

**Fund Democracy  
Consumer Federation of America  
Consumer Action  
Consumers Union**

May 16, 2005

The Honorable Daniel K. Akaka  
141 Hart Senate Office Building  
Washington, D.C. 20510

Dear Senator Akaka,

We are writing to express our enthusiastic support for your Mutual Fund Transparency Act of 2005. Your bill will benefit fund shareholders in three significant respects. First, it will strengthen the independence of fund board to help ensure that the gross abuses of trust committed by fund managers in connection with the recent mutual fund scandal will not be repeated. Second, the bill will require that fund shareholders be provided with full and understandable disclosure of brokers' fees and conflicts of interest, and that when brokers provide individualized investment advice they will be held to the same fiduciary standards to which all other investment advisers are held. Third, the bill will promote competition through increased price transparency, and thereby improve services and reduce costs for the almost 100 million Americans who have entrusted their financial security to mutual funds.

Fund Governance

The mutual scandal that erupted in September 2003 and continues to be litigated to this day revealed "a serious breakdown in management controls in more than just a few mutual fund complexes."<sup>1</sup> As noted by the Securities and Exchange Commission,

The breakdown in fund management and compliance controls evidenced by our enforcement cases raises troubling questions about the ability of many fund boards, as presently constituted, to effectively oversee the management of funds. The failure of a board to play its proper role can result, in addition to serious compliance breakdowns, in excessive fees and brokerage commissions, less than forthright disclosure, mispricing of securities, and inferior investment performance.<sup>2</sup>

The Act directly addresses the governance weaknesses revealed by the scandal by strengthening the independence of fund directors. It plugs loopholes that have allowed

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<sup>1</sup> Investment Company Governance, Investment Company Act Rel. No. 26323 (Jan. 15, 2004).

<sup>2</sup> Id.

former executives of fund managers and other fund service providers, among others, to qualify as “independent” directors when their independence is clearly compromised by their former positions. The Act also ensures that the board’s agenda will be set by an independent chairman, and not by the CEO of the fund’s manager, as is common practice, and that independent directors will control board matters and the evaluation of independent nominees. The Act’s requirement that independent directors seek shareholder approval at least every 5 years will enhance the accountability of independent directors to the shareholders whose interests they are supposed to serve.

Although the SEC recently adopted rules requiring independent fund chairmen and a 75% independent board, these rules will not prevent fund managers from terminating independent chairmen or reducing independent representation on the board to the statutory minimum of 40%. The SEC’s rules apply only when the funds choose to rely on certain exemptive rules. If there is a conflict between the fund’s independent directors and the fund manager, the fund manager can simply stop relying on the rules and seek to install its own executives in a majority of board positions. This is precisely what Don Yacktman did when the independent directors of his funds opposed him, and it will undoubtedly be repeated the next time that there is a similar confrontation. More importantly, independent directors know from the Yacktman experience that the protection given them by the SEC is limited, and they therefore will be less likely to stand up for shareholders than if – as you have proposed – the SEC’s requirements were codified.

#### Fiduciary Duties and Full Disclosure for *All* Investment Advisers

Recent regulatory investigations and enforcement actions have uncovered persistent and widespread sales abuses by brokers. Regulators have found that brokers have systematically overcharged investors for commissions, routinely made improper recommendations of B shares, accepted undisclosed directed brokerage payments in return for distribution services, and received revenue sharing payments that create incentives to favor funds that pay the highest compensation rather than funds that are the best investment option for their clients.

Last fall, the Commission promised that it would address the problems that have so long plagued brokers’ sales practices, but the Commission’s efforts have fallen far short of the mark. Its recent proposals fail to require full disclosure of brokers’ compensation, much less the disclosure of information that would enable investors to fully evaluate their brokers’ conflicts of interests. The new disclosure requirements that you have proposed will ensure that brokers’ conflicts of interest will be fully transparent to investors. Investors will be able to view the amount the broker is being paid for the fund being recommended compared with the (often lesser) amount the broker would receive for selling a different fund, which cannot help but direct investors’ attention to the conflict of interest created by differential compensation structures. We especially applaud your proposal to ensure that all broker compensation, including revenue sharing payments, is disclosed in the point-of-sale document, which ensures that disclosure rules

will not create an incentive for brokers to favor revenue sharing as a means of avoiding disclosure.

Remarkably, in the wake of a longstanding pattern of brokers' sales abuses, the Commission has recently repealed Congress's narrow exemption from advisory regulation for brokers who provide only "solely incidental" advice. The Commission's strained interpretation of "solely incidental" advice to include any advice provided "in connection with and reasonably related to a broker's brokerage services"<sup>3</sup> has effectively stripped advisory clients of the protections of an entire statutory regime solely on the ground that the investment advice happens to be provided by a broker. The Commission's position flatly contradicts the text and purpose of the Investment Advisers Act, which, as the Supreme Court has stated:

reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested.<sup>4</sup>

Your proposal restores crucial components of Congress's carefully constructed regulatory scheme for the distinct and complementary regulation of brokerage and advisory services. It properly recognizes that a "fiduciary, which Congress recognized the investment adviser to be,"<sup>5</sup> is also what consumers expect an investment adviser to be, as is generally the case when professional services are provided on a personalized basis. The Act also recognizes the importance of "expos[ing] all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested,"<sup>6</sup> by requiring full disclosure of such conflicts of interests and other material information at the time that the prospective client is deciding whether to enter into the relationship.

### Fee Disclosure and Price Competition

Your fee disclosure provisions will do double duty, by addressing conflicts of interest and brokers' sales abuses while also promoting competition, thereby improving services and driving down expenses. Requiring brokers to disclose the amount of differential payments and average fees for comparable transactions will provide the kind of price transparency that is a necessary predicate for price competition and the efficient operation of free markets. In addition, the requirement that funds disclose the amount of commissions they pay will ensure that the fund expense ratio includes all of the costs of

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<sup>3</sup> Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Rel. No. 2376 (Apr. 12, 2005).

<sup>4</sup> SEC. Capital Gains Research Bureau, 375 U.S. 180, 191 – 92 (1963).

<sup>5</sup> *Id.* at 194.

<sup>6</sup> *Id.* at 191 – 92.

the fund's operations and enable investors to make more informed investment decisions. The best regulator of fees is the market, but the market cannot operate efficiently when brokers and funds are permitted to hide the actual cost of the services they provide.

#### Financial Literacy and Fund Advertisements

Finally, we strongly agree that there is a need to further study of financial literacy, including especially information that fund investors need to make informed investment decisions and methods to increase the transparency of fees and potential conflicts of interest. Your proposed study of mutual fund advertisements is also timely, as the regulation of fund ads continues to permit misleading touting of outsized short-term performance and other abuses.

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Mutual funds are Americans' most important lifeline to retirement security. The regulation of mutual funds, however, has not kept pace with their enormous growth. We applaud your continuing efforts to enhance investor protection, promote vigorous market competition and create wealth for America's mutual fund investors through effective disclosure and truly independent board oversight.

Respectfully submitted,

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