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MUTUAL FUNDS

Information on Trends in Fees and Their Related Disclosure

Statement for the Record by
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Highlights

Highlights of GAO-03-551T, a statement for the record to the Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

Why GAO Did This Study

Millions of U.S. households have invested in mutual funds whose value exceeds $6 trillion. The fees and other costs that these investors pay as part of owning mutual funds can significantly affect their investment returns. Recent press reports suggest that mutual fund fees have increased during the market downturn in the last few years. In addition, questions have been raised as to whether the disclosures of these fees and other costs, such as brokerage commissions, are sufficiently transparent. GAO updated its analysis from its June 2000 report, which showed the trends in mutual fund fees from 1990 and 1998 for large funds by collecting data on how these 76 funds' fees changed between 1998 to 2001. GAO also reviewed the Securities and Exchange Commission's recent rule proposal on fee disclosure as well as studies by industry.

www.gao.gov/cgi-bin/getrpt?GAO-03-551T.
To view the full statement, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

MUTUAL FUNDS

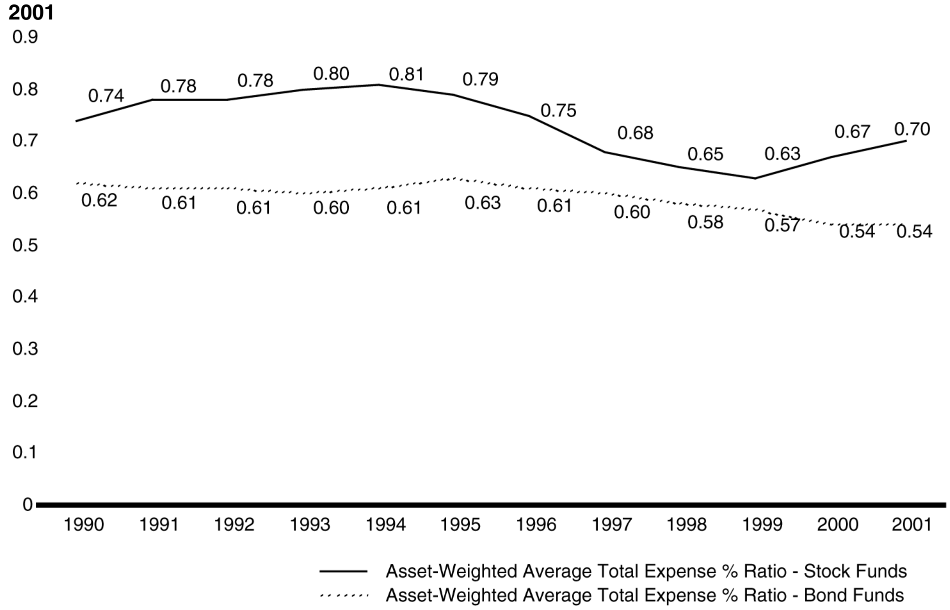
Information on Trends in Fees and Their Related Disclosure

What GAO Found

Recent data indicate that mutual fund fees may have increased. Studies by the staff of the Securities and Exchange Commission (SEC) and the Investment Company Institute found that expense ratios for mutual funds overall have increased since 1980. GAO's prior analysis of large mutual funds showed that these funds' average expense ratios generally decreased between 1990 and 1998, but between 1999 and 2001, the average ratio for the large stock funds analyzed has increased somewhat while the average ratio for the large bond funds has continued to decline. The average expense ratio for these large funds overall remains lower than their average in 1990.

SEC is proposing that investors receive additional information about mutual fund fees in the semiannual reports sent to fund shareholders. If adopted, these new disclosures would appear to provide additional useful information to investors and would allow for fees to be compared across funds. However, various alternatives to the disclosures that SEC is proposing could provide information specific to each investor and in a more frequently distributed and relevant document to mutual fund shareholders—the quarterly account statement, which presents information on the actual number and value of each investor's shareholdings. Industry participants have raised concerns that requiring additional disclosures in quarterly statements would be costly and that the additional benefits to investors have not been quantified.

Asset-Weighted Average Expense Ratios for 76 Stock and Bond Funds 1990 - 2001



Sources: GAO (analysis), Morningstar and Lipper (data).

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to provide information on GAO's recent work on mutual fund fees. Millions of U.S. households have invested in mutual funds whose value exceeds $6 trillion. The fees and other costs that these investors pay as part of owning mutual funds can significantly affect their investment returns. Recent press reports suggest that mutual fund fees have increased during the market downturn in the last few years. In addition, questions have been raised as to whether the disclosures of these fees and others costs, such as brokerage commissions, are sufficiently transparent. In a report issued in June 2000, we found that fees for the largest stock and bond mutual funds had declined from 1990 to 1998 but that not all funds had reduced their fees.[1] We also found that mutual funds do not usually compete directly on the basis of their fees, and we recommended that Securities and Exchange Commission (SEC) consider additional disclosures regarding fees to increase investor awareness and to encourage additional price competition among funds.

The operating costs that mutual funds incur are expressed as a percentage of fund assets and called the fund's operating expense ratio. This expense ratio includes the management fee (the amount the fund's investment adviser charges for managing the fund), the fund's other operating expenses (such as fund accounting or mailing expenses), and 12b-1 fees (distribution expenses paid out of fund assets).[2] Moreover, funds incur other costs not included in the expense ratio that also can affect investor returns. For example, funds pay commissions to broker-dealers to execute trades for their fund. This statement responds to your request that we (1) provide updated information on how mutual fund fees have changed since our June 2000 report, (2) discuss how fund fees are currently disclosed and various alternatives for expanding these disclosures, and (3) provide information on how mutual funds' trading costs are disclosed.

To evaluate trends in mutual fund fees, we obtained and analyzed data on the fees and other expenses of 76 mature stock and bond mutual funds from financial research organizations to update analysis presented in our June 2000 report. At the time we conducted the work for our June 2000

[1] U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000).

[2] 12b-1 refers to the specific rules under the Securities Exchange Act that authorized mutual funds to pay for marketing and distribution expenses directly from fund assets.

report, these were the largest funds in existence during the period 1990-1998.[3] Because these funds had grown more than other funds, we expected them to have been subject to the greatest economies of scale, which could have allowed their advisers to reduce the fees they charge investors. For this statement, we obtained information on these funds' assets, expenses, and other information from 1999 to 2001, which was the latest year complete data were available for all these funds. We also reviewed recent studies by regulators and industry associations on trends in mutual fund fees. To describe how fund fees are disclosed and various alternatives for expanding these disclosures, we relied on our prior work on this subject; also we reviewed current SEC rule proposals and comment letters by industry participants and investors.[4] To assess the brokerage commissions mutual funds pay and how these are disclosed, we reviewed SEC rules and studies by academics and others. For each of the topics we addressed in this statement, we also gathered views and relevant documentation from staff at SEC, three mutual fund companies, the Investment Company Institute (ICI), which represents mutual fund companies, and an investor advocate.

In summary, recent studies show that mutual fund fees may be on the rise. Our prior analysis of large mutual funds showed that these funds average expense ratios generally decreased between 1990 and 1998, but between 1999 and 2001, the average ratio for the large stock funds we analyzed has increased somewhat while the average ratio for the large bond funds has continued to decline. The average expense ratio for these 76 funds overall fees remains lower than their average in 1990. However, since 1998, the majority of stock and bond funds we analyzed had higher expense ratios in 2001 than they did in 1998. The decline in assets for many stock funds since 2000 may have contributed to the recent increase in expense ratios because many funds have fee schedules that decrease fees at various increments as fund assets increase.[5] However, when assets decline, less of

[3] For our June 2000 report, we analyzed data for 77 large funds—46 stock funds and 31 bond funds—between 1990 and 1998. However, since we issued that report, one of these funds no longer exists, so our data for 1999 to 2001 presented in this statement included data for 76 funds.

[4] U.S. General Accounting Office, *SEC's Report Provides Useful Information on Mutual Fund Fees and Recommends Improved Fee Disclosure*. GAO-01-655R (Washington, D.C.: May 3, 2001).

[5] For example, a fund's management fee could be 0.35 percent on assets up to $5 billion, 0.30 percent on assets between $5 billion and 10 billion, and 0.27 percent on assets above $10 billion.

these funds' assets are charged the lower fee increments, which increases the expense ratio they report as a percentage of their total assets. Although most of the expense ratios for the large bond funds we analyzed had also increased, the overall average of these funds' ratios had declined because assets for lower-fee funds were growing faster than those of higher-fee funds.

In response to the recommendation in our 2000 report that SEC consider additional disclosures regarding fees, SEC issued proposed rule amendments in December 2002 that would require that mutual funds make additional disclosures of fees to their shareholders. These new disclosures would appear to provide additional useful information to investors and will allow for fees to be compared across funds. However, SEC is proposing that this information be included only in the semiannual shareholder reports, which provides information to all of a mutual fund's investors that is not investor specific. Various alternatives to the disclosures that SEC is proposing were discussed in our prior reports and those of others that could provide information specific to each investor in a more frequently distributed and relevant document to mutual fund shareholders—the quarterly account statement, which presents information on the actual number and value of each investor's shareholdings. However, industry participants have raised concerns that requiring additional disclosures in quarterly statements would be costly and their additional benefits to investors have not been quantified.

Industry participants and others are also debating whether to increase the disclosures that mutual funds are required to make about their trading costs, such as the commissions funds pay to broker-dealers when they trade securities. Currently, funds are required to disclose the amount of brokerage commissions they paid only in reports sent to SEC, which are available to investors only if specifically requested. Although SEC has not proposed any changes to how funds disclose these costs, academics and investor advocates believe that additional disclosures of these expenses would be useful to investors. However, industry participants raised concerns over whether such disclosures would provide information that could be meaningfully compared across funds.

Mutual Fund Fees Appear to Have Risen Recently

Data from others and our own analysis indicates that mutual fund fees may have increased recently. Studies by SEC and ICI found that expense ratios for mutual funds overall have increased since 1980. Our own analysis finds that average expense ratios for large stock funds have increased since 1998, but those for large bond funds have declined since then.

Recent Studies Indicate that Mutual Fund Expense Ratios Have Increased

Since we issued our report in 2000, the staff at SEC have published a study of mutual fund fees that showed that fund expense ratios have increased.[6] The SEC staff study measured the mutual fund expense ratio of all stock and bond mutual funds between 1979 and 1999. The study used a weighted average of mutual funds in order to give more weight to funds with more assets. Their study found that the average expense ratio for these funds rose from 0.73 percent in 1979 to 0.94 percent in 1999. However, they noted that the increase in mutual fund expense ratios since the 1970s can be attributed primarily to changes in the manner that mutual funds and their shareholders pay for distribution and marketing expenses. Over this period, many funds have decreased or replaced front-end loads, which are not included in a fund's expense ratio with ongoing rule 12b-1 fees, which are included in a fund's expense ratio. Front-end loads are charged to investors as a percentage of the initial investment when they buy shares and are used to compensate financial professionals, such as the investor's broker or financial planner.

Using a different methodology, ICI also published a series of studies that show that, although expense ratios may be rising, the overall cost of investing in mutual funds has decreased. ICI's studies attempt to measure what it calls the "total shareholder cost" of investing in mutual funds by considering both a fund's operating expense ratio and any sales charges, such as loads, investors paid when investing in that fund. To determine the average total cost of investing in funds as a percentage of fund assets, ICI also weights each individual fund's total cost by the fund's sales each year. By using sales to weight each fund's contribution to the overall average, ICI indicates that it is attempting to present the cost and the actual investment choices made by investors purchasing mutual fund shares in particular years. In its latest study using this methodology, ICI reports that the total shareholder costs for equity funds fell from 2.26 percent of fund assets in 1980 to 1.28 percent in 2001, and that the total cost of investing in bond funds declined from 1.53 percent to 0.90 percent during the same period.[7]

[6] U.S. Securities and Exchange Commission Division of Investment Management, *Report on Mutual Fund Fees and Expenses* (Washington, D.C.: December 2000).

[7] Investment Company Institute, *Total Shareholder Cost of Mutual Funds: An Update* (Washington D.C.: September 2002).

According to ICI's study, the primary reason that the total cost of mutual fund investing has declined results from the reduction in sales and other distribution costs paid by mutual fund investors over this period. For example, ICI finds that the average load has fallen from 7.0 percent of the dollar value of investors' purchases to 5.2 percent and sales of shares not subject to such loads have also increased. For example, some funds waive the load for certain investors, such as purchases by retirement plans.

Some industry participants have criticized the ICI's methodology. As we discussed in our June 2000 report, analysts at one industry research organization acknowledged that the ICI data may indicate that the total cost of investing in mutual funds has declined.[8] However, they said that because ICI weighted the fund fees and other charges by sale volumes, the decline ICI reports results mostly from actions taken by investors rather than advisers of mutual funds. These research organization officials noted that ICI acknowledged in its study that about half of the decline in fund costs resulted from investors increasingly purchasing shares in no-load funds.

Although ICI's study shows that the total cost of investing in funds may be declining, it also shows that stock funds' expense ratios have risen. According to ICI's September 2002 study, the average stock fund operating expense ratio has risen from 0.77 percent in 1980 to 0.88 percent in 2001. ICI's study also shows that the average expense ratio of the stock funds it reviewed has continued to rise in recent years from 0.83 in 1998 to 0.88 percent in 2001. ICI attributes this increase to two factors. First, funds with higher expense ratios, such as aggressive growth funds or international stock funds, have been popular lately and increased sales of these funds would increase the overall average. Second, the decline in assets experienced by many stock funds as a result of the market decline since 2000 also means that such funds have fewer assets over which to spread their fixed operating costs and thus their expense ratio would rise as a percentage of their assets.

Recent press reports have also indicated that fees for mutual funds may be increasing. For example, a March 2003 press report presented data from Lipper, Inc., a mutual fund research service, that shows that the median

[8] Morningstar, Inc., *Morningstar.Net Commentary: Revisiting Fund Costs: Up or Down?*, Scott Cooley, (Feb. 19, 1999).

expense ratio for stock funds increased from 1.30 percent in 1998 to 1.46 percent in 2002.

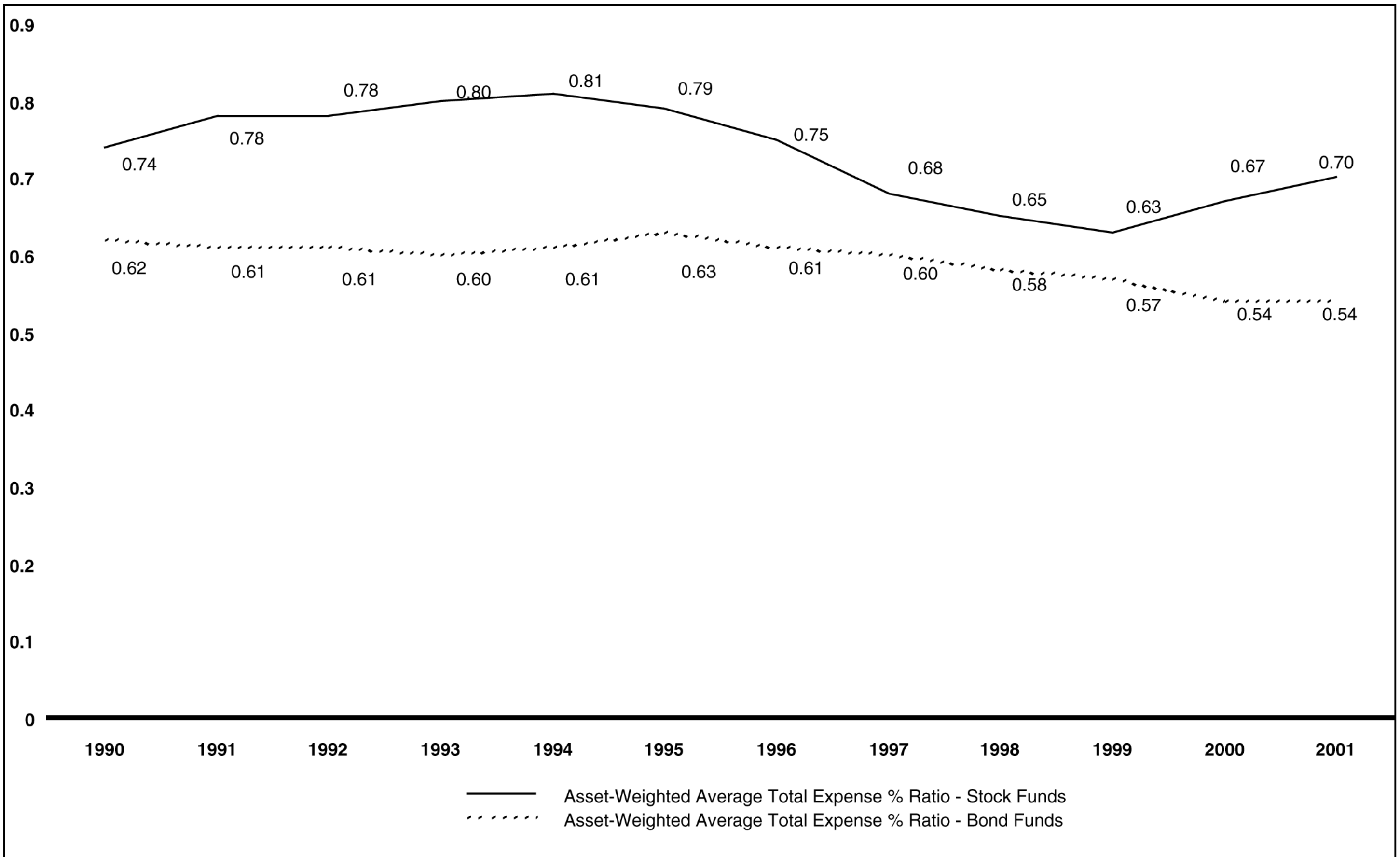
Our Analysis Shows that Average Fees for Large Stock Funds Have Increased Recently, but Fees for Large Bond Funds Have Declined

Although our June 2000 report found that fees for large stock and bond funds had generally declined between 1990 and 1998, analysis of recent years shows that the average expense ratios for large stock funds have risen since 1998 while fees for bond funds have continued to decline. For our June 2000 report, we analyzed the change in expense ratios from 1990 to 1998 for 77 large stock and bond mutual funds, which because of their growth during this period—which collectively averaged over 600 percent—were likely to have experienced economies of scale in their operations that would allow them to reduce their expense ratios. To calculate the average expense ratios on the large mutual funds identified in our previous report, we weighted each fund's expense ratio by its total assets. The resulting asset-weighted average expense ratios represent the fees an average investor would expect to pay on every $100 dollars invested in these funds during this period. Since our 2000 report one of the bond funds was liquidated, so our analysis for this statement presents comparable results for 76 funds.

As shown in figure 1, since 1990, the average expense ratio charged by the large stock funds we analyzed, after generally rising during the mid-1990s, declined the second half of the 1990s and then began rising again. The asset-weighted average expense ratio for these stock funds declined from 0.74 percent in 1990 to 0.70 percent in 2001. However, the average expense ratio of these funds has increased recently by about 8 percent, from 0.65 percent in 1998 to 0.70 percent in 2001. The average expense ratios for the large bond funds also generally declined between 1990 and 2001, from 0.62 percent to 0.54 percent. However, unlike the stock funds, the bond funds have continued to decline since 1998.[9]

[9] For our June 2000 report, the asset-weighted average expense ratios were calculated using each fund's year-end net assets. Consistent with industry practice, we calculated the average expense ratios for our updated analysis using each fund's average net assets for each year. Based on a comparison of 1998 information calculated both ways, the difference does not appear to materially affect the overall trends we identified.

Figure 1: Asset-Weighted Average Expense Ratios for 76 Large Stock and Bond Funds, 1990–2001



Sources: GAO (analysis), Morningstar and Lipper (data).

Various factors may explain the recent rise in stock fund expense ratios. ICI and industry participants attribute recent increases in average expense ratios industrywide to asset declines among stock funds. For example, ICI reported that total assets held by stock funds have declined from over $4 trillion in 1999 to about $3.4 trillion at the end of 2001. The decline in assets for many stock funds may have contributed to the recent increase in expense ratios because many funds have fee schedules that charge lower management fees at various increments as the fund's assets increase. As the assets of a fund with such a declining rate fee schedule increase, these additional assets are assessed a lower-percentage rate fee, which results in the fund reporting a lower total expense ratio overall. However, when assets decline, more of the fund's assets are charged the higher management fee increments, resulting in an increase in the overall expense ratio of the fund.

However, asset declines and resulting increases in some expense ratios do not explain all of the increases in the average expense ratio for the large stock funds we analyzed because the assets of most of these funds continued to grow. Overall, the total assets in the 46 stock funds we reviewed increased from $835 billion in 1998 to over $1,052 billion in 2001. Individually, 28 of the 46 stock funds experienced asset growth between 1998 and 2001, although most of these funds' assets declined from 2000 to 2001.

The decline in the average expense ratio for bond funds shown in figure 1 appeared to arise from stronger asset growth in lower-fee funds. We divided the 30 bond funds in our analysis into two groups: (1) those funds with expense ratios in 1998 that were higher than the 0.60 percent weighted average ratio for all 30 funds and (2) those funds with expense ratios in 1998 that were lower than the 0.60 percent weighted average ratio for all 30 funds. As shown in table 1, the 16 low-fee funds experienced overall asset growth of about 32 percent, whereas the assets of the 14 high-fee funds declined 16 percent from 1998 to 2001. In addition, the low-fee funds' average expense ratio declined by 7 percent whereas the high-fee funds' ratio decreased only 2 percent.

Table 1: Change in Assets and Expense Ratios for 30 Bond Funds, by High- and Low-Fee Funds, 1998—2001

	Total assets (in millions)		Percentage change	Expense ratios (in percent)		Percentage change
	1998	2001		1998	2001	
14 high-fee funds	$74,295	$62,045	-16 percent	0.84	0.82	-2 percent
16 low-fee funds	87,571	115,380	32 percent	0.41	0.38	-7 percent

Source: GAO analysis of data from Lipper.

Looking specifically at the extent to which individual funds expense ratios changed, we found that the expense ratios for the majority of the large stock and bond funds we analyzed had also increased since 1998. As shown in table 2, the expense ratios for 28 or 61 percent of the 46 large stock funds we analyzed increased from 1998 to 2001. The table also shows that half of these 28 funds had increased their total assets but their expense ratios continued to increase. However the majority of these expense ratios increases were less than 10 percent. Table 2 shows four funds whose assets increased by more than 30 percent and whose expense ratios increased by more than 10 percent. However, these four funds management fees included provisions that would allow the fund adviser to charge a higher rate if the fund's performance exceeded certain benchmarks. For example, the expense ratio of one of these funds increased from under 0.60 percent in 1998 to 0.88 percent in 2001. This increase is due in large part to the fund's fee schedule, which calls for part of the fund's management fee to go up or down between 0.02 percent and 0.20 percent of assets annually, depending on whether the fund's 3-year performance was better or worse than the return of the S&P 500 index, which this fund's performance did exceed. Of the remaining 18 funds we analyzed, most of whose assets increased, their expense ratios either did not change or decreased between 1998 and 2001.

Table 2: Changes in Assets and Expense Ratios in 46 Large Stock Funds, 1998–2001

	Percentage change in assets					
Change in expense ratios	**+100 or more**	**+100 to +30**	**+30 to 0**	**0 to –30**	**-30 or more**	**Total**
Increase over 30 percent	1	1	1	1	-	4
Increase between 10 percent and 30 percent	-	2	1	2	-	5
Increase under 10 percent	-	3	5	9	2	19
Subtotal	**1**	**6**	**7**	**12**	**2**	**28**
No change	-	-	1	-	-	1
Decrease under 10 percent	5	4	2	3	-	14
Decrease between 10 percent and 30 percent	1	1	-	-	1	3
Decrease over 30 percent	-	-	-	-	-	-
Subtotal	**6**	**5**	**3**	**3**	**1**	**18**
Total	**7**	**11**	**10**	**15**	**3**	**46**

Source: GAO analysis of data from Lipper.

The expense ratios for the majority of bond funds that we analyzed also increased. As shown in table 3, the expense ratios for 18, or 60 percent, of the 30 large bond funds we analyzed also increased from 1998 to 2001. Over this period, 14 of the funds' assets decreased—which could increase their expense ratios because less of their assets would be subject to lower fee rates under a declining rate fee schedule. Four funds assets and expense ratios increased between 1998 and 2001. However, of the 18 funds with increased expense ratios, the majority of the increases were less than 10 percent.

Table 3: Changes in Assets and Expense Ratios in 30 Large Bond Funds, 1998–2001

Change in expense ratios	Percentage change in assets: +100 or more	+100 to +30	+30 to 0	0 to –30	-30 or more	Total
Increase over 30 percent	-	-	-	-	-	-
Increase between 10 percent and 30 percent	-	-	-	2	1	3
Increase under 10 percent	1	2	1	9	2	15
Subtotal	**1**	**2**	**1**	**11**	**3**	**18**
No change	-	-	-	-	-	-
Decrease under 10 percent	-	1	5	2	-	8
Decrease between 10 percent and 30 percent	-	3	-	1	-	4
Decrease over 30 percent	-	-	-	-	-	-
Subtotal	**-**	**4**	**5**	**3**	**-**	**12**
Total	**1**	**6**	**6**	**14**	**3**	**30**

Source: GAO analysis of data from Lipper.

SEC Is Proposing Additional Fee Disclosures, but Other Alternatives Could Provide More Specific Information

SEC is proposing that investors receive additional information about mutual fund fees, but other alternatives for disclosing fees exist that could better inform investors of the actual fees they are charged. The SEC proposal would allow fees to be compared across funds, but would present information to investors in dollar amounts using only illustrative investment amounts. In contrast, various alternative means of providing additional fee disclosures would provide dollar amounts calculated using each investors' own account balances or number of shares owned and present this information in the quarterly statements they receive that show the value of their mutual fund holdings. Although mutual funds generally do not emphasize the level of their fees in their advertisements, SEC is also proposing that additional disclosures be made in such materials.

SEC Proposal Provides Additional Information on Fees

Since 1988, SEC has required that mutual fund prospectuses include a table that shows all fees and charges associated with a mutual fund investment as a percentage of net assets. The fee table reflects (1) charges paid directly by shareholders out of their investment such as front- and back-end sales loads and (2) recurring charges deducted from fund assets such as management and 12b-1 fees. The fee table is accompanied by a numerical example that illustrates the aggregate expenses that investors could expect to pay over time on a $10,000 investment if they received a 5-percent annual return and remained in the fund for 1, 3, 5, or 10 years.[10] In addition, SEC adopted requirements in January 2001 that require mutual funds to disclose their after-tax returns. SEC staff told us that taxes can have an even more significant impact on investors' returns than fund expenses.

In response to the recommendation in our 2000 report that SEC consider additional disclosures regarding fees, SEC released proposed rule amendments in December 2002 whose primary purpose is to require mutual funds to disclose additional information about their portfolio holdings, but also proposes that they make additional disclosures about their expenses.[11] Under this proposal, SEC would require that mutual fund investors be provided with information on the dollar amount of fees paid using preset investment amounts. This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to present a table showing the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. This disclosure is intended to permit investors to estimate the actual costs in dollars that they bore over the reporting period using the actual return for the period. In addition, SEC is also proposing that mutual funds present in the table the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. This second disclosure, would allow investors to more easily compare the differences in the actual expenses of two funds irrespective of any performance differences between the two.

SEC is also proposing that a narrative accompany these two new expense disclosures. The narrative would explain that mutual funds have transaction-based charges, such as loads or fees for exchanging shares of

[10] In 1998, SEC increased the hypothetical investment amount illustrated in the fee table example from $1,000 to $10,000 to reflect the size of the more typical fund investment.

[11] Securities and Exchange Commission, *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, 68 Fed. Reg. 160-01 (Washington, D.C.: Dec. 18, 2002).

one fund for another, and ongoing costs, as represented by the expense ratio, and that the numerical examples are intended to help shareholders understand these ongoing costs and to compare these costs with the ongoing costs of investing in other mutual funds. The narrative would also explain the assumptions used in the examples, note that the examples do not reflect any of the transaction-based costs, and advise investors that examples are useful in comparing ongoing but not total costs of investing in different funds.

The method of disclosure that SEC is proposing is consistent with one of the alternatives discussed in our June 2000 report. As SEC's rule proposal states, the two new expense figures being proposed are designed to increase investor understanding of the fees that they pay on an ongoing basis for investing in a fund. The proposed disclosure in shareholder reports would supplement the fee disclosure required in the mutual fund prospectus. According to SEC staff, the new disclosures they are recommending would be placed in the annual and semiannual reports because these documents contain more information than quarterly statements and thus would allow investors to better understand fee information in an appropriate context. SEC staff also believe that providing this information in these reports will allow investors to compare the fees of one fund to another. If adopted, we agree that the proposed disclosures would provide investors with additional useful information.

SEC has received a wide range of comments on their proposal specific to disclosure of fund expenses. Most comments were in support of SEC's requirement to include the dollar cost associated with a $10,000 investment. For example, one investment advisory firm commented in its letter that the new disclosures SEC is proposing would benefit investors by allowing them to estimate actual expenses and compare costs between different funds in a meaningful way. Some commenters also noted that requiring specific dollar disclosures was not necessary, given the potential costs and burdens to mutual fund companies. One large labor union supported SEC's proposal, but encouraged SEC to explore cost-effective methodologies to provide investors with their actual share of fees. An industry association representing attorneys stated in its letter that it generally supported the additional disclosures SEC was proposing, but given existing disclosures requirements, the benefits of these additional disclosures appeared marginal at best.

Alternative Disclosures Could Provide Investors More Specific Information

Alternatives to the SEC proposal could offer more investor-specific information. While SEC's proposed disclosures would provide additional information that investors could use to compare fees across funds, the disclosures in SEC's 2002 proposed rule amendments would not be investor specific because they would not use an investor's individual account balances or number of shares owned. In addition, SEC's proposed placement of these new disclosures in the semiannual shareholder reports, instead of in quarterly statements, may be less likely to increase investor awareness and improve price competition among mutual funds. Quarterly statements, which show investors the number of shares owned and value of their fund holdings, are generally considered to be of most interest to investors.

In our June 2000 report, we offered another alternative for disclosing fee information that would provide shareholders with the specific-dollar amounts of fees paid on their shares in their quarterly account statements. We noted that such disclosure would make mutual funds comparable to other financial products and services such as bank checking accounts or stock or bond transactions through broker-dealers. As our report noted, such services actively compete on the basis of price. If mutual funds made similar specific-dollar disclosures, we stated that additional competition on the basis of price would likely result among funds.

SEC and industry officials raised concerns about requiring specific-dollar disclosures in quarterly statements. They believed that the potential costs associated with accounting for, and reporting, costs on an individual basis could be significant. After our June 2000 report was issued, ICI commissioned a study by a large accounting firm to survey mutual fund companies about the costs of producing such disclosures.[12] This study obtained information from 39 mutual fund companies and entities that provide services to mutual funds.[13] To produce specific-dollar disclosures, the respondents indicated the most costly activities that would be necessary to produce this information included

[12] PriceWaterhouseCoopers, *ICI Survey on GAO Report on Mutual Fund Fees*, (Jan. 31, 2001).

[13] The survey obtained information from 39 mutual fund companies and their designated affiliates, as well as from independent transfer agents and shareholder servicing agents, national and regional broker-dealers, securities clearing firms, and financial planning firms. The assets of 39 mutual fund companies that provided data represent approximately 77 percent of total industry net assets as of June 30, 2000.

- enhancing current data processing systems
- modifying investor communication systems and media
- developing new policies and procedures and
- implementing employee training and customer support programs.

Officials highlighted, in many cases, that mutual fund companies do not have access to the name and account information for individual shareholders to whom the fee disclosures would be made. Instead, broker-dealers or financial planners maintain account information on the many shareholders who purchase their mutual fund shares through these third parties. The third parties in turn maintain what are called omnibus accounts at the mutual fund. As a result, the mutual fund will know only the total number of shares owned by clients of a particular party, but not know how many actual shareholders there are and how many shares each shareholder owns. To disclose the specific-dollar amount of fees for each of these shareholders would require funds and third parties to communicate daily to receive the specific cost information that would then have to be attributed to each shareholder's individual account.

The ICI study concluded that the aggregated estimated costs of the survey respondents to implement specific-dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. However, this estimate did not include the reportedly significant costs that would be borne by third-party financial institutions, which maintain accounts on behalf of individual mutual fund shareholders.

Although ICI's estimates are significant in the aggregate, when spread over the accounts of many investors, the amounts are less sizeable. For example, ICI reported that at the end of 2001, a total of about 248 million shareholder accounts existed. If the 39 fund companies, which represent 77 percent of industry assets, also maintain about the same percentage of customer accounts, then the 39 companies would hold about 191 million accounts. As a result, apportioning the estimated $200 million in initial costs to these accounts would amount to about $1 per account. Apportioning the estimated $66 million in costs to these accounts would amount to $0.35 per account.

Another option to improve mutual fund fee disclosures would involve calculating estimates of fund expenses attributable to individual investors. One former fund adviser suggested that mutual funds could provide investors with fairly precise estimates of what they are paying in fees in their quarterly account statement by multiplying the funds' expense ratio for the prior year by the assets that the shareholder held as of the last day of the year or period. According to the former fund adviser, this calculation, which would help investors better understand the fees their investments are incurring, could be made at minimum cost to mutual funds.

According to some mutual fund officials, the expense calculation disclosure presents similar cost concerns and raises other issues. According to ICI staff, mutual funds and third-party financial institutions may have to develop improved communication links to pass the information needed to make this calculation, and thus would incur some of the same costs as specific-dollar disclosures would entail. In addition, mutual fund officials expressed concerns that providing investors estimates could also create problems. For example, an estimate calculated on the basis of the investor's holding on the closing day of the statement could be highly inaccurate if the number of shares owned by the investor has changed dramatically during the period. ICI staff also noted that fund complexes would likely want to include considerable explanatory material or disclaimers about the nature of the estimated information that this type of disclosure would provide. Before requiring mutual fund companies and others to incur such costs to produce these additional disclosures, ICI officials said that the benefits to investors would have to be better quantified.

As a result, although additional disclosures could provide investor-specific information and in documents that investors receive more frequently, fund companies and other financial institutions would incur costs to produce such additions to the existing reporting made to fund shareholders. The benefit to investors from receiving this additional information has not been quantified.

Mutual Fund Advertisements Usually Do Not Focus on Fees, but SEC Is Proposing Additional Disclosures

Although mutual fund officials say that funds compete vigorously against each other, they generally do not emphasize fees in their advertisements and SEC is proposing additional disclosures be made. In our 2000 report, we reported that fund advisers generally do not emphasize the level of their fees when attempting to differentiate their funds from those of their competitors. We recently analyzed 29 different mutual fund advertisements that ran in the 2002 and 2003 mutual fund editions of three major business magazines. Of these, only three advertisements emphasized low management fees, 12b-1 fees, or expense ratios. In addition, while one mutual fund family, which accounted for 9 of the 29 advertisements, frequently advertised that its funds had no loads, the primary emphasis in the majority of advertisements was on other themes such as, in order of their frequency, the importance of long-term investments, risk management, good performance as evidenced by high rating by mutual fund advisory services, and tax savings.

In 2002, SEC proposed amendments to investment company advertising rules.[14] These changes would allow mutual funds to advertise more timely information than that appearing in fund prospectuses and would require more balanced disclosure of information, particularly in the area of past performance. The proposal also includes a provision that would require funds to indicate that information about charges and fees can be found in a fund's prospectus. Under current requirements, mutual funds are not required to discuss fees in advertisements. Nevertheless, in practice, most of the mutual fund advertisements that we analyzed already included language that referred investors to the fund prospectus for information on fees and charges.

Mutual Fund Trading Costs Are Additional Expense to Investors but Are Not Prominently Disclosed

In addition to the expenses reflected in the expense ratio, mutual funds also incur trading costs that also affect investors' returns. Among these costs are brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf. Currently brokerage commissions are not routinely or explicitly disclosed to investors and there have been increasing calls for disclosure as well as debate on the benefits and costs of added transparency.

Brokerage Commissions Add to Investor Costs

When mutual funds buy or sell securities for the fund, they may have to pay the broker-dealers that execute these trades a commission. In other cases, trades are not subject to explicit brokerage commissions but rather to markups or spreads. For example, the broker-dealers offering the stocks traded on NASDAQ are often compensated by the spread between the buying and selling prices of the securities they offer.[15] Other trading-related costs that mutual funds can incur include potential market impact or other costs that can arise when funds seek to trade large amounts of

[14] U.S. Securities and Exchange Commission, *Proposed Amendments to Investment Company Advertising Rules*, 67 Fed. Reg. 36712-01 (May 24, 2002).

[15] These different prices are called the (1) bid, the price at which the broker-dealer is willing to pay and (2) ask, the price at which the broker-dealer is willing to sell.

particular securities. For example, a fund seeking to buy a large block of a particular company's stock may end up paying higher prices to acquire all the shares it seeks because its transaction volume causes the stock price to rise while its trades are being executed.

Data from mutual funds indicates that brokerage commissions and other trading costs can be significant. Estimates of the size of brokerage commissions mutual funds pay ranged from 0.15 percent of funds' assets to as much as 0.50 percent. Various academic studies conducted in the mid-1990s found that brokerage commissions were around 0.30 percent of a mutual fund's total assets.[16] For example, a study that looked at more than 1,100 stock and bond funds found that brokerage commissions for these funds averaged 0.31 percent of fund assets.[17] These studies also found that brokerage commissions increase as turnover—the extent to which the fund buys and sells securities—increases.

In some cases, a portion of the brokerage commissions that funds pay may represent payment for research services from the executing broker-dealer. When a portion of the commission entitles the fund to such research, this amount is called "soft dollars." One academic study estimated that mutual funds pay brokerage commissions of about $0.06 per share traded.[18] Because individual investors trading through discount broker-dealers can trade for as little as $0.02 per share, the study's author attributes the higher amount of commissions—about 66 percent of the total amount per share—paid by mutual funds to charges for soft dollar research. Fund managers are allowed to engage in this practice under a provision created by the Congress in Section 28 (e) of the Securities Exchange Act of 1934. In adopting this section, the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to fund managers and permitted fund managers to use commission dollars paid by managed accounts to acquire research. SEC staff told the authors of this study that funds that obtain research using soft dollars would have the opportunity to reduce their expense ratios because the fund's manager

[16] These studies include: R. Fortin and S. Michelson, "Mutual Fund Trading Costs," *Journal of Investing*, (Spring 1998); J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania, (Nov. 2, 1999); and M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *Journal of Financial Research*, (Summer 1996).

[17] R. Fortin and S. Michelson.

[18] M. Livingston and E.S. O'Neal.

is not incurring as many direct costs for research activities. However, this study, which looked at 240 stock funds, also found that the funds with higher expense ratios also had higher brokerage commission costs. The authors said that this could either mean that these funds are investing in stocks that are more costly to research and to trade or that the managers of these funds were less resolute about reducing their expense ratios even though they did not have to pay directly for some of the research services obtained for their funds.

Calls Made for Increased Disclosure of Brokerage Commissions

Brokerage commissions are not disclosed in documents routinely sent to investors, and some parties have called for additional disclosures.[19] Currently, SEC requires mutual funds to disclose the amount of brokerage commissions paid in the statement of additional information (SAI), which also includes disclosures relating to fund policies, officers and directors, and tax matters. Specifically, SEC requires funds to disclose in their SAI how transactions in portfolio securities are conducted; how brokers are selected; and how they determine the overall reasonableness of brokerage commissions. Unlike fund prospectuses or annual reports, SAIs do not have to be sent periodically to a fund's shareholders, but instead are filed with SEC annually and are sent to investors upon request. The amount disclosed in the SAI does not include other trading costs borne by mutual funds such as spreads or the market impact cost of the fund's trading. SEC staff told us that, although investors are not sent the disclosures on brokerage commissions unless they request it, funds are required to disclose their portfolio turnover in their prospectuses, which new and existing investors are routinely sent.

Academics and other officials have called for increased disclosures relating to mutual fund brokerage commissions and other trading costs. In the academic studies we reviewed that looked at brokerage commission costs, the authors often urged that investors pay increased attention to such costs. For example, one study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing

[19] The cost of brokerage commissions to a fund is reflected in the fund's daily net asset value. Nevertheless, SEC requires a fund to disclose the aggregate amount of brokerage commissions paid during its 3 most recent fiscal years in the statement of additional information. If there is any material difference from the most recent fiscal year's brokerage commissions paid as compared with the prior 2 fiscal years, the material difference must also be explained.

trading costs as relevant information.[20] The authors of another study note that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' SAIs.[21]

Others who advocated additional disclosure of brokerage commissions cited other benefits. Some officials have called for mutual funds to be required to include their trading costs, including brokerage commissions, in their expense ratios or as separate disclosures in the same documents in which they disclose their expense ratios. For example, one investor advocate noted that if funds were required to disclose brokerage commissions in these ways, funds would likely seek to reduce such expenses and investors would be better off because the costs of such funds would be similarly reduced. He also indicated that when funds are required to disclose information, competition among funds usually results in them attempting to improve their performance in the area subject to the disclosures. He explained that this could result in funds experiencing less turnover, which could also benefit investors as some studies have found that high-turnover funds tend to have lower returns than lower-turnover funds.

However, mutual fund officials raised various concerns about expanding the disclosure of brokerage commissions. For example, some officials said that requiring funds to include brokerage commissions in their expense ratios would not present comparable information to investors because of the differences between funds that invest in securities upon which commissions are usually paid, such as shares listed on the New York Stock Exchange and funds that invest more in securities listed on the NASDAQ, for which usually the broker-dealers offering such securities are compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. ICI staff and others also told us that the costs of trading, including brokerage commissions, are required under current accounting practices and tax regulations to be included as part of the initial value (or basis) of the security purchased. As a result, this amount is used to

[20] J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec.

[21] M. Livingston and E.S. O'Neal.

compute the gain or loss when the security is eventually sold and thus the amount of any commissions or other trading costs are already explicitly included in funds' performance returns. If these costs were to be included in the expense ratio, then funds could seek to be allowed to present their returns without such costs included so that the additional disclosure would not appear to be a new expense amount.

In addition, SEC staff told us that fund directors are expected to oversee their fund's brokerage arrangements and review the fund's transactions to ensure that they are getting good trade executions. As a result, these directors have a fiduciary obligation to ensure that the level of brokerage commissions and other trading costs are being managed in the fund investors' best interests.