

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Associate Professor of Law
University of Mississippi School of Law

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

on

*Enhancing Investor Protection and the
Regulation of Securities Markets*

March 11, 2009

Chairman Dodd, Ranking Member Shelby, members of the Committee, thank you for the opportunity to appear before you to discuss investor protection issues. It is an honor and a privilege to appear before the Committee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Associate Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an Internet web site for the posting of information. I also have served as a consultant and expert witnesses for plaintiffs and defendants in a variety of securities cases, including some that are discussed in this testimony.

INTRODUCTION

This testimony focuses on investor protection issues related to investment management and investment advisory services. Some of these issues have arisen in connection with the current financial crisis, such as the question of prudential regulation of money market funds. This testimony begins with a discussion of different aspects of this question. But many investor protection issues reflect longstanding problems that have been left unattended by the SEC. There continue to be significant gaps in mutual fund fee disclosure rules, reform of fund distribution regulation is long overdue, and the SEC's fund governance initiative seems to have been all but forgotten. The SEC continues to allow hedge funds to offer their shares to unsophisticated investors, and brokers continue to receive undisclosed selling compensation that creates an incentive to sell the most remunerative funds even if they are not the best funds for the client.

On the whole, however, the investment management industry has fared well in the current crisis. Equity mutual funds have experienced their largest single year loss in history, yet net redemptions have remained small. Employee benefit plan participants generally have continued to make regular investments in funds. The mutual fund structure has been shown to be remarkably resilient in this time of stress. Investors seem to have faith in mutual funds' promise to convert their accounts to cash in short order at their next computed NAV, which is based on actual market values as opposed to malleable accounting principles. More money has flowed out of broker-managed accounts than mutual funds. Only one money market fund has experienced a loss of principal (compared with the failure of dozens of banks), and, with the playing field with banks temporarily leveled by the Treasury's temporary insurance program, money market funds have increased their total assets. The investment management industry's success depends, however, on its and its regulators' keeping pace with the needs of investors.

This testimony is organized as follows:

I. Money Market Funds	4
A. Money Market Fund Insurance	4
B. Prudential Regulation	6
C. Prudential Regulator	7
D. Electronic Filing of Portfolios	8
E. Sponsor Support	8
F. Liquidation Procedures	9
G. Liquidity Oversight	10
II. Mutual Funds	10
A. Excessive Fees	10
i. Fiduciary Duty Standard	11
ii. Fee Disclosure	11
1. Portfolio Transaction Costs	12
2. Dollar Disclosure of Fees	15
3. Fee Comparisons	17
4. Distribution Fees	17
5. Disclosure of Brokers' Compensation	17
B. Distribution Arrangements	18
i. 12b-1 Fees	18
ii. Revenue Sharing	21
iii. Misleading Fund Share Classes	22
C. Fund Advertising	23
D. Soft Dollars	25
E. Fund Names and Investor Expectations	28
F. Fund Governance	32
III. 529 Plans	33
A. Regulatory Oversight	33
B. Fee Disclosure	34
C. Disparate State Tax Treatment	36
IV. Hedge Funds	36
A. Systemic Risk	36
B. Public Offering of Hedge Funds	37
C. Accredited But Unsophisticated Investors	37
V. Investment Advisers	38
A. Fiduciary Standard	38
B. Madoff Scandal	39
C. Principal Trading Exemption	41
D. Pay-to-Play Ban	42

I. MONEY MARKET FUNDS

A. Money Market Fund Insurance¹

As discussed above, mutual funds have been a singular success story in the midst of the current financial crisis. Money market funds arguably have been the best illustration of this success. As often happens when those who succeed are surrounded by failed competitors, however, some have responded to the failure of a single retail money market fund – the first in history – by demanding that money market funds be converted to and regulated as banks. A former Fed chairman explained this position as follows: "If they are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank." The problem with this argument is that money markets do not *fail* like banks.

Since 1980, more than 3,000 U.S. banks have failed, costing taxpayers hundreds of billions of dollars. During the same time period, two money market funds have failed, costing taxpayers zero dollars.² The lesson that the Group of 30 takes from this history is that it is money market funds that should be regulated as banks. The lesson that Congress *should* take from this history is that banks should be regulated more like money market funds. As discussed further below, banks routinely fail because they are permitted to invest deposits that can be withdrawn at a moment's notice in illiquid, long-term, risky assets. In comparison, money market funds invest in liquid, short-term, safe assets. The Group of 30 has disparaged money market funds as "underscor[ing] the dangers of institutions with no capital, no supervision, and no safety net," yet the extraordinary stability of money market funds relative to banks makes a mockery of their argument.

It is banks that should be regulated like money market funds, with the investment of insured bank deposits being limited to liquid, short-term, safe assets. There is no longer any good policy reason to insure bank deposits backed by long-term, risky assets. The current financial crisis has demonstrated that banks no longer play a special role in this market. Many types of entities now play a significant role in the creation of liquidity through investment in long-term assets that historically was dominated by banks. And many of these entities rely on short-term liabilities (*i.e.*, funds subject to payment on demand), including mutual funds, to fund such investments. Any regulatory regime that seeks to mitigate the systemic risk inherent in the investment of short-term funds in long-term ventures must consider the full spectrum liquidity-creation mechanisms and reject a bank-centric

¹ See generally Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (Mar. 2, 2009) available at <http://ssrn.com/abstract=1351987>.

² Ironically, money market funds to date have provided a net positive contribution to the ongoing bailout of financial institutions. The Treasury has collected more than \$800 million in money market fund insurance premiums only a small fraction of which, if any, are likely ever to be paid out in claims.

view of finance that distorts efficient investment and leaves unregulated large areas of financial activities.

What should be insured is cash accounts on which the stability of the payments system depends. The current crisis has demonstrated the need to ensure that the cash management vehicles that form the foundation of our payments system are absolutely secure. Deposit insurance provides this security. Its weakness, however, is that it also insures risks that are necessary to the provision of transactional services. Banks are permitted to invest insured bank deposits in long-term risky ventures, thereby destabilizing the payments system and inflicting large losses on the insurance fund and taxpayers. Money market funds have been a paragon of stability because they are permitted to invest only in a diversified pool of short-term, high-quality assets.

The answer to whether money market fund insurance should be made permanent seems obvious. Terminating the temporary insurance program could lead to another run on money market funds and require that the program immediately be restored. Even if a run does not follow termination of the program, money market funds will continue to represent a major source of transactional services the failure of which would threaten the viability of our payments system. Money market fund shareholders know this. The question of whether there is an implied federal guarantee of money market funds has been answered. The next time that a run on money market funds seems imminent, a federal entity will have to stop the run with a guarantee, except that without an insurance program in place it will not have collected any premiums that (if risk-based) might have reduced risk-taking and that would have provided non-taxpayer funds with which to cover losses. Taxpayers will be left to back up this guarantee.

At the same time that federal insurance is extended to all significant sources of transaction accounts, it should be used to reduce exposure to risk from the investment of short-term deposits in long-term, risky assets. To some extent, this would be accomplished by making money market fund insurance permanent. The higher yields historically offered by money market funds would siphon even more deposits from banks reduce the attendant risk of their investment in risky assets. Federal insurance also should be extended to a new kind of bank that was required to invest deposits in the same kinds of assets as money market funds. In order to enable compete such “narrow banks” to compete effectively, they would be relieved of burdens unique to banks, such as the requirements of the Community Reinvestment Act. Narrow banks also would continued to have the advantage of access to the discount window. Without making any changes to existing deposit insurance coverage, extending coverage to money market funds and narrow banks would reduce the amount of deposits subject to long-term risk and the likelihood of failure.

B. Prudential Regulation

Prudential regulation, as used herein, refers to government-imposed rules designed to ensure that adequate assets stand behind the liabilities of financial institutions. Prudential regulation is an inherently suboptimal approach to risk because free markets are far more efficient at pricing risk than governments. Governments cannot avoid injecting political considerations into the underwriting of risk, which results in inevitably inefficient risk-minimization structures. Nonetheless, short-term social instability can cause permanent damage to social, political and commercial institutions. In some cases, government intervention is necessary to mitigate potentially destabilizing fluctuations in free markets.

Under this admittedly oversimplified framework for government intervention in the capital markets, I would argue that our payments systems creates the kind of risk that should not be left to free market forces. The payments system refers to the network of providers of transactional services that enable a non-specie-based economic system of exchange to operate. The temporary collapse of our payments system could leave economic activity to be conducted on a strictly barter or specie basis until the payments system was restored. The difficulty with leaving the payments system to the mercy of free markets is that the social and political upheaval that might result from a temporary collapse of our payments system could turn the collapse into a long-term event with long-term political, social and economic consequences. On this basis, it is advisable to support the payments system with an unconditional government guarantee of cash accounts on which the payments is primarily based. Notwithstanding the likely inefficiencies of such an insurance regime, they are outweighed by the potential benefits of protecting the payments system.

One purpose that deposit insurance serves is to guarantee bank deposits and thereby stabilize an important foundation for the payments system. There are two difficulties with deposit insurance, however. First, deposit insurance covers risks that are not necessarily attendant upon the operation of cash accounts. Cash accounts can serve as an important linchpin of the payments system without being invested in long-term, high-risk assets such as the types of assets in which banks typically invest deposits. Money market funds also provide an important linchpin on the payments system, and they do so without taking such risks.

Second, deposit insurance is exclusive to bank deposits. It is not available to other types of cash accounts even if those accounts pose a similar systemic threat to the payments system. When a run on money market funds seemed imminent in late September 2008, there was no government guarantee to prevent the run from turning into a wholesale transfer of assets out of money market funds. With \$4 trillion in assets, such a stampede could have shut down the payments system with potentially devastating long-term effects. The Treasury Department prudently installed a government guarantee and halted the run. With temporary money

market fund insurance in place, the vast majority of assets in transaction accounts are covered by a federal guarantee.

Thus, insuring money market funds and narrow banks would promote appropriate prudential regulation that was designed to protect the stability of our payments system without transferring unnecessary risk to the government and taxpayers.

C. Prudential Regulator

The current financial crisis has exposed a persistent flaw in our regulatory structure. Prudential oversight should be provided through a regulatory structure that is amenable to the regulatory philosophy that prudential oversight entails. Prudential regulators are risk averse. Their purpose is to prevent loss. A regulator that is tasked with protecting investors and promoting free and efficient markets, on the other hand, will not be risk averse. The securities laws focus on full disclosure of material information is designed to promote and reward risk-taking based on the efficient flow of capital to its highest value use, even when some uses entail significant risk. Permitting such risk-taking is inimical to the essence of prudential regulation.

In more concrete terms, the SEC's roles: (1) in protecting investors and promoting free, efficient markets, and (2) as the prudential regulator of broker-dealers and money market funds, are in conflict. Similarly, banking regulators' consumer protection role has always suffered in the shadow of its primary prudential regulator role. The SEC's and banking regulators' contradictory positions on fair value accounting reflect this conflict. The SEC favors accurate pricing that reflects market values; banking regulators favor pricing that will restore investor confidence. As a prudential regulator, the SEC's failure to properly administer net capital rules has led to disappearance of the five largest investment banks as independent entities and its approach to money market funds has necessitated the intervention of a true prudential regulator, the Treasury Department, to stop a run on money market funds. Conversely, banking regulators' record of consumer protection has been abysmal, with their role more often undermining consumer protection than enhancing it.

In short, the areas of financial activity that necessitate prudential regulation should be administered by a prudential regulator. Investor protection and free markets should be handled by a different regulator. Although I support the creation of a single prudential regulator in theory, I believe it would be more realistic to shift prudential regulation to existing banking regulators and to locate consumer protection responsibility with respect to financial products and services with the SEC or FTC. If prudential regulation for insurance companies were established at the federal level, a special prudential regulator may be needed. It is not clear that the unique characteristics of insurance liabilities would be good fit for a prudential regulator that was responsible for other types of financial products. Insurance

products that have predominantly investment characteristics (*e.g.*, equity-indexed annuities), however, should be regulated by the SEC as to sales practices and disclosure, and by the same federal prudential regulator that would be responsible for overseeing money market funds and banks.

D. Electronic Filing of Portfolios.

In January 2008, my advocacy group, Fund Democracy, and the Consumer Federation of America, Consumer Action, AFL-CIO, Financial Planning Association and National Association of Personal Financial Advisors petitioned the SEC to adopt a rule requiring money market funds to file their portfolios electronically with the SEC.³ The letter was motivated by our concern that the SEC's *ad hoc* practice of allowing fund sponsors to bail out their money market funds before they broke a dollar was inadequate in a time of market turmoil. The letter proved to be, unfortunately, prescient. Within the year, a retail money market fund broke a dollar for the first time.

Money market fund regulation, whether administered by the SEC or a true prudential regulator, should include an electronic, portfolio-filing requirement. Electronic filing would enable the regulator to monitor, among other things, the prices at which different money market funds are carrying the same securities. Although small pricing discrepancies would be inevitable and no cause for concern, large pricing discrepancies would indicate that some fund was underpricing or, more importantly, overpricing its shares. Moreover, filings would show the liquidity of the market for securities and thereby provide insight into the credibility of prevailing prices in more thinly traded issues. As stated by the SEC when it made a similar proposal 1995, money market fund portfolio filing would enhance regulators' ability: "to monitor money fund compliance with the federal securities laws, target its limited onsite examination resources, and respond in the event of a significant market event affecting money funds and their shareholders." The SEC's own justification for this proposal is far stronger today than it was twelve years ago.

E. Sponsor Support

The SEC has historically dealt with the risk of a money market fund's breaking a dollar by granting no-action relief to fund sponsors to purchase the problem assets at par, pump cash into the fund, extend guarantees, or take other steps to restore the fund's per share net asset value. This continues to be an appropriate tool for addressing the risk of money market fund failure, but it has become far too routine. The frequent granting of no-action relief for transactions

³ Petition from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-CIO, Financial Planning Association and National Association of Personal Financial Advisors, to Nancy Morris, Secretary, U.S. Securities and Exchange Commission (Jan. 16, 2008) *available at* <http://www.funddemocracy.com/MMF%20Rulemaking%20Petition.pdf>.

that generally violate the affiliated transaction prohibitions of the Investment Company Act undermines the rule of law and encourages lax oversight by fund managers.

First, the SEC should amend the rule that exempts certain of these transactions to cover a broader range of sponsor support mechanisms. Sponsors should then be expected to have established written procedures that address scenarios in which their funds may need support and the mechanisms that the fund expects to use to provide it, if any.

Second, the sponsor's rescue policy should be disclosed in its Statement of Additional Information (a fund filing that investors can obtain on request or on the SEC's web site). As indicated by Fitch's recent announcement that it intends to revise its money market fund rating system to reflect sponsors' rescue plans, these plans have become material aspects of a fund's stability. Banking regulators have previously indicated that they might not permit a bank affiliate to bail out its money market fund. This risk also should be disclosed to investors. As discussed in the consumer groups' January 2008 letter, the 11th hour negotiation of the terms of sponsor support between sponsors and SEC staff behind closed doors should not be the model by which the SEC and the fund industry manage unexpected market events.⁴

F. Liquidation Procedures

The haphazard liquidation of certain Reserve Funds has exposed a significant gap in the regulatory structure for money market funds. The complete liquidation of any mutual fund, even a highly liquid money market fund, cannot be accomplished overnight, but there should be no delay in the distribution of some percentage of a money market fund's assets in short order. Money market fund shareholders use these funds as the functional equivalent of bank accounts on which they often rely for daily living expenses. The SEC should require that money market fund compliance manuals include procedures that set forth the manner in which immediate redemptions can be effected in the event that circumstances cause the suspension of regular distributions. The FDIC generally is able to ensure that insured depositors receive a substantial part of their funds almost immediately following the closure of an insured bank. While it is reasonable for some money market fund assets to be withheld pending a final resolution by a receiver, there is

⁴ If money market fund insurance is made permanent, such sponsor support arrangements should be formalized and made mandatory. Sponsor support of money market funds is the functional equivalent of the equity buffer that insured banks are required to maintain under banking regulations. In this respect, it should be noted that claims that money market funds have no "capital" are misleading. Money market funds do have capital; it is the sponsor support that has, in dozens of instances prevented money market funds from breaking a dollar and resulted in a record of only two failures in almost 30 years. The problem is that the capital support is informal and voluntary.

no excuse for not releasing some percentage of shareholders' accounts in short order.

G. Liquidity Oversight

Many of the problems underlying the current crisis result from a failure to incorporate liquidity risk into prudential regulation. Although money market funds present less liquidity risk because of the short maturity, high quality and diversification of their assets, Rule 2a-7 should require that money market fund directors specifically consider the liquidity risk posed by the fund's portfolio. Fund directors should be required to ensure that procedures have been adopted and implemented that are reasonably designed to ensure that the pricing of portfolio securities has been tested against various market failure scenarios.

II. MUTUAL FUNDS

A. Excessive Fees

Section 36(b) of the Investment Company Act, which was passed in 1970, provides that a fund director and fund manager shall have a fiduciary duty with respect to the fees charged by the fund, and tasks the Commission with bringing actions against directors and fund managers who violate this duty. The Commission has never brought a case for excessive fees.⁵ No plaintiff has ever prevailed in litigated claim under this provision although there have been some significant settlements.

Recent developments have made it unlikely that a section 36(b) claim will ever survive a motion to dismiss. Defense experts often have argued that mutual fund fees are set in a competitive marketplace and therefore are necessarily fair under section 36(b). In a Seventh Circuit decision, Judge Easterbrook adopted this theory, thereby effectively repealing the Act's private cause of action. In a split *en banc* opinion, Judge Posner rejected Judge Easterbrook's analysis, arguing that markets are not always efficient. The same Seventh Circuit also recently ruled that an Erisa fiduciary has no duty when selecting investments for a 401(k) plan not to choose funds that charge excessive fees. The court granted defendants' motion to dismiss even after accepting as true, among other things, plaintiffs' allegation that the plan sponsor had lied to plan beneficiaries about absorbing all of the costs of administering the plan (beneficiaries actually paid part of the costs). The Department of Labor filed an *amicus* brief opposing the defendants' position in that case.

⁵ I am aware of two cases that the Commission has brought under Section 36(b), neither of which involved an excessive fees claim. See *In the Matter of American Birthright Trust Management Company, Inc.*, Litigation Rel. No. 9266, 1980 SEC LEXIS 26 (Dec. 30, 1980); *SEC v. Fundpack, Inc.*, No. 79-859, 1979 WL 1238 (D.D.C., Aug. 10, 1979).

The Supreme Court has granted *certiorari* in the Seventh Circuit's 36(b) case. Unfortunately, the Court has been quite hostile to private claims under the federal securities. I support many of the statutory limits on private claims that Congress has enacted over the last 15 years, as well as some of the interpretive restrictions imposed by the Court. But some decisions have gone too far and/or created absurd results. There is significant risk that the Court's decision will result in a complete evisceration of section 36(b). This will leave mutual fund investors at the mercy of opaque fee disclosure and no private claim against fund managers that charge excessive fees. It is therefore imperative that Congress strengthen the fiduciary duty standard under section 36(b) and implement long-overdue reforms in fee disclosure requirements.

i. Fiduciary Duty Standard.

Section 36(b) applies a fiduciary duty to directors only with respect to fees paid to the fund manager. When a fund's excessive fees are attributable not to fees paid to the fund manager, but to fees paid on account of the administrative expense of operating a small fund, this fiduciary duty is not triggered. Thus, a fund director's decision to offer a fund with an 8% or 10% expense ratio may be reviewable only under the toothless state law standard that section 36(b) was designed to supplement.⁶

Congress should enact legislation that creates a fiduciary duty for fund directors that would require, for example, that directors affirmatively find that the fund could be a reasonable investment in light of its investment objective, performance history and expenses. If a fund's fees were so high so as to render the investment irrational, the directors would have to take action to cure the problem, such as by merging the fund into another fund with lower fees.

ii. Fee Disclosure.

As the Commission has recognized, fund fees "can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years."⁷ Notwithstanding the importance of fees, "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern."⁸ The Department of Labor has

⁶ A number of years ago, my research assistant was able to identify 18 funds in Morningstar's database with expense ratios in excess of 5%, yet the average management fee for the same funds was only 1.06%, and only one fund's management fee exceeded 1.29%.

⁷ Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, Part I.B (Dec. 18, 2002).

⁸ *Id.* (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest

found that employee benefit “plan participants on average pay fees that are higher than necessary by 11.3 basis points per year.”⁹

In many respects, investors’ lack of understanding is directly attributable to the way in which fees are disclosed. The current expense ratio is misleading because it excludes what can be a fund’s single largest expense: portfolio transaction costs. 12b-1 fees are misleading because they create the impression that funds that do not charge 12b-1 fees therefore do not incur distribution expenses. Fund fees are disclosed in dollars based on hypothetical amounts, rather than a shareholder’s actual costs, and the location of this disclosure makes it unlikely that investors will pay attention to this information. Nowhere are funds required to put their fees in context by comparing them to fees charged by index funds and comparable managed funds. The Commission has failed to support or actively opposed reforms designed to address each of these problems.

1. *Portfolio Transaction Costs*

The current expense ratio, which to be accurate should be referred to as the “partial expense ratio,” excludes portfolio transaction costs. Portfolio transaction costs are the costs incurred by a fund when it trades its portfolio securities. Some portfolio transaction costs are easy to measure. For example, commissions paid by funds are disclosed as a dollar amount in the Statement of Additional Information, which is provided to shareholders only upon request. Other portfolio transaction costs must be measured indirectly, such as spread costs, but their existence and their substantial impact on fund expenses is no less certain.

The Commission concedes that portfolio transaction costs constitute a significant expense for fund shareholders. “[F]or many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points.”¹⁰ A 2004 study commissioned by the Zero Alpha Group, a nationwide network of fee-only investment advisory firms, found that commissions and spread

mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns”).

⁹ See Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, Employee Benefits Security Administration, U.S. Department of Labor, 73 F.R. 43014, n.13 (July 23, 2008) (“DoL Proposal”).

¹⁰ Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313, at Part I (Dec. 19, 2003) (“Concept Release”) (citing John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management*, at 10 (Aug. 30, 2001) (available at http://finance.wharton.upenn.edu/~edelen/PDFs/MF_tradexpenses.pdf). “These estimates omit the effect of market impact and opportunity costs, the magnitude of which may exceed commissions and spreads.” *Id.*

costs for large equity funds, the expenses and turnover of which are well below average, exceeded 43% of the funds' expense ratios. A 2004 survey by Lipper identified at least 86 equity funds for which the total amount paid in commissions alone exceeded the fund's total expense ratio, in some cases by more than 500%. The Department of Labor expressly cited, as a significant failing of the mutual fund expense ratio, its omission of portfolio transaction costs, which can equal many multiples of a fund's other expenses.¹¹

Notwithstanding the significance of portfolio transaction costs, the Commission has opposed including these costs in the mutual fund expense ratio. In a June 9, 2003, memorandum, the Commission demonstrated that it had already prejudged the issue of the disclosure of portfolio transaction costs. It concluded that "it would be inappropriate to account for commissions as a fund expense" and unequivocally answered the question of "whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe that the answer is 'no.'"¹² Only after reaching this decision did the Commission proceed with the formality of issuing a concept release asking for comment on disclosure of portfolio transaction costs, apparently for the purpose of considering any alternative other than full inclusion in the expense ratio.¹³ Six years later, the Commission has not taken any action on its proposal other than to include turnover ratios (an indirect and opaque reflection of portfolio transaction costs) with the fee table in new the summary prospectus. The expense ratio continues to be a partial expense ratio.

The Commission's position is flatly inconsistent with its responsibility to provide the information that the marketplace needs to promote price competition. By requiring funds to use the partial expense ratio, the Commission is effectively forcing the public to choose funds based on the Commission's view of the proper measure of fund costs. The Commission's decision to second-guess the market by deciding for investors which kinds of information they are capable of understanding contradicts basic market principles and is inconsistent with our capitalist system of free enterprise.

Investors logically look to the Commission to provide standardized reporting of expenses, and it is appropriate for the Commission to provide this service. But once the Commission has provided the important service of providing standardized

¹¹ See DoL Proposal, *supra*, at n.13.

¹² Memorandum from Paul F. Royce, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, at 28 & 30 (June 3, 2003) (available at <http://financialservices.house.gov/media/pdf/02-14-70%20memo.pdf>) ("Donaldson Memorandum").

¹³ See Concept Release, *supra*.

information, it should remove itself from the market-driven determination of which information provides the best measure of a fund's true costs.

The Commission has argued that including portfolio transaction costs might distort fund managers' behavior. As noted above, this is not for the Commission to judge. The marketplace should decide which expense ratio – the partial expense ratio or a total expense that includes portfolio transaction costs – is the best measure of a fund's costs.

Furthermore, it is the partial expense ratio that distorts fund managers' and investors' behavior alike. The partial expense ratio distorts fund managers' behavior by not holding them accountable for their decisions to spend a substantial amount of fund assets on trading securities.

As illustrated in Exhibit A, for example, the Commission believes that investors should only be told that the expense ratio for the PBHG Large Cap Fund is 1.16%, and that they should not be told that when commissions and spread costs are included, the Fund's expense ratio for the period shown is 8.59%.¹⁴ The true cost of that Fund is more than seven times the amount shown in the Commission's expense ratio. How can it be in the best interests of investors or consistent with free market economics to require, much less permit, the Fund to show its total costs of 1.16%? The partial expense ratio is misleading because it impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership.

The data in Exhibit A does not reflect outliers, but randomly selected examples from funds with more than \$100 million in assets. If smaller funds with high turnover were considered, the differentials would be so large as to render the Commission's partial expense ratio fraudulent. For example, Lipper reports that the Rydex Telecom Fund's commissions for the fiscal year ending March 31, 2003, equaled 8.04% of assets. By applying the Zero Alpha Group study's methodology of estimating spread costs, we can estimate that total spread costs during that period equaled 8.75% of assets. Thus, whereas the Commission tells us that the Rydex Telecom Fund's is only 1.37%, its true costs are 18.16%, or 13 times higher.¹⁵ The Commission's partial expense ratio distorts investors' behavior because investors obviously would make different investment decisions if they knew the true costs of owning certain funds.

¹⁴ Exhibit A also shows that, when commissions and spread are included, the expenses of the Strong Discovery Fund rise from 1.50% to 4.50%, the CGM Focus Fund from 1.20% to 4.48%, and the RS Mid Cap Opportunities Fund from 1.47% to 7.52%.

¹⁵ The Lipper data show that at least 31 funds' expense ratios would exceed 10% if they include commissions and spread costs.

The Commission's partial expense ratio also distorts managers' behavior because it creates an incentive for them to pay for non-execution expenses with fund commissions. Under current law, fund managers can pay higher commissions – that is, more than it would cost merely to execute the fund's trades – in return for non-execution services. By paying for these non-execution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not – even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that “[t]he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services.”¹⁶

Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized,

“[s]oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers.”¹⁷

The continued concealment of portfolio transaction costs permits the soft dollar conflict to operate virtually unchecked by market forces, whereas including portfolio transaction costs in a total expense ratio would, at least, permit the marketplace to judge the efficacy of soft dollar arrangements. If Congress does not take steps to eradicate soft dollars, at least it can require that these costs be disclosed so that the market can reach its own judgments regarding their efficacy.

2. *Dollar Disclosure of Fees*

Under current disclosure rules, funds are not required to disclose to investors how much they pay in fees. Many other financial services documents show investors exactly how much they are paying the service provider, including bank statements, insurance bills, credit card statements, mortgage loans and a host

¹⁶ Concept Release at Part III.A, *supra*.

¹⁷ Donaldson Memorandum, *supra*, at 36. Regarding directed brokerage, the Commission recently stated: “We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders.” Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (Feb. 24, 2004).

of other documents. But mutual funds provide only an expense ratio (and a partial one, at that, see supra) and the dollar amount of a hypothetical account.

Congress should require that funds provide individualized dollar disclosure of fund expenses in shareholder statements, as recommended by the Government Accounting Office¹⁸ and proposed for employee benefit plans by the Department of Labor.¹⁹ This requirement is necessary for two reasons. First, although the expense ratio is appropriate for providing comparability across different funds, it does not pack the same import as a dollar amount. Providing investors with the amount in dollars that they actually spent will give concrete form to an indefinite concept and make investors consider more fully the costs of different investment options.

Second, placing the dollar amount of expenses in the shareholder statement will direct shareholders' attention to the actual costs of fund ownership. No document is more likely to be read than a shareholder statement that shows the value of the shareholder's account and transaction activity during the period. Whereas the prospectus and shareholder report typically go directly from the mailbox to the trash can, even the most uninformed investors normally open their statements to check on the status of their accounts. There is no better way to draw shareholders' attention to the costs of investing than to require that the dollar amount of fees for the period be disclosed next to the value of the investor's account.

Some members of the fund industry have opposed informing investors about the actual costs of their fund investments on the grounds that doing so would be too costly and might mislead investors. It appears that MFS Investment Management, one of the largest mutual fund managers in America, disagrees. MFS offers to include actual dollar disclosure in investor statements, which undercuts industry arguments that providing this information is economically infeasible. The Department of Labor has proposed to require dollar disclosure of fees for plan participants and the Government Accountability has recommended that the SEC do the same.

The Commission opposes disclosure of shareholders' actual costs and opposes including dollar disclosure in shareholder statements. The Commission concluded its consideration of a proposal some years ago to require funds to disclose individualized costs in shareholder statements by expressly rejecting both concepts. Instead, the Commission decided to require disclosure of the hypothetical fees paid on a \$1,000 account in the shareholder report, despite the facts that the hypothetical fees paid on a \$10,000 account are already disclosed in the prospectus, and shareholders who most need to have their attention directed to the fees that they pay are least likely to read the shareholder report. In view of the

¹⁸ Government Accounting Office, *Mutual Funds: Information On Trends In Fees And Their Related Disclosure* (March 12, 2003).

¹⁹ See DoL Proposal, *supra*.

Commission's, express opposition to effective disclosure of actual fees paid by shareholders, shareholders will receive disclosure of their actual fees in shareholder statements only if Congress requires funds to provide that information.

3. Fee Comparisons

Congress should take additional steps to promote price competition in the mutual fund industry by requiring that funds disclose fees charged by comparable funds and, for managed funds, the fees charged by index funds. Without any context, current fee disclosure provides no information about whether a fund's fees are higher or lower than its peers. Current disclosure rules also do not show the premium paid to invest in a managed funds as opposed to an index fund. Requiring comparative information in the fee table would enable investors to consider a fund's fees in context and evaluate how they compare to fees across the industry.

4. Distribution Fees

The Commission currently requires that 12b-1 fees be disclosed on a separate line that describes those fees as "distribution fees." It does not require that the fee table show the amount spent on distribution by the fund manager out of its management fee. This is inherently misleading, as investors often use the presence of 12b-1 fees as a negative screen that they use to avoid paying any distribution fees. In fact, investors in non-12b-1 fee funds may actually pay as much or more in distribution expenses than some investors in 12b-1 fee funds.²⁰

Congress should overrule the Commission's position and require that, if distribution fees are stated separately in the fee table, they must reflect all distribution expenses paid by a fund, directly or indirectly. Alternatively, Congress should require that fund expenses be displayed in a pie chart that shows how much of a fund's fees were spent on each type of service. The Commission's current fee table is misleading and understates the amount of fund assets spent on distribution.

5. Disclosure of Brokers' Compensation

For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and

²⁰ In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "the idea that investors ought to prefer the funds that don't tell what they're spending on distribution over the ones that do is nonsense. You know, if you're spending money on distribution, say it. If you're not spending money on distribution don't say it; but don't pretend that there are no expenses there for a fund that doesn't have a 12b-1 plan." Conference on the Role of Investment Company Directors, Washington, D.C. (Feb. 23 & 24, 1999) (Haaga was not ICI Chairman at this time).

harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and non-cash compensation.

Mutual fund shareholders should be entitled to receive the same information as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

Brokers also should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund. When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, however, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs.

In January 2004, the Commission proposed to require brokers to provide, both at the point-of-sale and in the transaction confirmation, disclosure of the costs and conflicts of interest that arise from the distribution of mutual fund shares.²¹ More than 5 years later, the Commission has failed to take final action on its proposal. Congress should require that the SEC take final action on disclosure requirements that will result in brokers' customers receiving disclosure of the broker's economic incentives in the transaction.

B. Distribution Arrangements.

i. 12b-1 Fees

When Congress enacted the Investment Company Act of 1940, it expressly prohibited fund managers from using fund assets to finance the distribution of the fund's shares. Section 12(b) of the Act recognized the inherent conflict of interest between the manager's desire to increase fund assets in order to increase its fees on the one hand, and the fund's desire to hold down costs on the other hand. Unfortunately, the policy underlying Section 12(b) has long been abandoned, as fund assets are used for a wide range of distribution expenses that benefit fund managers at the expense of fund shareholders.

The policy of separating the product from its distribution was first abandoned by the Commission when, after a prolonged review, it adopted Rule 12b-

²¹ Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341 (Jan. 29, 2004).

1 in 1980. In the 1970s, mutual funds experienced periods of net redemptions that prompted fund managers to lobby the Commission to permit the use of fund assets to finance the distribution of the funds' shares. Fund managers argued that net redemptions resulted in increased costs and that the financing of distribution by the fund would help reduce or eliminate net redemptions.

The Commission initially rejected these arguments, but ultimately relented, provided that certain conditions were observed. For example, the Commission required that the fund's independent directors approve the 12b-1 plan. Among the factors that the Commission said a fund's directors should consider when evaluating whether to adopt or renew a 12b-1 plan was the plan's effectiveness in remedying the problem that it was designed to address, *i.e.*, increased costs resulting from net redemptions.

The Commission's most significant concern regarding 12b-1 fees was the conflict of interest that they created between the fund and its adviser. The Commission feared that 12b-1 fees would result in higher advisory fees and the fund's adviser would not share the benefits of asset growth.²² Some would argue that this is precisely what has happened, with any growth-based economies of scale realized from 12b-1 fees being pocketed by fund managers and not shared with fund shareholders.

Of course, this analysis goes primarily to the use of 12b-1 fees for marketing the fund, which is what Rule 12b-1 was intended to permit. It does not address the ways in which 12b-1 are actually used today and that were wholly unanticipated by the Commission when Rule 12b-1 was adopted. According to an Investment Company Institute report, only 5% of 12b-1 fees are spent on advertising and sales promotion, whereas 63% of 12b-1 fees are spent on broker compensation.²³

The use of fund assets to compensate brokers is precisely what Section 12(b) was intended to prohibit. This practice puts the fund squarely in the position of underwriting its own securities. The fund's assets are used to incentivize brokers to recommend the fund over competing funds. The lesser the quality of the fund, the greater the pressure on the fund and its manager to pay brokers more to sell the fund.

This irreconcilable conflict is mirrored on the distribution side of the business. When brokers are paid by the funds, rather than their customers, they

²² See Donaldson Memorandum, *supra*, at 70-71 ("When a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.").

²³ Use of Rule 12b-1 Fees by Mutual Funds in 1999, Investment Company Institute, 9 Fundamentals 2 (April 2000). Funds spend the other 32% of 12b-1 fees on administrative services. *Id.*

have an incentive to recommend the fund that offers the biggest payout, rather than the fund that will provide the best investment for their customers.²⁴ There is another incentive for brokers to favor arrangements whereby they are compensated by funds, and that is the fact that the compensation from the fund is not transparent. Whereas the payment of a front-end load is relatively evident to the investor, the payment of a 12b-1 fee is not. It is even less clear that the already opaque 12b-1 fee is ending up in the broker's pocket. For this reason, brokers and investors have begun to favor classes of fund shares where the broker is compensated by the fund, regardless of whether that class is in the best interests of shareholders.²⁵

Thus, the Commission has created a distribution compensation structure that is directly at odds with the interests of investors and the Investment Company Act. Rather than tying brokers' compensation to their relationships with their customers, where the Investment Company Act requires that it be placed, the Commission has tied brokers' compensation to their relationships with the funds, where the Investment Company Act expressly forbade its placement.

Congress should reaffirm the supremacy of Section 12(b) and prohibit funds from compensating brokers for selling fund shares. Although this will necessarily entail the repeal of Rule 12b-1, it will in no way limit the ways in which investors can choose to pay their brokers. It will simply require that however brokers are compensated – through a front-end load, back-end load, level-load, or any combination thereof – they are compensated by their customers, not by the funds. Thus, if a customer chooses to pay his broker on an installment basis, at 0.50% each year, for example, that amount would be paid by the customer directly or deducted from his fund account.

One might argue that, to maintain perfect legislative coherence, Congress should also prohibit fund managers from paying for general marketing services that are not connected to specific sales. I disagree. The conflict is substantially reduced in this situation because the fund manager's and the fund's interests are generally aligned. General marketing payments do not create a direct incentive for brokers to favor one fund group over another. General marketing does what advertising for decades has been shown to do: promote competition. Indeed, by locating these payments in the management fee, the manager will be spending its own money and accordingly will have an incentive to minimize costs. With an express requirement that independent fund directors evaluate the efficacy of fund manager expenditures on marketing and determine that resulting economies have been shared with fund

²⁴ See Laura Johannes and John Hechinger, *Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds*, Wall St. J. (Jan. 9, 2004); see also *In the Matter of Morgan Stanley DW Inc.*, Exchange Act Rel. No. 48789 (Nov. 17, 2003).

²⁵ See Complaint, *Benzon v. Morgan Stanley*, No. 03-03-0159 (M.D. Tenn.). The SEC has banned the use of brokerage as compensation for fund brokerage.

shareholders, expressly permitting fund managers to use the management fee to pay for marketing would be appropriate.

ii. *Revenue Sharing.*

Over the last two decades, a compensation practice has evolved that strikes at the heart of the principle of full disclosure of conflicts of interest. Known as “revenue sharing,” this practice involves the payment of a part of fees collected by a mutual fund manager to a third party in return for administrative and/or distribution services. Notwithstanding the somewhat pejorative term “revenue sharing,” there is nothing necessarily inappropriate about the practice itself. Broadside critiques of revenue sharing are off base. Revenue sharing primarily reflects a compensation structure that can be a more efficient method of compensation than direct charges by each service provider to the client. Indeed, 12b-1 fees are functionally a kind of revenue sharing that are subject to enhanced (but still inadequate, *see supra*) disclosure requirements.

That being said, the regulation and practice of revenue sharing disclosure has been abysmal. Revenue sharing payments are generally included in the total fees charged by a fund. Unlike 12b-1 fees, they are not, and are not required to be, broken out separately in the mutual fund fee table. More importantly, they are not necessarily disclosed by the service provider that receives them. Revenue sharing constitutes compensation to service provider that is not part of the fees charged directly to the client, so the client often is unaware of the service provider’s economic incentive to sell the fund. When a broker recommends funds to clients, the broker does not disclose, and has not been required to disclose by the SEC or FINRA, that the broker will receive different amounts of revenue sharing payments depending on the fund purchased. The revenue sharing payments are made under the table; this blatant conflict of interest goes undisclosed.

This is a significant problem in the context of brokers’ mutual fund sales. The SEC and FINRA continue to defend a suitability standard for brokers that does not require full disclosure of conflicts of interest, even when the broker is providing individualized investment advice to the client (as opposed to acting solely as a salesperson). This means that brokers can recommend funds that are “suitable” without disclosing that they are receiving higher revenue sharing payments from that fund’s manager than they would receive from the manager of a *more* suitable fund. The fees are not trivial. One SEC settlement involving revenue sharing payments revealed that brokers were receiving payments equal to 25% of the fund advisory fee in revenue sharing payments on every sale of that fund’s shares. It is inexcusable that brokers are not required to disclose this payment differential to their clients.

Unlike brokers subject only to a suitability standard, fiduciaries generally have been required to disclose revenue sharing to their clients. In *SEC v. Capital Gains Research Bureau*, the Supreme Court held that that an investment adviser, as a

fiduciary, was required to disclose all material conflicts of interest to clients. Courts have generally applied this principle to the disclosure of revenue sharing payments on the ground that this information would be of importance to advisory clients. The Seventh Circuit recently held, however, that an Erisa fiduciary has no obligation to disclose revenue sharing payments to beneficiaries as long as the total fees being paid are disclosed. This is a truly remarkable position, especially in the wake of recent legislation that permits conflicted persons to provide investment advice to 401(k) plan participants on the condition that their compensation be the same regardless of the investment option selected. In other words, while Congress has been addressing the conflicted advice problem by flatly **prohibiting** differential compensation, the Seventh Circuit has decided not only that differential compensation can be received by an Erisa fiduciary, it does not even need to be **disclosed**.

Both the SEC and FINRA have proposed rules that, depending on their final form, would require the disclosure of differential compensation. These rules, like many important investment management initiatives, have been pending for years. While the SEC has been paralyzed with indecision, state attorneys general have sued fund managers and brokers for their failure to disclose revenue sharing arrangements in their prospectuses and to their clients. The SEC's failure to take a position one way or the other has created an unpredictable patchwork of regulation that benefits no one, especially not those who appropriately use revenue sharing in their compensation structures. And the SEC's failure to require the disclosure of revenue sharing payments has allowed the practice to flourish.

Congress should not continue to wait for regulators to recognize the obvious policy imperative of requiring full disclosure of conflicts of interest to financial services clients. In the last six years, a number of bills have been proposed that would, in one form or another, require the disclosure of revenue sharing and other forms of differential compensation. Congress should act promptly to enact some form of this legislation. The committee reports should make it clear that payments that create potential conflicts of interest must be disclosed and that the legislation is intended to overrule the Seventh Circuit's *Deere* decision.

iii. Misleading Fund Share Classes

Mutual funds often offer several classes of shares that reflect different ways of paying for distribution services. Typically, Class A shares carry a front-end load, Class B shares a back-end load, and Class C shares carry a level load. An investor is usually better off buying Class A shares if he intends to hold his shares for the long-term, and Class C shares if he may sell in the short-term. When Class B shares are best option, it is for the shareholder who holds for the mid-term. In some cases, however, there is virtually no shareholder for whom Class B shares are the best option.

The Commission does not prohibit funds from offering Class B shares, even when there is no shareholder for whom Class B shares could be the best investment option. The Commission even rejected a rule amendment that would have required that funds illustrate in the prospectus the relative costs of each class of shares. Following the Commission's lead, a federal court held in January 2004 that, even assuming that there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.²⁶

It is unconscionable that under current Commission positions a fund can offer a class of shares that would not be the best investment for any rational investor. Congress should require that multi-class funds illustrate, in a graphic format, the costs of investing in different classes over a 15-year period. In addition, Congress should require that the fund's independent directors find, subject to a fiduciary duty as described above, that each class of shares offered could be a reasonable investment alternative.

C. Fund Advertising

Throughout the late 1990s, the Commission frequently berated the fund industry for misleading investors by advertising short-term performance. Funds with short life-spans routinely advertised one-year, sometimes even two- and three-year annualized investment returns in excess of 100%. With the crash of the stock bubble in 2000, the Commission's concerns were validated, as many of these funds experienced huge losses, in some cases in excess of 70% of their value.

The Commission's actions have not reflected its words, however. In September 2003, the Commission adopted advertising rules that utterly failed to address the very problems that it had identified in the late 1990s.²⁷ The rules require funds to provide a telephone number or web address where current performance information is available, as if the problem with short-term performance was that it wasn't current enough. The Commission also required that the text in fund ads include the statement that "current performance may be higher or lower than the performance data quoted."

Fund advertisements posted following market declines in 2000 - 2002 demonstrate the inadequacy of the Commission's new rules. After three years of negative returns, stock funds had a banner year in 2003. Many of those funds are now advertising their stellar one-year performance without any disclosure of their poor returns in 2000, 2001, and 2002. Because they are required only to show their one-, five- and ten-year returns, the negative returns of 2000 to 2002 are hidden

²⁶ See *Benzon v. Morgan Stanley, Morgan Stanley*, 2004 WL 62747 (M.D. Tenn.).

²⁷ Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 26195 (Sep. 29, 2003).

from view. The ads create a misleading impression by showing the outsized returns of 2003 without any mitigating disclosure of the down years that preceded them and the performance volatility that those years' returns illustrate.

For example, one ad shows SEC-mandated performance for four funds, each of which experienced superior returns in 2003, but experienced losses or substantially lower performance in each year from 2000 to 2002. As illustrated in the table below, the disclosure of each fund's annual performance in the years preceding 2003 would have presented a very different, far more accurate picture. The Commission's rulemaking has done nothing to prevent such misleading ads, which have appeared routinely in business and personal finance magazines in the first few months of this year.

Funds	Disclosed*	Not Disclosed**		
	2003	2002	2001	2000
Fund #1	51.68%	(21.27%)	(7.56%)	(18.10%)
Fund #2	42.38%	(9.37%)	(12.99%)	(8.96%)
Fund #3	23.36%	(20.44%)	(3.74%)	12.25%
Fund #4	29.96%	(17.16%)	(5.02%)	8.54%

* Source: Business 2.0 (March 2004)

** Source: Fund Prospectuses.

The Commission's rulemaking also did nothing to address the problem of the disconnect between the advertised performance of funds and the actual returns experienced by shareholders. As confirmed by a recent DALBAR study, "[i]nvestment return is far more dependent on investment behavior than on fund performance."²⁸ DALBAR found that the average equity fund investor earned **2.57%** annually over the last 19 years, in comparison with the S&P 500's **12.22%** annual return during the same period. This translates into a cumulative return for the S&P 500 of **793.34%** from 1984 to 2002, compared with equity fund investors' actual cumulative return of **62.11%** during the same period.

These stunning and disheartening data illustrate, in part, a failure of investor education and individual choice. Investors have consistently chased the best performing funds just before they crashed, and dumped the worst performing funds just before they recovered. This sell-high, buy-low mentality is only encouraged by the Commission's current approach to fund performance advertising, which permits funds to present outsized returns with no meaningful caveats regarding their volatility and the likelihood that performance will soon revert to the mean.²⁹

²⁸ DALBAR, Quantitative Analysis of Investor Behavior at 2 (2003).

²⁹ Notably, the Commission requires that the prospectus include a bar chart that shows a fund's return for each of the preceding ten years. If such a disclosure is necessary to make the prospectus

Not only do current rules fail to require meaningful disclosure about the volatility of fund returns, but they also fail to place outsized, one-year returns in the context of the market as a whole. To illustrate, the performance of the S&P 500 for 2003 was 28.68%, which puts the 51.68% return of the Fund cited above in a light very different (albeit still positive) from one in which the performance data stands alone. The Fund's advertised ten-year return of 10.58% would tell a different story if it were required to be juxtaposed against the S&P 500's 11.07% ten-year return.

The Commission also has recognized the need for investment returns to be considered in the context of fees, yet its rules do virtually nothing to benefit investors in this respect. In its proposing release, the Commission promised that its new rule would "ensure that fund advertisements remind fund shareholders about the availability of information about fund charges and expenses."³⁰ Yet the final rule required only that fund advertisements refer investors to the prospectus for consideration of fund expenses, among other things.³¹ In contrast, the NASD has proposed that fund advertisements include a box that shows both the fund's maximum sales charge and its expense ratio.³²

Congress should require that fund advertisements include all information necessary to make the information presented not misleading. This must include, at a minimum, investment returns for each individual year where such returns differ materially from fund's one-year performance, disclosure of the fund's total expense ratio (*i.e.*, including the fund's portfolio transaction costs) and sales charges, and the performance and expenses of a comparable index fund.

D. Soft Dollars

The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded \$1 billion in 1998.³³ An executive with American Century Investment Management has testified that the research

not misleading, it is unclear why the same reasoning is not applicable in the context of a fund advertisement.

³⁰ Proposed Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 25575, Part II.C (May 17, 2002).

³¹ Amendments to Investment Company Advertising Rules, *supra*.

³² See Disclosure of Mutual Fund Expense Ratios in Performance Advertising, National Association of Securities Dealers (Jan. 23, 2004).

³³ Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998).

component of soft dollar commissions costs six times the value of the execution component.³⁴

Soft dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for themselves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft dollar benefits.³⁵

Soft dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.³⁶ Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio. Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

The Commission has frequently recognized but declined to address the problem of soft dollars. As discussed above, the Commission is opposed to including portfolio transaction costs in funds' expense ratios, which would have the benefit of enabling the market to determine for itself the efficacy of soft dollar arrangements.

³⁴ Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (Mar. 12, 2003).

³⁵ *Id.* at 2 (the statutory safe harbor permitting soft dollars arrangements "encourages investment managers to use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager")

³⁶ See Investment Company Act Section 17(e); Inspection Report at 38, *supra*.

The Commission previously proposed a rule that would require that soft dollars costs be quantified, but decided against adopting it.³⁷ When the Commission staff last evaluated soft dollar arrangements in 1998, it concluded that additional guidance was needed in a number of areas.³⁸ For example, the staff found that many advisers were treating basic computer hardware -- and even the electrical power needed to run it -- as research services qualifying under the Section 28(e) safe harbor.³⁹ The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars, but it has failed to do so.

In fact, the only formal action that the Commission has taken in recent years is to ***expand the use of soft dollars***. In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions."⁴⁰ This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that section 28(e) "does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."⁴¹ Although the Commission has, once again, suggested that intends to narrow the scope of soft dollars, its recent history suggests that Congressional action is necessary. In any case, the Commission lacks the authority to ban soft dollars.

There is no better evidence that the time has come to ban soft dollars than the recognition of the insidious nature of this practice by members of the fund industry. In addressing the fact that soft dollars enable fund managers to use the fund's money to pay for research used by the manager, the independent chairman of the Putnam Funds has stated that "[t]he best decisions get made when you buy services with your own money."⁴² Similarly, MFS' chairman, Robert Pozen,

sees the soft-dollar funnel as a lucrative one for brokers, but one that hides the true cost of such services to shareholders. "It's all

³⁷ Donaldson Memorandum at 13-17, *supra*. Fidelity recently recommended that the Commission reconsider its decision not to require the quantification of soft dollar costs. Ann Davis, Fidelity Wants Trading Costs to Be Broken Down, Wall Street Journal (Mar. 15, 2004).

³⁸ Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998) ("Section 28(e) Report").

³⁹ *Id.* at Section V.C.4.

⁴⁰ Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Rel. No. 45194 (Dec. 27, 2001).

⁴¹ Investment Advisers Act Release No. 1469 (February 14, 1995).

⁴² *Id.* (quoting John Hill).

camouflaged,” said Mr. Pozen, a former associate general counsel of the SEC. Now, he added, “If we want something, if we think it's valuable, we will pay cash.”⁴³

A Fidelity executive has acknowledged the pro-competitive advantage of a ban on soft dollars, stating: “[w]e don't rule out a competitive environment through which all research is acquired through cash rather than commissions.”⁴⁴

The difficulty for fund firms, however, is that without a statutory ban on soft dollars they may suffer a competitive disadvantage. MFS has estimated that paying for its own research will reduce its advisory fees.⁴⁵ Fidelity has estimated that of the \$1.1 billion in commission it paid in 2003, \$275 million paid for soft dollar research.⁴⁶ It is unrealistic to expect these fund managers to maintain the high road at the expense of reduced advisory fees, while other fund managers continue to pay their own research expenses through soft dollars rather than out of their own pockets.

E. Fund Names and Investor Expectations.

The recent collapse of the stock market has exposed a significant gap in the regulation of mutual fund names. The average investor will reasonably assume that funds will invest consistent with their names, but mutual fund rules do not require that funds honor these expectations.

To illustrate, one would expect a Target Date 2010 Fund to be designed to fit the needs of someone who planned to retire at age 65 in 2010. Such a fund would invest in mix of stocks and bonds. The investment of stocks carries higher risk, but this risk is necessary to provide the growth potential needed by someone who may live 30 or more years after retirement. The fixed income securities provide stability to ensure that assets that will be needed for living expenses in the near term are not exposed to risk. There is no definitive asset allocation between stocks and fixed income securities in which a Target Date 2010 Fund should invest, and one could not argue that under no circumstances would it be appropriate for a 65-year-old retiree to have an 80% stock/20% bond mix, but such a mix would fall well outside the generally expected asset allocation of a Target Date 2010 Fund.

⁴³ *Id.*

⁴⁴ Landon Thomas, Jr., *Mutual Fund Tells Wall Street It Wants à la Carte Commissions*, New York Times (Mar. 16, 2004).

⁴⁵ *MFS Ends 'Soft Dollar' System*, *supra*.

⁴⁶ *Fidelity Wants Trading Costs to Be Broken Down*, *supra*.

Mutual fund disclosure rules would allow a Target Date 2010 Fund to adopt such an 80%/20% asset allocation. Notwithstanding that the Fund's name suggests a substantially lower stock allocation, the description of the Fund's investment objectives and style in its prospectus could correct this misimpression and investors would be expected to have read and understood such clarifying disclosure. Under current prospectus liability rules, the true nature of the Fund's aggressive asset allocation strategy could even be omitted from the summary of its investment objectives and style in the summary prospectus as long as corrective disclosure appeared elsewhere in the full prospectus. (It is likely that some courts would find that even corrective disclosure buried in the Fund's Statement of Additional Information, which is delivered to investors only upon request, would be a sufficient defense for prospectus liability purposes.) Thus, investors that expect the stock allocation suggested by the name of the Target Date 2010 Fund to be substantially lower than 80% and do not carefully scrutinize other fund disclosure documents will be subject to more risk than they expected. For example, a 45% decline in the stock market would result in a 36% decline in the value of their Fund shares, when they might have expected an 18% or 22.5% based on a 40% or 50% stock allocation.⁴⁷

It is helpful to consider a recent example of this problem. A particular Target Date 2010 Fund has been criticized for declining 38% in value, but this decline is consistent with its aggressive asset allocation. The fourth page of the fund's prospectus (for the relatively assiduous investor) states that each retirement fund:

is managed to the specific year of planned retirement included in its name (the 'retirement date'). The Strategies' asset mixes will become more conservative each year until reaching the year approximately fifteen years after the retirement date (the 'target year') at which time the asset allocation mix will become static.

At this point, the prospectus has only reinforced the expectation that the 2010 fund's asset allocation strategy will reflect a stock allocation in the range of 40% to 50%. Under current law, this disclosure by no means created an expectation on which investors could actionably rely. Indeed the same paragraph includes a state that 15 years after retirement the static allocation would be: 27% short-term bonds, 37.5% other fixed-income securities, 25% equities and 10% real estate investment trusts ("REITs"). From this, a very attentive investor could assume that the stock allocation at retirement would be fairly aggressive. The fifth page of the prospectus includes table that shows an expected allocation of approximately 77%

⁴⁷ Tom Laurcella, *For Retirement, 'One Size' Isn't Always a Good Fit*, Wall. St. J. (Mar. 2, 2009) available at <http://online.wsj.com/article/SB123549381087960625.html> ("A typical fund for an investor aiming to retire 20 years from now might have at least 80% in stocks. By the time the retirement date approaches, most funds typically have less than 40% in stocks.").

of the 2010 fund's assets to equities, REITS and high-yield debt in the year before retirement.

The problem is that this fund's allocation is inconsistent with what many investors will expect from a Target Date 2010 Fund. There is no reason that this fund's sponsor should not be allowed to offer a fund for retirees who wish to adopt an aggressive asset allocation. In combination with other investments the retiree might hold, the retiree's overall asset allocation might fall within the more typical 40% to 50% range. But, in the words of a Fidelity executive, something called a "target-date" fund should follow a "one size fits most" strategy, and this fund fails that test.

This problem is not limited to target-date funds. In some 529 plans, there are asset allocations designed for children expected to need the funds for college within one or two years that experienced substantial losses. These losses were inconsistent with the investment performance range one would expect from a conventionally constructed portfolio for such a short time horizon. Some of these 529 plans invested in bond funds that included "short-term" in the fund's name, but their investment returns fall well outside of the variance one would associate with short-term bond funds. Many "short-term bond" funds held outside of 529 plans have produced abnormally high losses.

To reiterate, the problem here is **not** that some funds have experienced substantial losses. To the extent that investors knowingly assumed the risk of large losses, criticizing these funds is somewhat unfair. For example, actively managed funds that lost 60% of their value while comparable markets lost only 40% provided their investors with returns that were within the range of variance from market returns that one assumes by accepting active management risk. One could criticize such funds for poor stock-picking, but it was the shareholder who chose to assume the active management risk that the fund would underperform the market. Similarly, the shareholder invested in a Target-Date 2050 Fund should expect to experience large losses when stock markets experience significant declines. In this case, it would be the Target-Date 2050 Fund that invested most of its assets in money market instruments that would be contradicting the asset allocation implied by its name.

The SEC has had the opportunity to address the potential of fund names to mislead investors. Pursuant to a request from consumer advocates, the SEC adopted a misleading fund names rule in 2001. The rule fell far short of providing reasonable assurances that fund names that strongly implied a particular investment objective or style would stick to it. The rule allows "stock" funds to invest 100% of their assets in cash in emergency situations, "short-term bond" funds to risk substantial losses, "value" funds to invest primarily in growth stocks, and "target-date 2010" funds to invest a more than 75% of their assets in equities. The SEC has taken the position that no matter how strongly a particular fund name implies a particular investment objective or style, the name's potential to mislead

investors can be entirely corrected through narrative disclosure that is often buried in fund documents. The SEC staff went out of its way to reassure fund managers that funds that included the term “U.S. Government” in its name could nonetheless invest 100% of its assets in securities issued by Fannie Mae and Freddie Mac.⁴⁸ As I testified before this Committee in 2004, the term “U.S. Government” implies that the fund will invest in government-guaranteed securities, which Fannie Mae and Freddie Mac securities are not.

Although investors should read prospectuses carefully before investing, I disagree that investors whose investments in a “target-date 2010” fund, a “short-term bond” fund or 529 plan investment option for a 16-year-old that declined more than 40% in one year are entirely to blame for their misfortune. Congress should enact legislation that meaningfully regulates fund names. It should require the SEC to prohibit the use of fund names that create a common expectation among investors regarding a fund’s investment objectives and style unless the fund invests consistent with that style. The precise scope of the rule should be left to the SEC, but there should be no question that terms such as “target-date,” “short-term bond,” and “value” would be covered. Fund sponsors use these terms in fund names precisely to communicate something about the fund to investors. They should not be permitted to contradict the fund name’s message with qualifying disclosure in fund documents.

Some have criticized this position as requiring that the government dictate how funds invest. This argument is a red herring designed to divert attention from the real issue. The only restriction that would apply would be to the names that funds are permitted to use. The new rule would have no effect on any fund that chose a name that did not imply a particular investment objective or style. I strongly agree that free markets should determine what mutual funds invest in, not regulators. Requiring that *all* mutual funds invest only in a portfolio the returns of which will fall within a fairly predictable range would be inefficient, impracticable and inconsistent with basic principles of individual liberty. There are and should be mutual funds the variance of the investment returns of which essentially match the scope of the fund manager’s investment discretion.

Requiring that a fund that uses a particular name produce predictably variable returns, however, does not implicate these concerns. When Magellan Fund manager Jeff Vinik invested a large amount of the Fund’s assets in fixed income securities prior to a run-up in the stock market in the late 1990s, the opportunity lost by its shareholders was a risk that they knowingly assumed. There is nothing about the name “Magellan Fund” that implies that its investment returns will reflect the variance that is characteristic of a particular market. Indeed, the name “Magellan” aptly suits a fund that may explore any and all investment opportunities

⁴⁸ Letter from Paul F. Royce, Director, SEC Division of Investment Management, to Craig Tyle, General Counsel, Investment Company Institute (Oct. 17, 2003).

around the globe. In contrast, it is misleading that a so-named “stock” fund can, consistent with its name, invest 100% of its assets in cash, or that something called a “short-term bond” fund could lose 40% of its value in a single year.

F. Fund Governance

As indicated by this testimony, the breadth and depth of investor protection issues in the mutual fund industry that have been left unattended by regulators calls for new ideas on the most efficient structure for mutual fund regulation. The mutual fund scandal of 2003 also demonstrated the need for more independent boards. As described in greater detail in my March 23, 2004 testimony before this Committee, Congress should implement the following reforms to strengthen the oversight of mutual funds:

- Create a Mutual Fund Oversight Board that would have examination and enforcement authority over funds and fund boards.
- Require that a fund’s chairman be independent.
- Require that a fund’s board be 75% independent.
- Prohibit former directors, officers and employees of the fund manager from serving as independent directors.
- Require that independent directors stand for election at least once every five years.

The Commission does not have the authority to impose any of these requirement on an unconditional basis. Each of these proposals requires Congressional action.

IV. 529 PLANS

As this Committee is aware, 529 plans have become an increasingly popular means for Americans to save for higher education. These plans have enjoyed enormous appeal in part because they offer a unique combination of federal and state tax benefits, high contribution limits, matching state contributions, donor control, automatic rebalancing and, in many cases, low costs. However, 529 plans also have been subject to criticism on the grounds of excessive and inadequately disclosed fees, inconsistent state tax treatment across different plans, and questionable sales practices. The following discussion briefly sets forth some of the issues relating to 529 plans and proposes regulatory reforms.⁴⁹

A. Regulatory Oversight

Permitting states to sell and regulate 529 plans has effectively added 50 new regulators for tax-deferred mutual fund wrappers (*e.g.*, 401(k) plans, IRAs, Roth IRAs, and 403(b) plans), which are subject to too many different regulators and sets of rules as it is. The Commission is responsible for fee disclosure for variable annuities, the Department of Labor is responsible for fee disclosure for employee benefit plans, and banking regulators and the Internal Revenue Service are responsible for fee disclosure for IRAs. Multiple disclosure regimes confuse investors and increase the costs of offering investment products, as each provider must tailor its program to the particular state's requirements. The Committee should take this opportunity to explore ways of rationalizing fee disclosure and other regulatory aspects of various tax-deferred mutual fund wrappers.

One option would be to assign exclusive oversight of 529 plans to the SEC. The SEC has greater experience and expertise in this area than any other government entity, and it would bring greater independence and objectivity to the creation and enforcement of 529 plan fee disclosure requirements. The states, as the issuers of interests in 529 plans, lack the independence and objectivity to regulate their own plans and to enforce any rules they might devise. Congress should consider specifically authorizing the Commission to establish comprehensive rules governing the 529 plan fee disclosure, and consider expanding this responsibility to all aspects of 529 plans operations.

In addition, Congress should consider amending the municipal securities exemption to exclude 529 plans or permitting private firms to offer 529 plans outside of state sponsorship. The municipal exemption under which 529 plans operate was not intended for the offering of retail financial services, but for the conduct of *bona fide* government activities. There is nothing state-specific about

⁴⁹ Many of these issues are discussed in greater detail at: Mercer Bullard, *The Visible Hand in Government Sponsored Financial Services: Why States Should Not Sponsor 529 Plans*, 74 U. Cin. L. Rev. 1265 (2006).

529 plans that could not be accomplished outside of the framework of a money management structure.

B. Fee Disclosure

Some commentators have criticized 529 plans on the ground that the high fees charged by many plans have reduced the potential tax benefits of the plans. Indeed, one commentator decried a plan that consumed more than 10 percent of participants' balances each year for two years. Determining whether a particular fee is too high or too low, based solely on the amount of the fee, is a difficult and uncertain exercise. In my view, the best way to promote efficient pricing is through standardized, transparent disclosure of fees. It is generally accepted that standardized, transparent fee disclosure promotes competition and reduces prices. The disclosure of 529 plan fees, however, is generally incoherent and obscure, and 529 plans would likely be forced to reduce their fees if adequate fee disclosure were provided.

The lack of transparent, prominent, standardized disclosure of 529 plan fees is exacerbated by factors in the 529 plan context that make fee disclosure even more important than in other contexts. In effect, certain governmental entities have been granted an exclusive monopoly to sell a particular tax-deferred investment product in competition with private providers of other tax-deferred investment products. This intrusion of the government into the private sector may distort many functions of the financial services markets, including the setting of fees.

For example, investors may lower their guard when evaluating 529 plans on the assumption that a public-minded governmental entity would sell only a high-quality, low-cost investment product. In fact, states' interests may not be aligned with plan participants' interests with respect to negotiating fees and choosing investment options, and investors' trust in states' motivations and interests may be misplaced. States may have incentives to offer plans that charge high fees. States may charge high fees as a means of increasing their general revenues, or charge higher fees to out-of-state residents as a way to subsidize services provided to in-state participants. Political considerations also may influence the selection of money managers and cause states to be less diligent when negotiating fees. For example, states may favor in-state money managers or managers that have contributed to the election campaigns of state officials. State officials may even use 529 plan assets for self-promotion.

Further, participants in 529 plans have limited control over fees. Mutual funds can raise advisory and 12b-1 fees only with shareholder approval, whereas states generally can raise fees at will without notice to participants, thereby making it more important that investors understand the fees charged before making an investment decision. When a mutual fund that is a 529 plan investment option seeks to raise its fees, the state has the right to vote on the fee increase, but, as noted above, it may not have the same interests to negotiate low fees as plan participants

have. Finally, federal law gives mutual fund shareholders legal recourse against a fund's directors and manager with respect to excessive fees charged by the manager, which may provide some restraint on fees. Participants in 529 plans, however, have no such rights absent a violation of the antifraud rules under the federal securities laws.

Restrictions on 529 plan investment options, participants' limited control over fees and fee increases, the costs and burdens of transferring from one plan to another, states' monopoly on state tax benefits, limited legal recourse against plan sponsors, and the divergence of state and participant interests are some of the special factors that make it especially critical that 529 plan fees be fully disclosed in an understandable, standardized, accessible format.

These special factors militate for prompt Congressional action to ensure that 529 plans are required to provide standardized, transparent, prominent fee disclosure. In short, fee disclosure for 529 plans, at a minimum, should be:

- Standardized, both in the way in which the fees are calculated and the terms used to describe the fees;
- Prominently disclosed relative to other information about the plan;
- Presented both as a percentage of assets and a dollar amount, and on an illustrative and individualized basis;
- Inclusive of a total expense ratio for each investment option that includes all fees incurred in connection with an investment in the plan, to include, among other things, portfolio transaction costs, distribution costs, operating costs and administrative fees, whether charged by the state, plan manager, investment manager, or other person;
- Inclusive of a pie chart that illustrates the components of the total expense ratio according to standardized categories of fees, such as investment management, administrative services, and marketing and distribution;
- Inclusive of information on fees charged by other 529 plans both in a disclosure document and in an easily accessible format on the Internet; and
- Inclusive of separate disclosure of all payments received by intermediaries for executing the transactions in plan interests, both as a dollar amount and percentage of assets, whether or not the payment is made directly by the participant.

As discussed above, Congress should ensure that fee disclosure requirements for 529 plans are promulgated and enforced by an independent, objective government entity.

C. Disparate State Tax Treatment

Most states that permit state deductions for 529 plans limit the deductions to the in-state plan. This disparate state tax treatment of 529 plans distorts the marketplace for investment products. Investors may opt for a higher-cost, in-state plan specifically in order to receive the tax benefits of the in-state plan, or may miss out on the in-state tax benefit offered by a low-cost in-state plan because brokers recommend out-of-state plans that pay higher compensation to the broker.

The disparate state tax treatment of 529 plans has the effect of reducing price competition among 529 plans because in-state plans can exploit their monopoly on in-state tax benefits to offset their higher fees. This is essentially a kind of bundling, not dissimilar to a private company that has a government-granted monopoly over one product (state tax deductions) to help it sell another, possibly inferior product (the 529 plan). States will inevitably exploit this monopoly to the detriment of investors in 529 plans. The unavailability of state tax deductions for out-of-state plans may further undermine market efficiency and create incentives to charge higher fees, as discussed in the next section. A small minority of states have extended their state tax deduction to out-of-state 529 plans, but most continue to frustrate Congress's intent in creating the plans. Congress should consider mandating that any state tax deductions for 529 plan contributions or distributions be reciprocal across all qualified 529 plans.

V. HEDGE FUNDS

A. Systemic Risk

There is no question that hedge funds are a potential source of systemic risk, that is, the kind and scope of financial risk that is systemic in the sense of posing a threat to our political, social and economic systems. Systemic risk warrants government oversight because our society might not be able to absorb an extreme contraction of free financial markets without long-term damage to political, economic and social institutions. This concern militates for appropriate prudential oversight of hedge funds, such as requirements that they report net positions and leverage ratios.

This does not mean that hedge funds or their advisers should be subject to substantive regulation, however. It is important that capital be allowed to flow to unregulated intermediaries such as hedge funds. Investment in hedge funds is limited to sophisticated investors, and these investors are presumed to be in the best position to protect their interests without costly governmental oversight. Substantive regulation of hedge funds will simply drive sophisticated capital offshore and provide little benefit to the financial markets.

As discussed below, however, the SEC has permitted hedge funds to be sold to unsophisticated investors in certain circumstances.

B. Public Offering of Hedge Funds

In 2007, the SEC effectively decided to permit hedge funds to publicly offer their shares. These hedge funds argued that they reflected investments in hedge fund *managers*, not in the funds, yet the value of interests that they sold were predominantly depended on the success of their funds. The financial structure of these public companies is closer to a hedge fund than to a conventional money manager,⁵⁰ and the behavior of the stock prices of public hedge funds and conventional money managers over the last two years has reflected the significantly greater risks posed by the former. As predicted, these publicly held hedge funds are acting like hedge funds, not money managers. Much attention is being – and should be -- paid to the systemic risk posed by hedge funds, but too little has been paid to the sale of hedge fund interests to unsophisticated investors. If the SEC continues to be unwilling to ensure that hedge funds are sold only to sophisticated investors, Congress should prohibit the public offering of shares of these entities.

C. Accredited But Unsophisticated Investors.

Under current law, persons with net worth of \$1 million either alone or with their spouse qualify to invest in hedge funds. The SEC has conceded that this test, which has not been adjusted since 1982, has made millions of new investors eligible to invest in hedge funds at the same time that “private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.” The Commission estimated that the minimum net worth requirement, if adjusted only for inflation and disregarding the issue of increased complexity, would have been \$1.9 million as of July 1, 2006. That year, the Commission issued a modest proposal to increase the \$1 million minimum to \$2.5 million. That minimum would be inflation-adjusted again on July 12, 2012 and every five years thereafter. In 2007, the Commission requested additional comments on the proposal, but almost three years after the initial proposal, the Commission has yet to take final action.

The effect of the SEC’s position is that a newly retired couple with \$700,000 investments and a \$300,000 home -- the SEC continues to count a person’s personal residence counts toward the \$1 million net worth minimum while conceding that the “value of an individual’s primary residence may have little relevance with regard to the individual’s need for the protections of Securities Act registration” – is

⁵⁰ See *After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?* Hearing before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform (July 11, 2007) (testimony of Mercer Bullard); Mercer Bullard, *Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen*, 13 Stanford J. Law, Bus. & Fin. 286 (2008).

sophisticated enough to invest in a hedge fund. With \$700,000 in investments, a retired couple's typical withdrawal rate would be 4 or 5 percent annually, or about \$31,000 per year, plus Social Security income and, in some cases, a company pension. Even assuming additional income of \$20,000 per year (which would not be needed for the couple to meet the SEC standard), it is self-evident that this couple's net worth in no way qualifies them to risk their retirement security in a hedge fund. Nearly three years after its initial proposal (and 27 years after the \$1 million minimum was first established), the SEC continues to permit hedge funds to prey on unsophisticated investors. Congress should take steps to ensure that any individual net worth standard for private offerings bears a reasonable relationship to the likely financial sophistication of the purchaser.

VI. INVESTMENT ADVISERS

A. Fiduciary Standard

It is hard to understand how, after years of regulatory review, the simple question of whether those who provide individualized investment advice should be subject to a fiduciary standard has not been answered. It is accepted that professionals who provide individualized, technical advice similar to investment advice – *e.g.*, lawyers and doctors – are fiduciaries. They are required to act solely in their clients' best interests. They may charge higher fees than other advisers, but their fees must be fair. They must disclose all potential conflicts of interest to their clients. In many cases, doctors and lawyers are prohibited from assuming a conflicted role no matter what amount of disclosure they provide.

The Supreme Court agrees. In the *Capital Gains* decision, it held that investment advisers are subject to a fiduciary duty to their clients. Yet the SEC and FINRA have taken the position that when brokers provide individualized advisory services to their clients, they should not necessarily be subject to a fiduciary duty, even when they charge a separate, asset-based fee and advertise themselves as "financial consultants," financial planners," and "wealth managers." In the narrow circumstances in which the SEC would consider a broker to be an adviser, such as when it had provided a variety of financial planning services to a client, the SEC still would allow the broker to revert to a non-fiduciary role in executing the financial plan. As a practical matter, the "financial consultant" can provide a generic financial plan subject to a fiduciary duty, and then take off its fiduciary hat when selling the client mutual funds that pay the broker higher distribution fees than other funds *without disclosing the fees*. As long as the funds are suitable, which they generally will be, the broker has acted consistent with FINRA's standards of conduct.

The SEC's approach to this issue has been consistently anti-investor. Ten years ago, it adopted a rule that expressly eliminated Congress's requirement that the broker exclusion apply only if the broker receives no special compensation for investment advisory services. The rule also read Congress's requirement that the advisory services also be "solely incidental" so broadly so as to be meaningless. The

SEC took the position that advice was solely incidental if the advisory services were provided “in connection with and reasonably related to” brokerage services. As stated in an *amicus* brief filed by Fund Democracy and the Consumer Federation, “[t]he Commission’s ‘in connection with and reasonably related to’ standard sets no limits on the degree of advisory services provided in relation to the brokerage services, much less in any way limit the advisory services to those that are ‘minor’ or otherwise ‘incidental.’”

Congress needs to take action to end this debate. For over a decade, the SEC has been unable to muster the backbone to defend fiduciary standards for investment advisers, and the current SEC Chairman and one Commissioner spent years defending FINRA’s self-interested position that a suitability standard is adequate,⁵¹ notwithstanding that, for example, it does not require the disclosure of conflicts of interest. Congress should enact legislation that imposes a fiduciary duty on any persons who provide individualized investment advice or sell products pursuant to their providing of such individualized investment advice. Americans who naturally expect those providing fiduciary services to act solely in their clients’ best interests are entitled to nothing less.

B. Madoff Scandal

It should not be necessary to include the Madoff scandal as a separate category in this testimony, but the import of the scandal for investment adviser regulation has been so distorted that some clarification is necessary. We still don’t know exactly how Madoff perpetrated his fraud, except that he did so without detection for many years. Some have argued that this reflects a failure of investment adviser regulation despite the fact that he was exclusively regulated as a broker-dealer during most of the period of the fraud. These arguments may simply reflect nothing more than a short-sighted political strategy to curry favor as the preferred choice as the SRO for the adviser industry, but they nonetheless need to be addressed. I agree that an SRO for advisers would be appropriate, but if the Madoff scandal has revealed anything with respect to this issue, it is that some regulators lack a full understanding of the nature of investment adviser services and regulation and could not adequately protect investors’ interests in overseeing the investment adviser industry.

During most of the period during which Madoff defrauded his clients, he was not registered as an investment adviser – he was registered as a broker. It appears that he was not registered as an investment adviser because the SEC had interpreted the broker exclusion from the definition of investment adviser for

⁵¹ See, e.g., Letter from Mary Schapiro, Vice Chairman and President, NASD, and Elisse Walter, Executive Vice President, NASD to Annette Nazareth, Director, Division of Market Regulation, and Meyer Eisenberg, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission (Apr. 4, 2005) *available at* <http://www.sec.gov/rules/proposed/s72599/nasd040405.pdf>.

“solely incidental” investment advice to be available for discretionary accounts. The SEC has since abandoned this ill-advised position, but during most of Madoff’s illegal activities he was able to rely on the exclusion and was regulated solely as a broker. Thus, while FINRA, the SRO responsible for broker oversight, has suggested that the Madoff scandal illustrates the risk of “the absence of FINRA-type oversight of the investment adviser industry,” this position is belied by the undisputed fact that Madoff was subject only to broker regulation during most of the relevant period.

FINRA’s position is understandable and not necessarily a negative reflection on its capacity as the broker SRO. Its leadership lacks a deep understanding of and experience with investment adviser regulation, and it has a close relationship with and is naturally protective of the brokerage industry. Its sometimes excessive exuberance for extending its jurisdiction over functionally dissimilar services is a common, unavoidable symptom of agency politics, especially in the inexperienced hands of new leadership. And one would expect that a fraud perpetrated by a man who for years served in a variety of leadership roles with FINRA’s predecessor (the NASD), and who used the luster that the NASD gave his reputation to help entice unknowing victims, would put FINRA on the defensive and make its objective evaluation of the situation difficult.⁵² Indeed, FINRA’s precipitate response to the Madoff scandal is quite understandable, but it is also, unfortunately, evidence that it is not capable of providing effective self-regulation of the investment adviser industry.

This is not to say that the Madoff scandal tells us nothing about investment adviser regulation. As noted, it demonstrates the problem of leaving solely to broker regulation the kinds of advisory activities that are clearly in need of investment adviser oversight. The SEC has corrected the regulatory gap that allowed brokers who provided discretionary advice to avoid advisory regulation. As discussed below, the Commission should take steps to ensure that *all* individualized investment advice is subject to advisory regulation.

In addition, during the last stages of the scandal Madoff was registered as an investment adviser. His registration statement indicated that he had custody of \$17 billion in assets under management. The Investment Advisers Act generally requires that an investment adviser maintain custody of client assets with a broker-dealer or a bank, and in doing so relies on FINRA and banking regulators to ensure that the custodied assets actually exist. In view of reports that much of the Madoff-related losses will be covered by SIPC, it appears that the failed custody arrangement was with a broker. It is unclear why, if the stolen assets were

⁵² See Susan Antilla, *Investors happily handed Madoff Billions*, Business Times (Dec. 17, 2008) (Madoff’s “company website describes him as ‘a major figure in the National Association of Securities Dealers’, the regulatory agency now known as Finra. He was board chairman of the Nasdaq Stock Market; was on the board of governors of the NASD; sat on an advisory committee for the Securities and Exchange Commission (SEC); and was chairman of the trading committee of Sifma, formerly the Securities Industry Association.”).

custodied by a broker, regular broker examinations by Madoff's SRO did not uncover the fraud. As discussed below, such prudential oversight should be assigned to a prudential regulator, not to a regulator such as FINRA with concurrent investor protection jurisdiction. A regulator such as FINRA should focus solely on what it knows and does best: regulating the sales activities of brokers.

A final word is necessary regarding the argument made by some that the Madoff scandal demonstrates the weakness of a fiduciary standard. A fiduciary duty is not designed to nor could it protect investors from those who are willing to steal their money outright. The Madoff scandal is no more a reflection on the fiduciary standard (or FINRA's lower suitability standard) than would be a bank robbery. What would have detected Madoff's fraud is adviser registration triggered by the providing of individualized investment advice and competent examinations of his custody arrangements.

C. Principal Trading Exemption

One of the primary reasons that brokers seek to avoid triggering investment adviser regulation is the principal trading prohibition. Section 206(3) of the Investment Advisers Act requires that investment advisers obtain written notice and consent from their clients prior to completion of the transaction in which the adviser acts in a principal capacity. Brokers chafe under the requirement to obtain client consent prior to every principal trade, and they hoped to be relieved of this restriction by the SEC's proposed rule excluding virtually all brokers managing nondiscretionary accounts from the definition of investment adviser (known as the "Merrill Rule"). When the Merrill Rule was vacated by the Court of Appeals, the SEC quickly sought to accommodate brokers' concerns by adopting an interim rule that exempted virtually all trades not conducted in a discretionary account from section 206(3).

Before considering this interim rule, some history on the SEC's ill-advised Merrill Rule is in order. As with the principal trading exemption, the SEC effectively adopted the Merrill Rule without prior notice and consent. The SEC took a no-action position with respect to activity conducted within the proposal's purview, thereby circumventing Administrative Procedures Act requirements. Those who opposed the rule were left in limbo waiting for the Commission to adopt a final rule so that it could be challenged in court. Almost five years later, the Commission had yet take final action on the rule and the Financial Planning Association sued to force a final resolution of the issue. The SEC repropose the rule in 2004, and then again in 2005. It finally adopted the rule in 2005, after it had been in operation for almost six years, and the Court of Appeals vacated the rule in its entirety in 2007.

Even before the Court's order went into effect, the SEC embarked on the same path of adopting effectively final rules without prior notice and comment. It scheduled its "interim" exemption from section 206(3) to expire more than two years after its adoption. The SEC's repeated abuse of notice and comment

procedures undermines faith in the rule of law and the administrative process, especially when it abuses its authority by enacting broad exemptions from carefully crafted laws enacted by Congress specifically to protect investors against abusive transactions.

In this instance, the interim rule has created significant investor protection gaps that continue to remain unaddressed. For example, the rule does not expressly require firms to develop policies and procedures that are specifically designed to detect, deter and prevent disadvantageous principal transactions. Such procedures are necessary to ensure that the fairness of the price at which the principal trade is effected can be objectively verified. The market's current difficulty in valuing certain fixed income securities that previously were considered relatively liquid and easily valued illustrates the potential risk. Securities that are difficult to value often are more likely to be securities that an adviser may be attempting to dump on its clients. The incentive to engage in the abuses that section 206(3) is designed to prevent rises with the difficulty of determining whether the transaction was fair. Congress should insist that the SEC take prompt action to address this and other concerns relating to the principal trading exemption.⁵³

D. Pay-to-Play Ban

In August 1999, the SEC proposed to prohibit money managers from engaging in pay-to-play. The Commission had thoroughly documented the practice among public pension officials of awarding investment management business to large political donors.⁵⁴ The retirement accounts of millions of our nation's schoolteachers, fire fighters, police officers and other public servants were being invested by money managers who qualify for the job not by earning it, but by financing the political campaigns of public pension fund officials. The SEC's proposal was elegantly simple. It would have required that money managers give up any compensation they received for managing public money for two years after the firm, its executives or agents made a campaign contribution to an elected official or candidate who could have influenced the selection of the money manager.

The pay-to-play proposal was modeled on Rule G-37, which prohibits municipal bond underwriters from contributing to the campaigns of elected officials who may influence the award of bond underwriting contracts. The rule is widely

⁵³ See Letter from Mercer Bullard, President and Founder, Fund Democracy and Barbara Roper, Director of Investor Protection, Consumer Federation of America to Nancy Morris, Secretary, U.S. Securities and Exchange Commission (Nov. 30, 2007) *available at* <http://www.funddemocracy.com/principal%20trading%20ltr%2011.30.07.pdf>.

⁵⁴ These findings in a series of articles published in 2001, *see* Mercer Bullard, *Pay-to-Play in America*, TheStreet.com (Apr. 26-30, 2001), *available at* <http://www.thestreet.com/funds/mercerbullard/1406251.html>, and a state-by-state guide to pay-to-play practices uncovered by the SEC is posted on Fund Democracy's web site. *See* <http://www.funddemocracy.com/Pay-to-Play%20Page.htm>.

credited with cleaning up the municipal bond industry. An unfortunate byproduct of Rule G-37 has been its incidental effect on pay-to-play in the money manager arena. State treasurers and other elected fiduciaries of municipal pension funds saw campaign contributions from municipal underwriters dry up, so they turned to money managers and lawyers doing business for the pension funds to make up the difference.

Pay-to-play practices continue to plague the awarding of money management business by public pension funds at the same time that public pension underfunding has reached crisis proportions. It is imperative that managers tasked with restoring financial stability to public pension plans are not selected on the basis of political favor, but on the basis of their expertise and experience. This will not happen as long as the SEC allows investment advisers to pay-to-play in the public money management arena. Congress should strongly encourage the SEC to repropose the pay-to-play rule and see it through to final adoption.

Exhibit A
from Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage
Commissions (Jan. 2004)

Exhibit 2: Total 2001 costs of investing: 4 representative large equity funds

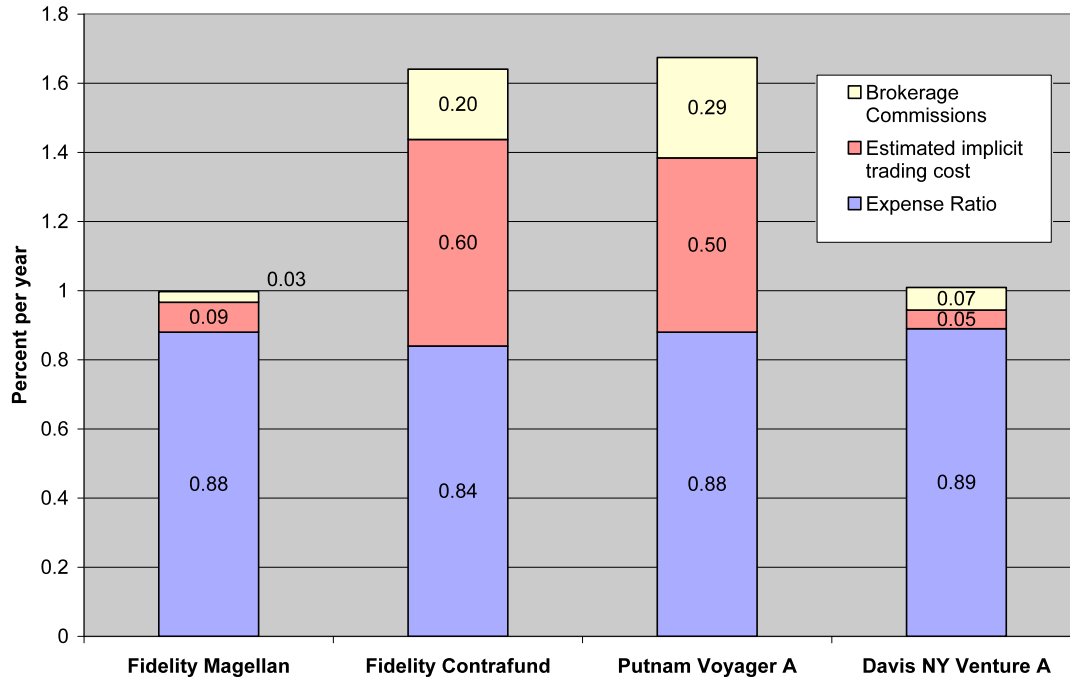


Exhibit 3: Total 2001 costs of investing in high turnover equity funds with total net assets greater than \$100 Million

