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Before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security
January 27, 2004

**"No issuer of securities is subject to
more detailed regulation than a mutual fund."[1]**

A LAW PROFESSOR COMMENTS ON THE MUTUAL FUND FEE MESS

The Fund Industry's Moral Compass is Broken; Conflicts of Interest are Rampant.
The fund industry's hallmark is its external management set-up by which an outside company manages the fund while populating a number of seats on the fund's board, including the Chairman's seat. The external manager typically controls all facets of fund life, from the fund's incorporation through the selection of the initial board. Historically,

[1] Letter of SEC Chairman Ray Garrett, Jr., to Honorable John Sparkman, August 1974, at v, transmitting REPORT OF DIVISION OF INVESTMENT MANAGEMENT, SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 (1974).

this control has tended not to be relinquished over time.[2] This curious and dysfunctional external management governance system prevails throughout most of the fund industry, with the Vanguard Group being a key exception.

The fund industry's structure thus features a built-in conflict of interest; it creates and perpetuates the risk, always, that the manager will treat fund shareholders unfairly. It was this inherently conflicted structure that gave us the Investment Company Act of 1940, an Act created specifically to address and protect against over-reaching by conflicted fund managers to shareholders' detriment. In 1940, after exhaustive study, Congress determined that

> [t]he national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated and managed in the interest of investment advisors, rather than in the interest of shareholders . . . or when investment companies are not subject to adequate independent scrutiny.[3]

These findings are still valid. As a result of the fund industry's conflicted governance structure, fee overcharging is pervasive, and commonly it is accompanied by cover-up.

A prime example of overcharging is funds' advisory or "management" fees. These are key, because the principal thing fund investors buy is "professional investment advice." In our 2001 article in the *Journal of Corporation Law*, Professor Brown of Florida State University and I found that fund advisors are overcharging fund shareholders for portfolio management. There was nothing new about this finding. Consider this quote from my article on mutual fund advisory fees: Fund shareholders "pay nearly twice as much as institutional investors for money management. And that calculation doesn't even include any front- or back-end sales charges you may also pony up." The quoted language was not written by me or my co-author, Professor Stewart Brown of Florida State University. The comment was written by financial writer Ruth Simon in 1995. *See* Ruth Simon, *How Funds Get Rich at Your Expense*, MONEY, Feb. 1995, at 130. The quote appears in footnote 10 of our 2001 article.

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[2] In the words of one of the industry's earliest and most vociferous critics:

> Now, this is about the birds and the bees of the American corporate scene. . . . The fund is conceived by a bunch of people whom we call advisors or managers. . . . This group gives birth to the fund. The fund is manned by the advisors. If I may carry this figure of speech, the umbilical cord is never cut after birth, as would be true in ordinary biological life.

Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659, 739 (1967). As former SEC Commissioner Manuel Cohen once remarked when referring to testimony by fund investment advisors:

> They also made the point that the investment advisor creates the fund, and operates it in effect as a business. Many of them stated that "It is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong with them saying it. They were just admitting what is a fact of life. The investment advisor does control the fund.

Investment Company Act Amendments of 1976: Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Fin. of the Comm. on Interstate and Foreign Commerce, 90th Cong. 674 (1967) (statement of Manuel Cohen, Commissioner, SEC).

[3] Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (1994).

Professor Brown, Ruth Simon, and I were not the first to detect fee overcharges by mutual fund managers. Nearly forty years ago, a study conducted for the SEC by the Wharton School of Finance and Commerce determined that where fund advisors had outside advisory clients, there was a "tendency for systematically higher advisory fee rates to be charged open-end [mutual fund] clients." WHARTON SCHOOL OF FINANCE & COMMERCE, 87TH CONG., A STUDY OF MUTUAL FUNDS 493 (Comm. Print 1962). Why this price disparity?

Here is what the authors of the Wharton Report concluded:

> In the case of fees charged open-end companies [mutual funds], they are typically fixed by essentially the same persons who receive the fees, although in theory the fees are established by negotiation between independent representatives of separate legal entities, and approved by democratic vote of the shareholders. This suggests that competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds.

Id. at 493-94. In a nutshell, the reason for the price-gouging harkens back to the industry's dysfunctional, conflicted governance system. The chief problem with most mutual funds lies in the inherent conflict of interest between the shareholders and the funds' management.

The Wharton Report's findings later were corroborated by a study authored by the SEC itself and submitted to Congress in 1966. That study, entitled *Public Policy Implications of Investment Company Growth*, H.R. REP. NO. 89-2337 (1966), revisited the Wharton School's fee disparity findings and determined that, "[t]he Wharton Report's conclusions correspond to those reached by the more intensive examination of selected mutual funds and mutual fund complexes made by the Commission's staff." *Id.* at 120.

Conflicts of interest are pervasive throughout the fund industry. They infect the way the industry is managed and the way it is regulated. The lobbying arm, the Investment Company Institute, epitomizes the industry's conflicted management structure. Drawing most of its money from fund shareholders, the ICI resolutely protects the status quo for fund sponsors, even when its positions ill-serve fund shareholders.

The SEC is MIA.

I referred to conflicts of interest infecting the way the industry is regulated. The SEC's Division of Investment Management ("DIM") presents a classic case of "regulatory capture." It is conflicted as well. Bluntly stated, over time, DIM has become far too deferential to the industry. The SEC's Division of Investment Management represents a Chihuahua watchdog, not the Doberman shareholders need.

And then there are the DIM alums. What we almost always find when SEC staffers move on are SEC-honed skills being put to work protecting the wealth of fund managers,

not fund shareholders. My analysis of SEC personnel movements, using data I obtained from the SEC under FOIA, shows that most of the SEC's senior personnel who leave the DIM go to work for mutual funds as officers or directors, for the ICI, or for service suppliers (law firms or accounting firms) who advise fund sponsors. These professionals are dedicated to protecting the industry's managers, and the industry's managers have an agenda that does not place fund shareholders first.

When I was working with the SEC in DIM years ago, I was told by a fellow staff lawyer: "Let's face it, in five years we'll all be working for these guys." Then and now, that staff lawyer's observation holds true. I tell you bluntly the SEC has failed mutual fund investors.

The clouds have been gathering for many years. In the course of Senate hearings during consideration of fund reform in the late 1960s, Nobel Laureate Paul Samuelson's warned:

> Self-regulation by an industry tends usually to be self-serving and often inefficient. *There is a danger that government commissions, set up . . . originally to regulate an industry, will in fact end up as a tool of that industry, becoming more concerned to protect it from competition than to protect the customer from the absence of competition*. . . . The SEC must itself be under constant Congressional scrutiny lest it lessen rather than increase the protection the consumer receives from vigorous competition.[4]

As recently as last Thursday, the public was treated to the spectacle of the SEC being roasted in *The Wall Street Journal* for intervening as amicus in a fund case over fee disclosure. Had the SEC intervened on the side of shareholders, calling for greater disclosure? Of course not. As the *Journal* observed, the SEC took the position that "disclosure with precision is not necessary" about an industry practice recognized as being a problem by "just about everyone except the SEC."[5]

Epitomizing the agency's indolence is the behavior of former SEC Chairman Arthur Levitt. As Chairman, for years Levitt presided over the industry's marketing boondoggle, Rule 12b-1.[6] While at the SEC, Levitt did nothing about Rule 12b-1. Once

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[4] Mutual Fund Legislation of 1967: Hearing on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong. 368-69 (1967) (statement of Professor Paul Samuelson) (emphasis added).

[5] Tom Lauricella & Deborah Solomon, SEC Defended Fund-Broker Compacts in Past, *The Wall Street Journal*, January 22, 2004, at C1.

[6] Rule 12b-1 allows fund managers to tap fund assets to pay for costs incurred in selling fund shares. It is controversial because there is no proof that new fund sales confer a net financial benefit on existing fund shareholders who, under Rule 12b-1, get stuck with huge marketing bills. The rule was adopted by the SEC in 1980 and was little-used initially. Since then, the growth of 12b-1 fee payments extracted from fund assets has been staggering. Today, Rule 12b-1 pumps around $9 billion annually into fund sellers' pockets, money paid at fund shareholders' expense.

he left, he wrote a book, *Take on the Street*, offering investors this advice about 12b-1 fees:

> You should avoid owning shares in a fund that charges these fees, which are no more than a levy on existing investors to help find new investors. Why should you pay to tell the rest of the world how good your fund is?[7]

This is good advice, but it raises this question: While he was SEC Chairman, why didn't Arthur Levitt do something about this demonstrably flawed, SEC-authored rule?

We now turn to other industry fee-related problem areas, each of which ties into to the industry's conflicted and dysfunctional governance system.

SOME SPECIFIC CONFLICT/FUND FEE HOT SPOTS

The Advisory Fee Mess

Fund managers are smart. Like the wily innkeeper Thenardier in *Les Miserables*, they know that a little nick, or slice, or cut here or there can add up.[8] As the late Senator Everett Dirksen allegedly observed: "A billion here, a billion there, and pretty soon you're talking about real money." Well, we are talking about real money taken from America's investing public, and the fund industry's conflicted investment advisors have been working under the radar and collecting it.

Fund managers well know that most shareholders do not even understand what a basis point is. (For the uninitiated, a basis point is a hundredth of a percent.) Advisory fee overcharges of twenty-five basis points, .25 percent, do not seem like much, but when applied to an asset base running in the trillions, they are huge. Fund investors are being overcharged to the tune of many billions of dollars per year, and the SEC has been asleep at the switch.

Price gouging over advisory fees is rampant, and the industry is in denial. Over-charging for portfolio management has been the industry's dirty secret for years. Remember the Ruth Simon quote? Note also that our findings echo the prior findings found in the

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[7] Arthur Levitt, *Take on the Street* 48 (2002).

[8] Charge 'em for the lice
Extra for the mice
Two percent for looking in the mirror twice
Here a little slice
There a little cut
Three percent for sleeping with the window shut
When it comes to fixing prices
There are a lot of tricks he knows
How it all increases
All those bits and pieces
Jesus! It's amazing how it grows!

Cameron Mackintosh, *Les Miserables.*

Wharton Report and the SEC's own Public Policy Implications Study. For our efforts, in calling attention to the waste, my co-author and I have been called "irresponsible" by ICI President Matthew Fink. Our sin is that we had the brass to suggest that advisory fees are excessively high.

According to the ICI's Fink, fund advisory fees are highly competitive, and the fund industry epitomizes disclosure transparency. He's wrong on both counts. Fund advisory fee gouging is a national disgrace.

Consider these facts. Recently, Alliance Capital was charging 93 basis points (.93 percent) for managing the $17.5 billion Alliance Premier Growth Fund. This is a fee paid by shareholders of $162.7 million per year. At the same time as it was charging 93 basis points to its *own shareholders*, Alliance was managing the Vanguard U.S. Growth Fund for 11 basis points (.11 percent) -- less than 1/8 of what it was charging Alliance shareholders. Alliance was also managing a $672 million portfolio for the Kentucky Retirement System for 24 basis points, a $1.7 billion portfolio for the Minnesota State Board of Investment for 20 basis points, a $730 equities portfolio for the Missouri Retirement System for 18.5 basis points, and a $975 equity portfolio for the Wyoming Retirement System for 10 basis points.

These price discrepancies cannot be justified on the basis of differences in service. According to the prospectus for the Alliance Stock Fund, the management company's institutional accounts shared "substantially the same investment objectives and policies" and were managed with "essentially the same investment strategies and techniques" as the Alliance Premier Growth Fund. Moreover, the different clients "shared a nearly identical composition of investment holdings and related percentage weightings."[9]

Obviously, Alliance's shareholders, to whom Alliance owed fiduciary duties, were getting gouged; non-shareholder outsiders paid Alliance Capital far less in the free market for equivalent services. These sorts of price discrepancies are intolerable.

Other Fee-related Practices that Injure Fund Investors.

Less than a year ago, in February of 2003, the ICI's head, Matthew Fink, sent a letter to Congress extolling the industry's embrace of "transparency and accountability principles," and proclaiming that the "mutual fund industry's governance and investor protection standards 'read like a blueprint for the guidelines publicly traded companies are only now being urged to follow.'"[10] I beg to differ. I say that the only thing transparent about the mutual fund industry are the ICI's lame arguments made in sponsors' defense. Here are some questions bearing on "transparency and accountability" for Mr. Matthew Fink and the ICI:

> **What is the deal with "revenue sharing"?** The GAO found in June that fund advisers are shelling out around $2 billion per year in "revenue sharing" to

[9] Alliance Stock Funds Prospectus (Feb. 1, 2002), at 46.

[10] Letter from Matthew Fink, President Investment Company Institute to Michael G. Oxley and Richard H. Baker, Feb. 21, 2003.

brokers who bring new customers into the funds. GENERAL ACCOUNTING OFFICE, MUTUAL FUNDS-GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 38 (2003). This lush payout, which the GAO says is growing in size over time, *id.*, supposedly comes not from fund assets but from "advisory profits." The GAO found that this "major expense" is one that "most fund advisers are not willing to publicly discuss." *Id.* at 38-39. So much for transparency.

If fund advisory fees are rock-bottom competitive, as the ICI insists, then how are advisors able and willing to throw away $2 billion in profits annually to generate sales? Revenue sharing is blatant and worrisome. According to last Thursday's *Wall Street Journal*: "just about everyone except the SEC recognized this was a problem . . . .'" The revenue sharing problem is a $2 billion dollar a year problem, and growing.

What is the deal with "directed brokerage"? Directed brokerage refers to the advisor doling out cash created by excessive brokerage expenses (a cost borne by fund shareholders). The dirty cash is laundered as brokerage fees for fund portfolio trading. It is used to pay brokers to encourage them to sell fund shares. Never mind that there is no proof that using fund assets to generate new sales confers any net benefit on the existing fund shareholders who pay the marketing charge. For funds that already are paying money up to their 12b-1 ceiling, this directed brokerage boondoggle payment is a clear-cut violation of 12b-1, which provides the exclusive means by which fund assets can be used to subsidize distribution.[11] I want to know why the directed brokerage slush payments by funds that have reached the 12b-1 payout ceiling aren't flatly illegal. The SEC has belatedly started to do something about directed brokerage.

Directed brokerage is a mechanism used to milk fund shareholders and create income for the advisor (by bringing in more assets to manage via new sales) without running up the fund's expense ratio. Like Enron's use of SPEs, this ploy is off-the-books.

What is the deal with soft dollars? The ICI says advisory fees are kept low by keen competition. How can you tell what they are when the advisor is running up brokerage commissions to generate soft dollar benefits kicked back to it by brokers in the form of supposed research services furnished to the advisor? These service costs are not included in the advisory fee; they are buried in fund commission costs which are not included in funds' expense ratios.

Bloated portfolio trading commissions are a hidden problem and a serious one. *See* Statement for the Record by Richard J. Hillman, Director Financial Markets

[11] According to the American Bar Association-authored, *Fund Director's Guidebook,* "a Rule 12b-1 plan is the *exclusive means* by which a fund may use its assets to bear the cost of selling, marketing or promotional expenses associated with the distribution of its shares. Fund Director's Guidebook, 59 Bus. Law., 201, 231 (2003) (emphasis added).

and Community Investment, General Accounting Office, Mutual Funds Information on Trends in Fees and Their Related Disclosure, March 12, 2003, at 17, *available at* www.gao.gov/cgi-bin/getrpt?GAO-03-551T:

> One academic study estimated that mutual funds pay brokerage commissions about $0.06 per share traded. Because individual investors trading through discount broker-dealers can trade for as little as $0.02 per share, the study's author attributes the higher amount of commissions—about 66 percent of the total amount per share—paid by mutual funds to charges for soft dollar research.

Summary On Transparency and Accountability.

The fund industry features a bizarre landscape, replete with excessively high advisory fee costs, and featuring hidden, off-the-books payments, all designed to use fund assets to fuel sales growth for the advisor. The conflict is blatant. I say again, there is no proof that new sales of fund shares benefit existing fund shareholders. The benefit to advisors, on the other hand, by bringing more assets under management, is clear. When assets under management increase, fees for the advisors increase.

To this point I have not mentioned the most damning pieces of evidence showing that the fund industry is out of control: the market timing and late trading frauds. I reference those disturbing occurrences now to drive home a simple point: Both of those scams, and the other depredations mentioned above, tie into the industry's dysfunctional, conflicted management system. In both the late trading and market timing scams, we observe the same thing that we have seen with the directed brokerage, etc., problems chronicled above: conflicted managers eager to reap profit for themselves, even at the expense of fund shareholders to whom fiduciary duties are owed.

The Problem: The Fund Industry Is Over-Regulated and Under-Policed

If regulatory attention were equivalent to investor protection, we would not be here today. Unfortunately, the SEC, the self-proclaimed "Investor's advocate," has failed mutual fund shareholders. Today we confront a fund industry that is under-policed.

The only effective sheriffs on the scene today are operating at the state level, William Galvin in Massachusetts and Eliot Spitzer in New York. Together, they have exposed more corruption and brought more sunlight and fresh air to the fund scene in 6 months than the SEC has in the last 60 years.

What is Needed?

The SEC needs to shape up. It calls itself the "Investor's advocate." It needs to start acting like one. The SEC has hundreds and hundreds of lawyers; comparatively, Messrs. Galvin and Spitzer have a handful. Those two state regulators have been running circles around the SEC and the fund industry. Spitzer and Galvin have shown what is possible if a regulator has the "want-to."

Contrast the direct, correct treatment given fund managers by Spitzer and Galvin with the way the SEC dealt with Putnam in the face of grave wrongdoing exposed by Galvin in Massachusetts. Early in the game, to Mr. Galvin's consternation, the SEC announced that it had settled with Putnam under the SEC's traditional milquetoast formulation, by which the wrongdoer admits no wrongdoing, while promising never to do it again. The SEC needs to start enforcing the laws on the books. Making fund managers honor their fiduciary duties to shareholders would be a good place to start. Moreover, directed brokerage and soft dollars need to go. Rule 12b-1 needs to be eliminated or drastically overhauled.

Shareholders Need Clear, Rigorous Disclosure of Big Ticket Expenses.
The 1940 Act could be vastly improved by requiring detailed, clear disclosure about things like advisory fees, advisors' profitability, and revenue sharing (assuming it is allowed to continue, which I do not favor).

Disclosure is not a panacea. It is true that most shareholders will not read and fully understand all the data and nuances. But what makes our capital markets especially efficient is careful review of data by financial analysts, academics and the financial press. Members of these groups can be counted on to give important fund fee information the thorough study it deserves.

To date, the fund management industry has been able to hide the facts behind a weak, ineffectual disclosure system that allows key information, like management fee costs and advisory profits, soft dollar data, and revenue sharing data, to be presented in confusing ways, if these items are disclosed at all. This needs to change.

Shareholders Need Most Favored Nation Treatment.
Likewise, adopting "most favored nation" treatment of advisory costs would confer a huge benefit. Our 2001 article demanded for fund shareholders "most favored nation" treatment when it comes to fund advisory fees. We concluded the SEC

> should use its rule-making authority to declare that a presumption exists that fund shareholders deserve "most favored nation" treatment over advisory fees charged by their advisors. The "most favored nation" concept is both simple and powerful. Fund shareholders should pay a price for investment advice that is no higher than that charged by the fund's advisor and its affiliated entities when billing for like services rendered to other customers, such as pension funds, endowment funds, "private counsel accounts," or other advisory service users.

Most favored nation treatment will squeeze a lot of fat out of fund fees. Neil Weinberg of *Forbes* has called the "most favored nation" treatment the fund industry's "worst nightmare." Without "most favored nation" treatment, we will continue to find fund sponsors like Alliance Capital, lunching off fat fees paid by fund shareholders for advisory services, while selling those same services in the free market to institutional investors for far, far less.

Why should advisors be able to charge fund shareholders, to whom fiduciary duties are owed, fees that are multiples of the fees charged by the advisor on the free market for equivalent service? Simple fiduciary concepts demand that fund shareholders be treated no worse than strangers. When confronted with unfairly high price quotes, fund directors need to learn how to say “No,” or, perhaps, “You’re fired.” As Delaware’s Supreme Court has observed:

> *The power to say no is a significant power. It is the duty of the directors* serving on [an independent committee] to approve only a transaction that is in the best interests of the public shareholders, *to say no to any transaction that is not fair to those shareholders and is not the best transaction available.*

Kahn v. Lynch Communications Sys. Inc., 638 A.2d 1110, 1119 (Del. 1994) (brackets in original) (emphasis added) (quoting *In re First Boston, Inc. Shareholder Litig.*, C.A. 10338, 1990 WL 78836, at *15-*16 (Del Ch. June 7, 1990)).

Where is All of This Headed?

Being a realist, I find it hard to be optimistic. The fund industry is a $7 trillion colossus. Like numerous Americans, the fund management industry is obese, and in denial. To fund industry leaders, there are no problems that getting Eliot Spitzer out of their hair won’t cure. The industry is banking on Congress leaving matters to the SEC which, until recently has been in a “partnership” with the ICI. For fund shareholders, the agency has been missing in action.

Will the ICI and the fund sponsors prevail? I hope not, but they are clever, well-heeled, driven, and used to getting their way. With its pro-business orientation, the Congress tends to side with business managers, losing sight of the interests of the millions of Americans who made money, paid taxes on it, and entrusted their savings to mutual fund managers expecting a fair shake. Those investors are the lifeblood of our capitalistic system, and they deserve far better than the fund industry has given them.

To those who believe that the marketplace holds all the answers, I offer this observation: Markets don’t work well where there is deception, weak disclosure, and conflicts of interests. This is why Congress gave us the Investment Company Act of 1940 in the first place. Over 60-plus years, the fund industry has figured out how to game the system. There is much repair work to be done.

Thank you for inviting me. I welcome the opportunity to answer your questions.