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Investor Fees Finance Interests of Lobbyists

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Mutual fund investors might not be surprised to learn that the companies that manage their funds actively lobby Congress and the states regarding regulation of their industry. But they may be startled to learn that these managers have lobbied hard over the past decade for policies that investor and consumer advocates say often run counter to the interests of average mutual fund shareholders.

And what many investors surely do not realize is that they are footing much of the bill for the lobbying effort, industry critics say. In a sour addition to recent revelations of widespread misconduct in the \$7.1 trillion industry by fund managers and brokerages, the fund industry has, among other causes, lobbied to keep proxy votes secret and has persuaded legislators in Maryland and Massachusetts to adopt a lenient definition of what makes a fund director independent.

The Investment Company Institute, the lobbying group for mutual fund managers, says a portion of the \$31 million it received last year in annual membership dues was billed to mutual fund shareholders, though it doesn't know the exact amount, according to spokesman John Collins.

Many fund managers charge shareholders at least half of the cost of ICI dues, with many others charging all of it to them, said C. Meyrick Payne of Management Practice Inc., a consulting firm that specializes in advising independent directors on mutual fund boards. Directors must approve fees and other expenses that are paid to fund managers out of shareholder money.

"We still live in a capitalist system," Payne said. "So if managers can make shareholders pay, they will."

Few funds, however, tell shareholders they are paying, industry and government lawyers say. Most opt instead to include the charge in disclosure material under the general heading "other expenses," which is what large, well known fund complexes such as Fidelity and Putnam do.

To Russel Kinnel, director of mutual fund analysis at Morningstar Inc., most of the ICI's efforts are geared toward helping portfolio managers, not shareholders. Because those managers already earn high fees, he said, presenting shareholders with a separate tab for lobbying, whether it's 50 percent of the bill or 100 percent, "is a lousy deal."

The ICI makes repeated references to shareholders in its literature, saying it works hard on their behalf. For example, the group says on its Web site that "a considerable portion of the institute's work is devoted to representing the fund industry and its shareholders before Congress, the Securities and Exchange

Commission, other regulatory agencies, as well as state and foreign regulators." For that reason, spokesmen for the group say, it makes sense that shareholders pay for part of the lobbying cost.

But some investors -- and even some SEC officials who police the mutual fund industry -- say they think the lobbying group acts primarily on behalf of the fund managers, not shareholders.

Attorney Joel C. Feffer has tried unsuccessfully to sue fund managers and the ICI to recover these and other fees, which he argues are set illegally by directors who, because they sit on many boards within a mutual fund family -- often a dozen or more -- aren't really independent. "The ICI is the industry, and they lobby on behalf of the industry but, unlike most lobby groups, they get their money from investors to lobby against the interests of investors," he said. "I really think it's time for the SEC to stop this."

The SEC has no plans to do so, agency officials say. The amount of money involved is simply too small -- less than \$1 per investor a year.

Even though Feffer's legal challenge was unsuccessful, it has had a major effect on the industry, said Payne of Management Practice. "Four or five" large fund complexes, Payne said -- while refusing to say which ones -- recently have undertaken studies of the subject and, as a result, have decided to change how they allocate membership costs. He said the efforts reflect a larger concern, even anger, that independent directors feel in the current scandal, during which New York Attorney General Eliot L. Spitzer and some members of Congress have characterized the directors as, in Payne's words, "empty suits."

Proper or not, everyone agrees the pennies per shareholder the ICI receives adds up to a sizable amount that helps the lobby group build clout and win support for the issues its members care about.

"The ICI's primary purpose is to represent the interest of fund managers, and their record is completely consistent with that," said Mercer E. Bullard, a former assistant chief counsel at the SEC and now a law professor. "They are getting their marching orders from the CEOs of the fund managers."

To be fair, Bullard -- the founder and director of Fund Democracy, a mutual fund investor advocacy group based in Oxford, Miss. -- and other critics say, the ICI does provide some services that benefit fund shareholders. It provides consumer education materials. It communicates changes in SEC rules to fund managers. And sometimes its lobbying agenda coincides with investor interests, such as pushing for lower taxes on mutual fund investments.

Paul Schott Stevens, formerly the ICI's general counsel and for the past four years a private lawyer who consults with the organization, said he thinks the group is being unfairly blamed for the industry's problems and isn't receiving credit for many reforms it has pushed.

For example, he said, the ICI advocated for years, to no avail, that Congress give the SEC more funding to police the industry. Now, with a steady succession of business scandals -- not just in the mutual fund arena -- Congress and the White House have agreed to give the SEC significantly more money and

manpower, though lawmakers cut \$30 million from the \$841 million budget they initially planned to give the agency for fiscal 2004, which began Oct. 1.

A decade ago the lobby group proposed to the SEC that it require all funds to have a compliance officer to ensure that laws were being followed, he said. Last month the SEC did adopt such a rule, but, over ICI objections, the agency required that the compliance officer report directly to the fund's board of directors. The ICI had proposed that compliance officers report to fund managers. That, SEC staffers decided, would merely reinforce the status quo -- a system that allows managers to control the information directors receive.

In 1995 the ICI proposed to NASD, which regulates Wall Street brokerage houses, that it require brokers to disclose to consumers at the point of sale if the brokers were being paid by a fund to promote sales of that fund's shares. NASD didn't do anything until this year, Stevens said, when it began to move such a proposal forward.

For these efforts, he and others say, shareholders should pay a portion of ICI membership dues.

Bullard and other critics say the reality is that most of ICI's activities revolve around fund managers, who dominate its board of directors and are among the handful of people who decide which issues to push and which elected officials will receive money from the lobby group's political action committee.

The ICI's PAC made political contributions in the 2002 election cycle of more than \$400,000. So far in the 2004 cycle, the institute's PAC has already contributed more than \$225,000.

Barbara Roper, director of investment protection for the Consumer Federation of America, says that over the past decade the ICI has won a series of victories with the SEC and Congress that have loosened rules and given mutual fund managers greater freedom in how they buy and sell securities, what they buy, and what they can advertise.

It's hard to draw a direct line between those policy and rule changes and the trading and disclosure abuses that have been unearthed in federal and state regulators' widening probe into the fund industry, securities law experts say. But several current and former SEC officials say the wins erased in many cases what was known as a "bright-line" prohibition on some activities.

Most of the changes occurred during the Clinton administration, when Arthur Levitt Jr. chaired the SEC and securities attorney Barry P. Barbash ran the SEC division that oversees the mutual fund industry. Coming as they did during the bull market of the late 1990s, the changes contributed to a go-go atmosphere in which some fund managers adopted an attitude of pushing the limits, industry and government lawyers say.

At the least, the changes helped unleash new activities that the SEC had to police even as the number of mutual funds to be regulated skyrocketed. At the same time, the size of the agency's oversight staff didn't

change. The SEC examination staff, for example, until recently had 350 people to inspect 8,000 mutual funds with about \$7 trillion in assets. That's the same number it had in 1993, when there were 4,500 funds with \$2 trillion in assets.

Key policy changes in the past decade have included a rule the SEC adopted in 1997 that allowed mutual funds to buy more shares in initial public offerings underwritten in part by fund affiliates. The ICI had sought to increase the limit from 3 to 50 percent. Some SEC staffers fought for a 10 percent limit, arguing that anything higher could open the door for an IPO underwriter to create artificial demand for, and thereby inflate the value of, such shares by "stuffing" them into an affiliate mutual fund.

The SEC eventually agreed to increase the limit to 25 percent, but it also allowed a hedge fund affiliated with a mutual fund to buy the remaining 75 percent of IPO shares underwritten in part by yet another affiliate. That meant a hedge-fund manager and a mutual fund manager in the same fund family had the ability to buy all the shares of an affiliate's IPO.

The SEC closed the hedge-fund loophole in 2000. The current investigation by federal and state regulators includes a probe of IPO shares and potential abuses, sources say.

Another trend that has been backed by the ICI is the practice of many fund families to have portfolio managers oversee both a mutual fund and a hedge fund for private investors. Managing the two can often pose conflicts of interest, which are at the heart of some of the current federal and state investigations.

Another instance of ICI lobbying began in 1998, when a federal judge dismissed as groundless a Feffer suit against Scudder Kemper Investments Inc. Feffer had argued that the fund complex's "independent" directors weren't really independent, because they sat on multiple boards of affiliated funds. Consumer groups have long complained that most "independent" directors are handpicked by fund-management companies, albeit behind the scenes, and then sit on so many boards within the same fund family they become more beholden to the fund managers than to shareholders.

A letter sent to SEC Chairman William H. Donaldson on Dec. 31 by an ICI committee representing independent directors may illustrate the critics' point. In the letter, the committee outlines its opposition to several SEC and congressional proposals to bolster oversight of independent directors. The independent director who heads the committee and signed the letter, James H. Bodurtha, sits on 39 mutual fund boards, which oversee more than 50 portfolios for Merrill Lynch & Co. In the letter, on ICI letterhead, Bodurtha argues against efforts to require that directors certify the fees they agree to pay fund managers are in the "best" interest of shareholders." He said such certification would force directors to adhere to a standard that's higher than the law requires, namely that directors ensure only that fees are "reasonable."

In dismissing the Feffer suit, the judge left open the possibility that in state court, under laws in Maryland and Massachusetts, multiple board memberships could be used to prove a director's lack of independence. Most mutual funds are incorporated in those states because of favorable mutual fund laws, but the definition of what constitutes an independent director in those states was stricter than the federal

definition. Subsequently, the ICI successfully lobbied state lawmakers to make the definition of an independent director similar to the more flexible federal definition.

In 1996, at the ICI's urging, Congress passed a law that gave the SEC preemption over state regulators in deciding what a mutual fund must disclose in its prospectus, thus ending the need for a fund to confer with 50 state regulators and possibly create 50 different documents. Roper and others say that change was good, because it cut the time and expense funds needed to produce a prospectus. But the law went too far, she and others say, in curbing the states' ability to oversee brokers on a daily basis. State regulators, in monitoring how brokers sell fund shares to consumers, might have found earlier some of the abuses now coming to light, she and others say.

The importance to the fund industry of overriding state jurisdiction was underscored by one ICI lobbyist who in 1995, a year before the bill passed, sent out a holiday card that featured a crazy-quilt, wildly colored map of the United States and then opened to a blank, white U.S. map carrying the greeting "Dreaming of a white Christmas." The next year, after the bill passed giving regulators preemption over state law, his holiday card featured a blank white map of the United States and opened to the greeting, "May all your Christmases be white."

With the tide in Congress and elsewhere turning to more accountability, the ICI has sustained some losses. It failed to win exemption for the mutual fund industry from a law Congress passed in the summer of 2002 -- in response to the Enron Corp. and WorldCom Inc. scandals -- requiring chief executives and financial officers to vouch for the accuracy of their firms' financial statements.

The ICI has also fought for years efforts to require fund managers to disclose how they vote proxies on behalf of investors. Bullard and others say such disclosure is necessary to ensure that a fund manager isn't voting with management -- and possibly against shareholders -- at companies whose pension fund business the mutual fund company hopes to win.

Last January, the ICI lost the fight when the SEC voted to make disclosure mandatory. An SEC spokesman said preliminary information suggests the rule has already caused a significant shift in how fund managers vote, making them much less likely to side with management than before disclosure was required.