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COMMENTARY

Mutual Madness

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From all indications, the SEC is planning, *again*, to require that at least three-quarters of every mutual fund board of directors be independent of the fund's investment adviser. The D.C. Court of Appeals has twice struck down this move because the agency failed to consider efficiency, competition and capital formation, as the law requires. But even if the agency does so this time, the new requirements won't be in the interests of investors.


Still, many readers may wonder why more independent directors aren't good for investors. The answer lies in the peculiar role of directors in approving the fees of investment advisers. The system discourages price competition among advisers and keeps mutual fund costs higher than they should be. Here's how it works.

Mutual funds are corporations, legally controlled by boards of directors but managed under contracts by investment advisory firms that receive a fee for their advisory and management services. Mutual fund shares are sold at their net asset value (NAV) -- that is, the value of a proportionate share of the fund's portfolio -- but the NAV is reduced slightly by the adviser's fees and costs of managing the fund. Under the Investment Company Act of 1940, boards of directors must approve the fees and expenses of the investment adviser for each fund. In order to obtain this approval, the adviser submits its fees and expenses to the board, and in most cases the board determines, in light of these costs, whether the adviser's resulting profit is "reasonable."

If this sounds familiar, that's because this cost-plus system is substantially the same as the way that electric rates are determined by local utility commissions. As economic studies have shown, however, cost-plus ratemaking creates no incentive for efficiency or cost-cutting on the part of the regulated entity. The same problem exists in mutual fund pricing: The adviser has little incentive to lower its costs. If it does so, its profit *percentage* will rise and the board may require a cut in fees to keep the adviser's profits within the range that the board considers reasonable. In addition, if the adviser takes the risk of reducing its costs, and succeeds in attracting more investors, the board may require the adviser to lower the advisory fee further, because the adviser is now thought to be profiting from economies of scale.

This system, by stunting the adviser's incentive to cut costs, reduces the likelihood that price competition will develop among advisers, and that is precisely what we see when we look at mutual fund costs. The mutual fund industry has a highly competitive structure -- with about 500 fund groups managing \$10 trillion in assets through over 8,000 funds -- yet there is a wide disparity in the costs paid by investors for advisory services to their funds. Among a sample of

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over 800 ordinary equity funds listed in Morningstar, for example, there is a difference of nearly 300% between the lowest-cost fund and the highest. There are also disparities almost as wide among the largest and most competitive funds and fund groups. These disparities do not correspond to performance, and even exist among index funds, where there can be no significant differences in performance.

The United Kingdom presents an instructive contrast. There, investment advisers can establish their own fees without the intervention of a board of directors. Yet the dispersion of prices in a sample of more than 450 equity mutual funds is much tighter than in the U.S. -- about one-third the difference in the U.S. group. Also, a 2005 Lipper report compared the pricing of equity funds sponsored by six large U.S. fund managers that also sponsor equity funds in the U.K. The average cost for their advisory services in the U.K. differed in this study by not more than ten basis points, while the difference was as much as 55 basis points for their U.S. funds. These comparisons suggest that the cost-plus system in the U.S. is impairing the ability of mutual fund advisers to compete on price.

This is a significant public policy issue. Millions of American families rely on mutual funds for their retirement, and even small differences in costs, over time, can have a major effect on investment results. Recognizing this, the SEC has attempted for over 40 years to reduce the wide disparity in mutual fund pricing by empowering and increasing the independence of mutual fund boards. This was supposed to give directors more leverage in negotiating fees with advisers. This policy is a loser, as the experience of regulated utilities shows. It isn't the power of the rate-maker that's important -- utility commissions have plenty of that -- but the fact that the regulated entity has no incentive to reduce its costs.

In 1992, the SEC staff recommended eliminating the rate-making authority of the mutual fund board of directors, but the commission never acted on this proposal. Instead of plodding ahead with a failed solution -- increasing the independence of boards -- the SEC should take seriously the 15-year-old recommendation of its own staff. Freeing investment advisers from the shackles of cost-plus rate regulation will allow and encourage investment advisers to compete on price, with the same effect for mutual fund advisory costs as the elimination of rate regulation has had for securities brokerage, air fares and long distance telephone rates -- more competition, more innovation and lower costs for the investing public.

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