Critics of 12b-1 fees note that they, unlike sales loads, are not paid directly by the investor in connection with a transaction, but deducted from the fund’s assets. Thus, in effect, current shareholders bear the cost of attracting new shareholders.

—Paul G. Mahoney [2004]

The purpose of this article is to describe fully the New Total Expense Ratio construct as a major improvement in the SEC’s expense ratio. This new construct sheds light on the realities hidden “behind the mutual fund curtain.”

The New Total Expense Ratio applies the concept of “normative transparency of disclosure” to mutual fund fee and cost categories and sub-categories. This disclosure concept evolved in Haslem [2004, 2006, 2007, 2010] and is defined as follows:

Normative transparency of disclosure refers to the degree of mutual fund voluntary and proactive disclosure and also new and revised legal and regulatory disclosure required for shareholders to be able to make information efficient fund investment decisions.

Adoption of the New Total Expense Ratio with normative transparency of disclosure requires mutual fund independent directors to force the issue at the fund level, which is a difficult challenge. At the industry level, adoption requires active support of the fund industry (unlikely) and political pressure on Congress and the SEC. Most fund advisers would strongly resist this assault on self-interest—the status quo is much too profitable.

Normative transparency of disclosure can also be facilitated by the SEC’s adoption of “best-efforts” standards for assessing and disclosing the practices of mutual fund advisers. These standards with disclosure of adviser practices would go a long way toward providing shareholders with information they need to identify “stewardship funds”—those stewards of shareholders and their money discussed in Haslem [2005, 2010].

12B-1 FEES AND OTHER ISSUES

The SEC’s required Annual Fund Operating Expenses for mutual funds include 1) distribution [and/or service] (12b-1) fees, 2) management fees, and (3) other expenses. SEC approval of 12b-1 fees requires mutual funds to have formally adopted “12b-1 plans.” If funds limit 12b-1 customer service fees to 0.25%, they are allowed to advertise as “no load” funds. Funds may also pay customer service fees without adopting 12b-1 plans, but in these cases the fees included in “other expenses” are limited to 0.25% of fund average annual net total assets.

Researchers and even some regulators have called for prohibition of 12b-1 fees. It is
well established that 12b-1 fees are “dead-weight” costs paid from mutual fund and shareholder assets. The issue of prohibition is considered in Haslem [2008].

Rule 12b-1 fees pay brokers to “grow” mutual fund assets. Asset growth provides advisers with the largest additional source of dollars from management fees and 12b-1 fees. Rule 12b-1 fees are discussed generally in Haslem [2003, 2010].

Rule 12b-1 fees have also facilitated adviser creation of multiple mutual fund share classes. Each share class has a different mix of loads and 12b-1 fees, which often makes investor choice of share class a confusing and costly exercise. This unnecessary complexity benefits fund advisers at the cost of shareholders. The SEC should permit only one basic share class with one-time payments of inclusive front-end loads (discussed below).

Economies of scale from mutual fund asset growth provide another source of adviser income that, unfortunately, is not generally shared properly with fund shareholders. However, asset growth also increases transaction costs through larger trade sizes that eventually subsume economies of scale.

Larger-fund portfolio holdings limit the ability of portfolio managers to invest in smaller-capitalization stocks, which trade in less-liquid markets with higher transaction costs. These higher transaction costs reduce opportunities for increasing fund performance.

As mutual fund portfolios become larger, the talents of superior portfolio managers and analysts are spread over a larger number of securities, which can reduce their overall performance. Further, additions to staff are unlikely to have the same level of talent and expertise, which can constrain performance of the superior managers and analysts. The result is often more index-like portfolios (and performance), with higher effective advisory fees for the smaller portfolio proportions that remain actively managed.

Morningstar’s Gogerty [2007] finds hypocrisy in the mutual fund industry’s strong support for 12b-1 fees: “The fact that closed funds continue to charge 12b-1 fees clearly illustrates that the fees are no longer primarily used for their intended purpose—to market and promote a fund. A 2005 survey conducted by the Investment Company Institute reveals that less than 5% of the estimated $10.9 billion collected in 12b-1 fees that year were used for promotion and advertising …”

Until the SEC adopts the New Total Expense Ratio based on normative transparency of disclosure, and makes the identified changes and prohibitions, mutual fund independent directors should take the lead in prohibiting current conflicted and improper adviser practices. These practices have negative implications for fund and shareholder assets and performance.

THE NEW TOTAL EXPENSE RATIO

The New Total Expense Ratio construct with normative transparency of disclosure provides additional categories and comprehensive sub-categories relative to the SEC Expense Ratio, which does not provide a “behind the fund curtain” view of hidden payments to brokers. The New Total Expense Ratio was developed and evolved in Haslem [2009a, 2009b, 2010].

The dollar amounts of the New Total Expense Ratio’s four categories with sub-categories should be computed as percentages that permit comparison with the SEC Expense Ratio and its categories. The required use of this construct would also provide standardized descriptors for uniform reporting among funds.

Here is an outline of the categories and sub-categories of the New Total Expense Ratio:

1. Management fees (%)
   a. Investment advisory fees
   b. Administrator expenses
   c. Service provider fees to adviser affiliates
   d. Adviser fall-out benefits from revenue-sharing payments (see distribution fees)
   e. Adviser rebates from soft-dollar trades (see distribution fees)

2. Distribution fees (%)
   a. Selling group payments
      1. Dealer (broker) concessions
      2. Account servicing fees
   b. Revenue-sharing payments, net of adviser fall-out benefits
      1. Broker marketing pools
      2. Broker bonus compensation
      3. Syndicated distributions (indirect payments)
      4. Sub-transfer agency fees
      5. Networking fees
   c. Adviser soft-dollar trades net of rebates
3. “Other” expenses
   a. Service provider fees to other than adviser affiliates
   b. “Residual” “fund fees and expenses”

4. Transaction costs
   a. Total transaction costs, net of adviser rebates from soft-dollar trades
   b. “Flow induced” trade transaction costs
   c. “Discretionary” trade transaction costs

The New Total Expense Ratio thus provides additional categories with sub-categories relative to the SEC’s total expense ratio. Further, distribution fee sub-categories are modeled after actual “inside” adviser/distributor accounts from which payments to brokers are made. The sub-category descriptors are generalized to allow matching to “inside” sub-category labels used by specific adviser/distributors in their financial arrangements with sales brokers. Distribution fee sub-categories and descriptions also provide much more normative disclosure than the SEC’s Expense Ratio.

A discussion of the New Total Expense Ratio’s normatively disclosed four fee categories with sub-categories follows.

Management Fees (%)

Investment advisory fees include payments to the fund adviser (including any sub-adviser) for research and portfolio management expenses consistent with fund objectives.

Administrator (often adviser) expenses include fund management and regulatory oversight, evaluation of performance of other affiliates, and perhaps fund expenses and general accounting services.

Service provider fees to adviser affiliates and to non-affiliates that include 1) fund distributor for share distribution (direct sold and broker-sold funds) expenses, including advertising and promotion; 2) custodian for safeguarding fund assets and settling portfolio and shareholder transactions; 3) auditor for fund accounts; 4) legal counsel for fund legal services and regulatory oversight; and 5) transfer (servicing) agent for fulfilling fund shareholder transactions, receiving and disbursing monies, and providing customer service and communication.

An individual listing of service provider fees includes advisory fees, servicing agent fees, marketing fees, administrator fees, custodian fees, printing fees, directors’ fees, SEC registration fees, auditing fees, legal fees, and “other” fees.

Adviser fall-out benefits from revenue-sharing payments (see distribution fees).

Adviser rebates from soft-dollar trades (see distribution fees).

Distribution Fees (%)

Selling group payments are fund distributor payments to brokers to reward sales of adviser fund shares. “Brokers” include financial advisors, traditional brokers, wire house brokers, broker-dealers, and bank trust departments.

Dealer (broker) concessions are fund distributor payments to brokers based on front-end loads of broker-sold adviser fund shares.

Account servicing fees are fund distributor payments to brokers for providing continuing customer service to accounts holding adviser fund shares, and are based on distributor payments of sales fees and/or asset fees to brokers for sales of adviser fund shares. Account servicing fees are normally 5 to 15 basis points of distributor-allocated broker sales targets and computed as percentages of broker annual dollar sales (sales fees) and/or dollar holdings (asset fees) of adviser fund shares.

Revenue-sharing payments net of adviser “fall-out” benefits are stated as defraying broker costs of providing marketing support services to customers holding adviser fund shares. But in fact, fund distributor payments are based on or result from broker sales of adviser fund shares. Adviser fall-out benefits are broker rebates paid directly to fund advisers from “excess” revenue-sharing payments. These conflicted rebates should be repaid to the source, fund assets, which would negate use of revenue-sharing payments with fall-out benefits. Revenue-sharing payments with adviser fall-out benefits should be prohibited. The following three types of revenue-sharing payments are based on broker sales of adviser fund shares:

- “Broker marketing pools” are fund distributor allocated payments to each high-selling broker of adviser fund shares. Payments from marketing pools are based on broker annual dollar sales (sales fees) and/or dollar holdings (asset fees) of adviser fund shares.
- “Broker (bonus) compensation” are fund distributor payments of “bonus” compensation to very top-selling brokers of adviser fund shares.
• “Syndicated distributions” are investment banker allocations of shares of initial public offerings to fund advisers based on brokerage history. These distributions are not direct payments to brokers but when used reflect adviser allocations of syndicated distributions to brokers to reward sales of adviser fund shares.

The following two types of revenue-sharing payments result from broker sales of adviser fund shares:

• “Sub-transfer agency fees” are fund distributor payments to brokers for providing transfer agency services to customer accounts holding adviser fund shares.

• “Networking fees” are fund distributor payments to brokers for transmission of customer account and transaction data through the Networking Securities Clearing Corporation. Networking fees are usually $6 to $10 for each customer account holding adviser fund shares.

Soft-dollar trades net of rebates require funds to pay “premium” brokerage commissions, and perhaps higher trading costs, than brokers selected for low-cost trade execution. Thus, soft-dollar trades are more costly to fund assets and shareholders. Soft-dollar trades provide advisers with broker-agreed rebates of some 70% of the premium brokerage commissions that are paid in in-kind investment products and services—the “soft dollars.” Brokers also benefit from higher net brokerage fees. Soft-dollar trades provide financial benefits to both fund advisers and brokers, which encourages additional soft-dollar trades. Soft-dollar trades are thus conflated, as they are paid from fund and shareholder assets, and they should be prohibited.

“Other” Expenses (%)

Service provider fees to other than fund adviser affiliates (see Management Fees for types).

“Residual” fund fees and expenses.

Securities Transaction Costs (%)

Total transaction costs net of adviser soft-dollar rebates (see Management Fees) represent transaction costs for broker trades of fund portfolio securities.

Flow-induced transaction costs reflect sales of portfolio securities (“operational trades”) to provide immediate liquidity as needed to pay shareholders for sales of fund shares.

Discretionary transaction costs reflect more cost-effective securities trades initiated prudently by portfolio managers to implement investment strategies.

Adoption of the New Total Expense Ratio with normative transparency of disclosure should be followed by SEC prohibition of total distribution fees, including adviser fall-out benefits and soft-dollar trades. What would be selling-group payments should instead be paid once by fund share purchasers at the time of purchase in inclusive front-end loads to fund distributors in direct sales and to brokers for share sales.

SEC adoption of the New Total Expense Ratio and more so-recommended prohibitions and changes in payments requires strong support and action. These major changes will take the concerted efforts of objective proactive independent directors, fund advisers practicing stewardship, the (unlikely) support of the fund industry, and, finally and most importantly, the political will for regulatory action. The vast majority of mutual fund advisers will strongly resist any loss in their hugely profitable (at shareholder expense) franchises. Hopefully, fund shareholders will finally receive their longtime just due: low costs with actual “fiduciary protections” and normative transparency of disclosure in regulation and practice.

CONCLUSIONS

This article presents the construct of a New Total Expense Ratio built upon the concept of normative transparency of disclosure. This construct presents the reality of adviser/distributor payments to brokers “behind the mutual fund curtain.” The source of these payments is fund and shareholder assets. The New Total Expense Ratio includes: 1) management fees, 2) distribution fees, 3) “other” expenses, and 4) transaction costs. Subcategories are also included.

SEC adoption of the New Total Expense Ratio would foster significant prohibitions and changes in the huge payments mutual funds make to advisers, distributors, and brokers. However, adoption and recommended prohibitions and changes will require the concerted efforts of objective and proactive independent directors, fund advisers practicing stewardship, the (unlikely) support of the fund industry, and, finally, the political will for regulatory reform.
REFERENCES


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