

Introduction

The Economics of the Mutual Fund Industry

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In recent months, two of the largest financial services providers in the country—Merrill Lynch and Citigroup—both gave up control of the huge mutual fund families they had developed over many years. In addition, but much less dramatically, there are indications that many smaller fund families are selling out to larger groups—that the industry is engaged in consolidation. Yet concentration in the mutual fund industry has not seemed to increase, even though the top ten providers have changed over the years.

These facts reflect some powerful economic and perhaps regulatory forces coursing through the industry, and today's conference—the sixth in our series—is intended to help us understand what these forces are and their relationship to the regulation of mutual funds.

Regulatory compliance costs are certainly rising. These include requirements for a compliance officer, for more independent directors and an independent chair, and the fact that Sarbanes-Oxley and its expensive requirements are applicable to mutual funds. But are these costs significant enough to affect large fund groups like Citigroup or Merrill? If compliance costs per se are not the cause of the departure of major players—what a recent Wall Street Journal article called “a steady stream of banks, brokerage houses and insurance companies fleeing fund management”—what is?

And if rising compliance costs are not a factor for the larger groups, they certainly could be for the smaller ones, since regulatory costs are relatively fixed and fall more heavily on the smaller players in an industry than on the larger ones. It is important to recall that the Investment Company Act of 1940 requires the SEC to consider “efficiency, competition and capital formation” when it makes its rules, and if compliance costs are one of the reasons small fund groups are exiting the field—or not entering—is it because the SEC has failed to take the question of competition seriously when it imposes regulatory costs?

If regulatory factors are important in shaping the industry, that is important for our study. On the other hand, it can be argued that the changes within the industry are primarily the result of economic forces. Competition may have reduced returns below the levels that some fund groups consider acceptable. Or competition from some of the new developments in collective investment—exchange traded funds, hedge funds or separately managed accounts—may be drawing off the high value customers that made it profitable to open mutual funds in the first place. Or these new structures may be

attracting away the management talent that is necessary to compete through performance. The growth of the mutual fund industry has leveled off in recent years, but some of these new structures have been growing rapidly. We have scheduled a conference on this question for April 26 to explore this issue more fully.

A third possibility is that the distributional arrangements now in place for the industry are primarily responsible for the structural changes that are occurring. The sales function has to be compensated in some way, and this is done through 12b-1 fees, front-end and back-end loads and other mechanisms. Sales are also heavily influenced by securities regulation, which in some instances imposes the unusual requirement that sales personnel actually be objective in recommending the mutual fund products of their employer. Finally, there is section 22(d) of the 40 Act, which requires the price of a mutual fund share to be sold only at the price stated in the prospectus, including any load or sales fee. This prevents competition at the sales level and may also have a distorting effect on market structure.

Today's conference will be a start on helping us sort out the varying roles of regulation or economic forces in changes that are occurring in the mutual fund industry.

Our panel for this inquiry could not be a better one for this purpose. Bob Pozen, now the chairman of yet another mutual fund group, Massachusetts Financial Services, has managed mutual funds, written widely-read books about the industry, and taught law school courses on the 40 Act. Paul Stevens was one of the most skilled, knowledgeable and respected mutual fund lawyers in this country before becoming the President of the Investment Company Institute, Bob Dorsey specializes in advising small fund groups on strategy, and Michael Sharp is general counsel of Citigroup's wealth management sector, and the lawyer most directly involved in the sale of Citi's controlling interest in its fund family.

Thanks for attending. Bob and I are looking forward to a highly interesting and productive session.