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Statement of the Shadow Financial Regulatory Committee on

Mutual Fund Expenses and Soft Dollars

December 8, 2003

The recently passed US House of Representatives bill, "Mutual Funds Integrity and Fee Transparency Act of 2003" (H.R. 2420), calls for improved transparency in the reporting of mutual fund expenses. The Shadow Financial Regulatory Committee lauds this goal. Mutual fund expenses are an important determinant of investor's actual returns. Though market fluctuations may swamp the impact of fund expenses on short-run returns, such expenses become much more significant in determining differential returns among funds over a number of years. Therefore, expense ratios are particularly important to long-term investors.

Current expense ratios of mutual funds, as reported in publications such as Morningstar and Lipper, ignore the cost of research purchased with "soft dollars." Soft dollars are those commissions in excess of those that a mutual fund would pay solely for execution. Importantly, GAAP requires that all commissions, including soft dollars, be capitalized into the price of an asset, and thus are not recorded as an expense.

Because an investment adviser can use soft dollars to purchase research without showing the expenditure as an expense, an adviser can artificially lower a fund's reported expense. The use of soft dollars thus distorts reported expense ratios and undermines the goal of the House bill to achieve greater transparency.

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor for investment advisors of mutual funds to use soft dollars for the purchase of research. To provide transparency among mutual funds, the Committee recommends repeal of the safe harbor provisions of section 28(e). This repeal, in conjunction with section 17 of the Investment Company Act of 1940, would prohibit investment advisors of mutual funds from using soft dollars. The expense ratios of mutual funds then would include all research expenses, making published expense ratios more useful to investors for comparing mutual funds.