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ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ON

"OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES THAT HARM INVESTORS"

JANUARY 27, 2004

EXECUTIVE SUMMARY

Like other investments, mutual funds have fees and expenses that investors pay to cover costs of services and benefits associated with fund investments. Mutual funds fees are subject to extensive disclosure requirements, including a requirement to provide a standardized fee table at the front of each fund prospectus.

The SEC has proposed several further enhancements to existing disclosure requirements. The SEC's proposals would require: (1) disclosure of the dollar amount of fund expenses in shareholder reports; (2) improved prospectus disclosure concerning sales charge breakpoint discounts; and (3) additional disclosure about distribution-related costs (including 12b-1 fees and revenue sharing payments) prior to purchasing fund shares and on confirmation statements. The SEC is also seeking comment on how to improve disclosure of portfolio transaction costs. These far-reaching proposals should improve investor awareness and understanding of mutual fund fees and costs.

Studies conducted by the Investment Company Institute, the SEC staff, the GAO, and industry analysts show that mutual fund fees have declined over time. In addition, in a recent study refuting the findings of an Iowa law journal article, the Institute found that mutual funds and pension plans likely pay similar fees for similar portfolio management services.

12b-1 Fees

- The SEC adopted Rule 12b-1 in 1980, authorizing funds to use their assets to pay distribution costs in an effort to help funds increase sales to offset net redemptions. The use of fund assets to pay for distribution has evolved over time and has allowed funds to give investors options in how and when they pay for professional advice or other services provided by financial intermediaries.

- 12b-1 fees are disclosed in fund prospectuses and are subject to substantive regulation, including numerical limits and fund director oversight. The SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors about 12b-1 fees before they purchase mutual fund shares.

Revenue Sharing Arrangements

- Intermediaries such as broker-dealers often demand compensation for distributing fund shares and providing services to shareholders beyond the amounts they receive through sales charges and 12b-1 fees. Thus, it is common for fund investment advisers or principal underwriters to enter into "revenue sharing" arrangements under which the adviser or underwriter makes payments to compensate selling intermediaries out of its own resources.

- The principal investor protection concern raised by revenue sharing payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. For this reason, the Institute has long advocated additional, point-of-sale disclosure to help investors assess and evaluate recommendations to purchase fund shares. The NASD and the SEC have recently proposed new point-of-sale disclosure requirements in this area.

Brokerage Allocation Practices

- In order to avoid the appearance of conflicts of interest as well as the potential for actual conflicts, the Institute recommends tightening existing regulations to curtail the use of soft dollars by all investment advisers, including mutual fund advisers, and to ban the practice of directing brokerage to reward broker-dealers for selling fund shares. The Institute is pleased that the SEC has announced plans to propose rulemaking in the near future to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.

The Institute looks forward to working with the Subcommittee, regulators and others to achieve the important goal of promoting investor understanding of mutual fund fees and costs.

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I. INTRODUCTION

My name is Paul Schott Stevens. I am a partner in the Financial Services Group of Dechert LLP. From 1993 to 1997, I was Senior Vice President and General Counsel of the Investment Company Institute.[1] I currently serve as outside counsel to the Institute.

I am pleased to appear before the Subcommittee today on the Institute's behalf to discuss disclosure and substantive regulation of, as well as trends in, mutual fund fees and expenses, including Rule 12b-1 distribution fees, and to provide the Institute's views on regulation of revenue sharing and soft dollar arrangements.

Issues concerning mutual fund fees and expenses, and in particular investor understanding of those fees and expenses, are very important. These issues deserve, and receive, attention on a regular basis to determine whether improvements can be made. But I am compelled to note that these issues are completely unrelated to the late trading and market timing scandals. As the Institute has indicated in previous testimony before this Subcommittee, strong actions are required to address the late trading and market timing abuses that have been brought to light.[2] It would be a huge mistake, however, to point to those scandals as the basis for making wholesale changes to the basic structure and economics of the mutual fund business that some have proposed. While the problems found at some fund firms are extremely serious and must be redressed, we should not lose sight of the fact that mutual funds still offer the best and least expensive way for millions of Americans to invest in the securities markets and achieve important financial goals.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies ("mutual funds"), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.240 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] *See* Statement of Matthew P. Fink, President, Investment Company Institute, *Mutual Funds: Trading Practices and Abuses That Harm Investors*, Before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate, 108th Cong., 1st Sess. (Nov. 3, 2003).

My testimony will first discuss mutual fund fees generally, including the requirements governing disclosure of mutual fund fees and expenses, the continued decline of mutual fund fees and a comparison of mutual fund and pension fund fee levels. Next, I will outline current and proposed regulatory requirements relating to 12b-1 fees and revenue sharing. Finally, I will describe the Institute's recommendations for reform regarding brokerage allocation arrangements, including soft dollar arrangements and directed brokerage.

II. MUTUAL FUND FEES

Mutual funds, like all investments, have fees and expenses that investors pay to cover costs of services and benefits associated with fund investments. Mutual fund fees are subject to extensive disclosure requirements, as described below.

A. Clear and Prominent Fee Disclosure Is Provided to Investors

It is critical that investors receive complete and understandable disclosure before making investment decisions. The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Each investor receives a prospectus at or before the time of buying fund shares. The prospectus provides detailed information about a fund's investment objectives and policies, risks, returns, fees and expenses, the fund manager, and how to purchase and redeem shares.

Reflecting their importance as part of the information that investors and their professional advisers should consider when deciding whether to invest in a fund, fund fees and expenses are disclosed in a straightforward, standardized fee table at the front of each prospectus. The fee table presents fund

fees in two broad categories: shareholder fees (such as sales charges paid to compensate financial professionals who provide investment advice and other services) and annual fund operating expenses.

The fee table shows annual fund operating expenses broken down into three categories that are identified by specific, required captions. The first category of expense is the "management fee" that the fund pays its investment adviser for managing and administering the fund's portfolio. The second category is the "distribution (12b-1) fee," if any, that the fund pays to cover costs such as compensating broker-dealers, financial planners and other financial professionals for investment advice and other services they provide directly to investors. The third category is "other expenses," which includes expenses that the fund incurs for items such as shareholder services and recordkeeping, custody of the fund's assets, outside audits, legal counsel, and directors. Each type of annual operating expense is expressed as a percentage of the fund's average net assets. The fee table also shows total annual fund operating expenses as a percentage of average net assets (sometimes referred to as a fund's "expense ratio").[3]

In addition to listing a fund's fees and expenses, the prospectus fee table includes an example that illustrates the effect of fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare the costs of two or more funds because the invested amount and time periods are standardized. The total is an "all-in" figure, expressed as a single dollar amount, that takes into account both sales charges and annual operating expenses.

The required disclosures of mutual fund fees are reinforced by SEC rules governing mutual fund performance advertising. Under SEC rules, funds that advertise performance information must provide standardized total return data for prescribed periods. Importantly, all standardized performance numbers

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[3] A variety of other readily available sources of information about mutual fund fees supplement the Securities and Exchange Commission's fee disclosure requirements described above. These sources include brokers and financial advisors, newsletters, newspapers and magazines. They also include the SEC itself, which in recent years has developed and made available on its website (www.sec.gov) both an interactive mutual fund cost calculator designed to assist investors in comparing the costs of different funds and other educational materials about investing in mutual funds. The Institute and many individual fund groups also offer educational resources and tools for investors to help them better understand fees and expenses as well as other important aspects of mutual fund investing.

must be presented net of fees. Thus, when investors review and compare fund performance data, the effect of all fees has already been taken into account. Moreover, the SEC recently amended its mutual fund advertising rules to require narrative disclosure that advises investors to consider fund charges and expenses before investing and explains that the prospectus contains this and other information.[4]

Taken together, the foregoing disclosure requirements provide investors and their professional advisors with the information needed to make informed decisions about investing in a particular fund.

B. SEC Proposals Would Enhance Fee Disclosure

The SEC has proposed several new requirements to further enhance the disclosures provided to investors about mutual fund fees and the costs investors incur when purchasing fund shares. These various proposals, when taken together, represent a far-reaching package of enhancements to fund fee and distribution-related cost disclosures and, consequently, should improve investor awareness and understanding of mutual fund fees and costs. These proposals are described below.

1. Dollar Amount of Fund Expenses. The SEC has proposed to require new disclosure concerning fund expenses in shareholder reports, similar to the example in the fee table discussed above.[5] Specifically, the SEC has proposed that fund shareholder reports disclose the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period.[6] The proposed disclosure is intended to improve investor understanding of ongoing fund expenses and allow

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[4] *See Amendments to Investment Company Advertising Rules*, SEC Release Nos. 33-8294; 34-48558; IC-26195 (Sept. 29, 2003). This disclosure must be presented in a type size at least as large as and of a style different from, but at least as prominent as, that used in the major portion of the advertisement.

[5] *See Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, SEC Release Nos. 33-8164, 34-47023, IC-25870 (Dec. 18, 2002) ("Shareholder Reports Release"). SEC Chairman Donaldson has indicated that the SEC will consider adopting this proposal at an open meeting on February 11th. *See* Speech by SEC Chairman: Opening Statement at the SEC Open Meeting by Chairman William H. Donaldson, U.S. Securities and Exchange Commission, Washington, D.C., Jan. 14, 2004 ("Donaldson Opening Statement"), available at http://www.sec.gov/news/speech/spch011404whd.htm.

[6] A similar requirement is included in H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," which was approved by the U.S. House of Representatives on November 19, 2003.

investors to estimate the costs they bore over the reporting period. The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment returns and will also assist them in comparing the expenses of different funds.[7]

2. Breakpoint Discounts. The SEC has proposed new prospectus disclosure requirements relating to breakpoint discounts on front-end sales loads.[8] Many mutual funds that are sold with front-end sales charges (or "loads") offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory examinations revealed instances in which investors did not receive the benefit of sales charge reductions to which they were entitled. These examinations led to the formation of the Joint NASD/Industry Task Force on Breakpoints, which issued a report last summer making a series of recommendations for addressing this issue.[9] The SEC's proposal would implement the recommendations of the Task Force concerning prospectus disclosure. The Institute supports the SEC's proposal. It will benefit investors by helping ensure that they are aware of and knowledgeable about breakpoint opportunities.

3. Distribution-Related Costs. The SEC has proposed new rules to enhance the information that broker-dealers provide to their customers in connection with their transactions in mutual fund

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[7] As an alternative to its proposal, the SEC considered an approach recommended by the U.S. General Accounting Office (GAO) in a June 2000 report. *See* U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 2000) ("2000 GAO Report"). The GAO recommended that the SEC require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement. (S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," which was introduced by Senators Jon Corzine (D-NJ) and Christopher Dodd (D-CT) late last year, similarly would call for individualized expense disclosure to investors.) In rejecting this approach, the SEC stated that its proposal was "intended to strike an appropriate balance between investors' need for [expense] information and the costs and burdens that would be associated with providing this information on an individualized basis." *See* Shareholder Reports Release.

[8] *See Disclosure of Breakpoint Discounts by Mutual Funds*, SEC Release Nos. 33-8347; 34-48939; IC-26298 (Dec. 17, 2003).

[9] *See Report of the Joint NASD/Industry Task Force on Breakpoints* (July 2003), available at http://www.nasdr.com/pdf-text/breakpoints_report.pdf.

shares.[10] The new rules would require broker-dealers to provide point of sale disclosure about distribution-related costs and conflicts to customers prior to effecting transactions in fund shares, and as part of transaction confirmations.[11] The SEC also has proposed new requirements to improve prospectus disclosure of sales loads and revenue sharing. While we are still analyzing the specific details of these proposals, we fully support their objectives.

4. Portfolio Transaction Costs. The SEC recently issued a concept release soliciting comments on how to improve disclosure of mutual fund portfolio transaction costs, including the feasibility of constructing a transaction cost measure.[12] In the release, the SEC acknowledges that quantitative disclosure of portfolio transaction costs presents many difficult issues.[13] The Institute supports the Commission's efforts to explore ways to improve disclosure of fund transaction costs and looks forward to commenting on the concept release in an effort to assist the Commission in crafting an appropriate proposal in this area.

5. Mutual Fund Advertising. Recent regulatory initiatives specifically seek to focus investors' attention on fund expenses when they view fund advertisements. For example, in addition to the recently adopted amendments to the SEC's mutual fund advertising rules discussed above, the NASD has issued a

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[10] *See* SEC Proposes New Investment Company Governance Requirements, New Investment Adviser Codes of Ethics Requirements, and New Confirmation and Point of Sale Disclosure Requirements (Jan. 14, 2004), available at http://www.sec.gov/news/press/2004-5.htm.

[11] The proposed point of sale disclosure includes: the amount of sales loads that would be incurred at the time of purchase, and the amount of that load that would be paid to the broker-dealer; estimated 12b-1 fees that would be paid by the fund in the year following the purchase; and the maximum amount of any deferred sales load that would be charged if the shares purchased are sold within a year, along with a statement about how many years a deferred sales load may be effect. Disclosure also would be required about whether the broker-dealer receives revenue sharing or portfolio brokerage commissions from the fund complex. The proposed confirmation statement would require broker-dealers to provide more quantitative disclosure of the information included in the point of sale document.

[12] *See Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, SEC Release Nos. 33-8349; 34-48952; IC-26313 (Dec. 18, 2003). In view of the complexity of the issues relating to quantifying portfolio transaction costs, the SEC has requested comment from persons within and outside of the fund industry, including investors, mutual funds, academics, regulators, and the public generally.

[13] For example, only one type of trading cost (commissions) can be measured directly, but disclosing commissions alone would be misleading because some securities – notably, fixed income securities – are sold without explicit commissions. In addition, two types of transaction costs discussed in the concept release – spreads and market impact costs – while real, are not readily quantifiable. There are a variety of estimation techniques that can be used but, as the SEC has pointed out, there is no accepted standard and this could confuse investors seeking to make comparisons among funds using different methods of estimation.

proposal that would require all mutual fund performance advertisements to include the fund's expense ratio.[14] The Institute supports this proposal.[15]

C. Mutual Fund Fee Levels

1. Mutual Fund Fees Continue to Decline. Mutual fund industry critics often target mutual fund fees and expenses as an area in need of reform, claiming that such fees and expenses have risen over time. Unfortunately, studies that claim that mutual fund fees are rising reach this conclusion by paying inadequate attention to the details of mutual fund fees and expenses or fail to track the expenses of particular funds over time. Studies of fund fees that are mindful of these factors invariably find that mutual fund fees and expenses have declined over time.[16]

According to Institute research, the average total cost that investors incurred when purchasing mutual funds[17] has declined steadily and significantly since 1980. From 1980 to 2001, the total cost of equity funds fell by 43 percent, the total cost of bond funds decreased by 41 percent and the total cost of money market funds decreased by 35 percent.[18]

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[14] *See* NASD Notice to Members 03-77 (December 2003), available at http://www.nasdr.com/pdf-text/0377ntm.txt.

[15] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Barbara Z. Sweeney, Office of the Corporate Secretary, NASD, dated Jan. 23, 2004.

[16] Studies conducted by the Institute, the SEC staff and the GAO are discussed below. Other fee studies reaching this conclusion include Lipper Analytical, "The Third White Paper: Are Mutual Fund Fees Reasonable," reprinted in The Mutual Fund Business, R. Pozen, ed., 1999 and LaPlante, M., "Influences and Trends in Mutual Fund Expense Ratios," Journal of Financial Research, Spring 2001.

[17] To properly measure the total cost of investing in mutual funds, it is important to consider both (1) the sales charges paid by investors directly to compensate financial professionals who provide investment advice and other services, and (2) the annual operating expenses that are paid out of the fund's assets to cover the costs of running a fund and other services. Unlike annual operating expenses, sales charges are one-time charges. Thus, to measure total shareholder cost accurately, it is necessary to "annualize" the sales charge, *i.e.,* convert it into the equivalent of an annual payment paid by the investor over the life of his or her investment.

[18] *See* Investment Company Institute, "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals,* Vol. 11, No. 4, September 2002, available at http://www.ici.org/pdf/fm-v11n4.pdf.

The SEC's Division of Investment Management published its own study of mutual fund fees in 2000.[19] The SEC looked at both expense ratio trends and total ownership costs. According to the SEC study, the weighted average expense ratio for all fund classes declined in three out of the last four years that the SEC studied (from 0.99% in 1995 to 0.94% in 1999). While the SEC found an increase in the weighted average expense ratio from 0.73% in 1979 to 0.94% in 1999, it explained that this increase was due to the shift from use of front-end sales charges (which are not included in a fund's expense ratio) to finance distribution, to the use of 12b-1 fees (which are included in the fund's expense ratio). When examining the total ownership costs of "load classes,"[20] the SEC found a decline of 18% between 1979 and 1999.

In 2000, the GAO also issued a report on mutual fund fees.[21] The GAO examined expense ratios for the 46 largest equity funds and 31 largest bond funds as of December 31, 1998 that had been in existence since January 1, 1990. The GAO report found that eighty-five percent of these equity funds reduced their expense ratios, with an average decline of 20 percent. The expense ratios of the bond funds declined by an average of three percent.

The GAO updated its findings in 2003. The GAO found that the average expense ratio of the 46 largest equity funds rose nearly 8 percent between 1998 and 2001.[22] The GAO's report, although technically correct, failed to explain that the increase in the average expense ratio of the 46 equity mutual funds studied by the GAO was due entirely to performance fees.[23]

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[19] *See* Division of Investment Management, U.S. Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (December 2000), available at http://www.sec.gov/news/studies/feestudy.htm.

[20] The SEC defined "load classes" as classes with 12b-1 fees higher than 25 basis points, classes with 12b-1 fees and contingent deferred sales charges, and classes with traditional front-end sales charges.

[21] *See* 2000 GAO Report, *supra* note 7.

[22] *See* U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure* (March 2003).

[23] *See* Investment Company Institute, "Performance Fees and Expense Ratios," *Fundamentals,* Vol. 12, No. 2, August 2003, available at http://www.ici.org/pdf/fm-v12n2.pdf.

More recently, the Institute undertook a study of mutual fund distribution channels and trends in distribution costs since 1980.[24] The study found that changes in fund distribution over the last 25 years have been accompanied by a significant decrease in the average cost of distribution services incurred by mutual fund buyers. The average distribution cost incurred by buyers of equity funds decreased from 1.49 percent (or 149 basis points) of their initial investment in 1980 to 40 basis points in 2001 – a 73 percent decrease. Similarly, distribution
costs of bond funds fell 60 percent, from 82 basis points in 1980 to 33 basis points in 2001.

2. Mutual Funds and Pension Funds Have Comparable Fee Levels. In addition to claims that mutual funds fees have been rising, statements have been made to the effect that mutual funds pay substantially more than public pension funds for portfolio management services. Such statements are primarily based upon an Iowa law journal article that attempts to compare public pension plan and mutual fund fees.[25] The Institute recently published a study that refutes those statements. The Institute's study discovered serious deficiencies in the Iowa article's methodology. Most importantly, the Iowa article compared the "investment advisory fees" of public pension plans with the "management fees" of mutual funds, treating the two as if they were identical accounting concepts. They are not. The "investment advisory fees" paid by pension plans are primarily for portfolio management. The "management fees" of mutual funds encompass portfolio management costs, but also the costs of a range of business and administrative items that are necessary for fund operations, such as fund pricing, clerical staff, office space and equipment, the salaries of fund officers and interested directors, certain accounting and recordkeeping facilities, preparation of shareholder reports and prospectuses, supervising relationships with fund transfer agents and custodians, and Federal and state regulatory compliance. Not surprisingly, the authors of the Iowa article found that the "investment advisory fees" of public pension plans are lower than the "management fees" of mutual funds. However, that finding is not indicative of the relative costs that the

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[24] *See* Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, July 2003, available at http://www.ici.org/stats/res/per09-03.pdf. For purposes of the study, distribution costs were defined as charges incurred by mutual fund investors directly through the payment of sales loads or indirectly through 12b-1 fees.

[25] *See* John P. Freeman and Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *Journal of Corporation Law,* 26(3), Spring 2001, pp. 609-673.

two entities incur for portfolio management. The Institute's study also attempted to compare the "investment advisory fees" of pension plans with a like quantity for mutual funds. That comparison indicates that mutual funds and pension plans likely pay similar fees for similar portfolio management services. [26]

III. 12b-1 FEES

A. 12b-1 Fees Expand Investor Choice

Innovations in the mutual fund industry have given investors many choices about how and where they purchase mutual fund shares. Some investors prefer to buy mutual funds directly from the company sponsoring them. Others choose to purchase funds through brokers, financial planners, or other financial professionals who provide assistance and advice in selecting funds to help investors reach their long-term goals, such as retirement and education.

Investment professionals traditionally were compensated for their services by an upfront sales commission, or "load," paid by investors when they purchased mutual fund shares. In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act of 1940. The rule authorizes funds to use their assets to pay distribution costs. Although the rule initially was conceived as a way to help funds increase sales to offset net redemptions, the use of fund assets to pay for distribution has evolved since Rule 12b-1 was adopted. Most significantly, it has allowed funds to give investors the option of paying distribution expenses over time instead of in a single, upfront payment. Many funds now offer various classes of shares that invest in the same portfolio of securities but provide a variety of different payment options.[27]

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[26] *See* Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," *Perspective,* Vol. 9, No. 6, December 2003, available at http://www.ici.org/stats/res/per09-06.pdf. The Institute found that fees for portfolio management services average 31 basis points (or 0.31%) for mutual funds and 28 basis points (0.28%) for pension plans. *Id.* at 7-8.

[27] Different classes may be sold through different distribution arrangements (*e.g.,* retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

These payment options can include a direct fee (*i.e.*, a sales charge), a payment made from the fund's assets over time (*i.e.*, a 12b-1 fee), or a combination of both.[28] Most investors use the services of a financial intermediary; thus, most funds have sales charges and/or ongoing fees to cover these costs. Indeed, Institute data show that among shareholders holding funds outside of defined contribution plans, more than 70 percent primarily purchase funds through financial advisors and other intermediaries.[29] In other words, in many cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds; Rule 12b-1 has made it possible for funds to provide investors with a choice of how and when to pay for these services.

B. 12b-1 Fees Are Fully Disclosed

Assertions that 12b-1 fees are "hidden costs" are completely without merit. As discussed above, all mutual fund fees and expenses are fully disclosed in a standardized fee table that is required to be at the front of a fund's prospectus. If a fund has a 12b-1 fee, it will be clearly identified as a separate line item in the fee table as part of the fund's annual operating expenses. In addition, it is reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table.

Investors also can determine whether a fund charges a 12b-1 distribution fee by reviewing the mutual fund listings published in most newspapers. A newspaper's listings offer information about a fund's fees by using a series of symbols next to the fund's name. A fund that has a 12b-1 fee will have the letter "p" next to its name in the newspaper.

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[28] Institute research indicates that each of these options can be optimal for particular investors, depending on the expected time horizon of their investment (including whether they are uncertain about the length of their holding period) and the amount invested. *See* Reid and Rea, *supra* note 24, at 11-13.

[29] *See* Investment Company Institute, 2001 Profile of Mutual Fund Shareholders, at 68.

In addition to disclosing the fact that a fund has a 12b-1 fee, such funds are required to include disclosure in the prospectus concerning the impact of this ongoing fee. Specifically, the prospectus must disclose that over time, 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges.[30]

As noted above, the SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors before they purchase mutual fund shares.[31] Such disclosures would include the estimated amount of 12b-1 fees to be paid in the year following purchase, if the fund's net asset value remained constant.

C. Substantive Regulation of 12b-1 Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees, including in particular 12b-1 fees.

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[30] Additional, more detailed disclosure about a fund's 12b-1 fee is required in the Statement of Additional Information, which is available to fund shareholders free of charge upon request. Such disclosure includes, among other things, a breakdown of the dollar amount of 12b-1 payments made for various activities, such as advertising and compensating broker-dealers.

[31] *See supra* note 10.

First, NASD rules place limits on all mutual fund sales charges, including "asset-based sales charges" (12b-1 fees).[32] In addition, a fund that has a front-end or deferred sales charge, or a 12b-1 fee higher than 25 basis points, cannot be referred to as a "no load" fund.[33]

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to any 12b-1 fee.

Pursuant to Rule 12b-1, any payments by a fund for distribution-related expenses must be in accordance with a written plan approved annually by the fund's board of directors, including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.[34]

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that

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[32] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales. These limits appropriately treat 12b-1 fees, in effect, as an alternative form of sales charge.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.,* NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000, available at http://www.nasdr.com/rca_summer00_reg.htm#suitability.

[33] NASD rules permit funds with a 12b-1 fee of no more than 25 basis points to be designated as "no load" funds in recognition that the expenses of funds with a low 12b-1 fee tend to more closely resemble those of funds with no sales charges or 12b-1 fees.

[34] Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. The continuing payment of 12b-1 fees in these circumstances is entirely consistent with the 12b-1 fee concept. Specifically, the fund underwriter "fronts" money to salespeople with the expectation that these expenditures will be recouped through the 12b-1 fee over time. It generally would not be appropriate, in this type of scenario, for funds to cease 12b-1 payments. The NASD's maximum sales charge rules (discussed above) operate in such a way that if a fund with a 12b-1 fee does not have new sales (*e.g.*, if the fund has closed), it will more rapidly approach the applicable rolling cap, at which point 12b-1 payments would have to cease.

shareholders must approve any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise 12b-1 fees, nor may the board alone approve a fee increase.[35]

IV. REVENUE SHARING ARRANGEMENTS

As discussed above, mutual fund investors currently have choices in the manner and timing of payments to compensate investment professionals for the services they provide (*i.e.,* through sales charges, 12b-1 fees, or a combination). Competition among funds for the services of selling intermediaries (*e.g.,* broker-dealers) has led these intermediaries, however, to demand compensation, or expense sharing, for distributing fund shares and providing services to shareholders beyond the amounts they receive through sales charges and 12b-1 fees. Consequently, it is common practice in the fund industry for fund investment advisers or principal underwriters to enter into "revenue sharing" arrangements, under which the adviser or principal underwriter makes payments out of its own resources to compensate intermediaries who sell fund shares.

The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them.[36] Disclosure concerning revenue sharing payments is already required in fund prospectuses, and the

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[35] Similar substantive requirements apply to a fund's investment advisory fee. For example, under Section 15 of the Investment Company Act, both the board as a whole and a majority of the fund's independent directors are required to review and approve any investment advisory contract entered into by a fund on an annual basis, after an initial term of no more than two years. Fund directors must request, and the adviser is obligated to provide, information reasonably necessary to review the terms of the contract, including the advisory fee. A fund's adviser has a fiduciary duty with respect to the receipt of compensation from the fund. Section 36(b) of the Investment Company Act. The SEC and fund shareholders may bring suit against the adviser for breach of this duty. *See, e.g.,* Kalish v. Franklin Advisers, Inc., 928 F. 2d 590 (2d Cir. 1991); Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982). Shareholders must approve any material changes to the advisory contract (including any proposed fee increase).

[36] Legislation currently pending before Congress contains a provision that would impose a fiduciary duty on fund directors to determine that any revenue sharing arrangements are in the best interests of fund shareholders. *See, e.g.,* H.R. 2420 and S. 1971. Such a requirement is misguided. The directors are responsible for overseeing uses of the fund's assets. Revenue sharing arrangements, by definition, do not involve the use of fund assets. Indeed, if revenue sharing payments are made directly or indirectly by a fund, they must comply with Rule 12b-1. H.R. 2420 and S. 1971 would address any possible concern that revenue sharing arrangements may involve an indirect use of fund assets by requiring fund directors to review revenue sharing arrangements to ensure that they comply with the Investment Company Act of 1940. Fund directors do not have control over, and should not be held responsible for, the investment adviser's or principal underwriter's use of their legitimate profits.

Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[37]

The NASD recently proposed new point-of-sale disclosure requirements in this area.[38] The Institute supports the NASD proposal.[39] In addition, earlier this month, the SEC proposed new point-of-sale and mutual fund confirmation statement disclosure that would address, among other things, revenue sharing arrangements and other inducements for brokers to sell particular funds.[40] Under the SEC's proposal, broker-dealers would be required to disclose to customers, prior to a purchase of mutual fund shares, whether they receive revenue sharing payments from the fund complex, and whether the broker-dealer pays differential compensation in connection with transactions in shares of the fund. In addition, confirmation statements would have to disclose quantified information about revenue sharing arrangements from persons within the fund complex and whether the broker-dealer pays its salespersons more compensation if they sell funds that carry a deferred sales charge and/or proprietary funds. Disclosure also would be required of any revenue sharing arrangement that would be applicable to the transaction. The Institute supports the objectives of the SEC's proposal and is studying it in detail in anticipation of filing a comment letter on it.

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[37] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997.

[38] *See* NASD Notice to Members 03-54 (September 2003), available at http://www.nasdr.com/pdf-text/0354ntm.txt. The NASD proposal also addresses differential cash compensation arrangements, in which a broker-dealer firm pays its registered representatives different rates of compensation for selling different funds.

[39] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated Oct. 17, 2003.

[40] *See supra* note 10.

V. BROKERAGE ALLOCATION PRACTICES

The Institute believes that the time has come for a top to bottom reexamination of mutual fund brokerage allocation practices and the applicable regulatory requirements. Investment advisers, including advisers to mutual funds, may use the brokerage commissions from transactions for client accounts to obtain research products and services from broker-dealers and third parties ("soft dollar arrangements"). Advisers to funds also may take into account a broker-dealer's sales of fund shares in allocating brokerage ("directed brokerage"). While both of these practices are clearly permissible under existing applicable regulations, they can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. The Institute therefore believes that it would be appropriate to tighten regulation in each of these areas.

A. Soft Dollar Arrangements Should Be Significantly Restricted

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor that permits money managers, including advisers to mutual funds, to pay for brokerage and research services with client commissions, subject to various conditions. This section was enacted in response to concerns that, with the unfixing of commissions, money managers might be held liable if they paid more than the lowest possible commission rate and received these services.

As noted above, these arrangements can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. Some assert that these arrangements may create incentives for advisers to (1) direct client brokerage to a broker-dealer based on the research services provided to the adviser rather than the quality of execution its clients' accounts will receive and/or (2) pay too much in commissions or engage in unnecessary trading to generate soft dollars credits to pay for products and services that the manager might otherwise have to pay for from its own assets. To reduce any such

potential conflicts, the Institute recommends that the scope of the safe harbor under Section 28(e) be narrowed to exclude certain products and services.[41] These products and services would include:

> Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
>
> Publications, including books, periodicals, newspapers and electronic publications, that are generally available to the public; and
>
> Third-party research services, *i.e.*, research services that are not produced and provided by the broker-dealer effecting the securities transaction.[42]

This change would (1) ensure that the payment through commissions for products and services that have the attributes of traditional overhead and more routine expenditures of investment managers would fall outside of the safe harbor, and (2) limit the scope of the safe harbor to those research-related products and services that are produced by and provided directly by the broker-dealer receiving the commissions. Narrowing the safe harbor in this manner would be beneficial for investors because it would clarify application of the safe harbor in areas where guidance is needed; would make it easier for investors to understand the costs of various investment advisory products, including mutual funds; would reduce incentives for money managers to engage in unnecessary trading; and would interpret Section 28(e) in a manner that is more consistent with its original purpose – a narrowly tailored provision that allows a money manager to take into account the intellectual resources, as well as the execution capabilities, of a brokerage firm in determining how to allocate trades.[43]

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[41] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated December 16, 2003 (recommending that the Commission adopt a revised interpretation under Section 28(e) of the Exchange Act to narrow the safe harbor in this manner). The Institute's recommendation could be accomplished by either Congress amending Section 28(e) or the Commission adopting a more restrictive definition of the scope of services and products covered by Section 28(e).

Some have suggested that Section 28(e) be repealed altogether to prohibit soft dollar arrangements. The Institute agrees that this is an issue that may warrant further study and consideration.

[42] This recommendation does not represent a judgment that proprietary research is somehow "better" than third-party research. It is, rather, based on the Institute's conclusion that there is no inherent reason why research provided by one firm should be bundled with execution services provided by a different firm. In contrast, where both types of services are provided by the same entity, allocating costs between the two can be difficult, particularly since brokerage firms do not typically break out such costs.

[43] Because Section 28(e) is a safe harbor, failure to comply with its terms does not, in and of itself, violate any provision of law. For certain advisers, however, using commissions outside of the safe harbor raises serious issues under federal law. These include advisers to mutual funds and to pension plans under ERISA. In contrast, advisers to other types of accounts are not subject to similar substantive limitations. Instead, such advisers are only required to provide disclosure about their use of soft

B. Directed Brokerage Arrangements Should Be Prohibited

The ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules.[44] The rules only permit funds to consider sales in allocating brokerage "after the fact;" conditioning fund sales on the payment of brokerage commissions is expressly prohibited. In addition, the rules provide that a fund can only take a broker's sale of fund shares into account in selecting a broker if it is otherwise receiving best execution. Notwithstanding the strict nature of these restrictions, this practice can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the fact-specific nature of the best execution determination. For these reasons, the Institute believes that this practice should be prohibited.[45] The Institute is pleased, therefore, that SEC Chairman Donaldson announced recently that the Commission plans to consider amending Rule 12b-1 to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares at an open meeting on February 11th.[46]

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dollars in Form ADV. The Institute recommends that all investment advisers be prohibited from using brokerage commissions outside of the safe harbor to pay for any products or services used by the adviser. This change will extend the protections afforded to mutual funds and ERISA accounts to all investment advisory clients.

[44] *See* NASD Conduct Rule 2830(k).

[45] It should be recognized that such a prohibition could have the potential to improperly discourage funds from using brokers that sell fund shares for portfolio transactions, for fear of being second-guessed. This could result, in some cases, in funds not using the brokerage firm that would be best suited for executing a trade. In order to address this concern and ensure that such a prohibition does not inadvertently call into question legitimate brokerage allocations, the Institute recommends that a safe harbor be adopted for funds that use brokers that also sell shares of the fund in those cases where a fund has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation.

[46] *See* Donaldson Opening Statement, *supra* note 5.

VI. CONCLUSION

I appreciate the opportunity to provide testimony to the Subcommittee on these important issues on behalf of the Institute. The Institute supports initiatives to promote investor understanding of mutual fund fees and costs, and looks forward to working with the Subcommittee, regulators and others to achieve this goal.