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MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

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Financial Markets and Community Investment

January 27, 2004

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Highlights

Highlights of GAO-04-317T, a testimony to the Chairman, Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate

Why GAO Did This Study

Concerns have been raised over whether the disclosures of mutual fund fees and other fund practices are sufficiently fair and transparent to investors. Our June 2003 report, *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763, reviewed (1) how mutual funds disclose their fees and related trading costs and options for improving these disclosures, (2) changes in how mutual funds pay for the sale of fund shares and how the changes in these practices are affecting investors, and (3) the benefits of and the concerns over mutual funds' use of soft dollars. This testimony summarizes the results of our report and discusses certain events that have occurred since it was issued.

What GAO Recommends

GAO recommends that SEC consider the benefits of requiring additional disclosure relating to mutual fund fees and evaluate ways to provide more information that investors could use to evaluate the conflicts of interest arising from payments funds make to broker-dealers and fund advisers' use of soft dollars. SEC generally agreed with the contents of our report and indicated that it will consider the recommendations in this report carefully in determining how best to inform investors about the importance of fees and other disclosures.

www.gao.gov/cgi-bin/getrpt?GAO-04-317T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

Although mutual funds disclose considerable information about their costs to investors, the amount of fees and expenses that each investor specifically pays on their mutual fund shares are currently disclosed as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. SEC staff has proposed requiring funds to disclose additional information that could be used to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that investors receive. Although some of these additional disclosures could be costly and data on their benefits to investors was not generally available, less costly alternatives exist that could increase the transparency and investor awareness of mutual funds fees, making consideration of additional fee disclosures worthwhile.

Changes in how mutual funds pay intermediaries to sell fund shares have benefited investors but have also raised concerns. Since 1980, mutual funds, under SEC Rule 12b-1, have been allowed to use fund assets to pay for certain marketing expenses. Over time the use of these fees has evolved to provide investors greater flexibility in choosing how to pay for the services of individual financial professionals that advise them on fund purchases. Another increasingly common marketing practice called revenue sharing involves fund investment advisers making additional payments to the broker-dealers that distribute their funds' shares. However, these payments may cause the broker-dealers receiving them to limit the fund choices they offer to investors and conflict with their obligation to recommend the most suitable funds. Regulators acknowledged that the current disclosure regulations might not always result in complete information about these payments being disclosed to investors.

Under soft dollar arrangements, mutual fund investment advisers use part of the brokerage commissions they pay to broker-dealers for executing trades to obtain research and other services. Although industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and provide other benefits, these arrangements also can create incentives for investment advisers to trade excessively to obtain more soft dollar services, thereby increasing fund shareholders' costs. SEC staff has recommended various changes that would increase transparency by expanding advisers' disclosure of their use of soft dollars. By acting on the staff's recommendations SEC would provide fund investors and directors with needed information about how their funds' advisers are using soft dollars.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss GAO's work on the disclosure of mutual fund fees and the need for other disclosures of mutual fund practices. The fees and other costs that mutual fund investors pay as part of owning fund shares can significantly affect their investment returns. In addition, changes over time in how mutual funds pay intermediaries to sell fund shares have also raised concerns. As a result, it is appropriate to debate whether the disclosures of mutual fund fees and fund marketing practices are sufficiently transparent and fair to investors.

Today, I will summarize the results from our report entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors, GAO-03-763 (Washington, D.C.: June 9, 2003). Specifically, I will discuss (1) mutual fund fee disclosures and opportunities for improving these disclosures, (2) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (3) the benefits and concerns over fund advisers' use of soft dollars. I will also provide information relating to certain events that have occurred since our June 2003 report was issued.

In summary:

The results of our work suggest a need to consider ways to increase the transparency of mutual fund fees and other fund practices. Mutual funds disclose considerable information about their costs to investors, including presenting the operating expense fees that they charge investors as a percentage of fund assets and providing hypothetical examples of the amount of fees that an investor can expect to pay over various time periods. However, unlike many other financial products and services, mutual funds do not disclose to individual investors the specific dollar amount of fees that are paid on their fund shares. The Securities and Exchange Commission (SEC) has proposed that mutual funds make additional disclosures to investors that would provide more information that investors could use to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that inform investors of the number and value of the mutual fund shares they own. Our report recommends that SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC has agreed to consider requiring such disclosures but was unsure that the benefits of implementing specific dollar disclosures outweighed the costs

to produce such disclosures. However, we estimate that spreading these implementation costs across all investor accounts might not represent a large outlay on a per investor basis. Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees.

The work that we conducted for our report also found that 12b-1 fees, which allow fund companies to deduct certain distribution expenses such as sales commissions from fund assets, can raise costs to investors but also provide additional ways for investors to pay for investment advice. Our work also found that mutual fund advisers have been increasingly engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses of fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that these broker-dealers offer investors. However, under current disclosure requirements investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Our report recommends that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving. On January 14, 2004, SEC proposed new rules and rule amendments designed to enhance the information that broker-dealers provide to their customers concerning conflicts of interest that arise from the sale of mutual funds.

We also reviewed a practice known as soft dollars, in which a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. These soft dollar arrangements can result in mutual fund advisers obtaining research or other services, including research from third party independent research firms, that can benefit the investors in their funds. However, these arrangements also create a conflict of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain additional soft dollar research or chooses broker-dealers more on the basis of their soft dollar offerings than their ability to execute trades efficiently. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on some of its own recommendations. Our report recommends that more disclosure be made to mutual fund directors and investors to allow them to better evaluate the

benefits and potential disadvantages of their fund adviser's use of soft dollars.

Finally, since September 2003, federal and state authorities' widening investigation of illegal late trading and improper timing of fund trades has involved a growing number of prominent mutual fund companies and brokerage firms. To address these abusive practices, regulators are considering the merits of various proposals that have been put forth. In addition, in November 2003, the House of Representatives acted on legislation that addresses abusive trading and various other mutual fund issues and legislation was introduced in the Senate. The House of Representatives passed H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. H.R. 2420's purpose is to (1) improve transparency of mutual fund fees and costs and (2) improve corporate governance and management integrity of mutual funds. Also in November 2003, three bills addressing mutual fund concerns were introduced in the Senate. The Mutual Fund Transparency Act of 2003, S. 1822, would require disclosure of financial relationships between brokers and mutual fund companies and of certain brokerage commissions paid by mutual fund companies. S. 1958, the Mutual Fund Investor Protection Act of 2003, was introduced to prevent the practice of late trading by mutual funds, and for other purposes. S. 1971, the Mutual Fund Investor Confidence Restoration Act of 2003 seeks to improve transparency relating to the fees and costs that mutual fund investors incur and to improve corporate governance of mutual funds.

Additional Disclosure of Mutual Fund Costs Might Benefit Investors

Although mutual funds already disclose considerable information about the fees they charge, our report recommends that SEC consider requiring that mutual funds make additional disclosures to investors about fees in the account statements that investors receive. Mutual funds currently provide information about the fees they charge investors as an operating expense ratio that shows as a percentage of fund assets all the fees and other expenses that the fund adviser deducts from the assets of the fund. Mutual funds also are required to present a hypothetical example that shows in dollar terms what investors could expect to pay in fees if they invested $10,000 in a fund and held it for various periods. It is important to understand the fees charged by a mutual fund because fees can significantly affect investment returns of the fund over the long term. For example, over a 20-year period a $10,000 investment in a fund earning 8 percent annually, with a 1-percent expense ratio, would be worth $38,122; but with a 2-percent expense ratio it would be worth $31,117—over $7,000 less.

Unlike many other financial products, mutual funds do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. Table 1 shows that many other financial products do present their costs in specific dollar amounts.

Table 1: Fee Disclosure Practices for Selected Financial Services or Products

Type of product or service	Disclosure requirement
Mutual funds	Mutual funds show the operating expenses as percentages of fund assets and dollar amounts for hypothetical investment amounts based on estimated future expenses in the prospectus.
Deposit accounts	Depository institutions are required to disclose itemized fees, in dollar amounts, on periodic statements.
Bank trust services	Although covered by varying state laws, regulatory and association officials for banks indicated that trust service charges are generally shown as specific dollar amounts.
Investment services provided to individual investment accounts (such as those managed by a financial planner)	When the provider has the right to deduct fees and other charges directly from the investor's account, the dollar amounts of such charges are required to be disclosed to the investor.
Wrap accounts[a]	Provider is required to disclose dollar amount of fees on investors' statements.
Stock purchases	Broker-dealers are required to report specific dollar amounts charged as commissions to investors.
Mortgage financing	Mortgage lenders are required to provide at time of settlement a statement containing information on the annual percentage rate paid on the outstanding balance, and the total dollar amount of any finance charges, the amount financed, and the total of all payments required.
Credit cards	Lenders are required to disclose the annual percentage rate paid for purchases and cash advances, and the dollar amounts of these charges appear on cardholder statements.

Source: GAO analysis of applicable disclosure regulations, rules, and industry practices.

[a]In a wrap account, a customer receives investment advisory and brokerage execution services from a broker-dealer or other financial intermediary for a "wrapped" fee that is not based on transactions in the customer's account.

Although mutual funds do not disclose their costs to each individual investor in specific dollars, the disclosures that they make do exceed those of many products. For example, purchasers of fixed annuities are not told of the expenses associated with investing in such products. Some industry

participants and others including SEC also cite the example of bank savings accounts, which pay stated interest rates to their holders but do not explain how much profit or expenses the bank incurs to offer such products. While this is true, we do not believe this is an analogous comparison to mutual fund fees because the operating expenses of the bank are not paid using the funds of the savings account holder and are therefore not explicit costs to the investor like the fees on a mutual fund.

A number of alternatives have been proposed for improving the disclosure of mutual fund fees, that could provide additional information to fund investors. In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[1] This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to disclose the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, SEC also proposed that mutual funds be required to disclose the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. If these disclosures become mandatory, investors will have additional information that could be directly compared across funds. By placing the disclosures in funds' annual and semiannual reports, SEC staff also indicated that it will facilitate prospective investors comparing funds' expenses before making a purchase decision.

However, SEC's proposal would not require mutual funds to disclose to each investor the specific amount of fees in dollars that are paid on the shares they own. As result, investors will not receive information on the costs of mutual fund investing in the same way they see the costs of many other financial products and services that they may use. In addition, SEC did not propose that mutual funds provide information relating to fees in the quarterly or even more frequent account statements that provide investors with the number and value of their mutual fund shares. In a 1997 survey of how investors obtain information about their funds, the Investment Company Institute (ICI) indicated that, to shareholders, the account statement is probably the most important communication that they receive

[1]"Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission," Release Nos. 33-8164; 34-47023; IC-2587068 (Dec. 18, 2002).

from a mutual fund company and that nearly all shareholders use such statements to monitor their mutual funds.

SEC and industry participants have indicated that the total cost of providing specific dollar fee disclosures might be significant; however, we found that the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement for the record to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House Committee on Financial Services, ICI commissioned a large accounting firm to survey mutual fund companies about the costs of producing such disclosures. [2] Receiving responses from broker-dealers, mutual fund service providers, and fund companies representing approximately 77 percent of total industry assets as of June 30, 2000, this study estimated that the aggregated estimated costs for the survey respondents to implement specific dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. Although the ICI study included information from some broker-dealers and fund service providers, it did not include the reportedly significant costs that all broker-dealers and other third-party financial institutions that maintain accounts on behalf of individual mutual fund shareholders could incur. However, using available information on mutual fund assets and accounts from ICI and spreading such costs across all investor accounts indicates that the additional expenses to any one investor are minimal. Specifically, at the end of 2001, ICI reported that mutual fund assets totaled $6.975 trillion. If mutual fund companies charged, for example, the entire $266 million cost of implementing the disclosures to investors in the first year, then dividing this additional cost by the total assets outstanding at the end of 2001 would increase the average fee by 0.0038 percent or about one-third of a basis point. In addition, ICI reported that the $6.975 trillion in total assets was held in over 248 million mutual fund accounts, equating to an average account of just over $28,000. Therefore, implementing these disclosures

[2]U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003).

would add $1.07 to the average $184 that these accounts would pay in total operating expense fees each year—an increase of six-tenths of a percent.[3]

In addition, other less costly alternatives are also available that could increase investor awareness of the fees they are paying on their mutual funds by providing them with information on the fees they pay in the quarterly statements that provide information on an investor's share balance and account value. For example, one alternative that would not likely be overly expensive would be to require these quarterly statements to present the information—the dollar amount of a fund's fees based on a set investment amount—that SEC has proposed be added to mutual fund semiannual reports. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative could be to require quarterly statements to also include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information. In September 2003, SEC amended fund advertising rules, which require funds to state in advertisements that investors should consider a fund's fees before investing and directs investors to consult their funds' prospectus.[4] However, also including this information in the quarterly statement could increase investor awareness of the impact that fees have on their mutual fund's returns. H.R. 2420 would require that funds disclose in the quarterly statement or other appropriate shareholder report an estimated amount of the fees an investor would have to pay on each investment of $1,000. S. 1958, like H.R. 2420, would require disclosure of fees paid on each $1,000 invested. S. 1971, among other disclosures, would require that funds disclose the actual cost borne by each shareholder for the operating expenses of the fund.

SEC's current proposal, while offering some advantages, does not make mutual funds comparable to other products and provide information in the

[3]To determine these amounts, we used the operating expense ratios that ICI estimated in its September 2002 fee study—which reported average expense ratios of 0.88 percent for equity funds, 0.57 percent for bond funds, and 0.32 percent for money market funds. By weighting each of these by the total assets invested in each fund type, we calculated that the weighted average expense ratio for all funds was 0.66 percent. Using this average expense ratio, the average account size of $28,000 would pay $184 in fees. The additional expense of implementing specific dollar disclosures of 0.0038 percent would therefore add $1.07 to this amount.

[4]Final Rule: Amendments to Investment Company Advertising Rules, Securities and Exchange Commission, Release Nos. 33-8294; 34-48558; IC-26195 (Sep. 29, 2003).

document that is most relevant to investors—the quarterly account statement. Our report recommends that SEC consider requiring additional disclosures relating to fees be made to investors in the account statement. In addition to providing specific dollar disclosures, we also noted that investors could be provided with a variety of other disclosures about the fees they pay on mutual funds that would have a range of implementation costs, including some that would be less costly than providing specific dollar disclosures. However, seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees. Because the disclosures that SEC is currently proposing be included in mutual fund annual and semiannual reports could also prove beneficial, it could choose to require disclosures in these documents and the account statements, which would provide both prospective and existing investors in mutual funds access to valuable information about the costs of investing in funds.

Disclosures of Trading Costs Could Benefit Investors

Academics and other industry observers have also called for increased disclosure of mutual fund brokerage commissions and other trading costs that are not currently included in fund expense ratios. In an academic study we reviewed that looked at brokerage commission costs, the authors urged that investors pay increased attention to such costs.[5] For example, the study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing trading costs as relevant information because the impact of these unobservable trading costs is comparable to the more observable expense ratio. The authors of another study noted that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' Statement of Additional Information.[6]

[5]J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania (Nov. 2, 1999).

[6]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *Journal of Financial Research* (Summer 1996).

Mutual fund officials raised various concerns about expanding the disclosure of brokerage commissions and trading costs in general. Some officials said that requiring funds to present additional information about brokerage commissions by including such costs in the fund's operating expense ratios would not present information to investors that could be easily compared across funds. For example, funds that invest in securities on the New York Stock Exchange (NYSE), for which commissions are usually paid, would pay more in total commissions than would funds that invest primarily in securities listed on NASDAQ because the broker-dealers offering such securities are usually compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. Officials at one fund company told us that it would be difficult for fund companies to produce a percentage figure for other trading costs outside of commissions because no agreed upon methodology for quantifying market impact costs, spreads, and markup costs exists within the industry. Other industry participants told us that due to the complexity of calculating such figures, trading cost disclosure is likely to confuse investors. For example funds that attempt to mimic the performance of certain stock indexes, such as the Standard & Poors 500 stock index, and thus limit their investments to just these securities have lower brokerage commissions because they trade less. In contrast, other funds may employ a strategy that requires them to trade frequently and thus would have higher brokerage commissions. However, choosing among these funds on the basis of their relative trading costs may not be the best approach for an investor because of the differences in these two types of strategies.

To improve the disclosure of trading costs to investors, the House-passed H.R. 2420 would require mutual fund companies to make more prominent their portfolio turnover disclosure which, by measuring the extent to which the assets in a fund are bought and sold, provides an indirect measure of transaction costs for a fund. The bill directs funds to include this disclosure in a document that is more widely read than the prospectus or Statement of Additional Information, and would require fund companies to provide a description of the effect of high portfolio turnover rates on fund expenses and performance. H.R 2420 also requires SEC to issue a concept release examining the issue of portfolio transaction costs. S. 1822 would require mutual funds to disclose brokerage commissions as part of fund expenses. S. 1958 would require SEC to issue a concept release on disclosure of portfolio transaction costs. S. 1971 would require funds to disclose the estimated expenses paid for costs associated with

management of the fund that reduces the funds overall value, including brokerage commissions, revenue sharing and directed brokerage arrangements, transactions costs and other fees. In December 2003, SEC issued a concept release to solicit views on how SEC could improve the information that mutual funds disclose about their portfolio transaction costs.[7]

Changes in Some Fund Distribution Practices Likely Beneficial But Others Raise Potential Conflicts of Interest

The way that investors pay for the advice of financial professionals about their mutual funds has evolved over time. Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. Previously, the compensation that these financial professionals received for assisting investors with mutual fund purchases were paid by either charging investors a sales charge or load or by paying for such expenses out of the investment adviser's own profits.

However, in 1980, SEC adopted rule 12b-1 under the Investment Company Act to help funds counter a period of net redemptions by allowing them to use fund assets to pay the expenses associated with the distribution of fund shares. Rule 12b-1 plans were envisioned as temporary measures to be used during periods of declining assets. Any activity that is primarily intended to result in the sale of mutual fund shares must be included as a 12b-1 expense and can include advertising; compensation of underwriters, dealers, and sales personnel; printing and mailing prospectuses to persons other than current shareholders; and printing and mailing sales literature. These fees are called 12b-1 fees after the rule that allows fund assets to be used to pay for fund marketing and distribution expenses.

NASD, whose rules govern the distribution of fund shares by broker dealers, limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts. Therefore, 12b-1 fees included in a fund's total expense ratio are limited to a maximum of 1 percent per year. Rule 12b-1 provides investors

[7]Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, release Nos. 33-8349; 34-48952; IC-26313; File No. S7-29-03 (Dec. 19, 2003).

an alternative way of paying for investment advice and purchases of fund shares. Apart from 12b-1 fees, brokers can be paid with sales charges called "loads"; "front-end" loads are applied when shares in a fund are purchased and "back-end" loads when shares are redeemed. With a 12b-1 plan, the fund can finance the broker's compensation with installments deducted from fund assets over a period of several years. Thus, 12b-1 plans allow investors to consider the time-related objectives of their investment and possibly earn returns on the full amount of the money they have to invest, rather than have a portion of their investment immediately deducted to pay their broker.

Rule 12b-1 has also made it possible for fund companies to market fund shares through a variety of share classes designed to help meet the different objectives of investors. For example, Class A shares might charge front-end loads to compensate brokers and may offer discounts called breakpoints for larger purchases of fund shares. Class B shares, alternatively, might not have front-end loads, but would impose asset-based 12b-1 fees to finance broker compensation over several years. Class B shares also might have deferred back-end loads if shares are redeemed within a certain number of years and might convert to Class A shares if held a certain number of years, such as 7 or 8 years. Class C shares might have a higher 12b-1 fee, but generally would not impose any front-end or back-end loads. While Class A shares might be more attractive to larger, more sophisticated investors who wanted to take advantage of the breakpoints, smaller investors, depending on how long they plan to hold the shares, might prefer Class B or C shares because no sales charges would be deducted from their initial investments.

Although providing alternative means for investors to pay for the advice of financial professionals, some concerns exist over the impact of 12b-1 fees on investors' costs. For example, our June 2003 report discussed academic studies that found that funds with 12b-1 plans had higher management fees and expenses. Questions involving funds with 12b-1 fees have also been raised over whether some investors are paying too much for their funds depending on which share class they purchase. For example, SEC recently brought a case against a major broker dealer that it accused of inappropriately selling mutual fund B shares, which have higher 12b-1 fees, to investors who would have been better off purchasing A shares that had much lower 12b-1 fees. Also, in March 2003, NASD, NYSE, and SEC staff reported on the results of jointly administered examinations of 43 registered broker-dealers that sell mutual funds with a front-end load. The examinations found that most of the brokerage firms examined, in some

instances, did not provide customers with breakpoint discounts for which they appeared to have been eligible.

Revenue Sharing Raises Conflict of Interest Concerns

One mutual fund distribution practice—called revenue sharing—that has become increasingly common raises potential conflicts of interest between broker-dealers and their mutual fund investor customers. Broker-dealers, whose extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, have increasingly required mutual funds to make additional payments to compensate their firms beyond the sales loads and 12b-1 fees. These payments, called revenue sharing payments, come from the adviser's profits and may supplement distribution-related payments from fund assets. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. According to the officials of a mutual fund research organization, about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments. For example, some broker-dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker-dealers. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms with revenue sharing payments.

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. A 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing might affect other fees that funds charge, such as 12b-1 fees or management fees, was uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments increased any fund's fees, but also noted that by reducing fund adviser profits, revenue sharing would likely prevent advisers from lowering their fees. In addition, fund directors normally would not question revenue sharing arrangements paid from the adviser's profits. In the course of reviewing advisory contracts, fund directors consider the adviser's profits not taking into account marketing and distribution expenses, which also could prevent advisers from shifting these costs to the fund.

Revenue sharing payments may also create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their

sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue sharing arrangements might unduly focus the attention of broker-dealers on particular mutual funds, reducing the number of funds considered as part of an investment decision–potentially leading to inferior investment choices and potentially reducing fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable given the investor's financial situation and risk profile.

Although revenue sharing payments can create conflicts of interest between broker-dealers and their clients, the extent to which broker-dealers disclose to their clients that their firms receive such payments from fund advisers is not clear. Rule 10b-10 under the Securities Exchange Act of 1934 requires, among other things, that broker-dealers provide customers with information about third-party compensation that broker-dealers receive in connection with securities transactions. While broker-dealers generally satisfy the 10b-10 requirements by providing customers with written "confirmations," the rule does not specifically require broker-dealers to provide the required information about third-party compensation related to mutual fund purchases in any particular document. SEC staff told us that they interpret rule 10b-10 to permit broker-dealers to disclose third-party compensation related to mutual fund purchases through delivery of a fund prospectus that discusses the compensation. However, investors would not receive a confirmation and might not view a prospectus until after purchasing mutual fund shares.

As a result of these concerns, our report recommends that SEC evaluate ways to provide more information to investors about the revenue sharing payments that funds make to broker-dealers. Having additional disclosures made at the time that fund shares are recommended about the compensation that a broker-dealer receives from fund companies could provide investors with more complete information to consider when making their investment decision. To address revenue sharing issues, we were pleased to see that a recent NASD rule proposal would require broker-dealers to disclose in writing when the customer first opens an account or purchases mutual fund shares compensation that they receive from fund companies for providing their funds "shelf space" or preference over other funds. On January 14, 2004, SEC proposed new rules and rule amendments designed to enhance the information that broker-dealers provide to their customers. H.R. 2420 would require fund directors to review revenue sharing arrangements consistent with their fiduciary duty

to the fund. H.R. 2420 also would require funds to disclose revenue sharing arrangements and require brokers to disclose whether they have received any financial incentives to sell a particular fund or class of shares. S. 1822 would require brokers to disclose in writing any compensation received in connection with a customer's purchase of mutual fund shares. S. 1971 would require fund companies and investment advisers to fully disclose certain sales practices, including revenue sharing and directed brokerage arrangements, shareholder eligibility for breakpoint discounts, and the value of research and other services paid for as part of brokerage commissions.

Soft Dollar Arrangements Provide Benefits, but Could Adversely Impact Investors

Soft dollar arrangements allow fund investment advisers to obtain research and brokerage services that could potentially benefit fund investors but could also increase investors' costs. When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets. In return for these brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products.

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can directly benefit a fund's investors if the adviser uses it to select securities for purchase or sale by the fund. The prevalence of soft dollar arrangements also allows specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars might also have other benefits. For example, an investment adviser official told us that the research on smaller companies helps create a more efficient market for such companies' securities, resulting in greater market liquidity and lower spreads, which would benefit all investors including those in mutual funds.

Although the research and brokerage services that fund advisers obtain through the use of soft dollars could benefit a mutual fund investor, this practice also could increase investors' costs and create potential conflicts of interest that could harm fund investors. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. One academic study shows that trades executed by broker-dealers that specialize in

providing soft dollar products and services tend to be more expensive than those executed through other broker-dealers, including full-service broker-dealers.[8] Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to "over-consume" research because they are not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which investment advisers use to register with SEC and must send to their advisory clients. However, this form is not provided to the shareholders of a mutual fund, although the information about the soft dollar practices that the adviser uses for particular funds are required to be included in the Statement of Additional Information that funds prepare, which is available to investors upon request. Specifically, Form ADV requires advisers to describe the factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of the products, research, and services given to the adviser affects the choice of brokers or the brokerage commission paid, the adviser must also describe the products, research and services and whether clients might pay commissions higher than those obtainable from other brokers in return for those products.

In a series of regulatory examinations performed in 1998, SEC staff found examples of problems relating to investment advisers' use of soft dollars, although far fewer problems were attributable to mutual fund advisers. In response, SEC staff issued a report that included proposals to address the potential conflicts created by these arrangements, including recommending that investment advisers keep better records and disclose more information about their use of soft dollars. Although the recommendations could increase the transparency of these arrangements and help fund directors and investors better evaluate advisers' use of soft dollars, SEC has yet to take action on some of its proposed recommendations.

[8]J.S. Conrad, K.M Johnson, and S. Wahal, "Institutional Trading and Soft Dollars," *Journal of Finance* (February 2001).

As a result, our June 2003 report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, because SEC has not acted to more fully address soft dollar-related concerns, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

To address the inherent conflicts of interest with respect to soft dollar arrangements, H.R. 2420 would

- require SEC to issue rules mandating disclosure of information about soft dollar arrangements;
- require fund advisers to submit to the fund's board of directors an annual report on these arrangements, and require the fund to provide shareholders with a summary of that report in its annual report to shareholders;
- impose a fiduciary duty on the fund's board of directors to review soft dollar arrangements;
- direct SEC to issue rules to require enhanced recordkeeping of soft dollar arrangements; and
- require SEC to conduct a study of soft-dollar arrangements, including the trends in the average amounts of soft dollar commissions, the types of services provided through these arrangements, the benefits and disadvantages of the use of soft dollar arrangements, the impact of soft dollar arrangements on investors' ability to compare the expenses of mutual funds, the conflicts of interest created by these arrangements and the effectiveness of the board of directors in managing such conflicts, and the transparency of soft dollar arrangements.

S. 1822 would discourage use of soft dollars by requiring that funds calculate their value and disclose it along with other fund expenses. S. 1971 also would require disclosure of soft dollar arrangements and the value of the services provided. Also, it would require that SEC conduct a study of the use of soft dollar arrangements by investment advisers.

Various Scandals Involving Mutual Funds Surfaced in 2003

Since we issued our report in June 2003, various allegations of misconduct and abusive practices involving mutual funds have come to light. In early September 2003, the Attorney General of the State of New York filed charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profiting at the expense of other fund shareholders. Since then federal and state authorities' widening investigation of illegal late trading and improper timing of fund trades has involved a growing number of prominent mutual fund companies and brokerage firms.

The problems involving late trading arise when some investors are able to purchase or sell mutual fund shares after the 4:00 pm Eastern Time close of U.S. securities markets, the time at which funds price their shares. Under current mutual fund regulations, orders for mutual fund shares received after 4:00 pm are required by regulation to be priced at the next day's price.[9] An investor permitted to engage in late trading could be buying or selling shares at the 4:00 pm price knowing of developments in the financial markets that occurred after 4:00 pm, thus unfairly taking advantage of opportunities not available to other fund shareholders. Clearly, to ensure compliance with the law, funds should have effective internal controls in place to prevent abusive late trading. Regulators are considering a rule change requiring that an order to purchase or redeem fund shares be received by the fund, its designated transfer agent, or a registered securities clearing agency, by the time that the fund establishes for calculating its net asset value in order to receive that day's price.

The problems involving market timing occur when certain fund investors are able to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. For example, such disparities can arise when U.S. mutual funds use old prices for their foreign assets even though events have occurred overseas that will likely cause significant movements in the prices of those assets when their home markets open. Market timing, although not illegal, can be unfair to funds' long-term investors because it provides the opportunity for selected fund investors to profit from fund assets at the expense of fund long-term investors. To address these issues, regulators are considering the merits of various proposals that have been put forth to

[9]SEC rule 22c-1, promulgated under the Investment Company Act of 1940, prohibits the purchase or sale of mutual fund shares except at a price based on current net asset value of such shares that is next calculated after receipt of a buy or sell order.

discourage market timing, such as mandatory redemption fees or fair value pricing of fund shares.[10]

To protect fund investors from such unfair trading practices H.R. 2420 would, with limited exceptions, require that all trades be placed with funds by 4:00 pm and includes provisions to eliminate conflicts of interest in portfolio management, ban short-term trading by insiders, allow higher redemption fees to discourage short-term trading, and encourage wider use of fair value pricing to eliminate stale prices that makes market timing profitable. S. 1958 would require that fund companies receive orders prior to the time they price their shares. S. 1958 would also increase penalties for late trading and require funds to explicitly disclose their market timing policies and procedures. S.1971 also would restrict the placing of trades after hours, require funds to have internal controls in place and compliance programs to prevent abusive trading, and require wider use of fair value pricing.

In conclusion, GAO believes that various changes to current disclosures and other practices would benefit fund investors. Additional disclosures of mutual fund fees could help increase the awareness of investors of the fees they pay and encourage greater competition among funds on the basis of these fees. Likewise, better disclosure of the costs funds incur to distribute their shares and of the costs and benefits of funds' use of soft dollar research activities could provide investors with more complete information to consider when making their investment decision. In light of recent scandals involving late trading and market timing, various reforms to mutual fund rules will also likely be necessary to better protect the interests of all mutual fund investors.

[10]Fair value pricing is a process that mutual funds use to value fund shares in the absence of current market values, such as for assets traded in foreign markets.

This concludes my prepared statement and I would be happy to respond to questions.

Contacts and Acknowledgements

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