ICI VIEWPOINTS

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Fund Shareholders Have to Receive Reports. They Don't Have to Pay So Much for Them

By Paul Schott Stevens

ICI has filed a comment letter calling on the Securities and Exchange Commission (SEC) to overhaul the framework for fees that funds are required to pay to vendors when intermediaries such as broker-dealers hire those vendors to distribute legally required reports and disclosures to shareholders. The issue may sound dry and technical—but if the SEC follows through on our recommendations, shareholders will save real money.

In a nutshell, the current system for distributing fund materials is broken. It has created a near-monopoly for the predominant vendor with little to no incentive to reduce fees charged to fund shareholders to process deliveries. As a result, fund shareholders pay unnecessarily high costs to receive shareholder reports, prospectuses, and other legally required documents.

An ICI survey of 1,700 funds found that they pay three to five times as much to distribute materials through intermediaries as they pay when they can distribute materials directly—an excess cost caused by lack of competition and lack of incentives to control costs.

To its credit, the SEC has asked for comment on this broken fee structure. ICI's Law, Research, and Industry Operations groups teamed up for an in-depth examination of these fees and the gap between what funds pay now and what they'd be likely to pay in a competitive system. The picture isn't pretty: millions of dollars in excess charges, some of which get transferred from fund shareholders to intermediaries through inappropriate and unacceptable "remittances" from the vendors that intermediaries hire. These costs land on fund shareholders—not the fund adviser.

For years, ICI and its members have fought to change the delivery fee system. Now, thanks to the SEC's interest, we can hope for reforms that will help create a more competitive marketplace for delivering fund materials and significantly reduce costs for fund shareholders.

Maxing Out on Fees

How did this broken system come about?

Under SEC rules, funds bear the obligation and the expense to ensure that shareholders receive shareholder reports, prospectus updates, and other materials. When investors buy funds directly from the sponsor (direct-held accounts), the fund adviser or transfer agent can arrange those deliveries directly and seeks competitive bids from vendors to hold down the cost to shareholders.

But millions of shareholders hold their funds through financial intermediaries, like broker-dealers. Intermediaries usually hold their clients' shares in a fund collectively in "omnibus" accounts. These accounts benefit investors by creating economies and efficiencies, but under this structure, the fund has no direct contact with shareholders. In such cases, the intermediary distributes the materials.

SEC rules require the fund to reimburse the intermediary for "reasonable" expenses incurred in forwarding materials to beneficial owners of fund shares. These costs are fund expenses borne by shareholders—not by the fund adviser.

Intermediaries generally outsource the forwarding of fund materials to a vendor that then bills the fund to pay the expenses. This system creates a disconnect between the intermediary that negotiates the vendor fees and the fund that pays the vendor's bill, reducing the incentive for competitive pricing. That's the first reason that shareholders are paying too much.

The second reason revolves around the fee schedule for such deliveries, set by the New York Stock Exchange. The NYSE specifies maximum rates for what constitutes “reasonable” expenses for the costs of processing the delivery. (Funds additionally pay direct costs like printing or postage.) But even when the intermediary negotiates a rate with the vendor that is lower than the NYSE-set maximum rate, the fund does not receive the lower rate.

Instead, when the intermediary negotiates a lower rate, the vendor commonly bills the fund for the maximum rate, and then remits a portion of the fund’s payment to the intermediary. These “remittances” divert shareholder assets to the intermediaries. They also limit the opportunity for other vendors to compete. As a result, one vendor, Broadridge Financial Solutions, Inc., has a near monopoly, delivering fund materials for almost all intermediary-held accounts.

Nothing about this system is transparent. Funds don’t know what rate the intermediary has negotiated with the vendor, or how much of the fees they pay are being remitted to the intermediary. Funds just know that they’re being billed the highest fees that the schedule allows.

Fees upon Fees upon Fees

A third reason why shareholders pay too much: the predominant vendor layers fees upon fees. If a brokerage customer owns four funds with the same fiscal year, the vendor charges seven fees to mail one consolidated annual report. And if the investor has opted to receive materials via email, the vendor charges even more—in this case, eight fees—*not* to mail anything.

How does that happen? As our letter explains, the fee schedule allows the vendor to charge 15 cents to process each fund’s report (four fees)—even if all four funds are in the same report. It then allows the vendor to charge 10 cents to “suppress” sending three of those reports for a total of seven fees. And if it emails the report instead, it charges another “suppression” fee—a total of eight fees—so that nothing goes out in the mail.

(As a fan of the Marx Brothers, I’m reminded of thescene in *Animal Crackers* where Chico Marx, posing as a musician, explains his band’s fees: $10 an hour to play, $12 an hour for not playing, $15 an hour for rehearsing. “And what do you get for not rehearsing?” Groucho’s Captain Spaulding asks. “You couldn't afford it,” Chico responds. “You see, if we don't rehearse, we don't play. And if we don't play—that runs into money.”)

The perverse system of layered fees for delivering fund materials could greatly reduce the savings that fund shareholders otherwise could gain from the SEC’s newly adopted Rule 30e-3. That rule was a breakthrough that permits funds to mail shareholders a short notice that shareholder reports are available online. (Shareholders who want to receive full paper reports can opt into paper delivery with a phone call.)

We fought hard for 30e-3—but we’re concerned that a large portion of shareholders’ savings on print and mailing costs could be diverted into paying fees. Indeed, our fund members tell us that the predominant vendor is already inventing a new “tracking fee” for shareholders who request the paper report. This is, of course, the same paper report that the vendor has already been paid to process and send.

What difference would a competitive distribution structure make? ICI conducted a survey of more than 1,700 mutual funds from 50 ICI member firms to compare what funds pay to deliver fund materials to intermediary accounts with what they pay to deliver fund materials to direct-held accounts, where vendors compete to offer funds attractive pricing.

ICI Member Survey Indicates Processing Fees That Funds Pay for Direct Accounts Are Significantly Less Than NYSE Processing Fees

Processing fees for delivery of fund shareholder reports to direct[1] and beneficial accounts, cents

[1] Data on processing fees for direct accounts obtained from survey of 1,704 mutual funds from 50 ICI member firms.
[2] Median based on funds that mailed or suppressed at least 100 shareholder reports for their direct-held accounts.
Sources: ICI tabulations of data from ICI members, and the NYSE fee schedule.

The survey found that the median fund pays *three times* more in processing fees for mailing the same shareholder report to an intermediary-held account than to a direct-held account. The median fund pays *five times* more to email the same shareholder report to an intermediary-held account than to a direct-held account.

Vendors and intermediaries may disagree with these numbers. But the SEC can discern the true picture by conducting an independent examination of fees—something ICI has been advocating for years.

How to Fix the Broken System

If the SEC wants to stop the diversion of millions of dollars from fund shareholders to vendors and intermediaries, it can follow one of two courses.

The first course would be to eliminate the disconnect between who negotiates and who pays, which will introduce market competition and alleviate the need for a fee schedule. In our letter, we suggest two ways that the SEC could accomplish this by requiring intermediaries to provide to funds, on request, the shareholder information that funds need to deliver regulatory materials directly. Funds could then select their own vendors for delivery and negotiate competitive prices on behalf of fund shareholders. Funds bear the costs and have the incentive to hold down prices—an incentive that intermediaries lack.

If the SEC does not follow this path, it can rework the regulatory fee schedule to replace the existing fees and fee layering with simple, flat fees that reflect actual costs, using cost for direct-held accounts as a guide. In this case, it also must eliminate unreasonable billing practices, such as remittances, that pump up intermediary and vendor profit at shareholder expense. And the new fee schedule would need robust regulatory oversight and regular independent review of fees and vendor billing practices.

Whichever course the SEC pursues, the time to act is now. Fund shareholders have been paying too much for too long.

Paul Schott Stevens was President and CEO of ICI.