

Statement of Senator Daniel K. Akaka
Senate Banking Committee
"Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry:
Fund Costs and Distribution Practices."
March 31, 2004

Thank you Chairman Shelby and Ranking Member Sarbanes for the opportunity to participate in today's hearing.

Mutual fund reform is important because 95 million people have placed a significant portion of their future financial security into mutual funds. Mutual funds provide middle-income Americans with an investment vehicle that offers diversification and professional money management. Mutual funds are what average investors rely on for retirement, savings for children's college education, or other financial goals and dreams.

On November 5, I introduced S. 1822, the Mutual Fund Transparency Act of 2003. I believed that legislation was necessary to bring about structural reform in the mutual fund industry, increase disclosures in order to provide useful and relevant information to mutual fund investors, and restore trust among investors. I was appalled by the flagrant abuses of trust among mutual fund companies.

I commend the SEC for its proposals to improve the corporate governance of mutual funds and to increase the transparency of mutual fund fees that investors pay. The proposed requirements for an independent chairman for mutual fund boards, increased percentage of independent directors to 75 percent, and development of a confirmation notice so that investors will be able to know how their broker gets paid in mutual fund transactions are a solid and measured response to the litany of transgressions which have undermined public confidence in the mutual fund industry. These provisions mirror those in my legislation. In addition, I have

been impressed with the SEC's attempts to address point-of-sale disclosure.

However, I continue to believe that legislation is necessary to codify some of the proposed regulations so that the reforms will not be rolled back in the future. It is also important to legislatively address areas where the SEC needs additional statutory authority to address problems and abuse in the mutual fund industry. Mr. Mercer Bullard, in his testimony before this Committee, indicated that the "Commission's proposal does not effectively require fund boards to be 75 percent and have an independent chairman" because the rules would only apply to funds that rely on one or more of the Exemptive Rules. This means that these rules would not apply to all funds. Legislation is necessary to ensure corporate governance improvements apply these rules universally among mutual funds. Finally, additional legislation may be necessary if disclosures of revenue sharing agreements and portfolio transaction costs are not adequately addressed by the Commission.

S. 1822 includes a number of provisions that are important for Congress to enact. Boards must be strengthened and more independent to be more effective. Investment company boards should be required to have an independent chairman, and independent directors must have a dominant presence on the board. My bill strengthens the definition of who is considered to be an independent director. It also requires that mutual fund company boards have 75 percent of their members considered to be independent. To be considered independent, shareholders would have to approve them. In addition, a committee of independent members would be responsible for nominating members and adopting qualification standards for board membership. These steps are necessary to add much needed protections to strengthen the ability of mutual fund boards to detect and prevent abuses of the trust of shareholders.

My bill will also increase the transparency of often complex financial relationships between brokers and mutual funds in ways that are meaningful and easy to understand for investors. Shelf-space payments and revenue-sharing agreements between mutual fund companies and brokers present conflicts of interest that must be addressed. Shelf-space and revenue sharing agreements present risks to investors. Brokers have conflicts of interest, some of which are unavoidable, but these need to be disclosed to investors. Without such disclosure, investors cannot make informed financial decisions. Investors may believe that brokers are recommending funds based on the expectation for solid returns or low volatility, when the broker's recommendation may be influenced by hidden payments. S. 1822 will require brokers to disclose in writing, to those who purchase mutual fund company shares, the amount of compensation the broker will receive due to the transaction, instead of simply providing a prospectus. The prospectus fails to include the detailed relevant information that investors need to make informed decisions. Prior to their recent rulemaking, the SEC exempted mutual funds from Rule 10b-10, which requires that confirmation notices of securities transactions be sent to customers to indicate how the broker was compensated in the trade. My legislation would prevent the exemption of mutual funds from confirmation notice requirements.

To increase the transparency of the actual costs of the fund, brokerage commissions must be counted as an expense in filings with the SEC and included in the calculation of the expense ratio, so that investors will have a more realistic view of the expenses of their fund. Consumers often compare the expense ratios of funds when making investment decisions. However, the expense ratios fail to take into account the costs of commissions in the purchase and sale of securities. Therefore, investors are not provided with an accurate idea of the expenses involved.

Currently, brokerage commissions have to be disclosed to the SEC, but not to individual investors. Brokerage commissions are only disclosed to the investor upon request. My bill puts teeth into brokerage commission disclosure provisions and ensures that commissions will be included in a document that investors actually have access to and utilize.

The inclusion of brokerage commissions in the expense ratio creates a powerful incentive to reduce the use of soft dollars. Soft dollars can be used to lower expenses since most purchases using soft dollars do not count as expenses and are not calculated into the expense ratio.

There have been calls for the prohibition of soft dollars. This is a recommendation that needs to be examined. However, my bill provides an immediate alternative, which is an incentive for funds to limit their use of soft dollars by calculating them as expenses. If commissions are disclosed in this manner, the use of soft dollars will be reflected in the higher commission fees and overall expenses. This makes it easier for investors to see the true cost of the fund and compare the expense ratios of funds.

Some may argue that this gives an incomplete picture and fails to account for spreads, market impact, and opportunity costs. However, the SEC has the authority to address the issue further if it can determine an effective way to quantify these additional factors. My bill does not impose an additional reporting requirement that would be burdensome to brokers. It merely uses what is already reported and presents this information in a manner meaningful to investors.

One of the provisions in my bill requires the SEC to conduct a study to assess financial literacy among mutual fund investors. This study would identify the most useful and relevant information that investors need prior to purchasing shares, methods to increase transparency of

expenses and potential conflicts of interest in mutual fund transactions, existing efforts to educate investors, and a strategy to increase the financial literacy of investors that results in positive change in investor behavior. This study is necessary because any additional disclosure requirements for mutual funds will not truly work unless investors are given the tools they need to make smart investment decisions, and we must first know what education exists.

I look forward to working with my colleagues and the SEC to address problems identified in the mutual fund industry.

Thank you, Mr. Chairman.