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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

"MUTUAL FUND INDUSTRY PRACTICES AND THEIR EFFECT ON INDIVIDUAL INVESTORS"

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EXECUTIVE SUMMARY

- The last several years have been challenging ones for investors, including mutual fund investors, market conditions and corporate and accounting scandals have shaken investor confidence.

- Throughout these difficult times, the comprehensive regulatory scheme under which mutual funds operate has served the interests of fund investors well.

- The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Every investor must receive a prospectus, which contains key information about a fund to help an investor make an investment decision. This includes information about fund fees and expenses.

- Mutual fund fees and expenses are clearly and prominently disclosed in a standardized, easy-to-read fee table at the front of every fund prospectus. Performance information in mutual fund advertisements must be presented net of fees. Fees also are subject to substantive regulation under the Investment Company Act of 1940 and NASD rules.

- The broad availability of information about mutual fund fees and expenses has helped promote price competition in the industry. Recent government and industry studies support the conclusion that competition is working in the interests of fund investors. Among the findings are that the average total cost of purchasing mutual funds has declined steadily and significantly since 1980, that mutual fund investors benefit from economies of scale, and that the overwhelming majority of investors buy and own funds with lower than average expenses.

- The SEC continues to improve disclosure of mutual fund fees and other costs, as demonstrated by various new and pending disclosure requirements, including proposed expense disclosure in mutual fund shareholder reports, proposed disclosure in fund performance advertisements directing investors to the prospectus for information about fund fees and expenses, and standardized disclosure of after-tax returns.

- In addition to disclosure and substantive regulation of fund fees and expenses, mutual funds are subject to comprehensive regulation under the Investment Company Act that has been effective in protecting investors and helping the industry avoid major scandal. The fact that many of the central tenets of mutual fund regulation – including independent boards, mark-to-market accounting, prohibitions on complex capital structures, prohibitions on self-dealing, and direct oversight by the SEC – are now being extended to other businesses (*e.g.,* through the Sarbanes-Oxley Act of 2002) serves as a strong endorsement of the mutual fund regulatory system.

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I. INTRODUCTION

My name is Paul G. Haaga, Jr. I am Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company, the investment adviser to the 29 funds in The American Funds Group, with more than $350 billion in assets under management. The American Funds Group is the third largest mutual fund group in the United States and the largest group distributed exclusively through unaffiliated financial intermediaries. I also serve as Chairman of the Board of Governors of the Investment Company Institute, the national association of the American investment company industry, and I appear here today on behalf of the Institute. The Institute's membership includes 8,929 open-end investment companies ("mutual funds"), 553 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.322 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

I am pleased to appear before the Subcommittee today to discuss how Securities and Exchange Commission (SEC) disclosure requirements and substantive regulation have provided mutual fund investors with a sound basis for making informed investment decisions, fostered competition in the mutual fund industry, and shielded the industry from major scandal.

The last two to three years have been challenging ones for all investors, including mutual fund investors. Because mutual funds themselves are investors in the securities markets, they have felt the impact of market downturns. In addition, the egregious corporate

and accounting scandals that have surfaced during this period have broadly impacted investor confidence.

In these difficult times, when so many Americans have entrusted their hard-earned dollars to mutual funds, it is entirely appropriate to conduct this review of mutual fund industry practices and their effect on individual investors. My testimony will describe how fund shareholders benefit from the current system of SEC mutual fund regulation.

First, I will describe mutual fund disclosure requirements, especially the requirements governing disclosure of fund fees and expenses. The availability of clear and prominent fee disclosure has served to create a basis for informed investment decisions. It also has promoted price competition in the industry, which has the beneficial effect of limiting costs to fund shareholders. Recent industry and government studies of mutual fund fees confirm the existence of competition. Moreover, in recent years, the SEC has adopted and proposed changes to further enhance fund disclosures.

Second, I will discuss key elements of the strong system of substantive regulation that has protected funds from the scandals that have shaken investor confidence in corporate America. In fact, in the aftermath of these scandals, many of the central tenets of mutual fund regulation – including independent boards, mark-to-market accounting, prohibitions on complex capital structures, prohibitions on self-dealing, and direct oversight by the SEC – are being extended to other industries through the provisions of the Sarbanes-Oxley Act of 2002 and other regulatory initiatives.

II. BENEFITS OF DISCLOSURE AND REGULATION OF MUTUAL FUND FEES

A. Clear and Prominent Fee Disclosure Is Provided to Investors

The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Each investor receives a prospectus at or before the time of buying fund shares. The prospectus provides detailed information about a fund's investment objectives and policies, risks, returns, fees and expenses, the fund manager, and how to purchase and redeem shares. In 1998, with strong support from the fund industry, the SEC adopted changes designed to improve the quality and usefulness of information in fund prospectuses in order to promote the primary purpose of the prospectus – to help an investor make an informed investment decision. One of the innovations adopted by the SEC at that time is the requirement for a standardized "risk/return summary" at the beginning of every fund prospectus that lays out concisely and in a specified order information about the fund's investment objectives, strategies, risks and performance, as well as its fees and expenses. [1]

Reflecting their importance as part of the information that investors and their professional advisors should consider when deciding whether to invest in a fund, fund fees and expenses are disclosed in a straightforward, standardized fee table. The fee table presents fund fees in two broad categories: shareholder fees (such as sales charges paid to compensate financial professionals who provide investment advice and other services) and annual fund

[1] At the same time that the SEC proposed these changes to fund prospectuses, it also proposed a rule, which the Institute supported, designed to prevent misleading fund names. The SEC adopted the "fund name rule" in 2001. It requires any fund whose name suggests that the fund invests in certain investments, industries, countries or geographic regions to have a policy of investing, under normal circumstances, at least 80 percent of its assets in a manner consistent with its name.

operating expenses. The fee table shows annual fund operating expenses broken down into specified categories. These include, for example, the "management fee" that the fund's investment adviser charges to manage the fund and the "distribution (12b-1) fee," if any, that the fund pays to cover costs such as compensating broker-dealers, financial planners and other financial professionals for services they provide directly to investors. Each type of annual operating expense is expressed as a percentage of the fund's average net assets. The fee table also shows total annual fund operating expenses as a percentage of average net assets (sometimes referred to as a fund's "expense ratio").[2]

One distinction between shareholder fees and annual fund operating expenses is that shareholder fees are paid directly by investors, whereas annual fund operating expenses are paid out of the fund's assets (and, thus, indirectly by investors) to cover the ongoing costs of running the fund and other services. Notably, investors often have the option of paying for the assistance and ongoing services of their financial advisers, including administrative services related to maintaining shareholder accounts, in more than one way. These payment options could include a direct fee (*i.e.*, a sales charge), a payment made from the fund's assets over time (*i.e.*, a 12b-1 fee), or a combination of both. Most investors use these services; thus, most funds have sales charges and/or ongoing fees to cover these costs. Indeed, Institute data show that the vast majority (approximately 80 to 85 percent) of mutual fund purchases are made by investors through financial intermediaries, including both financial advisers and employer-

[2] A variety of other readily available sources of information about mutual fund fees supplement the SEC's fee disclosure requirements. These sources include brokers and financial advisers, newsletters, newspapers and magazines. They also include the SEC itself, which in recent years has developed and made available on its website (www.sec.gov) both an interactive mutual fund cost calculator designed to assist investors in comparing the costs of different funds and other educational materials about investing in mutual funds. The Institute and many individual fund groups also offer educational resources and tools for investors to help them better understand fees and expenses as well as other important aspects of mutual fund investing.

sponsored retirement plans.[3] In other words, in most cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds. To provide investors with a choice of how to pay for these services, many funds offer various classes of shares that provide a variety of different payment options.[4]

The American Funds Group provides a good example of this. Our funds are sold exclusively through third parties, primarily retail broker-dealers. We have adopted a multiple class structure that, by providing choices, seeks to satisfy the different needs of the different types of customers we serve. The overall expenses of our share classes vary based largely on two important factors: (1) the level of compensation paid by the fund on behalf of its shareholders to financial intermediaries; and (2) the level of administrative services supported by the share class.[5]

In addition to listing a fund's fees and expenses, the prospectus fee table includes an example that illustrates the effect of fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare the costs of two or more funds because the invested amount and time periods are standardized. The total is an "all-in" figure,

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[3] *See* Investment Company Institute, 2002 Mutual Fund Fact Book, at 33.

[4] In a multiple class structure, each class of shares invests in the same portfolio of securities. Different classes may be sold through different distribution arrangements (*e.g.,* retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

[5] For example, we offer five share classes designed for use exclusively by retirement plans. These share classes have a broad spectrum of expense levels. The expense differences reflect the fact that some retirement plan sponsors wish to have the fund pay for all expenses of financial intermediaries and plan administration, while others prefer to pay most of these expenses directly and outside of the fund.

expressed as a single dollar amount, that takes into account both sales charges and annual operating expenses.[6]

The required disclosures of mutual fund fees are reinforced by SEC rules governing mutual fund performance advertising. Under current SEC rules, funds that advertise performance information must provide standardized total return data for prescribed periods. Importantly, all standardized performance numbers must be presented net of fees. Thus, when investors review and compare fund performance data, the effect of all fees has already been taken into account.

Taken together, the foregoing disclosure requirements provide investors and their professional advisers with the information needed to make decisions about the value that a particular fund can offer.

B. Substantive Regulation of Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees.

First, NASD rules place limits on mutual fund sales charges and 12b-1 fees.[7]

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[6] As discussed in Section II.D below, the SEC has proposed to require similar dollar amount disclosure in fund shareholder reports. The Institute supports that proposal.

[7] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to the most significant components of ongoing fund expenses – the investment advisory fee and any 12b-1 fee.[8]

For example, both the board as a whole and a majority of the fund's independent directors must review and approve any investment advisory contract entered into by a fund on an annual basis, after an initial term of no more than two years. Fund directors are required to request, and the adviser is obligated to provide, information reasonably necessary to review the terms of the contract, including the advisory fee.[9] My firm, Capital Research and Management Company, prepares extensive information for this purpose and provides it to the directors of The American Funds and their independent legal counsel approximately two weeks in advance of a meeting of the contracts committee of independent directors that is convened for the purpose of considering renewal of the investment advisory contract, the 12b-1 plan (discussed further below) and other key agreements between the funds and the investment management

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fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.,* NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000.

[8] As discussed further in Section III below, significant new SEC fund governance requirements designed to enhance board independence and effectiveness have recently gone into effect.

[9] While fund directors have a responsibility to make sure that advisory fees are reasonable in light of all relevant facts and circumstances, they are not required to engage in a competitive bidding process or to award the advisory contract to the adviser offering the lowest rates. Either of these approaches would, inappropriately, ignore the fact that the fund's shareholders have chosen the fund and the fund family in which they wish to invest. In the words of former SEC Chairman Arthur Levitt, "Directors don't have to guarantee that a fund pays the lowest rates. But they

organization. Every committee meeting includes an executive session involving the independent directors and their legal counsel outside the presence of fund management.

A fund's adviser has a fiduciary duty with respect to the receipt of compensation from the fund.[10] The SEC and fund shareholders may bring suit against the adviser for breach of this duty.[11]

Pursuant to Rule 12b-1 under the Investment Company Act, any payments by a fund for distribution-related expenses must be in accordance with a written plan approved annually by the fund's board of directors, including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that shareholders must approve any material changes to the advisory contract (including any proposed fee increase) and any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise these fees, nor may the board alone approve a fee increase.

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do have to make sure that fees fall within a reasonable band." Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

[10] Section 36(b) of the Investment Company Act of 1940. A mutual fund also enters into a number of contracts with other service providers, such as the fund's principal underwriter, administrator, custodian, and transfer agent. As part of its overall responsibilities, the board of directors oversees the performance of these service providers. If the service provider is the investment adviser or an affiliate of the adviser, the fund board must review and approve the contract with the service provider to ensure that any compensation paid thereunder meets the standards of Section 36(b).

[11] *See, e.g.,* Kalish v. Franklin Advisers, Inc., 928 F.2d 590 (2d Cir. 1991); Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).

C. Transparency of Fee Disclosure Has Helped Foster Competition

The broad availability of information about mutual fund fees and expenses has helped promote competition in the industry. Individual investors, as well as the intermediaries who assist investors in making their investment decisions, have access to and use this information. When the Institute testified on price competition in the fund industry in 1998, a central theme of the Institute's testimony was that competition in the mutual fund industry is working effectively in the interests of investors.[12] As evidence of this, we noted: (1) that mutual funds compete for investor dollars; (2) that there are low barriers to entry into the fund business; (3) that the industry is not concentrated; (4) that the total costs of investing in mutual funds are declining; (5) that mutual fund investors are benefiting from economies of scale; and (6) that a substantial majority of fund shareholders own equity funds that charge lower fees than the industry average. Each of these points remains valid today and several have been reinforced by developments since 1998.

1. The Market Structure of the Fund Industry Promotes Active Competition. In its 2000 report on mutual fund fees,[13] the United States General Accounting Office (GAO) described the mutual fund industry as one that features a large number of competitors, low barriers to entry, and product differentiation on the basis of performance, quality and services.

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[12] Statement of Matthew P. Fink, President, Investment Company Institute, before the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce on "Improving Price Competition for Mutual Funds and Bonds," September 29, 1998.

The GAO Report noted that both the number of funds and the number of fund families rose significantly during the period of 1984 to 1998 and that the industry was not concentrated.[14]

2. Mutual Fund Fees Continue to Decline. The Institute's 1998 testimony discussed several studies indicating that the total purchase cost of investing for mutual fund shareholders had steadily declined over time.[15] Additional studies of trends in mutual fund fees have been conducted more recently. These studies all reach the same conclusion: total costs of purchasing mutual fund shares have continued to fall.

According to Institute research, the average total cost that investors incurred when purchasing mutual funds[16] has declined steadily and significantly since 1980. From 1980 to 2001, the total cost of equity funds fell by 43 percent, the total cost of bond funds decreased by 41 percent and the total cost of money market funds decreased by 35 percent.[17]

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[13] United States General Accounting Office, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition" (June 2000) ("GAO Report").

[14] GAO Report at 58-59.

[15] These studies included: (1) Erik R. Sirri and Peter Tufano, "Competition and Change in the Mutual Fund Industry," *in Financial Services: Perspectives and Challenges,* edited by Samuel L. Hayes, III, Cambridge, MA, HBS Press, 1993; 92) Steve S. Savage, "Perspective Amid the Debate Over Mutual Fund Expenses," *AIA Investor News,* published by the American Investors Alliance, February 1993; (3) Lipper Analytical Services, Inc., "The Third White Paper," September 1997; and (4) "Advisory Fee Contracts," *Strategic Insight Overview,* May 1998, p.ii.

[16] To properly measure the total cost of investing in mutual funds, it is important to consider both (1) the sales charges paid by investors directly to compensate financial professionals who provide investment advice and other services, and (2) the annual operating expenses that are paid out of the fund's assets to cover the costs of running a fund and other services. Unlike annual operating expenses, sales charges are one-time charges. Thus, to measure total shareholder cost accurately, it is necessary to "annualize" the sales charge, *i.e.,* convert it into the equivalent of an annual payment paid by the investor over the life of his or her investment.

[17] *See* Investment Company Institute, "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals,* September 2002, available at http://www.ici.org/pdf/fm-v11n4.pdf.

The SEC's Division of Investment Management published its own study of mutual fund fees in 2000.[18] The SEC looked at both expense ratio trends and total ownership costs. According to the SEC study, the weighted average expense ratio for all fund classes declined in three out of the last four years that the SEC studied (from 0.99% in 1995 to 0.94% in 1999). While the SEC found an increase in the weighted average expense ratio from 0.73% in 1979 to 0.94% in 1999, it explained that this increase was due to the shift from use of front-end sales charges (which are not included in a fund's expense ratio) to finance distribution, to the use of 12b-1 fees (which are included in the fund's expense ratio). When examining the total ownership costs of "load classes,"[19] the SEC found a decline of 18% between 1979 and 1999.

3. Fund Investors Continue to Benefit from Economies of Scale. Some critics have suggested that the mutual fund industry has not passed economies of scale on to investors. These critics usually rely upon a fundamental misconception – that economies accrue to an *industry* that has grown. Economies do not accrue to an industry but rather only to individual funds or fund families as they grow. In fact, evidence shows that mutual fund investors have benefited from economies of scale.[20] Institute research shows that the expense ratios of large

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[18] Division of Investment Management, U.S. Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (December 2000).

[19] The SEC defined "load classes" as classes with 12b-1 fees higher than 25 basis points, classes with 12b-1 fees and contingent deferred sales charges, and classes with traditional front-end sales charges.

[20] The term "economies of scale" refers to the expectation that a growing fund should be able to spread certain fixed costs across a larger asset base, resulting in a declining expense ratio. In fact, the fee structures of many funds have been specifically designed to pass along economies of scale by means of management fee "breakpoints," which refer to a specific level of asset growth, and provide that when this level is achieved, the management fee rate will be reduced by a predetermined amount (*e.g.*, 5 or 10 percent).

equity funds were lower than those for smaller funds and that expense ratios declined as funds grew.[21]

The findings in the GAO Report are consistent with the Institute's research. For example, the GAO found that between 1990 and 1998, 85 percent of the equity funds included in its study reduced their expense ratios, with an average decline of 20 percent.[22] Another more recent empirical study of mutual fund advisory contracts provides further support for the proposition that mutual fund investors are benefiting from economies of scale. This study found that fee rates in mutual fund advisory contracts are lower for advisers of large funds and members of large fund families, leading the author to conclude that these results "are consistent with economies of scale being passed along to investors – suggesting a competitive environment."[23]

My own experience backs this up. Like many other fund groups, The American Funds have management fee schedules that provide a series of breakpoints at specified asset levels. As a result, our funds' shareholders have benefited greatly from economies of scale. For example, as a result of the amount of assets in our oldest and largest fund, Investment Company of America, the current advisory fee is .24%.

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[21] John D. Rea, Brian K. Reid, and Kimberlee W. Millar, "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds, *Perspective,* Vol. 5, No. 5, December 1999.

[22] The GAO examined expense ratios, asset growth rates, and related data for the 46 largest equity funds and 31 largest bond funds as of December 31, 1998 that had been in existence since January 1, 1990.

[23] Daniel N. Deli, *"Mutual Fund Advisory Contracts: An Empirical Investigation,"* The Journal of Finance, Vol. VII, No. 1, Feb. 2002, at 110.

4. Most Investors Buy and Own Lower Cost Funds. In 1998, the Institute testified that the overwhelming majority of both shareholders' equity fund accounts and equity fund assets were in mutual funds that charged annual fees below the simple average. More recent Institute data indicate that this is still true. In fact, in 2001, 79% of equity fund accounts and 87% of equity fund assets were in share classes with a below average expense ratio. Institute research also shows that the percentage of new sales attributable to share classes with a lower than average expense ratio was at least 80% in each year from 1997 through 2001, when it reached 86%.[24]

D. The SEC Continues to Improve Mutual Fund Disclosure

As discussed above, existing mutual fund fee disclosure requirements provide a high degree of transparency that has played a significant role in fostering competition in the mutual fund industry. The SEC continually seeks ways to further improve disclosure of mutual fund fees and other costs, as evidenced by various new and pending SEC disclosure requirements.

1. Shareholder Report Disclosure. Mutual funds are required to furnish to shareholders on a semi-annual basis reports containing the fund's financial statements and additional financial and other information. The SEC recently proposed changes to simplify and improve the disclosure in fund shareholder reports. Among other things, the proposals would allow mutual funds to provide summary portfolio schedules and require funds to provide graphic presentations of their portfolio holdings. The Institute strongly supports most of the

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[24] The experience of bond funds has been similar: 74% of bond fund accounts and 85% of bond fund assets were in share classes with below average expense ratios in 2001. The percentage of new sales of bond funds attributable to

proposed changes, which build on earlier SEC disclosure initiatives such as fund prospectus simplification.[25]

As part of its shareholder report disclosure improvement initiative, the SEC has proposed to require new disclosure concerning fund expenses in shareholder reports. Specifically, the SEC has proposed that fund shareholder reports disclose the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period. The proposed disclosure is intended to enhance investor understanding of ongoing fund expenses and allow investors to estimate the costs they bore over the reporting period.

The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment return and will also assist them in comparing the expenses of different funds. The proposed disclosure would complement the extensive fee and expense disclosure that funds currently provide.

In making its proposal, the SEC noted that it had considered an alternative approach that would require every quarterly account statement delivered to an investor to disclose the actual dollar amount of fees paid with respect to each mutual fund held by that investor during the last quarter. The SEC expressed concerns about the cost and logistical complexity of such a requirement. For example, in many cases, fund shares are held by broker-dealers, financial advisers, and other third-party financial intermediaries. In order to calculate and timely report

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bond fund share classes with lower than average expenses increased from 79% in 1997 to 85% in 2001.

[25] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated February 14, 2003.

personalized expense information for each fund held in an account each quarter, not only funds but also each intermediary would have to implement new systems, which would be extremely burdensome.[26] Based on these concerns, the SEC determined not to propose such an approach.[27]

Individual expense disclosure in account statements also would have other disadvantages. For example, it would not provide any context for an investor to assess the expenses paid in a meaningful way or to make comparisons with different funds. If an account statement reflected investments in several different funds, it is likely that the amount invested in each one would be different, thus making it difficult to make a fair comparison. The SEC's proposed approach uses a standardized investment amount ($10,000), which is specifically designed to facilitate comparisons. Also, account statement disclosure of fund expenses could be misleading because there could be other investments reflected on the same statement that would not include similar disclosure. This could create the mistaken impression that mutual funds are the only type of investment that involves costs, which might lead to ill-informed investment decisions.

2. Disclosure in Fund Advertisements. As discussed above, standardized quotations of fund performance are calculated in a manner that takes fund fees and expenses into account. The SEC has proposed amendments to the rules governing fund advertisements. Among other things, the proposed amendments would require a legend in fund performance advertisements

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[26] The American Funds, for example, are sold through approximately 2,000 dealer firms.

[27] An ICI survey of various industry participants conducted in late 2000 confirmed that the costs and burdens of providing individualized expense disclosure on quarterly account statements would be substantial. ICI Survey on GAO Report on Mutual Fund Fees (January 31, 2001).

to direct investors to additional information about fees and expenses in fund prospectuses. This proposed change will call further attention to fund fees and expenses and their impact on returns.

3. Disclosure of After-tax Returns. As part of the SEC's continuing efforts to improve mutual fund disclosure of costs, in early 2001, the SEC adopted rules requiring most mutual funds to disclose in their prospectuses returns on an after-tax basis.[28] This disclosure is presented in a standardized format and included as part of the risk/return summary required at the front of the prospectus. Significantly, to our knowledge, no other financial product is subject to a similar disclosure requirement. Nevertheless, the Institute generally supported the rules because we agree that it is relevant for investors to understand the impact that taxes can have on returns.[29]

4. Disclosure of Brokerage Costs. Questions have arisen concerning the disclosure of brokerage costs (commissions) that a fund pays in connection with buying or selling portfolio securities. Information about brokerage commissions paid by mutual funds is included in a fund's Statement of Additional Information, which is available to investors for no charge upon request.[30] The SEC previously required disclosure of average commission payments in fund

[28] Certain types of funds, such as money market funds and funds used as investment options for 401(k) plans and other types of retirement plans, are exempted from these requirements.

[29] We continue to have concerns with some of the specific aspects of the rule, however. The most significant concern is that the rules require funds to use the highest marginal tax rate in computing after-tax returns. This rate is much higher than the rate applicable to the majority of mutual fund shareholders. We believe that using the rate applicable to the average fund investor would provide more useful information by presenting a more realistic measure of after-tax returns.

[30] Funds also include this information in Form N-SAR, which is filed with the SEC. (Both documents are available on the SEC's EDGAR system.)

prospectuses, but eliminated this requirement as part of its 1998 prospectus simplification initiative.[31]

The industry would welcome ideas for ways to better disclose these costs. One suggestion that has been raised – requiring that they be included in the fund's expense ratio – would not improve disclosure of brokerage costs. There are several reasons for this. For example, including brokerage commissions in a fund's expense ratio could confuse investors, distort expense ratios and make fair comparisons across funds more difficult, because the expense ratio would include commissions paid for securities that trade on an agency basis but would *not* include the spread for securities traded on a principal basis. As a result, it might appear that a fund that holds securities that trade on a principal basis would have lower trading costs and lower overall expenses than a fund that pays commissions, when this might not be the case. Other components of trading costs (*e.g.,* market impact) also could not be included in the expense ratio. By including *some*, but not all costs associated with trading, the expense ratio would no longer serve its primary function – allowing investors and others to compare ongoing fund expenses in a consistent manner. Finally, the level of brokerage costs can fluctuate significantly, sometimes as the result of a one-time occurrence, such as a change in the fund's portfolio securities in connection with the assignment of a new portfolio manager. This could lead to volatility in the fund's expense ratio that may confuse investors by appearing to indicate changes in the cost of providing fund services to investors.

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[31] In eliminating the requirement, the SEC stated that "a fund prospectus appears not to be the most appropriate document through which to make this information public." SEC Release No. IC -23064 (March 13, 1998), 63 Fed. Reg. 13916, 13936 (March 23, 1998).

III. BENEFITS OF A STRONG REGULATORY SCHEME

The disclosure and substantive regulatory requirements governing fund fees and expenses and the other disclosure requirements discussed above represent just some of the ways in which mutual fund regulation informs and protects investors. Mutual funds are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for over 60 years. Their operations are regulated under all four of the major federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and, most importantly, the Investment Company Act of 1940.

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) insure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or restrict forms of self-dealing; (4) prohibit unfair and unsound capital structures; and (5) insure fair valuation of fund purchases and redemptions.

The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and also has kept the industry free of the types of problems that have surfaced in other businesses in the recent past. An examination of several of the regulatory measures that have been adopted or are under consideration to address

problems that led to the massive corporate and accounting scandals of the past several years provides a strong endorsement for the system under which mutual funds already operate.[32]

For example, under the Investment Company Act, mutual funds – unlike any other financial product – are governed by a board of directors that is required to have at least a certain percentage of directors who are independent from fund management. In early 2001, the SEC adopted new requirements designed to enhance the independence and effectiveness of independent fund directors, and to "reaffirm the important role that independent directors play in protecting fund investors."[33] As a result, funds that rely on any of several key exemptive rules under the Investment Company Act (which includes the vast majority of funds) are subject to the following requirements: (1) independent directors must constitute a majority of their boards of directors; (2) independent directors must select and nominate other independent directors; and (3) any legal counsel for the independent directors must be an "independent legal counsel" as defined by the SEC.[34]

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[32] Mutual funds also are subject to most of the requirements that apply to corporate issuers under the Sarbanes-Oxley Act of 2002, including the following: (1) mutual fund shareholder reports must be certified by the fund's principal executive and principal financial officers; (2) mutual funds must disclose whether their audit committee includes at least one member who is an "audit committee financial expert," and if not, why not; (3) mutual funds must disclose whether they have adopted a code of ethics that covers specified fund officers and other personnel and if not, why not; (4) mutual funds must comply with the new auditor independence requirements, including the requirement to periodically rotate auditors; and (5) legal counsel to mutual funds (which the SEC has interpreted to include legal counsel to the fund's investment adviser, for this purpose) must comply with new requirements governing attorney conduct. Congress excluded mutual funds from some of the Act's provisions where existing law already prohibits the conduct in question. For example, because Section 17(a) of the Investment Company Act prohibits most transactions with affiliates, mutual funds were exempted from Section 402 of the Sarbanes-Oxley Act, dealing with issuer loans to insiders.

[33] SEC Release No. IC-24816 (January 2, 2001), 66 Fed. Reg. 3734 (January 16, 2001).

[34] Even before the SEC issued its fund governance proposals, the Institute formed an industry Advisory Group, on which I served, that issued a report recommending that fund directors consider adopting a series of fifteen "best practices" – which go beyond legal requirements – to enhance the independence of independent directors and the

Recognizing the significant role that independent directors can play in protecting investors, the New York Stock Exchange and other self-regulatory organizations are considering adopting board independence requirements for listed companies.[35]

Fundamental provisions of the Investment Company Act – affiliated transaction prohibitions, restrictions on capital structure and daily mark-to-market accounting – contribute greatly to the transparency of mutual fund operations. Perhaps more importantly, they prevent the types of conduct and practices of corporate issuers (*e.g.,* loans to insiders or "creative" accounting practices) that have caused millions of Americans to lose not only significant amounts of money but also their confidence in the capital markets.

The extensive regulatory scheme that applies to mutual funds has been effective in protecting investors and helping the industry avoid major scandal due, in large part, to another important aspect of mutual fund regulation – direct SEC oversight and regular examinations of funds. The Institute has always strongly supported adequate funding of the SEC to ensure that it can fulfill these roles effectively, and we are pleased that the SEC's latest budget increase recognizes the importance of a strong, well-funded SEC.[36] We note that Section 408 of the Sarbanes-Oxley Act, which provides for regular and systematic SEC review of certain

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effectiveness of fund boards as a whole. Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999).

[35] *See, e.g.,* Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee (2002).

[36] Congress recently passed a spending bill for fiscal year 2003 that earmarks $716 million for the SEC, an increase of approximately 47 percent above the amount the SEC spent in fiscal 2002. The SEC has announced plans to make significant additions to its examination staff and restructure its current mutual fund examination process.

disclosures made by corporate issuers, affirms the value of direct SEC oversight and regular examinations.

IV. CONCLUSION

In these challenging times that we all face – where public confidence has been shaken and weak market performance continues – it is clear that investors have benefited from the stringent regulation of mutual funds. The disclosure and substantive regulatory requirements imposed upon mutual funds have enhanced competition and helped the industry avoid major scandal.