April 26th, 2004

Jonathan G. Katz
Secretary, Securities and Exchange Commission
450 Fifth Street, NW,
Washington, DC 20549-0609

Dear Mr. Katz,

My only worry about this proposal is that you will not be specific in what data and metrics the funds must disclose about their contract renewal process. Currently, boards are overloaded with data and statistics, usually purchased from Lipper. Since most trustees are not competent in statistical methods, they eyeball these large reports and quickly sign-off. If you require that funds release this material to shareholders you can be sure that some fund managers will reverse tactics and give boards the minimal amount of data necessary to approve the advisory contract.

COMMENTS

Q: Should disclosure regarding the basis of the board's approval of an advisory contract be required in any additional location (e.g., the prospectus, fund websites)?

Yes, all the materials the board compiles for contract renewal should be available on a web site or by mail for a nominal fee. The materials must include any data the fund has purchased from Lipper, or run itself, using SIMFUND or Morningstar. All data and information used by the board is theoretically the property of all shareholders and should be available to them. Due to their length, they should not be included in the prospectus. In this Internet age I don't see why they can't be posted on-line inexpensively.

Q: Will the fact that we have enumerated certain specific matters that should be included in the discussion encourage funds to omit other, equally significant matters from the discussion?

Yes, therefore a fund must specifically list a minimum of 10 funds closest to it in structure (its peer group).

Q: If a fund's board did not rely upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, should the fund be required to disclose the reasons why the board did not do so?

I doubt any major fund does not run peer groups. If they don't, they should be required to do so.

Should a fund be required to disclose whether, and if so, how, the board separately assessed amounts to be paid for portfolio management services and amounts to be paid for services other than portfolio management?

If the portfolio manager is in any way related to a 3rd party service provider this relationship should be spelled out in full.

Q: Will any of our proposed disclosure requirements have a chilling effect on boards' consideration of investment advisory contracts?

This assumes the boards are already warm to shareholder interests. The object should be to allow the shareholder to view the same information their representative (the trustee) uses to negotiate fees. After all, the trustee works for the shareholder (and should not withhold any information). The advantage of allowing shareholder's access to this data is that the boards can lessen their liability for negotiating the contract and focus on investigating issues that are unique to their particular fund(s).

Q: …when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

To answer the above considerations let me relate some of my experience over the past few years.

The S.E.C. Stifles Competition for Fiduciary Consulting

I never expected to get rich providing fund data and analysis with a fiduciary mindset. But even I am surprised how difficult the S.E.C. makes it to provide new services to mutual fund trustees.

If, in March of 2003, for example, the S.E.C. had acted* on what I posted on my site, that Putnam had incorrectly filed a form for the 25th largest mutual fund in America, Putnam's trustees would have realized that FundExpenses.com had facts which its own senior management did not possess. Putnam might have hired my services. Instead, they concluded (and who am I to argue) that they should only worry about the S.E.C.

I can't legitimize my work. Only the S.E.C. can set the value for anyone's fiduciary analysis. So, it doesn't matter how many problems I find (or anyone else finds), it seems the S.E.C. doesn't recognize externally reported problems. I find this ironic for the reasons below.

The S.E.C.'s posture toward fund companies (and Wall Street in general) is to stand back and make sure the rules are followed, and if they're not, to work out a solution behind closed doors. (Of course, fund companies that run afoul of the law are fined and sanctioned.) The S.E.C. seeks to fairly apply the rules of the 1940 act without getting into philosophical or political issues.

Yet the very neutrality the S.E.C. works so hard to achieve ends up fueling a huge growth of cynicism in financial services. By ignoring the work of people like me, the S.E.C. essentially splits all fiduciary power between it, the big four, and the registrant. In practical terms, the managers end up exerting pressure to increase sales, people like me are ignored (because the technical aspects are too difficult for the shareholders to follow), and the S.E.C. only acts when, to put it bluntly, it feels like it.

So it doesn't matter how many problems I, or any other consultant may find. The S.E.C. sends the very message I believe they don't want to send—the facts don't matter. Nothing matters until the S.E.C. says it matters.

Yet when the facts are ignored how effective can public disclosure be in the first place?

Fund Boards Are Not Responsive

One of the primary roles of a mutual fund board of directors is to investigate any issue that may affect their shareholders. In any event, their names and addresses are provided in the prospectuses in the event that the manager is conspiring to hide something from the shareholders. I'm fairly certain that, between 1950 and 1980, any lawyer who allowed an incorrect address to be filed would have been asked to leave. I don't expect that's the case today.

In my first mailing to 200 trustees 5 were returned because they were undeliverable (a later mailing of 800 generated 60 returns). Someone in the industry remarked that the return rate didn't sound bad. "How many do you think should have been returned?" she asked. I said, "none, of course." She thought about it for a second and replied, "You know, you're right."

Another disturbing fact is that I didn't receive any responses. For all I know, not one of my letters ever reached a mutual fund trustee. It's not a question of what I should expect, or what the trustee wants to do. The question is - is such lack of responsiveness what the 1940 act had in mind when it required that these addresses become published in the first place?

My experience shows that there should be no doubt about the complacency that has taken hold within the S.E.C. and the fund boards. It's not about corrupt people. It's about people allowing themselves to degenerate into the lowest common denominator—cronyism.

So, for starters, wouldn't it be prudent for the S.E.C. to curtail its cozy relationship with the fund industry. (Why do they speak at the ICI conferences now that the ICI has clearly shown its primary allegiance to the fund companies?) The S.E.C. has plenty of space to hold conferences on any subject important to the fund companies.

Board Compensation

When the 1940 Act allowed fund trustees to set its own pay it did so because it felt no one else could be trusted. The honor and responsibility of the position were paramount. Trustee compensation was held to honorarium levels. Today, many trustees pay themselves like members of the executive committee. Some trustees argue that they do a lot of work for the funds and should be paid for it. Others still hold to the 1940s intent and work for little. Who is right?

You don't need to be a cynic to see that some board's compensation has gotten out of hand. Why the S.E.C. hasn't rationalized trustee compensation is a mystery to me. It's not as if trustees have any hard-to-find skills. Almost every honest American is eligible to be a trustee. In other words, I can't believe that there are not enough capable Americans who wouldn't find it a privilege to work for the American public through mutual funds for a nominal fee.

For the shareholders the S.E.C. has added insult to injury. It's not bad enough that the trustees didn't prevent the trading; they have also failed to keep themselves accountable. Again, I'm not arguing that trustees are bad people or should not be paid. Trustees seem to feel, "if no one is going to listen to me—the last person to take a stand on an issue was forced off the board—then I might as well get paid to sit through these meetings." I don't blame them. Who is going

to defend them when they speak their mind? The S.E.C.? When the S.E.C. talks to trustees it's usually through an ICI conference. What kind of message does that send?

Lipper

Why can lawyers not work for both board and management companies while Lipper plays both sides with its data? I understand Lipper's rational, but sorry, I just don't buy it. Lipper provides data and analysis to all the major media, the publicity of which makes them a "name" with the fund boards. They protect their 15-C data business vigorously and have successfully kept Morningstar and others from gaining any real 15-C related market share.

The S.E.C. should require that any fund board which uses Lipper data for board work not allow the management companies to use Lipper awards or indexes for other purposes. Why does the S.E.C. believe Lipper can be objective in keeping the two businesses separate (board versus management) but not the lawyers?

Conclusion

There are fewer than 1,000 people who have any real power in the fund industry. It's an insular club surrounded by an equally insular set of lawyers. There's nothing preventing anyone from starting their own mutual fund and competing. But on the fiduciary and contract-advisory side of the business there will be little competition until the S.E.C. recognizes its complicity in maintaining form over substance.

Sincerely,
Max Rottersman
Founder
www.fundexpenses.com

My analysis of trustee data is here: Fund Directors and the National Interest

Footnotes:

* I never sent any of my findings to the S.E.C. directly because I'm not an aggrieved party (fund shareholder). Again, my focus is fund data analysis.