"Leading Fund Intelligence"

Testimony of

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Introduction

On behalf of Lipper Inc. (Lipper), I appreciate the opportunity to testify before the Financial Management, Budget, and International Security Senate Subcommittee with regard to our recent study on **12b-1 fees,** and generally on **management fees, fund expenses, "hidden costs," and governance structure** issues. All three topics are of vital importance to the $7 trillion mutual fund business. Careful handling will undoubtedly ensure investor trust in the business is elevated, distribution mechanisms are not crippled, free market forces are appropriately left to their own devices, and directors/trustees are supported and empowered properly as 'watchdogs' on behalf of underlying investors.

As background, Global Fiduciary Review is a unit inside Lipper that provides analytics and reports to directors/trustees to enable them to fulfill their fiduciary obligations. Advisory contract renewal – required by Section 15(c) of the Investment Company Act of 1940 – and quarterly performance reporting are the most prominent examples of the services we provide.

About Lipper: Lipper, a wholly owned subsidiary of Reuters, is a leading global provider of mutual fund information and analysis to fund companies, financial intermediaries, and media organizations. Lipper clients manage more than 95% of U.S. fund assets. The firm, founded in 1973 and headquartered in New York, tracks 115,000 funds worldwide through its offices in major financial capitals in North America, Europe, and Asia.

Rule 12b-1 Background

Introduction

Rule 12b-1 is a section of the Investment Company Act of 1940 that allows fund sponsors to spend fund (shareholder) assets to promote distribution. Yet, a wide variety of unforeseen distribution activities that are "intended to result in the sale of fund shares" have burgeoned since the Rule debuted. Sales and distribution practices have become necessarily intertwined with complicated issues such as brokerage, advisor profitability, and general business competition. As such, Lipper's primary intent of our lengthy research effort was to bring together all aspects surrounding Rule 12b-1, cull the information to uncover core issues, level the educational playing field, spur rigorous discussions, and set the stage for removing the Rule's antiquities.

[**Full copies of the study are available to subcommittee members upon request**.]

History

Debuting in 1980, Rule 12b-1 was originally conceived as a way to provide direct-marketed fund groups (*which sell shares directly to investors without a sales person*) with a way to compete with dealer-distributed complexes (*which use various "financial intermediaries" such as brokers, planners, and insurance agents to sell shares*). At the Rule's inception, the business was struggling, no-load funds had precious little market share, and the overall equity securities market was depressed. The Rule allowed a modest amount of fund assets to be used to provide groups such as Vanguard the financial wherewithal to 'spread the word' of no-load funds and achieve (size) economies of scale through asset growth. Expenditures were expected not to exceed around 0.25% of assets (25 basis points) per annum and be used for direct marketing and advertising campaigns as well as printing of fund documents for prospective investors. Plans were viewed as **temporary** to rectify distribution issues, i.e., low sales rates, and board involvement for review, analysis, and eventual approval was expected to be high. For the Rule to reach fruition, the SEC came to terms with the inherent conflict that advisors received as much or more benefit in advisory fee revenues as investors presumably would in incurring lower expense ratios. Yet, in enacting the Rule, the SEC did not specify what particular expenditures were to be considered lawful, presumably to not squelch creative distribution strategies and add a timeless quality to the rulemaking. With no formal qualms from the SEC, 'distribution freedom' implicitly provided by the Rule enabled it to quickly burgeon far beyond direct marketing. Today, **12b-1 fees predominantly pay for sales commission and personalized service-fee payments to financial intermediaries.** Perhaps most pertinent, the argument that 12b-1 plan payments should directly correlate to fund asset growth (economies-of-sale) only partially applies due to the small proportion of 12b-1 plan expenditures for advertising and marketing.

1988 Revision Proposal

The enactment of Rule 12b-1 was accompanied by an SEC statement committing to close observance of the legitimacy of fund assets used for distribution. Modifications to the Rule were promised if and when the SEC felt changes were required. In 1988, based on those observations, they floated a revision proposal that outlined the following significant changes for consideration and comment:

Limit the use of excess distribution expense recoupment (expenditures beyond a 12b-1 plan's maximum may be 'recouped' in subsequent years)

Update NASD limits on maximum sales charges to include 12b-1 fees (put in place)

Restrict the ability of funds to define themselves as "no-loads" when they carry – and charge – 12b-1 plans (put in place)

Require more methodical analysis between 12b-1 plan expenditures and shareholder benefits realized

Formally validate that 12b-1 payments are within a range that would have been recognized at arms-length

Require annual shareholder approval of 12b-1 plans

The revision proposal was intensely debated and, aside from a new "no-load fund" definition and the NASD sales charge cap rules incorporating 12b-1 fees, none of the proposals reached fruition. Since 1988, the SEC has entertained revisions several times, but has not revisited Rule 12b-1 presumably due to more pressing matters and limited resources.

Rule 12b-1 Today

Direct-marketed vs.Intermediary-sold funds

Distribution plans implemented pursuant to Rule 12b-1 for most **direct-marketed** funds serve some of the same purposes today as were originally envisioned: advertising, direct marketing, and new investor documents. Due to the success of fund supermarkets, a not insignificant portion of plan fees also flow to supermarket proprietors to aid in building distribution muscle. Institutional funds focused on the qualified pension plan market may use 12b-1 fees to pay for plan administration and recordkeeping. A large proportion of 12b-1 plans currently in place are 'attached' to **intermediary-sold** mutual funds for three (3) primary purposes: 1) pay financial intermediaries for ongoing personalized investor service; 2) act as a method by which fund sponsors may recoup up-front commission payments to intermediaries who have already sold back-end loaded fund shares; and 3) pay out annual trailing commissions to intermediaries for products that possess a perpetual compensation structure ("level-load funds"). According to a recent Investment Company Institute (ICI) study covering 95 large fund complexes, approximately **63%** of 12b-1 plan expenditures went for intermediary compensation (commission), **32%** for administrative services (third-party recordkeeping and personal service), and **5%** for advertising and other promotional activities. Clearly, **the current role of Rule 12b-1 is primarily to facilitate fund share sales through financial intermediaries and supermarkets, while only a very modest proportion serves the original intent**. Classes of fund shares serve to provide investors with different ways to compensate their financial intermediary and service fees incentivize those sale personnel to "keep the assets on the books." Expenditures made pursuant to the Rule now total just shy of $10 billion encompassing 67% of the funds, are entrenched in the business, and hardly may be classified as temporary.

Board Review of 12b-1 Fees

While board involvement was originally viewed as a necessary ingredient of keeping

12b-1 plan expenditures in check and applicable to current sales woes, the evolution of fee uses rendered active oversight virtually fruitless in many instances. Due to commissions paid out to financial intermediaries for B-sale shares which then required 'reimbursement' (recoupment), securitization of 12b-1 fee cash flows, service fees for existing shareholders using intermediaries, and various other distribution commitments such as supermarkets, boards simply did not realistically have the option to terminate 12b-1 plans. While expenditures such as advertising and direct marketing could be considered discretionary and under board control, existing distribution arrangements could not truly be dismantled. Shareholder interests were better served by boards that supported existing sales channel arrangements through plan continuation.

Lipper Assessment

Recommendations

Given new market realities such as classes of fund shares, fronted commission payments (back-end loaded B shares), personalized shareholder servicing fees, securitized 12b-1 plan cash flows, supermarket sales commitments and the like, the Rule is undoubtedly due for an overhaul. Many of its provisions simply no longer apply. Lipper has formulated the following suggestions to be reviewed and considered by regulators and legislators alike in an attempt to point a Rule update in the right direction:

- Alter the Rule's language to account for the necessary continuation of some 12b-1 plans, e.g., remove temporary focus of plans, etc. – provide boards with the freedom to continue plans viewed as vital without reviewing antiquated considerations
- Embrace the 1988 SEC revision proposal that sought to eliminate a fund sponsor's ability to recoup distribution expenses in subsequent years when outlays in the current year

exceeded the maximum allowed – outlays beyond plan maximums should be at the discretion of, and borne by, the advisor

- Require more concrete analysis (at the board level) of the correlation between 12b-1 expenses and benefits to shareholders – more thinking beyond "…we need to do what everyone else is doing to be competitive…" should occur
- Issue guidelines to provide more specific ideas of what types of expenditures may, or may not, be considered valid for distribution purposes under the Rule – a list of acceptable uses, or unacceptable expenditures, may serve to curb abuse
- Eliminate the circumstances under which a shareholder may incur more sales charges than allowed under the NASD limits – a predictable cap which is not exceeded will serve investors more effectively
- Launch an education initiative to ensure investors possess detailed knowledge of the purpose of class-specific 12b-1 plans – investors do not understand the potentially many purposes of 12b-1 plans
- Provide shareholders with greater transparency on the specific uses of distribution expenses in offering documents and/or annual reports – currently, disclosure requirements do not provide investors with a basis for comparison and benefits of a plan; guard against abuses
- Provide boards the authority to pre-approve certain types of distribution expenditures – board members need to get back in the driver's seat and in control of many, but not necessarily all, provisions of a 12b-1 plan; guard against abuses
- Provide boards with legal constructs and/or standardized 'tools' to effectively assess a plan's cost versus shareholder benefit – cost/benefit analysis arguably diverges amongst boards currently and guidance is desired

- Undertake a study which considers whether the portion of 12b-1 plans used as "asset-based sales charges" should be removed from the auspices of fund companies and left to distributors and market forces (investors negotiate with intermediaries) – more comparability of expense ratios, price competition, and better matching of supply, demand, and price

Also worthy of note is the general sense by Lipper and other observers that fund sponsors' distribution arms do not routinely generate substantial profit margins. Lipper's investment advisory profitability analysis – which displays pre- and post-distribution margins – indicates that a large portion of distribution-related 'revenues' are quickly remitted to sales channels. Leverage is typically possessed by the large retail distribution networks and sales forces which demand large payouts, a market reality referred to as "pay to play."

Intertwined Issues

We believe that the above actions serve to provide appropriate regulatory control, promote competition in the fund business, account for appropriate board involvement, and better inform shareholders. Yet, critical questions remain that must be factored into any forthcoming regulation or legislation. While beyond the scope of Lipper's research, the following questions must be considered for the correct 'spirit' to be built into a Rule 12b-1 overhaul. For instance, how is competition fostered when the financial wherewithal of fund sponsors is highly divergent? Is SEC and NASD (proposed) regulation to disclose compensation at point-of-sale sufficient to promote free market forces? What limits, if any, should be placed on distribution-related activities such as directed brokerage? Should advisory profit margins be a consideration in the regulation of sales practices when revenue sharing is extremely prevalent, and necessary, in the world of fund supermarkets? Should Rule 12b-1 be repealed, what other business structure or forms of regulation may be implemented without undue harm to the business, maintain reasonable asset thresholds, and protect shareholders? Should the issue of fund pricing, i.e., load structures, be left to distributors of funds (rather than sponsors), whereby the fund themselves would all be sold at net asset value and investors would negotiate the commission rate and service levels with which they are comfortable and/or willing to pay? Would this not then simplify the concept of operating expense ratios and comparability?

Misperceptions

Lipper also believes many of the criticisms of Rule 12b-1 result from a lack of awareness of the Rule's effective operation. It is often noted that shareholders do not benefit from (size) economies of scale to the extent that asset growth makes up for expenses incurred under a 12b-1 plan. Realizing that (typically) the greatest portion of 12b-1 expenditures go towards intermediary compensation and are essentially an alternative to traditional front-end loads, **the economies-of-scale argument is effectively outdated**. A similarly hot topic surrounding the Rule is the continuation of a 12b-1 plan on funds closed to new investors. In our view, one must consider that all but a small fraction of current average 12b-1 expenditures is allocated to marketing and advertising efforts to attract new shareholders. Therefore, it is reasonable to assume that **a fund using 12b-1 fees primarily to cover fronted sales commissions and ongoing service to current shareholders would incur most of the same 12b-1 expenses whether the fund is open to new investors or not**.

Conclusion

We urge legislators and regulators to consider the aforementioned suggestions and evaluate the perhaps not fully answerable dilemmas outlined. We maintain that Rule 12b-1 was, and remains, a valid concept that should be reshaped and not abandoned.

Fund Management Fees

Definition

Lipper defines management fees as all activities surrounding the management of fund portfolios and supporting administrative functions. Therefore, a management fee includes services such as security analysis, security selection, trade placement, office space, administrative support personnel, portfolio recordkeeping, and preparation of regulatory filings. Industry participants who refer to "advisory fees" may or may not be referring to what Lipper classifies as management fees and be excluding all services with the exception of those directly related to portfolio management.

Historical Ratio Data

Many industry observers have claimed that management fees have steadily climbed through a period when assets have risen precipitously. That statement is only partially true if you dissect and analyze the ratios. The ten-year historical data are as follows:

Management Fee Ratios – All Actively-Managed Open-End Funds

	1992	2002/3 (Current)
Medians	0.504%	0.597%
Asset-Weighted Averages	0.461%	0.462%

Source: Lipper Inc.

The rising median ratio shows the effects of more specialized asset classes such as international small cap, emerging market, and sector (priced higher) in addition to many small (new) funds being created while **the asset-weighted management fee average is clearly flat**. [Note: an asset-weighted average gives more mathematical weight to larger funds when computing the average. Since assets typically correlate to number of shareholder accounts, the asset-weighted average may be viewed as more indicative of what "most shareholders tend to pay."] When one disaggregates the ratios, the trends are unique by asset class, i.e., type of fund, but **the net result for a diversified portfolio over time has been very minimal**. In general, the underlying costs for portfolio management have increased over the last decade and thus given rise to smaller funds' elevated management fee ratios as fund groups matched revenues with current costs.

Management Fee Breakpoints

A fee "breakpoint" is triggered when a higher asset threshold within a management fee schedule is reached and typically lowers the incremental percentage fee charged an investor. For instance, a shareholder may pay 0.50% on the first $500 Million of fund assets, 0.45% on assets between $500 Million and $1 Billion, and only 0.40% on assets above $1 Billion. The theory behind breakpoints is that economies of scale are realized in the portfolio management process that should, in many instances, be passed along to shareholders. Lipper data show that 75%, 70%, 91%, and 71% of domestic diversified equity, taxable bond, sector equity, and world equity funds with assets in excess of $1 Billion, respectively, possess breakpoints in their management fee schedules. Given that the business is highly skewed towards smaller portfolios that do not achieve economies of scale, it is fair to conclude that most of the larger funds utilize breakpoints. The vast majority of funds utilize either a flat percentage of assets (no breakpoints) or standard breakpoint management fee schedule.

Management Fee Benchmarking

Management fee benchmarking occurs inside fund companies in three basic instances: 1) the advisory contract renewal (15(c)) process conducted by boards; 2) new fund pricing; and 3) where warranted, the management fee change process. While older, more established funds have shown little fee elasticity when faced with rising investment management costs, newer funds have tended to emerge with higher costs to align themselves with inflated entry costs. Therefore, if simple management fee averages are used to benchmark all funds, "leapfrogging" or "fee creep" phenomena occur. As newer funds drive up the benchmark (average), all funds have some level of justification – if they seek to mimic the average – to raise their fee to a higher level. Using size- (dollar-) weighted averages curbs the propensity for funds to continually reach for a presumably rising benchmark. **Fund boards must be instrumental in ensuring that proper management fee benchmarks are used**.

The Alliance Settlement

One may easily view a portion of the highly publicized $600 Mil Alliance Capital Management settlement with the New York Attorney General's office as punitive or as effective management fee setting. To most industry observers and participants, the 25% reduction in management fees 'inflicted' upon Alliance over time was arbitrary and not based on traditional fee benchmarking methodology. Lipper's view mimics the SEC in that we feel **market forces should determine fee levels and more structured analysis should determine whether a fund's fees are in line with funds of a similar nature and are "fair" and "reasonable."** If regulators feel that the current legal constructs utilized to set fees are ineffective, then new regulations should be enacted to clarify what new methodologies should be considered and/or employed to maintain equity amongst fund complexes.

Management Fees – Funds vs. Pension Plans

Academics, observers, and the media have claimed that "investment advisory fees" should be set identically for similarly focused pooled investment vehicles regardless of the investor audience. While one may rightfully argue that core investment (portfolio) management fees should be very similar for retail funds and pension plans, there are two primary dissimilarities that warrant consideration. First, portfolio managers of retail funds must deal with constant investor purchases and redemptions whereas pension plans' cash flows tend to be more stable and investment mandate 'tamer' and less 'fluid.' Second, there are extensive administrative duties associated with retail funds that do not apply to pension plans, primarily those that are required as a registered investment company. To truly derive a valid "investment advisory" comparison, all related administrative charges must be removed from retails funds' "management fees." A full-scale analysis across the fund business is simply not feasible as in only certain instances are administrative fees contractually separated from advisory fees. One could also use sub-advisory fee levels as a proxy for an advisory fee comparison, but (again) the industry would not be fully represented since the majority of funds do not use sub-advisors. [Note: An ICI study entitled "The Expenses of Defined Benefit Pension Plans and Mutual

Funds" released on January 6, 2004 used such a methodology and concluded that fund advisory fees are only slightly higher than pension funds'.] Arguably, the only comparative approach, given available information, is to use administrative fee benchmarks (using only those funds with separate administrative contracts) to remove from funds utilizing only management fee contracts a similar (proxy) fee to presumably uncover pure advisory fees. While not empirically perfect, the results will at least give critics a rough idea of pension fund/retail fund spreads in management fees. To Lipper's knowledge, a study of this nature has not been undertaken to date.

Total Expense Ratios

Definition

A total expense ratio of a mutual fund is defined as all expenses required to support on-going operations. The items included are: management, shareholder servicing (transfer agency), 12b-1 fees, non-12b-1 service fees, custodial services, legal, audit, printing and postage, trustee/directors' fees, registration, taxes, fund accounting, credit line fees (if applicable), interest expense (where applicable), and other expenses. Shareholder costs that are excluded from total expense ratios: front-end sales charges, general account-level charges, wrap fees, and fund-generated brokerage costs.

Historical Ratio Data

As with management fees, many industry observers have remarked that "…total expense ratios have risen at an enormous clip during a time when assets enjoyed unprecedented growth." Again, depending on which statistic is cited, i.e., average, median, or asset-weighted, the story is different. The ten-year historical data are as follows:

Total Expense Ratios – All Actively-Managed Open-End Funds

	1992	2002/3 (Current)
Medians	0.897%	1.297%
Asset-Weighted Averages	0.773%	0.786%

Source: Lipper Inc.

Similar to management fees, the median total expense ratio (TER) shows the affects of many small (new) funds being created while **the asset-weighted TER average rose a mere 0.013%** (1.3 basis points). [As noted earlier, since assets typically correlate to number of shareholder accounts, the asset-weighted average may be viewed as more indicative of what "most shareholders tend to pay."] The often-quoted average ratio, which is subject to biases by more expensive and smaller funds, exceeds the 1.297% cited above and is the catalyst for many cries of "…where are the economies of scale?" When one disaggregates the overall ratios, the total expense trends are again unique by asset class, i.e., type of fund. The large divergence amongst the median and asset-weighted average total expense ratio deserves some analytical explanation as follows:

- The pronounced rise in the median TER was driven by the proliferation of additional class of shares carrying relatively high 12b-1 fees
- The median TER was pushed higher by the asset mix in the business pushing towards more specialized – and rightfully higher priced – products such as international small cap, sector, and emerging markets funds
- The median TER rise was also supported by higher shareholder servicing (transfer agency) costs
- The modest level and flat asset-weighted TER indicates that the largest funds either do not carry 12b-1 fees or their fee is modest and has not changed

The core points of this analysis are: 1) **the majority of shareholders are <u>not</u> paying more in operating and distribution expenses than they were ten (10) years ago**; 2) rises in median expense levels have been due to many more back-end and level-loaded classes of shares which are modest in size; 3) **economies of scale are evident on the fund and sometime fund complex level, but do not logically translate to the business as a whole**; 4) a rise in shareholder servicing costs – which have bumped total expense ratios upwards and have been driven by a demand for more service options – has been borne at least partially by the investor, but most likely by both sponsor and investor. When one removes 12b-1 fees from the historical TER data altogether, the trend is either flat or decreasing, depending on asset class.

GAO Study on Total Expense Ratios

The General Accounting Office conducted a study on TERs released in March of 2003 focused on the 76 largest stock and bond funds using Lipper expense data. Their two core findings may be summarized as follows: 1) the asset-weighted stock fund TER average rose seven (7) basis points (0.07%) over the period from 1999 to 2001; and 2) the asset-weighted bond fund total expense ratio average dropped three (3) basis points (0.03%) over the same period. We do not dispute the results of their data analysis; however, we would maintain that an analytical flaw and therefore bias is inherent in the conclusion. Several very large Fidelity funds with performance incentive fees skew the ratios. In comparison to prior periods, all three funds earned an unusually large incentive fee reward (in the form of an increased management fee) realized during the three (3) years ended 2001 due to index-exceeding performance over the trailing 36 months. Given the size of the funds and the incentive fee adjustment, the funds weighed on the results heavily. Over other 'less favorable' periods and with incentive fee penalties, the same Fidelity funds would have drug the asset-weighted TER down significantly. **When one subtracts the incentive fee adjustments, the asset-weighted average total expense ratio of the largest equity funds remains virtually unchanged**.

Recommendations

- Support the initiatives to report total expense levels in shareholder reports based on a hypothetical account size, standard holding period, and in dollars
- Simplify shareholder reports so expenses are much more easily understood and impact crystal clear
- Similar to index returns in a fund prospectus, **provide investors with expense benchmarks** from which comparisons may be made (while the peer fund selection process is problematic, some level of macro comparison is desirable to spur competition and investor education)

- Launch an investor education initiative – coupled with disclosure – that seeks to ensure investors fully appreciate the return erosion that occurs with much more expensive funds

Costs Opaque to Investors

Overview

The issue of "hidden costs" has recently surfaced, primarily the result of New York Attorney General Eliot Spitzer's investigation into fund trading practices and fiduciary obligations. His probe has led him down several paths unrelated to timing and late trading, primarily related to less-obvious costs borne by investors. Aside from the potential for trading abuses and related expense, the three costs cited by critics of current practice and disclosure may be characterized as **general brokerage, directed brokerage, and soft dollar use**. All three costs involve the use of shareholder assets in the form of fund securities transaction-generated brokerage commissions and are charged directly to fund net asset values (prices per share), not included in the total expense ratio, and therefore not transparent to investors.

General Brokerage

Total brokerage commission expense incurred by a fund is required disclosure in Part B of the prospectus (Statement of Additional Information (SAI)). However, two issues perpetuate some level of opacity. First, the brokerage expense reported in the SAI is simply an aggregate dollar amount and must be manually converted to a percentage by time-rich, resourceful investors. The reported brokerage commission figure only encompasses standard 'agency trades' (trades on an exchange floor and typically transacted on a cents/share basis). Electronic trades transacted through electronic communication networks (ECNs) and those done on a principal basis (bid-asked spread) are not included. Furthermore, an imputed cost referred to simply as "implementation shortfall" (difference between a share price at time of a trade decision and the actual price at which the transaction took place) is not included because of the inability to adequately and consistently quantify the actual expense. The obvious concern of investors, beyond and sometimes in spite of cost, is "quality of execution." Academics cannot agree on one 'correct' algorithm that accurately measures implementation shortfall and comprehensive data are scarce. We would argue that **trying to fully quantify brokerage costs in total and given every trading scenario is similar to attempting to nail Jell-O™ to a wall**. Yet, we would also argue that an elevated level of brokerage cost transparency – to the extent it may be computed in good faith – is more desirable than what exists today.

Directed Brokerage

Directed brokerage refers to a practice that involves directing security trades – thus creating brokerage commission revenues – to a specific brokerage firm in exchange for "sales support." We understand this support typically takes the form of certain funds being included on "preferred lists" or prominently garnering financial intermediary recognition ("shelf space"). In some cases, directed brokerage results in expense credits (expense offsets) paid by the brokerage firm and is shown on a fund's Statement of Operations (part of an annual shareholders' report). Three critical shareholder issues arise regarding directed brokerage. First, is the quality of execution of the trades commensurate with the commission price tag? Second, in the event that a commitment for a certain level of trades is made, could trades be placed elsewhere for a lower cost and/or to realize better execution? Third, might portfolio managers be 'overtrading' to meet a trade level commitment? To the best of our knowledge, the exact level of directed brokerage across the fund business is not known, but we are aware that several very prominent fund complexes have recently decided to terminate the practice voluntarily. Obvious to most observers is the very evident conflict of interest with directing brokerage, creating preferential sales support and the resulting disservice it may provide investor investment options.

Soft Dollar Use

In the context of the fund business, "soft dollars" refers to the somewhat common practice of a fund manager directing security trades to a specific broker to obtain market or security research and trade execution. While the commission price per share incurred by shareholders may, in some instances, exceed the going or lowest market rate, fund sponsors are **not** ignoring their fiduciary obligations. Section 28(e) of the Securities Exchange Act of 1934 allows fund sponsors to pay more than the lowest or current market rate if it is determined that the portfolio management value of the research warrants such a decision and/or the quality of trade execution is deemed worth the premium paid. **Many of the same issues that apply to directed brokerage similarly apply to soft dollars such as cost concerns, quality of execution, conflicts of interest, and the potential for 'overtrading.'** Many critics have also expressed concerns over soft dollar use to pay for goods and services beyond research. Yet, **if clear shareholder benefits are reaped and advisor overhead is <u>not</u> simply being covered, then valid use should not necessarily be questioned**. Additionally, business observers such as Lipper ask whether an advisor should be paying for market and security research (in cash) out of the fee it receives for management services? As implied above, the answer depends on the extent to which the services paid for with soft dollars benefit investors rather than the advisor. Is shareholder benefit commensurate with the presumably higher price paid?

Suggestions, Recommendations

In our view, a number of required actions or topics for consideration emerge from the above discussion as such:

- <u>Consider</u> quantifying the aspects of brokerage costs that may reasonably be converted to an expense ratio (do <u>not</u> include in the current TER)
- <u>Consider</u> requiring disclosure of the "brokerage ratio" in the prospectus alongside a benchmark and allow investors to discern whether returns justify (relative) brokerage costs incurred; encourage more rigorous language about the origination of, and reasoning behind, costs
- Elevate disclosure requirements to make all brokerage arrangements, such as soft dollars, fully transparent to investors including "fallout advisor benefits" and conflicts of interest
- Through a Chief Compliance Officer, ensure that boards of trustees/directors are aware of all details surrounding brokerage arrangements and the value derived by shareholders

- Review the scope of services allowed under Section 28(e) to ensure shareholder benefits are truly realized
- Consider requiring more formal board review and justification of soft dollar use
- As supported by many other industry participants, regulators, and observers, elevate the general level of fee and expense disclosure(s) in terms ($) that may be easily understood by investors and may be compared across funds; prominently display in the annual and semi-annual reports to which investors pay the most attention

Of final note, investors and board members alike must understand that actual trading costs incurred (dollars/share or flat dollar amount/trade) may only account for a small fraction of true brokerage costs due to implementation shortfall. The skill required in placing trades and in shareholders' best interest should not be minimized as they may play significantly into investor returns as a direct cost to a fund's NAV.

Fund Governance

Current Atmosphere

Viewed as "watchdogs" by some and "lapdogs" by those more critical, mutual fund boards have arguably seen their responsibilities grow along side the complexity and demands of the business. Directors have recently come under fire as a result of Eliot Spitzer's probe into fund trading, as they were presumably unaware of the violations. Questions of board due diligence and the adequacy of the governance structure obviously emerge. Critics of the board structure point to a lack of independence and blame overtaxed directors, generous compensation, a high retirement age, a dearth of independents, lack of personal investment, the definition of independence, and affiliated chairpersons. While all possess some validity, **some core issues still remain unearthed**. **Equally valid are compliance policy adherence, board information**

sources, board financial expertise, contract renewal processes, sales practice transparency, and the opacity of board decisions. A lack of compliance, detailed knowledge, effective tools, and an applicable legal framework all can detract from board effectiveness.

Level of Accountability?

Prior to Mr. Spitzer's realization that several fund groups were in direct violation of their own policies, directors could have potentially done more to prevent fraud. More hard-nosed questions could have been posed and a healthy level of skepticism could have been employed. Yet, what reason did they have to believe collusion or violations were occurring? Did they have sufficient information with which to exercise reasonable business judgment? We would argue that trust must be brought to bear on the advisor/board relationship and – in most instances – very little reason for distrust had arisen until just recently. Several dozen boards <u>now</u> have good reason to probe relentlessly and generally be skeptical.

Potential Solutions

- Appointment of a Chief Compliance Officer within each fund group who reports to the board and ensures sanctioned policies are adhered to
- Creation of an independent board administrative support group that would exist solely to serve each board's information desires and requirements
- Require board members to attain a mandated business knowledge level and achieve certification through an independent company
- Allow independent board members to elect the board chairperson, who then sets meeting agendas, surfaces issues, controls meeting flow and the like
- Elevate the level of fiduciary duty required of board members with regard to critical issues such as brokerage, cost structures, and affiliated payments

- Author more definitive rules and/or guidelines to assist boards in assessing advisory contract ‘performance,’ e.g., what possible actions to take under certain underperformance circumstances, etc.
- Require more board process and decision justification disclosure for critical items such as advisory contract renewal and business arrangements with related entities; relay clear, concise rationale to shareholders

Legislators and regulators are well advised to not dismantle the board concept, simply strengthen the structure through institutionalized compliance, education, administrative support, and more detailed guidelines to bolster oversight. When crafting reforms, regulators are further urged to consider cost of implementation – with smaller funds groups particularly in mind – that may be burdensome, out of reach for some sponsors, and harm shareholders over time. Fund governance was hardly ill-conceived. The complexity of the business now mandates further dimensions to governance to shore up its effectiveness.

Putting Management Contracts "Out for Bid"

Several legislators and industry observers have suggested that all management contracts be "put out for bid" each year to obtain the best manager and/or the most competitive cost structure, and generally allow market forces to operate freely. While such a suggestion appears to support the concept of a free, rather than captive, market system, observers arguably underestimate the cost and shareholder burden that may be incurred if and when a new manager takes over fund management for some – and perhaps all – of a competitive managers' funds. The total cost of 'uprooting' a fund would necessarily encompass transfer of all accounts to new shareholder servicing platform, portfolio management transition and likely security repositioning (increasing brokerage commissions), reassessment of other service provider contracts (that undoubtedly must mesh with internal systems effectively) and dealing with possible termination clauses, amongst other costs. Total cost versus benefit should obviously be considered before any board decides to take such drastic action. Opponents to freely moving advisory contracts amongst sponsors argue that raising underperformance issues and devising action plans is more desirable than effective "contract portability." In theory, **'very independent' boards should serve to keep costs in check and serve the same purpose as bidding with much less disruption to fund operations**. Nonetheless, in some instances such as fraud and negligence, putting an advisory contract out for bid may be the most desirable course of action. **A clearer picture of director/trustee fiduciary duty and resulting ramifications for <u>not</u> protecting shareholder interests with regard to the advisory contract renewal process would promote a stronger foundation and rigorous fee negotiations**.

Mutual Fund Oversight Board

More than a few legislators and observers have suggested that an "oversight board" responsible for controlling and monitoring the (consistent) duties of boards would cure many of the current governance ills. We tend to disagree. An oversight board simply creates yet another layer of bureaucracy, costs, and potential delays in action. A combination of a stronger governance structure and more definitive and stringent rulemaking by the SEC should serve to strengthen the board model. While on the surface centralized oversight appears desirable and may breed consistency, widely applicable policy design will be problematic, costs will be elevated, and board freedoms will be curtailed. Is there truly a regulatory hole that needs filling? We would argue that many of the mutual fund business ills recently raised are already covered by existing regulation(s) that need relentless enforcing or may be addressed through additional SEC rulemaking.

Concluding Remarks

Investor Costs

In Lipper's view, one of the core aspirations behind investor cost transparency is to promote competition. Competition creates price pressure, drives inefficient providers from the business, and serves investor interests long-term. Computation and disclosure of the true, total costs of owning a fund is the goal, but quite elusive. Items such as account-level and IRA maintenance fees could also be added to the prospectus fee table, but more investor assumptions would have to be made. However, there must be **focus by investors on costs** and the impact that they can have on account values over 10-, 20- and even 30-year periods. We are not convinced that most investors consider cost as a primary criterion in the fund selection process. Some commentators have cited large flows of investor money into three low-cost providers, e.g., Fidelity, Vanguard, and American Funds, as an indicator of cost sensitivity. One could surely take the viewpoint that investors are attracted to Vanguard, American, and Fidelity for reasons such as reputation, performance, desirable volatility profiles, very high visibility, service, and the virtually do-nothing and market-tracking appeal of index products. Expenses may not have entered into the decision. General fee levels may not deserve to seize the number one fund selection criterion spot, but **more investor education** of their impact would surely promote competition based on price. Furthermore, significant changes to costs that are anticipated or may occur, e.g., waivers disappearing, expense reimbursements ending etc., should be forewarned at the first sign of implementation.

Governance

In general and based on our experience, fund boards of larger fund complexes are extremely knowledgeable, savvy, have more resources at their disposal, and put much time and effort toward taking their stewardship duties seriously. However, questions remain whether more modest-sized groups can make these same claims. Decisions based on 'lesser' board models may result in governance that is less than optimal and counter to the spirit of board oversight. Furthermore, it is not clear what level of information is the basis for vital board decisions and the true 'strength' of compliance structures. Recent Heartland and Putnam board articles highlight the potential for misinformation flow and the general need for external administrative assistance for board members to obtain fully independent data and information on sponsor business practices. Finally, implementation of additional guidelines by boards with regard to the critical annual advisory contract renewal exercise would be helpful in framing what potential actions to take when certain unacceptable scenarios arise. **While an independent chairperson and 75% independent board members may appear to create a more external flavor, decision frameworks, information flow, and solid internal checks and balances must also be built into the governance model**.

General

Given the vast quantity of expert comments on the other pertinent industry issues on the table today, e.g., late trading, fund timing, selective holdings disclosure etc., Lipper has consciously chosen not to comment. We are not privy to the details of these more internal, operational issues and feel that the proposed solutions sufficiently cover what we perceive as the primary issues. We strongly contend that the end result of Mr. Spitzer's investigations will be very positive, yet temporarily very damaging to the image of the fund business. What will not kill it will make it stronger and shareholder interests will be better served long-term. Within an enhanced regulatory and/or legislative framework, funds will remain the best vehicle for most retail investors – the business will be vibrant for many years to come.

Yet, **we are currently in a period where "over-regulation" is quite feasible**. Overreaction to a dangerous situation is inherently human, but should be mitigated when applied to the current fund industry scandal. Perhaps most pertinent, the formulation of new rules or guidelines should unquestionably be left to those bodies whose constituents know the financial markets best. The SEC and NASD are arguably those bodies. While legislative action has been proposed by many well-intentioned, prominent individuals, unintended consequences that harm investors and impede markets may result. Many of the proposed solutions involve burdensome and costly infrastructure be built which may squelch competition and create a more oligopolistic model, thus reducing options. The SEC and NASD have overseen markets and governing bodies for decades and are best positioned to assess the efficacy of specific proposals that seek to eliminate malicious or self-serving activities, yet must not reduce fund investor freedoms and market forces. Above all, any **reforms that are designed to directly address shareholder-unfriendly practices should be crafted carefully and not rushed**.

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We trust that the subcommittee has found our statistics, comments, and insights useful and look forward – as investors and as a prominent service provider to the business – to a stronger mutual fund industry for many years to come.