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ICI Survey on GAO Report on Mutual Fund Fees

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I. Executive Summary

A. Background

In response to a request from Congressman Michael Oxley, Chairman of the House Subcommittee on Finance and Hazardous Materials, and Congressman John Dingell, Ranking Member of the House Commerce Committee, the U.S. General Accounting Office issued a report, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," ("the Report") in June 2000. The Report recommends that the Securities and Exchange Commission (the "SEC") require mutual funds to disclose each investor's share of mutual fund operating expenses on quarterly investor account statements ("the Recommendation"). The Report suggests that the SEC examine the Recommendation's costs and burdens on the mutual fund industry and investors. In a letter to the SEC dated June 30, 2000, Chairman Oxley and Congressman Dingell urged the SEC to implement the Recommendation, although they stated they were "open to other effective suggestions." They requested two progress reports from the SEC; the first by year-end 2000; the second by June 2001.

The Report offers three alternative methods for satisfying the Recommendation. The primary method presented is to calculate and disclose the actual dollar amount of fund operating expenses attributable to each investor. The second method is to disclose an *estimate* of fund operating expenses attributable to each investor. The third method is to disclose the actual dollar amount of fund operating expenses per thousand dollars invested in the fund. The first two methods would require separate calculations for each investor account, while the third method would require only one calculation for all investors in a given fund.

To better understand the extent and nature of the costs to comply with the Recommendation, the Investment Company Institute ("ICI")[1] conducted a survey. The survey objectives were to gather information regarding the changes in processes, systems and controls that would be necessitated by the Recommendation, the initial and ongoing annual costs of compliance, and the operational difficulties likely to be encountered in implementing the Recommendation. An industry task force provided advice and guidance to the ICI in the development and management of the project, and PricewaterhouseCoopers LLP assisted in survey design, collection and compilation of the survey data, and the development of this report.

Responses to the survey were received from a sample of organizations affected by the Recommendation, including mutual fund complexes and their designated affiliates,[2] independent transfer agents and shareholder servicing agents, national and regional broker dealers, securities clearing firms, and financial planning firms. This includes 39 mutual fund complexes with total net assets of $4.8 trillion, representing approximately 77 percent of total industry net assets[3] as of

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,358 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.161 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] Including fund accounting, transfer agent, shareholder servicing, and broker dealer operations.

[3] Total industry net assets of $6,256,289,864 as reported by the Investment Company Institute as of 6/30/00 excluding variable annuity assets.

June 30, 2000, nine national, regional and clearing broker dealers, three major independent transfer and shareholder servicing agents, and four financial planning firms.

B. Industry Environment

The mutual fund industry provides asset management and account recordkeeping services to 87.9 million investors in 50.6 million households. Investors interact with their mutual funds in a variety of ways. Investors can purchase shares and maintain accounts directly with a fund company, through a broker dealer, within a fund supermarket, via a financial planner or registered investment adviser, within a 401 (k) plan or through a bank trust department. In addition, investors use various technologies to reach their mutual fund complex. An investor can obtain information and transact business by visiting a branch office, calling the 800 number of a fund complex or intermediary to speak with a representative, or by using a touch tone telephone service. In addition, many fund companies permit shareholder access to account information and transaction services through proprietary Internet websites. Each of these channels of distribution and technologies require mutual funds and the various companies that provide services to them to synchronize efforts and share data so that investors receive the same information regardless of the channel or technology used.

The chart contained in Appendix A on page 11 illustrates these various organizations, systems and other mechanisms, and the role required of each to develop and deliver the mutual fund expense information called for by the Recommendation. The entities depicted comprise a complex network of mutual fund processing and servicing centers. Compliance with the Recommendation will require an extraordinary amount of coordinated action to create the new procedures and programs, and to enhance the communication links necessary to accommodate the new information. Modifying this infrastructure to calculate and report the new information in an accurate and consistent fashion to all fund investors through all investor contact points is a complex undertaking that would result in significant costs and numerous practical difficulties.

C. Survey Results

1. Costs of Compliance

Aggregate estimated costs of the survey respondents to implement the primary method detailed in the Recommendation would exceed $200 million and the annual ongoing cost of compliance would exceed $65 million. It is important to note these costs represent the estimated costs of the *survey respondents only*. That is, the Institute did not attempt to use the survey data to project a cost estimate for the entire industry and all mutual fund investors. As noted above, the survey includes only a small sample of broker dealers and other mutual fund distributors, each of whom would separately have to create the calculation and reporting infrastructures necessary to comply with the Recommendation. Thus, the survey data understates, most likely by a significant amount, the total cost of compliance. Moreover, as it is not clear whether variable annuities, 401(k) plans and bank trusts are included in the Recommendation, they were excluded from the survey. If they are included in the Recommendation, the survey data understate by an even greater amount the total cost of compliance.

As noted above, the Recommendation also suggested two additional alternative methods. A description of the three methods contained in the Recommendation, costs of implementation and annual ongoing costs of compliance are presented later in this report.

2. Significant Cost Drivers

In estimating costs to comply with the Recommendation, survey respondents identified the following major activities or cost categories:

a. Enhancements to current data processing systems.

- Additional computing and data storage capacity will be required to complete the computations envisioned by the Recommendation within the time frames required to meet investors' expectations for high quality service.

- Programming changes will be needed to enable the computation of the recommended numbers.

- System enhancements will need to be made to permit the electronic communication of the information to all intermediary organizations.

Currently, the mutual fund industry does not have the systems or procedures to compute, store and communicate mutual fund operating expenses to investors. To accomplish this, mutual funds, their servicing agents, and their distribution partners, would be required to implement extensive programming changes. See attached Appendix A for a full description of the changes that will be required.

b. Modifications to investor communication systems and media.

- Quarterly statement formats must be modified for each fund to display the required numbers and provide explanatory information.

- Financial intermediaries, such as brokers, financial planners and registered investment advisers, must redesign customer account statements to include information gathered from several mutual fund companies and determine how to portray this information on statements containing non-mutual fund investments.

- Redesigning each statement format requires separate programming. Given the large number of different statement formats in use throughout the financial services industry, statement redesign can only be accomplished at a considerable cost.

- Websites and telephone systems used to communicate directly with investors, and on-line account systems used by registered representatives require modification so that when an investor looks up their account, or calls the representative to inquire about the expense information, the representative can adequately respond.

See the flowchart in Appendix A for a depiction of the range of communication systems and media affect by the Recommendation.

c. New policies and procedures.

- Daily processes in fund accounting, transfer agent and financial intermediary operations must be developed and documented to ensure the financial information is correctly calculated and that quality control of new tasks is provided.

d. Employee training programs and customer support.

- Personnel involved in the daily calculation and reporting of the required information must be trained to perform new tasks.

- Ongoing training and appropriate explanatory materials will be required to ensure shareholder support personnel are able to properly answer shareholder questions and inquiries. Shareholder service representatives will require training to help investors understand the new information and how to interpret it within the context of performance information already provided.

- An expected rise in investor inquiries related to the new information will require the deployment of additional trained customer support staff upon implementation.

3. Implementation Concerns

Three principal concerns were identified by survey respondents that will need to be addressed if the Recommendation is implemented. First, it is not clear whether variable annuities, defined contribution plans, banks, and trust companies are within the scope of the Recommendation. Second, there is no existing infrastructure to accommodate transfers of fund operating expense information when shareholder accounts are transferred from one financial intermediary to another within a reporting period. Third, the Recommendation is likely to result in longer processing timeframes, causing delays in delivery of monthly or quarterly account statements.

II. Survey Results and Findings

A. Survey Methodology

In August 2000 the Investment Company Institute initiated a survey to determine the costs and burdens of complying with the GAO Recommendation that mutual funds disclose each investor's share of fund operating expenses on quarterly investor account statements. The survey was designed to solicit cost and cost related data on the three methods outlined in the GAO Report as alternatives to satisfying the Recommendation. A detailed description and flow chart depicting the primary method used in the survey by respondents to develop their cost estimates is presented in Appendix A. To ensure that cost estimates were prepared on a consistent basis, a set of assumptions, described in Appendix B, was provided to survey participants. ***The methodology and assumptions described in Appendices A and B were developed solely for the purpose of the survey to ensure uniformity in estimating the cost to comply with the Recommendation. The ICI recognizes that other approaches may be adopted should some form of the Recommendation ultimately be required.***

B. Scope of Survey

The survey included a sample of organizations affected by the Recommendation including:

- mutual fund complexes and designated affiliates,
- independent transfer agents and shareholder servicing agents,
- national, regional and clearing broker dealers, and financial planners.

These organizations represent the types of organizations that will need to create or modify procedures and systems to comply with the Recommendation. The survey results presented in the remainder of this report provide a basis for understanding the types of costs that will be incurred to comply with the Recommendation. However, the aggregate costs of the survey participants necessarily understate the total costs that will be incurred by mutual funds, service providers, financial intermediaries and ultimately mutual fund investors, because only a sample of affected organizations are represented in the respondent population.

Respondents to the survey included 39 mutual fund complexes with total net assets of $4.8 trillion representing approximately 77 percent of total industry net assets as of June 30, 2000, nine national, regional and clearing broker dealers, three major external transfer and shareholder servicing agents, and four financial planning firms. Thus, while the survey population includes many of the largest mutual fund organizations and the major independent transfer agents and shareholder servicing agents serving the industry, a relatively small number of independent mutual fund distributors, such as broker dealers and financial planning organizations, participated in the survey. Also, as noted in the Executive Summary, variable annuities, 401(k) plans, and bank trusts were excluded from the survey, as it is not clear whether they are included in the Recommendation.

The mutual fund industry can be characterized as a complex structure of organizations serving the investing public. Not long ago, the mutual fund industry could be divided into two groups;

those mutual funds that offered their shares directly to investors, and those that offered their shares exclusively through a network of broker dealers. Today, virtually all mutual fund companies offer shares through a variety of financial intermediaries. Currently, about 80 percent of all mutual fund transactions are completed with the assistance of a financial intermediary. Such intermediaries include in addition to broker dealers, financial planners, banks, trust companies, registered investment advisers, employee retirement plans, and financial "supermarkets." To better understand how mutual funds, their service providers and intermediaries would be required to interact to provide investors the information suggested by the Recommendation the chart included in Appendix A on page 11 has been developed. This chart depicts the computations and information flow necessary to support the Recommendation in the context of a direct investor relationship with a mutual fund and where one or more financial intermediaries are positioned between the investor and the fund.

The systems and linkages that exist today, as shown in the flowchart, do not currently accommodate the required calculation for individual shareholders, nor do they support the communication and presentation of the information. Survey respondents highlighted many of the complexities organizations would confront in modifying the processing systems and technology linkages, and in creating adequate controls that would ensure information is consistently and accurately transmitted between parties in a timely manner. Many of the cost burdens arise from the extensive interdependencies within the reporting infrastructure.

C. Survey Results

The survey results include the total initial and annual ongoing costs of compliance as reported by survey respondents, a summary of the most significant operational changes affected organizations would need to undertake, and a discussion of the major cost elements of those changes. Respondents also identified a number of practical questions and concerns associated with implementing the necessary changes in their organizations, which are also summarized below.

1. Costs of Compliance

The survey solicited information from a sample of key organizations in the mutual fund industry affected by the Recommendation. The aggregate costs of initial and annual ongoing compliance for each of the three methods described in the Recommendation are presented below.

	Total Initial Costs	**Total Annual On-going Costs**
Method 1	$200.4 million	$65.7 million
Method 2	$189.4 million	$58.3 million
Method 3	$141.3 million	$45.5 million

Virtually all of the $200.4 million of initial implementation costs reported by survey participants for method 1 can be separated into systems and personnel costs of approximately $128.1 million and communications related costs, including statement redesign, of approximately $67.6 million. The annual ongoing costs reported for method 1 of $65.7 million includes $48.4 million and $15.4 million, respectively, for the same cost categories.

Method 1 is the most costly method because calculations are conducted for each shareholder account each day and communicated daily throughout the reporting infrastructure. Method 2 is only slightly less costly than method 1, because while calculations are conducted and communicated quarterly rather than daily, they must be performed retroactively for each account for each day in the reporting period. All of the other costs for methods 1 and 2 are substantially similar. Method 3 is the least costly alternative, because a single calculation is made for all shareholders of a given fund, rather than individual calculations for each shareholder. The costs for method 3 are not insubstantial, though, because the considerable costs of supporting the communication of the information throughout the reporting infrastructure are still present. Respondents generally reported that it would take approximately nine to twelve months to implement the Recommendation.

2. Operational Areas Requiring Significant Changes

The responsibility to implement the Recommendation will affect three major operational functions – (1) mutual fund accounting, (2) mutual fund transfer agent and shareholder servicing, and (3) financial intermediary operations. The implications to each functional area are described below.

Fund Accounting Agents

Mutual fund accounting agents would be responsible for the determination of an expense factor to be communicated to and used by transfer agents, broker dealers, and other investor recordkeepers to calculate each investor's share of a fund's expenses. A separate expense factor must be determined for each class of shares of multiple class funds.

The impact of the Recommendation on fund accounting operations varies among respondents. For a few large, complex organizations, the costs would be significant. These organizations typically employ multiple methods of distribution (direct, broker dealer, etc.) with intricate system interfaces that would require considerable programming to capture and forward all of the expense factors through the applicable data interfaces to the appropriate parties. Other organizations provided more modest estimates based on less complex system architectures and interfaces. Most respondents reported that existing system architectures and communication mechanisms could be modified to accommodate the necessary changes.

Transfer Agents and Shareholder Servicing Agents

Mutual fund transfer agents and shareholder servicing agents would be responsible for calculating the expense amounts allocable to each individual shareholder account and

ensuring that this information was appropriately disseminated directly to investors or to financial intermediaries for further reporting to investors.

All transfer agent respondents believe that the Recommendation would require significant changes to existing data processing systems and electronic communication links. The magnitude of these system changes is largely dependent on the number and types of distribution channels (direct, broker dealer, etc.) supported by their mutual fund clients and the technological complexity of established interfaces. However, it should be noted that even those respondents with single distribution channels expect compliance with the Recommendation to require extensive and costly computer programming, hardware modifications, and procedural changes.

Transfer agent respondents also reported significant shareholder communications expenses. These include the costs of statement redesign, and explanatory and educational materials for investors. Cost estimates also include modifications to other communications media including shareholder websites, telephone voice response systems and customer support systems, so the applicable account information is readily available to service investors. Additional customer support to respond to inquiries would also be required, as well as education and training materials for investor service representatives.

Intermediary Organizations

Similar to mutual fund transfer agents and shareholder servicing agents, broker dealers expect compliance with the Recommendation will necessitate expensive systems changes, due primarily to the different forms in which mutual fund investments are held. Fund shares purchased through brokers (or any other financial intermediary) are generally held either "directly" with the fund, or in an "omnibus" account, where the individual investor accounts are maintained at the broker dealer. For accounts held directly, the fund's transfer agent would calculate each investor's share of fund expenses and the broker dealer would be responsible for communicating those amounts to clients. For omnibus accounts, broker dealers would need to calculate each investor's share of fund expenses *and* communicate the amounts to clients. The Recommendation would be particularly expensive for broker dealers and other intermediaries with extensive omnibus account operations, including mutual fund "marketplaces" or "supermarkets," where investors are offered a wide variety of funds from a large number of fund companies through one brokerage account.

Limited data were provided by financial planners. Therefore, we are unable to draw conclusions about the expected compliance costs of the financial planning community. However, those survey respondents generally confirmed that implementing the Recommendation would require a significant effort.

3. Major Cost Elements

The following major cost elements were highlighted by respondents when describing the significant operational changes required to comply with the Recommendation.

System Changes – Fund accounting, transfer agent, and financial intermediary systems, whether proprietary or provided by third parties, and the linkages between these systems,

would require significant and costly modifications in order to develop the necessary calculation and reporting infrastructures. The new information would need to be developed and disclosed in conjunction with already compressed quarter-end processing cycles.

The data would need to be processed in an accurate and timely fashion so that vendors, intermediaries, and service providers to the industry could seamlessly and simultaneously complete statement production cycles and update shareholder communications media, including internet websites, telephone voice response and account representative systems, so that the required information is readily available to investors. Significant testing and data processing equipment upgrades would be required to handle the additional data. System hardware capacity would also need to be enhanced to accommodate additional data storage requirements for those methods requiring customized disclosure at the individual account level (methods 1 and 2).

Shareholder Communications – Numerous shareholder communications issues were identified by respondents. Shareholder statements would require redesigns both from a marketing/aesthetic and systems/print-mail perspective. In addition, communications kits or materials explaining the new information contained in the statement, including separate statement inserts, website postings, in-branch educational events, and re-prints of existing communication materials would be required.

Many mutual fund transfer agents in the survey reported that typically when new information is provided to shareholders, telephone call center volumes increase. Some respondents indicated that call volumes would increase as much as 20 percent over normal levels, raising concerns about the ability to handle the activity with current personnel and system capacities. Many broker dealer respondents also expect increased inquiries from customers. This would likely result in additional inquiries being made by the broker to the fund complex for clarification. Inquires received by telephone, in writing or through the fund's website would increase staffing requirements in the correspondence and compliance servicing areas of transfer agents and broker dealers.

New Procedures – Fund accounting operations would need new daily procedures to calculate expense factors, and to perform quality assurance checks, supervisory reviews and error correction practices. Quality control functions would need to be established to reconcile, proof and perform periodic audits of calculations.

Transfer agent organizations, brokerage firms and other financial intermediaries would also need to establish procedures for obtaining the appropriate information from the fund accounting agent, calculating the daily account level expense, accumulating expenses for the quarter, and for performing quality assurance checks, supervisory review procedures, and error correction practices.

Training – Shareholder representatives and intermediaries (broker dealers, financial planners, etc.) would also need to be trained to address potential questions from shareholders. This training would require the development of educational materials as well as standardized response scripts to assist in servicing investors.

As previously mentioned, both fund accounting and transfer agent personnel would require training to perform the calculations and to ensure adherence to established policies and procedures. Operations personnel supporting omnibus accounts at broker dealers would need similar training.

D. Implementation Concerns

There were several important questions or concerns identified by survey respondents that will need to be addressed if the Recommendation is implemented. First, it is not clear whether variable annuities, defined contribution plans, banks and trust companies are within the scope of the Recommendation. *Therefore, mutual fund* s*hareholders that also maintain mutual fund investments within variable annuities or employer retirement plans may receive inconsistent information on their various account statements***.**

Next, there is no existing infrastructure to accommodate transfers of fund operating expense information when shareholder accounts are transferred from one financial intermediary to another within a reporting period, a common occurrence. Such account transfers could easily result in inconsistencies between reporting agents. For example, some agents will report the new information only on a quarterly basis while others may report cost information only for the time the account was open.

Last, while the survey requested that respondents assume no change in the timeliness of information reporting to shareholders in estimating costs, almost all said that the recommendation is *likely to result in longer processing timeframes, thus causing delays in delivery of monthly or quarterly account statements.* The delays are likely to be amplified in intermediary organizations relying on fund companies to provide information to complete their own customer statements, which is analogous to the annual Form 1099 reporting process between mutual funds and intermediaries. This is contrary to shareholder expectations for timely receipt of investment information.

APPENDIX A

This appendix is intended to assist the reader's understanding of the processes that industry participants (e.g. fund accounting agents, transfer agents and financial intermediaries) would need to establish to communicate fund operating expense information to individual shareholders in compliance with the GAO Recommendation.

Fund Operating Expense Information Flow

The diagram on page 11 illustrates the various organizations, systems and other mechanisms, and role required of each to develop and deliver the mutual fund operating expense information called for by the Recommendation. The fund's operating expense information for the principal method outlined in the Recommendation would be processed and reported to the individual shareholder as follows:

- The books and records of each mutual fund are the responsibility of the Fund Accounting Agent (FA). To comply with the primary method suggested by the Recommendation, on a daily basis the FA calculates a daily expense rate per share by dividing the total expenses by the number of fund shares outstanding used in that day's net asset value calculation. The rate per share, or "expense mil rate," is then communicated to the fund's transfer agent.
- Shareholder records are the responsibility of the Transfer Agent (TA). On a daily basis the TA multiplies the expense mil rate, obtained from the FA, by the number of shares each account holder owns to determine the portion of fund expenses allocable to that account for that day.
- The TA often maintains the mutual fund shares purchased by individuals through a Broker Dealer or Financial Planner Intermediary in an omnibus or "street" name account. That is, the investments in a particular fund of individual shareholders are aggregated and held by the TA in the Intermediary's name. The Intermediary, acting as a "Sub-Transfer Agent," maintains the relevant account information for each individual shareholder. For these omnibus accounts, on a daily basis the Intermediary would be required to multiply the expense mil rate by the number of shares each account holder owns to determine the portion of fund expenses allocable to that account for that day.
- Each day a new rate per share would be calculated by the FA, extended by the TA and any Intermediaries maintaining investor accounts, added to the previous day's accumulated balance for each shareholder account with a share balance, and stored in the investor recordkeeping systems.
- At the end of the reporting period, the cumulative expenses allocated to the individual shareholder's account would be communicated, and otherwise made available, to investors on printed account statements, voice-response units, websites and other shareholder servicing systems.

The processing steps outlined above would be essentially the same for alternative method 2. However, the fund transfer agent and any intermediaries maintaining investor accounts would not be required to process or determine fund operating expenses by account for alternative method 3.

Compliance with the Recommendation will require an extraordinary amount of coordinated action to create the new procedures and programs, and to enhance the communication links necessary to process the required information. Modifying this infrastructure to calculate and report the new information in an accurate and consistent fashion to all fund investors through all investor contact points is a complex undertaking that would result in significant costs and numerous practical difficulties.

APPENDIX B

Survey Assumptions

1. The Recommendation applies to open-end investment companies (mutual funds), and their SEC regulated financial intermediaries. Thus, it applies to broker dealers and registered investment advisers and financial planners. It is not clear whether the Recommendation applies to variable annuities, employer retirement plans or bank trusts. Accordingly, they are excluded from the survey.

2. Implementation of the Recommendation should not result in a degradation of investor services. Therefore when preparing your cost eliminates you should include any costs needed to ensure the data transmissions and other processing steps, and delivery of customer statements will occur in timeframes consistent with current processes.

3. The expenses and the shares used in the calculations are the same as those used in the daily calculation of the fund's net asset value.

4. The new disclosures will consist of the dollar amount of fund operating expenses allocable to the shareholder's account and a line or two of text labeling and/or explaining the dollar amount.

5. All shareholders will receive the new disclosure in a statement covering the quarter (or month) in which the redemption occurred.

6. Closed accounts will receive the disclosure either at the time of the redemption or in a statement covering the quarter (or month) in which the redemption occurred.

7. An ability to retroactively correct errors (mil rates, shares, NAV's etc.) will be built into systems and procedures developed to calculate and process the information, including procedures to determine if reprocessing and/or shareholder communication is necessary.

8. Sales loads, CDSCs, and other direct shareholder fees are not included in the calculation - only fund operating expenses.

9. Existing electronic interfaces between your organization and other parties my need to be modified or developed.

10. Personnel costs should include the costs of internal personnel and independent contractors or consultants hired to assist with implementing the Recommendation.