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July 9, 2003

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Paul E. Kanjorski
Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Baker and Ranking Member Kanjorski,

We are writing to express our support for H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act of 2003. Over the last two decades, mutual funds have become firmly established as Americans' investment vehicle of choice, and investors have benefitted greatly the ability mutual funds have offered even those of very modest means to diversify their portfolios and obtain professional management. Moreover, the relatively scandal-free record of the mutual fund industry attests to the effectiveness of the overall regulatory scheme for this important investment vehicle.

Nonetheless, fund rules in some areas have not kept pace with industry practices. Given the reliance of the least sophisticated investors on mutual funds, we applaud the Subcommittee's efforts to address weaknesses in the fund regulatory structure. Furthermore, we support this bill's focus on improving disclosure about fund costs and strengthening the role of independent directors. We urge prompt action on H.R. 2420 with a few strengthening amendments discussed below.

1. Improved Cost Disclosure

First and foremost, H.R. 2420 seeks to benefit investors by ensuring that they are provided with enhanced information about fund costs. We strongly support its provisions: to require that fees be disclosed in dollar amounts; to require that fee disclosures incorporate all fees, including portfolio transaction costs; and to require that fee disclosures identify all distribution expenses, including those paid outside of 12b-1 plans. We also support provisions to improve disclosure of compensation paid to

portfolio managers and retail brokers, as this will help shareholders to evaluate the extent to which these persons' economic interests are aligned with or conflict with their own.

Disclosure of individualized expenses. The disclosure of individualized expenses has the potential to benefit investors greatly by providing them with a clearer understanding of the impact of fees. It would achieve this by presenting them, in one place, with information both on the account's gains and what they paid to achieve those gains. This, in turn, should encourage price competition in the fund industry. But these benefits will only be fully achieved, particularly for the least sophisticated mutual fund investors, if the disclosures are provided on a document that is likely to be widely read, such as the annual or quarterly account statement.

We are concerned, however, that the wide latitude given the SEC to develop rules in this area may leave investors without the legislation's promised benefits. If, as we expect, the Commission interprets the legislation as being consistent with the approach taken in its pending rule proposal, investors are likely to get vague disclosures (actual fees on a hypothetical $10,000 account) in a document (the shareholder report) that few read closely. While the costs of such an approach are likely to be minimal, so are the benefits.

Unfortunately, in approaching this issue, the SEC has been far more sensitive to industry costs than to investor benefits. The SEC report on mutual fund fees and expenses, for example, discusses the cost of the GAO's proposal to require disclosure in the quarterly statement, but offers no discussion of whether the quarterly statement would be more likely to be read than other disclosure documents.[1] Nor does it address the argument that the disclosure of actual expenses has a greater potential to influence investor behavior than disclosure of expenses on a hypothetical account, although these issues have been raised repeatedly by investor advocates. We, too, are sensitive to costs, since those costs are ultimately borne by shareholders. But investors also pay a significant price when they invest in funds with higher than justified expense ratios, and that cost should also be taken into account when assessing the merits of various disclosure reforms.

We urge the Subcommittee, therefore, to amend the bill to require the SEC to base its rules in this area on a real cost-benefit analysis that thoroughly addresses such issues as where the disclosures are most likely to be read and what form of disclosure is most likely to motivate investors to make cost-conscious decisions. The Commission should be required to report to the Committee on the results of its assessment and explain how its rule proposal to implement this provision of the legislation appropriately balances costs and benefits. In conducting the cost-benefit analysis, the Commission should pay particular attention to determining the form of disclosure that is most likely to be read, understood, and acted on by the least sophisticated of mutual fund investors. As part of that analysis, the Commission should look at the costs and benefits of requiring pre-sale disclosure of expense information for funds sold through brokers. We believe changes in this area are more likely than any other to introduce more vigorous price competition into the mutual fund marketplace.

Portfolio Transaction Costs. Portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. Furthermore, these costs vary greatly among funds. However, they are not included in fee information provided in the prospectus. Instead, more limited information – the dollar amount of the fund's commissions – is included in the Statement of Additional

[1] Report on Mutual Fund Fees and Expenses, Division of Investment Management, Securities and Exchange Commission, December 2000.

Information, which is provided to shareholders only upon request. H.R. 2420 calls for the SEC to adopt rules requiring funds to set forth information about their portfolio transaction costs, including commissions, in a manner that facilitates comparisons across funds. Full disclosure of these expenses will help hold fund advisers accountable for their trading practices, which should in turn reduce costs to investors. Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices, by subjecting fund expenditures on soft dollar services to market forces. This should provide a practical solution to the problem of regulating soft dollar practices.

Disclosure of Distribution Expenses. H.R. 2420 requires the SEC to adopt rules to improve disclosure of various distribution expenses, including the use of fund brokerage to compensate brokers for selling fund shares, payments for fund distribution made by someone other than the fund, and breakpoints on front-end sales loads. The current fee table in the prospectus shows 12b-1 fees as a separate line item, but leaves investors in the dark about other types of distribution expenses. The legislation would remedy this by requiring disclosure of all distribution expenses, including distribution expenses paid for with fund brokerage or paid by the adviser out of its fee. It would also improve conflict of interest disclosure, by requiring brokers to disclose how much they were paid in connection with the sale of fund shares. This information is critical to ensure that fund investors understand their brokers' economic interest in the transaction.

2. Strengthening the Role of Independent Directors

H.R. 2420 also includes a number of provisions designed to strengthen the role of independent directors and further focus directors' energies where conflicts of interest between the fund adviser and fund shareholders are greatest. Its central provision in this area requires that two-thirds of fund board members be independent and that the board chairman be selected from among the independent members. The bill would also strengthen the hand of the SEC in defining who is qualified as independent for this purpose. These reforms are needed to counteract the effective dominance of funds by their advisers and to ensure that fund boards will be able to exercise independent judgment and control the operational aspects of fund governance. We strongly support their adoption without weakening amendments.

The fund industry has opposed the requirement for an independent chairman, noting that rules governing operating companies generally do not require that a company's chairman be independent. This argument fails on two counts:

- First, recent scandals have caused many leaders in the area of corporate governance to rethink this issue. For example, the Commission on Public Trust and Private Enterprise convened by The Conference Board in June 2002 recommended in its recent report that the position of board chairman not be held by a member of management.[2] We recognize that requiring that a chairman be independent in law will not guarantee that he or she will be independent in fact, but we firmly believe that a legally independent chairman is more likely to be truly independent than a person with ties to management.

- Second, the need for fund boards to be independent is much greater than for operating company boards. The conflicts between operating company directors and management are at least somewhat mitigated by the fact that they report to the same shareholders – the shareholders of the company. In contrast, fund directors and management generally report to different sets of

[2] Findings and Recommendations, The Conference Board Commission on Public Trust and Private Enterprise, January 9, 2003.

shareholders with potentially conflicting interests.[3] Fund directors report to the shareholders of the fund, while fund management reports to the shareholders of the manager. This unique structural conflict of interest lies at the heart of fund regulation, which has from the beginning recognized that this conflict of interest necessitates heightened standards of independence to ensure that shareholders' interests are protected. Requiring an independent chairman is consistent with this approach.

The industry has maintained that this provision is unnecessary, because independent directors already oversee all board matters involving conflicts of interest between advisers and their funds. There are numerous instances, however, in which this is simply not the case. For example, advisers routinely engage in certain affiliated transactions with their funds that are permitted only if reviewed by the independent directors, but the review of these transactions typically occurs in a meeting of all of the directors that is overseen by the board's non-independent chairman. The same non-independent chairman typically oversees meetings at which a variety of compliance issues may be addressed, such as mis-priced securities, failed trades, or personal trading violations. With respect to each of these compliance issues, the adviser's interests are often different from or contrary to the fund's interests.

In reality, virtually every issue that comes before a fund board raises potential conflicts of interest, in varying degrees, between a fund and its adviser. Independent leadership is necessary to ensure that fund shareholders' interests are protected. An independent chairman is in the best position to oversee the board's evaluation of these conflicts. Contrary to industry arguments that this requirement would deprive boards of essential expertise, nothing in this approach would preclude employees of the adviser from serving on the board as non-independent members or from providing their expertise to the board upon request.

3. The Need for Pre-sale Disclosure

H.R. 2420 provides a number of improvements to the current system of mutual fund disclosure in the area of cost disclosure. However, it fails to address what we view as the current system's most serious short-coming, the fact that the majority of mutual fund investors – those who purchase their funds through brokers – are not required to receive any pre-sale disclosure. In theory, brokers' obligation to make suitable recommendations is supposed to substitute for full disclosure, but one need look no further than the recent concerns about inappropriate sale of Class B mutual fund shares to see that this is not the case.

Encouraging investors to make more informed mutual fund purchases offers obvious benefits. Investors are less likely to be lured into inappropriately risky funds, for example, if they receive clear pre-sale disclosure of fund risks and investment objectives. And those who seek to introduce greater price competition to the fund industry must recognize that clear pre-sale cost disclosure is absolutely essential to bring that about.

We therefore urge the subcommittee to amend H.R. 2420 to require pre-sale disclosure of at least the information contained in the mutual fund profile to mutual fund investors who purchase

[3] Vanguard is the most notable exception, as the manager of Vanguard's funds is owned by the funds. This means that the manager's shareholders and the funds' shareholders are the same. This is widely viewed as one of the reasons Vanguard has led the industry both in keeping costs down and in providing clear and complete disclosure.

their funds from brokers. The brevity of these documents and the availability of a variety of effective delivery mechanisms – including fax, Internet, and email – should make it relatively easy for brokers to provide this disclosure. After all, mutual fund purchases are not delicately timed transactions that require the kind of instant turn-around that makes written pre-sale disclosures impractical. And, while we recognize that such an approach would impose significant new costs on brokers, we believe the considerable benefits of encouraging informed decision-making – including the potential introduction of real price competition to the fund industry – greatly outweigh those costs.

4. The Need for Legislation

The mutual fund industry has indicated that it does not believe this legislation is unnecessary, because there is little if anything in this bill that the SEC could not mandate under its existing statutory authority. While it is certainly true that the SEC could have acted in each of these areas, the fact is that it hasn't. We are sensitive to the difficulty the Commission faces when confronted with industry opposition to rudimentary regulatory reforms. The only effective antidote is a clear roadmap for reform from Congress. This bill provides that roadmap. For the same reasons, we are very concerned that well-intentioned attempts to replace the clear directives contained in H.R. 2420 with general guidance to the Commission may lead to half-measures that provide no real benefit to shareholders. **We therefore oppose any amendments that would have the effect of rendering the bill an advisory opinion to the Commission rather than a clear prescription for reform.**

Thank you for your attention to our concerns. We look forward to working with you to bring about the speedy passage of this important investor protection legislation.

Respectfully submitted,

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