

**MEMO# 15755**

March 13, 2003

## **CONGRESSIONAL HEARING ON MUTUAL FUND INDUSTRY PRACTICES; GAO REPORT ON FUND FEES**

[15755] March 13, 2003 TO: BOARD OF GOVERNORS No. 13-03 DIRECTOR SERVICES COMMITTEE No. 3-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 25-03 PUBLIC INFORMATION COMMITTEE No. 6-03 SEC RULES MEMBERS No. 32-03 RE: CONGRESSIONAL HEARING ON MUTUAL FUND INDUSTRY PRACTICES; GAO REPORT ON FUND FEES The House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing yesterday on "Mutual Fund Practices and Their Effect on Individual Investors." The following witnesses appeared at the hearing: Paul G. Haaga, Jr., Executive Vice President of Capital Research and Management Company and Chairman of the Board of Governors of the Investment Company Institute (on behalf of the Institute); James S. Riepe, Chairman, T. Rowe Price Funds; John C. Bogle, Founder, The Vanguard Group; Harold Bradley, Senior Vice President, American Century Investment Management; Gary Gensler, co-author of The Great Mutual Fund Trap and former Under Secretary of the Treasury; John Montgomery, Founder and President, Bridgeway Funds; and Wayne H. Wagner, Chairman, Plexus Group. House Financial Services Committee Chairman Michael G. Oxley gave an opening statement. The testimony of each of the witnesses, as well as Chairman Oxley's statement, are summarized below. The U.S. General Accounting Office (GAO) submitted a statement for the record entitled "Mutual Funds - Information on Trends in Fees and Their Related Disclosure." 1 The statement, which is also summarized below, responds to a request by Chairman Oxley. It provides updated information on how fund fees have changed since 2000, discusses how fund fees are currently disclosed and various alternatives for expanding these disclosures, and provides information on how funds' trading costs are disclosed. Institute Testimony Mr. Haaga testified that the last few years have been challenging ones for mutual fund investors. They have felt the impact of market downturns, and egregious corporate and 1 Prepared testimony and statements are available at <http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=187&comm=1>. 2 accounting scandals have broadly impacted investor confidence. He noted that throughout these difficult times, the comprehensive regulatory scheme under which mutual funds operate has served the interests of fund investors well. He pointed out that while mutual funds were not the cause of the scandals or abuses, the fund industry's responsibility to serve and protect the interests of fund investors makes it imperative that the industry work to devise and support solutions. For this reason, the industry strongly supported the Sarbanes-Oxley Act and many other reforms to the financial reporting and oversight system. Mr. Haaga also testified on the issue of mutual fund fees. He pointed out that an overwhelming majority of stock fund purchases by investors from 1997 to 2001 involved funds that had expense ratios below the industry average. He stated that "[t]he

fact that the typical shareholder who holds mutual funds today is paying far less than the average fund charges is compelling evidence that our industry's practices – the funds we offer, the services we provide, and the fees we charge – are serving tens of millions of fund investors faithfully and effectively. In particular, it is apparent that the market readily enables investors to find lower cost mutual funds.” He concluded by stating that the industry's “challenge of educating investors – about diversification, asset allocation, various types of risk, the impact of fees and taxes, the need for realistic expectations and a long-term focus – is a constant responsibility and an essential element of reinforcing confidence in our markets.” Mr. Haaga's written testimony emphasized the following key points: (1) mutual funds provide clear fee disclosure to investors; (2) substantive regulation of fund fees provides further investor protection; (3) the broad availability of information about mutual fund fees has helped promote competition in the industry; (4) the SEC continually seeks ways to improve disclosure of mutual fund fees and other costs; and (5) comprehensive regulation under the Investment Company Act has protected investors and helped the fund industry avoid major scandal. Testimony of James S. Riepe Mr. Riepe testified that funds have done a good job educating investors on the cost of investing in mutual funds by providing net performance, unlike many other financial products, including certificates of deposit. He also pointed out that management and shareholder interests are aligned in that both want good performance and good service at a reasonable cost. Mr. Riepe responded to criticism that the infrequency of firings of fund management companies indicates that fund directors are not doing their job. He stated that investors do not expect boards to replace fund managers because by choosing to invest in a particular fund, they have chosen to invest in a fund managed by that particular firm. Testimony of John C. Bogle Mr. Bogle testified that the costs of fund ownership have soared, and that this has adversely affected the returns earned by equity fund investors. He recommended that the SEC or the GAO conduct an economic study of the mutual fund industry, showing the specific sources and uses of shareholder money. 3 Mr. Bogle also stated that because fund investors are largely unaware of the high level of mutual fund costs, the SEC should enact new rules to require greater disclosure, including: requiring funds to provide annual statements that provide the dollar amount a shareholder is incurring through the fund's expense ratio (which would be forward-looking, showing the expected annual expenses based on the value of the shareholder's investment at year-end); requiring disclosure in the prospectus and the annual report of an estimate of the “all-in” cost of fund ownership by adding transaction costs (e.g., market spreads, market impact) to the current examples presented in the fee table; and requiring annual reports to disclose in a table the fund's total annual return compared to an appropriate market sector benchmark and the annual return of the broad market in which the fund invests (e.g., the total stock market), annual portfolio turnover rate, the estimated impact of transaction costs on returns, total annual costs as a percentage of net assets, and the total annual dollar amount of costs incurred by the fund. Mr. Bogle also recommended that the chairman of a fund's board be required to be an independent director and that the required percentage of independent directors be increased. Testimony of Harold Bradley Mr. Bradley delivered testimony that was critical of the SEC's expansive definition of “research” under Section 28(e) of the Securities Exchange Act, which permits advisers to use commission dollars to obtain certain products and services. He recommended that Congress better define and limit the scope of Section 28(e). He also recommended that commissions be disclosed as a percent of the dollar amount of each trade rather than as a per share charge; that the execution-only rate for each broker be disclosed; that commissions used by investment managers to pay for goods and services customarily available to the public for cash (e.g., telephone charges) be reflected in the fund's expense ratio; that initial public offerings be priced and allocated by Dutch auction pricing models; and that underwriters be required to disclose the recipients of the

largest 50 allocations on the day after an underwriting. Testimony of Gary Gensler Mr. Gensler testified that the cost of investing in mutual funds has greatly increased and provided several recommendations to address “the ever changing issues related to the inherent conflicts between mutual fund companies and mutual fund investors.” His specific recommendations included the following: requiring disclosure of total transaction costs, including commissions and an estimate of the costs of bid/offer spreads along with management fees as a percentage of average assets; requiring disclosure of after-tax performance in sales material; requiring funds to disclose risk-adjusted returns on their websites or in promotional material; tightening the advertising rules in light of the persuasive evidence that past performance does not predict future performance; requiring funds to disclose the performance results of liquidated or merged funds and to disclose these funds’ performance in reports on a fund company’s average performance; and requiring greater disclosure of revenue sharing arrangements. Mr. Gensler also recommended that consideration be given to requiring that fund directors seek competitive proposals on a periodic basis or prior to renewing advisory contracts. Alternatively, fund boards could be required to disclose the basis and reasoning for not seeking such competitive proposals. In addition, he suggested banning soft dollars or, alternatively, 4 requiring disclosure to include the amount by which any soft dollar arrangement is picking up costs for the fund company. He also recommended that the SEC consider rules to limit the use of IPO allocations to enhance the performance of incubator and small funds. Finally, Mr. Gensler recommended considering having all 401(k) and 403(b) plans include as investment alternatives a low cost broad market U.S. equity index fund and bond index fund. Testimony of John Montgomery Mr. Montgomery testified that uniform, standardized and improved disclosure would spur competition in the fund industry and improve investors’ returns over time. He identified a number of areas for potentially improved disclosure, including the following: disclosure of commission cost per average net assets in prospectuses, semi-annual and annual reports; disclosure of soft dollar commissions; disclosure of total trading costs, including commission costs, impact costs, and opportunity costs; providing better access to fund prospectuses and statements of additional information; standardized industry expense, performance and operating information; and disclosure of fund marketplace costs. In addition, Mr. Montgomery recommended requiring disclosure of portfolio manager compensation; requiring disclosure of the basis for each board decision to renew the advisory contract and requiring that boards put management contracts up for bid if the current adviser shows repeated underperformance; and requiring increased disclosure about 12b-1 plans. Testimony of Wayne H. Wagner Mr. Wagner made several recommendations that were intended to better inform mutual fund investors of the costs of their investments. His recommendations included requiring quarterly disclosure of trading costs, total commission expenditures, and trading activity on a delayed basis. Chairman Oxley’s Statement Chairman Michael Oxley delivered an opening statement in which he stated that the purpose of the hearing was to answer the question: are investors getting a fair shake? He stated that the rapid growth in the fund industry was “unquestionably a positive development,” noting that funds provide the opportunity to invest small sums of money in diversified portfolios of stocks, bonds and other securities. However, despite competition in the fund industry, Chairman Oxley expressed concern with “rising fees that are often hidden or not easily understood, and chronic under-performance.” He indicated that the Committee will look at these issues, as well as the role of mutual funds in corporate governance and the role of independent directors. He cited with approval the recent SEC mutual fund initiatives and expressed his hope that Chairman Donaldson would continue this work on behalf of fund investors. GAO Statement The GAO statement addressed the following issues: • Trends in Fund Fees. A 2000 GAO report showed that overall mutual fund fees generally declined from 1990 to 1998. The current

GAO statement, which looked at the 76 largest stock and bond funds, found that, while the average expense ratio for the stock funds increased by about eight percent from 1998 to 2001, the average expense ratio for the bond funds continued to decline. The statement indicated that a decline in assets for many stock funds may have contributed to the increase in expense ratios. Many stock funds offer breakpoints as fund assets increase. When assets decline, less of these fund assets are charged the lower fee, so the expense ratio as a percentage of total assets is higher. The continued decline in the average expense ratio for bond funds appeared to arise from stronger asset growth in lower-fee funds. When individual fund expense ratios were analyzed, the GAO found that the expense ratios for 28 of the 46 stock funds and 18 of the 30 bond funds increased from 1998 to 2001, but that the majority of increases were less than 10 percent.

- **Fee Disclosure.** In its earlier report, the GAO had recommended that the SEC require additional disclosures regarding fees to increase transparency and encourage price competition among funds. The GAO statement found that the recent SEC proposal to require new disclosure concerning ongoing expenses in shareholder reports would provide useful information to investors and would allow for fee comparisons. However, the disclosure would report information to shareholders in dollar amounts using only illustrative investment amounts. The statement offered that disclosure to investors in the quarterly account statement using each investor's own account balances or shares owned would provide information that is more frequent and more specific to each investor. As a result, the statement opined that additional competition on the basis of price would likely result among funds. The GAO acknowledged industry concerns that such disclosure would be costly and additional benefits to investors had not been quantified.
- **Disclosure of Trading Costs.** The GAO statement noted that some information on trading costs is currently disclosed to the SEC, and to investors upon request. The statement noted that academics and shareholder advocates support additional disclosures of trading costs to investors, while the industry questions whether such disclosure could be made in a manner that allows for meaningful comparisons. The GAO declined to make a recommendation on this subject.

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