

MEMO# 16223

June 19, 2003

GAO REPORT ON TRANSPARENCY OF MUTUAL FUND FEES AND CERTAIN PRACTICES

[16223] June 19, 2003 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 SMALL FUNDS MEMBERS No. 27-03 RE: GAO REPORT ON TRANSPARENCY OF MUTUAL FUND FEES AND CERTAIN PRACTICES The U.S. General Accounting Office has issued a report on the transparency of disclosures of mutual fund fees, distribution practices and soft dollar arrangements.* The report, entitled "Mutual Funds – Greater Transparency Needed in Disclosures to Investors," was in response to an earlier request from House Financial Services Committee Chairman Michael G. Oxley and Capital Markets Subcommittee Chairman Richard H. Baker. Messrs. Oxley and Baker had requested that the GAO "review issues relating to the transparency and appropriateness of certain fees and practices among mutual funds." The GAO report focused on the impact fees and costs associated with owning mutual fund shares may have on investment return. In order to evaluate whether the disclosure of fund fees and other practices are sufficiently transparent to allow investors to make informed decisions, the GAO studied four areas. A summary of the GAO's discussion of these areas, the SEC and ICI comments on the report and the report's conclusions are below:

- Disclosure of Fees and Costs. The GAO looked at how mutual funds currently disclose their fees and costs and how these disclosures may be improved. The report noted that investors currently receive information about the amount of fees and expenses on their mutual fund shares, expressed as a percentage of fund assets. In addition, the report states that the SEC is considering additional disclosures that would facilitate fee comparisons across funds. * A copy of the full report can be found at www.gao.gov/cgi-bin/getrpt?GAO-03-763.

2 The GAO report pointed out that there are additional disclosures that could further increase the transparency of fees, such as providing investors with the specific dollar amounts of the expenses paid in quarterly account statements. The report acknowledged that these alternatives may be costly and their benefits are difficult to quantify. However, the report concluded that the importance to investors of more transparency and enhanced awareness of mutual fund fees warrant consideration of these or less costly alternatives, including mandating the SEC-proposed disclosure (i.e., the dollar amount of a fund's fees based on a set investment amount) on quarterly account statements or including a notice on account statements to remind investors that they pay fees and to check the fund's prospectus and with their financial adviser for more information. The report also pointed out that this additional disclosure might encourage greater competition among funds on the basis of fees. The report considered disclosure of information about the brokerage commissions and other trading

costs funds incur, but found that standard methodologies to calculate these amounts do not exist and such disclosures could be misleading.

- **Director Oversight of Fees.** The GAO report examined the role of directors in reviewing fund fees. Some industry observers have argued that the process directors follow fails to produce sufficient actions to minimize fund fees. The suggestion that directors seek competitive bids was not embraced by the GAO because such a requirement may not produce lower costs and directors use other means to seek lower fees, such as negotiating with advisers for declining fees as assets grow. Further, the report acknowledged recent legislative and regulatory steps that have been taken to enhance board effectiveness. Many of the reforms being recommended for public companies, the report observed, are either already required for funds by rule or recommended by industry best practice.
- **Disclosure of Payments to Intermediaries.** The GAO looked at how payments that fund advisers make to intermediaries that sell fund shares impact investors and how practices in this area have changed. The report looked specifically at the way Rule 12b-1 fees are used and how the increased use of revenue sharing arrangements has evolved. The report noted that some of the changes in distribution practices have benefited investors, however, the disclosure currently required about the various payments to intermediaries may not provide investors with sufficient information to evaluate potential conflicts of interest. Disclosure at the time of sale of compensation a broker-dealer receives from a fund's adviser company may provide investors with more complete information, the report concluded.
- **Disclosure of Soft Dollar Arrangements.** The GAO studied how mutual funds use soft dollars. The report noted that, while soft dollar arrangements may provide advisers with access to a greater range of research and other benefits, the amount of brokerage commissions paid directly reduces the return earned by investors. The report noted the potential conflicts of interest presented by the use of soft dollars and the need to increase the transparency of these arrangements to enable fund directors and investors to better evaluate their funds' use of soft dollars. The report acknowledged various changes proposed by the SEC staff in a 1998 report that would increase transparency by expanding advisers' disclosure of their use of soft dollar arrangements, but commented that the SEC has yet to take action on these proposals and other recommendations relating to soft dollar recordkeeping.

Report The GAO report includes comments received on it from the SEC and the ICI. The SEC commented on the report's recommendation that more disclosure be included on quarterly account statements. The SEC staff agreed that additional disclosure may be helpful to investors and promised to consider, as they evaluate the comments on their proposed disclosure changes, whether some form of fee disclosure could be included on account statements. They also indicated that they intend to consider additional disclosures concerning revenue sharing and soft dollar arrangements. The ICI's letter, focused on two issues. First, the letter commented on the comparison of disclosures of fund fees to those of other financial service firms. The ICI's letter stated that current mutual fund disclosures allow individuals to make much more informed and accurate decisions about the costs of their funds than do the disclosures made by other financial services firms. The GAO report states that, unlike mutual funds, other financial products generally disclose their costs in specific dollar terms. It was not the GAO's intent, however, to make a judgment as to whether those disclosures are superior to that provided for mutual funds. Instead, the GAO believes that supplementing existing mutual fund fee disclosure will increase awareness of fees and prompt additional fee-based competition among funds. Second, the ICI also commented on the GAO's discussion of the role played by fund directors in overseeing fund fees. The ICI was pleased that the GAO understood the importance and seriousness with which directors approach this duty. In particular, the GAO properly noted the critical role of independent directors in reviewing the advisory fee each year. The ICI letter also noted, however, that independent directors are often not given credit for the many ways in which

they safeguard shareholder interests. In the report, the GAO agrees that independent directors have played an important role in overseeing funds. The report also notes that SEC reviews generally have found that directors have fulfilled their duties under the law. The report comments that, given the recent scandals and the importance of funds to the financial health and retirement security of investors, continued scrutiny of fund governance is appropriate. The ICI letter agrees that continued scrutiny is appropriate but indicated that the report would be strengthened if it included a description of the full range of directors' responsibilities to protect investors in addition to their fee-related duties. Conclusions The GAO report includes several specific recommendations. First, the GAO recommends that the SEC consider the benefits of additional mutual fund fee disclosure, including requiring that more fee information be included on fund account statements about the fees investors pay. Second, the report recommends that the SEC consider evaluating ways to provide more disclosure relating to revenue sharing arrangements so that investors can better evaluate potential conflicts of interest. Finally, the GAO recommends that the SEC consider evaluating ways to provide additional disclosure concerning soft dollars to assist directors and investors in evaluating the benefits and potential disadvantages of their fund adviser's use of 4 such arrangements. The report specifically urges the SEC to consider and implement the recommendations in its 1998 soft dollar examinations report. Matthew P. Fink President