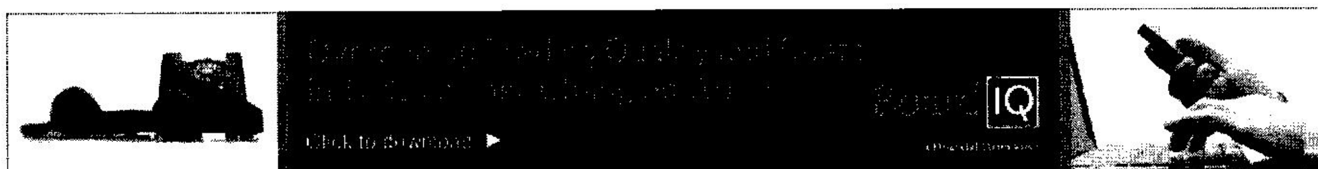

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Opinion

Boards Need Stronger Fee Oversight Processes

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Niels Holch is executive director of the Coalition of Mutual Fund Investors.

The SEC's mutual fund fee initiative will end up pushing directors into increased oversight of fund distribution arrangements, including the fees paid to intermediaries and other service providers. Directors should use the initiative's growing momentum as a reason to vastly improve their fund fee oversight process. This can include closely examining firms that receive compensation from the fund and verifying whether their services have been retained through competitive bidding.

The impact of the commission's initiative was highlighted last month by Morgan Stanley Investment Management's nearly $2 million settlement over allegations that it paid a subadviser for services that were never actually provided. The settlement's disclosure occurred around the same time that SEC asset management unit co-chief Robert Kaplan stressed that the commission would continue its scrutiny of fund fees.

As part of that effort, the unit is seeking to identify circumstances in which mutual fund advisers and boards are permitting excessive fees to be charged to retail investors. SEC officials have confirmed that the agency is also interested in evaluating excessive fees involving transfer agents, custodians and other vendors. It appears that all fee arrangements with affiliates and third-party providers are under the commission's microscope.

In response, boards should consider the following practical suggestions to improve securities law compliance.

Establish tougher processes to evaluate the nature, quality and cost of service provider arrangements. Independent directors need to dig deeper into any entity that is receiving compensation for services. Along with the issues raised in the Morgan Stanley case, similar problems may also exist with the fees paid to large broker-dealers for shareholder servicing and recordkeeping activities that are already required to be performed. In a study released in August 2010, the Coalition of Mutual Fund Investors estimated that more than $8 billion in annual fees are being charged for these services by broker-dealers using omnibus accounting. This is certainly an area that needs additional scrutiny by fund boards.

Boards should avoid relying too heavily on the fees being charged by other mutual fund advisers. The recent Jones v. Harris Associates decision clarified that a board's fee approval process should not rely solely on a comparison of fees charged by competing advisers. The Supreme Court stated that this practice is "problematic" primarily because competing advisers' fees may not be the product of arm's-length negotiations.

It is difficult to achieve arm's-length bargaining within the industry. This is primarily a result of the nature of the relationship between a fund and its adviser. It's also because a fund is not expected to sever the relationship

it has with its adviser. Despite this somewhat complicated structure, fund boards have access to a wealth of data about how much specific services should cost in a market-based environment. For example, the fees that an adviser receives for providing advisory services to institutional clients can be compared to similar services being provided to retail investors. Likewise, the fees paid to broker-dealers for shareholder servicing and recordkeeping can be compared to the costs of providing the same services to direct investors.

Boards should consider requiring the use of competitive bidding for new service provider relationships. Even though arm's-length bargaining is relatively rare in contracting for distribution-related services, boards should still require competitive bidding for new service provider relationships. For example, broker-dealers seeking to provide services to investors in omnibus accounts should have their fees set through a competitive bidding process, which is preferable to a fixed fee schedule imposed on funds through a "take it or leave it" approach by intermediaries. Competitive bidding should also be employed for custodial and subadviser services.

A more aggressive posture by fund boards regarding the use of competitive bidding in contracting for services could result in significant savings to retail investors. The Supreme Court criticized the SEC in the Jones v. Harris Associates case for not bringing an excessive-fee enforcement action since 1980. There is every reason to believe that the agency is now going to increase its regulatory scrutiny in this area and bring additional enforcement actions.

Directors should be digging deeper into the fees paid and the services provided by all entities involved with a fund. This will help them protect investor interests and ensure full compliance with the securities laws.

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