Testimony of Mark Treanor, General Counsel, Wachovia Corporation,
On behalf of the Financial Services Roundtable
Before the Senate Banking Committee,
Hearing on "Mutual Fund Costs and Distribution Practices,"
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Introduction to Financial Services Roundtable

The Financial Services Roundtable unifies the leadership of large integrated financial services companies. The Roundtable's membership includes 100 of the largest firms from the banking, securities, investment and insurance sectors. This broad membership, including investment advisers, broker-dealers, and administrators of retirement plans, makes the Roundtable uniquely qualified to comment on mutual fund distribution issues.

Summary of Position on Mutual Fund Distribution

The Roundtable would like to commend Chairman Richard Shelby and the entire Senate Banking Committee for conducting a thorough, deliberate examination of mutual fund issues. The Securities and Exchange Commission ("SEC") is also conducting a comprehensive review of mutual fund regulation. Not only is the SEC moving aggressively to consider proposals to prevent recurrences of abusive late trading and market timing, the agency has proposed or adopted rules across the entire spectrum of mutual fund operations. The Roundtable believes the regulatory process should be allowed to work before any legislative changes are enacted.

The SEC has put forward for public comment a number of proposals addressing distribution issues.[1] These proposals are discussed in greater detail below. In summary, the agency is seeking to improve disclosure to investors and at possible prohibitions on particular business practices. The comment periods for many of these proposals are still open and the Roundtable expects to file comments with the SEC.[2]

As a result, the Roundtable has not yet taken positions on each of the specific proposals put forward by the SEC. In general, the Roundtable favors disclosure over prohibitions, including prohibitions on specific types of distribution arrangements. Our goal should be the greatest possible choice for investors. Armed with appropriate information, investors can choose how they want to compensate the intermediaries who service them. The Roundtable also expresses its views below on improving mutual fund disclosure; strengthening fund ethics and governance; and protecting fund shareholders.

Introduction to Wachovia

Wachovia Corporation is one of the largest providers of financial services to retail, brokerage and corporate customers throughout the East Coast and the nation, with assets of $401 billion, market capitalization of $61 billion and

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[1] Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, SEC Rel. No. 33-8358 (January 29, 2004); Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Rel. No. IC-26356 (February 24, 2004).

[2] The Roundtable would be pleased to provide any comment letters it files for the Committee's hearing record.

stockholders' equity of $32 billion at Dec. 31, 2003. Its four core businesses, the General Bank, Capital Management, Wealth Management, and the Corporate and Investment Bank, serve 12 million households and businesses, primarily in 11 East Coast states and Washington, D.C. Wachovia's full-service brokerage, Wachovia Securities, LLC, serves clients in 49 states. Global services are provided through 32 international offices.

Distribution of Mutual Funds

Mutual funds have become the investment vehicle of choice for Americans seeking to reach long-term financial goals. Whether directly or through retirement plans and other investment channels, American investors have turned to mutual funds in order to save and build wealth. Mutual funds offer a convenient and affordable way to make diversified investments in stocks and bonds. Roughly half of all American households own mutual funds; nearly three-quarters of all mutual fund shares are owned by individual investors.

Some investors have the time, sophistication and inclination to investigate and evaluate mutual fund options on their own. Other investors prefer to have an intermediary help them identify their investment goals and funds that may be appropriate to help them meet those goals. In fact, 88% of mutual fund shares are purchased through intermediaries. Brokers, financial planners, insurance company separate accounts, retirement plan administrators – all serve as important channels

for distribution of mutual funds to the public. They provide investors a convenient means of comparing and accessing a variety of competing mutual fund families.

In addition to distributing mutual funds, intermediaries may have an important role to play in servicing customers' mutual fund accounts on an ongoing basis. Many investors prefer the convenience of receiving a single statement that presents all of their investments, including their investments in various mutual fund families, rather than receiving multiple statements from different financial institutions. Intermediaries may also help investors understand their statements and the performance returns on their mutual fund investments.

It is proper to compensate intermediaries for these services performed at the request and for the benefit of investors. Historically, that compensation took the form of an upfront charge paid by the investor – known as a "front end sales load." Sales loads typically ranged in amount up to 8.5%. Today, compensation may take various forms.[3] "12b-1 fees," so-called after SEC Rule 12b-1,[4] are fees deducted from fund assets to pay for distribution. Section 12(b) of the Investment Company Act gives the SEC authority to regulate a fund's distribution of its securities, in order to protect fund shareholders from excessive distribution costs.[5] Rule 12b-1 permits funds to adopt written plans for using fund assets to pay for

[3] "Class A" mutual fund shares may have a front end sales load, with breakpoints for larger investments. "Class B" shares may have no front end sales charge, but may have "12b-1 fees" and a sales charge deducted if the shares are redeemed within a certain period of time. "Class C" shares may have no sales charges but have 12b-1 fees.
[4] 17 CFR 270.12b-1.
[5] 15 U.S.C. 80a-12(b).

distribution. In effect, 12b-1 fees allow investors to pay for distribution and related costs over time rather than all at once.

Fund advisers make payments to intermediaries for distribution, sometimes known as "revenue sharing" payments. It is important to note these payments are made from the assets of the adviser, as opposed to the assets of the fund. Furthermore, a broker-dealer's registered representatives always remain subject to rules of self-regulatory organizations that require that any funds they recommend to investors be "suitable" for those investors.

Payments by fund advisers or their affiliates may also compensate broker-dealers for performing routine shareholder servicing. These functions may include processing fund transactions; maintaining customer accounts; mailing prospectuses and confirmation statements; and other tasks that mutual funds otherwise perform themselves. Payments for these administrative services have helped foster the development by broker-dealers of mutual fund "supermarkets." These allow investors the convenience of accessing multiple mutual fund families in a single place and receiving a single statement covering their mutual fund investments.

The term "directed brokerage" refers to the use of fund brokerage commissions to facilitate the distribution of fund shares. In general, pursuant to rule of the National Association of Securities Dealers ("NASD"), a broker may not condition its efforts in distributing a fund's shares on receipt of brokerage

commissions from the fund.[6] The rule allows a fund to consider sales of its shares in the selection of brokers to execute portfolio transactions for the fund, subject to best execution and provided the policy is disclosed.[7] In approving this rule, the SEC added that this should not generate additional expense to the fund and that fund boards should consider the potential conflict of interest inherent in using fund assets to pay for distribution.[8]

Disclosure of the Costs of Distribution

Mutual fund management fees are paid to investment advisors to select portfolio securities and to manage funds. They do not include all costs and expenses that have an impact on a fund's net performance. Mutual fund investors deserve to know how their assets are being spent on items such as fund distribution. When these costs and expenses are disclosed, investors can make informed decisions as to whether shareholders interests are being served.

Safeguards already apply to the imposition of 12b-1 fees and they are currently disclosed to investors. Under Rule 12b-1, a fund may not use fund assets to pay distribution-related costs except pursuant to a written plan approved by fund directors and shareholders. A majority of fund independent directors must approve the fees each year. Any increase in 12b-1 fees must be approved by both a majority of fund independent directors and the fund shareholders. A fund that

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[6] NASD Conduct Rule 2830(k) (Execution of Investment Company Portfolio Transactions).
[7] Id.
[8] SEC Investment Company Act Rel. No. 11662 (Mar. 4, 1981). The SEC has proposed to prohibit mutual funds from directing brokerage transactions to compensate broker-dealers for promoting fund shares. See text accompanying footnote 7 below.

charges 12b-1 fees must disclose that fact in its prospectus. A fund is required to disclose how 12b-1 fees increase costs over time and identify them as a separate item in the fund's fee table in the prospectus and as part of the fund's annual operating expenses.

While Rule 12b-1 itself does not limit the level of 12b-1 fees, rules adopted by the National Association of Securities Dealers ("NASD") act to do so. NASD rules limit the amount of aggregate mutual fund charges, including sales loads, 12b-1 fees, and service fees.[9] Pursuant to NASD rule, a broker may not sell shares of a mutual fund with a sales load in excess of 8.5 percent of the purchase price, whether assessed at the time of purchase or the time of redemption, and so long as the fund does not charge a 12b-1 fee or a service fee. The sales load of a fund with a 12b-1 fee and a service fee may not exceed 6.25 percent of the amount invested; the 12b-1 fee and service fee of a fund with a sales load may not exceed 0.75 percent per year of the fund's average annual net assets plus a 0.25 percent service fee. A fund also may not advertise itself as a "no load" fund if it imposes 12b-1 fees and/or service fees greater than 0.25 percent.

As described above, as part of its comprehensive review of mutual fund regulation the SEC is seeking comment on potential changes to the distribution of mutual funds, including under Rule 12b-1.[10] The public comment periods with respect to the following proposals remain open and the Roundtable anticipates that

[9] NASD Conduct Rule 2830 (Investment Company Securities).
[10] See footnote 1 above.

it will respond to the SEC's proposals in detail. In general, the Roundtable prefers improved disclosure of distribution and other business arrangements to attempts to prohibit specified types of arrangements.

First, the SEC has proposed amendments to the Rule to prohibit mutual funds from directing brokerage transactions to compensate a broker-dealer for promoting fund shares.[11] A fund that directs any portfolio securities transactions to a broker that sells its shares must have policies and procedures in place that are designed to ensure that its selection of brokers is not influenced by fund distribution issues.[12] Alternatively, the SEC is seeking comment on requiring greater disclosure of directed brokerage.

The SEC has also proposed requiring brokers to provide customers with information about distribution-related costs at the time of purchase of mutual fund shares. Brokers would have to estimate the total annual dollar amount of asset-based sales charges, including 12b-1 fees, that would be associated with the share purchased, assuming their value remains unchanged. Brokers also would be required to disclose the existence of differential compensation – broadly speaking, whether brokers have a greater financial incentive to sell certain mutual funds over others.

Separately, the SEC is also seeking comment on whether to prohibit funds from deducting distribution-related costs, including 12b-1 fees, from fund assets;

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[11] Proposed Rule 12b-1(h)(1).
[12] Proposed Rule 12b-1(i).

the proposal would provide instead that they be deducted directly from shareholder accounts with the deduction appearing on account statements.

> "Under this approach, a shareholder purchasing $10,000 of fund shares with a five percent sales load could pay a $500 sales load at the time of purchase, or could pay an amount equal to some percentage of the value of his or her account each month until the $500 amount is fully paid (plus carrying interest)."[13]

Among the potential benefits of this change identified by the SEC are increased transparency to shareholders; reduced payments by long-term fund shareholders; and reduced payments by existing shareholders.[14] The SEC is also seeking comment on whether to rescind the rule.

Other Mutual Fund Issues

The Roundtable would like to share its views on improving mutual fund disclosure; strengthening fund ethics and governance; and protecting fund shareholders.

Improving mutual fund disclosure

A mutual fund's management fee (the fee paid to the investment advisor to select portfolio securities for and manage the fund) does not include all costs and expenses that have an impact on a fund's net performance. The Roundtable believes that mutual fund investors deserve to know how their assets are being spent on items other than distribution, such as brokerage. When costs and expenses are disclosed, investors can

[13] SEC Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution, Rel. No. IC-26536 (February 24, 2004), at 9.
[14] Id.

make informed decisions as to whether shareholder interests are being served. The Roundtable's member companies agree that aggregate fund brokerage commissions, average commission rate per share and turnover information are useful types of disclosure. More information could also be disclosed about any services received by a fund in addition to trade execution, such as investment research. However, the Roundtable believes that efforts to require funds or brokers to assign precise dollar values or artificial prices to proprietary services that are not commercially available on an independent basis (such as an in-house research product) are likely to be unworkable and unreliable.

The Roundtable does not support disclosure of actual dollar amounts of compensation paid to individual portfolio managers. Instead, the Roundtable supports disclosure to fund investors of the structure and methodology of portfolio manager compensation.[15] This would help investors understand portfolio managers' incentives and whether the fund will meet their investment objectives.

Strengthening fund ethics and governance

In addition to robust disclosure obligations, the Roundtable believes mutual funds must have vigorous ethics and governance requirements. At the same time, it is important to understand that mutual funds differ from operating companies. Mutual funds typically do not have employees. Instead, the fund's investment advisor carries out its day-to-day operations.

[15] See Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, SEC Rel. No. 33-8396 (March 11, 2004).

The Roundtable supports requiring that a supermajority of a fund's board of directors be independent of the fund adviser. Independent fund directors play a critical role in the protection of fund shareholders. Directors approve an advisory contract and oversee the advisor's performance. Oversight by fund boards is the most effective method of managing potential conflicts of interest that could harm fund shareholders. Requiring that a supermajority of directors be independent is an important step toward ensuring that the board carries out this role.

The Roundtable believes that a board with a supermajority of independent directors can determine the individual best suited to serve as chairman and would not support a requirement that the chairman be an independent director. If a non-independent director serves as fund chairman, certain governance safeguards could be in place to promote the independence of the board as a whole. These include requiring the independent directors to choose a lead director and hire their own counsel; requiring the board nominating committee to be composed entirely of independent directors; and requiring that the independent directors set their own compensation. These measures would ensure that a non-independent chairman cannot control a board and that independent directors will be able to carry out their responsibilities to fund shareholders.

The SEC has recently taken a step that should enhance the ability of fund directors to safeguard shareholders' interests. The SEC has adopted rules requiring fund directors to approve written compliance policies and programs for

both the fund and the fund's advisor.[16] The fund's compliance program will be administered by a chief compliance officer, reporting directly to the board. This will increase accountability and provide fund directors a centralized assessment of fund compliance that is not influenced by the management of the fund's investment adviser.

Protecting mutual fund shareholders

Recent instances of late trading and market timing in mutual funds have undermined investor confidence. Roundtable members care deeply about restoring investor trust and preventing future abuses. The Roundtable supports a number of additional protections for mutual fund shareholders.

First, the Roundtable supports vigorous additional efforts by the SEC to protect mutual fund shareholders from late trading. From intermediaries to funds, more can and should be done to ensure that all investors are treated fairly in terms of the price they receive when buying and selling fund shares. Roundtable member firms support requiring participants in the process of transmitting investor orders in mutual funds to adopt forceful safeguards against late trading. The Roundtable advocates requiring funds and fund intermediaries, as a condition to be eligible to receive mutual fund orders up to the 4:00 p.m. closing time, to have electronic time stamping systems and abide by associated compliance, certification and independent audit requirements. The Roundtable believes these requirements

[16] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204 (December 17, 2003).

would better serve investors than the "hard close" at the fund only proposed by the SEC.[17] Roundtable members believe the "hard close" would be disruptive and confusing to investors. Investors buying or selling fund shares through brokerage or retirement accounts could face cut-off times of 2:30 p.m. or even earlier. The Roundtable suggests that it has put forward a more investor-friendly means of preventing late trading.

Roundtable members support vigorous additional efforts by the SEC to guard against market timing. The Roundtable supports the enhanced disclosure by funds of their market timing policies and practices proposed by the SEC.[18] In general, the Roundtable believes it is better to present investors with greater information regarding funds' market timing policies than to enforce new "one size fits all" rules on this issue. The Roundtable also supports the SEC's proposals on the wider use of fair value pricing and on disclosure of that issue and of disclosure to selected parties of fund portfolio holdings.

Finally, the Roundtable supports requiring mutual funds to disclose to investors the potential conflicts arising out of the joint management of mutual funds and other accounts.[19] At the same time, fund directors must ensure that advisers do not disadvantage fund shareholders in favor of other advisory clients. Investors can then evaluate the risks in deciding where to invest. A blanket ban on

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[17] Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, SEC Rel. No. IC-26288 (December 11, 2003).
[18] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Rel. No. 33-8343 (December 11, 2003).
[19] See Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, SEC Rel. No. 33-8396 (March 11, 2004).

joint management of mutual funds and hedge funds would actually harm mutual fund investors, as many portfolio managers would likely choose hedge funds because they typically offer higher compensation than do mutual funds.

Conclusion

Roundtable members believe that disclosure is a crucial tool to ensure that funds serve their shareholders and that shareholders can evaluate fund performance effectively. The Roundtable supports improvements to make certain that fund disclosures are periodic, timely, robust, efficient, uniform and easy to administer. However, proposals that would increase compliance costs without commensurate increases in investor protection would only reduce returns for mutual fund shareholders. The Roundtable is concerned that mutual funds not be undermined as an attractive product for investors.

The Roundtable is studying the SEC's proposals carefully and expects to file comments with the agency before the comment periods expire in April and May. As noted, the Roundtable in general feels that improvement to disclosure is a better response to these issues than is prohibition of specific business practices. The Roundtable commends the SEC for its vigorous efforts to ensure that mutual fund shareholders receive the information and protection they need and deserve. We look forward to continuing our dialogue with the agency, and the Committee, so that investors continue to have confidence in mutual funds as an investment vehicle.