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SEC STAFF REPORT ON MUTUAL FUND FEES AND EXPENSES

[13032] January 12, 2001 TO: BOARD OF GOVERNORS No. 5-01 PRIMARY CONTACTS - MEMBER COMPLEX No. 6-01 SEC RULES COMMITTEE No. 3-01 RE: SEC STAFF REPORT ON MUTUAL FUND FEES AND EXPENSES The Securities and Exchange Commission yesterday issued the Division of Investment Management's Report on Mutual Fund Fees and Expenses ("Report"). The Report presents the Division's study of trends in mutual fund fees and expenses experienced over the past twenty years. According to the Report, the Division conducted this study in light of: (1) the significant growth in the mutual fund industry during that period; (2) U.S. households' increasing reliance on mutual funds to finance retirement, housing, and children's education; (3) the significant impact that mutual fund fees and expenses have on investor returns; and (4) the ongoing debate over the appropriate level of mutual fund fees and expenses. The Report states that the Division's goal was to provide objective data about trends in mutual fund fees and expenses that may be useful to Congress and the SEC in overseeing the mutual fund industry. The Report makes clear that the staff's purpose was not to determine whether mutual fund fees are too high or too low and acknowledges that the Investment Company Act of 1940 does not give the SEC the direct role of arbiter in determining the appropriate level of fees to be paid by a mutual fund. Rather, the Report states that the current regulatory framework generally allows the level of fees to be determined by marketplace competition and entrusts fund independent directors with the responsibility to approve and monitor the arrangements under which funds pay for investment advice or the distribution of their shares. The Report concludes that this framework is "sound and operates in the manner contemplated by Congress." The Report includes four sections. Section I describes the background and scope of the Report and provides a summary of its findings. Section II describes the regulatory framework with respect to mutual fund fees and expenses. Section III provides the staff's findings regarding trends in mutual fund fees and expenses. Section IV describes the staff's recommendations to improve the effectiveness of the current regulatory framework for mutual fund fees. 2Set forth below is a summary of the staff's findings and recommendations in the Report. A copy of the Report is attached.1 Congressional reaction is also described below. Trends in Mutual Fund Fees and Expenses A. Methodology The staff analyzed the expenses of all stock and bond funds for the following years: 1979, 1992, and 1995 through 1999. The staff used 1979 as a benchmark because it is the year before Rule 12b-1 distribution fees were first permitted. Data for 1992 was used because it is the first year for which the staff had expense data in electronic format. Data for 1995 through 1999 was analyzed to get a more recent picture of trends in fund expenses. Money market funds were excluded from the study because of their different cost structure. Also excluded were underlying mutual funds of insurance company separate accounts, closed-end investment

companies, unit investment trusts and face amount certificate companies. B. Key Findings 1. Expense Ratio Trends – The Report found that the weighted average expense ratios for all classes declined in three of the last four years (from 0.99% in 1995 to 0.94% in 1999), but that they increased 21 basis points from the late 1970s (from 0.73% in 1979 to 0.94% in 1999). (Table 2, page 41) To avoid misunderstanding the import of the latter finding, the Report stresses that it is important to understand the changes in the industry that might explain this increase. The most significant change identified by the Report is the way that investors pay for the marketing and distribution of fund shares. Prior to 1980, most funds had front-end sales loads. Since the adoption of Rule 12b-1 in 1980, however, funds with a traditional front-end load became less popular and funds with 12b-1 fees and contingent deferred sales loads became more popular. The significance of this is that 12b-1 fees are included in a fund's expense ratio, whereas sales loads are excluded because they are paid directly by investors and not by the fund. 2. Total Ownership Costs – To take into account the decline in front-end sales loads that accompanied the increase in 12b-1 fees, the staff analyzed fund expense trends taking into account all costs that a shareholder would expect to incur in purchasing and holding class shares. The Report found that the total ownership costs (which include fund operating expenses, 12b-1 fees and sales loads) for load classes declined 18% between 1979 and 1999 – from 2.28% to 1.88%. (Table 6, page 47) This finding was based on an assumed 5-year holding period over which the sales load was amortized. 3. Expense Ratio Trends by Type of Investment – The Report states that it is generally believed that equity funds are more expensive to manage than bond funds because of the increased costs associated with selecting stocks. It further states that international and specialty funds (sometimes referred to as sector funds) are believed to be more expensive to manage than equity funds. The results in the Report show that bond fund classes have lower expense ratios than equity fund classes and that international and specialty fund classes have higher expense ratios than bond and equity fund classes. In 1999, for example, the average 1 The Report is also available on the SEC's website at sec.gov/news/studies/feestudy.htm. 3expense ratios by type of fund were as follows: 0.80% for bond classes, 0.90% for equity classes, 1.18% for international classes and 1.36% for specialty classes. (Table 9, page 50) 4. Factors Impacting Operating Expense Ratios – The Report found that certain factors are important in explaining variations among fund operating expense ratios (defined as the fund's total expenses minus 12b-1 fees divided by its average net assets). For example: • Fund Size – In 1999, a fund with assets of $10 million had an operating expense ratio that was 22 basis points lower than a similar fund with assets of $1 million, and a fund with assets of $1 billion had an operating expense ratio that was 66 basis points lower than a similar fund with assets of $1 million. (Table 12, page 56) • Fund Family Asset Size – In 1999, a fund's operating expense ratio fell 68 basis points if the total assets of its fund family rose from $1 million to $10 million, and fell 75 basis points if fund family assets rose from $1 million to $10 billion. (Table 13, page 57) • Index, Institutional and Multi-Class Funds – In 1999, the operating expense ratio of an index fund was 45 basis points lower than an equivalent fund that was not an index fund. The operating expense ratio of an institutional fund or class was 22 basis points lower than an equivalent fund or class that was not limited to institutional investors. Finally, a multi-class fund had an operating expense ratio that was 14 basis points higher than an equivalent single-class fund. (Page 58) 5. Economies in Management Expenses – The Report found that the management expense ratios (defined as the fees paid for investment advice and other services provided under a fund's management contract divided by its average net assets) of the 1,000 largest funds in 1999 did not show a statistically significant decline as fund assets grew (although the data did show a decline), but rather, showed a statistically significant decline as fund family assets grew. Specifically, a fund's management expense ratio fell 11 basis points in 1999 as fund family assets rose from $1 million to $10 million, and fell 42 basis points as fund family assets rose from $1 million to $10 billion. (Table 15, page 63) 6. Breakpoints in Management Fees – In order to obtain additional information about the extent to which economies are present in management fees, the staff examined the management contracts of the 100 largest mutual funds in 1997, 1998 and 1999 for evidence of management fee breakpoints. The staff observed contracts with five types of arrangements: (1) fee breakpoints based on fund assets (fund breakpoints); (2) fee breakpoints based on portfolio assets plus a performance fee (fund breakpoints-plus); (3) fee breakpoints based on fund family assets (fund family breakpoints); (4) a single, all-inclusive fee (single fee); and (5) at-cost arrangements. The Report found that 47 funds had fund breakpoint contracts, 21 funds had fund family breakpoint contracts, 8 funds had fund breakpoints-plus contracts, 19 funds had single fee management contracts and 5 funds had at-cost arrangements. (Table 16, page 65) With respect to the 47 funds that had fund breakpoint contracts, the Report found that the median number of breakpoints was 6, the median asset-size level at which the first effect 4was $10 billion. The Report further found that the median management fee at the first breakpoint was 65 basis points and the median management fee at the last breakpoint was 41 basis points, and that 34 of these funds had assets that exceed their last breakpoint. (Page 64) 7. Expenses of the Largest Mutual Funds in the Retirement Market – In response to concerns expressed about the level of 401(k) plan expenses, the staff selected a sample of 50 funds with the most 401(k) assets (retirement-oriented funds) and compared their expenses to those of all funds. The staff found that the equally-weighted average expense ratio for retirement- oriented funds (0.96%) is 28% below the average expense ratio for all mutual funds (1.35%), and that the asset-weighted average expense ratio for retirement-oriented funds is 24% below the average expense ratio for all funds (69 basis points compared to 91 basis points). (Page 67) The staff concluded that the primary reason why these funds have lower expense ratios is likely due to their size. Recommendations The Report notes that the current regulatory framework for mutual fund fees and expenses relies on a combination of disclosure, investor education, and fund governance. To further improve the effectiveness of the current framework, the Report makes the following recommendations. A. Disclosure and Investor Education 1. Dollar Amount of Fund Fees – The Report discusses the GAO report on mutual fund fees issued in June 2000,2 which recommended that the SEC require mutual funds and/or broker-dealers to send fund shareholders account statements that include the dollar amount of the fund's fees that each investor has indirectly paid. The GAO report acknowledged, however, that there are advantages and disadvantages to this recommendation and identified two alternatives that should be considered. One alternative would be to multiply the fund's per share asset value by the fund's expense ratio, multiply the result by the average number of shares an investor owned during the period, and show the result in the investor's account statement. A second alternative would be to provide information about the dollar amount of fees that were paid during the period for preset investment amounts, such as $1,000. Investors could use the results to estimate the amount they paid on their accounts. The GAO report stated that the SEC would need to weigh the costs of each approach against the benefits of the additional information to investors. Noting some of the problems associated with the GAO's recommendation to provide personalized fee information, including the significant compliance costs that would be incurred, the Report concludes that an approach based on the alternative to provide information about the dollar amount of fees paid for preset investment amounts is likely to have the most favorable trade-off between costs and benefits. It further recommends that this information be presented in shareholder reports (rather than account statements), "so that investors can evaluate the information alongside other key information about the fund's operating results, including management's discussion of the fund's performance." 2 See Memorandum to Board of Governors No. 38-00, Primary Contacts – Member Complex

No. 45-00 and SEC Rules Committee No. 94-00, dated July 5, 2000. 5Under this approach, funds would be required to include in fund shareholder reports a table that shows the cost in dollars associated with an investment of a standardized amount (e.g., $10,000) that earned the fund's actual return for the period and incurred the fund's actual expenses for the period. The Report further states that the table could include the cost in dollars, based on the fund's actual expenses, of a standardized investment amount (e.g., $10,000) that earned a standardized return (e.g., 5%). The Report states that this approach would provide additional information about fund fees, provide it in terms of dollar amounts, and provide it in a standardized manner that would facilitate comparison among funds. 2. Investor Education – The Report recommends that the fund industry expand its efforts to educate investors about SEC-mandated disclosures and other information they can use to identify the fees that they pay, compare funds to each other and to other investment alternatives with respect to the level of fees, and consider the effect that fees will have in reducing the amount of wealth they may accumulate as a result of an investment. The Report also recommends that the SEC continue its initiatives to improve investor understanding of mutual fund costs. 3. After-Tax Returns – The Report recommends that the SEC adopt proposed amendments to Form N-1A to require disclosure of standardized mutual fund after-tax returns. The staff concluded that due to the significant impact that taxes have on fund returns, investors would benefit by receiving this disclosure. B. Fund Governance 1. Role of Independent Directors – The Report states that the current statutory framework for fund fees and expenses will be enhanced by recent SEC initiatives designed to bolster the effectiveness of independent directors in dealing with fund management. In addition, the Report recommends that the SEC continue to emphasize that mutual fund directors must exercise vigilance in monitoring the fees and expenses of the funds that they oversee. The Report further recommends that the SEC continue to encourage efforts to educate directors about issues related to fund fees and expenses. 2. Rule 12b-1 Plans – The Report recommends that the SEC consider whether Rule 12b-1 needs to be modified to accommodate changes that have occurred in the industry since the rule was adopted in 1980. The Report notes, for instance, that the adopting release for Rule 12b-1 includes a list of factors that fund boards generally take into account when approving or continuing a 12b-1 plan. Those factors, however, may be obsolete in that they presuppose that funds would typically adopt 12b-1 plans for relatively short periods in order to solve a particular distribution problem or to respond to specific circumstances, such as net redemptions. The Report states that today many funds adopt a 12b-1 plan as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements. In addition, funds use a number of marketing and distribution practices (e.g., offering shares in multiple classes and through fund supermarkets) that did not exist when Rule 12b-1 was adopted. 6Congressional Reaction In a press release about the Report, Representative Michael G. Oxley, Chairman of the House Financial Services Committee, commented that he is "pleased with the result." He also stated that the additional disclosure recommendations in the Report "would be a reasonable step…and will help investors with their long-term financial planning." A copy of the press release is attached. In addition, Representative John D. Dingell, Ranking Member of the House Committee on Energy and Commerce, sent a letter in response to the Report to SEC Chairman Arthur Levitt and David M. Walker, Comptroller General, U.S. General Accounting Office. A copy of the letter is attached. The letter supports the recommendation to require disclosure in mutual fund shareholder reports about the dollar amount of fees and expenses paid for preset investment amounts. The letter states that he is transmitting the Report to the GAO for its reaction to the proposal. Related to the issue of disclosure, the letter notes that the Report finds that mutual funds are facing increased competition from sources outside the industry (e.g., on-line trading, individual accounts). The letter states that it is important that investors in these less regulated products receive adequate disclosure about the fees they pay. Therefore, Representative Dingell urges the SEC to develop disclosure requirements for these products similar to those applicable to mutual funds. He also strongly urges the SEC to adopt the pending rule proposal to require disclosure of standardized mutual fund after-tax returns. The letter expresses support for the SEC's actions to enhance the role of independent directors and with private-sector initiatives to enhance information and other support services to these directors. It also supports the staff's recommendation that the SEC review the requirements of Rule 12b-1 and examine how the rule and 12b-1 plans have operated. Craig S. Tyle General Counsel Attachments Attachment no. 1 (in .pdf format)

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