Washington University Law Review

Volume 83
Issue 4 *Mutual Funds, Hedge Funds, and Institutional Investors*

2005

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MUTUAL FUND EXPENSE DISCLOSURES: A BEHAVIORAL PERSPECTIVE

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The last few years have not been kind to the mutual fund industry. To be sure, financial indices have improved with the collateral benefit of boosting investor optimism so that the net gain in assets under management by registered investment companies rose by more than ten percent in 2004 to reach $8.6 trillion at the end of the year.[1] But the mutual fund scandals that were first unearthed in fall 2003, with the accusations of late trading involving the Canary Fund,[2] have been compounded by further allegations of late trading involving other funds.[3] These scandals have been joined by pervasive instances of fund advisors looking the other way as important clients were permitted to abuse fund prohibitions against rapid trading.[4] Even the well-established practice of revenue sharing, whereby brokers are rewarded by funds for recommending the fund to their clients,[5] are being reconsidered in the post-Enron era in light of rising concerns over pervasive conflicts of interest within the financial services industry.[6] For example, revenue

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* Brainerd Currie Professor of Law, Duke University. The authors are grateful for the insights and suggestions on an early draft of this paper by the distinguished commentators at the April 2005 conference sponsored jointly by the Washington University School of Law and Institute for Law and Economic Policy as well as the invaluable research assistance of Messrs. Segev Phillips and Raegan Watchman of the School of Law, Duke University.

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1. *See* INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 3 (45th ed. 2005), http://www.ici.org/stats/mf/2005-factbook pdf [hereinafter 2005 FACT BOOK].

2. *See In re* Theodore Charles Sihpol III, Securities Act Release No. 8288 (Sept. 16, 2003), *available at* http://www.sec.gov/litigation/admin/33-8288.htm. *See also* Landon Thomas, Jr., *S.E.C. Putting Mutual Funds Under Scrutiny On Late Trading*, N.Y. TIMES, Sept. 5, 2003, at C1.

3. *See, e.g.*, *Mutual Funds: Trading Practices and Abuses That Harm Investors: Hearings Before the Financial Management, The Budget, and International Security Subcomm. of the S. Comm. on Governmental Affairs*, 108th Cong. 9 (2003) [hereinafter *Hearings on Mutual Fund Abuses*] (statement of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission) (stating that in a recent survey more than twenty-five percent of firms admitted to late trading).

4. *See, e.g.*, *Enforcement Proceedings—SEC Files Civil Fraud Charges Against the PIMCO*, SEC NEWS DIGEST, May 6, 2004.

5. *See, e.g.*, *Hearings on Mutual fund Abuses*, *supra* note 3, at 20–23 (testimony of Mary L. Shapirio, NASD Vice Chairman and President Regulatory Policy and Oversight); *id.* at 6 (statement of Sen. Daniel K. Akaka, Member, S. Financial Management, The Budget, and International Security Subcomm.) ("revenue sharing agreements between mutual fund companies and brokers present conflicts of interest that must be addressed.").

6. *See, e.g.*, *id.* at 20–21 (testimony of Mary L. Shapiro, NASD Vice Chairman and President,

sharing is now regulated.[7] The various mutual fund scandals have invited public and political focus on the rising level of fees and expenses levied upon funds by their advisors.[8] Thus, 2004 found not only numerous government enforcement actions that resulted in significant financial settlements,[9] but also a tectonic shift in the regulatory quilt that covers the mutual fund industry.

Foremost among the regulatory developments for the mutual fund industry is the requirement of heightened transparency of how registered investment companies cast their proxies for their portfolio companies.[10] Greater transparency regarding how funds vote complicates the life of the fund manager by placing the manager between the conflicting needs of gaining admission as one of the acceptable vendors of 401K plans for a portfolio company's employees and confronting a shareholder-friendly proposal (e.g., separating the position of CEO and board chair) that is opposed by that portfolio company's management. The SEC also adopted corporate governance changes that essentially compel most funds to raise the number of fund directors who are independent of the fund's advisor to three-fourths (from the statutorily mandated level of forty percent).[11] And,

Regulatory Policy and Oversight).

7. *See, e.g.*, Securities Exchange Act Rule 15C-2(C)(5), 17 C.F.R. § 240.15C-2(C)(5) (2005).

8. *See, e.g.*, Mutual Fund Integrity and Fee Transparency Act of 2003, H.R. 2420, 108th Cong. § 2 (2003) (proposed legislation that among other features would expand the required disclosure of mutual fund fees). *See generally Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing before the Financial Management, The Budget, and International Security Subcomm. of the S. Comm. on Governmental Affairs*, 108th Cong. (2004) [hereinafter *Oversight Hearing*]; *Mutual Funds: Who's Looking Out for Investors: Hearings before Subcomm. on Capital Markets, Insurance And Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003); *Hearings on Mutual Fund Abuses*, *supra* note 3; *The Mutual Funds Integrity and Fee Transparency Act of 2003 on H.R. 2420: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003); *Mutual Fund Practices and Their Effect on Individual Investors: Hearing before the Subcomm. on Capital Markets, Insurance, And Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. (2003).

9. *See, e.g*., Heather Timmons, *2 Fund Groups Agree to Pay $450 Million to End Inquiry*, N.Y. TIMES, Sept. 8, 2004, at C1 (detailing the settlement terms of Invesco Funds Group and an Affiliate, AIM Advisors); *Janus Settlement Complete*, N.Y. TIMES, Aug. 19, 2004, at C6 (detailing the $226.2 million settlement by Janus Capital Group).

10. *See* SEC Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 33-8188 (Apr. 14, 2003), *available at* http://www.sec.gov/rules/final/33-8188.htm.

11. *See* INV. CO. INST., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS: ENHANCING THE CULTURE OF INDEPENDENCE AND EFFECTIVENESS (1999) (recommending a variety of mechanisms to improve the independent functioning of mutual fund boards); U.S. GEN. ACCOUNTING OFFICE, GAO-04-533T, MUTUAL FUNDS: ASSESSMENT OF REGULATORY REFORMS TO IMPROVE THE MANAGEMENT AND SALE OF MUTUAL FUNDS (2004) (discussing same).

as will be discussed below, in 2004 the SEC expanded the amount of information that funds must disclose regarding fees and other costs that are charged to the fund's assets.

The SEC's regulatory action with respect to enhanced disclosure of fees and costs was the least controversial of its actions. However, if improved disclosure has the remedial and protective effects believed to follow from disclosure in capital markets, this change has the potential to be one of the most profound regulatory steps taken by the Commission. To understand why this is so, consider a recent Forbes Magazine survey finding that eighty-four percent of the surveyed investors believe that higher fund expenses result in higher performance by the fund.[12] To students of the mutual fund industry, this statistic is a bit like saying higher maintenance charges are associated with better performing automobiles. The apparent public misperception of the impact of fund expenses on their return that is captured in the Forbes study is consistent with data showing significant inefficiencies among investors in fifty-two different S&P 500 index funds.[13] Among this group of funds the difference in return (as a percentage of fund net assets) between the best and the worst performing funds was 2.03 percent. Although one can expect several management practices to explain some of the difference,[14] the biggest

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12. *See* Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, FORBES MAG., Oct. 14, 2002, at 220.

CFOs have a very different perspective. *See* Roy Harris, *Raiding the Returns*, CFO MAG., May 2004 (reporting that ninety percent of surveyed financial executives believe mutual fund fees are too high). Concerns regarding fees transcend their poor understanding by retail investors. The source of further concern is data reporting that fees charged the advisor's captive mutual fund are twice as great as that the same advisors charge their pension plan and other institutional clients. *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001). Thus understanding of fees may cause their returns to be eroded by fees that are higher than if consumers of the funds had a better comprehension of the relative impact fees have on their investment return.

13. Cognitive deficiencies of many, if not most, individual investors are suggested by their failing to invest more of their money in index funds than they do. Less than eight percent of the new money flowing into mutual funds is directed into index funds. *See* John Waggoner, *Investors Pour Money into S&P 500 Index Funds*, USA TODAY, Mar. 31, 1999, at B1. Statistics reflect that investors are better off investing in index funds. *See generally* JACK BOGLE, BOGLE ON MUTUAL FUNDS: NEW PERSPECTIVES FOR THE INTELLIGENT INVESTOR (1994); R.E. EVANS & B.G. MALKIEL, EARN MORE (SLEEP BETTER): THE INDEX FUND SOLUTION (1999). The latter point is illustrated by the fact that eighty-four percent of actively managed mutual funds underperformed the market overall between 1981 and 1996. *See* S. Burns, *Vanguard Founder Decries Managed Funds Performance*, HOUS. CHRON., Oct. 6, 1997, at 4. For a review of the many social and psychological forces that can explain investors' preference for such suboptimal investment choices, see Don Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 95 (1999) (hypothesizing that the common traits of over-optimism and framing of choices against past performance contribute significantly to investors eschewing index funds).

14. For example, managers may differ in the amount of cash retained for redemption, the speed

portion of the difference in performance is due to advisory fees and other costs charged to the fund.[15] Not only are expenses relevant in explaining the relative returns investors can expect, but also future relative returns among the fifty-two funds are correlated with past returns so that investors who based their selection of an S&P 500 index fund based on which fund performed in the top decile in the prior year would garner 0.92% greater return than if they selected a firm that was in the bottom decile of the cohort in the prior year.[16] The authors of the study explain the observed results being due to irrational investor behavior in selecting funds, reasoning that their judgment is affected by salesmanship and marketing of such funds. This explanation is compelling in that the funds with poorer performance are those with higher distribution costs.[17] The study concludes on a discouraging note: the study's authors describe that new entrants to the S&P Index fund market have costs fifty percent higher than their sample and that the funds falling within the bottom decile in returns grew at an annual rate of 20.5% compared to a growth rate of 11.8% for low cost funds.[18] From this result we might conclude that marketing not only matters, but matters a lot. The authors, although recognizing that arbitrage can normally be expected to address inefficient price disparities for stocks and bonds, observe that there are no arbitrage opportunities for mutual fund shares, writing:

> In such a market, all that is necessary for inferior funds to exist and grow is a set of uninformed investors and a set of distributors who have an economic incentive to sell inferior products. In a market where arbitrage is impossible, we may be disappointed, but we should not be surprised when inferior products exist and even prosper.[19]

Their findings are doubly troubling because "index funds may be particularly attractive to sophisticated investors who suspect that active

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of reinvesting dividends received, and may not perfectly balance their portfolios to mirror the makeup of the S&P 500 Index.

15. *See* Edwin J. Elton, Martin J. Gruber & Jeffrey A. Busse, *Are Investors Rational? Choices among Index Funds*, 59 J. FIN. 261, 264 (2004) [hereinafter Elton et al.]. *See also* Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 170 (2004) (finding in a survey of eighty-seven Standard and Poors 500 Index Funds that after excluding section 12b-1 fees, operating expenses ranged from eight to eighty-five basis points).

16. *See* Elton et al., *supra* note 15, at 273.

17. *Id.* at 285.

18. *Id.* at 286.

19. *Id.* at 286.

management does not add value."[20] Thus, as we move from index funds to funds with more active management we are likely not only to find higher operating costs but also to find even less sensitivity to operating costs on the part of investors.

On an even broader level, a study of funds between 1970 and 1999 (during which the studied number of funds rose from 465 to 3,533) found that load fees declined whereas operating fees increased significantly.[21] Even more importantly, the study's authors observed a negative relationship between flows of money into funds and the presence and level of load fees. On the other hand, they detected no relationship between fund flows and operating expenses.[22] From this observation they surmise that investors had grown sensitive to point-of-sale charges such as load fees, but are apparently oblivious to on-going operating expenses. Moreover, over time fund managers have responded to investors' sensitivities and insensitivities by shifting their revenue source to the less noticed operating expenses.[23]

While it is not conceivable that meaningful arbitrage can be introduced efficiently in the pricing of mutual fund shares when the fund is, as is the custom, an open-end fund, we might understand the disquieting inefficiencies captured in the above study as due to another problem, namely the incompleteness of information disclosed to investors. That is, we should question not only whether investors are provided with ample information but whether the information they receive is in a context that makes it processible by them so that their choices among competing funds appears more rational. In 2004, the SEC improved the disclosure of fees and costs that mutual funds must make.[24] This paper examines the efficacy of the recently adopted disclosure requirements for mutual fund expenses through the lens of social and psychological insights. Although the principal focus is the impact of disclosure on fund holders or individuals considering investing in funds, we also consider whether properly designed disclosures can provide an important subsidiary function of enhancing the fund's independent directors' monitoring of the advisor's stewardship of the fund.[25]

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20. *See* Paul Mahoney, *supra* note 15, at 171.

21. *See* Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* (2002), http://faculty.haas.berkeley.edu/odean/papers/MutualFunds/Out%20of%/20Sight%20031202.pdf (working paper) (forthcoming J. Bus.).

22. *Id.* at 11–14.

23. *Id.* at 19–20.

24. See discussion in text accompanying notes 97–99.

25. One can understand the mutual fund governance issue vis-à-vis compensation in the larger

The organization of our article is straightforward. Part I reviews the mutual fund industry over time with particular emphasis on the rapid growth—both absolute and relative to fund assets—of expenses over the industry's short history. In Part II we review the many reasons why discipline for mutual fund fees[26] cannot be expected to flow from litigation that challenges the fees as either being excessive or even the product of self interest. The importance of governance and disclosure as a regulator of mutual fund fees, as contrasted with litigation, is examined in Part III. The newly developed disclosure requirements and heightened governance requirements are also described in Part III. In Part IV, we provide an overview of the insights provided by the judgment and decision-making research bearing upon how individuals, be they consumers or investors, make decisions. Finally, we conclude in Part V by evaluating how well the recent SEC disclosure requirements comport with the insights from the cognitive sciences. We also provide our own suggestions for enhancing investor choice through a reformulated disclosure format and speculate on how our suggested disclosure requirements are likely to complement the SEC's initiative in strengthening the oversight by the fund's independent directors.

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tapestry of executive compensation. Talented managers come with hefty compensation packages. But in America, we need not be so qualified; it is accurate to say that American business executives are expensive regardless of whether the particular executive has talent or not. Between 1982 and 1997, total compensation of executives of public companies rose 269.7%, or 11.5% annually. *See* Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437, 454–55 (2002). Only major league baseball and NBA players experienced faster compensation increases than those in the executive suites of American corporations. The large pay packages were not just lavished on the excellent. A separate public concern is observed for substantial severance packages awarded to unsuccessful managers. For the past two decades, the rising tide of executive compensation lifted the pay of the entire executive flotilla and prompted a national debate over the phenomenon. The antidote for the public concern for executive compensation has been SEC regulations calling for greater transparency in how executive pay is established and the exchanges stiffening their governance requirements by requiring independent compensation committees for listed companies. By all accounts, neither has had much effect. Indeed, there is some cause to believe that the heightened disclosures have had the unintended consequence of stimulating further increases in executive pay rather than retarding the upward spiral. Thus, we question whether disclosure or governance in the mutual fund area will have any greater impact than it has outside the mutual fund area in retarding the rise of executive compensation.

26. The fees and expenses referred to in this article are those customarily known as a fund's operating expenses which are made up of the management fee (this is the amount the adviser charges to manage the fund) as well as other operating expenses incurred by the fund, e.g., accounting, custodial, and mailing expenses. The operating expenses also include 12b-1 fees which are distribution expenses that are paid from the fund. There are other expenses that are not included among operating expenses, such as brokerage costs. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-03-551T, MUTUAL FUNDS INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE 1 (2003).

I. BIGGER AND BIGGER: THE MUTUAL FUND INDUSTRY OVER TIME

At the close of 2004, there were 8,044 mutual funds—broadly divided among equity, bond/hybrid, and money market funds—with a total of $8.107 trillion in assets.[27] The 4,550 equity funds[28] are the largest sector of the fund industry, with $4.384 trillion in assets.[29] Thanks primarily to the bull market of the 1990s and the growing importance of 401K retirement plans, more than two-thirds of the increase in funds since 1990 has been in equity funds.[30] There appear to be no substantial barriers to entry to the mutual fund industry, even though there are several well-recognized fund complexes. For example, eighty-one percent of all equity and hybrid funds and sixty percent of all bond funds were formed after 1991.[31] The new entrants neither removed nor conferred market share to the large fund complexes. The five largest fund complexes' market share (in terms of assets under management) was thirty-seven percent in 1990 and increased slightly to thirty-nine percent by 2004; similar stability is reflected during the same time period among the twenty-five largest fund complexes whose market share in 1990 was seventy-six percent and was seventy-four percent in 2004.[32]

Although nearly one-half of all household investments in mutual funds occur through their retirement plans, a healthy thirty-seven percent are sold through financial professionals, most commonly a stock broker.[33] Purchases through a broker frequently involve other assistance by the broker that can be seen as part of the implicit cost of the transaction so that some revenue sharing between the fund and the broker can be expected.[34]

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27. 2005 FACT BOOK, *supra* note 1, at 9, 122.

28. *Id.* at 63 tbl.5.

29. *Id.* at 61 tbl.3.

30. *Id.* at 63 tbl.5 (of the 4,965 additional funds since 1990, 3,451 (69.5%) have been equity funds). This pace was slowed, of course, in 2000–2002 with the arrival of the bear market. INV. CO. INST., 2004 MUTUAL FUND FACT BOOK 40 (44th ed. 2004), http://www.ici.org/statements/res/2004-factbook.pdf [hereinafter 2004 FACT BOOK].

31. *Id.* at 41. One impact of so many new entrants is their probable impact on increasing the overall fund expense ratio. *See* SEC DIVISION OF INVESTMENT MANAGEMENT: REPORT ON MUTUAL FUND FEES AND EXPENSES 24 tbl.10 (2000) [hereinafter SEC REPORT] (reporting that 3,873 funds with an existence of less than six years had an average expense ratio of 1.23% whereas those in existence more than ten years had an expense ratio of 0.80%). The size of the fund also impacts the expense ratio so that relatively smaller funds (those with assets of $51 million to $200 million) have an expense ratio over forty percent greater than the expense ratio for funds with assets exceeding $1 billion. *Id.* at 25 tbl.11.

32. 2005 FACT BOOK, *supra* note 1, at 8.

33. 2004 FACT BOOK, *supra* note 30, at 45.

34. The Investment Company Institute describes such services as:

The sum flowing into funds is staggering: net inflows to long-term (equity, bond, and hybrid) funds was $210 billion in 2004.[35] Assuming a fair amount of investor discretion prevails in most of the transactions underlying flows of cash into long-term funds, the magnitude of this sum underscores how important it is for investors to be armed with sufficient information in an understandable format so that they can be in a position to make wise choices. Stated differently, would we feel comfortable if consumers spent $210 billion annually in purchasing automobiles without knowledge of their relative fuel efficiency?

From a different perspective, 19.5% of household assets in 2004 were invested in mutual funds;[36] the stewardship of their individual nest egg is dependent upon their holders being informed about the performance and the related costs of their investments. Seventy-seven percent of these decisions are made by households (either as to mutual funds held in a retail account, employer-sponsored pension plan, individual retirement account, or variable annuity) and only twelve percent are by fiduciaries.[37]

In his recent testimony before Congress, industry critic Jack Bogle recounted how fees have grown rapidly during the relatively short life of the mutual fund industry. In 1965, the total asset value of equity funds was $26.3 billion; by 2003 the number had grown 128-fold to $3.36 trillion.[38] During this same period, fund expense ratios increased from 0.87% for the average equity fund to 1.62%, an 86% increase.[39] In absolute dollar

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> As an intermediary between investors and funds, financial professionals also conduct transactions for the shareholder, maintain the financial records for the investments under their management, send periodic financial statements to shareholders, and coordinate the distribution of prospectuses, financial reports, and proxy statements to shareholders on behalf of the funds.

Id. at 47.

35. 2005 FACT BOOK, *supra* note 1, at 5.

36. *Id.* at 12.

37. *See id*.

38. *See Oversight Hearing*, *supra* note 8, at 25 (testimony of John C. Bogle, Founder and Former Executive of the Vanguard Group, President of the Bogle Financial Markets Research Center). Many of the observations in Mr. Bogle's testimony are embodied as well in John C. Bogle, *Re-Mutualizing the Mutual Fund Industry—The Alpha and the Omega*, 45 B.C. L. REV. 391 (2004) (arguing that today's prevalent practice of external advisors for funds is inconsistent with the Investment Company Act of 1940).

39. *Oversight Hearings*, *supra* note 8, at 125. The cited figures are unweighted expense ratios; if the average is weighted by each fund's assets the 1965 average expense ratio is 0.51% and that in 2003 is 0.95%, still reflecting an 86% increase. *Id.* If we believe Mr. Bogle's cup is half empty, then industry consultant Lipper Inc.'s cup is half full in reporting that between 1992 and 2003 the total expense ratio edged up slightly from 0.773% to 0.786%. *See id*. at 193 (statement of Mr. Jeffrey C. Keil, Vice-President Global Fiduciary Review, Lipper Inc.). This would appear to conflict with the data assembled by Mr. Bogle. However, the Lipper data, in addition to capturing a much shorter and recent time period, also appears to report on *all* actively-managed open-end funds, so that it includes

amounts, total fees charged to equity funds grew from $134 million to $31.9 billion between 1965 and 2003, a 238-fold increase (nearly twice the increase in the absolute 128-fold increase in equity fund assets).[40] Mr. Bogle attributes the rapid rate of growth in fees to the demutualization of mutual funds, a process that has transformed nearly all mutual funds to portfolios that are managed externally rather than by a permanent staff that is in the employ of the fund.[41] So viewed, it is a massive and pervasive misnomer to refer to the industry as the *mutual* fund industry.

The industry trade group, the Investment Company Institute, counters charges by Mr. Bogle by its own study showing that total investor costs had declined in recent years.[42] However, about half of the reported decline was attributable to investors changing their consumption patterns by placing more of their investments in no-load funds. And, even the ICI study still reported that the average expense ratio (i.e., the portion of the fund spent as operating and sales costs) for stock funds rose from 0.77% in 1980 to 0.88% in 2001.[43] Even more recent data reflects the positive effects of increasing competition among funds. Lipper Inc. reported that 844 funds reduced their fees in 2004, more than double the number reported in 2002 and 2003 combined.[44] The trade group provides further reassurance by reporting that in 2003 two-thirds of net new cash invested in equity funds flowed into funds with an expense ratio under one percent and that fifty-seven percent of assets in equity funds were subject to expense ratios below one percent.[45] This response may not provide as much solace as we would like. The number reducing their fees in 2004 is only about ten percent of all funds. Moreover, it does not address the questions of whether fees are still relatively high even among those funds that have recently reduced their fees. We are all aware that, with the wonders of compounding interest, annual differences of twenty or thirty basis points can over twenty years translate into significant sums of

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bond funds and blended funds. In fact, when not weighted by asset amounts, the Lipper data reflects a median increase from 0.897% in 1992 to 1.297% in 2003. *Id*. The Lipper data therefore parallels the SEC's own study of all stock and bond funds that found their *combined* average expense ratio increased from 0.73% in 1979 to 0.94% in 1999, primarily due to greater use of 12b-1 fees to pay for fund distribution costs. *See* SEC REPORT, *supra* note 31, at 20.

40. *Oversight Hearing*, *supra* note 8, at 125.

41. *Id.*

42. *See* FUNDAMENTALS, INVESTMENT COMPANY INSTITUTE RESEARCH IN BRIEF, TOTAL SHAREHOLDER COST OF MUTUAL FUNDS, vol. 13, no. 5, 1 (Dec. 2004), http://www.ici.org/statements/res/fm-v13n5.pdf.

43. *Id.* at 3 fig.2.

44. *See* Tom Lauricella, *Fund Fees Are Falling*, WALL ST. J., Apr. 4, 2005, at R1 (reporting also that 135 funds raised their fees in 2004, whereas 417 raised their fees in 2003).

45. 2004 FACT BOOK, *supra* note 30, at 67.

money. And, for the fund managers, twenty basis points when applied to a billion dollar fund will equal two million dollars in additional income annually to the fund's advisor. As a distinguished senator was reported to have said regarding the national budget, "a billion here, a billion there, and pretty soon you're talking about some real money."[46]

II. WHY NOT SUE THEM?[47]

The rise in mutual fund fees has occurred without serious legal challenges to their being excessive. An understanding of why this situation is so begins with a full appreciation of the ineffectiveness of the legal system to redress complaints of excessive and wasteful compensation. The impotence of the American legal system to regulate executive compensation is well understood. Those bringing such complaints, whether against corporate executives or the advisors to mutual funds, face serious substantive and procedural hurdles. Indeed, we might conclude that courts have not only failed to be a restraining force on compensation, but also have, in their wayward tact, contributed mightily to the insularity of the compensation-setting process.

A review of the history of the courts' interface with executive compensation reveals that excessive executive compensation has long been a part of the public debate. In the wake of the Great Depression, there were many judicial attacks on executive compensation, especially bonus and incentive compensation arrangements. The focus of these suits and compensation-related abuses were captured in extensive congressional hearings leading up the enactment of the federal securities laws.[48] The most famous of the suits was prompted by the bonus awarded the executives and directors of the American Tobacco Company.[49] The president of American Tobacco, who in addition to receiving a salary in excess of one million dollars, was granted the option to purchase shares

46. This statement is most often attributed to Senator Everett Dirksen, see BARTLETT'S FAMILIAR QUOTATIONS 745 (17th ed. 2002), although his congressional center cannot find any proof he ever made the statement. *See* The Dirksen Center, http://www.dirksencenter.org/printemdbillionhere.htm (last visited May 24, 2005).

47. A portion of this section was adapted from JAMES D. COX, FAIR PAY FOR CEOS: MAXIMIZING FIRM VALUE BY MINIMIZING INCOME DISPARITY IN LAW AND CLASS IN AMERICA: TRENDS SINCE THE END OF THE COLD WAR (N.Y.U. Press 2006) (Paul D. Carrington & Trina Jones eds.).

48. *See* JAMES D. COX & THOMAS LEE HAZEN, COX AND HAZEN ON CORPORATIONS § 11.05, at 567–68 (2d ed. 2003) (reporting on suits against industry giants such as Bethlehem Steel Corporation, General Motors, and National Cash Register).

49. *See* Rogers v. Hill, 289 U.S. 582 (1933).

immediately for an amount $1,169,000 below there current market value. The approving directors as part of the same option arrangement, also awarded themselves handsome options. The case ended triumphantly for the plaintiff in the U.S. Supreme Court. The Court concluded that even though the arrangement had been approved by the stockholders and was therefore "supported by the presumption of regularity," that presumption nevertheless would not

> justify payments of sums as salaries so large as in substance and effect to amount to spoilation or waste of corporate property. . . . If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority. . . . The facts alleged by the plaintiff are sufficient to require that the district court, upon a consideration of all the relevant facts brought forward by the parties, determine whether and to what extent payments to the individual defendants under the by-laws constitute misuse and waste of the money of the corporation.[50]

The substantive reasonableness focus embodied in the American Tobacco case has since been replaced by an emphasis on process. The result of the shift from substance to process is that suits against executive compensation have their highest chance for success in close corporations and much less in public corporations. This fact is because process is more likely overlooked in close corporations whereas process is most always present in public corporations due to their ability to retain talented and compulsive counsel. Consider that, in their study of all litigated compensation disputes between 1912 and 2000, Professors Thomas and Martin report that plaintiffs' success rate is about fifty percent greater within the close corporation context than in suits arising within the public corporation when the complaint is substantively-based, not process-based and twice as high when the complaint focuses on process.[51]

The greatest barrier the plaintiff faces in litigating executive compensation claims is satisfying the "demand requirement."[52] A suit

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50. *Id.* at 591–92 (quoting in part Judge Swan's dissenting opinion in the Second Circuit's decision dismissing the suit, 60 F.2d 109, 113–14 (2d Cir. 1932)).

51. *See* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges To Executive Pay: An Exercise In Futility?*, 79 WASH. U. L.Q. 569, 608, 610 (2001).

52. The demand requirement applies with equal vigor to derivative suits under the Investment Company Act alleging breaches of fiduciary duty, but, as discussed later, does not apply to suits premised upon Section 36(b) for excessive fees. *See* Daily Income Fund, Inc. v. Fox, 464 U.S. 523

challenging executive compensation is a derivative suit so that in most states a precondition to bringing the suit is the necessity of the plaintiff proving that the board of directors is incapacitated by self interest or that the conduct that is the substance of the derivative is facially harmful to the corporation. A leading Delaware case, *Aronson v. Lewis*,[53] reflects how high a hurdle the demand requirement places in the path of the derivative suit plaintiff when the focus is executive compensation.[54] *Aronson* involved a challenge to the employment contract awarded to Leo Fink, the owner of forty-seven percent of the voting stock of Meyers Parking System, Inc. When Fink was seventy-five years old, the firm granted him an employment contract that would pay him $150,000 a year (plus five percent of the firm's pre-tax profits above $2.4 million). Fink could terminate the contract at any time and would receive a six-figure consulting payment for the remainder of his life; the payments would be made even if he became incapacitated. The board also approved interest-free loans to Fink that totaled $225,000. The court announced that the suit could only proceed without the approval by Fink's hand-picked board if the plaintiff's complaint alleged facts that created "reasonable doubt" regarding either the board's independence or the compensation arrangement's excessiveness.[55] The Delaware Supreme Court held that these facts failed to raise a reasonable doubt that the directors were independent or that their decision lacked a rational basis and, therefore, dismissed the action.[56] Neither the dominant stockholdings of Fink nor the facially one-sided employment and loan agreements were sufficient to raise a reasonable doubt as to whether the compensation package was reasonable or that it was the product of an independent judgment by the

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(1984). With respect to derivative suits under the Investment Company Act for which the demand requirement applies, the Supreme Court in *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 108–09 (1991) held that the federal court in such a challenge should apply the law of the state of incorporation to determine if a demand is required on the board of directors to initiate a derivative suit on behalf of the mutual fund. The deference to state law in this matter reflects the substantive nature of the demand requirement. As the *Kamen* court reasoned, "the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of 'substance', not 'procedure.'" *Id.* at 96–97. The Supreme Court earlier held that the power of a board of directors to establish a special litigation committee to evaluate the corporation's interest in a derivative suit's continuance and the effect, if any, to be accorded the committee's recommendation, was to be determined by the law of the corporation's domicile. *See* Burks v. Lasker, 441 U.S. 471, 478–82 (1979).

53. 473 A.2d 805 (Del. 1984).

54. *See generally* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (clarifying that appellate review is de novo but that discretion will still be accorded to the board of directors).

55. *Aronson*, 473 A.201 at 814.

56. *Id.* at 815–18.

directors approving the compensation.[57] Post-*Aronson* decisions support the view that *Aronson* was not a mere aberration.[58] One observable impact of *Aronson* is the greater prominence that the demand requirement plays in Delaware post-*Aronson*. Prior to *Aronson*, defendants made motions to dismiss the derivative suit challenging executive compensation for failure to make a demand on the board in roughly the same percentage of cases in Delaware (fourteen percent) as outside of Delaware (eighteen percent); after *Aronson*, such motions in executive compensation decisions are made in seventy-five percent of the Delaware cases compared with only fourteen percent for non-Delaware cases.[59]

We might view the recent Delaware decision, *In re Walt Disney Co. Derivative Litigation*,[60] as an important first step toward closer judicial scrutiny of executive compensation decisions. The case arose from the Disney board's approval of an executive compensation contract with Michael Ovitz and implicit approval of a non-fault termination of Ovitz that resulted in his receiving in excess of $140 million after barely one year of employment. The Chancery Court held, based on the egregious facts set forth in the complaint, that the plaintiff's complaint withstood the

57. Lewis was allowed to amend his complaint which, as amended, withstood the defendants' motion to dismiss. *See* Lewis v. Aronson, 11 DEL. J. CORP. L. 243 (1985). However, even this subsequent opinion held that demand was not excused by allegations that Fink controlled a *majority* of the shares, that the board nominees were his nominees, or that a majority of the directors served in subservient officer positions that could be terminated as a result of Fink's financial interests in various firms. *Id.* at 247–53. What permitted the complaint to withstand a motion to dismiss was the allegation that the compensation arrangement was a means of addressing Fink's concern that, in a multifaceted stock sale and purchase arrangement involving companies in which seven of the firm's directors were themselves officers or directors, Fink had received too low a price for the shares he sold. *Id.* at 250–53. Thus, the complaint alleged the consulting contract with Fink was a ruse, being merely a means to use the assets of Meyers to compensate Fink for his sale of shares to companies in which seven of the Meyers' directors were officers or directors. *Id.* So alleged, the court believed that a demand on the board could be excused since a majority of the Meyers directors were interested in the outcome of the suit. *Id.* The court also believed reasonable doubt was raised in the amended complaint as to whether the contract with Fink was the product of a reasonable business judgment. *Id.* at 253. The amended complaint alleged that Fink lived in Florida but Meyers' operations were in New York and states other than Florida. *Id.* at 252. Moreover, the amended complaint also alleged that through a contract Meyers had with a second corporation and that corporation's contract with Fink, he was already bound to provide managerial services to Meyers. *Id.* at 252–53. The court said this additional fact raised a reasonable doubt whether the services Fink would provide are so grossly inadequate that no sound business judgment would deem it worth what Meyers was called upon to pay for those services. *Id.* at 253.

58. *See, e.g.*, Levine v. Smith, 591 A.2d 194, 206 (Del. 1991) (requiring demand because at least twelve of the twenty-one directors of General Motors were believed to be independent). One cause to believe *Aronson* might be an aberration is that its plaintiff, Harry Lewis, is a professional plaintiff. *See* Richard B. Schmitt, *Attorneys Are Often Big Winners When Shareholders Sue Companies*, WALL ST. J., June 12, 1986, at 31 (reporting that Lewis has filed dozens of suits in Delaware).

59. *See* Thomas & Martin, *supra* note 51, at 579.

60. 825 A.2d 275 (Del. Ch. 2003).

defendant's motion to dismiss.[61] Among the facts alleged were the following: Ovitz was hired pursuant to pressure from Disney's CEO, Michael Eisner; Eisner and Ovitz had been close friends for twenty-five years; Ovitz had never been an executive for a publicly-owned entertainment company; internal documents warned that Ovitz was unqualified; a member of the compensation committee received a $250,000 fee for securing Ovitz's employment with Disney; neither the compensation committee nor the board received (and hence had no opportunity to review) either the draft or final employment contract with Ovitz; the compensation committee and the board devoted hardly any time at their meetings to reviewing and approving the employment of Ovitz; the compensation committee and the board delegated to Eisner the details of the employment contract and did not condition its becoming effective upon their final review or approval; the final version of the employment contract varied significantly from the drafts earlier summarized for the compensation committee;[62] from the outset of his employment Ovitz performed poorly; no experts were consulted at any time in either the employment or termination of Ovitz; the terms for Orvitz' departure were entered into without express committee or board approval; and the severance agreement entered into by Eisner (acting for Disney) and Ovitz awarded significant financial benefits to Ovitz more quickly than had he remained with Disney.

The Chancellor therefore concluded:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts . . . suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were

61. *Id.*

62. For example, the drafts summarized for the compensation committee provided that Ovitz could invoke the non-fault termination clause (which resulted in substantial financial awards) if he was *wrongfully* terminated, died or became disabled. The final version allowed any departure to trigger the clause unless he was terminated for gross negligence or malfeasance. *Id.* at 284.

> making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light . . . [the] complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.[63]

The facts alleged in *Disney* reflect nothing less than an abdication of the board's monitoring role, not simply sloppy procedures. But alleging facts and proving them are very different undertakings and, hence, frequently lead to very different outcomes. Chancellor Chandler concluded after a trial that, although many of the participants in the Ovitz odyssey no doubt acted negligently, none were found to have acted either grossly negligently or in bad faith.[64] Thus, assuming no reversal on the appeal pending when this article was before the printer, the conclusion to be drawn from *Disney* is that there is little, if any, reason to expect the judiciary to be an effective and devoted governor on executive compensation.

Moreover, it is to be expected that in most instances the flagrantly dominating CEO, perhaps supplemented by cronyism, as it appears to have been in Disney, will not be present. Instead, the record will be painfully constructed to support a result that may not be far from the windfall garnered by Ovitz. It is in this context that the next significant development must occur, if there is to be further judicial development to address what by all accounts is a breakdown in board control of executive compensation. Simply put, it appears that the facts alleged in *Disney* served up a nice softball for the Chancery Court to knock beyond the park's typical walls. It remains to be seen whether that court or any other court can make contact with the curve balls that are more frequently pitched.

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63. *Id.* at 289.

64. *In re* The Walt Disney Co. Derivative Litig., 205 Del. Ch. Lexis 113 (2005). Of special note is the Chancellor's suggestion that "bad faith" involving a conscious disregard of oversight arises only when the board has a separate duty to act, such as when state law conditions a merger upon their being approval by the board of directors. *Id.* at 175. However, this point is not emphasized in the opinion's treatment of the outside directors. For example, Chancellor Chandler concludes that the board was not required by statue to involve itself in hiring Ovitz, *id.* at 213, and proceeds to conclude that directors Poitier and Lozano did not disregard their duty to act. *Id.* at 224. Similar conclusions were reached with respect to the directors' non-action with respect to Ovitz's termination. *Id.* at 236–38.

Thus, the judiciary initially insulates pay challenges from meaningful attack through shareholder suit by unquestioning obeisance to the demand requirement. Even in the rare case where demand is excused, the courts' focus typically is on process, not substance, so that only in the truly extreme (devoid of the contrivances introduced by lawyers and other consultants to the board) situation such as *Disney* will the compensation decision be subject to review. With such a narrow focus on process, the directors who approve compensation defer to their advisors, be they the counsel or compensation consultants, who assure that the rights steps for orderly deliberations occur. Lost in this process is a perspective of what is the right compensation level.

The approach and the record for challenges of mutual fund advisory fees is procedurally easier than the process for questioning executive compensation generally. Section 36(b) of the Investment Company Act of 1940 provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services" paid for by the fund.[65] In *Daily Income Fund, Inc. v. Fox*[66] the Supreme Court held that, although the cause of action created by section 36(b) is procedurally a derivative suit, there is no demand requirement the suit's plaintiff must satisfy.[67] Despite removing this obstacle from the suit's path, serious substantive hurdles must still be overcome by those challenging the fund's fee because the highly deferential approach that emphasizes procedural rather than substantive factors that so dominates the demand requirement in corporate derivative suits has a parallel in the court's approach to interpreting section 36(b)'s fiduciary duty standard.[68]

Section 36(b) was added to the Act in 1970[69] in response to proposals by the SEC that the Act should be amended to establish a standard of "reasonableness" to apply to fund fees.[70] Just what Congress believed to

65. 15 U.S.C. § 80a-35(b) (2004).

66. 464 U.S. 523 (1984) (interpreting the language and legislative history of Section 36(b) of the Investment Company Act).

67. *Id.*

68. For an excellent analysis of the problems of courts according deference to the fund directors in the demand requirement and otherwise in suits under the general fiduciary requirements of section 36(a) of the Investment Company Act, see Donald Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005) (critically examining the courts' deference to state law regarding the demand requirement and their belief that fund directors will reflect a "consumerist" perspective to suit's challenging fund fees).

69. *See* Investment Company Act Amendments of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970).

70. *See generally* Robert N. Cowen, Note, *Mutual Fund Advisory Fees and the New Standard of*

be the difference between its call for the advisor to have a fiduciary duty with respect to setting its fees as opposed to the fees meeting presumably an objective reasonableness standard is not reflected in the committee reports accompanying the amendment.[71] What is known is that the advisors collectively opposed the SEC's standard and that plaintiffs are still seeking to achieve their first victory under section 36(b). Despite the relative procedural ease of initiating suits under section 36(b), there has not been a single adjudication of excessive fees since its enactment.

The bewilderment[72] with the lack of success under section 36(b) in challenging fees arises from industry-wide developments—such as rapid growth in the size of funds with fees appearing not to reflect there being economies of scale—that parallel the facts of the leading case challenging advisor fees under this provision. *Gartenberg v. Merrill Lynch Asset Management, Inc.*[73] challenged the advisor fees for a money market fund whose assets under management had grown in four years from $428 million to over $19 billion,[74] during which time the management fees jumped from $1.6 million to $39 million.[75] The advisor fees were based on a percentage of the average annual daily value of the fund's net assets, being 0.5% of assets below $500 million, declining by various intermediate percentages, and with a rate of 0.275% for assets greater than $2.5 billion.[76] The major argument of the plaintiff was that substantial economies of scale[77] were present even after the fund eclipsed the $2.5 billion level so that further reductions in the rate were in order.[78] *Gartenberg* held that in deciding whether the fees violate the fiduciary duty standard of section 36(b) requires the court to inquire whether the total fee is "so disproportionately large that it bears no reasonable relationship to the services rendered."[79] This standard becomes difficult to

Fiduciary Duty—Interpreting the 1970 Mutual Fund Act, 56 CORNELL L. REV. 627, 638–50 (1971) (contrasting the criteria the SEC proposed should be used under its "reasonableness" standard with the less intrusive criteria of section 36(b)'s fiduciary duty standard).

71. *See* Investment Company Amendments Act of 1969, S. REP. No. 91-184 (1969); Investment Company Amendments of 1970, H.R. REP. No. 91-1382 (1970).

72. *See* John P. Freeman & Stewart L. Brown, *supra* note 12 (reviewing the history of section 36(b) and criticizing *Gartenberg* and its progeny).

73. 694 F.2d 923 (2d Cir. 1982).

74. *Id.* at 930.

75. *Id.*

76. *Id.* at 926.

77. For evidence that economies of scale do exist within the mutual fund industry, see David A. Latzko, *Economies of Scale in Mutual Fund Administration*, 22 J. FIN. RES. 331 (1999) (finding the average cost curve of the all types of mutual fund is downward sloping).

78. *Gartenberg*, 694 F.2d at 926.

79. *Id*. at 928.

apply with any precision because, as the court recognizes, the incestuous relationships that are so common within the mutual fund industry require evaluating a wide range of services the fund obtains from the adviser as a part of the advisory fees.

> [B]ecause of the potentially incestuous relationships between many advisers and their funds, other factors may be more important in determining whether a fee is so excessive as to constitute a "breach of fiduciary duty." These include the adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager.[80]

The plaintiff's burden of persuasion on these considerations is enormous. For example, Merrill Lynch in *Gartenberg* produced three studies bearing on the relative profitability of the fund managed by it with profits to itself ranging from $15 million to a loss of nearly $7.8 million; the differences among the studies are explained by the differing cost allocation assumptions used in each report.[81] Other unsuccessful assaults on advisory fees have also fallen prey to the difficult revenue and expense allocation problems faced by the plaintiff.[82] In other legal arenas, the fairness of a transaction, and particularly in searching for evidence of overreaching, is suggested by comparison to the practices elsewhere.[83] Under this approach, the reasonableness of a fund's advisory fees would be assessed against those charged by others in the industry. However, *Gartenberg* dismissed the relevance of such comparisons, reasoning that funds, or at least money market funds such as those before it, although

80. *Id.* at 929–30.

81. *Id.* at 931 n.4. The plaintiff was similarly unsuccessful in challenging the fees the same advisor charged for 1982 in the face of the advisor's expert testimony that it had suffered a net loss of some $5.7 million in 1982. *See* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 740 F.2d 190, 193 (2d Cir. 1984).

82. *See, e.g.*, Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472, 493–94 (S.D.N.Y. 1988) (plaintiff's expert testified that manager earned profits of $47.5 million, defendant's expert testified the adviser suffered a $77 million loss, and the court essentially split the difference between the widely varying estimates to dismiss the suit); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 973–74 n.38 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987) (faulting plaintiff's expert for failing to match services provided to various types of clients with the fees charged those clients).

83. *See, e.g.*, Romanik v. Lurie Home Supply Ctr., Inc., 435 N.E.2d 712, 720 (Ill. App. Ct. 1982) (in assessing whether burden of proof met in self dealing contract the court compared the appraised value of property with the yearly rental called for under the lease); Johnson v. Witkowski, 573 N.E.2d 513, 521–22 (Mass. App. Ct. 1991) (fairness of a self dealing lease determined by reference to comparable leases arising in arms length dealings).

competing for investors' funds do not do so on their relative fees.[84] Thus, in *Kalish v. Franklin Advisors, Inc.*,[85] the court rejected evidence that Vanguard's low-cost GNMA fund was relevant in assessing the much higher advisory fees charged by Franklin Advisors for their own GNMA fund. Interestingly, the *Gartenberg* court suggests that the fund's independent directors could, in the interest of the fund's holders, initiate their own studies of fund costs and advisor profits.[86]

Thus, much like the experiences within corporate law, litigation under section 36(b) has not been a noticeable force in restraining advisor fees for mutual funds. The standard announced in *Gartenberg* and followed by other courts requires the plaintiff to prove that the fees are disproportionate, and therefore mandates evidence that is riddled with assumptions and estimates over which reasonable differences exist between the perspectives of the plaintiff and the defendant. Thus, if a regulatory governor for advisory fees is to be found, it is likely to be through the traditional approach of the securities laws: enhanced disclosure.

III. REGULATORY INITIATIVES

Mutual fund fees and expenses fall within two broad categories. The more transparent category is transactional fees which are the sales loads and redemption fees. These are readily observable because the investor learns no later than after receiving his confirmation that less than all the sums paid are actually invested in the fund or, in the case of redemption fees, he is receiving less than the net asset value of the shares upon redemption. The real issue with fee disclosures are those falling within the on-going category that includes management fees and so-called 12b-1 fees, which are fees charged to the fund's assets to pay for certain permissible marketing and distribution activities.[87]

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84. *See Gartenberg*, 694 F.2d at 929.

85. 742 F. Supp. 1222, 1250 (S.D.N.Y. 1990).

86. *See Gartenberg*, 694 F.2d at 933.

87. The authority for such fees is in Investment Company Act Rule 12b-1, 17 C.F.R. § 270.12b-1 (2004). For a sweeping review of 12b-1 fees, see LORI WALSH, SEC STAFF REPORT, THE COSTS AND BENEFITS TO FUND SHAREHOLDERS OF 12B-1 PLANS: AN EXAMINATION OF FUND FLOWS, EXPENSES AND RETURNS (2004) (advisors not fund owners benefit from 12b-1 fees), http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf. For evidence that 12b-1 is just one of several methods advisors employ to shift fund costs to fund owners, see Nicolai Siggelkow, *Expense Shifting: An Empirical Study of Agency Costs in the Mutual Fund Industry* 1 (Wharton Sch., Univ. of Pa., working paper, 1999) (allocating brokerage in exchange for research and other services, commonly known as "soft dollars," shifts significant operating expenses to fund owners). However, 12b-1 fees no doubt supported movement away from load fees. *See* Sean Collins, *The Effect of 12b-1 Plans on Mutual*

The SEC's various regulatory initiatives over the years with respect to fees are driven by several considerations, each linked to investor ignorance. First, fees are an important variable in explaining the returns an investor can expect by purchasing a mutual fund.[88] For example, one percent is the maximum level of distribution costs that Rule 12b-1 permits to be levied against the fund's assets by its advisor.[89] Therefore, if a fund that earned a net return of eight percent with a one percent expense ratio for twenty years had instead tacked on an additional one percent in 12b-1 fees (or for that matter imposed an additional one percent in its management fees) it would reduce the overall account balance by more than eighteen percent at the end of that twenty-year period, i.e., nearly one-fifth the value of the account.[90] A second force underlying the SEC's concern is that investors do not understand the source of fund fees and costs and, more importantly, how these costs adversely impact expected returns.[91] Thus, to the extent that information regarding fees has been disclosed, it was not having the effect, i.e., rational choices among competing funds, anticipated by regulators because investors did not understand relationships between expenses and returns so that they could understand the significance of the mandated disclosures. The final consideration has been congressional concerns about the growth in mutual fund on-going fees which appeared to be rising. This rise was believed due to a lack of competition among funds due to investors not being aware of the on-going fees of their funds.[92]

Investor ignorance has persisted despite several earlier regulatory efforts. Beginning in 1988, the SEC requires mutual fund prospectuses to include a fee table that shows all fees and charges associated with a mutual

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Fund Investors, Revisited 1 (Inv. Co. Inst., Working Paper, 2004) (setting forth data supporting view that 12b-1 fees have reduced for many investors the overall costs of acquiring and holding mutual fund shares).

88. *See* Theo Francis, *Getting the Most From Fund Costs*, WALL ST. J., Dec. 2, 2002, at R1 (exploring the importance of fund fees and related costs to overall expected returns).

89. *See* NASD Rule 2830.

90. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-04-317T, MUTUAL FUNDS: ADDITIONAL DISCLOSURES, COULD INCREASE TRANSPARENCY OF FEES AND OTHER PRACTICES 3 (2004) [hereinafter GAO MUTUAL FUNDS].

91. *See, e.g.*, Press Release, The Vanguard Group, Investors Need to Bone Up on Bonds and Costs (Sept. 25, 2002) (on file with Vanguard.com) (reporting that seventy-five percent of its survey respondents could not define what was meant by "expense ratio" or understand that expenses making up that ratio adversely impacted fund returns).

92. *See* U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION (2000) (responding to request of Congressmen Michael G. Oxley and John D. Dingell).

fund to be disclosed as a percentage of net assets.[93] The SEC has also sought to facilitate investors comparing the costs of owning different funds. One initiative is its "Mutual Fund Cost Calculator," an Internet-based tool that can be found on the SEC's website.[94] The SEC has also released several publications (that are also available at the SEC's website) designed to educate investors about the importance of fund expenses.[95] We are skeptical of the benefits of the "Mutual Fund Cost Calculator" or other efforts that require additional steps by investors to transform disclosed information before they can act upon it. Our skepticism arises from the strong evidence that consumers generally process information in the format in which it is made available to them; they do not further transform it, as they are expected to do with the "Mutual Fund Cost Calculator."[96]

In 2004, the SEC amended its disclosure requirements for mutual funds to require that their semi-annual and annual reports disclose the cost in dollars of an investment of $1,000 that earned the fund's actual return and incurred the fund's actual expenses during that fiscal period.[97] The 2004 amendment also requires disclosure of the costs in dollars based on the fund's actual expenses of a $1,000 investment that earned an assumed return of five percent. The expenses used in each of these new disclosures are those incurred by the fund in the most recent fiscal half-year (or the fund's second fiscal half-year in the case of the annual report). This information is required to be disclosed in tabular format, thereby making it more accessible to investors than if set forth textually.[98] A narrative explanation of the types of costs charged to the fund is also required. Before the 2004 amendments, funds disclosed such costs as an operating expense ratio. This ratio reported as a percentage of fund assets all the fees and other expenses that the fund adviser deducts from the fund's assets. The pre-2004 disclosure requirements, therefore, did not permit the

93. *See* Investment Company Act Rel. No. 16,244 (Feb. 1, 1988) (amending Item 3 of Form N-1A to require disclosure of the fund's expense ratio).

94. *See* http://sec.gov/investor/tools/mfcc/mfcc-int.htm.

95. *See* Invest Wisely: An Introduction to Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited Oct. 28, 2005) (brochure that describes types of fees and expenses related to investing in mutual funds).

96. *See, e.g.*, James R. Bettman & Pradeep Kakkar, *Effects of Information Presentation Format on Consumer Information Acquisition Strategies*, 3 J. CONSUMER RES. 233 (1977).

97. *See* Shareholder Reports and Quarterly Portfolio Disclosure Of Registered Management Investment Companies, Securities Act Release No. 8393 (May 10, 2004) [hereinafter SEC Fund Expense Adopting Release].

98. *Id.* at 3–8. Other steps taken in 2004 related to disclosure of fees included modifying the format for the expense example showing the effect of an initial investment of $1,000 as of the end of the period alongside the expense figures, and showing the fund's expense ratio expressed as a percentage. *Id.*

individual investor to easily approximate the expenses in dollars that were incurred by that investor's account. Overall, the Commission believed the approach taken in the 2004 amendments would better help investors understand the impact of fund expenses and the relationship between expenses and returns.[99]

The alternatives considered and rejected by the SEC called for disclosure of either the expenses paid by the individual investor or expenses associated with a standard investment account.[100] For example, the Government Accountability Office ("GAO") strongly recommended that the SEC require disclosure of the specific amount of fees, in dollars, for each individual investor's account.[101] The GAO believed that "seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis."[102] Additionally, the GAO believed disclosure should not be limited to semi-annual and annual reports; relying on a 1997 Investment Company Institute survey showing that account statements were the most important communication fundholders receive, the GAO recommended that disclosure occur in investor account statements.[103]

Although disclosure of specific amounts of fees for individual investor accounts would unquestionably sharpen the investor's focus on how fund costs impact her account, an investor armed with knowledge of the expenses incurred by her account cannot use this information to determine whether her expenses would be greater or less if she were the holder in a rival fund. As stated by the SEC, "personalized expense disclosure in quarterly account statements would not assist investors in making comparisons among funds because it would be based on different investment amounts and different rates of return."[104] The SEC was also concerned about whether such tailored calculations would be unduly costly in those instances where various financial intermediaries, for example brokers and financial advisers, hold the accounts for their customers and would be required in many instances to assemble data supplied from many unrelated fund groups before the customer statements

99. *See id*. ("these amendments are intended to provide better information to investors about fund costs, investments, and performance.").

100. *See id*. at 6.

101. *See* GAO, MUTUAL FUNDS, *supra* note 90, at 8.

102. *Id.*

103. *Id.* at 5–8.

104. *See* SEC Fund Expense Adopting Release, *supra* note 97, at 6.

could be forwarded.[105] The collateral disclosure of the reporting fund's specific expenses against an assumed five percent return is believed by the SEC to further facilitate comparisons of current period expenses across funds.

Notably absent from the SEC proposing and adopting releases for enhanced disclosure of fund costs is any development of how fund investors make comparisons among alternative mutual fund investors. For example, the SEC Fund Expense Adopting Release emphasizes that its approach better facilitates comparative judgments than does the approach urged by the GAO. The SEC's conclusions on this point are intuitively appealing. However, the SEC failed to explore just how investors can, in light of the newly disclosed information, proceed to the next step. That next step for fund investors and holders is not their consideration whether there are better mutual fund investment opportunities, but whether they have enough information to even ponder whether their interests are best served by doing some comparative shopping. This lacuna in the SEC's regulatory approach is explored in the next section.

As a preliminary matter in evaluating the steps the SEC has taken and those that it is advised to take in the future, it should be noted that the Investment Company Act stands in stark contrast to the remaining components of the U.S. securities laws. Where the major focus of the Securities Act and the Exchange Act are various mandatory disclosure requirements, the regulatory demands of the Investment Company Act transcend disclosure by proscribing certain types of transactions and undertakings. For example, the Investment Company Act regulates joint undertakings between the investment advisor and the fund, requires annual approvals of the advisory contract,[106] and forecloses complex financial structures.[107] All such limitations can be overcome either by obtaining an SEC exemptive order or by structuring the transaction to fit with the tightly drafted conditions set forth in an applicable regulatory exemption. More recently, the SEC adopted a series of governance requirements that condition many of its safe harbors from otherwise broad prohibitions on, among other conditions that the fund must satisfy, the fund having three-fourths of its directors be independent of the fund's advisor, its chair being

105. *Id.* at 6–7 (relying on a 2000 industry estimate that this would entail on-going costs of $65 million whereas the procedures adopted by the SEC would entail estimated costs of $16 million annually).

106. *See* 15 U.S.C. § 80a-15(a)(2) (2004) (permitting advisory contracts to have two-year terms provided they are renewed annually by a majority of the fund's outstanding shares).

107. *See* 15 U.S.C. § 80a-18 (2004) (foreclosing leverage and multiple classes of securities for most types of mutual funds).

independent of the fund's advisor, and its independent directors being advised by counsel with no historical relationship with the fund's investment advisor.[108] These recent initiatives are the most visible evidence that under the Investment Company Act, governance and not disclosure, is the first line of protecting the fund's shareholders.

Before considering how the SEC might improve upon its existing disclosure requirements for fund expenses, it is necessary to have some insight into how investors engage in meaningful comparisons between competing investment choices. The next section provides a behavioral background for disclosure recommendations we believe will enhance investor welfare. The core of our recommendations is our belief that regulation in this area should reflect contemporary insights regarding cognitive processes that will be used to evaluate the disclosed information.[109]

IV. INSIGHTS FROM JUDGMENT AND DECISION MAKING ("JDM") RESEARCH

For many decades now, one governmental approach to protecting consumers has been to provide or mandate the provision of information to consumers. There are three potential benefits associated with providing consumer information: improved decision-making, enhanced product quality, and reduced prices.[110] The last benefit, lower prices, often occurs when the new information facilitates product comparison, thereby encouraging competition. The second benefit, improved quality, occurs whenever new information about a product's attributes causes some consumers to alter their choices so as to get more of the featured attribute. The SEC's regulatory action with respect to enhanced disclosure of fees and costs can be seen as seeking both price lowering and quality improvement benefits. The first benefit, better consumer choice, in some

108. *See* Final Rule: Investment Company Governance, Inv. Co. Rel. No. 26,520 (July 27, 2004) (conditioning several safe harbor provisions on compliance with multiple governance requirements to strengthen board's independence). *But see* Chamber of Commerce of the U.S. v. SEC (D.C. Cir. 2005) (remanding rule change to SEC for reconsideration). The SEC, after a more developed record of costs of a new rule, re-adopted the earlier provision. *See* Commission Response to Remand by Court of Appeals, Inv. Co. Rel. No. 26,985 (June 30, 2005).

109. *See generally* James R. Bettman, John W. Payne & Richard Staelin, *Cognitive Considerations in Designing Effective Labels for Presenting Risk Information*, 5 J. PUB. POL'Y & MARKETING 1 (1986).

110. *See* Michael B. Mazis, Richard Staelin, Howard Beales & Steven Salop, *A Framework for Evaluating Consumer Information Regulaton*, 45 J. MARKETING 11 (1981) (exploring how the approach to disclosure can enhance consumer choice while reaching the optimal cost-benefit relationship).

sense subsumes the last two benefits, and it is almost self-evident since consumers armed with more complete information *should* be able to make better decisions than when their choice is based on limited knowledge about product attributes. However, none of these benefits will be realized unless the consumers understand the information *and* alter their decision patterns. In this section of our paper we draw on judgment and decision making ("JDM") research to address the question of how information should be presented to consumers. We will argue that an old and key distinction between the availability of information and the processability of information[111] needs to be taken into account in the design of SEC regulatory action. Processability refers to the cognitive ease with which information can be comprehended and used. Processability is a function of the way the information is presented, the kind of processing to be undertaken, and the knowledge base of the consumer. In general, information must be both available and easily processable to be used.

A. The Cornerstone of Bounded Rationality

The classic study of the distinction between available and processable information is that by Professor J. Edward Russo.[112] That study concerns the use of unit price information by supermarket shoppers spending their own money. Russo found that the use of unit price information increased (and consumers saved money) when the information was brought together for shoppers in the form of organized lists where the available brands were ranked by increasing unit price. Russo argued that the standard presentations of unit price information, with unit prices posted on the shelf under each item, made prices hard to compare and thus were not fully used. Note, however, that the standard method of presenting unit price information makes the information available.

The idea that information will have its greatest impact when it is *easy to process*, and not just available, is related to the more basic idea of "bounded rationality." Herbert Simon argued that we need to develop models of decision behavior that are compatible with the access to information and the computational capacities that are actually possessed

111. *See* J. Edward Russo, Gene Krieser & Sally Miyashita, *An Effective Display of Unit Price Information*, 39 J. MARKETING, Apr. 1975, at 11 (examining possible explanations for why unit pricing, regardless of its intuitive appeal, still leads to irrational consumer choices).

112. *See* J. Edward Russo, *The Value of Unit Price Information*, 14 J. MARKETING RES. 193 (1977) (study of how consumer choices are affected by unit pricing information, finding benefits to consumers when unit prices were reflected on separate shelf tags, but greater benefits when that information was presented in a single comparative list).

by humans, and not the assumptions found in classical economic theory.[113] Simon further argued that limits on computational capacity are particularly important constraints upon the definition of rational choice, i.e., people exhibit only "bounded" rationality.[114] As a consequence of limited cognitive capacity, even well-motivated consumers will often use mechanisms (heuristics) involving the selection and use of information to solve decision problems. Thus, it will not always be the case that more and more information will lead to better and better decisions.

In addition to the distinction between available and easy-to-process information, another implication of the idea of bounded rationality is the "concreteness principle" recognized by Professor Paul Slovic.[115] Because processing of information is costly, people tend to accept information in the format in which it is given rather than expending cognitive effort to transform it. More generally, it is clear that the particular formats and methods for organizing information can greatly influence the ease with which various types of decision processing can be carried out.[116]

Much of the research on information format effects during the 1970s and 80s clearly derived from the bounded rationality concept of Herbert Simon. More recently, work on information format has been expanded to include research that emphasizes the importance of the rapid, automatic, and relatively effortless judgments people reach regarding good-bad assessments. Professors Slovic, Finucane, Peters, and MacGregor[117] refer to this as the "affect heuristic." Evidence for the importance of an easy good-bad assessment of information values is illustrated below in terms of what Professor Christopher Hsee called the "evaluability hypothesis."[118]

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113. *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q. J. Econ. 99, 99–100 (1955) (providing definitions and model of decision-making procedures by individuals that result in simplifying heuristics).

114. *Id*.

115. *See* Paul Slovic, *Psychology Study Of Human Judgment: Implications For Investment Decision Making*, 27 J. FIN. 779 (1972) (early study of psychological forces that impede rational choice by investors).

116. *See* Bettman et al., *supra* note 109.

117. *See* Paul Slovic, Melissa Finucane, Ellen Peters & Donald G. MacGregor, *Rational Actors or Rational Fools: Implications of the Affect Heuristic for Behavioral Economics*, 31 J. SOCIO-ECON. 329 (2002) (examining factors that affect the heuristics employed in decision-making).

118. *See* Christopher K. Hsee, *The Evaluability Hypothesis: An Explanation for Preference Reversals between Joint and Separate Evaluations of Alternatives*, 67 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES, Sept. 1996, at 247 (reporting that decisions are affected by whether data for each item is presented separately or for all options are presented together).

B. The Evaluability Hypothesis

Imagine that you are interested in buying a second-hand music dictionary and are given the following information about such a dictionary:

	Number of entries	Cosmetic condition
Dictionary A	20,000	A torn cover

How much would you be willing to pay ("WTP") for dictionary A?

Now imagine that instead of dictionary A you had been asked about your willingness-to-pay for the following dictionary:

	Number of entries	Cosmetic condition
Dictionary B	10,000	Intact cover

How much would you be WTP for dictionary B?

When asked about dictionaries A and B separately, as above, the WTP was higher for dictionary B.[119] That is, an intact cover was seemingly more important than the number of entries in determining value (WTP). However, when dictionaries A and B were presented jointly, and the WTP amounts asked for both dictionaries at the same time, the WTP was higher for dictionary A. In this case, 20,000 entries was more important than the torn cover in determining WTP. Hsee proposed the evaluability hypothesis to account for this reversal in value. Specifically, according to the evaluability hypothesis, when it is hard to know how good an attribute value is, e.g., 20,000 entries, that value will tend to be discounted as compared to a more easily evaluated attribute, albeit one that perhaps is a less important attribute, such as a torn cover.[120] However, when the options are presented jointly (an information format effect), it is easier to evaluate the number of entries of dictionary A as being good when compared to the number of entries of dictionary B. Hsee later showed that failure in evaluability can lead people to value an objectively dominated option (a seven ounce serving of ice cream overflowing a five ounce cup) higher than an objectively dominating option (an eight ounce serving of ice cream in a ten ounce cup).[121] Apparently it is hard to evaluate seven

119. *Id.*

120. *Id.* at 255–56.

121. *See* Christopher K. Hsee & France Leclerc, *Will Products Look More Attractive When Presented Separately Or Together?*, 25 J. CONSUMER RES. 175 (1998) (showing how comparative presentation of choices results in different results depending on how the items were perceived as attractive or unattractive when first presented separately).

ounces or eight ounces of ice cream when considering each option independently. In contrast, whether a serving appears overfilled or underfilled is relatively easy to evaluate and makes a difference when the options are considered separately. However, when presented together, people did prefer the option with the eight ounces of ice cream.

Slovic, Finucane, Peters, and MacGregor[122] have extended to the idea of evaluability the general notion of an affect heuristic mentioned above, and the more specific principle that "the weight of a stimulus attribute in an evaluative judgment or choice is proportional to the ease or precision with which the value of that attribute (or a comparison on that attribute across alternatives) can be mapped into an affective impression."[123] This principle reflects a general belief of Slovic et al. regarding the importance of immediate affective responses in decisions. More generally, Slovic et al. have argued that without a context to give affective perspectives to quantities, even common or familiar attributes may not be evaluable and, thus, will be underweighted in decisions. To illustrate the power of context even on the evaluability of dollars, consider the following results:[124]

When asked to evaluate a gamble that offered 7/36 chances of winning nine dollars, otherwise receiving nothing, on a zero to twenty scale of attractiveness (twenty is most attractive), the average response was 9.4. Many people thought the 7/36 chance of winning was low—"I'm probably not going to win." However, when asked to evaluate a gamble that offered 7/36 chances of winning nine dollars, otherwise losing five cents, the average rating was 14.9. Apparently, nine dollars carries little weight but the more precise and favorable impression of nine dollars as compared to a loss of five cents carries more weight, and counterbalances the relatively poor probability of winning (7/36) in both cases. If winning nine dollars can be hard to evaluate, what difficulties may be experienced in evaluating an expense ratio of 0.897% or an expense ratio of 1.297%?

The importance of a context to give affective perspectives to quantities is well appreciated in the domain of consumer information provision for goods like household appliances. For example, twenty years ago the Federal Trade Commission issued the Appliance Label Rule to help consumers decide among appliances. Figure 1 shows an example of the now familiar Energy Guide labels showing the highest and lowest energy consumption estimates of similar models plus the energy consumption of the target brand. The Energy Guide label nicely illustrates a principle for

122. *See* Slovic et al., *supra* note 117.
123. *Id.* at 334.
124. *Id.*

information provision which is to provide information in a relative or comparative format whenever possible.

Unfortunately, even comparative scales are not always sufficient for making decisions easier. For instance, knowing that there are options that are better on an important attribute does not help the consumer find them. As the unit pricing study by Russo[125] indicated, a list of products ordered by relevant attribute values may be necessary to facilitate comparison across products.

Finally, it is important to recognize that the impact of information format on information use is not found just with "unsophisticated" decision makers. Professor Arkes, among others, provides many examples of biased information processing by even highly sophisticated decision-makers.[126]

To summarize, the research on judgment and decision-making over the past several decades makes clear that mandating the disclosure of fees and costs of mutual funds is at best only part of the solution. In addition, there is a need to worry about how "processable" the mandated information will be, given how that information is to be used. Fortunately, there is a wealth of research and practice, such as energy guidelines by the FTC, that might be used by the SEC to protect investors in making mutual fund decisions.

V. A PROPOSAL FOR ENHANCED INVESTOR COMPARISONS

Our thesis is both reasonable and we believe well-supported: the format and particularity of the context in which information is presented has a significant impact in decision-making by investors.[127] Learning that your

125. *See* Russo, *supra* note 112.

126. *See, e.g.*, Hal R. Arkes, *Costs and Benefits of Judgment Errors: Implications for Debiasing*, 110 PSYCHOL. BULL. 486 (1991) (identifying three types of judgment errors—strategy-based errors, association-based errors, and psychophysical-based errors—which each can impact the decision-maker's judgment).

127. *See, e.g.*, John W. Payne, *Contingent Decision Behavior*, 92 PSYCHOL. BULL. 382 (1987); Richard A. Winett & John H. Kagel, *Effects of Information Presentation Format on Resource Use in Field Settings*, 11 J. CONSUMER RES. 655 (1984). *See generally* JAMES R. BETTMAN, AN INFORMATION PROCESSING THEORY OF CONSUMER CHOICE (1979).

We do not address here the broader question of whether too much information is disclosed so that it exceeds the investors' processing capacities. *See, e.g.*, Troy A. Paredes, *Blinded By The Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (examining the SEC's extensive disclosure requirements in the context of investors' bounded rationality); Robert A. Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L.J. 1397 (2002). Moreover, we do not address the even more fundamental question of whether current SEC disclosure requirements are misguided because they seek the unrealistic goal of price accuracy. *See* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995). We instead proceed on the assumption that expense ratio is 1.29% is helpful but more so if this number can easily be placed in context.[128] What investors wish to know is how this expense ratio compares with comparable investment opportunities. Learning that you rate a nine on a scale of ten in a competition is much more informative than to receive a numerical score when the boundaries of the scale are unknown. Thus, much like unit pricing information for grocery products, providing operating expense and return disclosures in a truly comparative framework is much more likely to elicit an informed choice on the part of investors than if operating expenses or return disclosures are made in isolation. The material in Part IV supports our conclusion that any reporting of expenses should be placed in a context that invites easy comparisons by investors. Our proposal is not that there should necessarily be more information disclosed to mutual fund investors, but that much more attention should be given to the cognitive processes investors can be expected to employ in their response to the disclosures that are made.

We believe that registered funds should be required annually to calculate their expense ratio (as well as their net return) relative to other funds within their comparable investment classification and to file this information with the SEC. Thereafter, the SEC could aggregate the information within discrete categories such that each fund thereafter can be compared on the basis of its expense ratio and net return with similarly classified funds. Thus, SEC disclosure practices would force each fund to report the expense ratio range for the comparable group, the expense ratio for the reporting fund, and the percentile ranking of the reporting fund's expense ratio. We also believe the most significant moment for disclosure is the point of sale,[129] although such disclosures are also appropriate and

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certain information is widely recognized as important to investors, such as information regarding a fund's expense ratio and net return, and we focus on how best to make such disclosure processable by investors.

128. Our suggestion is even stronger yet. We advise that there should be a single disclosure format and that the information funds are required to disclose be the same for all funds regardless of their type. This suggestion is grounded on research that shows that investors are not assisted by disclosure guidelines that permit alternative formats for disclosing the same type of information. *See* Leslie Hodder, Lisa Koonce & Mary Lea McAnally, *SEC Market Risk Disclosures: Implications for Judgment and Decision Making*, 15 ACCT. HORIZONS 49 (2001) (concluding that the SEC's 1997 disclosure requirements for derivatives impedes investors' ability to assess risk because, among other examined deficiencies, reporting companies are permitted to employ a variety of reporting formats).

129. The SEC currently is proposing enhanced point of sale disclosures. However, its proposals do not include any comparative information related to rival funds. Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain other Securities, and Amendments to the Registration Form for Mutual Funds, Securities Act Release No. 8544, SEC Docket 3182 (proposed Feb. 28, 2005) (to be codified at 17 C.F.R. §§ 239, 240, 274). *See also* NASD, MUTUAL FUND POINT OF SALE DISCLOSURE INVESTOR RESEARCH FINDINGS (2005).

useful for present fund-holders as well. The information could be gathered from all registered funds by the SEC based on, for example, results through all the reporting funds' third quarter. This information would then be made available to all funds so that they could prepare their annual disclosures of their comparative expense ratio at the close of the fourth quarter.

The proposal we offer would include information that is consistent with JDM research because it communicates to investors not an isolated number, but instead a means by which to place that data point within in a comparative group. This greatly simplifies the individual investors' processing of the information. Investors are not required to assemble their own comparative information, a process that likely would overwhelm them.

We also believe such comparative information will improve the oversight of the fund's outside directors. Consistent with the wise maxim that you manage what is measured, the independent directors are far more likely to probe the causes for above-average expense ratios than when not aware that the fund's expense ratio is above average. To be sure, higher fees may well reflect more and better services that the advisor provides than its competitor with whom it is compared. This fact, of course, is a relevant area for close inquiry by the fund's board.[130] Thus, we envision that a comparative presentation will greatly facilitate director oversight.

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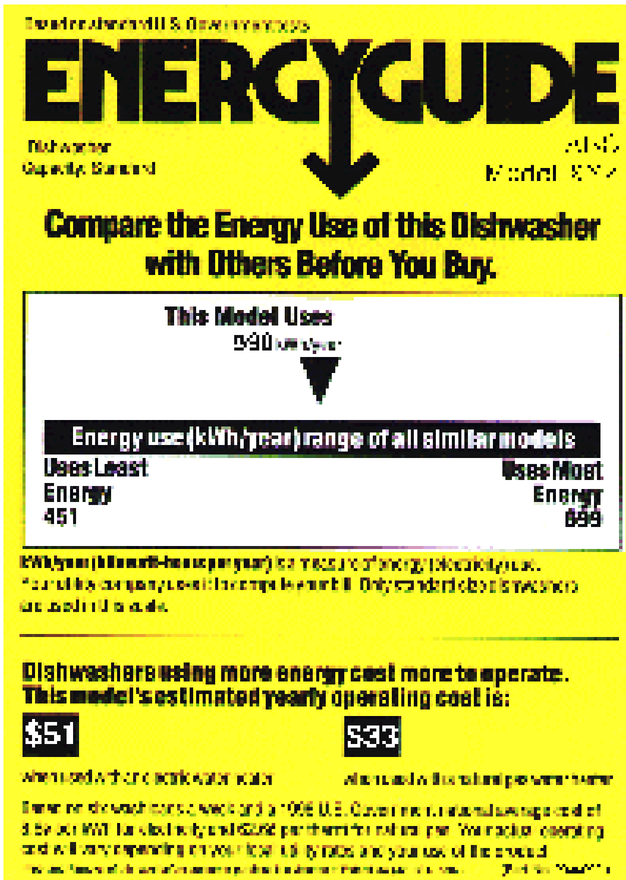
130. Equally relevant, but beyond the disclosures we propose here, is the board examining the fees advisors charge its institutional clients for whom it provides investment advisory services.

> Recently, Alliance Capital was charging 93 basis points (.93 percent) for managing the $17.5 billion Alliance Premier Growth Fund. This is a fee paid by shareholders of $162.7 million per year. At the same time as it was charging 93 basis points to its *own shareholders*, Alliance was managing the Vanguard U.S. Growth Fund for 11 basis points (.11 percent)—less than 1/8 of what it was charging Alliance shareholders. Alliance was also managing a $672 million portfolio for the Kentucky Retirement System for 24 basis points, a $1.7 billion portfolio for the Minnesota State Board of Investment for 20 basis points, a $730 equities portfolio for the Missouri Retirement System for 18.5 basis points, and a $975 equity portfolio for the Wyoming Retirement System for 10 basis points.
>
> These price discrepancies cannot be justified on the basis of differences in service. According to the prospectus for the Allliance Stock Fund, the management company's institutional accounts shared "substantially the same investment objectives and policies" and were managed with "essentially the same investment strategies and techniques" as the Alliance Premier Growth Fund. Moreover, the different clients "shared a nearly identical composition of investment holdings and related percentage weightings."

Oversight Hearing, *supra* note 8, at 270–71 (statement of John P. Freeman).

FIGURE 1


ENERGYGUIDE
Compare the Energy Use of this Dishwasher
with Others Before You Buy.
This Model Uses
Energy use (kWh/year) range of all similar models
Uses Least
Energy
451
Uses Most
Energy
899
Dishwashers using more energy cost more to operate.
This model's estimated yearly operating cost is:
$51
$33