

**Consumer Federation of America  
Fund Democracy, Inc.  
Consumer Action  
U.S. Public Interest Research Group  
Consumers Union**

October 31, 2003

The Honorable Daniel K. Akaka  
722 Hart Building  
U.S. Senate  
Washington, D.C. 20510

Dear Sen. Akaka:

We are writing to express our enthusiastic support for your draft legislation to increase the transparency of mutual disclosures and enhance the independence of fund oversight. Over the last two decades, mutual funds have become firmly established as average Americans' investment vehicle of choice, and investors have for the most part benefitted greatly from the ability mutual funds have offered even those of modest means to diversify their portfolios and obtain professional management. However, fund rules in some areas have not kept pace with industry practices, and the recent scandals embroiling the mutual fund industry have raised serious questions about the quality of corporate governance in this industry.

Given the importance of mutual funds in the financial portfolios of average Americans and the heavy reliance of the least sophisticated investors on these investment vehicles, we applaud your efforts to address key weaknesses in the regulatory structure for mutual funds. Your proposed reforms to improve disclosures about fund costs and strengthen the independence of mutual fund boards, if adopted, should help the fund industry to regain the investor trust that has been the key to its success over the years but has been to severely undermined by recent revelations.

**1. We support requiring disclosure of broker compensation for mutual fund transactions.**

The legislation would require disclosure of the compensation brokers receive for selling funds. While funds are currently required to disclose the existence of such payments in fund

prospectuses, the actual amount of the broker's compensation for a particular mutual fund transaction does not currently have to be disclosed. This form of compensation creates a conflict of interest between the broker, who may be inclined to recommend the fund that offers him or her the highest compensation, and the investor, whose interest is in obtaining the highest quality fund at the lowest cost. By requiring timely disclosure to investors of the actual dollar amount of these commissions, your bill should help to increase investors' awareness of the existence and extent of this conflict of interest and its potential to induce their broker to place his or her interests ahead of theirs.

Ample evidence that brokers do not always put investors' interests first can be found in the allegations of improper sale of fund B shares at some fund companies. In addition, a recent Consumer Federation of America-Fund Democracy study of excess costs paid by investors in S&P 500 Index funds found that many of the funds with unjustifiably high expense ratios were funds that brokers sold on commission. Since costs subtract directly from fund performance, investors in these funds end up paying a premium for sub-par performance. Had these investors been made aware of the often substantial payments their brokers received on the sale, they might have been encouraged to look more closely at whether the fund or share type being sold was really the best for them.

## **2. We support requiring improved disclosure of portfolio transaction costs.**

The legislation would also require mutual funds to disclose in the prospectus the brokerage commissions they pay on portfolio transactions and to include this cost in the fund expense ratio. Portfolio transaction costs vary greatly among funds and can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, currently included in fee information provided in the prospectus. The only public disclosure of portfolio transaction costs is a statement of the dollar amount of the fund's commissions in the Statement of Additional Information, a document never reviewed by the vast majority of mutual fund investors.

Fuller disclosure of portfolio transaction costs would help investors to hold fund advisers accountable for their trading practices. It also would provide a collateral benefit in connection with funds' soft dollar practices. Commissions paid by funds typically pay for both execution and research services. Since soft dollars pay for research that fund advisers would otherwise have to pay for themselves, this creates a significant conflict of interest for fund advisers. Requiring brokerage commission cost disclosure would subject these fund expenditures, including expenditures on soft dollar services, to market forces, and in the process provide a practical solution to the problem of regulating soft dollar practices.

## **3. We support reforms to enhance the independence of mutual fund boards.**

The legislation contains a number of provisions to strengthen the independence of fund boards. It would require that 75 percent of board members, including the board chairman, be independent. It would substantially strengthen the definition of independent director by

excluding individuals who had served as directors, officers, or employees within the past 10 years of the fund's manager, principal underwriter, or other significant service provider. It would delegate selection of new independent directors exclusively to existing independent directors. And it would establish qualification standards for board members that must be publicly disclosed.

The recent investigation into market timing and late trading at certain mutual funds has raised serious questions about the quality of oversight provided by fund boards. Of particular concern are the allegations that some Putnam fund managers and the CEO of the Strong fund family were timing their own funds – essentially picking the pockets of their own shareholders to the tune of several hundred thousand dollars in each instance. This is an unconscionable violation of these fund managers' fiduciary duty to their shareholders. It is also strong evidence of the need to end the domination of fund boards by the fund manager. Increasing the representation of independent members on boards, making sure that independent members are truly independent, and ensuring that the boards are led by independent members should go a long way toward advancing that goal.

#### **4. Other bill provisions would also benefit investors.**

The recent mutual fund scandals are not just a corporate governance failure – though they certainly are that. They are also a regulatory failure. The fact is that the SEC was apparently aware of problems related to market timing for years and had drifted along without doing anything about it. Given the lack of clear direction from the SEC, it is hardly surprising that fund boards failed to closely supervise the trading practices at funds they oversaw. Your bill offers an innovative approach to enhancing the quality of fund board oversight. It would direct the SEC to study the benefits of creating a Mutual Fund Oversight Board, generally modeled after the Public Company Accounting Oversight Board, with authority to examine and bring enforcement actions against mutual fund boards of directors. Under this approach, the SEC would retain responsibility for direct oversight of investment advisers, but that responsibility would be supplemented by the new independent agency's supervision of fund boards. We believe this approach is well worth studying.

We also support the bill's provisions requiring disclosure of portfolio managers' compensation and ownership of fund shares (something that might have discouraged market timing by fund managers), as well as its proposed GAO study of mutual fund advertising practices and SEC study of financial literacy. Such a study should look at innovative disclosure methods designed to reach unsophisticated investors – those who fail to take costs into account, for example – with information they understand and act on.

#### **Conclusion**

Recent events have provided a rude awakening to those who have long trusted mutual funds as the one place where the needs of average investors are generally well protected. Your bill offers a reasonable approach – one that recognizes the continued benefits of mutual fund

investing for millions of Americans but also recognizes that reforms are needed to restore investor confidence in the integrity of this industry. Please let us know what we can do to assist in its passage.

Respectfully submitted,

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