TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING TRANSPARENCY IN THE UNITED STATES DEBT MARKET AND MUTUAL FUND FEES AND EXPENSES

BEFORE THE SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 29, 1998

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

SUMMARY OF TESTIMONY
ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

This testimony discusses the level of price transparency for corporate debt and mutual fund fees and expenses, both key issues of concerns for investors.

Bond Market Transparency

An SEC staff review of the state of price transparency in the U.S. market for debt securities found that price transparency in the corporate bond market is less than that in the markets for government securities and, increasingly, municipal securities. To address this problem, the Commission is calling on the National Association of Securities Dealers to take three steps:

- Adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD, and to develop systems to receive and redistribute transaction prices on an immediate basis.
- Create a database of transactions in corporate bonds and preferred stocks.
- Create a surveillance program to better detect fraud in these markets.

The Commission intends to work closely with the NASD and the industry to achieve greater price transparency in the corporate debt market.

Mutual Fund Fees

Fund fees have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 17% on an investment held for 20 years. Mutual fund fees are extremely important, particularly now that ordinary Americans -- almost 40 million of them -- are relying on mutual funds to finance the American dream.

Historically, Congress and the Commission have taken a three-pronged approach to investor protection. First, reduce conflicts of interest that could result in excessive charges. Second, require that mutual fund fees be fully disclosed so that investors can make informed decisions. And third, let market competition, not government intervention, answer the question of whether any mutual fund's fees are too high or low.

The Commission remains vigilant on behalf of investors in its oversight of mutual fund fees and expenses. The Commission's recent initiatives include:

- Changes to disclosure requirements to make fee disclosure easier to understand;

- Increased focus on investor education about mutual fund fees;
- Use of public forums to increase industry attention to fund fees;
- Inspections focused on fund fees;
- A study of the trends in mutual fund fees; and
- A review of the role of independent directors in setting fund fees.

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COMMITTEE ON COMMERCE
U.S. HOUSE OF REPRESENTATIVES

September 29, 1998

Chairman Oxley, Representative Manton and Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee to testify on behalf of the Securities and Exchange Commission ("Commission") concerning two key issues for investors – the level of transparency in the United States debt market and mutual fund fees and expenses. I will begin with a discussion of debt market transparency.

I. DEBT MARKET TRANSPARENCY

A. Introduction and Summary

The Commission has long promoted efficiency and fairness in the U.S. capital markets, including the debt markets. In that tradition, earlier this year, the Commission staff conducted a review of the market for debt securities in the United States, with particular emphasis on the state of price transparency.

The Commission staff's review found that, as a whole, the market for government securities is characterized by high-quality pricing information for investors. The review also cited significant improvement over the last few years in the transparency of the municipal securities market. However, in the area of corporate bonds, the Commission staff found that price transparency is deficient.

Consistent with the findings of the staff's review, the Commission is requesting that the National Association of Securities Dealers do three things:

> First, adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices on an immediate basis;
>
> Second, create a database of transactions in corporate bonds and preferred stocks. This will enable regulators to take a proactive role in supervising the corporate debt market, rather than just reacting to complaints brought by investors; and
>
> Third, in conjunction with the development of a database, create a surveillance program to better detect fraud in order to foster investor confidence in the fairness of these markets.

The NASD has said that it will move forward on all of these recommendations, which are discussed further below.

B. History of the U.S. Bond Market

The bond market has played an important role in this country's development from the very first days of the republic. The New York Stock Exchange, in fact, originated in 1792 as a bond exchange. For the first time, securities issued by the new United States government could be readily bought and sold. Those first government bonds funded the debt of the American Revolution. Treasury Secretary Alexander Hamilton not only helped create a new money supply, but he also linked the interests of wealthy bondholders to the fate of the new country.

As American corporations formed and evolved, a market for the issuance of corporate bonds followed suit. Between 1850 and the early 1900's, railroad company bonds dominated the corporate debt market. At the same time, an expanding number of public utilities and industrial corporations were also issuing bonds. Between 1900 and our entry into World War I, corporate debt tripled from $6 billion to over $19 billion -- exceeding the federal debt.

However, with the onset of inflation in the mid-1970's, deficit spending in the 1980's and the proliferation of technology in the 1990's, the debt market fundamentally changed in practice and in scope. Global electronic markets, computer-based analytical services and rapid fluctuations in bond prices are the order of the day. It is now a fast-moving medium that plays a major role in America's economy.

The bond market touches all aspects of our lives -- from the cost of building schools and hospitals to corporate investment in areas such as plants and equipment. It impacts the assets of public and private pension funds, channels capital to mortgage and car loans, and even influences revolving credit.

The debt market also affects the prices in the equity market that are followed so closely. If a company's debt cannot be accurately valued, it is difficult to determine the baseline value of its equity.

The bond market's economic significance is matched only by its sheer size. Treasury securities alone account for more than $3.4 trillion outstanding, over $2 trillion in 1997 issuance, and trading of more than $200 billion per day in 1997. NYSE listed equities, in comparison, accounted for about $10.7 trillion in market value (May, 1998), but only about $26 billion per day in 1997 trading and $28 billion in 1998. In addition, the level of outstanding debt in the U.S. has grown sharply. For example, in the past 13 years, corporate debt outstanding has more than tripled – from $720 billion in 1985 to $2.3 trillion today. Table 1 below contains an estimate of bond market sizes in various market segments:[1]

Table 1: Estimated Size of U.S. Bond Markets

	Outstanding		1997 Issuance	Avg Daily
	Issues	Value	Value	Volume
		($billion)	($billion)	($billion)
U. S. Treasury and Agency Securities				
Treasury Securities	2192	$3,457	$2,168	$212
Agency Securities	15396	$984	$5,729	$40
Total Government Securities	17588	$4,441	$7,897	$252
Mortgage and Asset Backed Bonds				
Agency Mortgage Backed Bonds	875426	$1,827	$368	$47
Agency CMOs(tranches)	35393	$562	$167	
Private Label MBS and CMOs	9011			
Asset Backed Bonds	4292	$516	$185	$4
Total Mortgage and Asset Backed Bonds	924122	$2,905	$720	$51
Corporate Bonds				
Investment Grade Bonds	20971		$563	$8
High Yield & Unrated Bonds	5062		$124	$4
Variable Rate Notes				$2
Convertible Bonds				$1
Total Corporate Bonds	26033	$2,300	$687	$15
Municipal Bonds	1500000	$1,366	$267	$9
Foreign Sovereign Bonds				
Emerging Market Bonds				$23
Developed Country Bonds				

Although the market continues to largely consist of broker-dealers who commit capital and take orders over the phone, it is likely that electronic trading systems will grow in importance. According to a survey conducted by the Bond Market Association ("BMA") last year:

- 65% of BMA members believed that most dealers would offer electronic executions to institutional customers within two years;
- Almost 75% of these members expected institutions to demand multi-dealer systems within two years; and
- There was a consensus that the most liquid markets such as Treasury and agency securities are more amenable to electronic trading.

The Commission staff's review identifies ten electronic trading systems for bonds currently in operation and several others that are currently being developed.

C. SEC Review of the Bond Market

The Commission staff's review found that, as a whole, the market for government securities is characterized by high-quality pricing information for investors. In addition, because of steps taken over the last few years, transparency is much greater in the municipal securities market. However, in the area of corporate bonds, price transparency can be improved.

Historically, the debt markets have lagged well behind the equity markets in making price information available to investors and the public. This can partially be attributed to the facts that the debt market covers a much wider variety of instruments and is largely institutional. Nonetheless, the Commission, on several occasions, has acted to encourage debt market transparency.

In 1991 – with encouragement from the Commission and Congress, GovPX – a 24-hour, world-wide electronic reporting system – was formed to distribute real time quotes and transaction prices for U.S. Treasury and other government securities. As a result, these markets now enjoy a higher level of quality price information.

In 1995, again with the Commission's active encouragement, the Municipal Securities Rulemaking Board ("MSRB") began collecting the details of dealer-to-dealer transactions in the municipal bond market and distributing daily summary reports. In August of this year, with Commission approval, the MSRB expanded its daily reporting to include customer trades as well as inter-dealer trades.

Now, for the first time, investors, particularly smaller investors, are able to obtain the prices and volume data of municipal bond trading between dealers and their customers. Moreover, the Commission expects the momentum provided by the MSRB's efforts to continue, ultimately leading to more immediate transaction price reporting.

The Commission believes that it is now time for the corporate bond market to make similar progress. Although technology is revolutionizing how business is being conducted, the corporate debt market remains one of the last major markets in the United States to lack some type of electronic price disclosure system. The recent volatility in the markets underscores the need for greater price transparency in this market.

While the activity in the stock markets on August 31, 1998 is widely known, the no less real absence of buying interest in the corporate bond market that same day was far less visible. This lack of liquidity was readily apparent to the professional trader, but it was not known to the general public until reported by the press the following day. What was not reported until weeks later was the difficulty in the pricing of high-yield corporate securities. This lack of pricing information had an impact on a well-defined segment of mutual funds -- those which heavily invest in the high-yield market.

The Commission is aware of the concerns voiced by some that improved transparency will harm liquidity or confuse investors. Similar concerns were raised when the Commission sought to improve transparency in other segments of the debt markets. Those fears, however, proved to be groundless. The Commission's experience with

GovPX shows that enhanced information bolsters investor participation and market liquidity. Further, the MSRB has significantly improved municipal securities market transparency without harming liquidity.

Improved transparency, done correctly, will not confuse investors. Rather, in order to interpret pricing information, investors need the types of analytical tools that are already available to dealers and many institutional investors. It is reasonable to expect that, once prices are widely available, the market will also make available the analytical models needed to interpret those prices. Moreover, widespread availability of prices from actual transactions will improve the quality of the valuations created by end-of-day pricing services.

The Commission is not suggesting that the entire national market system built for equities be transposed to the debt markets. Instead, the Commission's goal is to protect the interests of investors by tailoring requirements to the manner in which bond markets operate. For example, while continuous quotes are customary in equity markets, corporate bond dealers do not generally publish firm quotes. Thus, until the market develops in that direction, it would not be appropriate to impose a rule requiring firm quotations on the corporate bond markets. Thus, the Commission has not suggested such a rule.

Although the Commission does not seek to impose the whole panoply of equity market regulations on the bond markets, it is clearly time for this segment of the debt market to improve the availability of pricing information.

The decision to call upon the NASD to address corporate debt transparency is an important step. These actions can result in a higher level of price transparency for the corporate debt market than what currently exists in municipal securities, which, as discussed above, has made significant progress in recent years. The Commission is determined to do everything it can to achieve that result.

D. Need for Improved Price Transparency

There is little doubt that the debt market has experienced strong growth. In many respects, it is the backbone of corporate development in this country. These facts, however, by no means suggest that the bond market, including its transparency, cannot be significantly improved. The imperatives of globalization and rapid advancements in technology have put a premium on information. Governments analyze and respond to it; the press reports and editorializes it; companies sell it; markets act on it; and investors rely on it.

Today, market information moves at the speed of light. The availability of accurate information to ensure the long-term stability of our markets has never been more important. The corporate debt market is not immune from these realities.

The Commission's efforts are aimed at making this market as transparent as other markets. These efforts are consistent with the values of trust, accountability, innovation and confidence that have been the hallmarks of America's capital markets.

Transparency is both a means and an end. It plays a fundamental role in making our capital markets the most efficient, liquid and resilient in the world. At the same time, transparency is a goal. The Commission's past experience illustrates that there is a direct relationship between information and investor confidence: the two values move in direct proportion to one another.

The Commission intends to work closely with the NASD and the industry to accomplish greater transparency in the corporate debt market.

II. MUTUAL FUND FEES AND EXPENSES

The subject of mutual fund fees and expenses is crucially important for all Americans investing in mutual funds -- almost 40 million today -- and it deserves the close attention of all of us who are charged with making decisions that affect those who have entrusted their savings to the fund industry.

A. Introduction

The investment company industry is one of America's true business success stories, having attained major significance in terms of size and stature in recent years. Assets under management have grown dramatically; fund assets grew from $770 billion at the end of 1987 to $4.5 trillion at the end of 1997, an increase of more than 484 %.[2] Today, fund assets exceed the assets of commercial banks. Over the same ten-year period, the number of available funds has increased from 2,300 to 6,800.[3]

Perhaps more significant than the growth in fund assets or the number of funds is the increasing role of mutual funds as an investment vehicle for many Americans. A number of factors, including low interest rates for bank deposits and the popularity of Individual Retirement Accounts and 401(k) plans, have caused the percentage of U.S. households that own funds to increase from 6% in 1980 to 37% today.[4] The mutual fund industry accounts for 16% of total retirement assets and almost 40% of 401(k) assets.[5]

The good news about growth in the fund industry has been accompanied by a rather sobering debate over whether fund fees and expenses are too high. At the core of the debate is whether fund investors are paying too much for the services they receive.

Those who believe that fund fees are too high point to statistics showing that the dramatic growth in fund assets has been accompanied by increasing levels of fees and expenses. They argue that investors have not received the benefits of economies of scale in the form of reduced fees and charges.[6]

Those who believe that fund fees are not too high argue that shareholders today are getting more for their money -- more services, such as telephone redemption and exchange privileges, check or wire redemptions, and consolidated account statements, and more investment opportunities, such as international and other specialized funds, which have higher operating costs than more traditional funds. And they argue that the numbers showing an increase in fund fees are misleading because they do not take into account the fact that funds have increasingly moved away from front-end sales charges (which are borne directly by the investor and do not enter into the computation of a fund's expense ratio) to 12b-1 fees (which are paid indirectly through the fund and do increase a fund's expense ratio).[7]

There is much room for debate over whether fund fees are too high, but there can be no debate over whether fund fees have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by <u>17%</u> on an investment held for 20 years. And so, the debate over the level of fees and expenses is an important one, particularly now that ordinary citizens are relying so heavily on investments in mutual funds to finance housing, children's educations, and retirement -- the American dream.

The debate over fund charges is not new. Both Congress and the Commission have been focusing on these issues since before the Investment Company Act was enacted in 1940. The result of 60 years of deliberation is a regulatory framework that takes a two-pronged approach to investor protection in the area of fees: first, create procedural safeguards to reduce conflicts of interest that could result in excessive charges and, second, require that fees and charges be fully disclosed so that investors can make informed decisions.

The Commission continues to believe that this approach is fundamentally sound. The Commission should not be the arbiter of the appropriate level of fund fees. Whether fund fees are too high or too low is a question that we believe must be answered by competition in the marketplace, not by government intervention. But the Commission does have a significant role in ensuring that conflicts of interest do not lead to excessive fees and that fees are fully and fairly disclosed -- in plain English.

The Commission remains vigilant on behalf of investors in its oversight of mutual fund fees and expenses. Recent and ongoing initiatives by the Commission in this area include:

- changes to disclosure requirements to make fee disclosure more useful and easier to understand;
- increased focus on investor education about mutual fund fees and expenses;
- efforts to use public forums and other means to increase industry attention to fund fees and expenses;
- inspections focused on mutual fund fees, and the role of investment advisers and fund directors in establishing fees;

- a study of the trends in mutual fund fees and expenses, including whether economies of scale are passed on to shareholders through the fees they pay; and
- a review of the role of independent directors in setting fund fees, including a roundtable on fund governance to be held this fall.

These are described more fully below.

B. Regulatory Framework for Mutual Fund Fees

Over the past 60 years, Congress and the Commission have sought to protect fund investors from excessive fees by using a two-pronged approach: first, create procedural safeguards to reduce conflicts of interest that could result in inappropriate charges, and, second, require that fees and charges be completely disclosed so that investors can make informed decisions. This approach has been refined over the years since the passage of the Investment Company Act, but its broad outlines have stood the test of time.

1. Conflicts of interest.

A mutual fund has a unique structure. Although mutual funds are usually organized either as corporations or business trusts, they are not typically managed by their own officers and employees. Rather, a mutual fund typically is organized and operated by an investment adviser that is a separate corporate entity with its own shareholders. The investment adviser provides investment advice and managerial services under contract with the fund, and the adviser or an affiliate often sells fund shares pursuant to a contract to act as "principal underwriter."

When an investment adviser, with its own shareholders, manages a mutual fund with a different set of shareholders, there is potential for conflicts of interest in the pricing of advisory and other services between the fund and the investment adviser. Congress and the Commission generally have not chosen to address the conflicts through fee caps or other direct regulation of fund fees and charges, preferring to leave the establishment of fees and charges primarily to market competition and the imposition of any caps on sales charges to the National Association of Securities Dealers, Inc. ("NASD"). Over time, however, Congress and the Commission have developed a regulatory scheme that provides procedural safeguards to guard against potential abuses resulting from these conflicts.

As enacted in 1940, the Investment Company Act had few limits on mutual fund fees, including sales charges and advisory fees.[8] The Act included a general prohibition on unconscionable or grossly excessive sales loads, to be defined by the NASD.[9] The Act also required that advisory services and fees be stipulated in a written contract approved initially by a fund's shareholders and directors.[10] In addition, the Act required that no more than 60% of the members of the board of directors be officers or employees of the investment company or affiliated with the investment adviser.[11]

In the mid-1960s, the Commission recommended greater regulation of advisory fees and sales loads after studying the fund industry at that time. The Commission recommended that Congress amend the Investment Company Act to require that any compensation received for services provided by investment advisers be "reasonable" and impose a statutory cap of 5% on sales loads for mutual funds.[12]

In response, Congress in 1970 amended the Investment Company Act provisions regarding advisory fees and sales charges. Congress added section 36(b) to the Investment Company Act to impose a fiduciary duty on the investment adviser of a fund with respect to the receipt of compensation for services.[13] The adviser's duty under section 36(b) applies not only to advisory fees, but also to distribution charges such as rule 12b-1 fees paid by funds to advisers and their affiliates.[14] Congress also amended section 15(c) of the Investment Company Act to impose on directors a duty to evaluate, and on an adviser a duty to furnish, all relevant information needed to review the terms of an advisory contract.[15] This amendment was designed to strengthen the ability of directors, particularly the independent directors, to carry out their responsibilities with respect to approval of these contracts.[16] In evaluating an adviser's breach of fiduciary duty with regard to compensation under section 36(b), courts have identified the role and decision-making process of fund directors in approving compensation arrangements to be among the most important factors.[17]

In 1970, rather than impose a cap on sales loads as the Commission recommended, Congress decided that industry regulation was the preferable approach.[18] Section 22(b) of the Investment Company Act was revised to provide the NASD authority to restrict sales loads subject to Commission oversight.[19] Subsequently, the NASD has promulgated a rule prohibiting NASD members from selling mutual fund shares if the sales charges exceed specified caps.[20]

In its rules relating to fees and charges, the Commission likewise has utilized procedural safeguards against conflicts of interest, rather than direct regulation of charge levels. For example, the Commission has adopted rule 12b-1, which permits mutual funds to pay for distribution of their shares with fund assets if they comply with procedural safeguards.[21] Because of the possible conflicts of interest involved in a fund's use of assets to distribute additional shares in the fund, the Commission required funds to follow procedures similar to those required by the Investment Company Act for the approval of an investment advisory contract. In particular, rule 12b-1 requires that payments for distribution out of fund assets be made pursuant to a written plan that has been approved by a majority of the fund's outstanding voting securities and a majority of the fund's board of directors and disinterested directors.[22]

2. Disclosure requirements.

The full disclosure approach to securities regulation employed by Congress and the Commission for over 60 years has proven to be very successful. For that reason, the Commission has complemented the conflict of interest regulatory scheme described above with a requirement that mutual fund fees and charges be fully and accurately disclosed. Full disclosure is responsible for the development in the United States of the world's fairest, most efficient, most liquid capital markets. It is equally responsible for the fact that an investor contemplating a fund investment today has access to comparable information about competing funds' fees and charges.

Mutual funds register on Commission Form N-1A, which specifies the information that is required in a fund prospectus, a fund's principal selling document.[23] In the 1980s, the Commission became concerned that the increasing variety of sales loads and other fund distribution arrangements could, unless uniformly presented, confuse investors. For that reason, since 1988, Form N-1A has required every mutual fund prospectus to include a fee table. The fee table is intended to present fund investors with expense disclosure that can be understood easily and that facilitates comparison of expenses among funds.[24]

The fee table is a uniform, tabular presentation that shows the fees and charges associated with a mutual fund investment. The table reflects both (i) charges paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and

(ii) recurring charges deducted from fund assets, such as management fees and 12b-1 fees. The table is located at the beginning of the prospectus. It is accompanied by a numerical example that illustrates the total dollar amounts that an investor could expect to pay on a $10,000 investment if he or she received a 5% annual return and remained invested in the fund for various time periods.

The fee table generally has served the Commission's intent. As a result of the Commission's efforts in designing and implementing the fee table, information about mutual fund fees and expenses is accessible. The very existence of the debate over whether mutual fund fees are too high illustrates this; the debate is possible only because data about mutual fund fees and expenses is readily available, both to investors and to the financial press.

Nonetheless, the Commission remains vigilant to ensure that the fee table is the best possible vehicle for dissemination and comparison of information about fund charges. Earlier this year, the Commission overhauled the prospectus disclosure requirements for mutual funds in order to provide investors with clearer and more understandable information about funds.[25] At the same time, the Commission adopted a rule that permits a mutual fund to offer investors a new disclosure document, called the "profile," that summarizes key information about the fund.[26] As part of those initiatives, the Commission made improvements to fund fee disclosure.

The Commission's recent disclosure initiatives require the front portion of all mutual fund prospectuses to contain a risk/return summary in plain English that functions as a standardized "executive summary" of key information about the fund. The fee table is included in the plain English risk/return summary because of the Commission's belief that fees and expenses are crucial to a typical investor's decision to invest in a fund.[27] The same risk/return summary, including the fee table, also is required to appear as part of the new fund profile. This reflects the Commission's commitment to promoting investors' access to fee information as a basis for a fund investment decision.[28]

The Commission made several improvements to the fee table. In order to give investors clearer information about the long-term costs of an investment, the Commission modified the manner in which a fund may show the effect of expense reimbursements and fee waiver arrangements that temporarily reduce costs.[29] The overhauled fee table includes narrative descriptions of the fee table and example, as well as modified fee table captions, that are intended to help investors understand the information provided. The Commission also increased the investment amount illustrated in the example from $1,000 to $10,000 to reflect the size of a more typical fund investment and to approximate more closely the amount of fees and expenses that a typical investor would expect to incur over time. Finally, the Commission added a line item to the fee table to ensure that all account fees charged by a fund and paid directly by typical shareholders, such as administrative fees charged to maintain an account, are disclosed.

C. Current Initiatives

1. Monitoring the industry.

Because of the importance of mutual fund fees and expenses to investors, the Commission continually monitors the fees of individual funds to verify compliance with the current requirements for setting and disclosing fees. The Commission also has concluded that it is appropriate to take a comprehensive look at fee trends and fee-setting practices in the industry as a whole, to determine whether the regulatory system is continuing to work well in this era of explosive industry growth.

On an ongoing basis, the Commission's inspections staff scrutinizes compliance by investment advisers and fund directors with their statutory duties in establishing and approving fund fees. The staff regularly evaluates the directors' review and approval of investment advisory contracts to confirm that advisers and directors are fulfilling their fiduciary duties with regard to fees. The Commission expects directors to be vigilant in their review and approval of fees.

Several months ago, the Commission staff commenced a study of trends in mutual fund fees. The staff is reviewing trends in the overall levels of fees, the manner in which fees are assessed, and whether economies of scale are passed on to shareholders through the fees they pay.[30] The staff is examining trends in fees assessed on funds sold to individuals and also on funds distributed through 401(k) plans. The Commission anticipates that the staff's review will be complete early next year.

Simultaneously with the staff's study, the Commission is reviewing the role of independent fund directors, including their important role in approving fund fees. Recently, the role of independent directors in safeguarding shareholder interests has received increased attention, and some have questioned whether independent directors act independently in all cases.[31] The Commission plans to host a roundtable on fund governance this fall that will bring together investor advocates, directors, fund managers, academics, and others for discussion of the important issues concerning fund directors and their duties. This will allow the Commission to obtain a broad range of opinions from many of the involved parties on how the Investment Company Act scheme for preventing conflicts of interest is working in practice.

Both the staff study of mutual fund fees and expenses, and our examination of the independent director's role, will be extremely useful to the Commission as we assess whether we are doing all that we can to protect investors. We will act promptly to fix any shortcomings that we discover.

2. Investor education.

The Commission believes that its efforts to make mutual fund fee information readily available to investors have succeeded. With the implementation of our recent disclosure initiatives, fee information will be available in a more understandable, easy-to-use format. The Commission is very concerned, though, that many fund investors are not paying attention to the available information about fees.

Our own research shows that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns.[32] Another recent study found that 40% of fund investors surveyed incorrectly thought that a fund's annual operating expenses have no effect on the gains they earn.[33] We believe that our recent disclosure initiatives will help to close the gap in investor understanding of fund fees and charges. But we also believe that better disclosure alone will not cure this problem.[34]

The Commission has mounted an extensive investor education campaign to improve the financial literacy of investors. Recently, the Commission and a coalition of other government agencies, businesses, and consumer organizations launched a "Facts on Saving and Investing Campaign" to motivate Americans to get the facts they need to save and invest wisely. A product of this effort is the "Financial Facts Tool Kit," which contains a wealth of information to assist investors in planning their financial future, that is available on the Commission's website.[35]

The Commission has published other educational materials, including a widely distributed brochure about investing in mutual funds that contains a section on the importance of fees.[36] We have posted this brochure and many other educational materials on our website for easy access by the investing public. In town meetings and speeches to investors across the country, we are emphasizing the importance of fees in evaluating mutual fund investments. Hearings like this one also will contribute to raising the awareness of the investing public to fund fees.

I continue to be struck by the lack of investor knowledge of fund fees and expenses. The typical investor simply is not using the wealth of available fee information in considering mutual funds. To address this, I have asked the staff to focus on two goals in considering additional investor education efforts. First, educate investors so they know what questions to ask about fees before they buy a fund -- questions like: How much do I pay up-front in sales charges? What portion of my assets will be used to pay for fund management and marketing costs every year? Second, help out the investor who knows what fees a fund charges, but does not understand the dollar effect those fees have on his or her return.

I am also calling on the fund industry to join with the Commission in our efforts to educate investors about fees and charges. The Commission has continually sounded the call for the mutual fund industry to do a better job of explaining fees and expenses to investors.[37] The industry has participated with us in education efforts, including the "Facts on Saving and Investing Campaign," but our continuing challenge – and theirs – is to do whatever it takes to improve investors' understanding of fund fees.

We have suggested that one way to meet the goal is for funds to provide their shareholders with personalized statements of expenses. The information, provided in quarterly or year-end account statements, would tell an investor how much, in dollars, he or she paid for an investment in the fund. Our hope is that if investors see, in dollars, how much they pay to be invested in a fund and how much they earn or lose on the investment, they will begin to understand the relationship between fees and return. Today I am inviting fund groups to engage in a dialogue with the Commission to consider whether we can make personalized statements of expenses a reality. Each and every investor deserves to understand what he or she is paying for a fund – plainly, simply, in dollars and cents. We want the industry to work with us to make that happen.

III. CONCLUSION

Transparency in the corporate debt market and mutual fund fees and expenses are both important issues for investors. Accurate and accessible price data is essential to maintain investor confidence, and thus ensure the long-term stability of the corporate debt market. The Commission will continue to work with the NASD and the industry to promote price transparency in this important market. In the area of mutual fund fees, we remain vigilant both to watch for abuses and to provide investors with the greatest possible understanding of the amounts they pay to invest in funds. The Commission has been especially concerned with the gap between available information about fund fees and investors' use of that information, and we intend to move forward with additional efforts to close that gap.

[1] Table 1 contains estimates of trading volume, number and value of issues outstanding, and the value of 1997 issuance. Estimates of value outstanding and 1997 issuance come from the Bond Market Association and are comparable. The numbers of non-municipal issues were provided by the Bridge Fixed Income Database and represent the number of unique CUSIP numbers in each category. The number of Treasury issues includes privately stripped Treasury bonds (Zeroes). The number of municipal issues was provided by the Municipal Securities Rulemaking Board ("MSRB") and represents the approximate number of CUSIP numbers for unexpired municipal bonds.

Definitions and conventions for volume data are not always compatible. For example, volume estimates for government securities and agency mortgage backed securities come from the New York Federal Reserve Bank, and are derived from reports from primary dealers. These estimates exclude customer volume of non-primary dealers, but include volume in Treasury and Agency money market instruments. Volume estimates for corporate bonds are derived from two sources: dealer/customer transactions settled through the Depository Trust Company, and interdealer trades cleared through the National Securities Clearing Corporation. Commercial paper is excluded, as are retail customer transactions. Volume estimates for foreign sovereign bonds are based on surveys done by the Emerging Markets Traders Association and exclude developed country bonds, but include at least some non-dollar denominated bonds. Volume estimates for municipal bonds come from the MSRB and are based on sample results from the MSRB's new Daily Report. All volume estimates are for the year 1997 except those for Corporate Bonds and Asset Backed Bonds which are based on the period January - April, 1998, and those for municipal bonds which are derived from a week in June 1998.

[2] Investment Company Institute, Mutual Fund Fact Book 63 (38th ed. 1998).

[3] *Id.* at 64.

[4] *Id.* at 40.

[5] *Id.* at 44, 48.

[6] *See, e.g.*, John C. Bogle, "Do Mutual Funds Charge You Too Much?," Mutual Funds 80 (Oct. 1998); Amy C. Arnott, "The Rising Tide," Morningstar Mutual Funds S1-S2 (Oct. 11, 1996).

[7] *See, e.g.*, Willard L. Umphrey, "Do Mutual Funds Charge You Too Much?," Mutual Funds 81 (Oct. 1998); Lipper Analytical Services, Inc., "The Third White Paper: Are Mutual Fund Fees Reasonable?" (Sept. 1997).

[8] Before the enactment of the Investment Company Act, the Commission conducted a congressionally mandated study of investment companies, which formed the basis for the Act. *See* SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 (1940). *See also* Division of Investment Management, Protecting Investors: A Half Century of

Investment Company Regulation ("Protecting Investors") ch. 8 (May 1992) (discussion of legislative and administrative history of mutual fund fee regulation).

9 Investment Company Act of 1940, Pub. L. No. 76-768, § 22(b), 54 Stat. 789, 823 (1940).

10 *Id.*, § 15, 54 Stat. at 812-13.

11 *Id.*, § 10(a), 54 Stat. at 806.

12 Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 126-27, 143-47, 221-23 (1966) ("PPI Report"). The PPI Report drew upon a report by the Wharton School of Finance and Commerce on mutual funds requested by the Commission and a Commission staff report. Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. (1962); Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

13 Investment Company Amendments Act of 1970, Pub. L. No. 91-547 ("1970 Amendments"), § 20, 84 Stat. 1413, 1428-1430 (1970).

14 Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b). *See also* Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), aff'd, 875 F.2d 404 (2d Cir. 1989), cert. denied, 493 U.S. 919 (1989).

15 1970 Amendments, *supra* at 13, § 8(c), 84 Stat. at 1420.

16 *See* S. Rep. No. 184, 91st Cong., 1st Sess. 15 (1969) ("S. Rep. No. 184").

17 Krinsk v. Fund Asset Mgmt., Inc. et al., 875 F.2d 404, 412 (2d Cir. 1989), cert. denied, 493 U.S. 919 (1989); Gartenberg v. Merrill Lynch Asset Mgmt., Inc. et al., 694 F.2d 923, 930 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983).

18 S. Rep. No. 184, *supra* note 16.

19 1970 Amendments, *supra* note 13, § 12, 84 Stat. at 1422.

20 Rule 2830, NASD Conduct Rules. Covered sales charges include front-end loads paid by an investor upon share purchase, asset-based sales charges or "12b-1 fees" paid out of fund assets on a continuing basis, and contingent deferred sales loads paid by an investor upon redemption prior to the completion of a specified holding period. A fund without an asset-based charge can charge a maximum of 8.5%. The rule also caps annual asset-based sales charges at 0.75% of average annual net assets, allowing an additional 0.25% for service fees.

21 Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)].

22 Investment Company Act rule 12b-1(b), 17 C.F.R. § 270.12b-1 (1998). Similarly, when the Commission adopted rule 18f-3 under the Investment Company Act to allow mutual funds to sell multiple classes of shares, the Commission included the requirement that a new multiple class

plan be approved by the board of directors and by a majority of the independent directors. Investment Company Act Release No. 20915 (Feb. 23, 1995) [60 FR 11876 (Mar. 2, 1995)] (codified at 17 C.F.R. § 270.18f-3).

23 Section 8 of the Investment Company Act requires mutual funds to register with the Commission. If the fund is conducting a public offering of its shares, it also must file a registration statement to register those shares under the Securities Act of 1933 ("Securities Act"). Form N-1A is used by a mutual fund both to register under the Investment Company Act and to register its shares under the Securities Act. The registration statement includes the fund's prospectus.

24 Investment Company Act Release No. 16244 (Feb. 1, 1988) [53 FR 3192 (Feb. 4, 1988)] (adopting release); Investment Company Act Release No. 15932 (Aug. 18, 1987) [52 FR 32018 (Aug. 25, 1987)] (reproposing release); Investment Company Act Release No. 14230 (Nov. 9, 1984) [49 FR 45171 (Nov. 15, 1984)] (proposing release).

25 Investment Company Act Release No. 23064 (Mar. 13, 1998) [63 FR 13916 (Mar. 23, 1998)].

26 Investment Company Act Release No. 23065 (Mar. 13, 1998) [63 FR 13968 (Mar. 23, 1998)].

27 Item 3, Form N-1A.

28 Securities Act rule 498(c)(2)(iv), 17 C.F.R. § 230.498(c)(2)(iv).

29 In an expense reimbursement arrangement, the adviser reimburses the fund for any expenses that exceed a predetermined amount. Under a fee waiver arrangement, the adviser agrees to waive a portion of its fees in order to limit fund expenses to a predetermined amount.

30 *See* Remarks by Barry P. Barbash, U.S. Securities and Exchange Commission, to the Mutual Funds and Investment Conference, Orlando, Florida (March 23, 1998) <http://www.sec.gov/news/speeches/spch208.txt> ("Barbash Remarks"); Edward Wyatt, "S.E.C. Studies Whether Mutual Funds Pass Along Merger Benefits," N.Y. Times D5 (Mar. 24, 1998).

31 *See, e.g.*, Migdal v. Rowe Price-Fleming Int'l Inc., et al., Civil Action No. AMD-98-2162 (D. Md. Jul. 6, 1998); Strougo v. Bassini, et al., 97 Civ. 3179 (RWS) (S.D.N.Y. May 16, 1997); Strougo v. Scudder, Stevens and Clark, 96 Civ. 2136 (RWS) (S.D.N.Y. Mar. 22, 1996). *See also* Edward Wyatt, "Empty Suits In the Board Room; Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung," N.Y. Times C1 (Jun. 7, 1998); Steven D. Kaye, "Whose board is it?," U.S. News & World Rep. 64 (Feb. 2, 1998).

32 Report of the Office of the Comptroller of the Currency/Securities and Exchange Commission Survey of Mutual Fund Investors (1996).

33 Ruth Simon, "We Put Investors to the Test – and, Boy, Did They Ever Flunk," Money 37 (Mar. 1998).

34 As the financial columnist James Glassman recently pointed out, despite the wide availability of mutual fund fee information, few investors pay attention to costs. James K. Glassman, "Funds' Lofty Fees Add Insult to Injury," Wash. Post H1, H13 (Sept. 13, 1998). *See also* Charles Gasparino, "Pain of Mutual-Fund Fees Is More Acute When the Market Is Going Down Than Up," Wall St. J. C1, C21 (Aug. 25, 1998).

35 <http://www.sec.gov/consumer/toolkit.htm>

36 Invest Wisely, An Introduction to Mutual Funds, Advice from the U.S. Securities and Exchange Commission (Aug. 1996).

37 *See, e.g.*, Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, at the Investment Company Institute, Washington, D.C. (May 15, 1998) <http://www.sec.gov/news/speeches/spch212.txt>; Remarks by Barry P. Barbash, U.S. Securities and Exchange Commission, to the Mutual Funds and Investment Conference, Orlando, Florida (March 23, 1998) <http://www.sec.gov/news/speeches/spch208.txt>.