

MEMO# 12168

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GENERAL ACCOUNTING OFFICE REPORT ON MUTUAL FUND FEES

[12168] July 5, 2000 TO: BOARD OF GOVERNORS No. 38-00 PRIMARY CONTACTS - MEMBER COMPLEX No. 45-00 PUBLIC INFORMATION COMMITTEE No. 26-00 SEC RULES COMMITTEE No. 94-00 RE: GENERAL ACCOUNTING OFFICE REPORT ON MUTUAL FUND FEES The U.S. General Accounting Office has completed a report on mutual fund fees. The 125-page report, entitled "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," was a response to a September 29, 1998 request from Representative Mike Oxley, Chairman of the House Subcommittee on Finance and Hazardous Materials, and Representative John Dingell, Ranking Member of the House Committee on Commerce. Chairman Oxley and Representative Dingell publicly released the report today when they forwarded it to Chairman Arthur Levitt of the U.S. Securities and Exchange Commission. The GAO report addresses a variety of topics related to mutual fund fees, including statistical trends, the nature of competition in the mutual fund industry, disclosure practices, and the role of fund directors. The report includes, as an appendix, a letter submitted in May by the Institute on an earlier confidential draft, the GAO's responses to the Institute's comments, and letters on the draft report from the SEC and the NASDR. The report makes one recommendation - that the SEC require that account statements provided to fund investors disclose the amount of fees paid by the investor. These statements are typically provided to shareholders by their fund company or by a brokerage firm. The report acknowledges that this recommendation will result in both "one time and ongoing costs," and suggests that the SEC examine its costs and burdens on the fund industry and investors. In addition, the GAO identifies two alternatives to this recommendation that it believes could also enhance investor understanding of fees. In submitting the GAO Report to the SEC, Chairman Oxley and Representative Dingell characterized it as an "exhaustive" study of mutual fund fees and expenses. The four-page letter summarized many of the Report's findings, and stated that its "major conclusion . . . is that additional targeted disclosure would help increase investor awareness and understanding of mutual fund fees." The letter urges the SEC "to take the necessary steps to implement" the Report's recommendation. The letter notes, however, that "we are not tied to any particular [disclosure] method and are open to other effective suggestions." The letter notes that "in varying degrees," the ICI, the SEC, and NASDR "raised reservations" about the account statement proposal. The representatives requested two progress reports from the SEC; the first by year-end 2000; the second by June 2001. A copy of the full report is enclosed. The report is also available on the GAO's web site (<http://www.gao.gov/new.items/gg00126.pdf>). We have also included the ICI's public statement, a one- 2page summary of the ICI's response to the final report, and the letter to the SEC from Chairman Oxley and Representative Dingell. A description of the report follows, with references to the ICI's May comment letter and the GAO response

where appropriate. Data Regarding Adviser Costs The report noted that because many advisers to mutual funds are privately held, comprehensive information on fund advisers' costs and profitability is not generally publicly available. According to the GAO, this precluded an examination of the actual costs to advisers of operating mutual funds at varying asset levels. The report notes that academic researchers and others believe that fund advisers experience economies of scale as fund assets grow, but that there was insufficient public data to enable the GAO to examine such views. As is discussed in more detail below, the GAO was able to analyze extensive historical expense ratio data for individual equity and bond mutual funds. Their analysis found that funds that experienced substantial growth from 1990 to 1998 reduced their fee levels, with the most sizable reductions occurring at funds that experienced the greatest growth. The report also acknowledged that these findings were consistent with a 1999 ICI study on economies of scale. The report indicates that many fund advisers told the GAO that the costs of operating a mutual fund were increasing. The report identifies new shareholder services, distribution and advertising costs, personnel costs, and technology expenditures as potential sources of upward cost pressure. The report states that fee revenues collected by advisers increased significantly during the 1990s and that data for some advisers indicate that profitability has also been increasing. The Institute's letter to the GAO addressing the draft version of the report noted that the fee revenue information set forth by GAO appeared to mistakenly include payments (such as 12b-1 fees) to third parties. As a result, the report appeared to overstate growth in adviser revenues. In response, the GAO clarified that this data included revenues to entities other than the fund's adviser.

Trends in Fund Expenses The report discusses several studies of trends in mutual fund costs, including extensive reviews of earlier ICI studies that showed significant declines in total shareholder costs since 1980. The report also describes the results of a separate GAO study of fund expenses, which examined expense ratios, asset growth rates, and related data. The study focused on 77 large mutual funds: the 46 largest equity funds and 31 largest bond funds as of December 31, 1998 that had been in existence since January 1, 1990. The GAO study found that eighty-five percent of the equity funds they examined reduced their expense ratios, with an average decline of 20 percent. The expense ratios of bond funds, which experienced much slower asset growth, declined by an average of three percent. Considering large equity and bond funds together, the GAO reports that seventy percent of these funds had lower expense ratios in 1998 than in 1990. The GAO also examined a subset of the large mutual funds, focusing on those that experienced rapid asset growth over the same nine year period. Data from the report shows that 38 of the 51 equity and bond funds whose assets grew by 500 percent or more between 1990 and 1998 reduced their expense ratios by 10 percent or more. Of the remaining 13 funds, only 3 actually experienced expense ratio increases. In commenting on the draft version of the report, the Institute commended the GAO and stated that its statistical analysis confirmed the results of academic studies and ICI research about the overall downward trend in mutual fund fees.

Competition The GAO report describes the mutual fund industry as one that features a large number of competitors, low barriers to entry, and product differentiation on the basis of quality, features or services (which are characteristic of "monopolistic competition"). In this regard, the report notes that both the number of funds and the number of fund families rose significantly during the period of 1984 to 1998 and that the industry is not concentrated. The report observes that funds compete primarily on the basis of performance rather than on price, although it also acknowledges that fees can be "indirectly taken into account" because performance must be reported net of expenses. Our May letter to the GAO emphasized that competition based on performance necessarily leads to competition based on price. We stated that the "indirect consideration of fees through performance" appeared to be relevant to investor decision-making, pointing to Institute research that shows 78

percent of equity fund shareholder accounts are in funds that charge less than the industry average. In response, the GAO stated that competition based on net returns “may or may not” be the same as competition based on price. The GAO also stated that the fact that most investors own shares in funds whose expense ratios are less than the industry’s simple average is not sufficient to show that investors are “highly fee conscious.”

Disclosure The GAO sought the views of various individuals on the adequacy of current fee and expense disclosure requirements for mutual funds. The report states that many of those interviewed (including researchers and regulators, as well as industry representatives) believed current requirements were “extensive” and “adequately highlight the fees that investors can expect to pay.” Several of those interviewed expressed strong support for the mutual fund fee table. These observers stated that the standardized presentation in the fee table is particularly important because it allows investors to compare costs easily. Others, however, did not agree that existing disclosure was adequate, and favored providing investors with the dollar amount of fees paid on quarterly account statements. The report cited a third-party investor survey in which 89 percent of those surveyed said that such information would be useful or very useful. The report noted, however, that 54 percent of respondents indicated they were “very unlikely” to be willing to pay for the information. The GAO report suggests that requiring fund companies and brokerage firms to provide fund investors with the actual dollar amounts paid by them individually might “increase investor awareness” and “potentially stimulate fee-based competition among fund advisers.” Some of the individuals the GAO interviewed concurred in this view. The report contends that other financial service providers disclose the specific dollar amount of charges that consumers incur, although the report also acknowledges that many of these same firms do not disclose the spreads they earn on, for example, deposit accounts. The report notes that studies indicate that investors tend to place greater emphasis on factors other than fees in selecting funds (such as performance and risk), and that investors are generally aware of sales loads. The report suggests that sales loads are more visible to fund investors than annual fees. The report acknowledges concerns with requiring customized fee disclosure on account statements. It suggests that the SEC consider its costs and burdens. These concerns include one-time and ongoing costs (both for funds and broker-dealers), the risk that such disclosure could lead some investors to make inappropriate investment decisions, and the fact that, unlike the fee table, such disclosure would not facilitate comparing funds on the basis of costs. The report suggests, however, that dollar amount disclosures could “further highlight” costs to investors and could promote more fee-based competition among funds. The report states that less costly means of providing this disclosure in account statements could be considered, including providing an approximation of costs based on the average number of shares held during the period. Another alternative identified was similar to the hypothetical in the fund fee table, and would use a pre-set dollar amount, such as \$1,000, to illustrate the impact of annual fees. The report also discusses requiring funds to provide fee information for comparable funds, but notes that it would be problematic to determine the relevant groupings for comparison purposes and that other financial products are not required to make such disclosure. The Institute’s letter to the GAO stated that promoting investor awareness of the important role fees can play in fund investments is a longstanding industry priority, but that the Institute and its members had reservations about the account statement recommendation. The letter expressed concern that the recommendation could erode the value of the standardized, all-inclusive information in the fee table, and thus could impede rather than facilitate informed assessments of fee levels at competing funds. The GAO’s response acknowledges that the current required fee disclosures are “comprehensive and reasonably understandable,” but states that they are “less direct indications of the specific prices charged to any one investor.”

Role of Fund Directors The

report discusses the role of fund directors in reviewing fund fees. It notes that the Investment Company Act requires directors to review fund advisory contracts annually. It also discusses judicial interpretations of Section 36(b) of the Act, which have established current expectations for fund directors in reviewing fees. The report notes that these involve consideration of several factors, such as the nature and quality of an adviser's services, the adviser's costs, and economies of scale. Fund officials interviewed by the GAO reported that their directors conduct a rigorous review of fund fees. In addition, a GAO review of SEC examinations revealed few deficiencies in this area. Others, however, criticized the role of directors. For example, one individual stated that, because directors base fees on those charged by similar funds, fees are higher than necessary. The report also discusses recent industry and SEC initiatives to strengthen the role of fund directors, but states that they are unlikely to "significantly affect the level of fees in the mutual fund industry." The Institute's letter to the GAO stated that mutual fund directors have contributed to broad-based fee reductions. We noted that a variety of research studies, including the GAO's own statistical analysis, had found that a significant majority of funds had reduced their fee levels. We also noted that fund directors have unique governance responsibilities that go well beyond the duties of typical corporate directors which are specifically designed to safeguard the interests of fund shareholders. Matthew P. Fink
President Attachments Attachment no. 1 (in .pdf format) 5

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