INVESTMENT COMPANY INSTITUTE

**MEMO# 17064**

February 5, 2004

# SENATE OVERSIGHT HEARING ON MUTUAL FUNDS

[17064] February 5, 2004 TO: BOARD OF GOVERNORS No. 10-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 9-04 FEDERAL LEGISLATION MEMBERS No. 3-04 INVESTMENT COMPANY DIRECTORS No. 6-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 12-04 PUBLIC COMMUNICATIONS COMMITTEE No. 7-04 SEC RULES MEMBERS No. 20-04 SMALL FUNDS MEMBERS No. 14-04 UNIT INVESTMENT TRUST MEMBERS No. 8-04 RE: SENATE OVERSIGHT HEARING ON MUTUAL FUNDS Last week, the Institute's outside counsel, Paul Stevens, testified on the Institute's behalf at a Senate oversight hearing on mutual funds entitled "Hidden Fees, Misgovernance, and Other Practices That Harm Investors." Also testifying at the hearing were: John C. Bogle, Founder, The Vanguard Group; John P. Freeman, Professor, University of South Carolina; Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office; Jeffrey C. Keil, Vice President, Board Analysis Services, Lipper, Inc.; Marc E. Lackritz, President, Securities Industry Association; James Nesfield, Nesfield Capital; Travis B. Plunkett, Legislative Director, Consumer Federation of America; Peter Scannell; and Eliot L. Spitzer, Attorney General, Office of New York Attorney General. The oral and written testimony of Mr. Stevens, the written testimony of the other witnesses, and the opening statement by the subcommittee's Chairman are summarized below.1 In response to questions during the hearing, Mr. Stevens stated that the Institute historically has advanced a policy agenda very much in the interests of fund shareholders. Following the hearing, he provided the Subcommittee with documentation for the record of the examples he had cited to illustrate this point. A copy of Mr. Stevens' letter to the Subcommittee (without the enclosures) is attached. 1 The written testimony and the Subcommittee Chairman's opening statement are available on the Committee's website at http://hsgac.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=146. 2 Statement by Senator Fitzgerald In his opening statement, Senator Peter G. Fitzgerald (R-IL), Chairman of the Subcommittee on Financial Management, the Budget and International Security, Senate Committee on Governmental Affairs, stated that the "general consensus" at a mutual fund oversight hearing in November was that excessive fees and inadequate fee disclosure posed a more serious threat to investors than illegal late trading and illicit market timing.2 He stated that the purpose of this hearing was to: (1) examine the propriety of mutual fund fees, the adequacy of their disclosure, and "hidden" fees and loads such as revenue sharing arrangements and Rule 12b-1 fees; and (2) discuss statutory or regulatory changes that might improve disclosure and allow for more informed comparison among funds. Chairman Fitzgerald also drew several comparisons between index mutual funds and the federal government's Thrift Savings Plan, which he indicated would be the focus of a future hearing by the Subcommittee. Institute Testimony In his testimony before the Subcommittee, Mr. Stevens began by underscoring the Institute's strong support for the ongoing efforts of federal and state authorities to uncover abusive

trading practices affecting mutual funds, and he pledged the Institute's full cooperation in working to restore and maintain the confidence of mutual fund investors. He then emphasized three points with respect to mutual fund fees. First, he expressed the Institute's strong support for initiatives to bolster investor awareness of fund fees and costs, noting that these efforts would build upon regulations that already assure a very high degree of transparency about the costs of mutual fund investing. Second, Mr. Stevens stated that the consensus of recent research is that the costs of mutual fund investing have trended downward over the past two decades. Finally, he addressed the current debate over how mutual fund fees stack up against those of pension plans. Mr. Stevens stated that comparisons (by Professor Freeman and others) between "advisory fees" paid by a pension plan and "management fees" paid by a mutual fund are seriously flawed, because the two types of fees are fundamentally different. Rather, he said, a recent study by the Institute using a different methodology appears to show that pension plans and mutual funds pay similar fees for similar portfolio management services. 3 In his written testimony, Mr. Stevens expanded upon the mutual fund fee issues summarized above. He discussed Rule 12b-1 fees, noting that the rule has made it possible for funds to provide investors with choices about how and when to pay for services from financial intermediaries. Mr. Stevens refuted arguments that Rule 12b-1 fees are "hidden costs," and he described the various regulatory protections that apply to such fees. In discussing revenue sharing arrangements, Mr. Stevens emphasized that the Institute has long advocated additional, 2 For a summary of the November 3, 2003 subcommittee hearing, see Institute Memorandum to Board of Governors No. 59-03, Closed-End Investment Company Members No. 88-03, Director Services Committee No. 21-03, Federal Legislation Members No. 21-03, Primary Contacts – Member Complex No. 95-03, Public Information Committee No. 37-03, SEC Rules Members No. 152-03, Small Funds Members No. 63-03, and Unit Investment Trust Members No. 40-03 [16744], dated November 6, 2003. 3 See Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," Perspective, Vol. 9, No. 6, Dec. 2003, available at http://www.ici.org/stats/res/per09-06.pdf. 3 point-of-sale disclosure by broker-dealers in this area. Finally, with respect to brokerage allocation practices, Mr. Stevens stated that the Institute advocates a top-to-bottom reexamination of such practices and applicable regulatory requirements, and he described the Institute's recent recommendations to: (1) narrow the scope of the current safe harbor for soft dollar arrangements; and (2) prohibit funds from considering fund sales in allocating brokerage.4 Testimony of Richard J. Hillman Mr. Hillman discussed the General Accounting Office's June 2003 report, entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors. 5 He summarized the report's recommendations, which call for the SEC to consider additional disclosures regarding mutual fund fees and expenses, payments to broker-dealers for the sale of fund shares, and the use of soft dollars by investment advisers. Mr. Hillman also summarized recent proposals by the SEC, NASD, and Congress in these areas. Finally, he touched on select proposals to address recent revelations of mutual fund trading abuses. Testimony of Eliot L. Spitzer Mr. Spitzer testified that the Subcommittee's earlier hearing in November played an important role in focusing attention on "the conflicts inherent in an industry where directors were beholden to management" and that several reforms which had seemed radical then – such as requiring an independent board chairman and providing fund directors with staff – "have already become conventional wisdom." He argued, however, that the mutual fund industry is "still opposing true reform in the area that most directly impacts investors: advisory fees." Mr. Spitzer testified that mutual fund investors are being charged exorbitant advisory fees compared to those charged to institutional clients, and he defended his office's inclusion of fee reductions in certain settlements. He also criticized the Institute's recent study comparing the portfolio management fees paid by pension plans and mutual funds. Finally, Mr. Spitzer asked the Subcommittee to give serious consideration to a set of mutual fund principles recently announced by officials in North Carolina, New York, and California that, in general, would apply to all firms managing money for those states. Testimony of John C. Bogle Mr. Bogle testified that it is time to “rebalance the scale on which the respective interests of fund managers and fund shareholders are weighed.” He stated that in order to tilt the scale so that a preponderance of the weight is on the side of shareholders, Congress must mandate that a fund board has: (1) an independent chairman; (2) no more than one interested director; (3) a staff or independent consultant that provides objective information to the board; and (4) a fiduciary duty to assure that funds are organized, operated, and managed in the interests of 4 See Letter from Matthew P. Fink, President, Investment Company Institute to William H. Donaldson, Chairman, Securities and Exchange Commission, dated Dec. 16, 2003, available at http://www.ici.org/issues/timing/03_sec_soft_com.html#TopOfPage. 5 For a summary of the GAO report, see Institute Memorandum to Board of Governors No. 30-03, Director Services Committee No. 10-03, Primary Contacts-Member Complex No. 49-03, Public Information Committee No. 19-03, SEC Rules Members No. 78-03, and Small Funds Members No. 27-03 [16223], dated June 19, 2003. 4 their shareholders. Mr. Bogle stressed that advisory firms must be owned by managers who act responsibly and put the interests of their fund shareholders first – by imposing limits on fees and marketing activities, and by focusing on long-term investment strategies and superior service to shareholders. He concluded his testimony by emphasizing that the mutual fund industry needs to regain a “spirit of mutuality,” and he predicted that firms that evince a spirit of trust would ultimately dominate the mutual fund industry. Testimony of Jeffrey C. Keil Mr. Keil testified that Rule 12b-1 is undoubtedly due for an overhaul, although he cautioned that the rule embodies a “valid concept that should be reshaped and not abandoned.” He summarized Lipper’s recommendations for Rule 12b-1 reform, which include: (1) revising the rule to account for the necessary continuation of some Rule 12b-1 plans; (2) issuing guidelines as to the types of expenditures that may or may not be considered valid for distribution purposes under the rule; and (3) undertaking a study of whether the portion of Rule 12b-1 plans used as “asset-based sales charges” should be removed from the auspices of fund companies and left to distributors and market forces. Mr. Keil stated that data for the last decade shows that the asset-weighted management fee average for mutual funds – which he said might be viewed as more indicative of what most fund investors tend to pay – is “clearly flat.” Mr. Keil cautioned, however, that fund boards must use proper management fee benchmarks to avoid “fee creep.” With respect to expense ratios, Mr. Keil stated that the asset-weighted total expense ratio rose a mere 0.013% over the last decade. He suggested that a March 2003 GAO study on total expense ratios would have reached a similar result but that the GAO failed to subtract the effect of incentive fees earned by several very large funds based on performance for the three years ending in 2001. Mr. Keil then discussed the “hidden costs” associated with general brokerage, directed brokerage, and soft dollar use. He stated that trying to quantify brokerage costs fully is like “attempting to nail Jell-O to a wall” but that a greater level of transparency – to the extent it may be computed in good faith – would be desirable. Mr. Keil suggested that regulators consider quantifying those aspects of brokerage costs that may reasonably be converted into a separate expense ratio, and consider requiring that this brokerage ratio be disclosed in the prospectus together with a benchmark. With respect to fund governance, Mr. Keil stated that current criticisms of fund directors “all possess some validity” and suggested that attention was also needed with regard to the following areas: (1) compliance policy adherence; (2) board information sources; (3) board financial expertise; (4) contract renewal processes; (5) sales practice transparency; and (6) the “opacity” of board decisions. He made several recommendations, including that fund directors be required to attain a mandated business knowledge level and achieve certification through an independent company. On the issue of competitive bidding for advisory contracts, he stated that "very independent" boards should be able to keep costs in check and serve the same purpose, with much less disruption to fund operations. Mr. Keil likewise was critical of calls for a mutual fund oversight board, suggesting instead a stronger governance structure and more definitive and stringent rulemaking by the SEC. 5 Mr. Keil concluded his testimony by calling for greater focus by investors on the impact of costs on account values over time. He also cautioned against the impulse to overregulate in response to the recent investigations, stating that reforms should be crafted carefully by those regulators – the SEC and NASD – that know the financial markets best. Testimony of Travis B. Plunkett Mr. Plunkett testified that the "scandal" of how mutual funds are sold to unsuspecting investors and the high costs that result does far more harm to investors than do the recently revealed trading abuses involving mutual funds. He contended that brokers mischaracterize themselves to mutual fund investors as financial professionals offering impartial advice, yet they select the funds they recommend based on lucrative incentives – including 12b-1 fees, directed brokerage, and payments for shelf space – that are complex and often disclosed poorly or not at all. Mr. Plunkett called on Congress to conduct a thorough investigation of the role and operations of both brokers and advisers as the basis for legislation to ensure that their conduct matches their representations about the services they offer. Mr. Plunkett testified that there is compelling evidence that management costs at some funds are excessive. He stated that a recent review by the Consumer Federation of America found large cost discrepancies among S&P 500 index funds and remarked that CFA has no reason to believe that such funds are alone in charging excessive fees. While acknowledging that mutual funds provide more and better cost disclosure than many other financial products, Mr. Plunkett contended that such disclosure: (1) fails to provide all the information that investors need to assess costs and their likely effect on investment returns; (2) is not in a format likely to be read, understood, and used by investors; and (3) is not delivered at a time when it is most likely to influence purchase decisions (i.e., pre-sale). Mr. Plunkett stated that there are "serious gaps" in the SEC's regulatory agenda and called upon Congress to take action in several areas, including: (1) strengthening the definition of independence as applied to fund directors; (2) mandating that portfolio transaction costs be included in expense ratios; (3) repealing the soft dollar safe harbor; and (4) assessing the adequacy of SEC resources and, if found to be inadequate, determining whether a mutual fund oversight board would be the best "supplement." Testimony of Marc E. Lackritz Mr. Lackritz testified that a two-pronged approach is needed to restore the public's trust in mutual funds: swift, sure, and tough enforcement of the law, coupled with reforms to ensure that investors' interests come first. With respect to disclosure reforms, he stated that the SIA strongly supports efforts to enhance the transparency of both revenue sharing arrangements and differential compensation. He observed, however, that payments to broker-dealers for costs associated with processing fund transactions and maintaining customer accounts generally do not present the same type of potential conflict as payments for "shelf space" or inclusion on a preferred list. Mr. Lackritz also testified that investors should have full, clear, and useful information on mutual fund fees, noting that the SIA generally concurs with provisions in H.R. 2420 that would require: (1) shareholder reports to contain an estimated amount of operating expenses, in dollars, that a shareholder would have paid on a hypothetical $1,000 investment; and (2) account statements to contain a legend indicating that the 6 shareholder has paid fees on the investment and that such fees have been deducted from the amounts shown.6 With regard to soft dollars and directed brokerage arrangements, Mr. Lackritz stated that "the key investor protection issue to maintain is best execution." He said that soft dollars generally are pro-investor and pro-competitive, although there are risks of abuse. He expressed the SIA's strong support for enforcement efforts to curb such abuses and stated that the SIA favors effective disclosure of soft dollar practices to investors and fund directors. Mr. Lackritz also said that the group would welcome a study of soft dollar arrangements to ensure that they continue to benefit investors. On directed brokerage, Mr. Lackritz acknowledged that certain practices might create a potential conflict of interest. He stated that such arrangements should be disclosed “fairly and in context” to investors and fund directors. Mr. Lackritz also touched on late trading, stating that reforms should make late trading “virtually impossible to achieve.” He stated that the SIA is concerned, however, that the SEC’s proposal for a “hard close” at the fund or registered clearing agency level could penalize innocent investors, and he described the SIA’s proposed alternative for a hard close at the intermediary level. Finally, Mr. Lackritz addressed the issue of side-by-side management of mutual funds and hedge funds. He criticized legislative proposals that would ban the practice, suggesting that enhanced disclosure of conflicts and policies to ensure fair allocation of investment opportunities should provide sufficient safeguards to investors. Testimony of John P. Freeman Professor Freeman testified that the fund industry’s “conflicted governance structure” has resulted in pervasive overcharging of fees and that this fact has been known for decades. His testimony was highly critical of both the SEC and the ICI. In particular, he asserted that the SEC’s Division of Investment Management has become far too deferential to the fund industry and that the only effective “sheriffs” policing the fund industry today are operating at the state level. Professor Freeman called for several reforms, including: (1) banning soft dollars and directed brokerage; (2) eliminating, or drastically overhauling, Rule 12b-1; and (3) requiring “most favored nation” treatment for advisory costs. Testimony of Peter Scannell Mr. Scannell, a former employee of Putnam Investments, testified that he became aware of market timing abuses at the firm in April 2000. He testified that his supervisors failed to respond to complaints by him and others that market timers were harming the interests of other investors. Mr. Scannell stated that he compiled information about market timing abuses at the firm and initiated contact with federal regulators, who were not responsive to his efforts. He testified that he then contacted state regulators, who promptly began an investigation into the firm. 6 The U.S. House of Representatives approved H.R. 2420, the “Mutual Funds Integrity and Fee Transparency Act of 2003,” on November 19, 2003. For a summary of H.R. 2420, see Institute Memorandum to Accounting/Treasurers Members No. 47-03, Board of Governors No. 65-03, Closed-End Investment Company Members No. 96-03, Federal Legislation Members No. 25-03, Investment Company Directors No. 20-03, Operations Members No. 35-03, Pension Members No. 48-03, Primary Contacts – Member Complex No. 103-03, Public Information Committee No. 41-03, SEC Rules Members No. 162-03, Small Funds Members No. 69-03, and Unit Investment Trust Members No. 44-03 [16786], dated November 21, 2003. 7 Mr. Scannell offered his view that mutual fund trading abuses can be curtailed with appropriate regulation. He further recommended that Congress enact a whistleblower statute applicable to the securities industry. Testimony of James Nesfield Mr. Nesfield, who told the Subcommittee that he had served as a consultant to Canary Capital, testified that mutual funds are vulnerable to abuses involving market timing and late trading. He stated that this is due primarily “to a failure of governance, and the delayed nature of settlement of both payments and transfers.” Mr. Nesfield offered his view that solutions to the abuses will not be found in more regulation but rather in “open governance” and a move toward real time gross settlement of all transactions involving mutual funds. With respect to governance, Mr. Nesfield stated that governance standards are normally set by regulators but that “the mutual funds sector is unregulated.” He asserted that, as financial systems become more complex, only investors themselves – rather than regulators – can make intelligent decisions as to the integrity and safety of an investment offering. Mr. Nesfield suggested that the SEC should “mandate the opening up of balance sheets and structures” and that the agency already facilitates this level of transparency with respect to public companies. As regards settlement, Mr. Nesfield stated that once it is possible to convert and trade incoming payments into fund shares on an immediate basis, the time delays that represent opportunities for abuse would disappear. He contended that this change could be employed by fund advisers “in short order” but that “massive pressure” for reform from outside the securities industry would be needed. Rachel H. Graham Assistant Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 17064, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17064.

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