April 26, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0609

Re: File No. S7-08-04

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America[1] and Fund Democracy, Inc.[2] in support of the Securities and Exchange Commission's proposed rule to improve the disclosure mutual fund boards must provide about how they evaluate and approve investment advisory contracts. When combined with other recent SEC rule proposals – to make fund boards more independent and to require them to keep copies of written documents they rely on in reviewing the management contract[3] – we believe this proposal will help to make fund boards more conscientious in reviewing the advisory contract with an eye toward ensuring that fees are reasonable.

Background

As the Commission notes in the proposing release, the Investment Company Act relies on fund boards to police conflicts of interest and ensure that funds are operated in shareholders' best interests. The primary way in which they fulfill that responsibility is

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Fund Democracy is an advocacy group for mutual fund shareholders that was founded in 2000.

[3] File No. S7-03-04

through their review and approval of the advisory contract. Yet, the high fees charged by many funds suggest that all too many fund boards do not provide the kind of rigorous review of advisory contracts, and the fees charged for those services, that shareholders have a right to expect.

The discussion of mutual fund fees tends to become mired in a debate over whether one can make relevant comparisons between the fees advisers charge their mutual fund clients and those they charge pension funds and other institutional clients for advisory services. One need not look beyond the mutual fund industry, however, to find evidence of dramatically different fees for substantially comparable products.

When CFA and Fund Democracy recently examined operating expenses for S&P 500 index funds, we found 16 fund companies that charged annual expenses of greater than 1.0 percent for these funds. In contrast, Vanguard charged just 0.18 percent for its S&P 500 index fund, and Fidelity charged just 0.19 percent. While distribution costs in the form of 12b-1 fees accounted for much of the difference, the underlying expenses at these funds, minus 12b-1 fees, still ranged from two to five times higher than those at Vanguard and Fidelity. While the economies of scale associated with Vanguard and Fidelity's funds doubtless explain part of the difference, it can't explain it all. Clearly, advisers to some of these funds are charging significantly more for essentially the same service, and their boards are permitting them to do so.

Similarly, one need only look at the gap between Vanguard's fees and the fees charged by most other fund companies for comparable funds to reach a similar conclusion. Because of its unique structure, Vanguard lacks the major conflict of interest with regard to fees that exists for other fund companies. As a result, its fund fees offer a reasonable benchmark for judging the true cost of operating a fund. For the many funds whose costs are far higher, it seems reasonable to assume that one factor contributing to these higher costs is an advisory fee that is being padded beyond the level necessary to assure a reasonable profit for the advisory firm.

Why have boards at some fund companies exerted so little discipline over the fees charged for advisory services? One problem, in our view, is that most fund boards are dominated by the very advisory firms whose conflicts they are supposed to police. The Commission has proposed rules to address this problem that we strongly support and believe are an essential element of any mutual fund reform program.[4] Another problem, in our view, is that boards simply haven't been held accountable for failing to ensure that costs are reasonable. By forcing boards to do a better job of explaining their reasons for approving, or recommending shareholder approval of, the advisory contract, this rule should help to make boards more accountable to shareholders. The SEC's separate rule

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[4] We also believe, however, that legislation is needed to strengthen the definition of independent director, to allow the SEC to impose its reforms directly without resort to applying them as a condition of various exemptive rules, and to extend the fiduciary duty of fund boards to ensure that the totality of fund fees, and not just the advisory fee, are reasonable.

proposal requiring the board to retain documents used in reviewing the contract should also help make boards more accountable to the Commission. If the Commission were then to use its existing authority to bring enforcement actions against fund boards that fail to fulfill their responsibility to ensure that fees are reasonable, these rules would acquire real teeth, and many investors would likely see significant reductions in fees.

We Support the Proposed Disclosure Enhancements

The Commission has done a good job of identifying the issues that fund boards should have to consider and discuss in reviewing the advisory contract. In particular, we think it is essential that advisers be required to reveal the actual cost of providing the services contracted for and the profits to be realized by the advisory firm and its affiliates on the services provided to the fund. No board can ascertain whether the fees being charged are reasonable without evaluating in some detail the actual cost of providing the service. Requiring disclosures to include a discussion of these issues should make boards more conscientious in their evaluation and advisory firms more cooperative in providing the necessary information at an appropriate level of detail.

To ensure the full effectiveness of this provision, we believe it is important that the disclosures be required to analyze separately the amounts to be paid for portfolio management services and the amounts to be paid for other services. A board cannot fulfill its responsibility to evaluate the reasonableness of fees without evaluating each service provided, the actual cost of providing that service, and the profits realized by the advisory firm or its affiliates in providing that service. The only way to ensure such a review, short of requiring it outright, is to require that the conclusions of such an evaluation be disclosed.

We also strongly support the requirement that disclosures discuss the extent to which economies of scale would be realized as the fund grows and whether fee levels reflect these economies of scale for the benefit of fund investors. Studies have shown that, as funds grow, they tend to reduce the fees they charge. It is not at all clear, however, that fee reductions fully reflect the economies of scale. According to data prepared for the fund industry by Strategic Insight Mutual Fund Research and Consulting, LLC, for example, the average advisory/administrative fee ratio for actively managed equity funds with over $3 billion in assets is 0.552 percent, compared with 0.830 percent for funds with $50 to $100 million in assets.[5] A 0.552 percent expense ratio on a $3 billion fund produces revenue of $16.56 million. A 0.830 percent expense ratio on a $100 million fund produces revenue of $830,000. We find it highly unlikely that it costs 20 times as much to offer advisory/administrative services to a $3 billion fund as it does to offer those same services to a $100 million fund. This suggests that the fee reductions that are adopted as funds grow do not fully reflect the economies of scale that are realized. Requiring boards to

[5] "Mutual Fund Fees: Facts, Trends, Economies of Scale, and Market Forces," Strategic Insight Mutual Fund Research and Consulting, LLC, © 2004.

examine, and disclose, the extent to which economies of scale are realized by fund shareholders should help to ensure that shareholders capture a fair share of the benefits of fund growth.

We have some concerns about the requirement that boards disclose whether they relied on comparisons of services provided and the charges for those services. It is often suggested that fund boards believe they have satisfied their obligation to ensure that fund costs are reasonable as long as they have ascertained that their costs are roughly in line with those charged by other fund companies. It would be counter-productive if this requirement were used to institutionalize this practice. We believe the requirement should specifically apply when the adviser provides similar services to another entity, such as a pension fund, at a lower cost. In that case, the board should have to disclose the basis for its determination that the higher cost charged to the mutual fund was justified.

Finally, we believe it is essential that boards be required to discuss these issues in reasonable detail and not rely on boilerplate disclosures. The requirement that the discussion state how the board evaluated each factor should be extremely useful in achieving this goal. We urge the Commission to keep a careful eye on how these rules are implemented, to ensure that funds are providing the appropriate level of detail in their disclosures.

We Support Requiring Inclusion of the Disclosures in Shareholder Reports

We support the rule requirement that the disclosures be provided in shareholder reports. We are inclined to believe, however, that they should also be included in the prospectus, rather than in the Statement of Additional Information (SAI). Few investors ever read the SAI. Thus, including the information in this location is unlikely to raise investor awareness. Because so little is known about what disclosure documents and what portion of those documents investors read, we don't know for sure whether disclosure in shareholder reports would be adequate. As we have suggested in commenting on other disclosure rule proposals, we therefore strongly recommend that the SEC conduct or commission research to determine the best location for disclosures such as these. Any such research should include questioning of Morningstar and Lipper, as well as personal finance publications and financial advisers, about where and how they would like to see the information provided.

Conclusion

If it adopts this rule, along with the proposed rules on fund governance and record-keeping, the Commission will have made great strides toward strengthening the role fund boards play in keeping fund fees reasonable. This is only part of a comprehensive approach to wringing out excess fund costs, albeit an important part. To add teeth to the requirement, the Commission must use its authority to bring enforcement actions against

fund boards and advisory firms that charge excessive fees. Only an effective enforcement program will ensure that funds take their responsibilities in this area seriously. In addition, if it wishes to harness the disciplining effects of the marketplace, the Commission should require pre-sale disclosure mutual fund operating costs in a format that is accessible and understandable to average, unsophisticated investors. Taken together, these steps would provide real discipline to mutual fund costs and in the process provide a real benefit to mutual fund investors.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Mercer Bullard
Founder and President
Fund Democracy, Inc.

cc: Chairman William Donaldson
Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Cynthia Glassman
Commissioner Harvey Goldschmid
Paul Roye, Director, Division of Investment Management