Fund Democracy
The Mutual Fund Shareholder's Advocate

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# A Pro-Investor Blueprint for Mutual Fund Reform

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Sweeping reforms are needed to restore badly shaken investor confidence in the mutual fund industry. These reforms must do more than address the specific abuses uncovered by the recent state and federal investigations, they must also recognize and address the systemic nature of recent compliance failures and other problems, the role of broker-dealers in assisting the abuses, and other problems, such as excessive and poorly disclosed fund fees, that also result from poor board and regulatory oversight. Only a comprehensive approach to reform will justify renewed investor confidence in the integrity of the mutual fund marketplace. With that in mind, Fund Democracy, Consumer Federation of America, Consumer Action, and U.S. Public Interest Research Group offer the following specific proposals that we believe must be included in the legislative and regulatory response to the current mutual fund crisis.

## 1. Adopt reforms designed to address specific abuses uncovered by the recent investigations.

While our organizations strongly encourage Congress and the Securities and Exchange Commission (SEC) to look beyond the recent scandal in adopting mutual fund reforms, it is certainly not our intention that the current scandal be ignored. Any legislative and/or regulatory reform package should take specific steps to ensure that abusive trading practices uncovered in recent investigations are ended, that the perpetrators are punished, and that investors receive full and fair restitution for their losses.

### A. Require Funds To Impose Short-Term Redemption Fees

The most substantial losses resulting from the current scandal were caused by funds' selling their shares at inaccurate or stale prices and allowing certain investors to trade rapidly in and out of the fund to take advantage of those pricing discrepancies. Some academics who have studied the issue have estimated that this practice costs long-term fund shareholders billions of dollars each year. Funds are already required to price their shares accurately, and this requirement should be more strictly enforced. To the extent that pricing is not a perfect science, however, some funds still may use slightly inaccurate prices that sophisticated traders can identify and exploit.

These opportunities would be eliminated by the imposition of a small redemption fee on all sales of fund shares occurring within a short time period after the purchase. Our organizations therefore support requiring funds (or at least those that claim to restrict short-term trading) to impose redemption fees of two percent for fund sales within 30 days of purchase, and permitting funds to impose redemption fees of up to five percent for sales within five days of the purchase. Funds that adopt such fees could also adopt procedures to permit redemptions without payment of the redemption fee in the case of a genuine emergency. In all cases, the redemption fee would be payable to the fund, so that shareholders would receive the benefits.

### B. Take Steps to Prevent Late Trading

While some mutual fund companies apparently conspired to allow late trading in their funds, others were the victims of brokerage firms and other trade processing intermediaries who assisted their clients in evading those restrictions. Steps must be taken to better prevent evasion of the late trading restrictions, including tough sanctions against those who knowingly violate or aid their clients to violate those restrictions. In addition, the quality of compliance systems at both the funds and the trade processing intermediaries must be upgraded to ensure detection of these and other abuses and to allow an effective regulatory inspection of those procedures. Intermediaries who cannot provide adequate assurances of the integrity of their order processing systems, including foolproof time-stamping of trades, should be prohibited from submitting orders to the fund after 4 p.m. While we are reluctant to rely on a system that depends at least to some extent on after-the-fact regulatory scrutiny for its effectiveness, we believe such an approach could be effective, particularly when combined with a redemption fee imposed on short-term trades, which would reduce, if not eliminate, the financial reward for late trading.

### C. Require Full and Fair Restitution of Shareholder Losses

Regulators, federal and state prosecutors, and the fund firms themselves have provided assurances regarding restitution for losses to shareholders. That is reassuring. However, these promises have been short on specifics indicating how those losses will be measured and how the compensation will be provided.

Any restitution remedy must, at a minimum, satisfy the following criteria. It must be accompanied by a public statement detailing the basis for the restitution amount and an explanation of the methodologies used to calculate the amount. Furthermore, payments must be based on a methodology that takes into account not just the dollar amount of the relevant trades, but also the dilution caused by those trades (whether resulting from the execution of the trades at a stale price or from the processing of an order entered after the fund was priced); any administrative, trading, performance and other costs resulting from such trades; and the amount that money would have earned in the interim based on the fund's subsequent performance.

Those who profited from abusive practices should be forced to disgorge those profits, including management fees received on accounts of traders who engaged in these practices, sales charges received on account of these traders' transactions, and interest or other compensation received on loans to these traders. High level executives who were aware of abusive practices but failed to take action should also pay their share of investor losses and should be required to forfeit any compensation they received in connection with those practices.

## 2. Improve Regulatory Oversight of Mutual Funds

The mutual fund scandal represents a structural breakdown in the regulatory oversight of mutual funds. Some have faulted the SEC's inspection program, which certainly appears to be in need of a major overhaul. However, allegations of abusive trading practices at mutual funds have been around for years. The SEC shouldn't have waited to uncover evidence of a problem in routine inspections, it should have gone looking for signs of trouble. This did not occur. Even when the problem had been exposed and the SEC received a tip of problems at a particular fund company, it was slow to act. These are signs of a regulatory oversight operation that is fundamentally broken.

The SEC has recently announced that it is creating a new risk assessment office whose purpose is to identify emerging problems and coordinate the agency's response. This is a good idea, but it is just a start. Congress needs to look further to determine whether additional reforms are needed to buttress the SEC's inspection and oversight program. We believe the following are among those that ought to be adopted.

### A. Create an Independent Regulatory Organization to Oversee Mutual Funds

One obvious conclusion from the recent scandals is that mutual fund directors at implicated fund companies have failed to provide fundamental compliance oversight of their funds. While fund directors have failed their shareholders, the existing regulatory structures have also failed fund directors, by not providing them with consistent, effective guidance regarding their duties. We believe the best way to redress this short-coming is for Congress to create an Independent Regulatory Organization (IRO), patterned on the Public Company Accounting Oversight Board, with examination and enforcement authority over mutual fund boards and financed out of fund assets or management fees. The purpose of the board would be to supplement, rather than supplant, the SEC as the primary regulator of the mutual fund industry. While the SEC would continue to oversee investment advisers directly, the new board would, among other things, establish uniform, minimum fiduciary standards for fund directors' oversight of their funds, including their evaluation of advisory contracts, fund compliance procedures, and the implementation of those procedures.

### B. Support and Expand SEC Efforts to Enhance its Regulatory Operations

As the SEC conducts its own internal investigation and reorganization, Congress should provide effective oversight of that effort in order to assure that it gets to the root cause of the SEC's lax regulatory response on this and other issues. The goal should be to revitalize the agency's inspection and oversight program, as well as to provide better direction for the agency's regulatory and enforcement efforts. In return for assurances of a newly aggressive approach to its regulatory responsibilities, Congress should provide the SEC with the resources it needs to fulfill those responsibilities effectively.

### C. Review SEC's Reliance on Settlements without an Admission of Wrong-doing

The SEC's recent settlement with Putnam included many beneficial provisions for shareholders, particularly in the area of enhancing the independence of the board of directors. However, by settling such an egregious case without an admission of wrong-doing, the SEC has sent the unfortunate signal that this is yet another scandal for which no one is personally to blame. In its response to the recent corporate scandals, this administration promised a tough enforcement program, with individuals forced to accept the consequences of their actions. Congress adopted tough new criminal penalties. So far, however, we have seen little evidence that much has changed in a culture that favors quick settlements. While not every case should be subject to a protracted legal action, the worst cases should be held up as examples. The Putnam case would seem to qualify for this treatment, with fund managers apparently having timed their own funds – picking the pockets of their own shareholders – and management having done nothing to make them give back the money once the practices were uncovered. Congress should look into this practice, not just with regard to the Putnam settlement, but with regard to the SEC's enforcement program generally.

## 3. Enhance the Independence and Effectiveness of Mutual Fund Boards of Directors

As we noted above, mutual fund boards of directors at fund companies implicated in the scandal have clearly failed to provide fundamental compliance oversight of their funds. The recent scandals are not the only such evidence. Further evidence can be found in the exorbitant and unjustifiable fees that some funds impose, with the approval of the board, or in the soft-dollar and directed brokerage practices engaged in by many fund companies. One problem is that, even where they are independent in theory, mutual fund boards tend to be dominated by the fund managers. Legislative and regulatory responses to recent scandals must include comprehensive reforms designed to make boards more independent and effective.

### A. Strengthen the Independence of Independent Directors

The current definition of an independent director includes a host of persons who are not independent from the fund manager. For example, a former director or officer of the fund's manager can be an independent director, as can a current officer or director of a service provider to the fund. The definition of independent director should be substantially strengthened, and the SEC should be given the authority to adopt rules excluding specified categories of persons from serving as independent directors.

### B. Require an Independent Chairman

Most fund boards have a chairman who works for the fund's manager. All things being equal, when it comes to weighing issues where there is a direct conflict between the interests of the fund manager and the interests of shareholders, an independent chairman should provide stronger leadership and exercise greater independence in thought and action than a chairman who is employed by the fund manager.

### C. Require a Substantial Majority of Independent Directors

To further clarify that boards really are designed as shareholders' representatives, three-quarters of their members should be required to be independent. This would allow the board to retain enough board members from the fund management to benefit from their expertise without risking domination by those members.

### D. Require Independent Directors to Stand for Election.

Most fund directors are appointed for life and rarely stand for re-election by shareholders. Even when independent directors retire or resign, new independent directors often are not elected, because fund mergers have provided enough replacements to continue without any shareholder action. Fund shareholders should have a say in who serves as an independent director, and should have the ability to remove those who fail to act in their interests. Requiring independent directors to stand for election every five years would give them that ability.

### E. Establish a Fiduciary Duty with Respect to All Fees.

Current federal law imposes a fiduciary duty on a fund's manager and directors only with respect to fees received by the manager. This has enabled the public offering of funds, in the most extreme examples, with annual expense ratios in excess of 10 percent – a level of fees that exceeds the one-time maximum sales load permitted under NASD rules and is inconsistent with the protections that should apply to a publicly offered investment vehicle. Fund directors and managers should have a duty to ensure not only that the manager's fee is reasonable, but also that the totality of a fund's fees is reasonable in relation to the services offered.

## 4. Improve Mutual Fund Sales Practices

Not all of the abusive practices in the recent fund scandals can be laid at the feet of fund companies. Some – like the failure to provide appropriate commission discounts and the sale of the inappropriate class of fund shares – are attributable to abusive sales practices by broker-dealers. We congratulate the SEC for its recent settlement with Morgan Stanley regarding its inappropriate sales practices, but a more comprehensive response is needed. Clearly, it is no longer reasonable to assert that brokers' obligation to make suitable recommendations substitutes for full pre-sale disclosure to investors. The following are important steps that Congress should take to reform broker-dealer sales practices.

### A. Require Delivery of Fund Profile Prior to the Sale

Because the broker's suitability obligation is supposed to substitute for full disclosure, the securities laws do not require that brokers provide any disclosure document to shareholders at or before the time that the investment decision is made outlining key characteristics of that investment, including costs, risks, or investment goals. Current law requires only that a prospectus be delivered with the transaction confirmation, which is typically mailed days after the investor has made his or her investment decision.

In the mutual fund arena, a document exists – the fund profile – which covers basic characteristics of the investment. Such a document could easily be provided in advance of the sale – in person, through email, or by fax – without unduly delaying the sale. Since brokers have repeatedly shown that they do not consistently operate in their clients' best interests, and since the SEC has failed to enforce the suitability obligation to provide meaningful protection for investors, the time has come to require pre-sale disclosure of key investment characteristics, at least in the sale of mutual funds. (The fund profile should be updated to reflect the disclosure reforms we are advocating below.)

### B. Require Disclosure of Brokers' Compensation

For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and non-cash compensation. Mutual fund shareholders should be entitled to receive the same information as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

### C. Require Point of Sale Cost Estimate

When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs. Brokers should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund.

## 5. Improve Mutual Fund Fee Disclosures

In addition to making fund boards more accountable for setting reasonable fund fees, Congress should take a number of steps to enhance the quality of fee disclosures to more accurately reflect real costs to investors. This would help to introduce greater competitive pressure on fund fees and would help to end distortions that result when certain types of cost are included in the fund's expenses and others are not.

### A. Include Portfolio Transaction Costs in the Mutual Fund Expense Ratio

The mutual fund expense ratio omits what can be a fund's single largest expense: its portfolio transaction costs. These costs include the commissions paid by funds on portfolio trades, costs associated with the market impact of those trades, and the spread (difference between the bid and ask price) paid in connection with each trade. These costs can exceed a fund's total expenses. Commissions, which are the easiest of these costs to be quantified, should immediately be incorporated in the expense ratio. Congress should direct the SEC to come up with a plan for including all other portfolio transaction costs in the expense ratio as well.

### B. Reform 12b-1 fees

The current method for disclosing 12b-1 fees is misleading, because it suggests that 12b-1 fees are the only distribution costs incurred by shareholders. In fact, shareholders also pay for distribution through fees paid to the fund's manager and through the allocation of fund brokerage to brokers in return for sales of fund shares. The fund fee table should provide investors with functional disclosure of how their money is being spent, regardless of the particular rule authorizing the fee. Fee tables should, in pie chart or other easily understood graphical presentation, show how fees are spent on portfolio management, transfer agent, distribution, custody and other services. Congress also should consider banning 12b-1 fees and requiring that all distribution expenses be paid out of the management fee, with disclosure showing on which types of services fees were spent.

### C. Require Fee Comparison Disclosures

Mutual fund fee tables do not show how fees charged compare to those charged by similar funds or index funds that invest in similar securities. Providing this information would make it much easier for investors to compare fees across funds. The fee table should be required to show the average fees charged by a peer group of funds and by an index fund that invests in the same types of securities. This would not only aid investors to make better informed choices, it would provide essential market discipline for fund costs.

### D. Require Disclosure of the Actual Fund Costs

Current rules do not inform shareholders about the actual cost they pay for their investments. A proposal put forward by the SEC – to require funds to disclose, in shareholder reports, the actual fees paid on a $10,000 account – does little to remedy this short-coming. In fact, the Government Accounting Office found that this disclosure would be less likely to be read than if it were placed in shareholders' quarterly statements, and that it would have less of an impact than if it showed shareholders' individual costs. Congress should require that quarterly (or at least annual) statements show the actual dollar amount of the shareholder's expenses during the period covered by the statement.

### E. Require Disclosure Comparing Different Fund Classes

Many funds offer a bewildering array of different share classes. In some cases, shareholders have been sold classes of shares that provided the greatest payoff for the broker but are least suitable for the shareholder. Fund prospectuses (and fund profiles) should be required to compare, in a graphic format, the costs of investing in different classes over a 15-year period.

## 6. Miscellaneous Additional Reforms

### A. Require Disclosure of Amount and Structure of Portfolio Managers'

### Compensation and Fund Investments

In some cases, a portfolio manager's compensation or fund investments may not align his or her interests with the interests of fund shareholders. For example, a fund portfolio manager who also manages a hedge fund or other private accounts may have an incentive to favor those accounts over the mutual funds. The highest-paid executives of operating companies are required to disclose their compensation and their trades in company stock, yet there is no comparable requirement for mutual funds. Recent revelations have included investments by portfolio managers that are harmful to shareholders' interests. At a minimum, Congress should require that fund managers disclose the amount and structure of their compensation and their investments (including timely reports of purchases and sales) in the funds they manage. In addition, Congress should consider banning, or sharply restricting, such practices as dual management of mutual funds and hedge funds when they pose significant risks to investors.

### B. Ban Soft Dollars

Mutual fund managers are allowed to cause their funds to pay higher commissions to cover services that the manager would otherwise pay for out of its own pocket. These services are not required to be used to benefit the fund that paid for them, and the cost of these services is not disclosed. These soft dollar arrangements increase fund costs and create unnecessary conflicts of interest.

### C. Prohibit Fund Managers from Allocating Brokerage in Return for Fund Sales

Many fund managers compensate brokers for selling fund shares with fund brokerage. Under these arrangements, the fund manager pays the broker through commissions received in connection with a fund's portfolio transactions. This practice increases funds' portfolio transaction costs while reducing the amount the fund manager might otherwise spend on distribution, thus creating a significant conflict of interest. Fund managers should be prohibited from considering sales of fund shares when selecting brokers to effect fund transactions and should be required to obtain best execution on their trades.

### D. Apply the Rule on Misleading Fund Names to "U.S. Government" Funds

Funds are prohibited from using misleading names, yet the SEC has taken the position that a fund with "U.S. Government" in its name can invest 100 percent of its assets in Fannie Mae or Freddie Mac securities. These securities are not guaranteed by the U.S. Government, which is the guarantee investors think they are getting when they invest in government securities. Congress should prohibit funds from using names that imply that they invest in U.S. government securities unless at least 80 percent of the funds' assets are actually invested in securities that are backed by the full faith and credit of the U.S. government.

## Conclusion

Investors have benefitted greatly over the years from the opportunity mutual funds offer even those of modest means to gain broad diversification and professional management. Many average, middle income investors have relied on mutual funds as the one place in the securities industry where their interests were likely to get fair consideration. Although the dollar amounts that individuals have lost as a result of recent scandals is likely to be quite small, the blow to investor confidence has been enormous. The above proposals are key elements in the comprehensive approach to reform that the current mutual fund crisis demands. It is imperative that Congress and the SEC act quickly and forcefully to restore badly damaged investor confidence.