

Statement of Senator Susan M. Collins

Senate Committee on Banking, Housing and Urban Development

March 31, 2004

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for inviting me to testify on legislation that I have introduced with Senators Fitzgerald and Levin, who have spent an enormous amount of time examining the complex issues involving mutual funds. Our bill, The Mutual Fund Reform Act, is a comprehensive approach that contains many different proposals for strengthening our system of mutual fund regulation. I commend the Committee for your work on these issues that affect approximately 95 million investors who have invested more than \$7 trillion into mutual funds.

As the Committee on Governmental Affairs pursued its investigation of mutual funds, I thought about a fundamental question. Why is it that in a society built on competition, market forces do not drive down mutual fund fees? Why is it that the legendary American consumer, who will search for the cheapest gas, clip newspaper coupons, and take advantage of early bird specials, is oblivious to fees that can, over time, affect his or her net worth by thousands of dollars? Why is it that mutual fund fees seem more impervious to competitive forces than almost any other cost in our society, surpassed in this regard perhaps only by college tuition?

I start with the basic notion that competition can only work when market participants have adequate information. If mutual fund investors do not fully understand either the level of their fees or their impact on fund performance, competition lacks one of its essential ingredients. Furthermore, if this is true of many mutual fund investors, then we cannot expect the informed decisions of the majority to protect the uninformed choices of the minority, as occurs in markets that are efficient. This theory would suggest that the government should act to improve either the amount of fee information provided to investors or the clarity with which it is presented, or both.

The most important reform that can be made, in my view, is to focus investors' attention on the costs of owning mutual funds. For most investors, high mutual fund expenses will cost them more than such abusive practices as "market timing" or "late trading." For example, assume a worker chooses a mutual fund at the beginning of her career. Should she choose one with high returns in recent years and expenses of 1.5 percent? Or should she choose another with steadier, less spectacular recent returns with only a 0.5 percent expense ratio? Unfortunately, there is a very good chance that she will choose the former when choosing the latter would, by the end of her career, have returned 35 to 40 percent more money in this particular case.

We cannot enjoy the benefits of competition unless we have an efficient marketplace. And, an efficient marketplace requires that prices be both transparent and easily accessible to investors. Currently, however, mutual fund expenses and fees are often opaque and obscure. In

contrast, historical performance is well known as successful funds tout the past performance data that puts them in the best light through large advertising campaigns.

The American Enterprise Institute's Shadow Financial Regulatory Committee, which is comprised of some of the top economists and financial experts in the country, recently stated:

“Mutual fund expenses are an important determinant of investors' actual returns. Though market fluctuations may swamp the impact of fund expenses on short-run returns, such expenses become much more significant in determining differential returns among funds over a number of years. Therefore, expense ratios are particularly important to long-term investors.”

I recognize the impediments to calculating the true costs of mutual funds. Most important, mutual fund trading costs, which funds pay to brokers when the fund buys or sells securities for its portfolio, are not included in the expense ratio, which is the most commonly used mutual fund cost metric.

Compounding this problem, there are many expenses that are bundled in with these transactions, which means that even more mutual fund expenses never make it into the expense ratio. They include research and related costs, which are purchased with so-called “soft dollars.” Another example is the practice of “directed brokerage,” by which trades are executed with certain brokers that sell the fund's shares, and are understood by both parties to be a form of compensation for such sales. This practice, in essence, combines distribution costs with brokerage costs and becomes a sort of hidden 12b-1 fee.

The SEC made a good start in improving cost disclosure with its recent proposal that mutual funds disclose their costs per thousand dollars invested in the funds' shareholder reports. I believe, however, that Congress should go further. S. 2059, for example, would require that personalized data be published on a shareholder's account statement at least annually.

It is not enough to tell an investor how much his costs would have been had he owned an amount of shares he does not actually own. Like a bank checking statement that tells a bank customer how much he or she was charged for individual banking services, a mutual fund statement should tell an investor how much his or her actual share of the fund's fees were.

I realize, Mr. Chairman, that there would be costs to generating and reporting personalized cost data to each mutual fund investor. Still, having reviewed work done by the General Accounting Office (GAO), I have concluded that this disclosure is warranted, just as it is in other types of financial records, such as checking account statements.

Specifically, using industry data, GAO calculated that, spread out over the vast number of accounts, such disclosure would cost each fund account holder about 65 cents every year after a one dollar initial cost.

Also, I would urge the Committee to report mutual fund reform legislation as soon as possible, so that it can be enacted prior to adjournment.

The Investment Company Act, which is the principal statute governing mutual funds, was originally passed in 1940. As originally enacted, the Investment Company Act of 1940 was considered to be a weak law. It has not been significantly amended since 1970. At 64 years of age, the law governing mutual funds is therefore approaching what we typically consider to be retirement age. Although I do not think we need to retire the 1940 Act, leaving matters to the SEC alone would be, in my view, an insufficient response to the recent revelations about wrongdoing in the mutual fund industry.

This is not to slight the SEC's recent activities. The SEC has taken many steps to improve the oversight and regulation of the mutual fund industry. They include new proposals regarding fund governance, broker compensation disclosure, and many other facets of mutual fund regulation. The end result of all of this activity will be a better-regulated and safer environment for Americans to invest in mutual funds. Still, I want to urge the Committee to report mutual fund reform legislation so that we can ensure that reforms endure regardless of who becomes future members of the SEC.

Since their earliest conception as 19th century English investment trusts, mutual funds have been touted as allowing small investors access to the same advantages enjoyed by larger and wealthier investors. What we have learned from practices such as "late trading" and "market timing," however, is that there has all too often been two sets of rules – one for favored investors, and another for everyone else. Although American families continue to invest in mutual funds, their continuing trust in them and our capital markets in general is not something that we can take for granted. We must not only address abusive practices but also, arguably even more important, excessive fees, and we must do so in a manner that maximizes investor faith in the mutual fund industry.

Striking the right balance, Mr. Chairman, is the job of you and your colleagues on this Committee. I wish you well in your efforts, as I believe that protecting our nation's mutual fund investors is one of the most important tasks that your Committee could undertake this Congress.