection for investors, the time has come to require pre-sale disclosure of key investment characteristics, at least in the sale of mutual funds. (The fund profile should be updated to reflect the disclosure reforms we are advocating below.)

B. Require 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.

C. Require Point of Sale Cost Estimate

When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs.

Brokers 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.

5. Improve Mutual Fund Fee Disclosures

In addition to making fund boards more accountable for setting reasonable fund fees, Congress should take a number of steps to enhance the quality of fee disclosures to more accurately reflect real costs to investors. This would help to introduce greater competitive pressure on fund fees and would help to end distortions that result when certain types of cost are included in the fund's expenses and others are not.

A. Include Portfolio Transaction Costs in the Mutual Fund Expense Ratio

The mutual fund expense ratio omits what can be a fund's single largest expense: its portfolio transaction costs. These costs include the commissions paid by funds on portfolio trades, costs associated with the market impact of those trades, and the spread (difference between the bid and ask price) paid in connection with each trade. These costs can exceed a fund's total expenses. Commissions, which are the easiest of these costs to be quantified, should immediately be incorporated in the expense ratio. Congress should direct the SEC to come up with a plan for including all other portfolio transaction costs in the expense ratio as well.

B. Reform 12b-1 fees

The current method for disclosing 12b-1 fees is misleading, because it suggests that 12b-1 fees are the only distribution costs incurred by shareholders. In fact, shareholders also pay for distribution through fees paid to the fund's manager and through the allocation of fund brokerage to brokers in return for sales of fund shares. The fund fee table should provide investors with functional disclosure of how their money is being spent, regardless of the particular rule authorizing the fee. Fee tables should, in pie chart or other easily understood graphical presentation, show how fees are spent on portfolio management, transfer agent, distribution, custody and other services. Congress also should consider banning 12b-1 fees and requiring that all distribution expenses be paid out of the management fee, with disclosure showing on which types of services fees were spent.

C. Require Fee Comparison Disclosures

Mutual fund fee tables do not show how fees charged compare to those charged by similar funds or index funds that invest in similar securities. Providing this information would make it much easier for investors to compare fees across funds. The fee table should be required to show the average fees charged by a peer group of funds and by an index fund that invests in the same types of securities. This would not only aid investors to make better informed choices, it would provide essential market discipline for fund costs.

D. Require Disclosure of the Actual Fund Costs

Current rules do not inform shareholders about the actual cost they pay for their investments. A proposal put forward by the SEC – to require funds to disclose, in shareholder reports, the actual fees paid on a $10,000 account – does little to remedy this short-coming. In fact, the Government Accounting Office found that this disclosure would be less likely to be read than if it were placed in shareholders' quarterly statements, and that it would have less of an impact than if it showed shareholders' individual costs. Congress should require that quarterly (or at least annual) statements show the actual dollar amount of the shareholder's expenses during the period covered by the statement.

E. Require Disclosure Comparing Different Fund Classes

Many funds offer a bewildering array of different share classes. In some cases, shareholders have been sold classes of shares that provided the greatest payoff for the broker but are least suitable for the shareholder. Fund prospectuses (and fund profiles) should be required to compare, in a graphic format, the costs of investing in different classes over a 15-year period.

6. Miscellaneous Additional Reforms

A. Require Disclosure of Amount and Structure of Portfolio Managers' Compensation and Fund Investments

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. 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. At a minimum, Congress should require that fund managers disclose the amount and structure of their compensation and their investments (including timely reports of purchases and sales) in the funds they manage. In addition, Congress should consider banning, or sharply restricting, such practices as dual management of mutual funds and hedge funds when they pose significant risks to investors.

B. Ban Soft Dollars

Mutual fund managers are allowed to cause their funds to pay higher commissions to cover services that the manager would otherwise pay for out of its own pocket. These services are not required to be used to benefit the fund that paid for them, and the cost of these services is not disclosed. These soft dollar arrangements increase fund costs and create unnecessary conflicts of interest.

C. Prohibit Fund Managers from Allocating Brokerage in Return for Fund Sales

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. 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. Fund managers should be prohibited from considering sales of fund shares when selecting brokers to effect fund transactions and should be required to obtain best execution on their trades.

D. Apply the Rule on Misleading Fund Names to "U.S. Government" Funds

Funds are prohibited from using misleading names, yet the SEC 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. These securities are not guaranteed by the U.S. Government, which is the guarantee investors think 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.

Conclusion

Investors have benefitted greatly over the years from the opportunity mutual funds offer even those of modest means to gain broad diversification and professional management. Many average, middle income investors have relied on mutual funds as the one place in the securities industry where their interests were likely to get fair consideration. Although the dollar amounts that individuals have lost as a result of recent scandals is likely to be quite small, the blow to investor confidence has been enormous. The above proposals are key elements in the comprehensive approach to reform that the current mutual fund crisis demands. It is imperative that Congress and the SEC act quickly and forcefully to restore badly damaged investor confidence.